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COLUMBIA LAW REVIEW

VOL. 120 NOVEMBER 2020 NO. 7

ARTICLES

CHAPTER 11'S RENEGOTIATION FRAMEWORK AND THE PURPOSE OF CORPORATE BANKRUPTCY

*Anthony J. Casey**

A fundamental question for corporate bankruptcy law is why it exists in the first place. Why are there special rules that apply only in financial distress? The conventional law-and-economics answer—known as the Creditors' Bargain Theory—identifies two core purposes of bankruptcy law: recreating a hypothetical ex ante bargain and respecting creditors' nonbankruptcy entitlements.

This Article challenges the Creditors' Bargain Theory and presents an alternative: The sole purpose of corporate bankruptcy law is to solve the incomplete contracting problem that accompanies financial distress. Because financial distress is difficult to contract over, relationships involving a distressed firm are governed by incomplete contracts that allow parties to hold each other up. All distressed firms face this same value-destroying hold-up problem, and so pressure arises for a uniform solution. The purpose of corporate bankruptcy law is to provide that solution.

In the United States, Chapter 11 of the Bankruptcy Code implements this purpose in the form of a framework for ex post renegotiation of incomplete contracts. This framework imposes judicial oversight and allocates bargaining power to minimize hold up among those with interests in a distressed firm. In a sense, it puts in place

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guardrails that give the parties room to bargain while keeping them from engaging in extreme forms of hold up. While this framework is not based on any hypothetical ex ante bargain and gives no special deference to nonbankruptcy entitlements, it is the fundamental attribute of Chapter 11.

INTRODUCTION 1711
I. MOVING BEYOND THE CREDITORS' BARGAIN 1717
  A. The Collective Action Problem 1719
  B. The Creditors' Bargain Theory 1721
    1. Demonstrative Utility 1722
    2. Limitations: Purpose and Scope 1725
  C. The *Butner* Fallacy 1727
  D. The Creditors' Bargain and the *Butner* Fallacy as Distractions 1728
    1. The False Promise of "Real-World" Agreements 1729
    2. Trying to Solve the Wrong Problem 1729
  E. Other Incomplete Heuristics 1731
II. DISCOVERING THE NEW BARGAINING THEORY OF CORPORATE BANKRUPTCY 1732
  A. Bankruptcy's Incomplete Contract 1734
    1. The Problem of Financial Distress 1736
    2. The Incompleteness of Contractual Responses 1738
  B. The Need for a Bankruptcy-Specific Solution 1743
  C. A Limited Scope 1747
III. CHAPTER 11'S RENEGOTIATION FRAMEWORK 1750
  A. General Description 1751
  B. Examples of the Chapter 11 Framework 1753
    1. Cramdown 1753
    2. The Automatic Stay 1755
    3. Executory Contracts 1756
    4. Critical Vendor Orders 1757
  C. The Balance Between Ex Ante and Ex Post Concerns 1758
IV. APPLYING THE NEW BARGAINING THEORY TO FRONTIER ISSUES 1763
  A. Court Splits: Sections 363(f) and 365(h) 1764
  B. Major Questions: Priority Rules and the New Value Exception 1765
CONCLUSION 1768

INTRODUCTION

Corporate bankruptcy presents a puzzle. Why does the law provide special rules that apply only in financial distress? One can imagine[1]—or advocate for—a world in which no such rules exist. But that is not the world we live in. Bankruptcy laws do exist in the United States and in most major legal systems throughout the world. And so to confront the puzzle, one must identify the purpose that bankruptcy law serves. This Article attempts to do just that and then shows how United States bankruptcy law pursues that purpose.

In short, corporate bankruptcy law's proper purpose is to solve the incomplete contracting problem that accompanies financial distress. And Chapter 11 of the United States Bankruptcy Code implements that purpose—perhaps imperfectly—by facilitating a structured renegotiation that allows parties to preserve value in the face of hold-up threats.[2] This Article suggests that the creation of this bargaining framework for renegotiation is the fundamental attribute of Chapter 11.

Thus, contrary to the prevailing view, the purpose of bankruptcy law is not to vindicate or mimic some hypothetical ex ante bargain among creditors.[3] That idea—the Creditors' Bargain Theory[4]—is, at best, a shorthand for the unexceptional claim that bankruptcy law should be

1. See, e.g., Douglas G. Baird, A World Without Bankruptcy, 50 Law & Contemp. Probs. 173, 174 (1987) [hereinafter Baird, World Without Bankruptcy].

2. Chapter 11 is the part of the United States Bankruptcy Code setting forth the rules specific to the reorganization of business entities. 11 U.S.C.A. §§ 1101–1195 (West 2020). By contrast, Chapter 7 deals with businesses and individuals who are liquidating their assets. Id. §§ 701–784. Provisions of other Chapters, like Chapters 1, 3, and 5, apply to all bankruptcy cases. Barry E. Adler, Anthony J. Casey & Edward R. Morrison, Baird & Jackson's Bankruptcy Cases, Problems, and Materials 31–35 (5th ed. 2020).

3. This prevailing view derives from the scholarship of Professors Douglas Baird and Thomas Jackson. See Douglas G. Baird & Thomas H. Jackson, Fraudulent Conveyance Law and Its Proper Domain, 38 Vand. L. Rev. 829, 835–36 (1985) ("The ambition of the law governing the debtor-creditor relationship . . . should provide all the parties with the type of contract that they would have agreed to if they had had the time and money to bargain over all aspects of their deal."); Thomas H. Jackson, Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain, 91 Yale L.J. 857, 860 (1982) [hereinafter Jackson, Non-Bankruptcy Entitlements and the Creditors' Bargain] (arguing that bankruptcy law should "mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position"). More recently, Baird himself has criticized this theory. See Douglas G. Baird & Robert K. Rasmussen, Antibankruptcy, 119 Yale L.J. 648, 652–53 (2010) [hereinafter Baird & Rasmussen, Antibankruptcy] (discussing how today's financial structures and reorganization process are "quite at odds with the standard account of corporate reorganizations"); Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 Stan. L. Rev. 751, 755 (2002) [hereinafter Baird & Rasmussen, End of Bankruptcy] ("Today's investors allocate control rights among themselves through elaborate and sophisticated contracts that already anticipate financial distress. In the presence of these contracts, a law of corporate reorganizations is largely unnecessary.").

4. See Jackson, Non-Bankruptcy Entitlements and the Creditors' Bargain, supra note 3, at 858 (introducing and applying the Creditors' Bargain Theory).

efficient. In a hypothetical world of perfect information, zero transaction costs, and rational behavior, the interested parties (assuming one can define that category) would agree to efficient rules. But that is a truism that applies to almost any efficiency problem in law. All-knowing rational actors will always bargain to the efficient outcome when bargaining costs are zero.[5]

But what should the law do when bargaining costs are *high* and information is *limited*? That is the bankruptcy question. Or, to be a little more precise, what should the law do when a particular set of relationships repeatedly presents the same problem of high bargaining costs and limited information? To that question, the hypothetical bargain is not responsive. It assumes perfect information and zero bargaining costs in a world where neither can ever be achieved. In a sense, the parties cannot write a complete contract because of uncertainty, and the Creditors' Bargain Theory responds by instructing lawmakers—who face the same uncertainty—to write a complete contract for them.[6]

Even worse, the Creditors' Bargain framework often leads scholars to focus on the wrong questions. For example, by focusing attention on the initial bargain, the framework attracts reform proposals designed to bring all creditors to the ex ante bargaining table.[7] But the real problem for any bankruptcy contract—or legislation—is not in convening the bargainers. It is in dealing ex post with the incomplete terms those parties actually drafted. This is a classic problem in law,[8] and the Creditors' Bargain Theory distracts from its importance.[9]

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5. Ronald H. Coase, The Problem of Social Cost, 3 J.L. & Econ. 1, 15 (1960) ("[I]f such market transactions are costless, such a rearrangement of rights will always take place if it would lead to an increase in the value of production.").

6. See Jackson, Non-Bankruptcy Entitlements and the Creditors' Bargain, supra note 3, at 860 (explaining that the Creditors' Bargain approach involves "view[ing] bankruptcy as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position").

7. See, e.g., Barry E. Adler & Marcel Kahan, The Technology of Creditor Protection, 161 U. Pa. L. Rev. 1773, 1794–809 (2013) (proposing a mechanism to facilitate remedies against third parties); Robert K. Rasmussen, Debtor's Choice: A Menu Approach to Corporate Bankruptcy; 71 Tex. L. Rev. 51, 100–11 (1992) [hereinafter Rasmussen, A Menu Approach to Corporate Bankruptcy] (offering a menu system to facilitate investor assent); Alan Schwartz, Bankruptcy Workouts and Debt Contracts, 36 J.L. & Econ. 595, 630–31 (1993) (advocating for private resolutions in place of mandatory rules); David A. Skeel, Jr., Rethinking the Line Between Corporate Law and Corporate Bankruptcy, 72 Tex. L. Rev. 471, 524–25 (1994) (arguing for state law systems to encourage private ordering).

8. In contract law it leads to incomplete contracts. Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87, 92–93 (1989) [hereinafter Ayres & Gertner, Filling Gaps]; Oliver Hart & John Moore, Incomplete Contracts and Renegotiation, 56 Econometrica 755, 756 (1988). In public law it leads to vague standards. Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 Duke L.J. 557, 562–63 (1992).

9. Similarly, the framework attracts projects attempting to predict what creditors have or would have agreed to. That is not a relevant inquiry. See infra section I.D.

The Creditors' Bargain Theory has also nurtured the fallacy that bankruptcy law is primarily about preserving nonbankruptcy entitlements.[10] This idea—the *Butner* Principle[11]—is a corollary to the Creditors' Bargain Theory and is often viewed as an additional source from which to derive bankruptcy's core purpose.[12] But this gets things wrong. The

10. "Nonbankruptcy entitlements" refers to rights that parties have when bankruptcy law does not apply. These rights exist by operation of statute, contract, or any other source of law unconnected with the bankruptcy system. Jackson, Non-Bankruptcy Entitlements and the Creditors' Bargain, supra note 3, at 858 & n.8.

11. Baird and Jackson coined the term by "grabbing onto a phrase from an otherwise forgettable Supreme Court case [*Butner v. United States*]." Thomas H. Jackson, A Retrospective Look at Bankruptcy's New Frontiers, 166 U. Pa. L. Rev. 1867, 1872 (2018) [hereinafter Jackson, A Retrospective Look] (citing Butner v. United States, 440 U.S. 48 (1979)). The Court's opinion in *Butner* presented a rather vanilla canon of textualist interpretation: The Bankruptcy Code only includes provisions that are found in or implied by its text. *Butner*, 440 U.S. at 54–55. Baird and Jackson consciously transformed this idea into a broader normative statement of a core bankruptcy principle. See Jackson, A Retrospective Look, supra, at 1872–73 & n.18.

12. For the original formations of the *Butner* Principle, see Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 20–33 (1986) [hereinafter Jackson, Logic and Limits] (explaining the justification for respecting nonbankruptcy entitlements); Douglas G. Baird & Thomas H. Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 51 U. Chi. L. Rev. 97, 110 (1984) [hereinafter Baird & Jackson, Corporate Reorganizations] (noting that bankruptcy is primarily focused on "recognizing nonbankruptcy entitlements"); Jackson, Non-Bankruptcy Entitlements and the Creditors' Bargain, supra note 3, at 859–60. On its predominance as a core theory, see Barry E. Adler, The Questionable Axiom of *Butner v. United States*, *in* Bankruptcy Law Stories 11, 11 (Robert K. Rasmussen ed., 2007) (questioning the principle's place as an "uncontested axiom" (quoting Douglas G. Baird, Bankruptcy's Uncontested Axioms, 108 Yale L.J. 573 (1998))); Kenneth M. Ayotte & David A. Skeel Jr, Bankruptcy Law as a Liquidity Provider, 80 U. Chi. L. Rev. 1557, 1565 (2013) (describing the principle as the second element of the theoretical foundation of corporate bankruptcy); David Gray Carlson, Bankruptcy Theory and the Creditors Bargain, 61 U. Cin. L. Rev. 453, 466 (1992) (critiquing the principle); Jackson, A Retrospective Look, supra note 11, at 1872–73 (identifying the *Butner* Principle as the starting point that brought clarity to the Creditors' Bargain Theory); Melissa B. Jacoby & Edward J. Janger, Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy, 123 Yale L.J. 862, 892 (2014) [hereinafter Jacoby & Janger, Ice Cube Bonds] (proposing a system with "careful attention to the scope of non-bankruptcy entitlements"); Melissa B. Jacoby & Edward J. Janger, Tracing Equity: Realizing and Allocating Value in Chapter 11, 96 Tex. L. Rev. 673, 682–83, 734 (2018) [hereinafter Jacoby & Janger, Tracing Equity] (deriving bankruptcy's core principles by tracing creditors' state-law entitlements); Ronald J. Mann, Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?, 70 N.Y.U. L. Rev. 993, 1000 (1995) (presenting a bankruptcy theory that "starts from entitlements of the parties that exist before the bankruptcy system comes into play"); Bruce A. Markell, Fair Equivalents and Market Prices: Bankruptcy Cramdown Interest Rates, 33 Emory Bankr. Devs. J. 91, 127 (2016) (deriving cramdown rules from nonbankruptcy entitlements); Charles W. Mooney, Jr., A Normative Theory of Bankruptcy Law: Bankruptcy as (Is) Civil Procedure, 61 Wash. & Lee L. Rev. 931, 934 (2004) ("[B]ankruptcy law should exist, essentially, in order to serve the interests of the holders of nonbankruptcy legal entitlements."); Juliet M. Moringiello, When Does Some Federal Interest Require a Different Result?: An Essay on the Use and Misuse of *Butner v. United States*, 2015 U. Ill. L.

bankruptcy system functions almost exclusively by doing the opposite of what the *Butner* Principle instructs—it achieves its purpose by directly interfering with nonbankruptcy entitlements.

This fallacy—that the *Butner* Principle is fundamental to bankruptcy theory—arises, perhaps, from a misunderstanding of bankruptcy's efficiency goal. An efficient bankruptcy law should create more value than it destroys, accounting for consequences in and out of bankruptcy. That requires a balancing of effects across all states of the world, but it does not require any *special* protection for nonbankruptcy entitlements. In short, bankruptcy law should not be put into effect unless it creates net value.[13]

All of this is to say, the law-and-economics theory of corporate bankruptcy needs to be restated. Though many scholars and lawyers invoke the Creditors' Bargain Theory and the *Butner* Principle, very few rely on the truth of their substance. The building blocks of a new theory can be found in much of today's bankruptcy scholarship, which usually advocates general efficiency goals,[14] often notes the importance of ex post bargaining,[15] and sometimes emphasizes the importance of procedure over substance.[16] Many scholars and lawyers also agree—at least

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Rev. 657, 665 (noting the iconic stature of the principle and that it has been cited thousands of times).

13. If *Butner* is read to present this efficiency concept, it is a circular direction that bankruptcy law should pursue its efficiency purpose (by altering nonbankruptcy rights) only when it is efficient to do so. Jackson, A Retrospective Look, supra note 11, at 1872 n.18 (noting that the principle yields to "a clearly defined bankruptcy-related reason for doing so" (emphasis omitted)); see also Robert E. Scott, Through Bankruptcy with the Creditors' Bargain Heuristic, 53 U. Chi. L. Rev. 690, 692 (1986) ("The cornerstone of this [creditors' bargain heuristic] is the normative claim that pre-bankruptcy entitlements should be impaired in bankruptcy only when necessary to maximize net asset distributions to the creditors as a group . . . .").

14. See Ayotte & Skeel, supra note 12, at 1566 (invoking the Creditors' Bargain Theory but advocating a general "Efficiency Principle").

15. See G. Eric Brunstad, Jr. & Mike Sigal, Competitive Choice Theory and the Broader Implications of the Supreme Court's Analysis in *Bank of America v. 203 North LaSalle Street Partnership*, 54 Bus. Law. 1475, 1483–85 (1999) (noting bankruptcy creates "a better decision-making environment"); Daniel J. Bussel & Kenneth N. Klee, Recalibrating Consent in Bankruptcy, 83 Am. Bankr. L.J. 663, 669 (2009) (arguing bankruptcy alters nonbankruptcy rights to facilitate consent); Diane Lourdes Dick, The Chapter 11 Efficiency Fallacy, 2013 BYU L. Rev. 759, 766 (2013) [hereinafter Dick, Efficiency Fallacy] (noting but critiquing the common view that bankruptcy law facilitates efficient renegotiation); Omer Tene, Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations, 19 Bankr. Devs. J. 287, 396 (2003) (arguing that bankruptcy should provide a platform for negotiation).

16. See Pamela Foohey, *Jevic*'s Promise: Procedural Justice in Chapter 11, 93 Wash. L. Rev. Online 128, 128–29 (2018) (discussing the importance of process in ensuring that bankruptcy law does not "disregard[] the interests and voices of parties *en masse*, potentially subverting the very tenet of value maximization"); Mooney, supra note 12, at 934–35 (providing an overview of a "procedure theory" of bankruptcy law).

implicitly—that corporate bankruptcy has something to do with facilitating ex post cooperation among stakeholders.[17]

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

This Article presents two claims, one normative and one descriptive. The normative claim is that bankruptcy's proper purpose is to solve a specific contracting failure. That failure arises because financial distress presents uncertainty that is not contractible.[18] For a business firm, financial distress involves too many parties with strategic bargaining incentives and too many contingencies for the firm and its creditors to define a set of rules for every scenario. Moreover, the terms the parties do contract for will often be unenforceable because the relevant contingencies are impossible to verify to a court.[19] Incomplete contracts therefore govern a firm's various relationships when distress arises.[20] The parties in those relationships can then take advantage of the incompleteness to extract individual gains from each other—to hold each other up. Any party who has specifically invested in its relationship with the debtor is vulnerable to this hold-up threat.[21]

The problem cannot be solved by ex ante rules—in a contract or in a statute.[22] Indeed, the issue arises precisely because no one can write such rules. This is a familiar problem, but the law treats it differently in the bankruptcy context. And for good reason. The noncontractible uncertainty associated with financial distress is a recurring characteristic across all firms. Where every relationship of a certain type is incomplete and requires judicial intervention upon the occurrence of the same event,

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

18. See infra section II.A.

19. See Ayres & Gertner, Filling Gaps, supra note 8, at 92–93 (noting that contracts can be incomplete because of the costs associated with verifying to a court that a contingency has occurred).

20. Hart & Moore, supra note 8, at 756 (describing the incomplete contract problem).

21. Oliver Hart, Incomplete Contracts and Control, 107 Am. Econ. Rev. 1731, 1733 (2017) (describing the hold-up problem); see also Hart & Moore, supra note 8, at 757 (describing issues of "lock-in" after the parties have made initial investments pursuant to a contract).

22. See infra section II.A.2.

a uniform bankruptcy system that deals with those relationships will produce consistency, efficiency, and market predictability.[23]

The descriptive claim of this Article is that Chapter 11 is an attempt—albeit an imprecise one—at such a system.[24] It creates a renegotiation framework designed to minimize the parties' ability and incentives to hold each other up. The framework imposes judicial oversight and substantive outer limits on the parties' decisions. It also allocates power over certain decisions to one party while subjecting the exercise or removal of that power to evidentiary burdens, pricing mechanisms, and other conditions targeted at proving the absence of hold-up behavior. The initial allocation of power and conditions is based on the perceived likelihood that the decision in question is subject to incomplete contracting and hold-up problems. In light of substantive uncertainty, the system relies mostly on procedural protections, giving judges wide discretion to define the bargaining parameters while leaving most substantive decisions to ex post bargaining among the parties. In a sense, the law puts in place guardrails that give the parties room to bargain while keeping them from taking positions that veer toward extreme hold up.

Bankruptcy law, then, is not about mimicking a hypothetical bargain. It is about facilitating an actual bargain. This is the New Bargaining Theory of corporate bankruptcy stated generally. Consistent with this theory, Chapter 11 implements a renegotiation framework to facilitate ex post bargaining.[25] This Article provides specifics on this theory and demonstrates that questions of cramdown, executory contracts, forum shopping, the automatic stay, third-party releases, intercreditor agreements, priority rules, and the like can all be understood and explained by a proper application of the New Bargaining Theory.

