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The Overstated Absolute Priority Rule

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INTRODUCTION

The absolute priority rule describes the basic order of payment in corporate bankruptcy: ¹ secured creditors get paid first, unsecured creditors get paid next, and only then do shareholders get paid, if at all.² The rule has obtained a kind of unassailable, near scriptural status in the corporate reorganization literature.³ As one august group of scholars has bluntly argued, “a good bankruptcy procedure should preserve absolute priority.”⁴ Another concludes, “simple rules that honor absolute priority

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1. See Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 537 (1983).

2. See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988).

3. See, e.g., Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy*, 72 WASH. U. L.Q. 1213 (1994); David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992).

4. Philippe Aghion et al., *Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849, 852 (1994).

are likely the best response.”⁵ And two well-known authors recently wrote that the “Bankruptcy Code’s *core principle* is that distribution conforms to predetermined statutory and contractual priorities.”⁶

The most strident statements of the absolute priority rule come from those who are not bankruptcy experts. For example, Jonathan Macey and a co-author recently declared that “[t]he bankruptcy process is meant to follow standard rules in which the proceeds of unencumbered assets are distributed to creditors according to a *strict priority schedule*, governed by the nature of each creditor’s claim.”⁷ A similar notion can be seen in many of Richard Epstein’s writings during the *Chrysler* bankruptcy case.⁸

The affection for the rule comes from a simple argument.⁹ Namely, supporters argue that the rule reduces the cost of debt capital because lenders can properly calculate their expected return on any loan at the time the loan is made.¹⁰ If lenders know that they will have to share value upon insolvency, they will charge more for their loans up front.¹¹

5. Barry E. Adler, *Finance’s Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107, 1150 (1994).

6. Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors’ Bargain*, 99 VA. L. REV. 1235, 1243 (2013) (emphasis added).

7. Jonathan Macey & Logan Beirne, *Stealing Fannie and Freddie 2* (2014) (unpublished manuscript) (on file with author) (emphasis added).

8. Richard A. Epstein, *The Deadly Sins of the Chrysler Bankruptcy*, FORBES (May 12, 2009, 12:00 AM), <http://www.forbes.com/2009/05/11/chrysler-bankruptcy-mortgage-opinions-columnists-epstein.html> [<http://perma.cc/5GSZ-BQQA>]. Todd Zywicki, a bankruptcy expert, makes similar points. See Todd J. Zywicki, *Chrysler and the Rule of Law*, WALL ST. J. (May 13, 2009), <http://online.wsj.com/article/SB124217356836613091.html> [<http://perma.cc/L43R-GWPP>].

9. The basic form of the argument dates to at least William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, LAW & CONTEMP. PROBS., Autumn 1977, at 13, 21, 30-31. But hints of the argument can be found even earlier, for example in Carl B. Spaeth & Gordon W. Winks, *The Boyd Case and Section 77*, 32 ILL. L. REV. 769, 777 (1938), where the authors argue that “Congress certainly intended to place the debtor railroads, that is, the corporations, on a sound financial basis; concessions to the shareholders will defeat that purpose by weakening the confidence essential to new investment at reasonable interest rates, especially where control is left in the hands of unqualified managements.”

10. See Meckling, *supra* note 9, at 33.

11. See Oscar Couwenberg & Stephen J. Lubben, *Solving Creditor Problems in the Twilight Zone: Superfluous Law and Inadequate Private Solutions*, 34 INT’L REV. L. &

In chapter 11, under federal law, the absolute priority rule only comes into play at plan confirmation, and then only when the plan is rejected by some class.¹² It seems strange that a rule that might never be invoked, in a bankruptcy that might never happen, could have a big role in credit pricing. Moreover, by the time the rule appears at the end of a chapter 11 case, it has already been breached so often that its entrance no longer matters.¹³ Indeed, sensible corporate reorganization requires frequent departures from absolute priority.¹⁴

There are several difficulties with the debt pricing argument—and whether shareholders might want to incur this extra cost is never considered¹⁵—but this paper focuses on two more basic problems with it. First, there is no absolute priority rule of the kind described in the literature under current law. It is not clear that there ever has been such a rule.¹⁶ And even if there were, adopting such a rule would be

ECON. 61, 65 (2013) (“The agency problems that crop up in the implicit contract between shareholders and debt holders include well-known strategies such as claim dilution, extraordinary dividends and risk shifting or overinvestment. These strategies lower the value of the debt, and may result in a wealth transfer from creditors if unanticipated *ex ante*.”).

12. Jonathan C. Lipson, *Directors’ Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1229 (2003) (“[T]he absolute priority rule has . . . been criticized in the reorganization context as being none of those three things (absolute, about priority, or a rule).”).

13. As explained below, the rule is often breached in connection with (a) new financing, (b) “first day” motions, and (c) assumption of executory contracts and leases, among other things. It might also be breached as part of a court approved settlement agreement.

14. This was once understood. See Edward H. Levi & James Wm. Moore, *Bankruptcy and Reorganization: A Survey of Changes. III*, 5 U. CHI. L. REV. 398, 408 (1938) (“The absolute theory of priority . . . is entirely unrealistic in the reorganization of a large company.”).

15. The basic form of the argument also assumes that all borrowers pay for the cost of priority violations, suggesting that lenders cannot predict which borrowers might default. That assumption is debatable for obvious reasons.

16. E.g., Walter J. Blum, *The “New Directions” for Priority Rights in Bankruptcy Reorganizations*, 67 HARV. L. REV. 1367, 1369 (1954) (“In railroad bankruptcy reorganizations the ICC and the Supreme Court both have talked in terms of adhering to absolute priority, but the approved plans contain allocations that give senior security holders substantially less compensation than called for by absolute priority in the classical sense.”); Note, *Absolute Priority Under Chapter X—A Rule of Law or a Familiar Quotation?*, 52 COLUM. L. REV. 900, 909 (1952) (“A detailed analysis of approved plans, however, compels the conclusion that the rule has not always been applied with the same degree of consistency that its ritualistic incantation by the lower

inconsistent with chapter 11, or any other sensible system of reorganization.¹⁷ That is, chapter 11 will not work under the kind of rigid absolute priority rule many academic commentators promote, and thus the rule would be certainly flouted.

The claim that the rule does not exist will take many by surprise. But consider the basic fact that there is no state law forum in which to vindicate the rule,¹⁸ and under chapter 11 of the Federal Bankruptcy Code, the rule only applies when there is a contested plan.¹⁹

The concepts behind the rule inform many state laws, like prohibitions on fraudulent transfers and restrictions on dividend payments,²⁰ but the rule itself is absent from any direct application in state corporate debt collection law.²¹ Secured creditors worry about the priority of their liens relative to other secured creditors, and creditors of all sorts worry about the debtor leaking assets. But absolute priority is only relevant when a firm's entire capital structure becomes due and payable at a single instant. That does not happen under state law.

Instead, state law is primarily focused on providing a mechanism whereby unsecured creditors can obtain a judgment, and thus become secured creditors. Once creditors undergo that transformation, the issue of priority is determined by the order in which the creditor obtained its

federal courts and the SEC would seem to indicate . . ."). Even in chapter 7, the rule only applies after a series of congressionally mandated deviations in the form of claims granted priority status. *See* 11 U.S.C. § 726(a)(1) (2012).

