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The Bankruptcy Partition

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ARTICLE

THE BANKRUPTCY PARTITION

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Many current bankruptcy debates—from critical vendor orders to the Supreme Court’s decision last year in Czyzewski v. Jevic Holding Corporation—begin with bankruptcy’s distributional rules and questions about how much discretion a judge should have in applying them. It is a mistake, however, to focus on distributional questions without first identifying the bankruptcy partition and ensuring it is properly policed. What appear to be distributional disputes are more often debates about the demarcation of the bankruptcy partition and the best way to police it.

Once the dynamics of establishing and policing the bankruptcy partition are taken into account, there is little room for departures from bankruptcy’s distributional rules. There might be a few rare cases in which maximizing the value of the estate requires it, but these inhabit an exceedingly narrow domain so small and so hard to navigate that they are sensibly handled with a per se rule that prohibits them.

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INTRODUCTION

The central ambition of Chapter 11 is to vindicate the creditors' bargain.¹ By the common account, if those who contribute capital to a firm could bargain among themselves, they would agree on a set of rules that would maximize value. As a group, they prefer more to less. There is, however, an important qualification to this idea. When investors gather to invest in a common venture, their focus is on maximizing the value of that venture, rather than maximizing their total wealth as a group. The creditors' bargain is similarly focused on the bankruptcy estate, something that is partitioned from the other interests of the creditors. The ambition of bankruptcy law is to put in place a process that maximizes its value.

At first approximation, the assets inside the bankruptcy partition are easy to define. The assets available to the general creditors of a common debtor in bankruptcy are those available to them outside.² The bankruptcy judge has no

¹ See, e.g., Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 862 (1982). We use this standard nomenclature, even while recognizing that the phrase is somewhat misleading because the bargain in question includes not just creditors, but shareholders as well. Both contribute capital to a common enterprise and, before the fact, each wants the managers of the firm to maximize the value of the enterprise across all states of the world. Modern finance teaches that "debt" and "equity" are only useful labels for common configurations of cash flow, control, and priority rights. There is no fundamental difference between them.

² This is the effect of 11 U.S.C. § 541(a) and § 544(a). These constitute the bulk of the bankruptcy estate, but added to the bankruptcy estate under § 547 are also assets transferred on the eve of bankruptcy on account of antecedent debts. The ability to retrieve such preferential payments

power to bring other assets into the estate merely because appropriating such assets would make the creditors better off. Moreover, everyone's focus is supposed to be on maximizing the value of the assets in the estate and not on how decisions might improve the outside assets or fortunes of the stakeholders.

Also inside the bankruptcy partition is a forum—the bankruptcy court—that resolves the rights of stakeholders. This process can extend beyond disputes about assets of the bankruptcy estate proper. Secured creditors must, for example, sort out their rights to their collateral as part of the bankruptcy process. Although bankruptcy respects nonbankruptcy entitlements, the rights of secured creditors, as well as those of others, are assessed according to “chancery methods.”³ Secured creditors can be forced to give up their rights to their collateral and to take something else in its stead, provided they receive its “indubitable equivalent.”⁴ Similarly, the bankruptcy court routinely enforces subordination agreements that creditors strike between themselves and uses its own procedures in the process.⁵

Establishing exactly which rights are sorted out in the bankruptcy forum requires line-drawing. Claims a creditor has against the debtor are almost always resolved in bankruptcy. Rights two creditors have against each other that are unrelated to their stake in a common debtor are not.⁶ Other matters are less clear. It is important, however, to ensure that sorting out rights among stakeholders in the bankruptcy forum does not bring benefits to general creditors that they would not receive outside of bankruptcy. They should not enjoy “a windfall merely by reason of the happenstance of bankruptcy.”⁷

This paper shows how focusing squarely on the bankruptcy partition sheds light on many debates about modern bankruptcy practice. Part I of the paper looks more closely at the assets and processes that take place inside bankruptcy. By doing so, it suggests how courts should approach a number of important questions—in particular third-party releases, which provide the bankruptcy court with the ability to release one party from liability to another as part of a larger plan to resolve the debtor's affairs.

prevents destructive asset grabs when bankruptcy is on the horizon. The trustee also has the power to bring in assets using the bankruptcy's own fraudulent conveyance powers, but the overlap between this power and the ability to use state fraudulent conveyance law is quite close. It is best understood as a sensible way to approximate a nonbankruptcy cause of action enjoyed by the creditors, rather than as a bankruptcy-specific substantive power in its own right.

³ See *Katchen v. Landy*, 382 U.S. 323, 337 (1966) (identifying bankruptcy courts as courts of equity).

⁴ 11 U.S.C. § 1129(b)(2)(A)(iii) (2012).

⁵ See 11 U.S.C. § 510(a) (2012) (“A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.”).

⁶ See 28 U.S.C. § 1334 (2012) (stating that bankruptcy jurisdiction is limited to civil proceedings “arising under title 11, or arising in or related to a case under title 11”).

⁷ *Butner v. United States*, 440 U.S. 48, 55 (1979) (quoting *Lewis v. Mfr. Nat. Bank of Detroit*, 364 U.S. 603, 609 (1961)).

Part II explores how the bankruptcy judge must police the bankruptcy partition in a fashion that ensures that the value of the estate's assets is protected and that wasteful rent-seeking is minimized. In the process, it explicates bankruptcy's longstanding prohibition on "gifting," a practice in which senior stakeholders divert value from themselves to others during the course of the bankruptcy process. Focusing on the need to police the bankruptcy partition also sheds light on such doctrines as vote designation, rights offerings, and equitable subordination.

Part III examines transactions that cross the partition. When the trustee seeks to maximize the value of the estate, she necessarily must transact with parties who hold assets outside the bankruptcy partition, including parties who are also prepetition creditors. Transactions benefiting the estate that involve assets outside the bankruptcy partition will, like any other mutually beneficial transaction, leave the party with assets on the other side of the partition better off as well. That the other party happens to be a prepetition creditor is not, on its own, reason to forbid it. But when a prepetition creditor is also a postpetition actor, opportunities for strategic behavior arise, and rules need to be put in place to minimize them. This perspective gives purchase on current controversies about critical vendor orders, roll-ups, settlements, and other postpetition transactions between the debtor and prepetition creditors.

Focusing on the bankruptcy partition largely moots a question that has recently been hotly debated both in the courts and in the academy: whether the bankruptcy judge should enjoy the discretion to depart from bankruptcy's distributional rules.⁸ Once the dynamics of establishing and policing the bankruptcy partition are taken into account, there is little room for departures

⁸ A case before the Supreme Court explored whether the bankruptcy judge has discretion to depart from bankruptcy's distributional rules at the end of the case. See *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017) (holding that a bankruptcy court did not have the discretion to deviate without consent from the distribution scheme normally associated with a Chapter 11 dismissal). It has generated extensive academic commentary. See generally Richard M. Hynes & Steven D. Walt, *Inequality and Equity in Bankruptcy Reorganization*, KAN. L. REV. (forthcoming 2018) (demonstrating that Pareto improvements, recently approved of as a standard for standard priority departures, appear in tests governing other types of departures); Jonathan C. Lipson, *The Secret Life of Priority: Corporate Reorganization After Jevic*, 90 WASH. L. REV. (forthcoming 2018) (assessing the framework put forth in *Jevic*); see also Stephen J. Lubben, *The Overstated Absolute Priority Rule*, 21 FORDHAM J. CORP. & FIN. L. 581 (2016) (questioning the existence and validity of an absolute priority rule); Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235 (2013) (exploring the centrality of fixed priority in bankruptcy proceedings and exploring incidents and implications of priority jumping); David A. Skeel, *The Empty Idea of "Equality Among Creditors"* 166 U. PA. L. REV. 699, 701 (2017) ("[I]f we look at current bankruptcy practice, creditor equality seems to be rapidly disappearing. Bankruptcy courts often bless arrangements that give one group of general creditors starkly different treatment than other groups.").

from bankruptcy's distributional rules.⁹ There might be some cases in which maximizing the value of the estate requires them, but these inhabit an exceedingly narrow domain so small and so hard to navigate that they are sensibly handled with a per se rule.

I. THE CREDITORS' BARGAIN AND THE BANKRUPTCY ESTATE

Thinking about bankruptcy policy sensibly begins with asking what creditors as a group would have agreed upon if they had been able to bargain with one another before the fact. Commentators often tacitly assume that bankruptcy law is built around the idea that creditors would agree to maximize their joint welfare, but this is too simple. The Bankruptcy Code focuses only on the assets of the estate itself and is designed to ensure that these assets bring the most value possible consistent with nonbankruptcy law. The trustee must try to maximize the value of what falls inside the bankruptcy partition, the line that separates the estate from the rest of the world.¹⁰

⁹ Much of the commentary couches the problem as one of whether there should be departures from bankruptcy's absolute priority rule, but nothing in our claim that departures from distributional rules should not be permitted turns on the absolute priority rule or any other distributional rule that bankruptcy law puts in place. It would apply equally, for example, to a regime that preserved the option value of junior creditors. For a discussion, see Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2011). It would also apply if there were no rank-ordering of creditor claims, and if it were simply a question of departing from bankruptcy's long-time pro rata sharing rule.

¹⁰ 11 U.S.C. § 541(a) (2012) (laying out what property may comprise the estate). In describing the bankruptcy partition, we are making a largely positive observation about existing bankruptcy law. We suggest why it makes sense to establish the bankruptcy partition and to focus on maximizing the value of what is inside, but our observations in the first instance are positive rather than normative. It might be possible to argue that, as a normative matter, the trustee should take into account the interests of creditors apart from the bankruptcy partition in a fashion analogous to some arguments about how boards should maximize shareholder welfare rather than the market value of the firm.

These debates typically arise in the context of corporate social responsibility. For example, if shareholders as a group are environmentally conscious, they might want the board to reduce pollution more than legally required even if it means lower profits. Such a decision might leave the shareholders better off than they would be if the higher profits were turned over to them and the shareholders then spent them on activities that promoted the environment. For a rigorous analysis, see Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L. FIN. & ACCT. 247 (2017).

Nothing about these sorts of arguments is limited as a theoretical matter to corporate social responsibility. Any activity that improves the welfare of investors more than it reduces the value of the firm (or the bankruptcy estate) might in theory be something investors would favor in their ex ante bargain. A critical issue, however, is whether the decisionmakers are capable of assessing these costs and benefits. Our strong intuition is that performing such a calculus is well beyond what can reasonably be expected.

A. *The Bankruptcy Partition and the Bankruptcy Estate*

Asset-partitioning is central to the modern account of the firm.¹¹ Investors are better off when they can contribute capital to a discrete pool that is used for defined projects. The investor wants to limit her own liability if the project is unsuccessful, and, more importantly, wants to be able to monitor the fate of this project independent of all the other projects that fellow investors might have. The directors of a corporation are, thus, charged with maximizing the value of the firm itself.¹² Those directors are not to take into account how actions they take at the firm benefit themselves—indeed, to do so would violate their duty of loyalty to the firm—or other parties in some other way. Focusing narrowly on the firm itself creates a risk of losing some projects that might be in the collective interests of all the stakeholders, but these losses are more than offset by the way the partition reduces monitoring costs.

Bankruptcy law embraces this idea of asset partitioning. It works somewhat differently than asset-partitioning in the context of corporate law, however. Most significantly, the bankruptcy process sometimes resolves disputes among stakeholders even when the disputes do not involve assets that belong to the bankruptcy estate. There is a need to partition those disputes that are heard within the bankruptcy process from those that are not. There is no ready analogue in the context of an ordinary business entity, but the basic idea is the same. Directors of a corporation are charged with maximizing the value of the firm independent of the consequences for different investors with respect to other projects. The bankruptcy trustee (or, as is most often the case in Chapter 11, the debtor in possession) is charged with ensuring the most value is obtained from the assets of the estate without regard to how doing this affects the outside interests of the creditors.¹³

In the hypothetical creditors' bargain, creditors recognize that it is not possible to establish a relationship in which the benefits of every possible mutually beneficial deal among them is vindicated. Nor is it realistic for the bankruptcy process itself to account for all the possible effects that a reorganization might have for the welfare of the parties. To the extent

¹¹ See generally Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000) (examining the role of organizational law as establishing asset-partitioning as a set of rights for all creditors). For an excellent discussion of asset-partition and organizational law, including its connection with bankruptcy, see Morgan Ricks, *Organizational Law as Commitment Device*, 70 VAND. L. REV. 1303, 1345-47 (2017).