Two key features are worth highlighting now: First, ex post bargaining is front and center. That is where bankruptcy law happens. To be clear, the New Bargaining Theory does not reject the idea of ex ante efficiency. An efficient bankruptcy system is focused on solving the ex post problem if, but only if, it can do so without creating bigger problems in other states of the world. This focus presents a meaningful limitation on the implementation of any bankruptcy measure.[26] Second, Chapter 11's renegotiation framework relies heavily on judicial discretion and procedural measures that facilitate the ex post bargain.[27] Substantive measures—including value redistribution and deviations from nonbankruptcy priority—do, however, come into play to facilitate the

23. See infra section II.B.
24. See infra Part III.
25. See infra Part III.
26. See infra sections II.C, III.C.
27. See infra section II.B.

bargain by realigning incentives or minimizing distortions that might otherwise occur.[28]

Notably, this Article does not claim that Chapter 11 operates perfectly—judicial error and misaligned incentives do exist. But the New Bargaining Theory coherently explains the major aspects of Chapter 11 and reveals the questions necessary to assess whether it achieves its purpose. For example, it provides insight into Chapter 11's proper scope. Because the potential for hold up arises when parties have made investments specific to relationships that involve or link in some way to the going-concern value of the debtor,[29] Chapter 11 should focus exclusively on regulating ex post behavior that might take advantage of those relationship-specific investments.

This Article proceeds in four Parts. Part I explores the usefulness and shortcomings of the Creditors' Bargain Theory, the *Butner* Principle, and other heuristics that have been used to describe the core purpose of bankruptcy law. Part II provides the foundation for the New Bargaining Theory of corporate bankruptcy. Part III describes Chapter 11's renegotiation framework. Part IV demonstrates the usefulness of this emerging theory by applying it to current issues of debate in bankruptcy law.

I. MOVING BEYOND THE CREDITORS' BARGAIN

An interesting shift has happened in corporate bankruptcy scholarship. Scholars widely and routinely invoke the Creditors' Bargain Theory and the *Butner* Principle as the foundational principles of corporate bankruptcy,[30] but virtually none of those scholars believe that the theory or the principle is normatively or descriptively correct. Indeed, most corporate bankruptcy scholars point to the Creditors' Bargain Theory and the *Butner* Principle as their analytical foundation, but they then criticize aspects of the theory and proceed to build their analysis on

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28. See infra Part III.

29. Going-concern value generally refers to the value derived from keeping an enterprise together. See Baird & Rasmussen, End of Bankruptcy, supra note 3, at 758 ("We have a going-concern surplus . . . only to the extent that there are assets that are worth more if located within an existing firm. If all the assets can be used as well elsewhere, the firm has no value as a going concern."). Thus, a firm has positive going-concern value when the whole of the business is worth more than the sum of its separate parts. Id. A firm without going-concern value is one that should be liquidated because its assets can be put to more valuable use elsewhere. See id.

30. See Douglas G. Baird, Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy, 165 U. Pa. L. Rev. 785, 792 n.21 (2017) [hereinafter Baird, Priority Matters] ("Framing the question as one about the hypothetical ex ante bargain among investors has been the standard trope in reorganization scholarship ever since Jackson introduced the creditors' bargain model in the early 1980s."); id. at 789 (noting the goal of reorganization is to "respect the nonbankruptcy bargain among the investors").

a more generic efficiency foundation.[31] The result is that when scholars invoke the Creditors' Bargain, they convey little more than a general commitment to an efficiency analysis of bankruptcy.[32]

This Part reflects on the initial appeal of the Creditors' Bargain Theory and the *Butner* Principle and then identifies their theoretical shortcomings. While the *Butner* Principle is often referred to as a quintessential part of the Creditors' Bargain Theory,[33] this Part attempts to disentangle the two ideas. It argues that the Creditors' Bargain Theory was a useful analytical tool for demonstrating certain important principles but never provided a complete theory to explain the purpose, reach, or limitations of a corporate bankruptcy system. The *Butner* Principle, in contrast, was at best a misunderstood shorthand for the idea that bankruptcy law should be efficient and limited in scope. In application it provides little guidance and instead draws scholars and courts to misleading and circular inquiries.

Corporate bankruptcy scholars have also developed a series of additional heuristics and rules of thumb to further explain or supplement the Creditors' Bargain Theory. The leading ones include the sole-owner

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31. See, e.g., Ayotte & Skeel, supra note 12, at 1566 (invoking the Creditors' Bargain Theory but rejecting what they call the "Normative Butner Principle" and suggesting an "Efficiency Principle" instead); Foohey, supra note 16, at 128–29 & n.5 (suggesting the existing focus on efficiency gives too little consideration to issues of procedural justice); Moringiello, supra note 12 , at 665 (criticizing some courts' extension of the *Butner* Principle to distributional questions); Randal C. Picker, Voluntary Petitions and the Creditors' Bargain, 61 U. Cin. L. Rev. 519, 525–26 (1992) (noting general skepticism regarding the Creditors' Bargain Theory as a positive theory of bankruptcy law); Rasmussen, A Menu Approach to Corporate Bankruptcy, supra note 7, at 55–56 & n.7 (criticizing the Creditors' Bargain Theory for overemphasizing the importance of nonbankruptcy entitlements); Mark J. Roe & Frederick Tung, Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain, 99 Va. L. Rev. 1235, 1269 (2013) (noting that the Creditors' Bargain Theory does not match reality on the ground); Yaad Rotem, Pursuing Preservation of Pre-Bankruptcy Entitlements: Corporate Bankruptcy Law's Self-Executing Mechanisms, 5 Berkeley Bus. L.J. 79, 85–86 (2008) (emphasizing efficiency as a goal in preserving pre-bankruptcy entitlements and that "preservation is a second order goal"); Schwartz, Contract Theory, supra note 17, at 1809–10 (arguing that bankruptcy is just about increasing efficiency by solving a coordination problem); Scott, supra note 13, at 692 ("Nonetheless, [the Creditors' Bargain Theory] is only partially successful in rationalizing current bankruptcy law.").

Even Baird, one of the scholars who originally formulated the theory, has moved on from its original content. See Baird & Rasmussen, Antibankruptcy, supra note 3, at 652–53 (noting that actual bankruptcy practice is at odds with the Creditors' Bargain Theory); Baird & Rasmussen, End of Bankruptcy, supra note 3, at 755 (indicating that, because of economic and investment changes since the nineteenth century, traditional conceptions of bankruptcy law "no longer matter[] much").

32. Notably, Professor Diane Lourdes Dick suggests that while efficiency is the general goal of bankruptcy law and scholarship, the prevailing reliance on neoclassical and other "outmoded" assumptions has doomed the enterprise to failure. Dick, Efficiency Fallacy, supra note 15, at 823.

33. See, e.g., Ayotte & Skeel, supra note 12, at 1564–65 (referring to the *Butner* Principle as the "second element" (of two) of the Creditors' Bargain Theory).

principle[34] and the rule of general averages.[35] These are useful for understanding some aspects of the corporate bankruptcy system, but they are not successful in stating a unifying theory. The following subsections lay out the usefulness and limitations of the Creditors' Bargain Theory, the *Butner* Principle, and these other heuristics. But first, a word about collective action.

A. *The Collective Action Problem*

Part I's core claim is that the Creditors' Bargain Theory provides insufficient guidance in deriving a theory of corporate bankruptcy. It does have demonstrative utility, however, if there is an accompanying external theory of bankruptcy's purpose.

One obvious candidate for that external theory is the collective action problem. That is certainly where Professors Thomas Jackson and Douglas Baird often looked.[36] Indeed, one pushback on this Article's critique might be that the original Creditors' Bargain Theory and the *Butner* Principle are not purpose theories themselves but are necessary limitations on a system that has a purpose of solving the collective action problem among creditors.

There is a lot going on in that statement, but it can be broken into two parts. First is the purpose definition. If one understands "collective action" to encompass the broad array of ex post bargaining and cooperation problems that arise from hold up associated with financial distress, then it is true that bankruptcy is aimed at solving that problem. And this Article explains why bankruptcy law should pursue that purpose and why the problem arises in the first place. That is not, however, the way that bankruptcy scholars define the "collective action problem." The existing literature cabins "collective action" to the narrow cooperation problem of general creditors self-interestedly racing to execute their

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34. The sole-owner principle suggests that the law should do what a single rational owner would do. See Jackson, Logic and Limits, supra note 12, at 12–13; infra note 94 and accompanying text.

35. The rule of general averages is borrowed from admiralty law and, in the bankruptcy context, would dictate that stakeholders share costs and losses in proportion to the value of their stake. Thomas H. Jackson & Robert E. Scott, On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain, 75 Va. L. Rev. 155, 171 (1989).

36. Baird, Loss Distribution, supra note 17, at 827 ("Jackson and I have asked *why* a parallel debt collection system is desirable at all. The answer, we assert, is the collective action problem."); Douglas G. Baird & Randal C. Picker, A Simple Noncooperative Bargaining Model of Corporate Reorganizations, 20 J. Legal Stud. 311, 311 (1991) (noting the traditional view that creditors face a collective action problem); Jackson, A Retrospective Look, supra note 11, at 1871 ("[The collective action problem] was, if you will, my 'eureka' moment. I could suddenly see a reason for a bankruptcy law apart from the fresh start for the individual."); see also Barry E. Adler, The Creditors' Bargain Revisited, 166 U. Pa. L. Rev. 1853, 1853–54 (2018) [hereinafter Adler, Creditors' Bargain Revisited] (describing Jackson's bargain theory as one about collective action).

claims on a debtor's assets.[37] To this problem, the automatic stay is the most direct response.[38]

But corporate bankruptcy is much more than that. Financial distress presents a multitude of other ex post bargaining and cooperation problems, which bankruptcy law addresses. For example, Professors Baird and Randal Picker explain that distress presents a noncooperative bargaining problem among senior and junior creditors that is distinct from the "collective action problem."[39] They note that to solve the bargaining problem, "[b]ankruptcy scholarship needs to go beyond examining the collective action problem faced by the residual owners of an insolvent firm."[40] Likewise, Professors Baird and Robert Rasmussen describe bankruptcy's ex post coordination problem among sophisticated creditors as "quite at odds with the standard account" of the collective action problem.[41] More recently, Professor Barry Adler distinguishes free-and-clear sales—which themselves solve a very specific cooperation problem[42]—from anything related to the "collective action problem."[43]

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37. See, e.g., Adler, Creditors' Bargain Revisited, supra note 36, at 1855 (describing a "potentially destructive creditor grab race" if a creditor "delayed its own action on the mere hope that the creditor would . . . agree to act collectively"); Baird & Picker, supra note 36, at 311–13, 322 ("The traditional view of bankruptcy law begins with the idea that diverse general creditors of a firm face a collective action problem when their corporate debtor becomes insolvent."); David A. Skeel, Jr. & George Triantis, Bankruptcy's Uneasy Shift to a Contract Paradigm, 166 U. Pa. L. Rev. 1777, 1778 (2018) (describing the "race to the courthouse" in response to financial distress in which "creditors as a whole would suffer").

38. 11 U.S.C. § 362 (2018); see also infra section III.B.2.

39. Baird & Picker, supra note 36, at 311–13, 322.

40. Id. at 349.

41. Baird & Rasmussen, Antibankruptcy, supra note 3, at 653. Professors David Skeel and George Triantis have similarly concluded that collective action problems "are much less pressing" today and solving them no longer forms the central objective of bankruptcy. Skeel & Triantis, supra note 37, at 1817.

42. Free-and-clear sales, which are provided for in 11 U.S.C. § 363(f), allow a debtor to sell some or all of its assets free of encumbrances. Thus, the buyer of the assets gets them "free and clear" of the claims against those assets. The claims must be fulfilled from the estate, which now consists of the proceeds of the sale. This solves the hold-up problem that arises when less than all creditors agree to release their claims against a debtor even when doing so would facilitate a value-maximizing sale. See infra text accompanying note 299.

43. Adler, Creditors' Bargain Revisited, supra note 36, at 1864. Professor Alan Schwartz goes even further, claiming that financial distress does not present collective action problems. He argues that bankruptcy law should therefore focus exclusively on facilitating liquidity injections from creditors, preventing certain preferential or fraudulent transfers, implementing voting rules for restructuring, and policing auctions for misbehavior. Alan Schwartz, Bankruptcy Related Contracting and Bankruptcy Functions, *in* Research Handbook on Corporate Bankruptcy Law 363, 384–85 (Barry E. Adler ed., 2020) [hereinafter Schwartz, Contracting and Bankruptcy Functions]. Schwartz does not view any of these functions as addressing a coordination problem. See id. at 379 ("[C]oordination among creditors apparently is not a serious problem."). But all of them involve legal interventions to coordinate multiparty behavior and prevent opportunistic hold-up behavior. Voting rules, for example, are inherently addressed at coordination and are unnecessary where coordination is not a problem. The same is true of liquidity measures.

Over the last three decades, bankruptcy law and scholarship have thus moved far beyond the idea of just solving a race to assets among general creditors.[44] Today's bankruptcy debates focus on more complex bargaining and cooperation problems.[45]

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

B. *The Creditors' Bargain Theory*

It is difficult today to separate the *Butner* Principle from the Creditors' Bargain Theory. They are often coupled together in bankruptcy law and scholarship, but they are distinct concepts.[46] The Creditors' Bargain Theory is a model whereby one "view[s] bankruptcy as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante*

See Ayotte & Skeel, supra note 12, at 1561, 1576. And preferences and auction misbehavior are forms of hold-up behavior that arise when traditional contracting cannot prevent them. As such, all of these functions fit squarely within the New Bargaining Theory of bankruptcy. Finally, Schwartz does not explain why bankruptcy law should focus on these coordination problems and not others beyond noting the preferences of creditors who lobbied for the 1898 and 1938 bankruptcy laws. Schwartz, Contracting and Bankruptcy Functions, supra, at 364. The theory Part II presents suggests that bankruptcy law should address all bargaining and cooperation problems arising from incomplete contracts, not just the ones historically favored by creditors.

44. Douglas G. Baird, Arturo Bris & Ning Zhu, The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study 5, 33 (Int'l Ctr. for Fin. at Yale Sch. of Mgmt., Working Paper No. 05-29, 2007), http://ssrn.com/abstract=866865 (on file with the *Columbia Law Review*) [hereinafter Baird et al., Chapter 11 Dynamics] (noting that most large business bankruptcies today are processes by which large institutional lenders—not ordinary general creditors—reach a deal with each other or effect a sale of the firm's assets and finding that typical small business bankruptcies do "nothing or close to nothing for ordinary general creditors").

45. See, e.g., Kenneth Ayotte, Anthony J. Casey & David A. Skeel, Jr., Bankruptcy on the Side, 112 Nw. U. L. Rev. 255, 257–58 (2017) (modeling ex ante and ex post bargaining involved with intercreditor agreements); Kenneth Ayotte, Disagreement and Capital Structure Complexity, 49 J. Legal Stud. 1, 28–29 (2020) [hereinafter Ayotte, Disagreement] (modeling bargaining and cooperation among creditors who are part of a complex capital structure); Douglas G. Baird, Bankruptcy's Quiet Revolution, 91 Am. Bankr. L.J. 593, 593–95 (2017) (examining the rise and bargaining dynamics of restructuring support agreements among stakeholders); Dick, Efficiency Fallacy, supra note 15, at 765 (examining negotiation and rent extraction in Chapter 11); Skeel & Triantis, supra note 37, at 1781–83 (noting the tension between ex ante and ex post bargaining in bankruptcy law).

46. See supra note 33.

position."[47] The *Butner* Principle, in its most commonly cited form, provides that bankruptcy law should give special deference to—and avoid interfering with—entitlements and rights that are created by nonbankruptcy law.[48]

Nothing about the Creditors' Bargain Theory necessitates the *Butner* Principle. Nor is the *Butner* Principle helpful in understanding a hypothetical ex ante agreement among creditors. For this reason, this Article will refer to it as the "*Butner* Fallacy." Nonetheless, the *Butner* Fallacy has repeatedly been justified as a quintessential element of the Creditors' Bargain Theory.[49] Indeed, the first articulation of the Creditors' Bargain Theory focused almost exclusively on explaining and justifying bankruptcy law's "substantial respect to non-bankruptcy entitlements."[50]

But—because they are separate concepts—this section will start by bracketing the *Butner* Fallacy and instead will explore the utility and limitations of the Creditors' Bargain Theory.

1. *Demonstrative Utility.* — The Creditors' Bargain model is useful in two ways. First, it helps demonstrate financial concepts and efficiency dynamics. Second, it provides rhetorical justification for bankruptcy law's interference with private ordering.

Starting with the financial concepts, the model demonstrates that ex post legal interventions will be priced into and can affect ex ante bargaining. In this way, a creditor who benefits from a legal intervention that redistributes ex post value may actually be worse off in other states of the world. For example, the Creditors' Bargain is often invoked for the following idea: Imagine all creditors bargaining with full information over the rules that will apply in bankruptcy. One can predict that they will first bargain for rules that expand the pie the most and then they will agree on prices and other methods to divide the surplus created by the expansion.[51] Another corollary prediction is that if one creditor proposes a rule that

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47. Jackson, Non-Bankruptcy Entitlements and the Creditors' Bargain, supra note 3, at 860.

48. See, e.g., Ayotte & Skeel, supra note 12, at 1564–65 ("The second element of the Creditors' Bargain theory is the claim that resolution of common-pool problems . . . typically does not require altering the substantive values of those rights as established by nonbankruptcy law."); Baird & Jackson, Corporate Reorganizations, supra note 12, at 100 (stating that "[b]ankruptcy law should change a substantive nonbankruptcy rule only when doing so preserves the value of assets for the group of investors holding rights in them"); Jackson, Non-Bankruptcy Entitlements and the Creditors' Bargain, supra note 3, at 859 (providing that bankruptcy law "to date accord[s] substantial respect to non-bankruptcy entitlements").

49. See supra note 12.

50. Jackson, Non-Bankruptcy Entitlements and the Creditors' Bargain, supra note 3, at 859.

51. See id. at 860–68 (describing the various incentives at play in the hypothetical bargain).

will increase their share of the bankruptcy estate, other creditors will charge them an ex ante fee to offset that ex post distribution.[52]

This is a salient version of a more complicated point: Among sophisticated rational actors, initial investment decisions and prices take into account expectations about ultimate returns. If a legal change reduces the expected payout for a creditor in bankruptcy, that creditor will charge a higher interest rate up front.[53] But because *all* creditors take expected returns into account,[54] legal rules that merely alter distributions among creditors without otherwise changing the size of the pie do not affect the firm's value.[55] The creditor who is favored (in expectation) by a rule that applies in bankruptcy will charge a lower interest rate, the creditor who is disfavored by the rule will charge a higher interest rate, and the debtor will

52. See Lucian Arye Bebchuk & Jesse M. Fried, The Uneasy Case for Priority of Secured Claims in Bankruptcy, 105 Yale L.J. 857, 881 (1996) ("Thus, Bank and Firm would never adopt an inefficient security interest in order to divert value from other creditors . . . [who] would simply respond by raising their interest rates to recover the value diverted, leaving Bank and Firm to bear the net efficiency costs associated with the inefficient security interest.").

53. Id.

54. Later work criticized this assumption of the Creditors' Bargain Theory by pointing out that some creditors may not be able to adjust interest rates to account for expected returns. See Baird, World Without Bankruptcy, supra note 1, at 180 (noting that tort victims cannot adjust interest rates); Bebchuk & Fried, supra note 52, at 895–902 (modeling the problems nonadjusting creditors pose for the Creditors' Bargain Theory); Richard Squire, The Case for Symmetry in Creditors' Rights, 118 Yale L.J. 806, 808–09 (2009) (showing how value can be extracted from nonadjusting creditors); Elizabeth Warren & Jay Lawrence Westbrook, Contracting Out of Bankruptcy: An Empirical Intervention, 118 Harv. L. Rev. 1197, 1203 (2005) ("We document the presence of substantial numbers of creditors who have little meaningful opportunity to negotiate with their debtors or adjust their prices to reflect risks."). These nonadjusting or maladjusting creditors receive the same interest rate regardless of their expected payouts in bankruptcy. Tort victims are the most obvious group of nonadjusting creditors, but some think employees and small vendors may also belong to this category. See, e.g., Bebchuk & Fried, supra note 52, at 908 (listing categories of easily identifiable nonadjusting creditors). Regulatory creditors may also fall into this category. See Joshua Macey & Jackson Salovaara, Bankruptcy as Bailout: Coal Company Insolvency and the Erosion of Federal Law, 71 Stan. L. Rev. 879, 887 (2019) (showing that coal companies' "ability to siphon off regulatory obligations" has allowed them to provide below-market returns to regulatory creditors). Virtually everyone agrees that the problem of nonadjusting creditors requires separate attention—and perhaps separate treatment—in bankruptcy. There is disagreement, however, about the size of the problem in most cases. See Baird et al., Chapter 11 Dynamics, supra note 44, at 33 (finding that Chapter 11 bankruptcy proceedings have little to do with the rights of nonadjusting creditors). Compare Warren & Westbrook, supra, at 1235–39 (finding the problem to be large), with Robert K. Rasmussen, Empirically Bankrupt, 2007 Colum. Bus. L. Rev. 179, 181–84 (2007) (questioning Warren and Westbrook's results).