17. *See* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1950-52 (2006).

18. *See* Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 893 (2014) ("Some critiques of Chapter 11, and their attendant formulations of the baseline distribution to secured creditors, proceed from an unduly romanticized account of creditors' rights under state law.").

19. 11 U.S.C. § 1129(b)(1). It is also important to remember that the "rule" only applies in chapter 11 cases, whereas each year thousands of business cases file under chapter 13. *See, e.g.*, U.S. Courts, Table F-2—Bankruptcy Filings (Dec. 31, 2015), <http://www.uscourts.gov/statistics/table/f-2/bankruptcy-filings/2015/12/31> [<http://perma.cc/WP7H-4QC7>].

20. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 160(a)(1), 170(a), 281(a) (2016).

21. *See* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1609-10 (2008).

lien.²² Thus, while the absolute priority rule focuses on the entire capital structure, priority under state law has no such concern because all creditors eventually become secured creditors by force of law if they seek payment.

Otherwise creditors are paid as a business matter by the debtor in the ordinary course of its operations, in which case the debtor pays irrespective of priority.²³ Indeed, the debtor's business decision to pay a particular creditor most likely turns on questions of creditors' relative importance to the debtor's ongoing operations, with little regard for strict legal rights. The academic conception of the absolute priority rule in corporate reorganization is based on a world that does not exist. Reorganizing companies are dynamic things, whereas most of the literature assumes a frozen pool of assets, to which the court might oversee an orderly allocation of value. Reorganization in reality is fundamentally inconsistent with heartfelt fondness for a strict absolute priority rule.

I. THE ORIGINS OF THE ABSOLUTE PRIORITY RULE

The absolute priority rule as a bankruptcy term dates back to a 1928 article by Bonbright and Bergerman,²⁴ although references to the idea in other, related contexts long predate that article.²⁵ Bonbright and

22. Ronald J. Mann, *The First Shall Be Last: A Contextual Argument for Abandoning Temporal Rules of Lien Priority*, 75 TEX. L. REV. 11, 16 (1997).

23. Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953, 974-75 (1981).

24. James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Securities Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127 (1928); see Baird & Bernstein, *supra* note 17, at 1936.

25. See, e.g., *The Cash Moratorium Negotiations*, 1922 WORLD PEACE FOUND. PAMPHLET SERIES 98, 111 ("Of this sum 50,000,000,000 was to have absolute priority, carrying interest at 5% and sinking fund at 2% from August 1, amortizing in 25 years."); A. R. Butterworth, *Australasia*, 4 J. SOC. COMP. LEGIS. (n.s.) 250, 269 (1902) ("The advances are to be secured by mortgage with absolute priority over all other claims . . ."); Frederick Thomas White et al., *A Selection of Leading Cases in Equity, with Notes*, 71 LAW LIBR. xxi, 131 (1851) ("By the Irish Act, 6 Anne, c. 2, an absolute priority is expressly given to the instruments first registered."); see also *In re Sauthoff*, 21 F. Cas. 542, 543 (W.D. Wis. 1877) (No. 12,380) (discussing partnership creditors and the "jingle rule," which provides that "in equity, partnership creditors have an absolute priority of claim upon the partnership property for the payment of their

Bergerman coined the phrase to describe one possible bankruptcy rule, which the Supreme Court had occasionally seemed to endorse in corporate reorganization cases going back to the middle Nineteenth Century.²⁶

During the first of the reorganization cases pertaining to Rock Island Railroad in 1869,²⁷ the Supreme Court struck down the sale of the railroad where about 16% of the sale consideration went to shareholders.²⁸ Invoking the now (largely) forgotten corporate trust fund doctrine,²⁹ the Court explained that:

Regarded as the trustee of the corporate fund, the corporation is bound to administer the same in good faith for the benefit of creditors and stockholders, and all others interested in its pecuniary affairs, and any one receiving any portion of the fund by voluntary transfer, or without consideration, may be compelled to account to those for whose use the fund is held. Creditors are preferred to stockholders on account of the peculiar trust in their favor, and because the latter, as constituent members of the corporate body, are regarded as sustaining, in that aspect, the same relation to the former as that sustained by the corporation.³⁰

demands, and that the interest of each individual partner is his share of the surplus after payment of the partnership debts.”).

26. See *infra* notes 27-33 and accompanying text.

27. The company also went into bankruptcy (or, more precisely, a receivership) in 1914. It went bankrupt again in 1933, and yet again in 1975.

28. See Charles D. Booth, *The Cramdown on Secured Creditors: An Impetus Toward Settlement*, 60 AM. BANKR. L.J. 69, 72 (1986).

29. The trust fund doctrine originated in *Wood v. Dummer*, if not earlier. *Wood v. Dummer*, 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944). There, a bank issued dividends of its capital stock to the bank’s shareholders. Then, the bank’s noteholders sued to be paid by the recipients of the dividends. The court reasoned that “the charters of our banks make the capital stock a trust fund for the payment of all the debts of the corporation.” *Id.* at 436; see also *Hollins v. Brierfield Coal and Iron Co.*, 150 U.S. 371, 384 (1893) (“The property of a corporation is doubtless a trust fund for the payment of its debts, in the sense that when the corporation is lawfully dissolved, and all its business wound up, or when it is insolvent, all its creditors are entitled, in equity, to have their debts paid out of the corporate property before any distribution thereof among the stockholders.”).

30. See *Chi., Rock Island & Pac. R.R. Co. v. Howard*, 74 U.S. (7 Wall.) 392, 410 (1868).

Rather than the “absolute priority rule,” this basic idea was known as the rule of *Boyd*, after *Northern Pacific Railway v. Boyd*.³¹ That case was really a kind of successor liability or fraudulent transfer case, which held that a reorganized debtor was liable for the claims of a creditor who was entirely unpaid in the prior reorganization.³² The basis for the successor liability—that the old shareholders had continued in the new firm without paying adequate value for those assets, while the complaining unsecured creditors were left out in the cold—was what made the case relevant to priority rule discussion. Into the 1920s, the Court continually proclaimed:

if the bondholder wishes to foreclose and exclude inferior lienholders, or general unsecured creditors and stockholders, he may do so; but a foreclosure which attempts to preserve any interest or right of the mortgagor in the property after the sale must necessarily secure and preserve the prior rights of general creditors thereof. This is based upon the familiar rule that the stockholder’s interest in the property is subordinate to the rights of creditors, first of secured and then of unsecured creditors. And any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.” *Louisville Trust Co. v. Louisville Railway Co.*, 174 U. S. 683, 684.

This doctrine is the ‘fixed principle’ according to which [*Boyd*] declares the character of reorganization agreements must be determined, and to it there should be rigid adherence.³³

However, neither *Kansas City Terminal* nor the Bonbright and Bergerman article directly addressed the absolute priority rule. Instead, Bonbright and Bergerman were addressing the “significant unanimity of agreement that a court has not only the power but the duty to pass upon the fairness of the reorganization plan.”³⁴ Priority was an issue

31. *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913).

32. See Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 79 (1991); Note, *The Effect of a Sale Under a Consent Decree as a Step in Corporate Reorganization*, 27 HARV. L. REV. 467, 468 (1914); see also Pamela Foohey, *Chapter 11 Reorganization and the Fair and Equitable Standard: How the Absolute Priority Rule Applies to All Nonprofit Entities*, 86 ST. JOHN’S L. REV. 31, 41-45 (2012).