¹² Of course, the obligation of directors to maximize the value of the firm is implemented in a way that limits second-guessing. They enjoy the benefit of the business judgment rule, and creditors can bring derivative actions against them only when the firm is insolvent.

¹³ See *In re Innkeepers USA Tr.*, 442 B.R. 227, 235 (Bankr. S.D.N.Y. 2010) (declaring "it is 'Bankruptcy 101' that a debtor and its board of directors owe fiduciary duties to the debtor's creditors to maximize the value of the estate").

creditors and other stakeholders want to realize other benefits or pursue other rights, they must do so outside the bankruptcy process or rely on their ability to strike entirely consensual bargains with each other during the course of the bankruptcy itself.¹⁴

The judicial inquiry becomes unmanageable if parties can justify transactions based on indirect benefits running to any stakeholder in any capacity. Imagine a debtor has to choose a new product line. It has two options. One choice indirectly benefits a creditor who happens to sell a product that is complementary to the first line, and the other choice benefits another creditor who happens to sell a different product that is complementary to the second line. The trustee is poorly equipped to trade off such benefits against each other. Things become even more complicated if we consider stakeholders who are also competitors or have investments that are equivalent to short positions in the debtor.

To avoid the mess of sorting through these scenarios, the Bankruptcy Code forces the trustee to attend to the assets of the bankruptcy estate and ensure they are put to their best use. The bankruptcy judge ensures that the trustee (or the debtor in possession) maintains this focus, and she resolves only those disputes that are sufficiently related to the collective proceeding so that the creditors as a group are better off if it is resolved as part of the bankruptcy process. Limiting the focus of bankruptcy in this fashion both makes things manageable and reduces the ability of creditors to behave strategically.

Once the focus is on the estate, the task is to maximize its value. There may also be distributional consequences that flow from decisions about how to use assets within the estate. Most obviously, senior investors favor safer projects and junior investors riskier ones. These tensions between junior and senior investors are pervasive.¹⁵ The Bankruptcy Code does have rules that mitigate these conflicts and prevent the tension from arising in the first

¹⁴ We refer here to consensual bargains that are outside the partition. Some agreements among a group of creditors may be within the partition in that they distort the bankruptcy and therefore violate the principles behind the creditors' bargain. See, e.g., Kenneth Ayotte, Anthony J. Casey, & David A. Skeel, Jr., *Bankruptcy on the Side*, 112 NW. U. L. REV. 255 (2017) (exploring how intercreditor agreements and other ex ante side agreements among creditors can distort the bankruptcy process and destroy value for the estate); Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593 (2017) (exploring how restructuring support agreements and other agreements among stakeholders can distort the bankruptcy process).

¹⁵ The problem exists whenever those making the decisions do not bear all the costs and enjoy all the benefits of their decisions. Identifying agency costs is a central feature of modern finance. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305 (1976) (introducing the concept of agency costs, describing how they can arise as a result of debt and outside equity, and demonstrating who bears them and why).

instance. For example, the right of a secured creditor to insist on adequate protection has the effect of internalizing the costs of a risky project on the junior investors.¹⁶ But these tensions cannot be eliminated altogether, and to the extent they persist, no particular group's interests take precedence.¹⁷ The focus remains on maximizing the value of the estate, and this works to the benefit of all the creditors over the long run. Those affected adversely are protected to the extent they can make *ex ante* adjustments to compensate themselves for the distributional consequences *ex post*.¹⁸

The focus, however, is upon maximizing the value of *the estate*, not on the total return to creditors as a group. Consider the following example. One group of creditors consists of prepetition suppliers owed \$20. The balance of creditors are institutional lenders owed \$80. The debtor wants to sell its assets as a going concern. One buyer offers to pay the estate \$50 for the assets of the firm. This buyer has no relationship with the suppliers and is indifferent as to how the \$50 is distributed. Under bankruptcy's pro-rata sharing rule, each creditor receives half of what it is owed. The suppliers will receive \$10 and the other creditors \$40.

A second buyer appears and bids \$40 for the firm. The suppliers are small, dispersed, and are not actively involved in the bankruptcy case, but this buyer is in the same industry as the debtor, and it has an ongoing relationship with virtually all of these prepetition suppliers. Because it does not want to jeopardize its relationship with them, this second buyer will top off the prepetition suppliers and pay them an additional \$12 if it acquires the firm.

¹⁶ See Douglas G. Baird, *The Rights of Secured Creditors After Rescap*, 2015 U. ILL. L. REV. 849, 851-54 (discussing the dynamics of adequate protection).

¹⁷ See, e.g., *In re Cent. Ice Cream Co.*, 836 F.2d 1068, 1072 (7th Cir. 1987) (stating that, in deciding whether to settle a lawsuit, the trustee is obliged to maximize value for not only the creditors, but also the shareholders). A similar issue arises in the context of corporate law, and the analysis there is the same. See, e.g., *Frederick Hsu Living Tr. v. ODN Holding Corp.*, No. 12108-VCL, 2017 WL 1437308, at *17 (Del. Ch. Apr. 14, 2017) (corrected Apr. 24, 2017) ("In a world with many types of stock . . . the question naturally arises: which stockholders? The answer is the stockholders in the aggregate in their capacity as residual claimants, which means the undifferentiated equity as a collective, without regard to any special rights."); see also *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 38 (Del. Ch. 2013) ("The duty to act for the ultimate benefit of stockholders does not require that directors fulfill the wishes of a particular subset of the stockholder base.").

¹⁸ We are focusing in this Article on institutional investors holding diversified portfolios. More complicated issues arise when the rights holders are nonadjusting. As an empirical matter, however, such creditors occupy only a small part of the capital structure. Protections can be created for them through statutory grants of priority, inside and outside of bankruptcy. The structural foundations of the law of corporate reorganizations should be grounded on institutional creditors, at least in large cases.

For this reason, if the second buyer's bid is accepted, the suppliers and the other creditors as a group will receive \$52.¹⁹

From the perspective of the creditors as a group, the second buyer is offering more (a total of \$52 instead of \$50), but this is not what matters. The first buyer is giving more to the bankruptcy estate (\$50 instead of \$40), and this is what is dispositive.²⁰ The creditors receive 50¢ on the dollar *from the estate* if the first bid is accepted, but only 40¢ if the second one is. Because of the bankruptcy partition, the trustee must accept the bid of the first buyer. What matters is what each bidder is offering the estate in return for its assets. The money that one buyer will later give one of the prepetition creditors is irrelevant. The proper focus is entirely on what goes to creditors *on account of their claims against the estate*.

There is nothing wrong with the second buyer topping off the prepetition trade creditors, but making such a payment does not put a thumb on the scale in their favor.²¹ Picking the first buyer might seem counterintuitive. By assumption, the second buyer values the firm the most and is willing to pay the most for it (\$52 instead of \$50), but the bankruptcy partition requires ignoring some of the benefits prepetition creditors receive from the second buyer.

Such partitioning is a core feature of bankruptcy law. The Bankruptcy Code is premised on the idea that the benefits of limiting the bankruptcy calculus in this fashion outweigh the costs. The ultimate costs are smaller than they appear. Requiring the award of the firm to a buyer who puts a lower value on it does not necessarily mean that the firm will end up in the hands of this buyer. The parties themselves are free to bargain in the shadow of this rule.

There is a deal to be cut between the old suppliers, who are topped off after the sale to the second buyer, and the institutional lenders who receive only a distribution from the estate. There is no guarantee, of course, that such

¹⁹ This amount is the sum of what the suppliers and the other creditors end up receiving. Between the estate and the second buyer, the suppliers will receive their pro-rata share of the purchase price from the estate, which is \$8. (This is 20% of the \$40 that the second buyer pays for the firm.) An additional \$12 is what is needed to pay them in full. The other creditors hold 80% of the claims against the debtor, so they will receive 80% of the \$40 that the estate receives from the second buyer. This comes to \$32. Hence, the total payments of the second buyer are \$52 (\$8 + \$12 + \$32).

²⁰ The reasons for the different valuations are irrelevant. Assume, for example, that an office building files for Chapter 11, and it is not worth enough to pay the creditors in full. It is completely appropriate for the shareholders, if they are the high bidders at an appropriately conducted auction, to reacquire the property in order to preserve the tax benefits they enjoy by virtue of their prior ownership. All that matters is that they are the ones paying "top dollar." *See Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 456-57 (1999) ("[I]t would, of course, be a fatal flaw if old equity acquired or retained the property interest without paying full value. It would thus be necessary for old equity to demonstrate its payment of top dollar . . .").

²¹ As we discuss in Parts II and III, such side payments can be problematic if the suppliers are active in the case and exercise control over the bankruptcy process such that they might distort it. By assumption, this is not the case with the suppliers in this hypothetical.

a deal will happen but, as is always the case with Coasean bargaining, the cost of reaching such a bargain puts a cap on the loss that the parties face.²²

B. *The Bankruptcy Partition and the Bankruptcy Process*

The estate includes all the assets that the debtor owns outside of bankruptcy and all the assets that the creditors could reach if they sued the debtor and reduced their claims to judgment.²³ But the bankruptcy process does not merely partition assets. It also sorts out rights among stakeholders.

For example, bankruptcy's automatic stay prevents secured creditors from reaching their collateral, even when their security interests are fully perfected. Such collateral is property that, under nonbankruptcy law, secured creditors are entitled to repossess and sell. Bankruptcy alters this. Even if secured creditors have already taken possession of their collateral, they must return it. They must vindicate their rights to it through the bankruptcy process.²⁴ A plan of reorganization can restructure a properly perfected security interest as long as the secured creditor is given the indubitable equivalent of its interest.²⁵

Expanding the bankruptcy partition to include the resolution and eventual recognition of such rights through a process that is consistent with the requirements of the collective proceeding ensures that a single secured creditor is not able to thwart a reorganization that works to the benefit of all the creditors. At the same time, the requirement that the secured creditor be given the indubitable equivalent of its collateral ensures that the partition is not shifted simply to give general creditors value that they could not enjoy outside of bankruptcy.

For the most part, matters adjudicated inside the bankruptcy partition involve assets in which the debtor or its creditors have a stake. Actions that individual creditors have against a third party remain largely outside the bankruptcy partition. These include such things as a veil-piercing action or claims of misconduct against an indenture trustee that arise only on account

²² In the absence of bargaining costs, the ability of two parties to bargain with one another always takes them to the Pareto frontier—a place where, by definition, all mutually beneficial transactions that can be made have been made. See Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 5 (1960) (noting that under conditions of perfect competition, private and social costs are equal).

²³ The Bankruptcy Code provides that these assets are inside the estate in 11 U.S.C. § 541 and § 544(a), respectively. The assets that levying creditors could reach that do not belong to the debtor under § 541 include principally collateral when the secured creditor has failed to perfect its security interest by filing in the public records or otherwise curing the ostensible ownership problem.

²⁴ See *United States v. Whiting Pools*, 462 U.S. 198, 203 (1983) (describing how secured creditors cannot retain possession of property that is part of a debtor's estate).

²⁵ See 11 U.S.C. § 1129(b)(2)(A)(iii) (2012) (describing how a reorganization plan must be "fair and equitable with respect to a class").

of a common relationship with the same debtor. Indeed, they remain outside even when all or nearly all of the creditors of the debtor have this independent action against a third party.²⁶

One can argue that such actions should be brought within the bankruptcy partition. It might be sensible to resolve such disputes as part of the bankruptcy process, as resolving them may make it easier to resolve the debtor's own affairs. But whether they are brought in or not, it is an important distinction to keep in mind that adjudicating such rights through bankruptcy processes is completely consistent with recognizing them in full. And it vindicates no coherent bankruptcy policy to distribute any recoveries that arise from the resolution of such disputes to the creditors as a group rather than to those who would have been entitled to them outside of bankruptcy.²⁷

Our ambition here is not to determine exactly which disputes should be brought within the bankruptcy partition. Instead, it is only to make clear that the process for fixing rights among stakeholders is something that creditors might sensibly include as part of their *ex ante* bargain. The debtor may be able to confirm a plan only if it can resolve a dispute with a third party, but the third party might be willing to settle only if it can also settle with one or more creditors of the debtor who have independent causes of action against it. The debtor is unable to form a plan without other disputes being resolved at the same time. Coasean bargaining may not be possible, especially if there is more than one third party and more than one creditor has such an independent action.