55. This all follows from the Modigliani–Miller theorem. Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 Am. Econ. Rev. 261, 268, 288–96 (1958) (explaining that in the absence of tax costs and other market imperfections, "the market value of any firm is independent of its capital structure").

face the same cost of capital.[56] No value is lost, and everyone ends up in the same (expected) position. In designing the system, only the rules that increase or decrease the size of the pie should be relevant, not those that change how the parties divide it.

The takeaway is that the only changes that matter are those that create or eliminate inefficiencies. Thus, a distribution rule that also distorted the incentives of those running the business *would* matter. For example, a bankruptcy rule that inflates distributions to management could cause managers to inefficiently expend resources in order to cause a bankruptcy filing.[57] That rule would reduce the value of the firm and constrain its ex ante ability to raise capital.[58] By focusing attention on a hypothetical ex ante bargain, the model highlights this important interaction between ex post and ex ante efficiency.

The Creditors' Bargain model can also provide rhetorical justification for the perhaps controversial idea that bankruptcy law should interfere with private ordering to achieve its efficiency goal. The rhetorical move is to tie the efficiency goal to the ideal private order. The Creditors' Bargain Theory frames bankruptcy law not as interfering with private ordering but as vindicating the order that creditors would agree to if they privately bargained over it.[59]

There is not much substance there,[60] but the rhetoric is important. The idea is that bankruptcy law provides a set of rules that interferes with private rights, but only when those private rights are misfiring. If bankruptcy law does that efficiently, the bargain model points out that the creditors can allocate any benefits achieved by adjusting their ex ante prices.[61] Thus, while bankruptcy law is—at its core—a federal law that

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56. Bebchuk & Fried, supra note 52, at 881 (explaining how creditors can adjust interest rates in response to distribution rules); Modigliani & Miller, supra note 55, at 268.

57. See Douglas G. Baird, Bankruptcy's Uncontested Axioms, 108 Yale L.J. 573, 592 (1998) [hereinafter Baird, Uncontested Axioms] (explaining that with special payouts and rules in bankruptcy, "parties will behave strategically and waste resources searching out the place where they will receive the most favorable treatment").

58. See Barry E. Adler, Game-Theoretic Bankruptcy Valuation, 41 J. Legal Stud. 209, 214 (2012) (noting that reducing creditor payouts in bankruptcy raises the ex ante cost of capital for debtors).

59. See, e.g., Rizwaan Jameel Mokal, The Authentic Consent Model: Contractarianism, Creditors' Bargain, and Corporate Liquidation, 21 Legal Stud. 400, 410 (2001) (noting that the bargain model is a rhetorical argument to justify implied consent by arguing that the parties would have agreed to it if asked).

60. Professor David Carlson has similarly—though more critically—labeled the model as merely rhetorical. David Gray Carlson, Philosophy in Bankruptcy, 85 Mich. L. Rev. 1341, 1342 (1987).

61. See supra note 52.

intervenes in state law and private ordering among creditors,[62] the model shows that the benefits of that intervention run to those same creditors.

In this way, the Creditors' Bargain model was useful in explaining why creditors should not object in principle to a paternalistic attempt to solve their coordination problem. But—as the next section discusses—it neither explains why bankruptcy law focuses on solving that particular problem and not others nor describes how it should do so.

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

As noted, the model helps to justify government intervention by demonstrating why creditors would prefer a law that is efficient—they prefer to take their slices from a larger pie.[63] But any model starting with rational actors who enter an agreement in a world of perfect information and no transaction costs will arrive inescapably at the solution that maximizes the welfare of those rational actors.[64] That is a mere nod toward the goal of welfare-maximizing efficiency.[65]

And yet even if one embraces the efficiency purpose as given—which this Article does[66]—one still has to answer fundamental questions about whose welfare is being maximized and within what parameters. For starters, why should bankruptcy law focus on the value of claims against the debtor's assets[67] but not the nonclaim interests of those affected by the debtor's business or even total outsiders? This question has divided

62. See Anthony J. Casey, Bankruptcy's Endowment Effect, 33 Emory Bankr. Devs. J. 141, 156 (2016) [hereinafter Casey, Bankruptcy's Endowment Effect] (noting that bankruptcy alters private ordering to achieve its purpose).

63. See supra section I.B.1.

64. This is really just the Coase Theorem. Without transaction costs, bargaining will lead to the socially efficient outcome. Coase, supra note 5, at 15. When transaction costs do exist, the law may need to step in to achieve efficiency. See id. at 16–19 (describing instances in which a legal system that interferes with market transactions can lead to economic efficiency).

65. Similarly, in the more general law-and-economics context, independent of bankruptcy, others have pointed out that hypothetical contracts frameworks do not add anything to general ideas of efficiency. See, e.g., Jules L. Coleman, Risks and Wrongs 169 (1992) ("[T]here appears to be nothing expressed by the concept of hypothetical consent that is not already captured in the idea of rational self-interest.").

66. Consistent with most law-and-economics approaches, this Article embraces the idea of maximizing welfare. The primary goal is to propose a workable welfarist theory. The Article does not undertake here a more fundamental defense of the general law-and-economics welfarist approach.

67. Baird and Jackson use the word "creditors" to encompass all those with claims against the debtor's estate. See Jackson, A Retrospective Look, supra note 11, at 1872 ("In retrospect, I might have better labeled it a 'claimants' bargain' or something broader.").

bankruptcy scholars for years.[68] The Creditors' Bargain model avoids the question by assumption: If the purpose is to mirror a creditors' bargain, then the creditors are the focus.

But why not mirror an ideal bargain between all affected parties? If bankruptcy is supposed to solve an ex ante bargaining problem among creditors, why shouldn't it solve other ex ante bargaining problems related to a debtor's distress? If there is a bargain that includes all possible creditors, one could imagine a bargain that includes employees, consumers, and communities with an interest (or the possibility of an interest) in the long-term success (or failure) of the debtor firm. And that bargain could take into account all of their interests, even those that do not take the form of a claim against assets—a consumer's interest in cheap goods, a local government's interest in tax revenue, a stakeholder's interest in maximizing its other investments in competing firms, any interest affected by any externality of the firm's actions.[69] As long as transaction costs are zero, all parties can reach an imagined bargain that includes enough transfer payments for an efficient outcome that maximizes the value of their interests.

But if one does not intend for bankruptcy to implement a theory of general welfare, then one needs to define a concrete purpose for the system and then develop a partition to limit the scope of actions taken to achieve that purpose.[70] One has to define what is—for lack of a better term—bankruptcy stuff and what is not.

The Creditors' Bargain model fails at drawing this partition as a descriptive and normative matter. Descriptively, the model is misleading.[71] It identifies only the claims against the estate as bankruptcy stuff when many corporate bankruptcy systems in the world draw the partition more broadly than that.[72] Normatively, the model never explains why one *should*

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68. See, e.g., Donald R. Korobkin, Contractarianism and the Normative Foundations of Bankruptcy Law, 71 Tex. L. Rev. 541, 572–75 (1993) (arguing for an approach to the Creditors' Bargain that includes all affected parties).

69. Some argue that bankruptcy law already accounts for these interests. See, e.g., Samuel L. Bufford, What Is Right About Bankruptcy Law and Wrong About Its Critics, 72 Wash. U. L.Q. 829, 838 (1994) (noting that Chapter 11 protects jobs, communities, and economic values); Elizabeth Warren, Bankruptcy Policy, 54 U. Chi. L. Rev. 775, 787–88 (1987) (arguing that Congress intended that bankruptcy law serve broader interests such as protecting jobs and serving the interests of customers, nearby property owners, municipalities, and others). Others have suggested expanding bankruptcy's scope to do so more explicitly. See, e.g., Mann, supra note 12, at 1000 (suggesting that value created by the bankruptcy process could be distributed to further other government interests).

70. On the importance of and challenges in drawing this partition, see Douglas G. Baird, Anthony J. Casey & Randal C. Picker, The Bankruptcy Partition, 166 U. Pa. L. Rev. 1675, 1677 (2018) [hereinafter Baird et al., Bankruptcy Partition]; see also Vincent S.J. Buccola, The Bankruptcy Firm, 167 U. Pa. L. Rev. Online 1, 6 (2019) (discussing the difficulties in drawing the partition around bankruptcy law matters).

71. See sources cited supra note 31.

72. See Baird et al., Bankruptcy Partition, supra note 70, at 1684–86 (demonstrating the ways in which bankruptcy power reaches beyond merely resolving claims against the

draw the partition where it does nor why the law should focus on the interests of claimants and not the interests of anyone who has a nonclaim interest affected by the debtor. And without coherent normative vision, there is no theory. This deficiency of theory manifests itself regularly in debates about whether new disputes—like third-party releases—fall within or without bankruptcy's partition.[73]

No doubt, many readers familiar with the Creditors' Bargain literature are objecting at this point. Surely, they will say, the Creditors' Bargain Theory does show where and why to draw the partition: The goal is to maximize the value not of generic interests in the world but of nonbankruptcy entitlements against the debtor.[74] And bankruptcy law must do so in the way that least interferes with those entitlements. And the reason for doing so? That raises the *Butner* Fallacy.

C. *The* Butner *Fallacy*

Lacking a purpose and a limiting principle, the Creditors' Bargain model spawned a specious scope limitation that is often mistaken for a core purpose. For nearly four decades, the Creditors' Bargain model—beyond stating the generic efficiency principle—has focused on the question of preserving and protecting substantive rights that exist outside of the bankruptcy system.[75] The idea takes its name from *Butner v. United States*[76] (which, incidentally, does not actually require that bankruptcy law provide any special respect for nonbankruptcy substantive rights).[77]

The assumption that connects the Creditors' Bargain Theory to the *Butner* Fallacy is that creditors would—if they could—bargain for rules that

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estate). The same is true of corporate insolvency systems around the world. See, e.g., Horst Eidenmüller, Comparative Corporate Insolvency Law, *in* The Oxford Handbook of Corporate Law and Governance 1003, 1012 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018) ("[T]here are jurisdictions that entertain a policy according to which insolvency law should serve not only creditors' but also other stakeholders' interests, for example those of the debtor, workers, and the (local) community.").

73. See Baird et al., Bankruptcy Partition, supra note 70, at 1686–90 (discussing the split in authority about whether and when a bankruptcy court has the power to issue third-party releases).

74. Jackson & Scott, supra note 35, at 155 (noting that the "cornerstone" of the Creditors' Bargain is "to maximize net asset distributions to the creditors").

75. See supra note 12.

76. 440 U.S. 48 (1979).

77. See supra note 11. Far from suggesting that bankruptcy law should not interfere with nonbankruptcy rights, the Court in *Butner* explicitly stated that the Bankruptcy Clause of the Constitution granted Congress the authority to alter nonbankruptcy rights: "The constitutional authority of Congress to establish 'uniform Laws on the subject of Bankruptcies throughout the United States' would clearly encompass a federal statute defining the mortgagee's interest in the rents and profits earned by property in a bankrupt estate." *Butner*, 440 U.S. at 54 (quoting U.S. Const. art. I, § 8, cl. 4). It was only because the Bankruptcy Code was silent on the matter that the Court deferred to state law. See id. at 55. This is a familiar interpretive move whereby the Court does not lightly presume that Congress has interfered with or preempted state law. Id. at 57–58.

vindicate their substantive ex ante entitlements. Thus, according to some versions of the *Butner* Fallacy, ex post bankruptcy laws can only reach matters that preserve those ex ante entitlements.[78]

This is both circular and wrong. It is circular—or at least self-contradicting—because it relies on nonbankruptcy entitlements to determine when the law should interfere with nonbankruptcy entitlements. The theory imagines a bargain where the parties are writing rules for what to do when their nonbankruptcy agreements are misfiring. Then, to limit the scope of those rules, the nonbankruptcy agreements must be respected as much as possible. So when should those nonbankruptcy rights be supplanted? When doing so will vindicate the nonbankruptcy rights. But, then, which nonbankruptcy rights are vindicated and which are supplanted?

The problem in answering these questions is that the corporate bankruptcy system is a system of laws that suspends, eradicates, or otherwise interferes with substantive rights that would exist outside of bankruptcy. This is true of virtually every key provision of the Bankruptcy Code.[79] The automatic stay prevents the enforcement of contracts.[80] The cramdown provisions prevent a secured creditor from foreclosing on its collateral.[81] The sale provisions allow the sale of assets free and clear of interests that would otherwise attach to the assets.[82] The contract-assumption provisions allow a debtor to enforce contracts where it would otherwise be in default.[83]

Thus, the *Butner* Fallacy is a prescription that bankruptcy law should not interfere with nonbankruptcy entitlements unless it should. As Professor Juliet Moringiello has pointed out, in this framing the principle has no content.[84] The idea parses out to an admonition that bankruptcy law controls substantive rights only when it serves a bankruptcy purpose. This does nothing more than highlight the idea that bankruptcy law should have a purpose.

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

The Creditors' Bargain and the *Butner* Fallacy tend to distract scholars and lawyers by directing their attention to the wrong data and the wrong

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78. See, e.g., Jacoby & Janger, Tracing Equity, supra note 12, at 676 (arguing that bankruptcy law is derived from nonbankruptcy entitlements); Mooney, supra note 12, at 934 (arguing that bankruptcy law exists to serve nonbankruptcy entitlements).

79. And this is equally true of many key provisions of corporate insolvency laws in other countries. See Eidenmüller, supra note 72, at 1012.

80. 11 U.S.C. § 362 (2018).

81. Id. § 1129(b).

82. Id. § 363(f).

83. Id. § 365.

84. See Moringiello, supra note 12, at 659 ("[T]he *Butner* . . . caveat 'unless some federal interest requires otherwise' swallows the rule as far as the treatment of property rights inside of bankruptcy is concerned.").

solutions. As a result, much time is spent trying to design bankruptcy policy to match "real-world" agreements or design bankruptcy reforms targeted at facilitating ex ante communications. This section addresses these two distractions.

1. *The False Promise of "Real-World" Agreements.* — A common move among judges, scholars, and lawyers is to justify (or refute) bankruptcy outcomes by pointing to evidence of real-world agreements that match (or contradict) the proposed outcome.[85] They suggest that the Creditors' Bargain model cannot be satisfied unless creditors are seen adopting such rules in the real world.[86] How, they ask, can it be said that parties would bargain for something when their actual bargain produces the opposite?

This misses the point. According to the Creditors' Bargain Theory, parties bargain in a world in which it is already stipulated that they cannot bargain efficiently to their desired outcome, and they bargain in the shadow of a mandatory bankruptcy system that forces a hypothetical bargain on them to protect them from their own bad bargain.[87] That reveals little about what they would choose if they were rationally designing a system in a perfect world.

Instead, the question is: What is the efficient rule? Or, in bargaining terms, what is the rule that would have resulted from a pristine bargain that exists nowhere in the world? The fact that creditors in the real world act strategically and possess incomplete and asymmetric information should surprise no one. Their actual agreements and their stated preferences are, therefore, poor evidence of the rules that they should adopt to fix contracting failures among them.

2. *Trying to Solve the Wrong Problem.* — The Creditors' Bargain Theory also misleads because it entices scholars to think that bankruptcy's problems are solvable by facilitating communication to make an explicit ex ante bargain possible. For example, some have proposed that helping debtors adopt custom-made bankruptcy rules that are transparent to

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85. See, e.g., Barry E. Adler & George Triantis, Debt Priority and Options in Bankruptcy: A Policy Intervention, 91 Am. Bankr. L.J. 563, 583 (2017) (deriving bankruptcy option value from the terms of loan agreements); see also Jacoby & Janger, Ice Cube Bonds, supra note 12, at 892 (deriving optimal bankruptcy rules from distributional rights that the parties have bargained for outside of bankruptcy); Jacoby & Janger, Tracing Equity, supra note 12, at 680 (rejecting bankruptcy rules because they are based on priority rights that cannot be created through real-world agreements under nonbankruptcy law).

86. See, e.g., Adler & Triantis, supra note 85, at 584 (looking to "real world" debt contracts as evidence of optimal bankruptcy rules); Schwartz, Contracting and Bankruptcy Functions, supra note 43, at 364, 383–84 (providing a normative analysis of bankruptcy law by looking to private covenants).

87. See Anthony J. Casey & Edward R. Morrison, Beyond Options, *in* Research Handbook on Corporate Bankruptcy Law 193, 195–98 (Barry E. Adler ed., 2020) (describing how "bankruptcy forc[es] creditors to forbear their rights and enter a collective bargaining process" to mirror an agreement "that maximizes collective value").

counterparties and affected parties would solve the bargaining problem.[88] This transparency would allow the law to infer contractual assent much like it does with mortgages and security interests.

But the real problem lies beyond the creditors' logistical ability to bargain with each other. As recent scholarship has pointed out, even small numbers of creditors in an explicit bargain will write incomplete contracts that produce inefficient results when financial distress arises.[89] The real problem stems from uncertainty about and complexity in the distressed state of the world. By its very nature, financial distress is hard to contract over; the relevant contingencies often cannot be enforced because they turn on private information about asset values and volatility that are impossible to verify to a court.[90] The time horizon, the number of parties, their incentives to bargain strategically, and the sheer number of contingencies also render the possible scenarios too numerous to define and negotiate.[91] Moreover, the dynamic nature of markets in distress requires flexibility that would be stifled by hard-edged ex ante rules.[92]

88. See sources cited supra note 7; see also Barry E. Adler, Financial and Political Theories of American Bankruptcy, 45 Stan. L. Rev. 311, 322–23 (1993) [hereinafter Adler, Financial and Political Theories] (examining investor choice proposals); Schwartz, Contract Theory, supra note 17, at 1811–12, 1833–39 (arguing generally for rules that facilitate private contracting); Skeel & Triantis, supra note 37, at 1817 (urging bankruptcy law to take ex ante contracting more seriously).

89. Professor Kenneth Ayotte's work is the most groundbreaking on this issue. See Kenneth Ayotte, On the Mandatory Stay of Secured Creditors in Bankruptcy, *in* Research Handbook on Corporate Bankruptcy Law 150, 158 (Barry E. Adler ed., 2020) [hereinafter Ayotte, Mandatory Stay of Secured Creditors] ("Under incomplete information, the bargaining game is slightly more complicated and can result in inefficient continuation and liquidation."); see also Ayotte et al., supra note 45, at 261 ("These side agreements, though profitable for the parties to the agreement, can shut down opportunities in the bankruptcy proceeding for one or more parties to strike efficiency-enhancing deals to defect.").

90. See supra note 19 and accompanying text.

91. See Jackson & Scott, supra note 35, at 166 (1989) ("[T]he creditors' bargain of necessity involves long-term relationships in which many of the contingencies that influence business prospects are uncertain and highly interactive."); see also Baird & Rasmussen, Antibankruptcy, supra note 3, at 652 ("In short, the new world of corporate reorganizations has more heterogeneous creditors whose rights against the business are deeply fragmented.").

92. The same can be said about attempts to regulate bailouts and other government action in times of systemic financial distress. See Anthony J. Casey & Eric A. Posner, A Framework for Bailout Regulation, 91 Notre Dame L. Rev. 479, 536 (2015) ("The paradox of bailout regulation is that because the conditions under which bailouts are issued are unpredictable, it is impossible to set up an ex ante insurance system to govern all such conditions."); see also Iman Anabtawi & Steven L. Schwarcz, Regulating Ex Post: How Law Can Address the Inevitability of Financial Failure, 92 Tex. L. Rev. 75, 93–96 (2013) (describing the challenges with ex ante financial regulation in preventing failures due to "interactive complexity" and "tight coupling" of the financial system); Jeffrey Manns, Building Better Bailouts: The Case for a Long-Term Investment Approach, 63 Fla. L. Rev. 1349, 1356–57 (2011) (describing the "amorphousness" of what constitutes a bailout and its proper scope).

As Part II shows, bankruptcy law responds to this incomplete contracting problem,[93] which cannot be solved by facilitating private contracts and ex ante bargains, or by adopting technology that allows dispersed creditors to express assent to a specific substantive bankruptcy regime.

E. *Other Incomplete Heuristics*

Over the years, the academy has produced other heuristics to explain or supplement the Creditors' Bargain Theory. The most prominent is the sole-owner principle.[94] Like the hypothetical bargain, this is another way of demonstrating the importance of efficiency. A principle envisioning a rational sole owner making decisions—instead of a group of creditors costlessly bargaining—leads again inevitably to an efficient outcome that maximizes the value of all assumed interests. Rational owners maximize the value of the things they own.

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

Moreover, the question in bankruptcy is how to solve a bargaining problem that arises with hold-up threats during financial distress.[95] But a single owner won't have anyone with whom to bargain, and so it makes little sense to ask what that owner would do to solve the problem.

One might instead ask what substantive rule the single owner would follow. But when the owner is uncertain about financial distress, they cannot specify a substantive rule ex ante.[96] Instead, what is necessary are procedural rules that move the parties' ex post bargaining decisions toward the correct substantive choice—which the court cannot verify.[97] No single owner would bother considering the content of such procedural rules.