33. *Kan. City Terminal Ry. Co. v. Cent. Union Trust Co. of N.Y.*, 271 U.S. 445, 454 (1926).

34. Bonbright & Bergerman *supra* note 24, at 127.

subsumed within fairness. The question was which rule of priority applied when determining fairness.

There were also exceptions to the rule of *Boyd*, particularly with regard to the generation of post-bankruptcy funding under what is today known as the “new value” exception to the absolute priority rule.³⁵ For example, even the Court in *Kansas City Terminal*, after proclaiming “rigid adherence” to the rule of *Boyd*, noted that that case “does not require the impossible, and make it necessary always to pay unsecured creditors in cash before stockholders may retain any interest whatever in the reorganized company.”³⁶ Initially many practitioners thought that *Boyd* would be a “nightmare,”³⁷ but ultimately found that reorganization courts were willing to bless a plan’s fairness in situations that did not involve strict application of what Bonbright and Bergerman termed the absolute priority rule.³⁸

Bonbright and Bergerman themselves ultimately concluded that “[t]he old doctrine of absolute priority is probably not well adapted to the corporate form of organization, and its place may properly be taken by a modified form of the doctrine of relative position.”³⁹ This new term coined by Bonbright and Bergerman for an old concept initially had little success, and did not appear again in the literature for almost seven

35. See *Bonner Mall P’ship v. U.S. Bancorp Mortg. Co. (In re Bonner Mall P’ship)*, 2 F.3d 899, 907-17 (9th Cir. 1993); see also Henry J. Friendly, *Some Comments on the Corporate Reorganizations Act*, 48 HARV. L. REV. 39, 75-76 (1934) (“Stockholders who furnish new money required by the reorganized company may be permitted to retain an interest in the company, even though sacrifices from creditors are compelled.”).

36. *Kansas City Terminal Ry. Co.*, 271 U.S. at 454.

37. James N. Rosenberg, *A New Scheme of Reorganization*, 17 COLUM. L. REV. 523, 526 (1917).

38. Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 COLUM. L. REV. 901, 907-15 (1927); see also Philip M. Payne, *Fair and Equitable Plans of Corporate Reorganization*, 20 VA. L. REV. 37, 61 (1933) (“[T]o understand the meaning of the terms ‘fair and equitable’, as applied to corporate reorganizations, requires considerable background.”).

39. Bonbright & Bergerman *supra* note 24, at 165.

years, until its use in a 1935 student note.⁴⁰ By this point corporate reorganization was codified and federalized.⁴¹

In 1933, Congress had added section 77 to the 1898 Bankruptcy Act.⁴² This section changed prior law by permitting railroads to enter bankruptcy, and also codified existing receivership practices, including the rule of *Boyd* that courts could only approve reorganization plans that were “fair”—the full phrase that we know, “fair and equitable,” was yet to be used, although Congress did include the full term in a somewhat different context in a composition provision enacted as part of the same bill.⁴³ Six days later, Congress actually used the full “fair and equitable” term when it passed the Bank Conservation Act. Section 207 of the statute allowed for the reorganization of depository banks—this was still before FDIC insurance—provided that the terms of the reorganization were “fair and equitable.”⁴⁴ This was the first deployment of the term in the bankruptcy context.

In May 1934, when extending bankruptcy relief to municipalities, Congress used the full “fair and equitable” phrase again.⁴⁵ And in June of that year, section 77B was added to the Bankruptcy Act to allow for general corporate reorganization, and that also required plans to be “fair and equitable.”⁴⁶ Then, just over a year later, section 77(e) was officially amended to include the full “fair and equitable” term with regard to railroads.⁴⁷ Section 77B was then replaced in 1938’s Chandler Act⁴⁸ with new chapter X, which was to be the primary reorganization

40. Note, *The “Fair” Plan in Corporate Reorganization: II*, 35 COLUM. L. REV. 549, 555 (1935).

41. For a nice, concise overview of the receivership process and the codification of corporate reorganization, see Warner Fuller, *The Background and Techniques of Equity and Bankruptcy Railroad Reorganizations—A Survey*, 7 LAW & CONTEMP. PROBS. 377 (1940).

42. Act of March 3, 1933, ch. 204, 47 Stat. 1467. See, in particular, section 77(g).

43. See *id.* at 1470 (“[T]he court, on such notice and on such terms, if any, as it deems fair and equitable, may enjoin secured creditors who may be affected by the extension proposal from proceeding in any court for the enforcement of their claims until the extension has been confirmed or denied by the court.”).

44. Act of March 9, 1933, ch. 1, tit. II, § 207, 48 Stat. 1, 3-4.

45. Act of May 24, 1934, ch. 345, § 80(e), 48 Stat. 798, 801-02.

46. Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911, 912-22.

47. Act of Aug. 27, 1935, ch. 774, § 77(e)(1), 49 Stat. 911, 918-20.

48. Chandler Act, ch. 575, 52 Stat. 840, 897 (1938).

provision for publicly traded firms.⁴⁹ The legislative history provided that “[s]ubsection (2) of section 221, derived from section 77B(f)(1), provides, as a condition to confirmation of a plan, that the judge be satisfied that it is ‘fair and equitable,’ and ‘feasible.’”⁵⁰ In 1935, the Public Utility Holding Company Act also provided for reorganization of utilities under a “fair and equitable” standard.⁵¹

In 1939, railroads that were afflicted by the Great Depression were offered “expeditious relief” under chapter XV of the Bankruptcy Act.⁵² This too required reorganizations be “fair and equitable.”⁵³

Then, in late 1939, the Supreme Court, speaking through Justice Douglas in *Case v. Los Angeles Lumber Products Co.*, handed down its first decision actually interpreting the phrase “fair and equitable” in a case arising under the by then repealed section 77B.⁵⁴ Douglas had just joined the Court that year, after a career as both an academic and an important member of the SEC staff, ultimately serving as its third chairman.⁵⁵ In his years with the SEC, he had been actively involved with the drafting of a multi-volume report⁵⁶ in which the agency criticized the equity receivership system for favoring insiders at the expense of small bondholders.⁵⁷ This report not only prompted the Chandler Act, but also the Trust Indenture Act of 1939, which made it

49. See generally Reuben G. Hunt, *The Proper Use of the Chapters X, XI and XII of the Bankruptcy Act*, 44 COMM. L.J. 72 (1939).

50. See S. REP. NO. 75-1916, at 35-36 (1938). As discussed below, and unlike modern practice, under former chapter X, a plan had to be “fair and equitable” in order to be confirmed whether or not it was accepted by the requisite majorities of each class. See also H.R. Res. 8046, 75th Cong. § 221 (1938).

51. See Act of Aug. 26, 1935, ch. 687, tit. I, § 11, 49 Stat. 803, 820-23.

52. See Act of July 28, 1939, ch. 393, 53 Stat. 1134; see also Hubert L. Will, *Chapter XV of the Bankruptcy Act—An American Adaptation of the Fait Accompli*, 7 U. CHI. L. REV. 203 (1940). This is not to be confused with the current chapter 15, added to the Bankruptcy Code in 2005.