One can argue that overcoming such holdout problems is appropriately done in bankruptcy. Bankruptcy exists to consolidate the affairs of multiple creditors and a common debtor in a fashion that facilitates the resolution of

²⁶ See *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 428 (1972) (“[N]owhere in the statutory scheme is there any suggestion that the trustee in reorganization is to assume the responsibility of suing third parties on behalf of debenture holders.”). Some courts have treated veil-piercing actions as part of the bankruptcy estate on the ground that the debtor could bring them outside of bankruptcy, and they are therefore property of the estate under § 541. See, e.g., *Steyr-Daimler-Puch of Am. Corp. v. Pappas*, 852 F.2d 132, 135-36 (4th Cir. 1988) (describing how the defendant's claim is “property of the estate” within the meaning of § 541(a)(1)). But the reasoning of these cases is suspect. The gravamen of a veil-piercing action is that there is no difference between the corporation and the shareholder, which is inconsistent with the idea that one should be able to sue the other. At least one state supreme court has rejected this idea that a debtor can bring such an action. See *In re Rehab. of Centaur Ins. Co.*, 632 N.E.2d 1015, 1017-20 (Ill. 1994) (stating the reasons why an alter ego claim is not “property of the company”).

²⁷ This distinction is partially lost in the context of avoidance actions. Recoveries under § 544(b) and § 548 are distributed generally among unsecured creditors even if only some of them would have been entitled to the recovery outside of bankruptcy. This is the unfortunate legacy of *Moore v. Bay*, 284 U.S. 4 (1931). See Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 747 (1984) (“The virtually universal reading of *Moore v. Bay*, however, is that the Supreme Court held that the trustee could avoid the chattel mortgage entirely and that the \$10,000 so recovered was an asset of the estate to be shared by all unsecured creditors.”).

disputes among them. Expanding the bankruptcy partition to include the power to settle such disputes might be part of the ex ante bargain that creditors would strike among themselves if they could.

This rationale—that judicial orders can help bring about “global peace”—is especially easy to justify if the merits of the actions among the stakeholders are not obvious and the stakes are relatively small. At the same time, the more power the bankruptcy judge has over such disputes among stakeholders, the greater the danger that some creditors will be able to commandeer assets to which they are not entitled. Third-party releases illustrate the problem, and they are the focus of the next section.

C. *The Anti-Commandeering Principle and Third-Party Releases*

The bankruptcy judge enjoys the power to issue orders that protect and enhance the value of the bankruptcy estate. But this is only a shorthand. The bankruptcy judge is not empowered to issue an order simply because it makes the estate more valuable. The estate of a failing cell phone manufacturer would be more valuable if the bankruptcy judge could issue an injunction blocking the next release of the iPhone, but the bankruptcy judge has no power to issue such an injunction. Outside of bankruptcy, a manufacturer of an inferior product has no right to be insulated from competition, and it does not acquire such a right when it enters bankruptcy.

Bankruptcy establishes a procedure that overcomes collective action problems and allows creditors to vindicate their nonbankruptcy rights. The bankruptcy judge can use her powers to adjudicate such rights using bankruptcy’s expedited and streamlined procedures. This ability to resolve disputes swiftly in a single forum has the effect of increasing the value of the estate. But such a power is vastly narrower than possessing a general license to make the estate more valuable. The bankruptcy judge cannot use her power to resolve disputes merely as a way to capture value for the benefit of the estate.

Someone without a previous relationship with the debtor who faces a potential liability of \$80 from another person cannot give the debtor \$40 in return for an order from the bankruptcy judge that will keep this other person from bringing a suit against her. To be sure, such release from liability increases the value of the bankruptcy estate by \$40 and makes the creditors as a group better off. But it does this only because the release is part of a deal that captures part of the value of an asset that belongs to someone else—the cause of action one third party enjoys against another. The cause of action belongs neither to the debtor nor its creditors outside of bankruptcy.

A harder question presents itself when resolving disputes between third parties makes it easier to resolve the debtor’s own affairs. Some circuits have

found that such third-party releases are absolutely forbidden.²⁸ The circuits that do approve third-party releases typically rely on a multi-factored test, typically without any explanation of why these factors matter. The factors commonly set out are, however, at first approximation, consistent with the idea that third-party releases are thinkable when they facilitate the debtor's own reorganization without at the same time depriving third parties of rights they would enjoy outside of bankruptcy. Resolving the dispute on the merits when it helps to reorganize the debtor does not need to have the effect of diverting value from a third party to the debtor.²⁹

Third-party releases are easiest to justify when the release affects a large group of similarly situated creditors and a supermajority are willing to accept the plan in which they are subject to a third-party release. In such a case, the dissenting creditors within the group are outliers. They are likely placing a value on the release that is unrealistically high.³⁰ When a supermajority of creditors sees the wisdom of the settlement and votes in favor of it, they likely believe that the benefits of the plan of reorganization compensate them for what they are losing by virtue of the release. If each of the creditors is as well positioned as the others to value the release, the collective wisdom of the supermajority is more likely to reflect the benefits of accepting the plan than the views of a small minority.

Even if a supermajority of similarly situated creditors consents to the release, one might require backup protection in addition to the approval by

²⁸ See, e.g., *In re Lowenschuss*, 67 F.3d 1394, 1401-02 (9th Cir. 1995) (holding that the defendant's release provision was contrary to § 524(e) of the Bankruptcy Code).

²⁹ One of the most commonly cited tests is the one set out in the discussion in *In re Dow Corning Corp.*, 280 F.3d 648, 658 (6th Cir. 2002):

We hold that when the following seven factors are present, the bankruptcy court may enjoin a non-consenting creditor's claims against a non-debtor: (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The non-debtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) The bankruptcy court made a record of specific factual findings that support its conclusions.

³⁰ If each of the creditors have different bits of information about the value of the cause of action, the best estimate of the value is, other things being equal, the value estimated by the median creditor. This is a standard observation from "wisdom of the crowds" literature. See, e.g., JAMES SUROWIECKI, *THE WISDOM OF THE CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMIES, SOCIETIES, AND NATIONS* 3-22 (2005) (providing an overview of the wisdom of the crowds principle in action).

the supermajority. For example, one might require the judge to find explicitly that the dissenting creditors were receiving benefits from the plan that compensated them for what they were losing by virtue of the release. An independent assessment of whether the parties subject to a release are being compensated is akin to the best-interest-of-the-creditors test that protects dissenters in the Chapter 11 voting process.³¹ In such a case, bringing the resolution of such claims into the bankruptcy process can be defended in a straightforward way as a coherent extension of the creditors' bargain. Binding a minority to the decision of the majority in this fashion is different from ordinary civil litigation, but completely consistent with notions of due process. It bears a kinship both with other bankruptcy procedures and with class-action settlements.³²

Even when all of those affected by a release of a third party from liability object, a judge might still be confident that the exercise of her power was in service of global peace if there were other ways in which she could be confident that there was complete compensation to the affected creditors. Forcing creditors with independent causes of action against third parties to accept their treatment under the plan in return for losing their actions against a third party is analogous to the way bankruptcy law treats security interests.³³

The reluctance of many courts to grant third-party releases and the insistence of others that it is an extraordinary remedy underscore the potential for abuse they bring. However, much mischief can be prevented by understanding that they are simply disputes that can be resolved on the merits as part of the bankruptcy process. What matters is that those with meritorious claims are compensated. Resolving disputes inside the bankruptcy partition according to Chancery methods is fully consistent with due process if there is compensation and nothing is lost by insisting on it. Parties forced to accept releases in the name of global peace can always be completely compensated. If they are not compensated, one should suspect that the estate is capturing the value of an asset—a cause of action one third-party has against another—that does not belong to it.

³¹ 11 U.S.C. § 1129(a)(7) (2012).

³² In class actions, a court may approve a settlement that binds class members “on finding that it is fair, reasonable, and adequate.” FED. R. CIV. P. 23(e)(2). Notably, the court may, but is not required, to provide class members a second opportunity to opt out at the settlement stage. See Jeannette Cox, Note, *Information Famine, Due Process, and the Revised Class Action Rule: When Should Courts Provide a Second Opportunity to Opt Out?*, 80 NOTRE DAME L. REV. 377, 401 (2004) (noting the discretionary nature of opt out at the settlement stage).

³³ Bankruptcy law allows a security interest, which is not an asset of the debtor outside of bankruptcy, to be brought into the estate and altered as long as the secured creditor is given value that is the indubitable equivalent of its collateral. See 11 U.S.C. § 1129(b)(2)(A) (2012). A third-party release imposed on a nonconsenting creditor might be treated the same way.

Situations do arise in which a creditor and the debtor have actions against the same third party, and the assets of the third party may be insufficient to satisfy both. It might seem that the bankruptcy partition should be extended to include such actions as well. If the action of the third party were successful, the pool of assets remaining after the judgment was satisfied might be insufficient to satisfy the debtor's claim.

One might argue that such a limited pool itself creates a bankruptcy-policy justification for resolving a third-party claim inside the bankruptcy partition. By bringing this action into a collective proceeding along with the debtor's action against the third party, one can ensure that there is not a destructive race to the third-party's assets.³⁴ The argument is even stronger when the action against the third party exists against the debtor as well and the party is entitled only to a single recovery.

But one must consider whether expanding the bankruptcy partition in this fashion makes sense when it is possible for the third party to enter into its own bankruptcy. If the third party did commence such a stand-alone bankruptcy action, the debtor's claim, the other party's claim, and everyone else's rights against the third party would be sorted out in that forum. The debtor's cause of action is an asset of the estate. That its vindication takes place in a different forum may not be of any special moment.³⁵

There is much to be said for the idea that bankruptcy should be an all-or-nothing affair. Bankruptcy's different powers are conceived as a coherent set of powers designed to sort out the problems of a debtor in a single forum. They should not be unbundled from one another. The third party should either be in bankruptcy with all its creditors subject to the automatic stay and with an estate assembled for their benefit, or it should be outside of bankruptcy entirely. When we empower the bankruptcy judge in one bankruptcy proceeding to sort out the financial distress of another debtor, the second debtor is subject only to some of the powers of the bankruptcy judge.

If one believed that the benefits and burdens of bankruptcy are sensibly constructed as a package, one should want to limit the ability of bankruptcy judges to exercise authority over a third party on the ground that the third party has a limited pool of assets. In contrast, the less confident one is that

³⁴ Arguments of this sort were put forward to justify staying litigation a creditor had brought against a third-party in the *Caesars* bankruptcy. See *In re Caesars Entm't Operating Co.*, 808 F.3d 1186, 1188 (7th Cir. 2015) (Posner, J.) (describing how the bankruptcy process does not allow any creditor to "jump the line").

³⁵ It might be more convenient for the bankruptcy judge to hear such actions, but it is not compelled. In any event, when the action in question is a contract dispute or some other common law action, the bankruptcy judge herself does not even have the power to resolve it on the merits without the consent of the parties, as she is not an Article III judge. See *Wellness Int'l Network, Ltd. v. Sharif*, 135 S. Ct. 1932, 1940 (2015) (describing the limited authority that bankruptcy courts have in resolving "non-core proceedings").

the processes and procedures of bankruptcy are a coherent whole, the more one should be willing to allow the bankruptcy judge to settle some, but not all, of the problems of financial distress that the third party faces. In all events, one of the challenges in establishing the bankruptcy partition requires confronting the question of whether the third party must be exposed to all of the consequences of bankruptcy when there are competing claims to limited assets.

