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Bankruptcy's Uneasy Shift to a Contract Paradigm

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ARTICLE

BANKRUPTCY'S UNEASY SHIFT TO A CONTRACT PARADIGM

DAVID A. SKEEL, JR.† & GEORGE TRIANTIS††

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† University of Pennsylvania Law School. David Skeel is a member of the Financial Oversight and Management Board for Puerto Rico ("Board"). This Article reflects only his personal views, not the views of the Board or any of its other members, and it is not intended to express an opinion on any issue that may come before the Board

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INTRODUCTION

A generation ago, the Creditors' Bargain theory provided the first comprehensive normative theory of bankruptcy.[1] Not least of its innovations was the fact that it put bankruptcy theory on a contractual footing for the first time. Earlier commentators had recognized that bankruptcy law can prevent a "grab race" or "race to the courthouse" by creditors of a financially troubled debtor as they attempt to collect what they are owed, and that bankruptcy can provide a less chaotic and more even-handed distribution of the debtor's assets than might otherwise be the case.[2] The articles that introduced the Creditors' Bargain were the first to suggest that bankruptcy's solution to these concerns was resolutely contractual in nature.

According to the Creditors' Bargain theory, bankruptcy can be seen as the product of an implicit—or hypothetical—bargain among the creditors of a debtor.[3] In practice, the argument went, creditors are too dispersed to effectively contract with one another over the best response to a debtor's financial distress.[4] But if they were able to contract, they would agree to provisions that put a halt to the race to the courthouse and provide for a collective solution to financial distress.[5] Although a few creditors might fare better in a grab race, creditors as a whole would suffer because the creditors' collection efforts could dismember an otherwise viable business. By preempting the race, bankruptcy law supplies the terms of a contract that the parties would agree to if they could contract directly.[6]

In addition to justifying the collective proceeding, the hypothetical contract had important implications for every other feature of bankruptcy as well. As Baird and Jackson envisioned it, the hypothetical contract would pursue a "sole owner" standard—that is, the approach that a sole owner of all of the debtor's assets would favor—and thus would seek to maximize the value of the debtor's assets without regard to the effect of the resolution decision

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1 Thomas H. Jackson introduced the Creditors' Bargain theory in *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 858 (1982). He and Douglas Baird subsequently developed the theory in other articles and a book. *E.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7 (Harvard Univ. Press 1986); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 100-01 (1984).

2 *See, e.g.*, EDWARD J. BALLEISEN, NAVIGATING FAILURE: BANKRUPTCY AND COMMERCIAL SOCIETY IN ANTEBELLUM AMERICA 82 (2001) (noting that "[a]ntebellum jurists characterized the legal jockeying that resulted from debtor–creditor law [in the absence of a bankruptcy framework] as 'a race of diligence'").

3 *See, e.g.*, JACKSON, *supra* note 1, at 16-17.

4 *Id.* at 16.

5 *Id.*

6 *See id.* at 17 n.22 (describing the argument as "an application of the famous Rawlsian notion of bargaining in the 'original position' behind a 'veil of ignorance'").

on any particular constituency.[7] The hypothetical contract would protect the parties' nonbankruptcy entitlements—especially property rights—except to the extent necessary to achieve a collective solution to financial distress that would preserve the debtor's value as a going concern. If bankruptcy were to alter rights otherwise, the reasoning went, the debtor and its creditors would engage in costly efforts to maneuver disputes toward their preferred fora.[8]

As the hypothetical bargain terminology suggests, the Creditors' Bargain theory focused on implicit rather than actual contracting and did not conceive of bankruptcy as a set of default rules that the parties would be free to contract around. This was because the theory was addressing a world of creditors so dispersed that they were unable to contract. The most dramatic development in the decades since the model was devised has been the increasing use of *actual* contracts to shape the bankruptcy process. Some of the increase in contracting is due to the rise in relative prominence of secured creditors since the inception of the Creditors' Bargain theory. Unsecured creditors are less likely to be the key constituency in current cases than they were a generation ago, and the traditional collective action problems are correspondingly less relevant in many cases.[9] Another important change has been the rise of sophisticated activists who purchase and aggregate bankruptcy claims or provide new financing with a view toward influencing the course of the bankruptcy. The body of creditors is far more dynamic than a generation ago and tilted toward creditors that can and do contract.