Another popular heuristic is the rule of general averages.[98] This heuristic is sometimes used to expand or enhance the Creditors' Bargain

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93. See infra sections II.A–.B.

94. See Ayotte & Skeel, supra note 12, at 1563 (identifying the first element of the Creditors' Bargain theory as one where "the ideal bankruptcy outcome is the one that would be chosen by a sole owner"); Baird, Uncontested Axioms, supra note 57, at 582 (explaining bankruptcy's purpose as asking "what someone would do if that person were the firm's sole owner"); Baird & Jackson, Corporate Reorganizations, supra note 12, at 110 (analyzing bankruptcy problems through a sole owner framework); Jackson, Logic and Limits, supra note 12, at 12 (explaining the sole owner view of bankruptcy); Skeel & Triantis, supra note 37, at 1778 ("As Baird and Jackson envisioned it, the hypothetical contract would pursue a 'sole owner' standard.").

95. See infra section II.A.

96. See infra section II.A.2.

97. See infra sections II.A–.B.

98. Jackson & Scott, supra note 35, at 171–73 (describing the rule of general averages); Scott, supra note 13, at 700 ("An analogy to the law of admiralty, in particular the law of

Theory by explaining why the creditors might agree to share risk when distress arrives.[99] Comparing the bankrupt debtor to a ship foundering at sea, the idea is that bankruptcy law might follow admiralty law's rule that all stakeholders "contribute thereafter to the general average expense according to their percentage of ownership."[100]

This adds two aspects to the Creditors' Bargain Theory. First, it introduces the important idea of uncertainty. And second, it introduces agency costs. Because the captain of a foundering ship will be making decisions for the benefit of others in an uncertain environment, the best the law can do is align incentives to "dissipate the captain's conflict between self-interest and duty at the moment of sacrifice."[101] So too might the law of bankruptcy create rules to dissipate the debtor's conflict.

This framing generally resembles the bankruptcy problem. Faced with uncertainty, the law wants to give ex post agents the right incentives. But no one has shown that general average contribution is the best way to do that. Nor is general average contribution a common method deployed as a solution by actual bankruptcy laws.[102]

Doubtless there are other analogies that one could draw. Indeed, any comparison to an area of the law that deals with ex ante regulation of ex post discretion is likely to resemble a generic description of the bankruptcy problem.[103] The key, however, is to move from these generic heuristics and analogies to a fuller theory describing the specific problems and solutions as they actually arise in corporate bankruptcy.

II. Discovering the New Bargaining Theory of Corporate Bankruptcy

The New Bargaining Theory provides that bankruptcy law's purpose is to minimize the value destroyed by the incomplete contracting problem

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general average, may provide insights into an underlying risk-sharing theme in bankruptcy law.").

99. Jackson & Scott, supra note 35, at 156–57.

100. Id. at 171.

101. Scott, supra note 13, at 701.

102. See infra sections III.C; see also David A. Skeel, Jr., The Empty Idea of "Equality of Creditors," 166 U. Pa. L. Rev. 699, 701 (2018) [hereinafter Skeel, The Empty Idea of "Equality of Creditors"] (noting that equal contribution and recovery is not the practice on the ground and that "[b]ankruptcy courts often bless arrangements that give one group of general creditors starkly different treatment than other groups"). The prevalence of secured debt and priority further detracts from any claims that Chapter 11 implements a rule of general averages.

103. Bailout literature comes first to mind. See supra note 92. Analogies to the famous *Alaska Packers* case and the renegotiation of contracts under duress would also work. Alaska Packers' Ass'n v. Domenico, 117 F. 99 (9th Cir. 1902). Professor Vincent Buccola has recently suggested a similar analogy between bankruptcy and tort law's private necessity doctrine from Vincent v. Lake Erie Transp. Co., 124 N.W. 221 (1910). Vincent S.J. Buccola, Bankruptcy's Cathedral: Property Rules, Liability Rules, and Distress, 114 Nw. U. L. Rev. 705, 723–25 (2019).

that parties face with regard to financial distress. Chapter 11 attempts to do this, if imperfectly, by facilitating a structured bargaining space where the relevant parties renegotiate their relationship. That bargaining space constrains the parties procedurally and substantively in ways that are targeted at minimizing their ability and incentive to hold each other up by deviating from the welfare maximizing course of action.

The reason an entire field of law exists to address this problem—rather than the application of something like routine contract law—is the ubiquity of the problem. An overwhelming majority of business relationships suffer from the same incomplete contracting problem at the moment financial distress arises.[104] As a result, a system of uniform procedures has arisen to deal with the value destruction associated with that problem. Indeed, if one imagines a world without bankruptcy law[105] or observes financial markets that exist in jurisdictions without a functioning bankruptcy system, it is not surprising that the incomplete contracting problem would produce pressures requiring a judicial or legislative solution.[106]

Recognizing bankruptcy law's purpose also sheds light on the scope of a proper bankruptcy system. Bankruptcy law is targeted specifically at solving hold-up problems related to the incomplete contracting problem that arises with financial distress. This means that bankruptcy law will seek to address ex post behavior that opportunistically uses incompleteness to extract value. Parties are vulnerable to hold up when they have made

104. Baird & Rasmussen, Antibankruptcy, supra note 3, at 698 (concluding that with newer financial innovation, agreements among creditors are likely to be incomplete); Jackson & Scott, supra note 35, at 166 (noting that risk-sharing agreements involve long-term relationships and many uncertain and interactive contingencies).

105. See Baird, World Without Bankruptcy, supra note 1, at 184 (noting that creditors would self-interestedly destroy value in such an imaginary world).

106. For example, India only recently adopted a unified corporate insolvency system. The demands for reform leading to its adoption were in response to problems that fit the hold-up model presented in this paper. See Nimrit Kang & Nitin Nayar, The Evolution of Corporate Bankruptcy Law in India, ICRA Bull. on Money & Fin., Oct. 2003–Mar. 2004, at 37, 38 (noting the need for reform in the absence of a "single comprehensive and integrated policy on corporate bankruptcy"); Kristin Van Zwieten, Corporate Rescue in India: The Influence of the Courts, 15 J. Corp. L. Stud. 1, 1–3 (2015) (describing two decades of sustained calls for reform); Rajeswari Sengupta, Anjali Sharma & Susan Thomas, Evolution of the Insolvency Framework for Non-Financial Firms in India 1, 3 (Indira Gandhi Inst. of Dev. Rsch., Working Paper No. 2016-018, 2016), http://www.igidr.ac.in/pdf/publication/WP-2016-018.pdf [https://perma.cc/N9K4-V95K] (describing stalled development of financial markets as a result of "the absence of a coherent and effective mechanism for resolving insolvency"). Calls for insolvency reform in France presented similar themes. See, e.g., Sophie Vermeille & Alain Pietrancosta, A Critical Appraisal of French Bankruptcy Law Through the Lens of the Law and Economics Movement: A Solution for the Future? 9–11 (Revue Trimestrielle de Droit Financier, No. 1, 2010) https://ssrn.com/abstract=1959420 (on file with the *Columbia Law Review*) (articulating how French bankruptcy law created negotiation inefficiencies and led to "unsound restructuring plans").

relationship-specific investments.[107] Thus, bankruptcy measures will properly target actions involving or affecting investments specific to relationships that relate in some way to the debtor or the debtor's going concern.[108] Attempts to fix other problems, while potentially valid, are not bankruptcy measures.[109]

In presenting the New Bargaining Theory, this Part explores these theoretical points in detail. First, it explores the incomplete contracting problem that bankruptcy law should attempt to solve. It then shows why this problem demands a bankruptcy specific solution. Finally, it discusses how the New Bargaining Theory informs the proper scope of Chapter 11.

A. *Bankruptcy's Incomplete Contract*

There are two types of incomplete contracts: obligationally incomplete and contingently incomplete.[110] Obligationally incomplete contracts have legal gaps; they are missing terms and do not provide instructions as to how the parties and the courts should respond to certain states of the world.[111] On the other hand, contingently incomplete contracts provide instructions, but they misfire in certain states of the world.[112] When the relevant contingency arises, those instructions are not what the parties intended and they fail to realize the potential gains from trade between the parties.[113]

Incomplete contracts of both types arise when the costs of writing terms to cover all contingencies are too high. The parties are bargaining

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107. Sanford J. Grossman & Oliver D. Hart, The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration, 94 J. Pol. Econ. 691, 695–97 (1986) (modeling the problem of incomplete contracts and relationship specific investments); Hart & Moore, supra note 8, at 757–62 (same); Patrick W. Schmitz, The Hold-Up Problem and Incomplete Contracts: A Survey of Recent Topics in Contract Theory, 53 Bull. Econ. Rsch. 1, 3–12 (2001) (same); see also Mark J. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 Colum. L. Rev. 527, 538–39 (1983) (noting that in the bankruptcy context parties who have committed funds to the enterprise are especially susceptible to hold up).

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

109. As many have recognized, using bankruptcy law to address nonbankruptcy problems can obscure both proper bankruptcy policies and the proper nonbankruptcy solutions to those problems. See, e.g., Baird, Uncontested Axioms, supra note 57, at 589–92 & n.58 (discussing traditionalist and proceduralist objections to the use of bankruptcy law to address nonbankruptcy problems).

110. Ian Ayres & Robert Gertner, Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules, 101 Yale L.J. 729, 730 (1992) [hereinafter Ayres & Gertner, Strategic Contractual Inefficiency] (defining obligationally incomplete and contingently incomplete contracts).

111. Id.

112. Id.

113. Id.

with each other, but they cannot write the necessary terms. Costs might result from a lack of information (the parties cannot predict or define the relevant contingencies) or from bargaining failure (the parties play strategic games that prevent them from agreeing to optimal terms).[114] The agreements might also be incomplete because the parties cannot verify the relevant contingencies to a court.[115] This renders any term that turns on that contingency unenforceable.[116]

When an incomplete contract governs a relationship, the parties can evade the spirit of their initial agreements and take advantage of unforeseen contingencies or misfiring terms to extract value from each other. This is the hold-up problem.[117]

Stated informally, one party can threaten ex post action that will destroy value in a contractual relationship.[118] To demonstrate the idea, imagine a contract between A and B. If a certain contingency arises, A might take action Y that will destroy the value in their relationship. The contract between them is incomplete in that it does not prohibit such action. The incompleteness might arise because the parties did not predict the contingency, or they could not or did not define it in the contract, or because they cannot verify its occurrence to a court.

In any event, A might then threaten to take action Y unless B pays a ransom. Imagine also that B has expended resources that are only valuable if their relationship with A continues. Having made these relationship-specific investments, B is willing to pay the ransom to A in order to preserve the relationship. A is using the incompleteness—which allows the threat—to extract a hold-up payment.[119]

The threat of this ex post hold up, in turn, distorts the parties' ex ante interaction.[120] Fearing hold up, they either do not enter into the relationship at all or they limit their relationship-specific investment in it over time.[121] The remainder of this subsection demonstrates how this theory applies in the bankruptcy context.

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114. See id. at 733 (demonstrating how strategic bargaining can lead to incomplete contracts).

115. See supra note 19 and accompanying text.

116. See Ayres & Gertner, Filling Gaps, supra note 8, at 93 ("If there are transaction costs of explicitly contracting on a contingency, the parties may prefer to leave the contract incomplete. Indeed, as transaction costs increase, so does the parties' willingness to accept a default that is not exactly what they would have contracted for.").

117. See Hart, supra note 21, at 1733.

118. Id.

119. See id. (illustrating this hold-up problem using a hypothetical contractual relationship between a coal mine and a power plant).

120. Id. at 1741 ("Unfortunately, when bargaining takes place ex post, ex ante investments will already have been sunk, hold-up is possible, and, anticipating this, the parties will choose these investments inefficiently.").

121. Grossman & Hart, supra note 107, at 695–96 (describing the setup of such a relationship); Hart & Moore, supra note 8, at 756 ("Given rational expectations by the parties, the fact that revisions and/or renegotiation will occur will affect the form of the

1. *The Problem of Financial Distress.* — Financial distress is common. But its contours and causes are difficult to predict with any reasonable degree of certainty. Generally, financial distress exists when a firm cannot finance new projects that have net positive value.[122] Because investors should be eager to fund profitable endeavors, financial distress implies a market imperfection and the opportunity for successful legal intervention.[123] The usual suspects for this imperfection are debt overhang, asymmetric information, and illiquid capital markets.[124]

Debt overhang arises when existing payment obligations get in the way of new financing.[125] A firm cannot raise new money for valuable projects because the future revenues from those projects are already claimed by existing creditors.

Asymmetric information and illiquid capital markets present a slightly different problem. Here, the debtor cannot convince the market to provide capital for valuable new projects—either because it cannot convince investors that it has good projects and is a good credit risk,[126] or because capital and credit markets are generally frozen.[127]

In a world of perfect ex post bargaining, these problems go away. For debt overhang, the debtor renegotiates its old relationships to allow new investments to take priority. The new projects increase the value of the firm, and everyone is better off.[128] The various parties with an interest in the debtor reach a bargain to coordinate their behavior, expand the pie, and split the surplus.[129] For asymmetric information, insiders with full

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original contract."); id. at 776 (noting that the parties to an incomplete contract cannot sustain efficient levels of relationship-specific investment).

122. See Adler et al., supra note 2, at 26–29 (defining financial distress as when a "firm cannot generate sufficient revenue to pay its debts" and as "a problem that arises *because* of the firm's capital structure").

123. Id. at 28 (describing how "legal rules can help firms in financial distress" because they "ensure that creditors assert their rights in a way that is consistent with the survival of the firm as a going concern").

124. See Ayotte & Skeel, supra note 12, at 1557, 1567–72, 1579–87 (describing these three phenomena).

125. See Adler & Triantis, supra note 85, at 579 (providing an example to illustrate the debt overhang problem); Ayotte & Skeel, supra note 12, at 1570–71 (explaining debt overhang); Stewart C. Myers, Determinants of Corporate Borrowing, 5 J. Fin. Econ. 147, 149 (1977) ("The firm financed with risky debt will, in some states of nature, pass up valuable investment opportunities—opportunities which could make a positive net contribution to the market value of the firm.").

126. See Ayotte & Skeel, supra note 12, at 1579–85 (describing how asymmetric information leads to adverse selection in lending, reducing liquidity).

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

128. See Ayotte & Skeel, supra note 12, at 1576.

129. Without bargaining costs, the parties can always bargain to achieve this mutually beneficial outcome. See Coase, supra note 5, at 2–15.

information could agree to self-finance the firm's future projects[130] or to sell the firm to an insider.[131]

Bargaining, however, is hindered because the parties have an incentive to hold out in an attempt to extract value from each other. In many cases, these hold-out attempts will prevent a negotiated outcome altogether. With multiparty negotiations, the hold-out incentives will lead to a collapse in bargaining where no deal is ever struck.[132] The problem is that for every proposed deal, at least one creditor can do better by holding out.[133] Things are even more tenuous when the parties' varied interests are complex and difficult for others to ascertain, or when the parties place different valuations on assets or projects.[134]

But even where the parties do reach a negotiated outcome, the hold out incentives are problematic. Say, for example, only one party holds out. The parties may reach a Coasean bargain that preserves the firm simply by agreeing that the other stakeholders will pay a ransom to the hold out.[135] In one sense, this is a fine outcome. The firm is preserved and the ransom is just a transfer of value. But there is a separate ex ante cost with respect to investment in the firm. The next time a potential stakeholder is investing in a relationship with a debtor, that investor will reflect on the possibility that when distress arises it will have to pay a ransom to a hold-out creditor to maintain the value of that relationship. Anticipating this result, the potential stakeholder will be reluctant to make the ex ante investment, thus reducing the sources of relationship-specific investment for all firms.

This is not a case where, ex ante, one stakeholder will charge more and another will charge less and the total cost will remain constant. Rather, the credible hold outs are likely to be those who have not made

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

131. Or they might agree to other solutions aimed at creating liquidity, like allowing the debtor to access cash or other assets belonging to its affiliates. For an example of this measure being facilitated by a court order rather than by negotiation, see In re Gen. Growth Props., Inc., 409 B.R. 43, 61–62 (Bankr. S.D.N.Y. 2009) (allowing the debtor to upstream cash from subsidiaries to the parent company to provide liquidity to affiliate entities).

132. See Roe, supra note 107, at 539 ("The multiplicity of parties usually present in the reorganization of a large public firm could increase the chances of deadlock.").

133. See id. ("[A]t least one party is often likely to reject the plan because yet another alternative is better for it . . . .").

134. See Baird & Rasmussen, Antibankruptcy, supra note 3, at 694 (describing how bargaining among sophisticated parties can collapse even when transaction costs are low because of problems stemming from "an empty core, radical disagreements about valuation, or strategic bargaining" and how it can be difficult to ascertain which of these is the problem in a given case).

135. See supra section II.A.

relationship-specific investments, whereas those paying the ransom will be those who have. The result is a reduction in relationship-specific investment. To put it another way, hold outs in bankruptcy extract the greatest value when others have made investments that only have value when the debtor's going concern is preserved, and that provides a powerful incentive against making those investments.[136]

2. *The Incompleteness of Contractual Responses.* — One of the two main claims in this Article is that Chapter 11 provides bargaining parameters that are intended to move the parties—somewhat coercively—toward the ex post bargains necessary to preserve the firm while minimizing their hold-up threats.[137] An alternative system—the one envisioned by contractarians and Creditors' Bargain theorists—might use ex ante rules in a contract or in legislation to strictly bind the relevant parties to take certain actions when financial distress arises. For example, creditors could agree to a defined trigger that automatically converts their claims to equity in order to eliminate debt overhang,[138] or they could agree to a trigger that creates an automatic commitment for certain creditors to provide a new loan.[139]

The difficulty for those mechanisms lies in the ex ante choice and definition of the precise remedial measures and the verifiable contingencies that will trigger them. The preceding subsection described distress generally, but every firm is distressed in its own way. Overhang and illiquidity might be caused by failed expansion,[140] a cyclical downturn,[141]

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

137. For example, Chapter 11 facilitates reorganization plans; global restructuring relationships and debtor-in-possession financing; cramdowns; and free-and-clear sales. 11 U.S.C. §§ 363–364, 1121–1129 (2018). And various forms of partial consolidation across entities allow for affiliate financing. See, e.g., In re Gen. Growth Props., Inc., 409 B.R. 43, 61 (Bankr. S.D.N.Y. 2009) (noting the particular advantages of extending credit to a partially consolidated corporate structure).

138. Professor Adler pioneered this idea. See Adler, Financial and Political Theories, supra note 88, at 312 ("Should [the hypothetical] firm become insolvent and default on its obligations, the common equity class would vanish as would the fixed claims of the next lowest investor class, which would then become the new common equity class.").

139. See Ayotte & Skeel, supra note 12, at 1594–99 (exploring the idea of coerced loan commitments).

140. See, e.g., Declaration of Jonathan Goulding, Chief Restructuring Officer of Forever 21, Inc., in Support of Chapter 11 Petitions & First Day Motions at 23, In re Forever 21, Inc., No. 19-12122 (Bankr. D. Del. filed Sept. 30, 2019) (noting international overexpansion as a cause of distress).

141. See, e.g., Tronox Inc. v. Anadarko Petroleum Corp. (In re Tronox Inc.), 429 B.R. 73, 88 (Bankr. S.D.N.Y. 2010) ("The impact of the Legacy Obligations on Tronox, combined with an inevitable, cyclical market downturn, left it no choice but to file for Chapter 11 protection."); see also Ben S. Bernanke, Bankruptcy, Liquidity, and Recession, 71 Am. Econ. Rev. 155, 155 (1981) ("The onset of recession strains the system by reducing the flow of income available to meet current obligations and by increasing uncertainty about future liquidity needs."); Mark C. Mathiesen, Bankruptcy of Airlines: Causes, Complaints, and

technological change,[142] a systemic liquidity shock,[143] a supply shock,[144] a demand shock,[145] new competition,[146] bad management,[147] asymmetric information,[148] a global pandemic,[149] or any combination of these or the many other possible candidates.[150]

Moreover, the state of affairs when distress hits can take many forms. The creditors may include banks,[151] vendors,[152] hedge funds, private equity

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Changes, 61 J. Air L. & Com. 1017, 1023 (1996) (noting a recession as a factor in a wave of bankruptcies).

142. See, e.g., Declaration of Antoinette P. McCorvey Pursuant to Rule 1007-2 of the Local Bankruptcy Rules for the Southern District of New York in Support of First Day Pleadings at 11–16, In re Eastman Kodak Co., No. 12-10202 (ALG) (Bankr. S.D.N.Y. filed Jan. 19, 2012) (noting the decline of the film business in the face of digital photography).

143. See, e.g., Affidavit of Ian T. Lowitt Pursuant to Rule 1007-2 of the Local Bankruptcy Rules for the Southern District of New York in Support of First-Day Motions & Applications at 7–10, In re Lehman Bros. Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. filed Sept. 15, 2008) (describing the liquidity crisis and its impact on Lehman Bros.).