Of course, if a second bankruptcy is required to sort out the competing claims of the first debtor and other creditors, the question then is whether the two bankruptcies should be consolidated together and resolved simultaneously. The prevailing view tends to forbid substantive consolidation across estates absent extraordinary circumstances and limit administrative consolidation to those cases in which the various debtors are related entities in the same corporate group.³⁶

One can easily imagine things quickly getting out of hand if the rules governing consolidation were mandatory and inflexible. When an industry becomes distressed, a number of firms in the same industry with relationships with one another enter bankruptcy at the same time. It may make sense to treat each bankruptcy of unrelated entities as a stand-alone affair. Each debtor can participate in the other bankruptcies in which it has the rights of a creditor on the same terms as other creditors.

D. Demarcating the Bankruptcy Partition

Connecting the demarcation of the bankruptcy partition to the creditors' bargain does not itself resolve close cases, but it does make it possible to identify some cases that are easy. Consider the following hypothetical.³⁷ The debtor owes its workers \$120 and its other creditors \$240. The debtor's sole asset is a fraudulent conveyance action against a private equity fund that is costless to bring and will yield \$120 with fifty-fifty probability. In addition, the workers have an independent, stand-alone cause of action against the same private equity fund completely unrelated to the workers' dealings with the debtor. If they can find the resources to bring the action against the private equity fund, they will succeed with certainty and generate a judgment of \$80. The workers, however, can bring claims against the private equity fund only if they receive a large enough distribution from the debtor's bankruptcy. The

³⁶ See *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005) (noting that courts tend to "respect entity separateness absent compelling circumstances calling [for] equity").

³⁷ This hypothetical and related ones introduced in the balance of the paper are loosely based on the facts of *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017). For a comprehensive view of the case and structured dismissals, see Bruce Grohsgal, *How Absolute Is the Absolute Priority Rule in Bankruptcy? The Case for Structured Dismissals*, 8 WM. & MARY BUS. L. REV. 439 (2017).

private equity fund is solvent and fully able to satisfy the two judgments even if it loses both actions.

The workers do not have the right incentives when it comes to settling the fraudulent conveyance action. They may press for settlement on the cheap if it gives them enough to pursue their claim against the private equity fund. This may be better for them than allowing the fraudulent conveyance action to go to trial and risk receiving nothing from either the fraudulent conveyance action or their stand-alone claim against the private equity fund. At the same time, they will fight against settlements that are in the interests of the creditors as a group if the settlements do not bring enough to finance the litigation against the private equity fund. In the extreme case, the workers may urge the debtor to refuse all settlements and try to hit a home run.

In reviewing any settlement of the fraudulent conveyance action, the bankruptcy judge must ensure that those negotiating on behalf of the debtor have focused on the correct question: whether it leaves the estate better off than it would be if the settlement offer was declined and the debtor litigated the avoidance action. Under these facts, there should not be any settlement that is for less than \$60. A settlement for less than \$60 might enable the workers to bring their own action against the private equity fund, but this benefit to the workers lies outside the bankruptcy partition. As far as the bankruptcy process is concerned, the use to which the workers or anyone else might put their share of the settlement is irrelevant. It is not a benefit *to the estate*. To this extent, those negotiating the settlement must keep the workers' cause of action separate from the bankruptcy estate.

Now change the hypothetical slightly. Assume that the other creditors (and not the workers) control the creditors' committee and the direction of the case. They negotiate with the private equity fund, and they reach a deal in which the private equity fund will contribute \$90 to the estate in exchange for the settlement of the fraudulent conveyance action, but the settlement also includes a release of the workers' completely independent cause of action against the private equity fund that is entirely unrelated to any dealings that the private equity fund had with the debtor. The institutional lenders, of course, favor this plan. Under it, they receive \$60 instead of \$40.³⁸ The workers oppose it, as they receive a total of \$30 instead of the \$60 they would have received if there were no settlement.³⁹

³⁸ The other creditors hold two-thirds of the debt (\$240 out of a total of \$360). Hence, they receive two-thirds of whatever is recovered from the private equity fund, either from the settlement (\$90) or from pursuing the litigation (a fifty-fifty chance of \$120). Two-thirds of \$90 is \$60; two-thirds of \$60 is \$40.

³⁹ The workers receive one-third of anything the estate receives from the private equity fund. Hence, their pro rata share of the \$90 settlement is \$30. They receive in expectation \$60 if the litigation is pursued. Half the time the fraudulent conveyance action will yield nothing, and the

Under these assumptions, the bankruptcy judge should have little difficulty rejecting the settlement. There is no procedural benefit from bringing the workers' cause of action into the bankruptcy process. The only thing that the third-party release is doing is bringing part of the settlement value of the workers' independent cause of action into the estate. (The private equity fund is, in essence, paying \$60 to settle the fraudulent conveyance action and another \$30 to rid itself of the workers' action.) No bankruptcy policy justifies this. The workers' cause of action does not belong to the estate.

II. POLICING THE BANKRUPTCY PARTITION

In addition to identifying assets that need to be within the partition, the bankruptcy judge must police the behavior of the parties with respect to what lies inside the partition. In the first instance, the bankruptcy judge must ensure that, as they advance their interests as creditors, parties do not engage in rent-seeking that distorts the bankruptcy process. In addition, the bankruptcy judge must ensure that creditors, while navigating the bankruptcy process, are not advancing some outside agenda. She must also prevent them from making side deals that keep her in the dark. Such policing must take place before there is any distribution of assets. It ensures the integrity of the bankruptcy process and is antecedent to the ultimate allocation of assets.

A. *Rent-Seeking and the Bankruptcy Partition*

Consider another variation on the hypothetical developed in the previous part. The institutional creditors and the workers are again owed \$240 and \$120 respectively. Assume that the creditors' committee is again in control of the case and have \$90 that they are prepared to distribute to the general creditors, including the workers. The workers have an independent action against a third party that has no relationship of any kind with the debtor. This action, if brought, will net them \$80 with certainty. They do not, however, have the resources they need to bring the action unless they receive a distribution from the estate. Assume now, however, that the third party approaches the creditors' committee and offers to contribute \$30 to the estate on the condition that nothing is distributed to the workers.

The creditors' committee is charged with maximizing the value of the estate. The estate is worth \$90 if the offer from the third party is rejected, but

workers will lack the resources needed to sue the private equity fund. As a result, they will end up with nothing. But the other half of the time, the workers will enjoy \$40 when the estate wins the fraudulent conveyance action and \$80 from the independent action against the private equity fund (now that the settlement gives them the resources they need to bring it). A fifty-fifty chance at \$120 is worth \$60.

it is worth \$120 if it is accepted. There is no commandeering. The workers still have their cause of action against the private equity fund. That they need additional resources to bring it is a concern that falls outside the bankruptcy partition. The problem seems to raise squarely the question whether bankruptcy's distributional rules should give way to the principle of asset maximization. In theory, the *ex ante* bargain could compensate creditors in the position of the workers for the possibility of a departure from the distributional rule in any given case.⁴⁰

A departure from bankruptcy's distributional rule, whatever it is, cannot be justified here. Parties with control over the bankruptcy process, such as the creditors' committee in this example, should not be able to put it up for sale. Accepting the money maximizes the value of the estate *ex post* and involves no third-party release, but it is most unlikely that allowing such a departure would ever be part of the creditors' bargain given the fear that having such a power would routinely generate rent-seeking in the bankruptcy case. Parties to the creditors' bargain, like parties to any bargain, insist on the rules governing the process to be insulated against manipulation.

Allowing those who control the bankruptcy process to compromise its distributional rules for a price invites mischief. Allowing those with their hands on the levers of control of the case to sell the process invites them to spend resources looking for such opportunities. This anti-hijacking principle has nothing to do with the particulars of any given distributional scheme. Once any set of distributional rules is put in place, the integrity of the process requires that they be respected.

B. *Guarding Against Creditors with Ulterior Motives*

When establishing rules of corporate governance and in many other contexts in which potential conflicts are manifest, elaborate rules deal with outside interests. Directors and officers are generally required to vote and act as fiduciaries of public corporations.⁴¹ The moment they have a conflict, they must reveal it to independent directors or to the shareholders for a cleansing

⁴⁰ One might push back for normative reasons in a case such as this in which the creditors in question are not institutional investors holding diversified portfolios, but there is no need to reach this question here. As explained in the text, departing from the distributional rule makes no sense even in the strongest case in which *ex ante* compensation is entirely unproblematic.

⁴¹ *See, e.g.*, *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (“[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.”); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (“In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders.”).

vote.⁴² Without a cleansing vote, they risk losing the protections of the business judgment rule.⁴³ By contrast, shareholders are generally permitted to vote however they see fit unless they hold a controlling stake.⁴⁴

These rules cannot be mechanically transferred to the bankruptcy process. The bankruptcy process is a complicated dance in which the votes of stakeholders determine the firm's future. Through plan voting and litigation, they exercise even more direct control than shareholders, and their own agendas never match those of the firm as a whole.

Bankruptcy law does not expect participants in the bankruptcy process to act as pure fiduciaries of the estate. But it also does not allow them to use their position to act opportunistically to further their outside interests. Judges use the bankruptcy partition to channel the self-interest of the parties. Stakeholders cannot bring their outside interests to bear when they participate in the bankruptcy process, but, in asserting their rights to the assets of the estate, they can choose the course that maximizes the value of their own stake in the firm.

Consider another variation on the hypothetical. Assume that, in order to prevent workers from bringing an action against it, a private equity fund resolves to vote against any plan that pays the workers' claim in cash.⁴⁵ Under these circumstances, the bankruptcy judge would very likely disqualify the private equity fund's vote.⁴⁶

Third parties cannot exploit the levers of the reorganization process to advance ulterior interests.⁴⁷ To be sure, it is sometimes hard to draw the line between advancing an ulterior agenda and protecting one's own interests as a stakeholder. But many cases are easy. For example, disgruntled former employees who have started a competing firm cannot acquire claims and cast their votes to inflict misery on their former employer.⁴⁸ A developer who

42 DEL. CODE ANN. tit. 8, § 144(a) (2018).

43 *Id.* For a discussion of the history of the law on interested transactions in Delaware and elsewhere, see Claire Hill & Brett McDonnell, *Sanitizing Interested Transactions*, 36 DEL. J. CORP. L. 903, 910-11 (2011).

44 See *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994) (setting forth the standards for controlling shareholder liability, particularly the entire fairness standard).

45 In this hypothetical, as in others, we are ignoring the statutory priority that the workers in *Jevic* enjoyed for part of their WARN Act claim. To the extent that the workers enjoyed statutory priority, 11 U.S.C. § 1129(a)(9) would prevent such a plan from being imposed on the workers as it requires payments for such priority claims to be in cash when the class rejects the plan.

46 The bankruptcy judge enjoys the power to "designate"—disqualify—votes that are cast in bad faith. 11 U.S.C. § 1126(e) (2012).

47 See *DISH Network Corp. v. DBSD N. Am., Inc.* (*In re DBSD N. Am., Inc.*), 634 F.3d 79, 102 (2d Cir. 2011) (stating that a bankruptcy court may designate the vote of a party who votes with an ulterior motive).

48 See *In re MacLeod Co.*, 63 B.R. 654 (Bankr. S.D. Ohio 1986) (determining that an intent to destroy or injure a debtor's business to further one's own interests constitutes bad faith).

recaptures rights if a debtor goes through foreclosure instead of reorganization cannot buy claims for the purpose of defeating the reorganization.⁴⁹

At the same time, creditors are entitled to advance their own interests as creditors.⁵⁰ As long as a creditor is voting for a plan that it believes will maximize the value of its stake in the firm, it is free to do so.⁵¹ But it is one thing for a creditor to try to maximize the value of a claim and quite another to use its vote to force the debtor to choose a path for the firm that suits the creditors' outside interests. A third party cannot buy claims merely to control the reorganization process and persuade the debtor to sell key assets to it.⁵² As the Second Circuit explained, when affirming a bankruptcy court's designation of a claims buyer's vote as bad faith: "In effect, [the claims buyer] purchased the claims as votes it could use as levers to bend the bankruptcy process toward its own strategic objective of acquiring [the debtor's assets], not towards protecting its claim."⁵³

These principles suggest a court would have little difficulty (apart from questions of proof) in constraining the private equity fund if it voted a particular way (against any plan that paid the workers in cash) in order to thwart the workers' independent action against it. The private equity fund does not owe fiduciary duties to other stakeholders, and it is free to advance its own interests as a stakeholder, but it is not free to promote other interests it might have. The private equity fund's stake in the debtor has nothing to do with its position in third-party litigation. Action taken solely in pursuit of the latter objective should not be permitted.