53. See *In re Baltimore & O.R. Co.*, 29 F. Supp. 608, 628 (D. Md. 1939).

54. *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106 (1939).

55. Justice Brandeis retired February 13, 1939; Justice Douglas was confirmed as his successor on April 4, 1939.

56. See SECURITIES AND EXCHANGE COMM’N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937–1940).

57. J. Ronald Trost, *Corporate Bankruptcy Reorganizations: For the Benefit of Creditors or Stockholders?*, 21 UCLA L. REV. 540, 542–44 (1973).

quite difficult to reorganize bond debt outside of a federal bankruptcy proceeding.⁵⁸ Justice Douglas personally lobbied his colleagues to grant certiorari in *Los Angeles Lumber*⁵⁹ presumably to advance the work he had started with the SEC.

In that case, holders of more than 92% of the debtor's bonds along with more than 99% of Class A stock and about 90% of Class B stockholders approved the debtor's reorganization plan. But the plan provided for bondholders to be transformed into preferred shareholders, and Class A shareholders to become the new common shareholders.⁶⁰ In short, Class A shareholders would retain their interest in the company in a situation where everyone would have otherwise agreed that the bondholders were not being paid in full. Justice Douglas wrote that

the phrase ["fair and equitable"] became a term of art used to indicate that a plan of reorganization fulfilled the necessary standards of fairness. Thus throughout the cases in this earlier chapter of reorganization law, we find the words "equitable and fair", "fair and equitable", "fairly and equitably treated", "adequate and equitable", "just, fair, and equitable" and like phrases used to include the "fixed principle" of the *Boyd* case, its antecedents and its successors. Hence we conclude, as have other courts, that that doctrine is firmly imbedded in [section] 77B.⁶¹

The question, he said, was whether the debtor's plan was fair. He concluded it was not because the bondholders "will be required under the plan to surrender to the stockholders 23 per cent of the value of the enterprise."⁶² Suggesting that "fair and equitable" had become "term of art" in the railroad receivership community probably exaggerated things more than a bit.⁶³

Nonetheless, *Los Angeles Lumber* indicated that the Supreme Court agreed with the SEC's inclination to read the term "fair and equitable"

58. See *Caplin v. Marine Midland Grace Trust Co. of N.Y.*, 406 U.S. 416, 422 (1972).

59. KENNETH N. KLEE, *BANKRUPTCY AND THE SUPREME COURT* 378–79 (2008).

60. Class B shareholders were eliminated.

61. *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 118–19 (1939) (footnotes omitted).

62. *Id.* at 119.

63. In the words of Jack Ayer: "Strictly speaking, this is poppycock, and Justice Douglas knew it." John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 975 (1989); see also De Forest Billyou, "New Directions": A Further Comment, 67 HARV. L. REV. 1379, 1380–81 (1954).

to include something like the absolute priority concept that Bonbright and Bergerman had described just over a decade before.⁶⁴ But when all was said and done, the absolute priority rule still lacked the basic features its name would suggest. Even Justice Douglas seemed to recognize as much⁶⁵—and he notably never used the term himself.⁶⁶ As Robert Swaine summarized after several further Supreme Court forays into corporate reorganization,

Thus the fullness of the compensation or payment, the making whole, the application of the full value of the property, the absolute and strict recognition of priority, all seem to be positional or comparative—*i.e.*, relative. Even in respect of relative positions in assets and earnings the words “absolute” and “strict” are to be taken in a much less “absolute” or “strict” sense than they might seem to imply. A senior securityholder may be given treatment in the same class of securities as is allotted to junior creditors provided the terms of the allotment to the senior creditors are sufficiently more favorable. This is evidenced not only by the actual treatment of the securities approved in the two cases but also by express language in both opinions.⁶⁷

Everyone apparently agreed that reorganization plans must be fair and equitable. After *Boyd*, this clearly prohibited freezing out entire classes of creditors when junior claimants, like shareholders, survived. But there was no definitive adoption of the “absolute priority rule” in its

64. See Eugene V. Rostow & Lloyd N. Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334, 1346 n.55 (1939) (“The S. E. C. is committed to a ‘strict priority’ view of reorganization draftsmanship.”).

65. See *L.A. Lumber*, 308 U.S. at 121 (“It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor.”)

66. *The “Fair and Equitable” Rule in Modern Corporate Reorganization*, 25 IOWA L. REV. 793, 799–800 (1940) (“[T]here is the possibility that the Supreme Court, in deciding a case involving a more difficult situation than that involved in the *Los Angeles* case, may distinguish that case on its facts and follow a rule more akin to the relative priorities rule. . . . [T]he *Los Angeles* case did not adopt the absolute priority rule by name and . . . neither the *Los Angeles* . . . nor the *Boyd*, *Louisville Trust Company*, or *Kansas Terminal Railway Company* cases on their facts called for the use of the rule.”).

67. Robert T. Swaine, *A Decade of Railroad Reorganization Under Section 77 of the Federal Bankruptcy Act*, 56 HARV. L. REV. 1193, 1208–09 (1943).

strict liquidation sense. Justice Douglas had successfully nudged the concept of “fair and equitable” closer to Bonbright and Bergerman’s absolute priority rule, but that was a more practical creature than the “strict priority schedule” that modern authors talk about today.⁶⁸

For the remaining years of the Bankruptcy Act, until 1978, the absolute priority rule, as defined in *Los Angeles Lumber*, remained the rule in chapter X.⁶⁹ And while it was often argued that cases involving publicly traded securities should be transferred to chapter X, the courts continued to allow companies to file under chapter XI in many situations.⁷⁰ That was highly significant because Congress eliminated the “fair and equitable” rule from chapter XI in 1952.⁷¹

In short, the rule of *Los Angeles Lumber* applied in a limited number of cases, namely those that were compelled to file under chapter X, which was increasingly seen as something of a moribund chapter, and the occasional railroad under section 77.⁷² And when it did apply, it was seen as a bother.⁷³ In particular, senior classes were unable to consent to deviations from the rule, so valuation fights were required in every case. In the late 1960s, the SEC suggested that the “fair and equitable” rule be modified.⁷⁴ In the early 1970s, the Commission on the

68. See Chauncey H. Hand, Jr. & G. Clark Cummings, *Consensual Securities Modification*, 63 HARV. L. REV. 957, 976 (1950); Note, *Strict Priority in Bankruptcy Reorganization*, 49 YALE L.J. 1099, 1103 (1940).

69. In *Consolidated Rock Products Co. v. DuBois*, Justice Douglas made it plain that the absolute priority rule applied to chapter X too. *Consol. Rock Prods. Co. v. DuBois*, 312 U.S. 510 (1941).

70. See, e.g., *Beach v. KDI Corp. (In re KDI Corp.)*, 477 F.2d 726, 737 (6th Cir. 1973); *In re Arlan’s Dep’t Stores, Inc.* 373 F. Supp. 520 (S.D.N.Y. 1974); see also Richard W. Jennings, *Mr. Justice Douglas: His Influence on Corporate and Securities Regulation*, 73 YALE L.J. 920, 958-62 (1964). Chapter XI involved a debtor in possession, while chapter X required a trustee in all cases with debts over \$250,000. Chapter XI only reorganized unsecured debt, and did not allow for involuntary filings. For a concise comparison of the two, see William J. Rochelle, *Rehabilitation in Bankruptcy: A Comparison of Chapters X and XI*, 34 J. KAN. B. ASS’N 17 (1965).