144. See, e.g., Affidavit of Isabella D. Goren Pursuant to Local Bankruptcy Rule 1007-2 at 6–11, In re AMR Corp., No. 11-15463 (SHL) (Bankr. S.D.N.Y. filed Nov. 29, 2011) (noting fuel prices as a contributing factor to financial distress); see also In re AMR Corp., 477 B.R. at 397 (noting how increased fuel prices contributed to the airline's bankruptcy); Mathiesen, supra note 141, at 1024 (noting how fuel prices led to a wave of bankruptcies).

145. See, e.g., Declaration of Jamere Jackson in Support of Debtors' Petitions & Requests for First Day Relief at 29, In re The Hertz Corp., No. 20-11218 (MFW) (Bankr. D. Del. filed May 24, 2020) (noting that "demand for our core products has been decimated").

146. See, e.g., Affidavit of Jeffery J. Stegenga Pursuant to Local Bankruptcy Rule 1007-2 in Support of First Day Motions at 16, In re Blockbuster Inc., No. 10-14997 (BRL) (Bankr. S.D.N.Y. filed Sept. 23, 2010) (noting that Blockbuster's financial challenges resulted in large part from the rise of new competitors in the media entertainment industry).

147. See, e.g., Third Interim Report of Neal Batson, Court-Appointed Examiner at 15, In re Enron Creditors Recovery Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. filed June 30, 2003) (finding that Enron's leaders struggled to manage its merchant investments portfolio).

148. See Ayotte & Skeel, supra note 12, at 1580 (describing how information asymmetries create problems of adverse selection in lending, which "make illiquidity problems more severe").

149. See, e.g., Declaration of James Howell in Support of Debtors' Chapter 11 Petitions & Related Requests for Relief at 9, In re CEC Ent., Inc., No. 20-33163 (MI) (Bankr. S.D. Tex. filed June 26, 2020) (noting that the COVID-19 pandemic was the cause of financial distress and that "[i]n ordinary times, the Company would be financially sound" and had remained profitable before the pandemic).

150. See, e.g., Declaration of Bill Wafford, Executive Vice President, Chief Financial Officer of J.C. Penney Co., Inc., in Support of the Debtors' Chapter 11 Petitions & First Day Motions at 25–27, In re J.C. Penney Co., Inc., No. 20-20182 (DRJ) (Bankr. S.D. Tex. filed May 15, 2020) (noting the combination of reduced demand, new competition, leadership turnover, and a global pandemic as causes of its financial distress).

151. See Michelle M. Harner, Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives, 16 Am. Bankr. Inst. L. Rev. 69, 75 (2008) (noting that banks will often sell their claims to exit a bankruptcy).

152. Id. at 75–76 (noting the presence but decreasing importance of vendors).

firms,[153] or tort victims.[154] They may be secured or unsecured.[155] They may include many layers of priority or few.[156] They may be dispersed or consolidated.[157] They may include employees[158] and competitors.[159] They may have bought or sold claims to or from other claimants.[160] They may have conflicting investments.[161] They may hold hedged positions or complex financial derivatives like credit default swaps.[162] They may need cash immediately or they may be reluctant to cash out their interests for regulatory reasons.[163] They may be parties to agreements with other creditors that dictate their actions when distress arises.[164]

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153. Id. at 76 (noting the role of hedge funds and private equity firms).

154. See Baird & Rasmussen, Antibankruptcy, supra note 3, at 653 n.14 (noting that tort claims are present in a very small number of bankruptcy cases); Richard A. Posner, The Rights of Creditors of Affiliated Corporations, 43 U. Chi. L. Rev. 499, 507 (1976) (discussing tort claims in bankruptcy).

155. Baird & Rasmussen, Antibankruptcy, supra note 3, at 653–76 (describing unsecured and secured lending practices).

156. See Harner, supra note 151, at 83 (describing investors' preferences for lending at different tranches of priority). See generally Randal C. Picker, Perfection Hierarchies and Nontemporal Priority Rules, 74 Chi.-Kent L. Rev. 1157 (1999) (discussing the different layers of priority lenders).

157. Baird & Rasmussen, Antibankruptcy, supra note 3, at 657 (noting a trend from cases with dispersed unsecured creditors toward cases with more concentrated groups of distressed debt investors).

158. See, e.g., Declaration of James Howell in Support of Debtors' Chapter 11 Petitions & Related Requests for Relief, supra note 149, at 22 (noting $8,500,431 in compensation obligations to employees).

159. See, e.g., DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.), 634 F.3d 79, 87 (2d Cir. 2011) (noting that one creditor was a competitor of the debtor).

160. See Anthony J. Casey, Auction Design for Claims Trading, 22 Am. Bankr. Inst. L. Rev. 133, 133–34 (2014) (describing how hedge fund involvement in corporate bankruptcy has dramatically increased the volume of claims trading); Jared Ellias, Bankruptcy Claims Trading, 15 J. Empirical Legal Stud. 772, 795 (2018) (noting that "claims trading is a pervasive feature of Chapter 11"); Edith S. Hotchkiss & Robert M. Mooradian, Vulture Investors and the Market for Control of Distressed Firms, 43 J. Fin. Econ. 401, 402 (1997) (explaining the various motives of vulture investors who purchase distressed claims); Victoria Ivashina, Benjamin Iverson & David C. Smith, The Ownership and Trading of Debt Claims in Chapter 11 Restructurings, 119 J. Fin. Econ. 316, 334 (2015) (describing empirical scholarship that associates higher debt concentration with the preservation of independent going concern).

161. See, e.g., *In re DBSD N. Am.*, 634 F.3d at 104 (designating the vote of a creditor that also held significant investment in a direct competitor of the debtor).

162. Baird & Rasmussen, Antibankruptcy, supra note 3, at 678–86 (explaining the use of credit default swaps as a way for lenders to reduce their risk exposure).

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

164. See, e.g., Salus Cap. Partners, LLC v. Standard Wireless Inc. (In re RadioShack Corp.), 550 B.R. 700, 703–05 (Bankr. D. Del. 2016) (noting a dispute arising out of a web of intercreditor agreements that dictated the relationships between multiple creditors); see also Jonathan C. Lipson, Bargaining Bankrupt: A Relational Theory of Contract in

Finally, different constituencies may have invested deeply in the relationships that require renegotiation in bankruptcy. The debtor may face financial concerns,[165] regulatory pressures,[166] union negotiations,[167] community pressures,[168] or a declining customer base.[169] Each of these problems implicates a different set of relationships as the subject for renegotiation.

In times of distress, the proper response for each party in these relationships depends on the specific characteristics of the entire constellation of interests. The best way to choose among and implement a reorganization, going-concern sale, or liquidation will turn on the state of the market, the causes of distress, and the relationships that exist between the parties. The specific causes of distress will impact the willingness and ability of outsiders to provide new capital and of insiders to take a haircut or forbear on enforcing claims.[170] The specific agreements and relationships that exist at the time of distress will affect the creditors' ability and incentives to bargain toward an optimal outcome, and so on.[171]

If claimants actually bargain ex ante, they will face insurmountable challenges.[172] Limits on information and time as well as the parties' incentives to bargain strategically will get in the way of their attempts to

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Bankruptcy, 6 Harv. Bus. L. Rev. 239, 243 (2016) ("[D]istress investors, who often influence large chapter 11 cases, increasingly use contract, or contract-like mechanisms such as settlement agreements, to evade bankruptcy's most important mandatory feature, its priority rules and norms." (footnote omitted)).

165. See Ayotte & Skeel, supra note 12, at 1559–60 ("Since the financial crisis, liquidity problems have been cited as the cause behind both the decisions to file for bankruptcy and the outcomes of many Chapter 11 cases.").

166. See, e.g., Fed. Commc'ns Comm'n v. NextWave Pers. Commc'ns Inc., 537 U.S. 293, 296–99 (2003) (describing the regulatory charges that led to the bankruptcy proceedings of NextWave).

167. See, e.g., Supplement B Pilot Beneficiaries v. AMR Corp. (In re AMR Corp.), 523 B.R. 415, 417–19 (S.D.N.Y. 2014) (describing the renegotiation challenges involved with a collective bargaining agreement in bankruptcy for American Airlines).

168. See, e.g., Press Release, Tom Carper, U.S. Senate, Carper, Carney Issue Statement on Fisker's Bankruptcy Court Proceedings (Jan. 9, 2014), https://www.carper.senate.gov/public/index.cfm/2014/1/carper-carney-issue-statement-on-fisker-s-bankruptcy-court-proceedings [https://perma.cc/BD5D-8CUC] (stating that in the *Fisker* bankruptcy, the Delaware Senator and Representative prefer a bankruptcy resolution that includes open bidding procedures and continued production at a Delaware plant to create jobs in Delaware).

169. See supra note 142 and accompanying text.

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

171. See Baird & Rasmussen, Antibankruptcy, supra note 3, at 687 (explaining that holders of the same type of claim can have different incentives and abilities, and thus hinder optimal outcomes).

172. See id. at 698 ("[T]he agreements will likely be incomplete and some recourse to gap-filling is necessary.").

write contingent substantive rules for every distress situation.[173] Similarly, attempts to write ex ante rules into legislation will be limited by the legislators' ability to predict and define verifiable contingencies.[174] This is why the Creditors' Bargain model and the proposed solutions in its wake fall short.[175] The legislators can no more write the complete contract than the parties themselves.

Moreover, such a hypothetical complete contract—even if it could be written—will often produce *inefficient* outcomes because it fails to account for asymmetric information and strategic bargaining. As others have noted in the nonbankruptcy context, "When the parties have asymmetric information, however, the hypothetical contract standard fails to provide an effective framework for choosing efficient rules."[176] The framework fails because it assumes away the bargaining costs that are at the core of the problem it is trying to solve.[177]

Also falling short are mechanisms aimed at bringing the creditors together to write a complete contract.[178] If, for example, every debtor could opt in to its own customized set of bankruptcy rules, and the law could facilitate the assent of all current and future creditors, those rules

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173. See Ayres & Gertner, Strategic Contractual Inefficiency, supra note 110, at 759 (noting various impediments to bargaining caused by asymmetric information).

174. See id. ("Setting an efficient default rule will depend upon *precise* determinations of underlying variables, a task that is extremely difficult for courts and legislatures.").

175. This weakness in hypothetical bargaining solutions has been recognized for decades in the more general context of incomplete contracts. See id. at 733 & n.17 (noting calls to move away from "hypothetical contract" approaches and "the growing consensus among contract scholars that default rules should not simply be the hypothetical contract that parties would choose in a world without transaction costs"); see also David Charny, Hypothetical Bargains: The Normative Structure of Contract Interpretation, 89 Mich. L. Rev. 1815, 1815 (1991) (noting that the hypothetical contract framework is often "incorrect, perhaps even incoherent").

176. Ayres & Gertner, Strategic Contractual Inefficiency, supra note 110, at 733.

177. For example, imagine there are two types of creditors dealing with the debtor—A and B. The debtor cannot distinguish between them. In a perfect world, the debtor would pay a certain price to A for an A-type contract and a certain price to B for a B-type contract. But in practice, the parties withhold information and bargain strategically, making it impossible to reach that outcome. Now imagine the law provides an immutable default rule that ex post applies A-type rules to A and B-type rules to B. The debtor still cannot distinguish A and B ex ante. What price should the debtor pay to any given creditor? Moreover, there is now a new wrinkle to the problem. Do all the parties have symmetric information about the default rules? If not, that could intensify strategic bargaining. You can add complications by assuming the creditors are the ones who cannot distinguish the types or by assuming that parties can switch their type in response to the rule and so on. The point is that the rule that the hypothetical bargain produces does not solve the problems presented by the real bargain in these cases. See id. at 765 ("The settings in which strategic contractual behavior can undermine the use of majoritarian defaults, however, are not negligible. In a large number of contexts, the parties will have private (asymmetric) information about a variety of issues relevant to contractual efficiency.").

178. See supra section II.A.1.

would still be incomplete because of strategic bargaining and limited information.[179]

B. *The Need for a Bankruptcy-Specific Solution*

Incomplete contracts are not a unique bankruptcy problem. Many contracts (and most pieces of legislation) are incomplete and raise questions about how to correct for gaps and otherwise incomplete terms.[180]

The law might, then, treat incomplete contracts in financial distress the same as any other incomplete contract. That entails a mixture of judicial gap filling[181] and enforcing terms as written. This is an imperfect response. When judges do not intervene, the incompleteness will remain.[182] And even when judges do intervene, they will fill gaps imperfectly and may be unable to verify the information necessary to enforce a contract.[183] Similarly, lawmakers might write a law that approximates a hypothetical *incomplete* contract and let courts enforce that. That contract would probably be short and say something like, "The parties must behave reasonably in favor of efficiency when distress arises."[184] Either approach would rely on the courts to fill the substantive gaps and would likely lead to different prescriptive outcomes from those advocated by the conventional law-and-economics theories of corporate bankruptcy.[185]

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179. See supra section II.A.1.

180. See supra note 8; see also Ayres & Gertner, Strategic Contractual Inefficiency, supra note 110, at 730–32 (describing how contracts are incomplete and require gap filling, and reviewing scholarship on the problem).

181. This Article uses "gap filling" to refer to a court directly filling in a missing term or rewriting a term that is at odds with the parties' interests. See Ayres & Gertner, Strategic Contractual Inefficiency, supra note 110, at 730–31 (noting that courts fill gaps both for "obligationally incomplete" and for "contingently incomplete" contracts).

182. Parties may try to create private solutions. Scholars have suggested some private ordering measures to reduce hold-up problems associated with incomplete contracts. See, e.g., Grossman & Hart, supra note 107, at 692 (developing a theory of integration based on the attempt of private parties to resolve incomplete contracting problems by allocating efficiently the residual rights of control between themselves); Hart & Moore, supra note 8, at 756 (developing a theory of incomplete contracts and exploring strategies parties use to avoid incomplete contracting problems). But most of those measures are not available in the corporate bankruptcy context. It is not feasible, for example, for a firm to integrate with all of its claimants.

183. See Ayres & Gertner, Strategic Contractual Inefficiency, supra note 110, at 732–33 (noting the difficulty for courts to fill gaps).

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

185. For example, criticisms of ex post judicial discretion interfering with ex ante contracting would be less powerful in cases like In re General Growth Properties, Inc., 409 B.R 43 (Bankr. S.D.N.Y. 2009) and Salus Capital Partners, LLC v. Standard Wireless Inc. (In

As Part III shows, Chapter 11 does not take these approaches. Nor do most bankruptcy systems in other jurisdictions.[186] There are at least two reasons for this. First, courts would be particularly bad at filling substantive gaps in times of financial distress. Courts are not experts in strategic business planning or financial structuring—especially not within an emergency timeframe. Not only does financial distress pose uncertainty, it does so in a context that requires decisions to be made fast: Firms in financial distress are often bleeding cash and their viability can disappear quickly.[187] To be sure, the idea that a debtor business is a melting ice cube and that any delay threatens its viability is overplayed in bankruptcy courts.[188] Lawyers will argue that the court must decide in a matter of days. The reality is likely more in the range of weeks or months. But the *years* that courts often take to fill substantive gaps in other cases[189] are not available in a corporate reorganization.

Second, this problem is ubiquitous. Virtually all firms that enter financial distress and need to be reorganized face major incomplete contracting problems. Of course, if the firm has totally failed and has no going-concern value, it can be liquidated easily. But firms that go into Chapter 11 reorganization are navigating questions of how to preserve going-concern value in the face of claims by multiple parties with different interests in the firm's survival.[190] Those parties naturally have different views and incentives for how to achieve the best reorganization outcome. This state of affairs poses complicated questions of valuation, control, and vision to which their contracts provide incomplete answers.

The ubiquity of the problem begs for a standardized solution. Given a class of relationships that routinely raise an incomplete contracting problem that the courts are bad at solving substantively, it makes sense to adopt a uniform procedural solution that reduces hold up and increases predictability. If courts will inevitably be involved when distress arises, the law can add value by providing a procedural framework for that

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re Radioshack Corp.), 550 B.R. 700 (Bankr. D. Del. 2016). See infra section III.C; see also Ayotte et al., supra note 45, at 269–72 (describing the Radioshack bankruptcy in detail).

186. See generally Global Insolvency Law Database, World Bank (Nov. 17, 2015), https://www.worldbank.org/en/topic/financialsector/brief/global-insolvency-law-database [https://perma.cc/QDV7-UDB8] (cataloging insolvency laws around the world).

187. See Jacoby & Janger, Ice Cube Bonds, supra note 12, at 865 (noting that "[f]inancially distressed companies can melt like ice cubes").

188. Id. at 865–66 (noting the prevalence and overuse of the melting ice cube argument); Lynn M. LoPucki & Joseph W. Doherty, Bankruptcy Fire Sales, 106 Mich. L. Rev. 1, 30–31 (2007) (revealing a lack of empirical evidence for melting ice cube claims).

189. See Inst. for the Advancement of the Am. Legal Sys., Civil Case Processing in the Federal District Courts: A 21st Century Analysis 4 (2009), https://www.uscourts.gov/sites/default/files/iaals_civil_case_processing_in_the_federal_district_courts_0.pdf [https://perma.cc/49LL-26SB] ("[A]bout 35% of cases took more than a year to resolve, and the longest cases took ten years or more before a final resolution was reached.").

190. Baird & Rasmussen, Antibankruptcy, supra note 3, at 651–53 ("Dozens of constantly changing stakeholders occupy every tranche, each pursuing its own agenda.").

involvement. There is little risk of market distortion in legislating a court-supervised procedure over a set of relationships that will require deep judicial intervention in any event. Indeed, the law can reduce distortions if it adds predictability and reduces errors. If courts are error prone in substantive gap filling, bankruptcy law can prescribe mechanisms that address incompleteness but constrain substantive gap filling as much as possible.

Moreover, resting that system in one central (federal) court increases predictability and reduces forum shopping that would otherwise result.[191] There are also economies of scale in using a uniform mechanism to address incomplete contracting in the context of financial distress. With corporate bankruptcy, the hold-up problem is front and center in virtually every case and it is always triggered by the same thing: financial distress. There is a unique efficiency,[192] then, in funneling this entire class of cases into one uniform system in one court that specializes in resolving this type of hold-up problem.[193] As the courts get better at policing hold up, the system becomes more efficient and more predictable.[194]

This also suggests that a uniform government system might be preferable to private arbitration systems where the economies of scale might be lost, repeat players—like banks—might take advantage of asymmetric knowledge and their relationships with the private arbitrators, or strategic bargaining might otherwise lead to incomplete arbitration contracts.[195]

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191. One must not, however, be too optimistic. Forum shopping is reduced, but it is surely not eliminated, by moving cases into the federal system. Parties can still use variations in the way different federal bankruptcy courts apply the law to extract value from each other. See Laura Napoli Coordes, The Geography of Bankruptcy, 68 Vand. L. Rev. 381, 388–89 (2015) (describing the availability of and incentives for forum shopping during federal bankruptcy proceedings).

192. The choice of whether to judicially regulate incomplete contracts always poses a cost comparison between the costs of allowing parties to simply live with the contracts as written and the costs of judicial involvement. Ayres & Gertner, Strategic Contractual Inefficiency, supra note 110, at 733 n.17 (noting the "horse race" between the competing costs). The economies of scale here make it more cost effective to judicially regulate problems from incomplete contracts.

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

194. There will be growing pains when a country first adopts a bankruptcy system as its judges develop this expertise or assign bankruptcy matters to nonspecialized courts. See, e.g., Andy Mukherjee, India's Bankruptcies Get a Dose of Common Sense, Bloomberg Op. (July 17, 2019), https://www.bloomberg.com/opinion/articles/2019-07-18/india-s-creaking-bankruptcies-get-lubrication [https://perma.cc/X34N-FA4T] (noting that judges had misapplied India's new bankruptcy law, necessitating a bold and quick amendment to clarify the law).

195. See Ayres & Gertner, Strategic Contractual Inefficiency, supra note 110, at 764 (describing the difficulties in writing complete arbitration contracts).

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

Looking beyond the United States adds support to this story. When financial markets around the world develop faster than local insolvency law, incomplete contracting problems related to financial distress produce pressures that demand solutions of the sort described in this Article.[196] Some jurisdictions allow those pressures to build, only to see dysfunction and hold up grow along with varied calls for reform.[197] In a financial system without a functioning insolvency law, the bankruptcy state of nature is likely to take one of two extreme forms. Either creditors are left free to enforce contract terms harshly and formalistically[198] or courts ignore contracts altogether and focus on ex post rescue measures without regard to the distortions those measures might create.[199] Both options allow for hold up, either by the creditors or by equity and management.

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

196. See supra note 106.

197. See supra note 106.

198. There are historical examples of this. Elena Cirmizi, Leora Klapper & Mahesh Uttamchandani, The Challenges of Bankruptcy Reform, 27 World Bank Rsch. Observer 185, 189–90 (2012) (noting that harsh procreditor formalism in nineteenth-century France and Italy resulted in lower returns for creditors).