For this reason, in this hypothetical the private equity fund's vote could be "designated." It is voting against a plan solely because the payout to the workers was in a form that would enable them to initiate litigation against it.⁵⁴ It is not

49 See *In re Dune Deck Owners Corp.*, 175 B.R. 839 (Bankr. S.D.N.Y. 1995) ("[T]he Court must decide whether the creditor opposes the plan because of how it affects its claim, or instead, because the creditor really seeks to obtain some collateral advantage in another capacity."). There are, of course, cases where matters are uncertain, especially when an outsider buys claims with a view to acquiring the firm as a whole.

50 See *Figter Ltd. v. Teachers Ins. & Annuity Ass'n*, 118 F.3d 635, 639 (9th Cir. 1997) (noting that "no bad faith is shown when a creditor chooses to benefit his own interest as a creditor"). At the same time, however, a creditor cannot undermine the reorganization itself or act in a way that "prevent[s] the Court from directing and having visibility into events unfolding in the case." *LightSquared LP v. SP Special Opportunites LLC (In re LightSquared Inc.)*, 511 B.R. 253, 360 (Bankr. S.D.N.Y. 2014). The court in *In re LightSquared* went on to hold that the creditor who deliberately derailed the reorganization process be equitably subordinated. *Id.* at 361.

51 See *Figter Ltd.*, 118 F.3d at 639.

52 *In re DBSD*, 634 F.3d at 104.

53 *Id.*

54 See 11 U.S.C. § 1126(e) (2012) (allowing a court to designate "any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith").

voting to maximize the value of its share of the bankruptcy estate, but rather to advance an interest that stands outside of the bankruptcy partition.

Matters are different when, as in earlier variations on the hypothetical,⁵⁵ the private equity fund is not voting on a plan, but rather negotiating a settlement. The private equity fund can argue that, with respect to the settlement of a cause of action against it, it stands as a third party outside the bankruptcy partition. There is a difference between participating in the shape of the plan of reorganization and defending against litigation brought by the debtor. In the former capacity, the private equity fund must conform to bankruptcy's rules of engagement, but, in the later capacity, it enjoys the same freedom to deal with the debtor at arm's length. When subject to litigation from the debtor, the private equity fund is, precisely because of the bankruptcy partition, entitled to treat the debtor as a stranger. In this capacity, it is free to demand the same settlement terms that it could demand in any other litigation.

But there is a big difference between what the private equity fund could demand as an outsider and that to which the creditors' committee could agree. Accepting demands about the distribution of the debtor's estate and allowing an outsider to dictate the shape of what is in effect a plan of reorganization is inherently troublesome. And, as we explore in the next Section, it is especially troubling if money is being diverted to the creditors' committee at the same time the committee is approving the private equity fund's plan.

C. Side Payments

In addition to ensuring that creditors do not act with ulterior motives, the bankruptcy judge must police the behavior of those who exercise control of the bankruptcy process to ensure that the judge remains able to ensure that the process's procedures are respected. Among other things, she must be alert to side payments that distort the behavior of those who exercise control over the bankruptcy process. Just as a creditor who is a competitor cannot misuse bankruptcy procedure to enhance its outside interest, another creditor cannot make a side payment to someone with influence over the bankruptcy process with the aim of distorting it.⁵⁶

One needs to be cautious. Transfers from a creditor to someone with control over the case are not necessarily problematic. In theory, junior parties should not be able to invoke procedures that are wasteful and unnecessary. Indeed, a junior creditor's vote can be designated when it is merely asserting

⁵⁵ See *supra* note 39 and accompanying text.

⁵⁶ *In re Bush Indus.*, 315 B.R. 292, 306 (Bankr. W.D.N.Y. 2004) (involving a plan not proposed in good faith when a secured creditor promises to continue to pay former CEO who is cooperating with the plan process but who will not actually do any work for company).

procedures in order to extract value for itself.⁵⁷ But there is a substantial domain in which procedures are unnecessary yet not abusive. One creditor may have the right to bring a procedural objection that brings little or no value to the estate as a whole. In this case, a creditor is not distorting the process if it makes a payment to keep such an objection from being made.

When a senior creditor who manifestly is owed more than the firm is worth wants to bring the bankruptcy process to a speedy conclusion, her decision to pay money to someone to truncate unnecessary procedures is, in the view of many, unobjectionable.⁵⁸ Some suggest that senior creditors should be able to make payments to junior creditors and to professionals who have done work for the debtor, the creditors' committee, and other constituents to ease frictions.⁵⁹ The amount of money tends to be small in the grand scheme of things. Nor is it troubling to some that the secured creditor is paying for professionals who work for others. The process is being run for the benefit of the secured creditor, so it is entirely sensible that she pays for it. The senior creditor should be able to use what is, in effect, her own money to bring the case to a swift conclusion when all the relevant issues are plain for all to see. Such payments are analogous to those routinely made when civil litigation is settled.

Distinguishing such "tips" from troublesome side payments can be hard, but the bankruptcy partition provides guidance. Consider one last variation: The only asset of the estate is again the fraudulent conveyance action. The private equity fund offers to settle that action, but insists on a distribution that gives the creditors' committee more than it would ordinarily receive. This should not be permitted either.

On its face, the settlement is a deal between the private equity fund and the estate, with the creditors' committee acting on behalf of the estate. The money then passes from the estate to the creditors' committee according to its terms. But the structure of the deal invites a different characterization. Instead of a payment from the private equity fund to the estate that is distributed according to a special scheme departing from the usual distributional rules,

⁵⁷ In the words of William O. Douglas when he was the head of the SEC and testifying to Congress on what would become the Chandler Act, it is not legitimate for a creditor to engage in holdup behavior and tell another stakeholder, "For a price, you can have our vote." *Revision of the Bankruptcy Act: Hearing on H.R. 6439 Before the House Comm. on the Judiciary, 75th Cong.* 182 (1937) (statement of William O. Douglas).

⁵⁸ See AM. BANKR. INST. COMM'N TO STUDY THE REFORM OF CHAPTER 11, 2012–2014: FINAL REPORT AND RECOMMENDATIONS, 238 (2014) ("[M]any commentators and some courts assert that class-skipping gifts lead to efficient resolutions and foster the bankruptcy policy of consensual plans.").

⁵⁹ See *id.* at 239 ("[A]llowing senior creditors to pay a small gift or tip to junior creditors can resolve objections to plan confirmation, facilitate the debtor's reorganization, and disperse value further down the debtor's capital structure.").

the payment could be characterized as a transfer from the private equity fund directly to the creditors' committee. In return for the payment, the creditors' committee agrees to drop the fraudulent conveyance action.

The transaction, in other words, might be objectionable because the creditors' committee, as matter of substance, is taking money in return for stepping away from the fraudulent conveyance action. The creditors' committee might not have the resources to litigate the action to the end, but it might have enough to do some digging and this might be sufficient to change the dynamics of the case. For example, there might be a bad email among the private equity investors at the time of the buyout suggesting that the deal left the debtor with unreasonably small capital.⁶⁰ In order to ensure that the email never comes to light, the private equity firm offers a settlement, the proceeds of which must go to the committee and its professionals. This "settlement" with a special distributional proviso is nothing of the sort; rather it is a side payment to the creditors' committee intended to pay them to stop their investigation.

The members of the committee are better off taking the side payment, rather than pursuing the litigation. Although each dollar of the side payment makes them better off, any value they capture for the estate through litigating the claim has to be shared. And the workers do not have to be part of the side deal. As long as the workers have no ability to exercise influence over the avoidance action, there is no need to pay them to look the other way.

Because of such possibilities, it is important for a bankruptcy judge to ask whether any particular settlement has the effect of distorting the bankruptcy process. The phenomenon, however, is not limited to settlements. It exists whenever value passes from one player in the bankruptcy process to another. Consider the facts of *In re ICL Holding Co.*⁶¹ In that case, the debtor proposed to auction off the company, and the senior creditor planned to bid.⁶² If the senior creditor bid its claim at the auction and that bid was the high bid, the senior creditor would end up as the owner of the firm.⁶³ Negotiations over the rules governing the auction ensued. In return for an agreed-upon sales process, the senior creditor agreed to pay the professionals of the committee and provide several million dollars to the creditors' committee.⁶⁴ If, as

⁶⁰ This would be enough to satisfy the elements of a fraudulent conveyance action. For an example of a case in which there was such an email, see *In re TOUSA, Inc.*, 422 B.R. 783, 793-94 (Bankr. S.D. Fla. 2009).

⁶¹ 802 F.3d 547 (3d Cir. 2015).

⁶² *Id.* at 550.

⁶³ *Id.* at 550-51.

⁶⁴ *Id.* at 551.

happened, the senior creditor proved the high bidder, the government would receive nothing for its tax claim.⁶⁵

These payments might have been side payments that distorted the process. The senior creditor may have feared that their liens were not sound or that more shopping around of the firm would bring out additional buyers. The payment to the creditors' committee may have had the effect of preventing what a well-run bankruptcy process requires. The procedures of the bankruptcy process permit everyone to raise objections, but not all parties are equally well positioned to raise them. Here, the government's tax lawyers were not privy to the particulars of the business. By contrast, the creditors' committee had access to information about the debtor and the debtor's business. It was thus much better able to assess whether the senior creditor's proposed auction would yield top dollar. The side payment might have induced the creditors' committee to look the other way, drop its objections, and support the sale.

On the other hand, *ICL Holding* might be an illustration of a permissible "tip." The senior creditor was not trying to prevent an auction that secured top dollar, but rather was striking a bargain that avoided unnecessary and costly procedures. The trick is distinguishing between legitimate "tips" that avoid unnecessary process and illegitimate side payments that cover up mischief.

The Third Circuit ultimately upheld the bankruptcy judge's approval of this bargain.⁶⁶ It gave weight to the fact that the payment was not a distribution of property of the estate. Taking into account whether estate property was involved may be sensible: payment from the estate may be more problematic than payments from elsewhere. Nevertheless, nothing in the opinion suggests that anything goes as long as the money parties are exchanging among themselves is not property of the estate. If a payment is effectively a side payment that disrupts the bankruptcy process, the bankruptcy judge must step in, regardless of where the money comes from.

The Third Circuit was willing to defer to the bankruptcy judge's implicit judgment in *ICL Holding* that the senior creditor was in a position similar to someone making a payment to settle ordinary civil litigation. The senior creditor was paying the creditors' committee in order to avoid unnecessary procedures that do nothing to maximize the value of the estate. The payment did not take anything from the estate because the procedures that were being waived would not have benefitted the estate. To a large extent, parties can sell their nuisance value on the side—that is, outside the bankruptcy partition.

⁶⁵ *Id.*

⁶⁶ *Id.* at 555-56.

But they cannot sell procedural rights that might benefit others in the estate, because those are inside the partition.

When the question is one of a judge policing the behavior of creditors during the bankruptcy process, the judge is not asking whether some creditors received more from the estate than they were entitled. Instead, she is asking whether the overall negotiations were conducted in a fashion that could be trusted to maximize the assets within the bankruptcy estate. Regulation of the partitioned bargaining environment, rather than following any particular distributional rule, is what matters most.