71. See Act of July 7, 1952, ch. 579, § 35, 66 Stat. 420, 433; Ayer, *supra* note 63, at 976-78.

72. Although the biggest case of this era, Penn Central’s 1970 filing, was under section 77, from the early 1950s, when the last of the post-war cases were completed, until the 1970s, there were very few major railroad bankruptcy cases. See Wyatt R. Haskell, *Railroad Reorganization for Beginners*, 24 ALA. L. REV. 295 (1972).

73. See Marilyn Huff, *The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5*, 50 AM. BANKR. L.J. 197, 215 (1976).

74. See Rochelle, *supra* note 70, at 19.

Bankruptcy Laws of the United States “both proclaim[ed] its attachment to the absolute priority rule and propose[ed] effectively to abolish the rule.”⁷⁵ There was a general sense that the rule was impractical. As Blum and Kaplan summarized:

In a sense, the absolute priority doctrine does prescribe a general rule: before a class of investors can participate in a reorganization, all more senior classes must be compensated in full for their claims, measured on the basis of their priorities upon involuntary liquidation, unless the junior class contributes to the reorganized enterprise something that is reasonably compensatory and is measurable. Reorganizers have always understood, however, that this general formulation does not dictate a specific pattern of adjusting rights among classes of investors. Reorganization plans are the result of a process in which representatives of the investors “negotiate” (indirectly and sometimes directly) with each other⁷⁶

Other commentators argued that liquidation value of the debtor should provide the value protected by the absolute priority rule—that is, the rule would not entitle senior creditors to going concern surplus.⁷⁷ While the Commission’s proposed Bankruptcy Act of 1973 was not to be,⁷⁸ it had real influence on the discussions that led to the 1978 Bankruptcy Code.⁷⁹ As Congress noted, times had changed, and the rule that once protected small investors as bondholders now hurt them as shareholders.⁸⁰

The Bankruptcy Code made several key changes to the absolute priority rule. First, the rule now only applies to dissenting classes—that

75. Victor Brudney, *The Bankruptcy Commission’s Proposed “Modifications” of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305, 308 (1974).

76. Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651, 652-53 (1974).

77. John H. Frye, III, *The Fair and Equitable Doctrine: Are Liquidation Rights a Realistic Standard During Corporate Reorganization?*, 20 CATH. U. L. REV. 394, 421-22 (1970). This argument had much older roots. See, e.g., Spaeth & Winks, *supra* note 9, at 772 (discussing, but not endorsing, the “composition” theory of section 77 in an article published before the *Los Angeles Lumber* decision).

78. See S. 2565, 93d Cong. (1973); H.R. 10792, 93d Cong. (1973).

79. See generally Kenneth N. Klee, *Legislative History of the New Bankruptcy Law*, 28 DEPAUL L. REV. 941 (1979).

80. See 124 CONG. REC. 34,004 (1978); see also Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity’s Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 133 (1990).

is, classes can waive the rule, and minority positions within the class are bound by the result. Moreover, classes that are unimpaired under the plan are automatically deemed to consent.⁸¹ Thus, in consensual plans, or even partially or “deemed” consensual plans, the holdout problem is solved and the absolute priority rule abolished. When there is a dissenting class, the cramdown option permits the confirmation of a plan notwithstanding the objection, if the plan is “fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.”⁸² Section 1129(b)(2)(A) goes on to specify certain standards to be used for ascertaining whether a given plan is “fair and equitable” with respect to a class.

For unsecured creditors and equity-holders, the absolute priority rule continues to apply, and thus either the dissenting class must be paid in full or no junior class can be paid under the plan.⁸³ In the case of a class of unsecured creditors, this means full payment or no equity participation. While in early cases there were sometimes attempts to preserve at least some “option value” for the old shareholders, the modern trend seems to favor cancellation of equity, whereas the debtor avoids the tricky question of whether the creditors have actually been paid in full.⁸⁴

After 1978, the absolute priority rule no longer applied to secured creditors,⁸⁵ but section 1129(b) does protect a dissenting secured class by providing that it must receive the full value of its collateral, either as a claim or by sale of the collateral and distribution of the proceeds to the dissenting class.⁸⁶ That is, a class of secured creditors must either

81. See 11 U.S.C. § 1126(f) (2012).

82. *Id.* § 1129(b)(1).

83. For a concise overview of how this operates in practice, see SALLY McDONALD HENRY, *ORDIN ON CONTESTING CONFIRMATION* § 12.03[D] (2015), Westlaw ORDNCC.

84. Of course, shareholders might eventually argue that the creditors are being overcompensated, as the “fair and equitable” rule protects interests beyond the absolute priority rule. See generally Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229 (1990).

85. See David Gray Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 AM. U. L. REV. 63, 82 (1991).

86. Lynn M. LoPucki et al., *Optimizing English and American Security Interests*, 88 NOTRE DAME L. REV. 1785, 1837 (2013). As Walter Blum noted, this calculation could actually become quite complex. Walter J. Blum, *The “Fair and Equitable” Standard for Confirming Reorganizations Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 165, 169–71 (1980).

consent, as in the recent *Chrysler* case,⁸⁷ or be paid full value of their collateral. Paying full value protects the same kind of interests as the absolute priority rule, while other classes are entitled to insist on a plan that complies with the absolute priority rule. This only comes into play when voting on a plan, and on its confirmation by the court. The Code may allow the debtor to distribute assets before this point in the case. Doing so may allow certain creditors, namely those who provide greater long-term value to the debtor, to obtain treatment that deviates from the “strict priority schedule” that some imagine applies under the Bankruptcy Code.

For example, if a debtor assumes a useful contract during the course of its bankruptcy case, section 365 requires the debtor to cure any pre-bankruptcy defaults.⁸⁸ Moreover, the debtor must continue to perform on the contract going forward. Section 365 thus allows the debtor to elevate certain contractual creditors into a special status, beyond mere creditor.⁸⁹ Instead, these lucky counterparties are excused from the bankruptcy process and resume normal, contractual relations with the debtor firm.

Of similar import—if somewhat vaguer statutory authority—are payments made under “first day” motions.⁹⁰ Providers of important inputs become “critical vendors,” and customers with prepetition warranty claims are paid “in the ordinary course,” in both cases effectively exempting them from the bankruptcy process.⁹¹ Some of

87. See Douglas G. Baird, *Lessons from the Automobile Reorganizations*, 4 J. LEGAL ANALYSIS 271, 277 (2012). Assuming the absolute priority rule is applicable in a section 363 sale, it is often said that *Chrysler* involves a violation of the rule. See, e.g., Macey & Beirne, *supra* note 7, at 2–3. But that typically either forgets that the rule applies on a class basis or involves some sort of elaborate conspiracy theory as to why consent should not matter in the case. In essence, these commentators would like to return to pre-1978 law, where consent was not permissible and the rule applied on an individual creditor basis, but amusingly they would do so to protect sophisticated distressed debt investors, rather than Justice Douglas’ small bondholders.

88. 11 U.S.C. § 365(b) (2012).

89. Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61, 66 (2009) (“The debtor’s election essentially decides whether the contract will be treated as an asset or a claim.”).

90. Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 574 n.8 (3d Cir. 2003) (en banc).

91. Richard E. Mikels & Ella Shenhav, *Chrysler Reflects Modern Reorganization Practice*, AM. BANKR. INST. J., Dec./Jan. 2011, at 38, 82.

these suppliers might be bound by contract, but nonetheless claim that the debtor's bankruptcy warrants non-performance or a change in the terms of performance. Of course this is a breach, but if no other supplier can step in and do the job, it may be optimal for the debtor to give in to these demands to some degree.

Another common first day motion allows the debtor to pay employees in the ordinary course. Thus, while employees normally have a priority over other unsecured creditors,⁹² they effectively obtain a priority over secured creditors as well when paid under a first day motion. If a debtor is to continue as a going concern—the basic difference between liquidation and reorganization—these sorts of priority “violations” may be inevitable, and even desirable.⁹³

A debtor in litigation with a counterparty might enter into a settlement, and that settlement might ultimately provide a greater recovery than the creditor-counterparty would have received if the debtor was liquidated.⁹⁴ Other counterparties have a right to extract assets from the debtor's estate at less than full value. For example, it has been widely noted that swaps and other derivatives are largely exempt from the bankruptcy process.⁹⁵ If the debtor is “in the money” on a particular contract, its non-bankrupt counterparty obtains a right to terminate the contract, and pay the debtor damages according to a calculation process the non-bankrupt party largely controls. Not surprisingly, there have been claims that this has resulted in loss of

92. See 11 U.S.C. § 507(a)(4).

93. See Oscar Couwenberg & Stephen J. Lubben, *Essential Corporate Bankruptcy Law*, 16 EUR. BUS. ORG. L. REV. 39, 52-53 (2015).

94. See *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452, 460 (2d Cir. 2007); see also *Czyzewski v. Jevic Holding Corp. (In re Jevic Holding Corp.)*, No. 08-11006(BLS), 2014 WL 268613, at *3 (D. Del. Jan. 24, 2014) (“As discussed by the bankruptcy court, the settlement does not follow the absolute priority rule. However, this is not a bar to the approval of the settlement as it is not a reorganization plan.”), *aff'd sub nom. Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3d Cir. 2015) (In affirming the district court's holding, the Third Circuit noted that “neither Congress nor the Supreme Court has ever said that the rule applies to settlements in bankruptcy.”). *But see United States v. AWECO, Inc. (In re AWECO, Inc.)*, 725 F.2d 293, 298 (5th Cir. 1984).

95. Stephen J. Lubben, *Transaction Simplicity*, 112 COLUM. L. REV. SIDEBAR 194, 198 (2012).

value for the debtor's estate.⁹⁶ That lost value presumably could have resulted in higher recoveries for creditors.

In short, the current law is that the absolute priority rule applies only if a class objects to the plan, and only at the point of plan's consideration. The debtor-firm's assets at the end-point of the case are subject to the rule, but those assets might have been significantly reshaped before that point.⁹⁷ Moreover, that reshaping may have allowed substantial deviations from the absolute priority rule that would have governed on the day the bankruptcy case commenced.

In this way, the current bankruptcy process resembles that of the old railroad receivership process, which the Chandler Act sought to end. In a receivership, numerous intermediate claimants were paid in full through specialized doctrines like the six-month rule⁹⁸ and the doctrine of necessity.⁹⁹ Those general creditors who remained after application of these rules were the ones protected by the rule of *Boyd*. Nonetheless, this practical version of the absolute priority or the rule of *Boyd*, which has developed over a century, is not the one that features prominently in the academic literature, a point I turn to next.

II. THE ACADEMIC VIEW OF THE ABSOLUTE PRIORITY RULE

Although scholarship about the absolute priority rule, or the *Boyd* or *Los Angeles Lumber* rules, dates back almost a century, the bulk of this work, until relatively recently, was particularly practical.¹⁰⁰ Even Walter

96. Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123, 129–32 (2010).

97. *Del. Tr. Co. v. Energy Future Intermediate Holdings, LLC (In re Energy Future Holding Corp.)*, 527 B.R. 157, 166 (D. Del. 2015) (“Plans of reorganization are not the exclusive mechanism to exchange debt or pay off existing creditors in chapter 11.”).

98. Upheld in *Fosdick v. Schall*, 99 U.S. 235 (1878); see also *In re Penn Cent. Transp. Co.*, 458 F. Supp. 1234, 1319–21 (E.D. Pa. 1978).

99. See *In re Boston & Maine Corp.*, 468 F. Supp. 996, 1008 (D. Mass. 1979). The doctrine of necessity, also known as the necessity of payment rule, dates back to *Miltenberger v. Logansport, C. & S.W.R. Co.*, 106 U.S. 286, 311–12 (1882). See also Tina M. Sutorius, *Are Certain Creditors Too Big (or Important) to Fail?*, 6 BROOK. J. CORP. FIN. & COM. L. 263, 270–73 (2011).

100. Judge Mabey collects this literature in *In re Barrington Oaks General Partnership. In re Barrington Oaks Gen. P'ship*, 15 B.R. 952, 958 n.17 (Bankr. D. Utah 1981) (noting that “[t]he literature analyzing the rule and advocating its modification is immense” and citing many articles therein).

Blum's papers, often pointed to as the origin of most modern scholarship in this area,¹⁰¹ have a kind of practical bent that deviates from modern scholarship,¹⁰² where the goal was not to provide a theory of the rule, but rather to explain how the rule worked in practice. Three (relatively) recent papers by professors Ayer,¹⁰³ Markell,¹⁰⁴ and Warren¹⁰⁵ fit easily within this literature, and also provide some modicum of broad theory as well.

Ayer finds constitutional and common law strands of the absolute priority rule in the course of expressing some skepticism about the new value exception to the rule.¹⁰⁶ Markell reviews the historical evolution of the rule from its successor liability roots to show how the so-called new value exception has always been part of the rule.¹⁰⁷ On the other hand, Warren justifies the absolute priority rule in the separateness of the bankruptcy estate from the debtor's old owner, before acknowledging that questions of valuation are the main intractable problem in all bankruptcy theories.¹⁰⁸

The full modern academic treatment of the rule does not really commence until 1988, with the publication of Baird and Jackson's *Bargaining After the Fall and the Contours of the Absolute Priority Rule*.¹⁰⁹ The article was in many ways a follow-up to their prior individual work that had questioned the utility of chapter 11, given a conspicuously rosy view of chapter 7.¹¹⁰

In short, Baird and Jackson argue that bankruptcy law would be well served by focusing on the residual claimant in the debtor's capital

101. See Lipson, *supra* note 12, at 1229 n.180; see also Douglas G. Baird & Thomas Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988).

102. E.g., Walter J. Blum, *Full Priority and Full Compensation in Corporate Reorganization: A Reappraisal*, 25 U. CHI. L. REV. 417 (1958).

103. Ayer, *supra* note 63.

104. Markell, *supra* note 32.

105. Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9 (1992).

106. Ayer, *supra* note 63.

107. See Markell, *supra* note 32, at 101.

108. See Warren, *supra* note 105, at 14 ("Two factors contribute to the difficulty of reaching the best value for the reorganizing business: the thinness of the market for the business, and the possibility for self-dealing by the manager charged with selling the business.").