199. This is the more likely dysfunction today. For example, Professor Kristin van Zwieten chronicles the experience in India where judges' interpretation of India's then-existent corporate rescue act, the Sick Industrial Companies (Special Provisions) Act, 1985, sought to rescue companies facing inevitable liquidation and protect employees, eventually leading to delay, inefficiency, dysfunction, and the need for reform. Van Zwieten, supra note 106, at 14–28.

to funnel their disputes through a uniform system to avoid inconsistencies, externalities, market inefficiencies, and the waste of judicial resources that would otherwise occur.

C. *A Limited Scope*

Because bankruptcy law is not a general welfare system, it should not address problems unrelated to distress. This conceptual limitation has several justifications: (1) doctrinal reasons grounded in constitutional law and federalism;[200] (2) institutional reasons grounded in a view of the appropriate authority for making those decisions;[201] and (3) efficiency reasons concerned with distorting incentives of parties in filing, avoiding, or pursuing bankruptcy.[202]

Saying that bankruptcy law is limited in scope and should address bankruptcy matters is not the same as the *Butner* Fallacy. Bankruptcy law should be directed at bankruptcy matters. But once there is an identified bankruptcy issue, nothing about the New Bargaining Theory requires special deference to nonbankruptcy rights. Rather, as the previous section demonstrates, the theory merely requires that any measure implemented to create value in bankruptcy must not destroy more value by distorting incentives in other states of the world.

True enough, one way that value can be destroyed is through forum shopping, where parties expend resources to manufacture a bankruptcy

200. See Robert H. George, Bankruptcy for Nonbankruptcy Purposes: Are There Any Limits?, 6 Rev. Litig. 95, 102–04 (1987) (exploring the Supreme Court's application of state and federal law in bankruptcy cases); Mooney, supra note 12, at 960–62, 977–78 (explaining Thomas Plank's "doctrinal theory of the limited powers of Congress and the courts under the Bankruptcy Clause of the Constitution"); Thomas E. Plank, Bankruptcy and Federalism, 71 Fordham L. Rev. 1063, 1089–95 (2002) (analyzing the limitations of Congress's power to enact bankruptcy law under the Bankruptcy Clause of the Constitution).

201. See George, supra note 200, at 104–13 (describing the "bankruptcy court's use of its equitable powers to protect the bankruptcy process from misuse and to ensure that nonbankruptcy rights are disturbed only to the extent necessary").

202. Though it is not a corporate issue, the parking-ticket-and-bankruptcy debacle in Chicago is a great example of this. A discriminatory parking enforcement policy in Chicago has led thousands of Black debtors to file for Chapter 13 bankruptcy simply because it provides the only relief to parking ticket enforcement. See Edward R. Morrison & Antoine Uettwiller, Consumer Bankruptcy Pathologies, 173 J. Institutional & Theoretical Econ. 174, 186–87 (2017). This has imported the racial disparities that exist in parking enforcement into the bankruptcy system and cost Black drivers thousands of dollars in legal fees. See id. at 175, 194. It is abundantly clear that a fix to the parking ticket system, rather than bankruptcy law, would be better. Anthony J. Casey, Consumer Bankruptcy Pathologies: Comment on Morrison and Uettwiller, 173 J. Institutional & Theoretical Econ. 197, 200–01 (2017) (suggesting that bankruptcy law is not a solution to the disparate racial effects of parking tickets in Chicago); Morrison & Uettwiller, supra, at 194–95 ("This finding suggests that some of the aberrational features of Chapter 13 may be a product of intersecting features of bankruptcy and nonbankruptcy law . . . .").

to change nonbankruptcy entitlements.[203] But the New Bargaining Theory shows us that the only relevant question is whether the costs from forum shopping outweigh the benefits from reducing other forms of hold up. The *Butner* Fallacy asks the question but provides nothing in the way of answers.

The New Bargaining Theory, on the other hand, instructs that the farther the parties' interests are away from a relationship involving the debtors' assets, the more skeptical the law should be in assuming that it can alter those interests to the collective benefit of all interested parties without causing collateral damage. Thus, bankruptcy law generally does not account for creditors' outside interests, such as investments in a competitor, when implementing bankruptcy's purpose.[204] Likewise, it generally does not alter the interests of those with no connections to the debtor.

The economics literature on incomplete contracting states this idea more formally. Incomplete contracting leads to hold-up problems when parties have made relationship-specific investments.[205] Thus, the bankruptcy solution to incomplete contracting over financial distress is only relevant to situations where the parties have made such investments. Parties who have no direct or indirect relationship with the debtor have made no investments specific to a relationship affected by the debtor's financial distress and are—by definition—not subject to an incomplete contracting problem with regard to that distress. On the other hand, those who have nonclaim relationships with the debtor might still be included in the partition if they have invested specifically in those relationships or if those relationships affect the debtor's going-concern value.

As Professor Mark Roe has pointed out, the possibility for strategic behavior and threats is enhanced when parties have committed resources to an enterprise.[206] A threat to tear apart the enterprise is a threat to destroy those committed resources. When such a threat is credible, parties can extract value as a payment to not carry through on the threat. According to the New Bargaining Theory, this is precisely the hold-up behavior that bankruptcy law should prevent.

The scope of bankruptcy, then, should be the set of relationships where parties have invested specifically in the enterprise as a going concern. Wherever parties have made relationship-specific investments

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203. See Baird, Uncontested Axioms, supra note 57, at 592 n.58 ("If there are two different legal regimes, parties will invest considerable energy in finding the legal regime that most favors them.").

204. See Baird et al., Bankruptcy Partition, supra note 70, at 1683 (explaining that the "proper focus" of the bankruptcy partition "is entirely on what goes to creditors *on account of their claims against the estate*").

205. See supra section II.A.

206. See Roe, supra note 107, at 538–39 (noting that because creditors' funds are already committed to the enterprise, the bargaining dynamic "provides enhanced opportunity for strategic behavior, threats, and appeals").

that are affected by the debtor's distress, hold up is a possibility and bankruptcy law should step in. On the other hand, where parties have made no such investment, there is no threat of hold up and bankruptcy law should not be implicated.

Importantly, this suggests a broader scope than the Creditors' Bargain Theory and a broader scope than some courts have been willing to adopt. The interest of nonclaimants who have made such relationship-specific investments will be relevant and subject to the bankruptcy power. The most likely expansion will be along the dimension of human capital, which is a major relationship-specific investment associated with most firms.[207]

To be clear, this just provides the scope or domain of bankruptcy law. The specific resolution of issues that arise within that domain will require the ex post/ex ante balancing section III.C discusses.

Likewise, contracts that are not directly with the debtor but reflect specific investments in the debtor's network of relationships or going-concern value will be bankruptcy matters. For example, consider the question of nonconsensual third-party releases. Third-party releases are provisions in reorganization plans that release one party from liability on a claim held by another party even when the debtor is not a party to the claims.[208] The controversy arises when the party holding the claim does not consent to the release.[209] The New Bargaining Theory suggests that the bankruptcy courts can release claims between stakeholders if (1) those claims are connected to the relevant parties' relationship with the debtor and (2) doing so prevents hold up and facilitates efficient ex post bargaining.[210] Of course, consistent with the New Bargaining Theory,

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207. See Margaret M. Blair, Firm-Specific Human Capital and Theories of the Firm, *in* Employees and Corporate Governance 58, 58–63 (Margaret M. Blair & Mark J. Roe eds., 1999) (arguing that the relationships among the people who make up firms ought to be "incorporated into the legal debate on corporate governance"). In practice, the law is often inconsistent in how much consideration it gives to these kinds of interests, sometimes prioritizing job preservation over creditor recoveries. See Thomas H. Jackson & David A. Skeel, Jr., Bankruptcy and Economic Recovery, *in* Financial Restructuring to Sustain Recovery 97, 114 (Martin Neil Baily, Richard J. Herring & Yuta Seki eds., 2013). As Jackson and Skeel note:

> Congress often stepped in with a fix, to ensure that the rights of workers, and the focus on jobs, was not lost in bankruptcy. Prominent examples of this include Section 1113, constraining the ability to reject collective bargaining agreements in bankruptcy and Section 1114, constraining the ability to reduce retiree health care benefits in bankruptcy.

Id. These bills were direct responses to court decisions seen as favoring creditors over employees. Id.

208. See Lacy v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648, 658 (6th Cir. 2002) (defining and outlining elements for courts to consider when assessing third-party releases).

209. Id.

210. One court has applied a standard similar to this in the related context of staying third-party litigation. See Fisher v. Apostolou, 155 F.3d 876, 882 (7th Cir. 1998) (staying

there also needs to be a check on the converse hold-up behavior that could arise from *allowing* such releases. That check will take the form of a cramdown payment from the debtor's estate to the party being forced to provide the release.[211] The appropriate amount of that payment will be an estimate of the market value of the released claim. Alternatively, the court could request indubitable proof that the released claims have de minimis value or that the debtor is not using the releases to extract hold-up value. Once the court sets the price and evidentiary burdens, then the parties can begin their bargaining. These measures reduce the potential for debtors to use third-party releases as a form of hold up.

Relatedly, the New Bargaining Theory suggests that intercreditor agreements—which often bind creditors to abstain from certain procedural maneuvers in a bankruptcy proceeding[212]—should fall under the bankruptcy umbrella even when the debtor is not a party and the agreements contain forum selection clauses suggesting otherwise. In practice, the hold-up risk in intercreditor agreements is high.[213] As a result, courts should not enforce them specifically unless the party seeking enforcement meets a very high evidentiary threshold to show that there is no value extraction.[214] But consistent with the analysis above, the court should impose a market price on the party seeking to escape enforcement. That price should take the form of expectation damages.[215] Once again, this system reduces the opportunities for hold up on both sides.

III. CHAPTER 11'S RENEGOTIATION FRAMEWORK

This Part turns to Chapter 11's specific approach for solving the hold-up problem associated with financial distress.[216] It first starts with a general

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litigation that was sufficiently related to the debtor and when not granting the stay could allow one party to derail the reorganization proceedings).

211. See Baird et al., Bankruptcy Partition, supra note 70, at 1688 (raising the possibility of requiring such a payment).

212. Ayotte et al., supra note 45, at 265–71 (describing various disputes over intercreditor agreements).

213. Prior work shows that parties can use intercreditor agreements to extract value from the debtor's estate. See id. at 284–85; see also ABI's 200th Podcast Features Judge and Academics Discussing Side Agreements in Corporate Bankruptcy, at 27:48, Am. Bankr. Inst. (Apr. 17, 2017), https://www.abi.org/podcasts/abis-200th-podcast-features-judge-and-academics-discussing-side-agreements-in-corporate (on file with the *Columbia Law Review*) [hereinafter ABI Podcast with Judge Shannon] (speaking with Judge Brendan Shannon, who notes that parties use intercreditor agreements to extract windfalls).

214. Ayotte et al., supra note 45, at 287–90.

215. Id.

216. Some relationships that connect to financial distress do not fall under the scope of Chapter 11—although the New Bargaining Theory suggests that they should. The ways that those relationships play out provide powerful examples of the incomplete contracting problem and the potential value of the bankruptcy solution. For example, the credit default swaps market is full of examples of ex post hold up. See, e.g., Matt Levine, Direct Listings Are a Thing Now, Also Bathroom Meetings, Sears CDS and Bank Culture, Bloomberg Op.

description of Chapter 11's renegotiation framework, showing how it implements the New Bargaining Theory. It then presents examples of the framework in action. Finally, it concludes with a note about how Chapter 11's renegotiation framework balances the conflicting ex ante and ex post considerations that lie at the heart of the New Bargaining Theory.

A. *General Description*

Consistent with the New Bargaining Theory, Chapter 11 treats the relationship between those who have an interest in a financially distressed debtor as governed by an incomplete contract.[217] Where there is little reason to suspect that terms will misfire—because the parties had full ex ante information or because the efficient outcome is not affected by contingencies—the law takes those terms as they are and enforces them.

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

Where the terms might be expected to misfire, Chapter 11 implements a structured renegotiation framework.[218] Rather than fill the gaps with specific substantive provisions or remove incomplete terms, the Code uses a set of parameters to encourage renegotiation and limit the parties' incentives and opportunities to engage in hold up.[219]

In some sense, the system is filling in the gaps in these contracts, but instead of having a judge do it, the parties negotiate the gap-filling terms applicable in distress under the court's oversight and within the law's parameters.[220] Chapter 11 sets up substantive and procedural guardrails

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(Jan. 11, 2019), https://www.bloomberg.com/opinion/articles/2019-01-11/direct-listings-are-a-thing-now [https://perma.cc/N8WH-65A8] (noting the ex post manipulation of bond prices that are used in calculating payouts from credit default swaps related to the Sears bankruptcy and explaining the difficulty in writing a better ex ante contract); Matt Levine, RadioShack Is Running on Credit Derivatives, Bloomberg Op. (Dec. 18, 2014), https://www.bloomberg.com/opinion/articles/2014-12-18/radioshack-is-running-on-credit-derivatives [https://perma.cc/56BQ-UY4M] (same for RadioShack). See generally Andrew Verstein, Benchmark Manipulation, 56 B.C. L. Rev. 215 (2015) (exploring ex post benchmark manipulation).

217. See supra Part II.

218. See 11 U.S.C. §§ 1101–1195 (2018).

219. The specific contours of the structure can be found throughout Chapter 11 and include committee representation, id. § 1102; the creation of creditor classes, id. § 1122; disclosure and solicitation rules, id. § 1125; voting rules, id. § 1126; the exclusive power of the debtor to propose a plan, id. § 1121; minimum plan requirements such as feasibility and the best interest of the creditors test, id. § 1129(a); and cramdown rules, id. § 1129(b). Other aspects can be found in judicial interpretations of the Code through case law. These aspects are discussed in detail in this subsection. See infra section III.B.

220. Professors Skeel and Triantis make note of the role of rules and standards and renegotiation in bankruptcy theory, but they place more trust in ex ante contracting than

that are intended to direct the parties toward an optimal bargain with minimal hold up.[221] It consolidates bargaining power by consolidating parties and their interests into classes and other groupings.[222] It then rules out bargaining positions that are either clearly inefficient or are very likely to lead to hold up.[223] Finally, courts subject the parties' renegotiation maneuvers to procedural scrutiny and valuation to limit the possibility of hold up. This is where most of bankruptcy law happens.

In taking this approach, the law accepts that the court cannot know precisely if ex post interventions are efficient.[224] As noted throughout this Article, the idea of what is efficient and inefficient is dynamic. Bankruptcy law takes into account the possibility that rules in bankruptcy will have costs outside of bankruptcy.[225] The key is to measure the benefits of a bankruptcy mechanism against the costs it creates outside of bankruptcy by distorting behavior. Because it is difficult for anyone—and especially courts—to measure these costs and benefits exactly, the law implements a proxy system with bargaining and pricing mechanisms in which parties must either present extreme evidence to support a deviation from a default rule or pay an estimate of a market price in exchange for invoking that deviation.

More specifically, Chapter 11—through specific provisions or the discretion of judges—sets certain default rules and then gives different

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Chapter 11 does. See Skeel & Triantis, supra note 37, at 1816. They offer what might be the strongest normative critique of Chapter 11's renegotiation framework: Bankruptcy law makes the wrong empirical assessment about the difficulty in ex ante contracting and the ability to constrain ex post contracting. Id. This Article is more optimistic that our bankruptcy system usually gets it right. The important point, however, is that the New Bargaining Theory identifies this as *the* key empirical question in assessing Chapter 11. It is a difficult question to answer. Comparing the experiences in markets in other jurisdictions around the world might begin to provide some guidance.

221. See Jonathan C. Lipson, The Secret Life of Priority: Corporate Reorganization after *Jevic*, 93 Wash. L. Rev. 631, 671 (2018) (discussing judicial safeguards and describing the guardrails included in bankruptcy plans pursuant to Chapter 11).

222. See, e.g., 11 U.S.C. § 1122 (classification of claims or interests); id. § 1123(5)(C) (consolidation of debtors).

223. See supra note 219 and accompanying text.

224. Various scholars have recognized this problem. See, e.g., Adler & Triantis, supra note 85, at 582–83 (acknowledging that fire sales can "yield discount prices because the market for the debtor's assets is often illiquid"); Ayotte & Skeel, supra note 12, at 1611–13 (underscoring the possibility of "judicial error" in applying "liquidity-generating rules" that lead to inefficient continuation of a business); Casey & Morrison, supra note 87, at 205 (describing junior creditors taking advantage of judicial error and valuation variance); Skeel & Triantis, supra note 37, at 1783, 1816 (describing how an "agreement to renegotiate may nevertheless be inefficient if it undermines the benefits of the ex ante entitlements"); see also Lucian Arye Bebchuk & Randal C. Picker, Bankruptcy Rules, Managerial Entrenchment, and Firm-Specific Human Capital 2–4 (Coase-Sandor Inst. for L. & Econ., Working Paper No. 16, 1993), https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=1073&context=law_and_economics [https://perma.cc/23K7-C59D] (noting the importance of measuring the ex ante effects of ex post interventions).

225. See infra section III.C.

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

B. *Examples of the Chapter 11 Framework*

This section presents examples of the Chapter 11 Framework in action. It starts with cramdown, a core example that best demonstrates the New Bargaining Theory at work in Chapter 11. It then turns to automatic stays, executory contracts, and critical vendor orders.

1. *Cramdown.* — The New Bargaining Theory functions as a sort of "cramdown for everything." It is analogous to the familiar cramdown provisions of the Bankruptcy Code, especially in how such provisions apply to secured creditors.[226] When a reorganization plan is crammed down on a secured creditor class—that is, when it is confirmed without the consent of that class—it has the effect of eliminating the creditor's right to foreclose on an asset.

Foreclosure rights are ripe for hold up because the parties cannot contract over all of the relevant contingencies involved, like the value of the asset being foreclosed, its importance to the firm's going concern, volatility, information asymmetries that affect the availability of financing for the asset, and the creditor's own liquidity constraints.[227] The Bankruptcy Code therefore grants a debtor the power to alter the default rule and deprive a creditor of its foreclosure right in a plan of reorganization. This ensures that the secured creditor cannot use an incomplete foreclosure contract to hold up the debtor and other creditors by threatening to withdraw a key asset in distress.

But the Bankruptcy Code also imposes constraints on the debtors' power. To deprive a secured creditor of its foreclosure right, a debtor must

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226. The term "cramdown" is used in the bankruptcy practice to describe the imposition of a reorganization plan on a class of creditors without their consent. 11 U.S.C. § 1129(b). A plan can be crammed down on a class of creditors if certain statutory requirements are met. The requirements are set out in Section 1129(b). Id.

227. In particular, these items can all be hard to verify to a court. Thus, even if the parties did try to contract over contingencies based on the value of an asset or a creditor's liquidity, those contracts would be incomplete because when it came time to enforce the provisions, the parties would not be able to prove to the court that the contingency had occurred. See supra note 19 and accompanying text.

do one of three things in a reorganization plan.[228] First, the debtor can give the creditor the proceeds of a sale of the asset if the creditor is allowed to bid in the sale.[229] This ensures that the ultimate buyer values the asset more than the secured creditor, eliminating the debtor's opportunity to use the threat of a sale to extract value from the creditor. The creditor either gets the asset or gets paid more than its subjective value of the asset.

Second, the debtor can "cram down" the secured creditor by providing it with a new lien and payments that are valued against what a new loan on similar terms would cost the debtor on the market.[230] This ensures that cramdown will not give the debtor better than market terms, thus reducing the debtor's incentive and ability to use cramdown threats to extract value in the form of below market terms from the creditor.[231] The only benefit the debtor gets from cramdown is eliminating the transaction costs and asymmetric information problems associated with finding a new loan.[232]

Third, the debtor can provide the creditor with some form of compensation that is the "indubitable equivalent" of the creditors' contract right.[233] This ensures that the court can allow for unusual solutions that are efficient and avoid the possibility of a secured creditor holding up the debtor by insisting on foreclosure when some other better solution is "indubitably" available. That last standard—"indubitable"—imposes a high burden because in most cases the court will not be able to measure the equivalence with precision.[234]

Thus, the parties must negotiate their way to payment, sale, foreclosure, a new lien, or something else. The alternative to a negotiated agreement is in the hands of one party—the party who might be held up by the default rule—who chooses between the default rule or an alteration

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228. 11 U.S.C. § 1129(b).

229. Id. §§ 363(k), 1129(b)(2)(A)(ii).

230. See id. § 1129(b)(2)(A)(i). This is the proper reading of the statute. Casey, Bankruptcy's Endowment Effect, supra note 62, at 149 (arguing that § 1129(b)(2) establishes "a floor for what will qualify as fair and equitable"). The Second Circuit has adopted this approach, but the question is unsettled in the courts. See Momentive Performance Materials Inc. v. BOKF (In re MPM Silicones, L.L.C.), 874 F.3d 787, 800–01 (2d Cir. 2017) (adopting a two-step approach that considers market rates).