Exactly how the bankruptcy judge polices the process turns on context. In the case of confirming a plan of reorganization, there are elaborate and hard-edged rules. Absolute priority must be enforced unless two-thirds of a class in amount and one-half in number consent.⁶⁷ A plan can be confirmed only if at least one impaired class accepts.⁶⁸ Administrative expenses must be paid in cash.⁶⁹

When the bankruptcy judge is confirming a plan, there is at least one hair-trigger: there is a strong presumption against any payment that flows from a senior creditor to a junior one that skips over an intervening, nonconsenting class.⁷⁰ This “anti-gifting rule” operates even when there is strong evidence that the senior creditor is owed more than the firm is worth. It nips mischievous side payments in the bud and aims at ensuring that the plan-formation process is squeaky clean. As the Second Circuit put it, “if the parties here were less scrupulous or the bankruptcy court less vigilant, a weakened absolute priority rule could allow for serious mischief between senior creditors and existing shareholders.”⁷¹

Even in the context of the absolute priority rule, however, not all principles constraining the behavior of the parties that are not so hard-edged. The bankruptcy judge, in addition to determining that the plan respects absolute priority, must also find, when a class votes against the plan, that the plan is “fair and equitable” and does not “discriminate unfairly.”⁷² These phrases have become terms of art over the course of more than a century of Supreme Court learning. They are sometimes used in a way that suggests that they embody only a substantive commitment to absolute priority.⁷³ This is a mistake.

⁶⁷ 11 U.S.C. § 1129(b)(2)(C) (2012); 11 U.S.C. § 1126(c) (2012).

⁶⁸ 11 U.S.C. § 1129(a)(10) (2012).

⁶⁹ 11 U.S.C. § 1129(a)(9)(A) (2012).

⁷⁰ See *DISH Network v. DBSD North America, Inc.*, 634 F.3d 79, 100 (2d Cir. 2011) (“[A]lthough Congress did soften the absolute priority rule in some ways, it did not create any exception for ‘gifts’ like the one at issue here.”).

⁷¹ *DBSD*, 634 F.3d at 100.

⁷² 11 U.S.C. § 1129(b)(1) (2012).

⁷³ See Baird, *supra* note 14, at 614-15 (reviewing the Supreme Court’s reception of cases on plan confirmation).

Consider a case in which a substantial shareholder of a business is also its CEO. The debtor proposes a plan in which the equity of the reorganized firm will go entirely to the old senior creditor. The senior creditor agrees to keep the CEO on as a consultant after the reorganization and will pay her with stock options. The general creditors receive nothing under the plan and oppose it. The debtor puts on witnesses showing that the business is not worth enough to pay the senior creditor in full. Can the bankruptcy judge approve this plan?

There are two different ways of characterizing the award of stock options to the CEO through the lens of the bankruptcy partition. The stock options could be seen as side payments from the senior creditor to the CEO to ensure that the CEO induces the debtor to put forward a plan that is to the senior creditor's liking. The CEO, in this scenario, is less inclined to reveal information showing that the firm is worth enough to put the general creditors in the money. As a result, the bankruptcy judge is not able to ensure that the value of the estate is maximized, and the arrangement is objectionable.

Alternatively, the judge might uphold the award of the options if she is confident that it does not interfere with her ability to police the assets inside the bankruptcy partition. If the firm is not worth enough to pay the senior creditor, it belongs to that creditor. The creditor is entitled to retain whomever it wants as a consultant. If the judge finds that the transaction is offered to the CEO in her capacity as a provider of future services, rather than in exchange for manipulating the bankruptcy process, the bankruptcy judge should not strike it down. Such services are not assets of the estate. They are outside the partition.

The "fair and equitable" language of the Bankruptcy Code addresses situations in which the senior creditor makes transfers to other stakeholders in the context of a plan. As the cases that developed the "fair and equitable" doctrine make plain, the focus is not on the distributions themselves, but rather on the process that led to the plan of reorganization.⁷⁴ Is the CEO taking a payment in return for agreeing to look the other way rather than to maximize the value of the estate, or is she an outsider selling future services in an arm's length transaction? The bankruptcy judge focuses on whether the parties are acting in a way that ensures that the value of the assets within the bankruptcy partition is being maximized.

The bankruptcy judge's ability to ensure the integrity of the plan process extends beyond transfers from one stakeholder to another. Assume, for example, that the CEO is not a shareholder at all. The senior creditor offers

⁷⁴ See, e.g., *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482, 508 (1913) (noting that a creditor "having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it").

her a lucrative consulting contract even though it is clear that her services are no longer needed. (She has, for example, retired and moved out of state.) The bankruptcy judge can refuse to confirm such a plan on the ground that it was not proposed in good faith.⁷⁵ What matters is whether the CEO is receiving a side payment because of the control she is able to exercise over the process, not whether she is a stakeholder herself or receiving property of the estate.

Outside the plan confirmation process, the Bankruptcy Code offers less explicit guidance, but it remains the judge's obligation to ensure that those with control are using their powers in service of maximizing the value of the estate. Imagine a senior creditor who desires a speedy auction in which it might well prove to be the only bidder. The secured creditor suggests that the debtor propose such an auction. At the same time, the secured creditor offers the CEO a consulting contract that requires little actual work. Here too, the judge can refuse to approve the sale.⁷⁶ The senior creditor's promise of money to the CEO may make the judge suspect that the speedy auction being proposed is not one that will maximize value.

Whenever these payments become large enough, the bankruptcy judge is likely to find that what are characterized as "tips" are nothing of the sort. They are just the price that the secured creditor is willing to pay to insulate its plan from close scrutiny. The Bankruptcy Code is designed to ensure that parties who exercise control work to maximize the value of the estate. Stakeholders cannot strike deals in which they agree to drop objections in return for payoffs that go only to them.⁷⁷

Distinguishing between illicit side payments and legitimate tips is our principal concern. What must be recognized, however, is that the regulation of these payments matters not because a creditor or shareholder is receiving a payment to which she is not entitled under bankruptcy's distribution scheme, but because the payment keeps the bankruptcy judge from protecting the assets inside the bankruptcy partition. Payments that buy off those with

⁷⁵ See 11 U.S.C. § 1129(a)(3) (2012) (requiring plans to be "proposed in good faith and not by any means forbidden by law"). For a variation on these facts, see *In re Bush Indus.*, 315 B.R. 292, 306 (Bankr. W.D.N.Y. 2004) (holding that offering a "golden parachute" to a principal officer of a corporation constituted a violation of good faith obligations).

⁷⁶ One might think that bankruptcy law need not play a role here. The CEO who accepts payment for a consulting contract when her advice is emphatically not wanted (but whose cooperation is essential) is probably violating her fiduciary duties to the corporation. The implicit quid pro quo is that she will look the other way and not attend to maximizing the value of the assets for the benefit of all the stakeholders. But the contours of those duties can be hard to delineate, and the bankruptcy judge has a responsibility to ensure that there is a process that leads to the assets being put to their highest and best use, independent of whether there are violations of nonbankruptcy duties.

⁷⁷ See *Young v. Higbee Co.*, 324 U.S. 204, 208 (1945) (holding that stakeholders who sold interests at a premium in return for dropping an appeal must account to others in their class for the difference between what they received and the fair value of their interest in the debtor).

control are illegitimate even if the money does not come from the estate and even if it does not go to an old shareholder or other stakeholders, as is the case when the secured creditor hands over its own money to a CEO who owns no stock. The payments between stakeholders may be either appropriate “tips” or impermissible bribes, but they are not “distributions.”

The ability of parties to divert value is limited only by their own imaginations. It is not even necessary for money to pass from one player to another. A plan might include a rights-offering that gives one of the players the ability to acquire an interest in the reorganized entity at a discounted price.⁷⁸ The discount might reflect what is necessary to obtain the commitment of new capital that the business requires, but there is also a less innocent possibility. It might be the price paid to persuade someone with influence to look the other way.

Alternatively, value can be diverted through a “backstop.” A plan proponent might want to give securities in the reorganized firm to an old creditor, but it may be hard for a court to know whether the new securities are worth what the plan proponent claims. The plan proponent can allay this concern by obtaining a “backstop.” The provider of the backstop promises to buy the new securities at the value set out in the plan (in the event that the old creditor would rather have cash instead). The willingness of a third party to buy the security at a particular price provides evidence of its value. But the commitment to buy a security for a fixed price does not magically appear. It is a put, and someone will sell a put only if adequately compensated. Hence, the plan proponent must pay the person who is furnishing the backstop. When the person who provides the backstop is also a player in the bankruptcy process, there is again cause for concern. The fee for the backstop might reflect the market value of the backstop, but the plan proponent might be paying more than the market price. Buying a backstop at a premium can again divert value to an existing player in a position to exercise control over the case.

Sensibly distinguishing between rights offerings and backstops that are legitimate from those that divert value requires judgment and the sound exercise of discretion. It is a problem cut from the same cloth as bankruptcy’s prohibition on “gifting.” These and other devices that have the potential to distort the bankruptcy process can arise in many contexts, and again they have nothing to do with bankruptcy’s distributional rules. Bankruptcy judges must police the parties to ensure that side payments do not compromise the

⁷⁸ For an excellent discussion of rights offerings and backstops, see Jane Lee Vris & Alexandra S. Kelly, *Rights Offerings Get Popular—and Contentious*, N.Y. L.J. (Mar. 7, 2011), <https://www.law.com/newyorklawjournal/almID/1202484161899/> [<https://perma.cc/4PJ6-GYF3>] (discussing three main categories of objections to rights offerings and backstops).

process. As the Supreme Court put it long ago, the court should not “become the mere silent registrar of the agreements”⁷⁹

III. BARGAINING ACROSS THE PARTITION

Return to the hypothetical in which the private equity fund was willing to settle only if there was no distribution to the workers. It is possible that everyone’s cards were on the table. There was no infirmity in the private equity investor’s security interest. No lawyer would take up an avoidance action against it because the costs of litigation vastly exceeded the expected value of the action. But the private equity fund is still willing to pay something to have this action disappear once and for all. It knows that the creditors’ committee lacks the resources to litigate the matter, but the cause of action will continue to exist even if the bankruptcy case is dismissed. This itself is an irritant even if it is exceedingly unlikely that anyone will bring the action. The private equity fund might not, for example, be able to close out some of its funds as long as the cause of action lingers.

The private equity fund is willing to pay something to make the action go away. It benefits if it can close out its investment in the debtor. But it is exactly for this reason that the private equity firm has no interest in any settlement that includes the workers. It is not willing to buy peace if it comes at the cost of triggering litigation from another quarter.

There is no commandeering or corruption of the process. The opportunity to settle with the private equity fund belongs to the estate and can be monetized only if the representatives of the estate can strike a deal with the private equity fund. When approached to make such a settlement, the private equity fund stands outside the bankruptcy partition. The estate is seeking to trade one asset (a fraudulent conveyance action that it cannot pursue) for another (the money the equity fund is willing to pay to make the action go away). Seeking to maximize the value of the estate by striking such deals is an essential part of the bankruptcy process.

Let us assume there is no question of the creditors’ committee selling out other creditors. An independent trustee would confront the same bargaining dynamic. Moreover, unlike the hypothetical in which a stranger appears and offers cash to distort the distributional scheme, the transaction is Pareto superior. Taking the money does not deprive the workers of anything they would otherwise receive. With or without the deal with the private equity fund, they will receive nothing. The settlement makes the others creditors better off without leaving the workers any worse off.

⁷⁹ *Louisville Tr. Co. v. Louisville, New Albany & Chi. Ry. Co.*, 174 U.S. 674, 688-89 (1899).

Such value-maximizing transactions seem in principle unproblematic even if they are with prepetition creditors or someone else with a history with the debtor. It is irrelevant that the transaction benefits someone who is also a player in the bankruptcy, as long as the relevant transaction is a bargain to obtain something that is outside the bankruptcy partition. Mutually beneficial trading between the estate and a third party leaves both better off by nature.

But there are important qualifications to this general principle. In policing the process, the bankruptcy judge must also take account of the potential for parties to engage in strategic behavior and the potential for error. Ruling some transactions out of bounds may bring benefits across the mine run of cases, even if some value-maximizing transactions in individual cases are lost in the process. Tying oneself to the mast is sometimes a good idea. Moreover, the bankruptcy judge must be able to identify whether a transaction in fact makes the estate better off. When a transaction is too hard to assess, it may make sense for her to step away, especially given the ability of parties to reach bargains on the side.