109. See Baird & Jackson *supra* note 101.

110. See *id.* at 741 n.10.

structure.¹¹¹ As such, they suggest that the absolute priority rule, or the rule of *Boyd* as they refer to it, should be discarded in place of rules that better increase that focus.¹¹² For example, if an intermediate class is the residual claimant, they argue that such a class is better protected by reinstating the senior creditors under section 1124(2), and taking ownership of the debtor-firm from the junior shareholders.¹¹³ With the benefit of hindsight, this focus on reinstatement seems odd, primarily because it happens so infrequently in actual practice. When the Code was first enacted in 1978, interest rates were quite high and debtors had some strong incentives to maintain old debt that has been issued under comparatively low rates. Since the 1990s, however, interest rates have been sufficiently low that debtors have had few reasons to reinstate very much debt.¹¹⁴

In general, while expressing some skepticism over the role of the absolute priority rule, Baird and Jackson put extra stress on the equally vexing issue of valuation. Yet, while the authors differ from their peers in calling for something other than the use of the rule, they are similar to those who followed in focusing on the single case in which the rule applies.

These attempts at thoughtful, theoretical understandings of the absolute priority rule were then buttressed by a wealth of proposals to replace chapter 11 with a market-type automated system.¹¹⁵ As part of this approach, the proponents of the new system inevitably argued that

111. *Id.* at 766 (“[W]e show that once one can identify the residual owner of the firm, the ordinary rule that the residual owner should be able to bargain on behalf of the firm should hold inside of bankruptcy as it does outside.”); *see also id.* at 775.

112. The purpose of this section of the paper is to develop the academic understanding of the absolute priority rule, not to critique the various key papers. Nonetheless, the Baird and Jackson proposal does obviously suffer from the near impossibility of identifying a single, stable residual claimant. *See generally* Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L.Q. 1341 (2004). One might also observe that the firms they utilize in their hypotheticals look more like small businesses than the big corporate debtors they purport to address, and the unity between shareholders and management they propose seems implausible. *See* LoPucki & Whitford, *supra* note 80, at 149–51.

113. *See* Baird & Jackson *supra* note 101, at 765.

114. For a rare recent example of an attempt at reinstatement under section 1124(2), see *JPMorgan Chase Bank, N.A. v. Charter Commc’ns Operating, LLC (In re Charter Commc’ns)*, 419 B.R. 221, 243–45 (Bankr. S.D.N.Y. 2009).

115. *See infra* notes 116–19 and accompanying text.

the new approach would facilitate payment of creditors “by strict application of the absolute priority rule.”¹¹⁶ More broadly, the general trend was to promote systems of “reorganization” that would quickly convert the debtor’s estate into a pool of cash.¹¹⁷ This avoided the difficulty that inevitably arose from the application of a strict form absolute priority rule outside of a chapter 7-style liquidation—going concern valuation being always subject to debate.¹¹⁸ Typically left unstated was why this strictness would be a good thing.¹¹⁹

As noted, the rule was not particularly strict even during its days under the old Act.¹²⁰ The new value exception, acknowledged by Justice Douglas himself, clearly opens the door to a form of bargaining unlike the prototypical sheriff’s sale.¹²¹ Section 1129(b) itself does not state the rigor with which the rule is to be applied. Somehow commentators assume that the invocation of the rule means the invocation of their preferred form of the rule: “a use of abstract words as if they had absolute meanings.”¹²²

More generally, as noted earlier, the application of a strict absolute priority rule at the point of plan confirmation seems somewhat odd given the well-known practices that allow deviations from priority for

116. See Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1085 (1992).

117. E.g., Lucian Arye Bebchuk, *A New Approach to Corporate Reorganization*, 101 HARV. L. REV. 775 (1988) (proposing that claimants and interest holders be given tradable options in the reorganized entity); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983) (proposing an all-equity capitalization, the value of the equity to be determined by offering 10% for sale on the market).

118. See Yaad Rotem & Omer Dekel, *The Bankruptcy Auction as a Game – Designing an Optimal Auction in Bankruptcy*, 32 REV. LITIGATION 323, 343 (2013).

119. But not always, for example in Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE L.J. 83, 88 (2001) (the assumption that managers and shareholders share unitary interests leads to the conclusion that “for the managers, anticipation of a soft landing in the event of insolvency would reduce the discipline debt can impose and thus could make failure more likely.”).

120. See Jerold B. Warner, *Bankruptcy, Absolute Priority, and the Pricing of Risky Debt Claims*, 4 J. FIN. ECON. 239, 272 (1977).

121. See Kevin A. Kordana & Eric A. Posner, *A Positive Theory of Chapter 11*, 74 N.Y.U. L. REV. 161, 195 (1999).

122. Raymond Chandler, *The Simple Art of Murder*, ATLANTIC MONTHLY (December 1944).

various practical reasons before confirmation.¹²³ Strict application at confirmation seems little more than rigor for rigor's sake, at a point when the barn door has been open far too long. And as I argue in the next and final section, the desire to apply "strict" priority in a reorganization case is seriously misguided. Reorganization is not liquidation. It requires different rules. More broadly, a review of the academic literature of the post-1978 era suggests an excessive focus on the absolute priority rule at a single, static point in time. This is understandable, because doing so isolates the rule from the equally challenging question of valuation.¹²⁴

The debtor is not static outside the liquidation when continuing as a going concern. Instead, an operating firm remains a dynamic organism, with constantly changing asset and debt values.

III. PRIORITY AND REORGANIZATION

Priority rules make the most sense when applied to a specified pool of assets, better yet, a pool of cash—hence the temptation to focus on plan confirmation in reorganization cases. But operating businesses are not static pools of assets, or pools of a single kind of asset, and applying a priority rule at confirmation is greatly influenced by what happened the day before the confirmation hearing. Strict priority requires knowing what is owed and what the debtor owns. The question of *when* those two should be measured cannot be divorced from the application of the priority rule if the debtor is to continue in existence. The possible methods of distributing value in an insolvency case lay on a continuum: at one end is the "strict priority schedule" or extreme liquidation form of the absolute priority rule, and at the other might be some sort of random distribution of assets. In the second, the debtor's assets might be handed out by lottery amongst all the claimants.

In the first, assets would be distributed by the absolute priority rule alone, without even the deviations long allowed for employee claims or other similar priority claims such as currently listed in section 507 of the

123. See Jacob A. Kling, *Rethinking 363 Sales*, 17 STAN. J.L. BUS. & FIN. 258, 308 (2012).

124. For a good example of that challenge, see *In re Mirant Corp.*, 334 B.R. 800, 809 (Bankr. N.D. Tex. 2005) ("The Valuation Hearing commenced on April 18, 2005 and continued for 27 days over the following 11 weeks.").

Code.¹²⁵ That pole is unobtainable in reality, because no system could function without paying for the costs of its operation.¹²⁶ But it is possible to imagine a kind of pure chapter 7 with section 507(a)(2) and no other forms of priorities.