231. See *In re MPM Silicones, L.L.C.*, 874 F.3d at 792, 800 (involving a debtor who threatened to cram down an interest rate $150 million below the market rate to extract procedural concessions); Casey, Bankruptcy's Endowment Effect, supra note 62, at 161 (arguing for limiting "opportunistic behavior by requiring the debtor to pay market rates when it opts to cram down a loan").

232. This requires the court to estimate the market value of the new loan. Evidence of that value is often available. See, e.g., In re MPM Silicones, LLC, No. 14-22503-rdd, 2014 WL 4436335, at *11, *25–29 (Bankr. S.D.N.Y. Sept. 9, 2014) (describing methodologies and availability of evidence for determining value).

233. 11 U.S.C. § 1129(b)(2)(A)(iii).

234. Douglas G. Baird & Anthony J. Casey, Bankruptcy Step Zero, 2012 Sup. Ct. Rev. 203, 220 (noting that the court's discretion is limited by the standard of indubitable equivalence to avoid erroneous dilution of a creditor's claim).

subject to paying some value or meeting some burden of proof. Chapter 11 puts in place these guardrails to make certain outcomes easier or harder for parties to force on each other depending on how much the system trusts the court to protect against misbehavior by the party advocating that outcome.[235] Because the debtor has the power to alter the default rule and cram a plan down on creditors—which becomes the alternative to a negotiated agreement—the debtor bears the burden of (1) providing an auction where the creditor is allowed to bid, (2) providing new loan terms that it can prove match the market, or (3) proving that it is providing an indubitable equivalent of the right that is being altered.[236]

2. *The Automatic Stay.* — The automatic stay is one of bankruptcy's central provisions.[237] It directly addresses the classic "collective action" problem.[238] That problem is one particular type of hold up, and the Bankruptcy Code responds to it by implementing default rules along with special altering rules that impose price and evidentiary burdens to reduce the risk of hold up.

The Bankruptcy Code's default rule is that actions to enforce or recover on prepetition claims or to obtain possession of property from the estate are prohibited during bankruptcy.[239] But the Bankruptcy Code allows a party to alter that rule if it can show that its interest is not adequately protected,[240] or where it can show it is enforcing an ownership right in property that is not necessary for the debtor to effectively reorganize.[241]

These rules track the analysis of the Chapter 11 Framework presented above. Because contracts are incomplete, parties have the ability to enforce claims against a debtor in financial distress even when those claims will destroy value. A complete contract would provide specific situations when individual enforcement is allowed because it does not destroy value and specific situations where it is not allowed because it does. But ex ante uncertainty and the cost of strategic bargaining are too high for the parties to write that contract. As a result, parties can use the incompleteness to threaten to enforce claims in a way that will destroy ex post value. That threat allows them to extract value from the estate.[242]

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235. The system operates as a set of altering rules customized to the law's expectations about hold-up behavior. See supra section III.A. See generally Ian Ayres, Regulating Opt-Out: An Economic Theory of Altering Rules, 121 Yale L.J. 2032 (2012) (developing a theory of altering rules).

236. 11 U.S.C. § 1129(b).

237. See id. § 362.

238. See supra section I.A for a discussion of "collective action."

239. 11 U.S.C. § 362(a)(1)–(3), (6).

240. Id. § 362(d)(1).

241. Id. § 362(d)(2).

242. See, e.g., United Airlines, Inc. v. U.S. Bank N.A., 406 F.3d 918, 924–25 (7th Cir. 2005) (noting that a creditor's threat to use a special statutory provision excepting aircraft from the automatic stay would result in "tough bargaining" and allow the creditor to extract

To combat this threat of hold up, the Code's default rule prohibits claimants from exercising their rights.[243] But that default rule itself creates a converse risk of hold up. The debtor can extract value from a claimant by threatening to eliminate its enforcement right with a bankruptcy filing. And so, the Code allows the claimant to alter the default rule by meeting one of the two requirements.[244] First, the claimant can demand adequate protection for its interest from the debtor.[245] This imposes a price of sorts that the debtor must pay to maintain the default rule. That price is set at an amount that ensures that the debtor is not using the automatic stay to extract value from the claimant.[246] Second, the claimant can lift the stay if it can meet a high evidentiary burden of showing that it is enforcing an ownership right that will not have a negative effect on the debtor's reorganization.[247] This amounts to an evidentiary showing that the claimant is not trying to hold up the debtor. If the property is not necessary to an effective reorganization, then the threat to enforce against it has no hold-up value.

3. *Executory Contracts.* — As another example, the Bankruptcy Code implements a similar but more crude approach to the assumption of executory contracts.[248] An executory contract is generally defined as one that is unperformed on each side such that failure by either party "to complete performance would constitute a material breach excusing the performance of the other."[249] These contracts provide ample ground for small acts of hold up.

For example, the debtor may have breached a critical contract on the eve of bankruptcy, perhaps by missing a payment. Pointing to the missed payment, the counterparty might then threaten to walk away from the contract unless the debtor pays a new higher price for the relationship. Where the debtor has invested heavily in the relationship with the counterparty, this threat can be powerful. And even though the walk-away threat might be a mere bluff, if the debtor pays the ransom, the counterparty has succeeded in its hold-up attempt.

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value from the estate); Chrysler LLC v. Plastech Engineered Prods., Inc. (In re Plastech Engineered Prods., Inc.), 382 B.R. 90, 110–11 (Bankr. E.D. Mich. 2008) (refusing to lift the automatic stay where a claimant was threatening an action that would shut down the debtor's business).

243. See 11 U.S.C. § 362(a)(1)–(3), (6).

244. See id. § 362(d).

245. Id. § 362(d)(1).

246. See, e.g., In re Rogers, 239 B.R. 883, 887 (Bankr. E.D. Tex. 1999) (noting that adequate protection is set by a "pragmatic and synthetic" balancing of all relevant factors to determine the risk that the creditor will lose value by the continuation of the stay).

247. 11 U.S.C. § 362(d)(2).

248. See id. § 365. A similar analysis applies to questions about critical vendor orders. See infra section III.B.4.

249. Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439, 460 (1973).

The appropriate solution to this problem would not be to allow the debtor to simply ignore all prior breaches, as that would turn the bankruptcy process into a tool to evade contract law. And so the Bankruptcy Code provides special rules for a debtor to assume the breached contract and bind the other party to perform.[250] But consistent with the Chapter 11's renegotiation framework, the Code requires the debtor to pay a market price to alter the default rules in that way.[251] This price takes the form of a payment to cure past defaults.[252] Because the stakes are lower, precision is not demanded and this price is only an approximate measure of the market.

Bankruptcy law thus allows a debtor to enforce executory contracts that it has breached.[253] This right ensures that the counterparty cannot use a technical breach to hold up the debtor by withdrawing a key agreement from the debtor's relationships. But the debtor must first cure all past defaults.[254] This serves as a price that roughly estimates the market value of the breached contract terms. It ensures that the debtor does not use bankruptcy to hold up the creditor by ignoring the value of substantive obligations in their relationship.[255]

4. *Critical Vendor Orders.* — A final—but related—example is that of critical vendor orders. In the same way that a counterparty to a contractual relationship might walk away from the debtor, so too can a counter party to a *noncontractual* relationship. In those cases, a debtor may then desire to make a market payment to keep that party from walking away.

Critical vendor orders allow the debtor to pay a chosen vendor on prepetition claims—ahead of other creditors—to entice the vendor to continue doing business with the debtor.[256] The result is similar to what happens when a debtor assumes an executory contract under 11 U.S.C. § 365. The relationship continues, and the counterparty gets paid ahead of other creditors. But there are two differences. First, the counterparty has the option of walking away; the debtor cannot coercively extend the relationship. Second, the debtor must meet a higher burden in proving that the vendor is critical.[257]

Chapter 11's renegotiation framework can explain this approach. A relationship counterparty can hold up a debtor by threatening to walk away even when their relationship is not a formal contract. But without the

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250. See 11 U.S.C. § 365.

251. See id. § 365(b)(1)(A).

252. See id.

253. See id. § 365.

254. See id. § 365(b)(1)(A).

255. This analysis suggests a justification for the current rule. It provides a counterargument to Professor Skeel's proposal to do away with the requirement that the debtor cure prebankruptcy defaults. See Skeel, The Empty Idea of "Equality of Creditors," supra note 102, at 721–22.

256. See In re Kmart Corp., 359 F.3d 866, 868, 872 (7th Cir. 2004).

257. Id. at 866.

contract, there is an exacerbated risk of debtor misbehavior. Evidence about the purpose and intended duration of the relationship is scant, and a debtor who could coercively extend the relationship might use a bankruptcy filing to extract value.

To deal with competing risks of hold up, the law on critical vendor orders allows the debtor to pay to extend the relationship over the objection of other creditors—who may themselves be trying to hold up the estate.[258] But the debtor is not allowed to pay too much. If it were, the critical vendor and the debtor could collude to extract value from the other stakeholder. The law thus requires the debtor to make a high evidentiary showing that the payment is efficient and not part of a hold-up scheme.[259]

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Throughout the Code, there are price and burden allocations like this that allow a party to pay a cramdown price of sorts to alter a rule that would otherwise apply. The Code implements this framework where the underlying terms of the parties' relationships are expected to misfire and provide hold-up opportunities. The prices and other limiting principles give the court comfort that the likelihood of abuse by the party altering those terms is low. Within the parameters set by these rights, prices, and limitations, the parties find their negotiating positions and bargain with each other. Thus, Chapter 11 implements default rules and then layers on altering rules[260] in the form of prices or other undertakings required to demonstrate a reduced risk of hold up.[261]

C. *The Balance Between Ex Ante and Ex Post Concerns*

Like the law of general averages, the New Bargaining Theory and Chapter 11's renegotiation framework take into account ex ante incentives. In the admiralty context, one could, of course, achieve the efficient ex post outcome by transferring title to all cargo to the captain (or any decision maker) at the moment the ship hits distress.[262] This would

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258. See id. at 868, 872 (describing when a debtor might be allowed to make critical vendor payments).

259. See id. at 873 ("[I]t is necessary to show not only that the disfavored creditors *will* be as well off with reorganization as with liquidation . . . but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued.").

260. For more on the theory of altering rules, see Ayres, supra note 235, at 2036–46.

261. Examples exist throughout the Bankruptcy Code. Another prominent nonprice example is the requirement that a plan of reorganization have one impaired class of creditors vote in favor of it. 11 U.S.C. § 1129(a)(10) (2018). This is intended to reduce—but certainly does not eliminate—the risk that a proposed plan is an inefficient hold-up maneuver asserted against impaired creditors. This purpose of § 1129(a)(10) is clear. In practice it is not difficult to circumvent and may do very little.

262. In bankruptcy, Professor Adler has made a proposal like this that gives complete ownership to a creditor class when distress hits. See supra note 138 and accompanying text.

efficiently align ex post control and ownership. But few would advocate for that law. The captain would do everything they could to lead the ship to distress and others would be reluctant to even bring cargo onto the ship.[263]

Chapter 11 likewise considers the impact of its interventions on ex ante and predistress incentives. But unlike the law of general averages, it does not implement a blanket rule of average contribution.[264] Rather it encourages the "passengers" to negotiate over their contributions under court supervision and within certain parameters.[265]

In all of this, there is no reason to think interventions that focus on ex post outcomes are per se inefficient. Consider the high-profile bankruptcy of General Growth Properties.[266] To provide a short summary, in 2009, General Growth Properties faced a liquidity crisis.[267] The firm had a profitable business, but it owed balloon payments on loans that it could not refinance in the midst of the Great Financial Crisis.[268] A bankruptcy filing for the whole enterprise—parent and subsidiaries—provided a solution.[269]

There was one problem: The subsidiaries of the business were set up to be bankruptcy remote.[270] The legal structure of the subsidiary entities, their corporate governance documents, and their agreements with lenders ostensibly prevented them from filing for bankruptcy.[271] The parent caused the subsidiaries to file bankruptcy anyway.[272] The creditors of the subsidiary entities challenged this maneuver.[273] In the end, the bankruptcy court allowed the filings notwithstanding the agreements set up to prevent them.[274]

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263. Similarly, few would advocate giving the ownership of all cargo to the poorest passenger when distress arises to achieve general redistributive justice. In addition to being one of the worst possible means for redistributing wealth, this measure would also distort predistress incentives by causing the poorest passenger to favor distress and distort ex ante incentives by driving other passengers out of shipping markets and perhaps leading captains to reject poor passengers altogether.

264. See, e.g., Skeel, The Empty Idea of "Equality of Creditors," supra note 102, at 701 (noting the lack of equality norms in Chapter 11 practice).

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

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

267. Id. at 53–54.

268. Id.

269. Id. at 54–55.

270. Id. at 63–64.

271. Id.

272. Id. at 54–55.

273. Id. at 55.

274. Id. at 69.

The court's ruling in *General Growth* has been criticized for ignoring ex ante contracts in the service of ex post value maximization.[275] Critics predicted that this would lead to an increase in ex ante interest rates as creditors no longer trusted the enforceability of their agreements.[276] There is no evidence that such increase ever occurred.

One might even predict the opposite result. At the end of the day, the General Growth bankruptcy was a great success story.[277] All stakeholders' claims were paid in full, equity retained its value, and the company was successfully reorganized.[278] It might actually demonstrate that courts are good at determining when hard-edged contract terms misfire. Perhaps the case was evidence that courts will ignore those terms if, but only if, someone has made a sufficient showing that the terms are inefficient, that they are being invoked as a hold-up maneuver, that deviating from them won't create hold up on the other side, and that an appropriate pricing mechanism has been implemented.[279] The court may have reached a high

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275. See, e.g., W. Rodney Clement Jr. & H. Scott Miller, *General Growth*: Special Purpose Entities (Barely) Survive First Bankruptcy Test, 25 Prob. & Prop. 31, 34 (2011) (outlining how the court's actions could be perceived as prioritizing the "massive forfeiture [that] was at stake" over "the separateness covenants existing in the loan documentation"); Jesse Cook-Dubin, New York Bankruptcy Court Topples Contractual Barriers to Filing Chapter 11: Part II, 28 Am. Bankr. Inst. J. 16, 16 (2010) (examining the implications of the court "finding good faith notwithstanding the subject debtors' alleged disregard of the SPE and bankruptcy-remote elements in their organizational documents"); Brian M. Resnick & Steven C. Krause, Not So Bankruptcy-Remote SPEs and *In re General Growth Properties, Inc.*, 28 Am. Bankr. Inst. J. 1, 62 (2009) (noting that the case "was viewed by many market participants as inconsistent with the protections thought to be provided to lenders in structured finance transactions involving bankruptcy-remote vehicles in the event of a bankruptcy of their corporate parent").

276. See Resnick & Krause, supra note 275, at 62.

277. Ilaina Jonas, General Growth Cleared to Exit Bankruptcy, Reuters (Oct. 21, 2010), https://www.reuters.com/article/us-generalgrowth/general-growth-cleared-to-exit-bankruptcy-idUSTRE69K41320101022 [https://perma.cc/XD4H-5LMD] (noting the success of the reorganization).

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

279. The court did require some significant proof on these matters. See In re Gen. Growth Props., Inc., 409 B.R. at 63 (noting that the ruling produced "no sacrifice of fundamental rights"); id. at 65 (noting the irony of the opportunistic use of "leverage" by the party trying to enforce the contract terms); id. at 67–70 (repeatedly noting the "good faith" of the debtor); id. at 69 (noting the other bankruptcy measures available to creditors to limit the debtors attempts to hold them up); id. at 55 (noting that the order allowing use of cash "had various forms of adequate protection . . . such as the payment of interest at the non-default rate, continued maintenance of the [subsidiary] properties, a replacement lien on the cash being upstreamed . . . and a second priority lien on certain other properties"). The court may have simply concluded that it was worth saving this one company in this unique set of circumstances because lenders would know that the threshold for such intervention is sufficiently high to avoid market distortions. But counterexamples may appear if courts are not vigilant about hold up. For example, in *In re MPM Silicones, L.L.C.*, the court allowed the debtor to exercise ex post control over interest rates to extract concessions and value from creditors before the opinion was reversed on appeal. Momentive Performance Materials Inc. v. BOKF (In re MPM Silicones, L.L.C.), 874 F.3d 787, 800–01 (2d Cir. 2017).

degree of confidence in its conclusion that the creditors of the subsidiaries were using an incomplete contract to hold up the firm and extract individual gains from the enterprise.

Indeed, if one thinks that bankruptcy disputes are rare relative to the number of firms operating in the market and that Chapter 11's renegotiation framework is good at excluding extreme bad faith positions, then one might conclude that Chapter 11 could interfere with all kinds of nonbankruptcy entitlements to create ex post value without imposing distortionary costs on the market. The actions and statements of judges in recent bankruptcy cases are consistent with this analysis. As one prominent bankruptcy judge recently explained, bankruptcy courts are reluctant to enforce contract terms that allow a creditor to opportunistically extract extra value, noting that "bankruptcy courts have, in a variety of different contexts, struggled mightily and usually successfully to avoid giving a party a windfall."[280]

The question in all of this is how much one trusts the process to identify these things. Chapter 11 relies heavily on the parties and finds comfort when sophisticated parties have bargained vigorously toward an arm's length resolution.[281] And judges do require a high level of confidence before exercising their discretion to achieve ex post value.[282] If this setup fails to identify and address these issues, then Chapter 11 does not work well. If the courts have a good process for ruling out extreme behavior, keeping the parties within the guardrails, and operating within an acceptable margin of error, then Chapter 11 is successful.

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One final and important critique of Chapter 11's renegotiation framework might be that destroying value ex post is actually a good thing. As many—including me—have pointed out, there is a positive disciplining effect from destroying value in bankruptcy.[283] Parties have an incentive to

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280. ABI Podcast with Judge Shannon, supra note 213, at 27:48; see also Lyondell Chem. Co. v. CenterPoint Energy Gas Servs. Inc. (In re Lyondell Chem. Co.), 402 B.R. 571, 594 (Bankr. S.D.N.Y. 2009) ("[T]here will sometimes be a harm requiring judicial intervention where the needs and concerns of other creditors simply trump commercial predictability."); Ayotte et al., supra note 45, at 269–72 (providing a detailed analysis of the RadioShack bankruptcy suggesting that the court may have interpreted contract rights to avoid hold up and facilitate an efficient sale of assets).

281. Ayotte et al., supra note 45, at 286 (noting that the system depends on the bargaining positions of sophisticated creditors to provide benefits to the estate as a whole).

282. See supra note 279 (presenting the thorough nature of the judicial inquiry in the *General Growth* case); see also ABI Podcast with Judge Shannon, supra note 213, at 27:15 (discussing the considerations of bankruptcy judges in dealing with contract terms that present "windfalls" in various cases).

283. See, e.g., Douglas G. Baird & Anthony J. Casey, No Exit? Withdrawal Rights and the Law of Corporate Reorganizations, 113 Colum. L. Rev. 1, 9–10 (2013) (detailing that investors with a withdrawal right will use it as leverage in negotiations during default and managers will consequently have a strong incentive to avoid default).

avoid distress if they will be punished when distress arises.[284] Creditors can use that incentive as a substitute for monitoring the debtor or each other.[285]

One could imagine a rule that allows the use of bankruptcy penalties but only if the court is sure that the penalty clause is a substitute for monitoring. Penalties like this work by making control and payment rights state-contingent.[286] But what if the specifics of that contingency are themselves noncontractible? Defining the different states that trigger the contingency might be very difficult, and that is where the renegotiation framework comes in. Bankruptcy law might treat state-contingent penalty terms as incomplete contracts that may or may not provide the opportunity for hold up depending on how things have played out in a specific case.

There is good reason to think state-contingent penalty terms are, indeed, incomplete. The tradeoff between the value preserved through ex post intervention and the ex ante discipline created by ex post penalties will always be uncertain. To put it another way, which is the first order problem: the ex ante incentives or the ex post coordination?[287] Parties cannot know the answers to these questions when they initially write their contracts. They would have to know the actual cause of distress. For example, can one really posit that General Growth, Kodak, American Airlines, Calpine, Toy "R" Us, Chuck E. Cheese, Hertz, and the like all would have avoided distress if only the decisionmakers had known that bankruptcy would be more severe? On the other side of the equation,

284. See Philippe Aghion & Patrick Bolton, An Incomplete Contracts Approach to Financial Contracting, 59 Rev. Econ. Stud. 473, 486 (1992).