A. *Deals with Nonstrategic Prepetition Actors*

The Bankruptcy Code expressly allows deals with prepetition creditors where there is an executory contract between the debtor and the creditor.⁸⁰ If the debtor chooses to assume an executory contract, payments will be made to the nondebtor party to the contract. Depending on how much it will cost the other party to complete the contract, it may be better off if the contract is assumed. Whether the third party benefits is irrelevant.⁸¹ Even though the party to the executory contract will be paid in full while other creditors will not be, blessing the assumption of many of these contracts is an entirely uncontroversial application of 11 U.S.C. § 365.⁸²

⁸⁰ A prepetition contract is “executory” when, at the time of the petition, there are meaningful obligations owing on both sides. For the classical discussion, see Vern Countryman, *Executory Contracts in Bankruptcy (Part I)*, 57 MINN. L. REV. 439, 460 (1973) (defining an executory contract as one in which “the failure of either [party] to complete performance would constitute a material breach excusing the performance of the other”).

⁸¹ There is a qualification to this point. If the transaction is manifestly beneficial to the nondebtor party to the executory contract, the debtor might reject the contract (or threaten to reject the contract) and renegotiate the deal on better terms. One could argue that this ability to renegotiate is something that the debtor should take into account in deciding whether to assume or reject the contract. For the same reason, the bankruptcy judge should take into account the ability to renegotiate in deciding whether to bless this decision. For our purposes, however, what matters is that the provision governing executory contracts explicitly empowers the debtor to pay off someone who is a prepetition creditor, using as her benchmark whether it makes the other creditors better off.

⁸² To take a concrete example, assume that the debtor has a contract with *A* in which the debtor promises to pay *A* \$10 in a week’s time for a specialized part. And assume that the transaction will, *after the \$10 is paid*, make the debtor’s business worth \$25. Assume further that, if the debtor fails to

The focus of the judge in reviewing the decision to assume an executory contract is on the effect of the assumption on the value of the bankruptcy estate. The only question is whether the decision to assume requires a payout from the estate that is less than what the estate will receive from the third party. The party to the executory contract is receiving the money only because of rights she established outside of bankruptcy long before the bankruptcy began. She is not engaging in holdout behavior or otherwise undermining the bankruptcy process. The relevant asset—her performance under the contract—is outside the bankruptcy partition, unless the estate performs its end of the bargain.

An executory contract is only one of many types of deals into which a debtor can enter that enhance the value of the estate. Courts have generally accepted the idea that bankruptcy judges can approve transactions with prepetition creditors beyond the context of executory contracts. The common touchstone is whether such deals result in the estate being better off.⁸³ There are problems of proof in many cases, but clear examples of value-enhancing transactions are easy to find.

In the Chapter 11 of Marvel Entertainment, for example, the debtor proposed, and the court approved, continuing shipment of products for which customers had already paid.⁸⁴ It was not burdensome to continue shipping, as the production costs were largely sunk. More to the point, a failure to ship would sow unhappiness in the customer base. The products in question were comic books, and the prepaying buyers were subscribers.

Apart from the sheer silliness of serving tens of thousands of twelve-year-olds with proper notice and inviting them to be heard as creditors in the case, demanding they pay a second time for *Spiderman* and the *Fantastic Four* would

go through with the deal, its assets will be worth only \$20 and its contracting opposite, *A*, will have to scrap the part and will have lost \$10. In this event, *A* will have an unsecured claim against the estate for \$10. Other creditors are owed \$50. If the debtor in possession asks the court for permission to assume this contract, the court should grant it.

Rejecting the executory contract leads to \$60 in claims (\$50 from other creditors and the additional \$10 claim from *A*) chasing \$20 in assets. Each creditor receives 33 cents on the dollar. By contrast, if the trustee assumes the contract, the creditors (a group that no longer includes *A*) receive 50 cents on the dollar (\$50 in claims chasing \$25 in assets). For a discussion of some of the other dynamics and effects arising from assumption decisions, see Kenneth Ayotte, *Leases and Executory Contracts in Chapter 11*, 12 J. EMP. LEGAL STUDIES 637, 656-59 (2015).

⁸³ See *In re Kmart Corp.*, 359 F.3d 866, 872-74 (7th Cir. 2004) (holding that the record did not reflect that preferential payments to a handful of Kmart's vendors would benefit the remaining creditors).

⁸⁴ See DAN RAVIV, COMIC WARS: HOW TWO TYCOONS BATTLED OVER THE MARVEL COMICS EMPIRE—AND BOTH LOST 81-82 (2002). The buyers had already paid for the product. Because they had no obligations to Marvel, there was no executory contract to assume. Hence, the buyers were simply, as a matter of bankruptcy law, unsecured creditors. Analytically, of course, it makes no difference whether they had obligations to the debtor. What mattered was whether shipping the product made Marvel on net better off.

have undermined the future of the comic business. Stopping the shipment of the comics would have saved little money and caused considerable reputational damage. All the other stakeholders would have been worse off if subscribers were treated like ordinary creditors. For these purposes, the twelve-year-olds were more sensibly treated in their capacity as future customers (who stand outside the partition) rather than their capacities as prepetition creditors (who stand inside). What was valuable to the estate (the goodwill of the subscribers) was not something that the estate enjoyed as of right. It resided outside the partition. The estate could continue to enjoy it only by servicing the subscriptions.

A similar issue arises with respect to frequent flyer miles in an airline bankruptcy. The obligation of an airline to provide additional services (in the form of free travel and upgrades) generates a “claim” within the meaning of the Bankruptcy Code.⁸⁵ Because the obligation arises before the filing of the petition, it is again a prepetition claim that ordinarily would be cashed out at cents on the dollar just like any other. But few doubt that the bankruptcy judge can approve a motion to honor frequent flyer miles. It is just good business.

The relevant question is not whether some creditors receive more than others, but again whether what the estate wanted—the continued business of frequent flyers—was something that belonged to it or something outside the partition that it had to use estate assets to acquire. Because the frequent flyers had no obligation to continue to fly with the debtor, the estate needed to keep them happy. That the frequent flyers happened to be prepetition creditors was neither here nor there, so long as the estate had no claim on their future patronage and was better off spending money to secure it. Similarly, it might be good business for a durable goods manufacturer, such as an automobile company, to continue to honor warranties in order to ensure the integrity of the brand and the good will associated with it. Discontent among existing customers might deter future ones.⁸⁶

⁸⁵ See 11 U.S.C. § 101(5) (2012) (defining “claim” as “the right to an equitable remedy for breach of performance if such breach gives rise to a right to payment”).

⁸⁶ A similar problem can arise when the debtor settles some types of liability claims. Consider, a firm manufactures an intrauterine birth control device (IUD) that proves defective. Facing massive tort liability, it files for bankruptcy. Many who used the IUDs were rendered infertile. If the estate pays for their tubal ligation surgery immediately, they might be able to have children and only pursue small claims against the estate. But if the estate does not pay for the surgery, the victims will have a claim both for the costs of the surgery and the damage from being rendered infertile—an amount at least an order of magnitude larger than the cost of the surgery. The atmospherics in this case are somewhat different than in the typical critical-vendor case. The purpose of making an early payment to the tort victims is to reduce the total claims against the estate by an amount that is much larger than the cost of the surgery itself. What matters is that money can be spent and, as a result, there is an increase in what every other stakeholder will receive from the estate. This is enough to create a potential problem. This hypothetical is closely based on the facts of *Official Committee of Equity Security Holders v. Mabey*, 832 F.2d 299, 299-302 (4th Cir. 1987). In that case, the court found

When a payment to a prepetition creditor is proposed and someone objects, the bankruptcy judge, in addition to assessing the evidence that the payment is value enhancing, will focus as much on the process that led to the proposal. From her perspective, the question is not whether the payment violates some distributional rule, but rather whether the process itself was one that allows the judge to infer that the deal being presented is a good one and other alternatives are not available.

B. *Bargaining with Strategic Actors*

All the examples of transactions with prepetition creditors examined so far involve payments to entirely passive prepetition creditors. The passive role makes it easier for the bankruptcy judge to conclude that those controlling the estate are paying them because it is good business. The only ones able to influence the decision had interests aligned with those of the estate as a whole. But this is not always the case—consider *In re Chrysler LLC*.⁸⁷

When Chrysler filed for Chapter 11 and proposed selling its assets, the prospective buyer of Chrysler offered the estate \$2 billion, far less than Chrysler's secured creditors were owed.⁸⁸ The buyer also agreed to pay substantial retirement benefits to Chrysler's workers. These benefits were unsecured prepetition claims against Chrysler.⁸⁹

The focus in the first instance should be on why the retirees were being paid. The buyer—in effect the federal government—may have simply wanted to bestow largess upon the retirees. In this event, the payments are not problematic. A third party's desire to bestow largess on someone who happens to be a prepetition creditor violates no bankruptcy policy. Indeed, in the absence of any other buyer willing to pay more than \$2 billion, Chrysler's senior creditors themselves were themselves beneficiaries of government largess. As such, they were hardly in a position to complain that someone else was receiving largess as well.⁹⁰

that the district court lacked the power to make the payment. *Id.* at 302. However, no other circuits have followed its lead. Even in its own circuit, the case, because of its suspect reasoning, is read extremely narrowly. See, e.g., *Coleman v. Cmty. Tr. Bank (In re Coleman)*, 426 F.3d 719, 726 (4th Cir. 2005) (quoting *Mabey* for the proposition that “the equitable powers that a bankruptcy court possesses ‘are not a license . . . to disregard the clear language and meaning of the bankruptcy statutes and rules.’”).

⁸⁷ 576 F.3d 108 (2d Cir. 2009), *vacated*, *Ind. State Police Pension Tr. v. Chrysler LLC*, 558 U.S. 1087 (2009).

⁸⁸ *Id.* at 111-12.

⁸⁹ *Id.*

⁹⁰ In *In re Chrysler*, the government was the high bidder and no one else wanted to operate Chrysler as a going concern. *Id.* at 112. There is, however, an important caveat. The bankruptcy judge may have chilled other bidders. The auction process was set up in such a way as to make it hard to submit bids that did not include paying the retirees, even if the bids were for more than \$2 billion.

More likely, however, the buyer chose to pay the benefits to the retirees because the existing workers would have gone on strike if the buyer was unwilling to pay the retirees, and the business could not operate without them. The workers had a credible threat. Bankruptcy puts in place rules like the automatic stay that constrain the efforts of prepetition creditors to take actions against the debtor to extract the payment of prepetition claims. Such rules are a sensible part of the creditors' bargain. Such behavior, and resistance against this type of behavior, consumes resources and threatens to put assets to less productive uses. Ensuring that bankruptcy has procedural rules to prevent such holdup behavior is part of maximizing the value of the estate. But these tools do not always work.

The difference between the workers in *Chrysler* and the dispersed suppliers in the example we used earlier,⁹¹ to the extent one exists, is not about whether it is permissible to pay prepetition creditors. When the estate has no right to insist that suppliers, subscribers, frequent flyers, or workers continue to do business with the debtor, it may need to pay them money to keep them happy. In such a case, the estate is paying for something that lies outside the partition. There is nothing inherently problematic about transactions over the partition that enhance the value of the estate. Bankruptcy policy is implicated only if the suppliers, subscribers, frequent flyers, or workers, acting as prepetition creditors, are undermining the collective proceeding and the judge has an ability to do something about it.

The power of a judge to prevent prepetition creditors from refusing to deal with the business going forward is necessarily limited. As a matter of existing labor law, the power of the bankruptcy judge stops well short of requiring former employees of the debtor to continue to work for a new buyer. In the absence of a collective bargaining agreement, employees can refuse to come to work for any reason or no reason at all.⁹² As long as the automatic stay does not trump labor law here, there is nothing the bankruptcy judge can do to order the employees back to work.

In the absence of this power, the implicit threat of the workers to strike if the retirees are not paid is credible. One can, of course, prevent the judge

This should not have happened. Senior creditors should always be able to object to a process in which the assets are being sold for less than the highest amount a third party was willing to pay for them, regardless of the use to which the third party would put them.