The other extreme flattens the capital structure: why accept a lower return on bonds if your recovery upon insolvency will be indistinguishable from that of equity? Here we would see real evidence of the *ex ante* effects that loom so large in the academic literature.¹²⁷

In the United States, and most other developed economies, liquidation proceeds under a modified form of the absolute priority rule. The effects of the basic rule are mitigated for specific favored creditors who either receive the benefit of a priority in payment, or an exception from the discharge that typically results from the process.¹²⁸ This is sufficiently close to the strict form of the rule to avoid untoward effects, and even if such effects did exist, there has been an implicit policy judgment that the social benefits outweigh the costs.

The trouble begins with the attempts to duplicate this rule in the reorganization context. Historically, the rule simply informed the broader fairness analysis. That is, under the receivership cases from the nineteenth and early twentieth century, the question was “is this plan fair?” The normal rules of liquidation provide some insight into that otherwise abstract question.

But as noted, the courts also found that the question of fairness was broader than the simple issue of priority.¹²⁹ Pure squeeze-outs of intermediate classes might be prohibited, but otherwise the question focused on the reasonableness of the plan. Thus, more than a decade after *Boyd* was decided by the Supreme Court, Bonbright and Bergerman could still note the variety of priority rules at play in reorganization cases.¹³⁰ Feeling the lower courts too generous to reorganization proponents, Justice Douglas, no doubt still influenced by his SEC perspective on the matter, arrested the meaning of “fair and

125. 11 U.S.C. § 507 (2012).

126. Senior lenders frequent grant of “carveouts” to professionals suggests as much. See generally Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 AM. BANKR. L.J. 445 (2002).

127. See Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors*, 46 VAND. L. REV. 1485, 1499 (1993).

128. E.g., 11 U.S.C. § 523.

129. See *infra* note 34 and accompanying text.

130. See Bonbright & Bergerman *supra* note 24, at 130-32.

equitable” in *Los Angeles Lumber*. However paradoxical, the Supreme Court effectively “codified” the meaning of “fair and equitable.” Then, in the 1970s when Congress wanted to relax *Los Angeles Lumber*, it had no choice but to actually codify the absolute priority rule.

But this codification should not have made the rule any more strident than under *Los Angeles Lumber*. Indeed, given the clear desire to relax the rule as announced in that case, it is arguable that Congress intended something more like the *Boyd* era version of the rule.¹³¹ Of course, regardless of congressional intent, many commentators would seem to favor a strict form of absolute priority.¹³² That, however, is the result of the obsessive focus on the endpoint, without regard for the duration of the process. Moreover, the fixation on the point of distribution allows commentators to ignore the basic paradox inherent in this interaction of contract and reorganization law. While credible, enforceable commitments are a good thing *ex ante*, unbending enforcement of those same agreements *ex post* results in value destruction.¹³³ *Ex ante* rigidity comes into conflict with the need for *ex post* flexibility.

As a general matter, a debtor-firm cannot compel counterparties to trade during a reorganization case. Thus, operating while under bankruptcy court protection involves the normal contractual process, with the added challenge that the debtor must bargain from a position of weakness. Given this reality, one way that the debtor can bargain is by offering to pay beyond what liquidation priorities would provide. Future dealing becomes tied to recoveries on past dealings. Investors, however, do not benefit from ongoing trading relationships with debtor-firms, and thus have little ability to engage in this sort of bargaining. Instead, employees, trade creditors, and the like benefit most. Investors benefit only indirectly, inasmuch as the debtor-firm is apt to be worth more, and thus pay more to creditors generally, if it keeps operating.

The bondholder faces a choice between the relatively certain return of liquidation and the potentially higher return of a reorganization case,

131. See Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1492 (1993).

132. E.g., Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1812-13 (1998).

133. See Robert Charles Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 70-71 (1976).

but the latter involves conferring benefits on other creditors who have more “soft” power with regard to the debtor.¹³⁴ Of course, in reality an individual bondholder does not get to make this choice, as the choice is made by a jurisdiction’s insolvency law.¹³⁵ And in the United States, the choice has been made to favor reorganization whenever feasible. Whether that choice is good, or wise, has been the subject of much academic commentary, to put it mildly.¹³⁶ In general, this debate has been about as fruitful as the Somme Offensive.

But this paper need not participate in that engagement. The point here simply is that, having chosen a reorganization system, it is impossible to make that system work while also adhering to strict liquidation priorities. The two are inherently in conflict.

Operating companies pay creditors according to business needs, without regard for actual priority. The hedge fund that holds tens of millions in senior notes, issued under an indenture replete with covenants, is in this sense subordinate to the trade creditor who provides \$100,000 of some vital input each week. The senior noteholders are only relevant every six months—when interest payments are due—and at maturity. The trade creditor is relevant with each invoice.

The relationship is little different in chapter 11. The hedge fund has strong rights at the confirmation hearing, but if the debtor-firm is to make it to the confirmation hearing as a going concern, the trade creditor must be kept happy. One of the easiest ways to keep them happy is to pay them regardless of their formal rights under the “strict priority schedule.” Easy, but could the trade creditor be handled some other way, perhaps more in line with the absolute priority rule?

Presumably a single trade creditor could be managed, albeit with some cost. Replacing a trusted vendor always involves some degree of

134. See *In re Kmart Corp.*, 359 F.3d 866, 872-73 (7th Cir. 2004).

135. See Robert K. Rasmussen, *Debtor’s Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 84-85 (1992).

136. See Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L.J. 573 (1998) (could be read as an effort to provide a kind of capstone to the debate. If so intended, it was wildly unsuccessful); see also e.g., Anthony J. Casey, *The Creditors’ Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 789 (2011); Diane Lourdes Dick, *The Chapter 11 Efficiency Fallacy*, 2013 B.Y.U. L. REV. 759, 760 (2013); Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399, 1455 (2012); Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197 (2005).

disruption to a business, and the new trade creditor in this instance is in a good position to extract extra returns from the debtor-firm. But a strict absolute priority firm would never apply to just one creditor; it must apply to all creditors. Here we begin to see the inherent incompatibility. The operation of the debtor as a going concern is fundamentally at odds with the notion of the debtor renegotiating with all of its trade creditors upon bankruptcy, and then renegotiating with all of its employees too. Application of a strict priority rule throughout reorganization essentially requires the firm's management to recreate the firm upon insolvency, at a point when the firm's lack of bargaining power is apt to increase the costs of doing so. The benefits of reorganization would be lost, raising real questions about any attempt to reorganize whatsoever. In short, reorganization simply cannot exist with such a strong form of the rule.

The strict form of the absolute priority rule, so favored by the academy, is thus nowhere to be found in actual reorganization practice.

CONCLUSION

That the absolute priority rule is both more flexible and less absolute than often asserted does leave us in a bit of a conundrum. Namely, a flexible form of the rule leaves open the question of when that flexibility should be exercised.¹³⁷ Flexibility in the furtherance of preserving going concern value generally seems laudable, while flexibility in service of undercompensating disfavored creditors is properly loathed.

The solitary benefit of the imaginary form of absolute priority rule is ease of application—at the expense of reorganization, however. A messy reality means that difficult choices of when liquidation priority should be broken need to be specified and understood. Recognizing the true nature of the absolute priority rule makes clear the work that remains to be done.

137. See Matthew Bruckner, *The Virtue in Bankruptcy*, 45 LOY. U. CHI. L.J. 233 (2013).