285. See id.

286. See id. at 490–91; Patrick Bolton & David S. Scharfstein, Optimal Debt Structure and the Number of Creditors, 104 J. Pol. Econ. 1, 5–8 (1996) ("[T]he threat of liquidation serves as a way of inducing the manager to pay out cash flow instead of diverting it to himself. If he were to keep the first-period cash flow, the creditor would be given the right to liquidate the assets with [a certain] probability . . . ."); Jaime F. Zender, Optimal Financial Instruments, 46 J. Fin. 1645, 1647 (1991) ("The state-contingent transfer of control relaxes an incentive constraint that would bind if bankruptcy were not allowed, enhancing the value of the firm as a going concern."). This academic theory may play a minor role in practice. The idea assumes that managers will be punished by losing their equity. But managers can be more directly punished through job insecurity, incentive-based pay, or reputational consequences. Moreover, equity is usually wiped out in bankruptcy. Destroying further would harm junior creditors, not equity holders. The prime question in practice is thus whether to penalize junior creditors. But that won't affect managers' incentives directly. Unless junior creditors are calling the shots (at least indirectly through monitoring) before bankruptcy, there is little sense in punishing them after the filing. Of course, if the junior creditors were the optimal monitors, then the penalties on them would be a way for senior creditors to "monitor the monitors."

287. Professor Ayotte's models have flagged a similar problem. See generally Ayotte, Disagreement, supra note 45 (exploring how in complex capital structures, unlocking ex ante value can lead to ex post inefficiencies in the form of valuation disputes); Ayotte, Mandatory Stay of Secured Creditors, supra note 89, at 150–51 (arguing that in order to evaluate the usefulness of legal subsidiaries as pathways around mandatory stays, one must first ask why mandatory stays are valuable in the first place).

would the reorganization values have been much lower if some creditors were allowed to inflict more pain on others when distress arose? The answer is likely different for each debtor.[288] An optimal approach would be to say that if misbehavior is likely to have occurred and may have contributed to the distress, then and only then should reasonable penalty terms be enforceable. And it may be that judges—even though they are not great at knowing exactly how to substantively restructure a company's finances—are pretty good at implementing Chapter 11's renegotiation framework and using its guardrails to detect when distress is a result of poorly disciplined management or uncontrollable market forces, and which penalty terms are worth enforcing.

IV. APPLYING THE NEW BARGAINING THEORY TO FRONTIER ISSUES

As noted above, bankruptcy's cramdown provisions provide a clear example of the New Bargaining Theory at work in Chapter 11's renegotiation framework.[289] Along the way, this Article has also demonstrated the theory's application to simple questions like executory contracts[290] and more cutting-edge problems like third-party releases and intercreditor agreements.[291] But the theory is broadly applicable—one can march through the core features of bankruptcy law to see this.[292] This Part presents two additional examples of how the New Bargaining Theory can resolve questions at the frontier of bankruptcy practice today. It starts with an example where the theory can resolve a recent split among courts and

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288. In the cases mentioned, the causes of distress, the role of management, and the balance between ex ante discipline and ex post value preservation varied widely. For example, Kodak's primary failure was in being too slow to respond to technological change, see Brook E. Gotberg, Technically Bankruptcy, 48 Seton Hall L. Rev. 111, 138 (2017), while Chuck E. Cheese's business was crippled solely by a global pandemic. See Declaration of James Howell in Support of Debtors' Chapter 11 Petitions and Related Requests for Relief, supra note 149, at 9 (noting the pandemic as the cause of financial distress). And while J.C. Penney struggled through the failure of four different management teams with different CEOs in the nine years before it finally filed for bankruptcy, Declaration of Bill Wafford, Executive Vice President, Chief Financial Officer of J.C. Penney Co., Inc., in Support of the Debtors' Chapter 11 Petitions & First Day Motions, supra note 150, at 5, 27, General Growth's bankruptcy was driven primarily by a liquidity crisis associated with financial markets and not operating performance. In re Gen. Growth Props., Inc., 409 B.R. 43, 53 (Bankr. S.D.N.Y. 2009) ("However, in the latter half of 2008, the crisis in the credit markets spread to commercial real estate finance, most notably the CMBS market. This in turn affected the ability of [General Growth] to refinance its maturing debt on commercially acceptable terms."). In contrast, the American Airlines bankruptcy was more complicated, involving residual effects of the events of September 11, 2001, stalled labor negotiations, the earlier restructuring of its major competitors, increased price and price volatility of jet fuel, the effects of the financial crisis of 2008, and other factors. Affidavit of Isabella D. Goren Pursuant to Local Bankruptcy Rule 1007-2, supra note 144, at 6–11.

289. See supra section III.B.1.

290. See supra section III.B.3.

291. See supra notes 208–215 and accompanying text.

292. See supra Part II.

then presents a theoretical approach to a more fundamental question regarding priority rules and the new value exception.

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

Recently, courts have struggled over an ambiguity in the Bankruptcy Code regarding the fate of leases in an asset sale.[293] Section 363(f) of the Code allows the debtor to sell its assets free and clear of a stakeholder's interests.[294] But Section 365(h) provides that even if a debtor rejects a lease, the lessee retains its rights to use and possession under the lease.[295] The question, then, is what happens to a lessee when the debtor sells the leased property under Section 363(f)? Is the sale free and clear of the lease under Section 363(f) or does the lessee retain its rights under Section 365(h) after the sale?

The statutory language is complicated and ambiguous at best, and courts have split on the appropriate reading.[296] The renegotiation framework provides policy guidance. Section 365(h) is addressed at reducing a hold-up threat. Lessees may make very large investments that are specific to their lease. A debtor who can threaten to terminate a lessee by filing bankruptcy has powerful hold-up leverage. As a result, the Bankruptcy Code prohibits that action.[297] It even implements a complex pricing mechanism to balance the dual risks of hold up.[298]

On the other hand, Section 363(f) is also addressed at reducing a hold-up threat. Often the only way to reorganize a debtor is through a free-and-clear sale.[299] To give one lessee the ability to veto that sale would create an enormous hold-up opportunity. Moreover, the sale through a competitive auction—which is itself a market-price test—reduces any risk

293. See Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holdings II, LLC), 872 F.3d 892, 897–98 (9th Cir. 2017) (noting that courts are split on whether a sale under 363(f) can extinguish a lessee's rights to remain in possession of the leasehold, and holding that the sale does extinguish the lessee's rights); Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 548 (7th Cir. 2003) (holding that a sale under 363(f) extinguished the lessee's possessory interest); Dishi & Sons v. Bay Condos LLC, 510 B.R. 696, 702–07 (S.D.N.Y. 2014) (highlighting the court split and concluding that a sale does not extinguish the lessee's possessory interest except in limited circumstances).

294. 11 U.S.C. § 363(f) (2018).

295. Id. § 365(h)(1)(A)(ii).

296. See In re Zota Petroleums, LLC, 482 B.R. 154, 160 (Bankr. E.D. Va. 2012) (providing an overview of contrasting approaches to the interplay between sections 363(f) and 365(h)).

297. 11 U.S.C. § 365(h)(1)(A).

298. Id. § 365(h)(1)(A)–(B) (establishing that the lessee must pay rent, can offset any damages caused by the debtor's nonperformance of obligations, but does not otherwise have a right to collect those damages).

299. Id. § 363(f)–(g).

that the debtor is attempting to hold up the lessee.[300] While it is likely that a debtor might use a bankruptcy filing to terminate a lease, it is much less likely that it would sell its business to do so. Thus, as long as there is no evidence that sale is a sham, the rule that best constrains hold up on both sides is one that allows a sale free and clear of leases with appropriate market tests and compensation requirements.

B. *Major Questions: Priority Rules and the New Value Exception*

The *Butner* Fallacy and the Creditors' Bargain are probably most pernicious when it comes to debates about priority rules in bankruptcy. Priority rules dictate the order in which creditors are paid from the value that results after a bankrupt debtor is reorganized.[301] In theory, the current bankruptcy system requires "absolute priority," which means that creditors are paid strictly in order of their nonbankruptcy priorities as if the firm was being liquidated.[302] In reality, absolute priority is a rough guideline from which outcomes often deviate.[303]

For decades, scholars have argued about whether absolute priority is essential to a properly functioning bankruptcy system. Some scholars have proposed an alternative regime known as "relative priority," which would allow junior creditors to share in the future value of the reorganized debtor.[304] The American Bankruptcy Institute has recently entered the fray with a proposal to adopt its own version of relative priority.[305]

Too often the debates about these priority schemes devolve into an inquiry about nonbankruptcy entitlements and whether one rule is required by the Creditors' Bargain. The conventional argument for absolute priority is that the only way to respect nonbankruptcy entitlements is to pay the creditors as if the debtor firm is being

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300. The Code also includes a catchall provision allowing the court to intervene where the sale is suspect. See id. § 363(e) (directing the court to prohibit a sale "as is necessary to provide adequate protection" of a stakeholder's interest).

301. See Baird, Priority Matters, supra note 30, at 786–87 ("If one creditor has priority over another, this creditor needs to be paid in full before the other is entitled to receive anything.").

302. Walter J. Blum & Stanley A. Kaplan, The Absolute Priority Doctrine in Corporate Reorganizations, 41 U. Chi. L. Rev. 651, 652 (1974) ("[B]efore a class of investors can participate in a reorganization, all more senior classes must be compensated in full for their claims, measured on the basis of their priorities upon involuntary liquidation . . . .").

303. See Bebchuk & Fried, supra note 52, at 911–13 (noting the deviations from absolute priority); Roe & Tung, supra note 31, at 1269 (describing the importance of modern priority jumping schemes over absolute priority guidelines).

304. See, e.g., Baird, Priority Matters, supra note 30, at 789–806 (describing relative priority and its appeal).

305. Comm'n to Study the Reform of Chapter 11, Am. Bankr. Inst., 2012–2014: Final Report and Recommendations 208–09 (2014), https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h [https://perma.cc/WV8H-8CSU] [hereinafter ABI Report].

liquidated.[306] Others have countered that absolute priority unnecessarily terminates junior investors' future interests even though the debtor is not actually liquidated.[307] A relative priority system that kept those future interests alive might, they argue, be more consistent with the Creditors' Bargain.[308]

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

As this Article demonstrates, the New Bargaining Theory provides that bankruptcy law should implement a default rule that can be altered subject to pricing mechanisms and evidentiary burdens. The most obvious default rule—which is consistent with either absolute or relative priority—is that the debtor must pay a senior secured creditor at least what that creditor would have received in a nonbankruptcy foreclosure.[309] Setting that rule ensures that the debtor cannot hold up senior creditors by threatening bankruptcy as a means to underpay them.[310]

But—within a coherent renegotiation framework—this baseline can be altered if the debtor meets certain requirements. A proper priority rule

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306. See Barry E. Adler & Ian Ayres, A Dilution Mechanism for Valuing Corporations in Bankruptcy, 111 Yale L.J. 83, 88–90 (2001) (describing the desirability of absolute priority systems that uphold contractual agreements); Jackson, Non-Bankruptcy Entitlements and the Creditors' Bargain, supra note 3, at 869 (arguing that the Creditors' Bargain "requires respecting a secured creditor's ability to be paid first"); Alan Schwartz, A Normative Theory of Business Bankruptcy, 91 Va. L. Rev. 1199, 1202 (2005) (summarizing early theories justifying absolute priority).

307. See Baird, Priority Matters, supra note 30, at 792–93 (arguing that relative priority systems provide "the most sensible division of value"); Anthony J. Casey, The Creditors' Bargain and Option-Preservation Priority in Chapter 11, 78 U. Chi. L. Rev. 759, 764–65 (2011) [hereinafter Casey, Creditors' Bargain] (criticizing the destruction of future value under the absolute priority rule); Jacoby & Janger, Ice Cube Bonds, supra note 12, at 913 (noting that sales under absolute priority terminate junior creditors' interest in the future value of the firm); Jacoby & Janger, Tracing Equity, supra note 12, at 678–81 (arguing against absolute priority and in favor of a relative-priority-like "equitable realization" based on nonbankruptcy entitlements).

308. See, e.g., Casey, Creditors' Bargain, supra note 307, at 773 ("[An absolute priority regime] alters the nonbankruptcy rights of the creditors[,] . . . act[ing] as a razor's edge that collapses all future possibilities to present value.").

309. I have argued elsewhere for this baseline payment as part of a relative priority mechanism. Id. at 765.

310. This analysis suggests that a recent controversial case was wrongfully decided. The court in *In re Sunnyslope Housing Ltd. Partnership* interpreted the Bankruptcy Code to allow the debtor to confirm a plan that left the secured creditor holding a lien that was worth less than the foreclosure value of its claim. See First S. Nat'l Bank v. Sunnyslope Hous. Ltd. P'ship (In re Sunnyslope Hous. Ltd. P'ship), 859 F.3d 637, 646 (9th Cir. 2017).

might include exceptions for rare cases when one party can show that another party is indubitably asserting its priority rights as part of a hold-up threat. Another exception might allow small deviations when the parties advocating them can show—by evidence or market tests—that those deviations are efficient and not part of a hold-up attempt.

The "new value exception" to priority that courts apply in Chapter 11 matches that last category of exceptions. The new value case law provides that old equity owners of an insolvent firm can only take a stake in the reorganized firm if they pay for that stake and if the payment is market tested.[311] Once again, the rule operates to curb hold up on both sides. Old equity owners often exercise control in the bankruptcy process, especially in smaller firms where they serve as managers. There is a constant risk that they will use that control to hold up other stakeholders. On the flip side, the owners, managers, and founders of a debtor firm might be valuable components of its going concern, and it might be in the interest of the whole estate to include them in the reorganization. If one creditor could absolutely veto the owners' involvement going forward, that creditor would possess a threat to derail the whole process. By allowing the owners' involvement only after a robust market test, the new value exception implements Chapter 11's renegotiation framework to navigate between these two threats.[312]

Notably, the priority guidance in this Part provides a range of solutions that might take the form of modified absolute or relative priority. The key takeaway is that the New Bargaining Theory does not require one specific form of priority. Rather it simply gives us parameters or guardrails

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311. See Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 457–58 (1999) (holding that plans allowing former owners to acquire new equity "free from competition and without benefit of market valuation" violate the absolute priority rule); Douglas G. Baird & Robert K. Rasmussen, Boyd's Legacy and Blackstone's Ghost, 1999 Sup. Ct. Rev. 393, 419 (summarizing case law on the new value exception). See generally Randolph J. Haines, The Unwarranted Attack on New Value, 72 Am. Bankr. L.J. 387 (1998) (describing the new value exception).

312. This analysis is important for bankruptcy systems in other countries as well. For example, questions about new value and owner involvement in reorganization have been front and center in debates about bankruptcy reforms in India. After India introduced its bankruptcy reform in 2016, there was concern that owners were planning to use their control of the firm to hold up creditors and remain in control of firms after reorganization. See Deepshikha Sikarwar, Big Tweak in Insolvency Law on Cards, Defaulters May Be Barred from Bidding, Econ. Times, https://economictimes.indiatimes.com/news/economy/policy/big-tweak-in-insolvency-law-on-cards-defaulters-may-be-barred-from-bidding/articleshow/61634341.cms [https://perma.cc/U7PZ-ZTY6] (last updated Nov. 14, 2017). In response, the government amended the statute to prohibit the original owners of a firm from participating in the reorganization. Samanwaya Rautray, Supreme Court Upholds Bankruptcy Code, Rejects Promoters' Challenges, Econ. Times, https://economictimes.indiatimes.com/news/economy/policy/supreme-court-upholds-insolvency-law-in-entirety/articleshow/67683544.cms [https://perma.cc/FKQ4-DSGN] (last updated Jan. 26, 2019). Litigants challenged the controversial provision's validity in court. Id. On January 25, 2019, the Indian Supreme Court upheld the validity of the entire bankruptcy law including the amendment. Id.

within which any chosen priority regime must operate. Notably, the American Bankruptcy Institute's relative priority proposal does not explicitly include a requirement that the debtor's estate pay senior creditors an amount equal to the nonbankruptcy liquidation value of their claims.[313] Without that requirement, it is inconsistent with the New Bargaining Theory and the renegotiation framework.

CONCLUSION

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

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

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

313. ABI Report, supra note 305, at 208–09, 218 ("[A] chapter 11 plan may be confirmed over the non-acceptance of a senior class of creditors, even if the senior class is not paid in full within the meaning of the absolute priority rule . . . .").

courts, like settlements,[314] gifting,[315] debtor-in-possession financing,[316] and opt-out mechanisms.[317]

The strong normative claim of this Article is that bankruptcy law's proper purpose is to solve the hold-up problem. The descriptive claim is that Chapter 11 attempts to do this by implementing a structured renegotiation framework. A remaining normative question is whether Chapter 11 succeeds at this purpose. This Article's main contribution is to help identify the metrics by which to answer that question. Future empirical research should test whether (1) Chapter 11 does in fact reduce hold-up costs and (2) whether it does better than alternative regimes. The answers may depend on the competency of bankruptcy judges, the appropriateness of the law's guardrails, and simply how good the parties are at exploiting hold-up opportunities. No doubt, these questions will also require comparative studies of the existing and emerging frameworks implemented by other jurisdictions.

One hopes that Chapter 11 does reduce hold up, at least compared to a bankruptcy state of nature. It is worth noting, however, that such a claim will only be true if courts have the ability to accurately set or market test the necessary prices within the framework. Throughout, this Article discusses pricing mechanisms by which the courts test the efficiency and hold-up risks associated with certain decisions. For those price tests to work, the court needs to value the relevant assets, claims, and outcomes. This may be the Achilles heel of Chapter 11's renegotiation framework.

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314. See, e.g., Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 981–83 (2017). In addressing the question of whether a debtor can agree to receive a settlement payment that requires it to alter the payment priority of creditors, the Supreme Court narrowly ruled that such alterations are prohibited when they are part of a dismissal order or other final disposition of the case. Id. at 984–86. Consistent with the analysis throughout this Article, final dispositions are likely to be the situations where hold-up risk is at its highest. The Court left open the possibilities of interim alterations where the hold-up risk is lower and where the debtor can meet an evidentiary burden of showing that the alteration "would 'enable a successful reorganization and make even disfavored creditors better off.'" Id. at 985 (quoting In re Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004)). Consistent with the New Bargaining Theory's focus on relationship-specific investments, the Court also pointed out that the prohibited alterations "do[] not preserve the debtor as a going concern . . . [and] do[] not protect reliance interests." Id. at 986.

315. See In re ICL Holding Co., Inc., 802 F.3d 547, 555 (3d Cir. 2015) (allowing side payments, or gifts, when the funds did not come from the bankruptcy estate and thus were not subject to the distribution priority rules).

316. See Transcript of Final Hearing on Motion for Post-Petition Financing Before the Honorable Robert E. Gerber Chief U.S. Bankruptcy Judge at 732–40, In re Lyondell Chem. Co., No. 09-10023 (REG) (Bankr. S.D.N.Y. Feb. 27, 2009) (approving a debtor-in-possession loan that included extreme terms drastically altering nonbankruptcy rights and shifting power to creditors because it was evident that no other source of funding existed and the alternative was liquidation).

317. See Franchise Servs. of N. Am., Inc. v. U.S. Tr. (In re Franchise Servs. of N. Am., Inc.), 891 F.3d 198, 209 (5th Cir. 2018) (approving a structure that allowed one equity stakeholder the power to veto a bankruptcy filing without discussion of the possibility of hold up or the impact that such veto would have on renegotiation).

Judicial valuation is messy and imperfect.[318] That said, it is not completely broken, and it can be fixed.[319] If anything, the analysis presented here highlights the importance of research and reform agendas that focus on valuation procedures and methodologies as the key to improving the functioning of Chapter 11.

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318. See Kenneth Ayotte & Edward R. Morrison, Valuation Disputes in Corporate Bankruptcy, 166 U. Pa. L. Rev. 1819, 1845–46 (2018) ("Our quantitative analysis demonstrates that disagreement about valuation is large and pervasive."); Anthony J. Casey & Julia Simon-Kerr, A Simple Theory of Complex Valuation, 113 Mich. L. Rev. 1175, 1177 (2015) ("It is no secret that courts are ill equipped to perform complex valuations—at least on their own."); Diane Lourdes Dick, Valuation in Chapter 11 Bankruptcy: The Dangers of an Implicit Market Test, 2017 U. Ill. L. Rev. 1487, 1501 [hereinafter Dick, Valuation in Chapter 11] ("Of course, judicial valuation is admittedly a costly and imprecise exercise . . . ."); Keith Sharfman, Valuation Averaging: A New Procedure for Resolving Valuation Disputes, 88 Minn. L. Rev. 357, 358–60 (2003) ("[C]ourts are ill-equipped to assess expert valuation evidence and end up adopting arbitrary, unpredictable valuations that fall somewhere between the widely divergent values offered by the parties.").

319. See Casey & Simon-Kerr, supra note 318, at 1198–210 (proposing a new approach to judicial valuation); Dick, Valuation in Chapter 11, supra note 318, at 1501–02 (considering proposals to improve valuation); Sharfman, supra note 318, at 372–77 (describing how the concept of valuation averaging could work in a variety of contexts).