⁹¹ See *supra* note 19 and accompanying text.

⁹² In a decision that is hard to defend, the Second Circuit has, however, found an exception when the collective bargaining agreement involves the Railway Labor Act. See *Nw. Airlines Corp. v. Ass'n of Flight Attendants-CWA*, 483 F.3d 160, 164 (2d Cir. 2007) (finding that a preliminary injunction precluding the Association of Flight Attendants from engaging in any form of work stoppage was appropriate because the Railway Labor Act "forbids an immediate strike when a bankruptcy court approves a debtor-carrier's rejection of a collective bargaining agreement that is subject to the Railway Labor Act").

from approving payments to prepetition creditors, but an outright prohibition cuts broadly. Moreover, such a prohibition serves its purpose only if, when the judge prevents the estate from dealing with the workers, the workers continue to do business with the estate.

Another type of transaction with prepetition creditors who have negotiating power arises when the debtor seeks postpetition financing. Before the petition was filed, the debtor might have had a relationship with a certain bank that provided it credit. At the time of filing the debtor owes that bank a sizeable amount. To keep doing business as usual, the debtor needs new credit to fund its ongoing operations. The bank that provided the financing prepetition agrees to provide postpetition financing, but it insists that a portion of the new loan be used to pay off its old loans.

The effect of such a “roll-up” is to pay off prepetition debt. The bank ceases to be a prepetition creditor and instead becomes an extender of postpetition credit and enjoys the stronger rights associated with that status. Roll-ups, by their nature, lead to prepetition debt being paid off—and paid off with first priority.

The bank, of course, is exploiting its leverage. Other prospective postpetition financiers do not know as much about the debtor as the bank does, and the bank has this knowledge as a result of its prepetition relationship with the debtor. But again, the focus should be on crafting rules that keep creditors from exploiting such leverage.

One might, of course, sharply limit critical vendor orders, at least when the suppliers are active in the case. Similarly, one might ban roll-ups entirely. If a person is disabled from paying ransom, she will be subject to fewer ransom demands in the first instance. Preventing hold-up behavior by prepetition creditors is a tricky business, however. A rule that is too broad would sweep in actors—such as small suppliers, comic-book subscribers, frequent flyers, holders of product warranties, and tort victims—who are prepetition creditors, but are not in any sense acting strategically or engaging in hold-up behavior. Moreover, the prohibition does not operate when the party’s own self-interest will lead it to refuse to reach a deal unless its terms are met.

To return to the hypothetical in which the private equity fund demands a particular distribution because it has no interest in replacing one lawsuit with another, a ban on the settlement might block a value-enhancing deal.⁹³

⁹³ Einer Elhauge explores these issues in a variety of contexts. See Einer Elhauge, *Contrived Threats Versus Uncontrived Warnings: A General Solution to the Puzzles of Contractual Duress*, 83 U. CHI. L. REV. 503, 507 (2016) (arguing that “a threat to engage in otherwise-lawful action that induces contract modification is unlawfully coercive only when the threat is contrived, meaning that the threatened action would not have occurred if no threat could have been made”).

There is a strong temptation to allow the judge to approve any transaction that is Pareto superior.⁹⁴

One might argue, however, that bankruptcy judges should walk away from some transactions. In addition to accounting for strategic behavior, bankruptcy law must also take account of the difficulties in determining whether the transaction is in fact aboveboard and wealth-enhancing. Payments to insiders and strategic players are always troublesome. The more ties the estate has with a party, the more likely it is that the deal is not what it appears to be. And the more exotic the transaction, the less likely it is that the bankruptcy judge can completely understand what is going on.⁹⁵

C. *Judicial Restraint and Coasean Bargaining*

A judge's refusal to bless a transaction is not the end of the matter. If a transaction that the judge refuses to approve would leave the remaining creditors better off, there is still a deal to be struck. If all the affected parties consent, no bankruptcy policy prevents such a deal from being consummated. For this reason, a judge's inability to prevent a party from making a credible threat and her refusal to approve a transaction with someone outside the partition will not necessarily leave the prepetition creditors without the benefit of a mutually beneficial bargain.

Bankruptcy, of course, posits the existence of a collective action problem that prevents the parties from reaching an agreement with each other, but part of the way bankruptcy solves the collective action problem is by making it easier for parties to bargain with each other in parallel with the bankruptcy process. The possibility that parties will be able to reach a bargain with each other in bankruptcy reduces the risk that creditors will end up in a place that is contrary to their collective interests. This may be especially important when the only issue on the table is simply a question of distributing the assets at the end of the case. Unlike critical vendor orders or DIP financing, the deal to be made does not involve operational decisions, decisions that creditors as a group may have difficulty assessing.

⁹⁴ Justice Kagan focused on this issue in oral argument in *Jevic*, couching the problem in exactly these terms, specifically discussing the notion of "Pareto superiority." See Transcript of Oral Argument at 44, *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017) (No. 15-694) (stating that a "Pareto-superior solution . . . might be a completely sensible bankruptcy provision").

⁹⁵ Justice Breyer emphasized this point at oral argument in *Jevic* when he asked what would happen if someone controlled the pirate's gold that lay buried beneath the debtor's land and was willing to part with it only under the condition that it be given to a creditor that happened to be that person's cousin. Transcript of Oral Argument at 41-43, *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017) (No. 15-649). On the face of it, cutting a deal seems Pareto superior, but one can never be sure. There might be other ways of getting the gold.

There are only a handful of bankruptcy judges who hear large cases, and there are comparatively few lawyers who litigate before them. The local rules and the practices of individual judges fix the structure of the bargaining that takes place outside the courtroom. The bankruptcy judge may want to limit her own discretion going forward. She must worry about both Type I as well as Type II errors. And having in place clear rules about what sorts of transactions she will and will not approve establishes the environment in which creditors bargain.

Consider again *Jevic*, the recent case presenting this issue to the Supreme Court. The bankruptcy judge below found that, in the absence of approving the settlement, none of the creditors would receive anything.⁹⁶ But it is possible that if the judge had refused to approve the settlement, some new bargain would have emerged.⁹⁷ One can imagine a deal that would distribute value to the workers that would overcome the private equity fund's resistance to funding litigation against it. The parties, for example, could set up a "litigation escrow."⁹⁸

A fund could be created in which a third party held the funds until after the statute of limitations for the workers' independent action against the private equity fund expired. To prevent the workers from borrowing against it, the escrow agreement might also provide that the workers would enjoy none of the money if they used the funds as collateral for a loan. If the existence of the litigation escrow would itself make financing of the lawsuit possible, a settlement might require that its existence be kept secret. We are not suggesting such litigation escrows are a good idea. Rather, we are noting only that the parties might still have reached a settlement even if the judge refused to enforce the deal presented and insisted that the parties continue negotiating.

Of course, it is possible that no deal would be reached. Cooler heads do not always prevail. But one of the functions of bankruptcy is to create an environment in which forging an agreement among the parties is possible. Assessing how the bankruptcy judge should exercise her discretion to approve transactions with those who hold prepetition claims as well as assets outside the partition is linked to the bargaining environment in which the parties find themselves. This bargaining environment is in turn shaped by the rules of engagement that the Bankruptcy Code puts in place.

⁹⁶ See *In re Jevic Holding Corp.*, 492 B.R. 416, 422 (Bankr. D. Del. 2013), *aff'd*, 526 B.R. 547 (D. Del. 2014), *aff'd*, 656 F. App'x 617 (3d Cir. 2016) (noting that at the time of the bankruptcy filing, Jevic had no viable offer of sale or available funding).

⁹⁷ We are, of course, speculating here. There are likely aspects to the case to which we are not privy. In assessing the merits of the decision itself, there is much to be said for deferring to the judgment of the extremely able bankruptcy judge who was on the ground and attuned to everything that was occurring.

⁹⁸ Releases of claims properly structured might also achieve the desired bargain.

Cases in which maximizing the value of the estate actually requires proceeds from an otherwise beneficial transaction to be distributed in a particular fashion are rare. It is seldom the case that, holding its own share constant, one party affirmatively wants some of the other parties to receive more and others less. Rational economic actors care about their own welfare, not on how an arm's length transaction affects the welfare of some other party. And even when such cases exist, the number of transactions that cannot be salvaged through bargaining among the stakeholders may be rarer still.

Exceptions can, of course, be found in bankruptcy. An outright prohibition on deals that depart from distributional rules would have made the creditors worse off in the bankruptcy of the City of Detroit. The city owned the art museum and the creditors pressed for a sale of its treasures. The mediator in the case organized a "Grand Bargain" in which a group of foundations and the state of Michigan contributed \$800 million in return for putting the museum into private hands permanently. But the state and the foundation were willing to contribute this money only if it was used to pay benefits to workers, not if it went to institutional lenders. Both entities were willing to help put Detroit and the people who lived there back on their feet. Neither had any interest in bailing out municipal bondholders.⁹⁹

Here the bankruptcy court was in fact faced with a choice of approving a transaction that could take place only if the proceeds of the transaction favored one set of general creditors at the expense of another. Forbidding a departure from bankruptcy's distributional rules would have prevented the Grand Bargain. No amount of private bargaining would have led the state or the foundations to give money to the bondholders.

In re Detroit, however, may be an exception that proves the rule. A distinctive characteristic of a Chapter 9 municipal bankruptcy that distinguishes it from a Chapter 11 corporate reorganization is that no estate is created.¹⁰⁰ There is no partition with hard boundaries directing the parties to act with a narrow focus.

One cannot exclude the possibility that Pareto superior transactions exist in Chapter 11 in which value will be lost unless there is a departure from bankruptcy's distributional rules. But the rarity of such cases in Chapter 11 favors a hardline rule. Strictly enforcing distributional rules limits costly rent-seeking. A creditor who cannot receive more than its pro-rata share is disabled from bargaining for more. The estate, in most cases, is better off with

⁹⁹ See *In re City of Detroit*, 524 B.R. 147, 169-71 (Bankr. E.D. Mich. 2014) (outlining the terms of the state of Michigan's contribution agreement with the city of Detroit). For a discussion of how the Grand Bargain was struck, see NATHAN BOMEY, *DETROIT RESURRECTED: TO BANKRUPTCY AND BACK* 129-61 (2016).

¹⁰⁰ See 11 U.S.C. § 901(a) (2012) (omitting § 541 from the list of Bankruptcy Code provisions that apply in Chapter 9).

fixed distributional rules especially when few, if any, cases actually require distributional flexibility.

CONCLUSION

Central to any account of bankruptcy is the bankruptcy partition and the challenges associated with locating it, policing conduct inside of it, and allowing transacting across it. A debtor might want to pay one group of creditors before the plan is confirmed to reduce friction in the negotiation process.¹⁰¹ Or it might agree to take actions that protect one creditor from a preference challenge in exchange for that creditor's support of a smooth plan process.¹⁰² These close-to-the-line partition questions implicate fundamental questions of bankruptcy policy. These sorts of actions shift value, usually from one set of institutional investors to another. Should the shift of value itself be something that troubles the judge, even if it benefits the estate? The answer to those questions is often reached through unspoken analysis of the bankruptcy partition. The tests that courts nominally apply do not focus on the bankruptcy partition explicitly, but the partition drives the analysis. A greater focus on the bankruptcy partition itself will lead to better bankruptcy decisionmaking.

¹⁰¹ See *In re Energy Future Holdings Corp.*, 648 Fed. App'x. 277, 280-82 (3d Cir. 2016) (establishing that dispute settlement with a group of creditors using tender offer procedures was consistent with bankruptcy law).

¹⁰² This could conceivably have been going on beneath the surface in the dispute over the filing date in the *Caesars* bankruptcy. See Motion of Statutory Unsecured Claimholders' Committee Pursuant to Bankruptcy Code Sections 363(B)(1) and 1107(A) to Compel Debtor to Consent to Involuntary Chapter 11 Petition at 2-3, *In Re Caesars Entm't Operating Co.*, No. 15-01145 (Bankr. N.D. Ill. Apr. 7, 2015) (noting a dispute over the date on which debtors agreed to file the petition).