A debtor's creditors might agree to bankruptcy rules at the time they extend credit, after the debtor becomes insolvent or files for bankruptcy, or at any point in between. For simplicity, we refer to contracting before insolvency as "ex ante" and that which occurs afterward as "ex post." Much bankruptcy-related contracting does in fact occur ex ante—particularly before or at the time credit is extended. Notably, the debtor assigns priority rights among its creditors. It may do so by granting security interests or liens, or by

7 *Id.* at 12.

8 *See, e.g.*, *id.* at 21 ("[T]he establishment of new entitlements in bankruptcy . . . create[s] incentives for particular holders of rights in assets to resort to bankruptcy . . . to gain for themselves the advantages of those changes, even when a bankruptcy proceeding would not be in the collective interest of the investor group."). The go-to judicial pronouncement of this concern had been previously made by the Supreme Court in *Butner v. United States*: "Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'" 440 U.S. 48, 55 (1979) (quoting Lewis v. Mfrs. Nat'l Bank, 364 U.S. 603, 609 (1961)).

9 Even when unsecured creditors are a key constituency, much of the unsecured debt is often held by distressed debt traders and other sophisticated players by the time of the bankruptcy. *See* Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 657 (2010) ("By the time of the bankruptcy, unsecured claims are in the hands of distressed debt professionals.").

having some creditors agree to be subordinated to others. A firm may also allocate priority among its creditors through its corporate structure, particularly the division of assets among parent and subsidiary entities.

In some cases, the ex ante contracting goes further to address procedural rights if the debtor should file for bankruptcy. In one common form of ex ante contract discussed below—intercreditor agreements between senior and junior lienholders—the junior lienholders may agree to forgo objections to a plan the senior lienholders support, or may agree to vote as instructed by the senior lienholders.[10] As we discuss in this Article, however, the courts have limited the degree to which the parties can effectively bind themselves and the courts through such ex ante contracts.

Contracting is also ubiquitous after insolvency and the initiation of bankruptcy (ex post). For several decades, debtor-in-possession (DIP) financers have been using the terms of their DIP loans to contract around key provisions of the Bankruptcy Code, and to steer the course of the Chapter 11 case.[11] More recently, debtors and their creditors have entered into restructuring support agreements to dictate the terms of an anticipated reorganization plan. These agreements often include many of the principal creditor groups, and effectively lock in the terms of the plan.[12] Given the growing market for claims against a debtor in bankruptcy, many of the agreements are among parties that did not extend the credit initially but subsequently purchased outstanding claims. The courts have been far more receptive to such ex post than ex ante contracts that attempt to settle reorganization terms.

In this Article, we attempt to make sense of bankruptcy's new contract paradigm. We begin by taking a closer look at the contractual structure of the Bankruptcy Code of 1978. The wave of contracting has taken place against the backdrop of a bankruptcy law framework that has been generally viewed as mandatory in structure. As we suggest in Part I below, a closer look reveals that the Code is not nearly as mandatory in practice as was once thought. The language of some of the Code itself contemplates and even encourages contracting during bankruptcy as an alternative to judicial decisionmaking in an adversarial process. The essence of the Chapter 11 plan confirmation process is a set of voting rules that enables a class of creditors or shareholders

10 For a discussion and analysis of recent cases involving intercreditor agreements, see generally Kenneth Ayotte, Anthony J. Casey & David A. Skeel, Jr., *Bankruptcy on the Side*, 112 NW. U. L. REV. 255, 264-73 (2017).

11 For early discussion in the academic literature, see, for example, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 784-85 (2002) and David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 929, 935-39 (2003).

12 *See, e.g.*, Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593, 603 (2017) ("[S]ecured creditors have . . . discovered that they could increase their control over the debtor . . . through the use of restructuring support agreements.").

to bind potential holdouts to the will of the majority. The cramdown rules authorize the court to enforce an ex post bargain over the objections of one or more classes of creditors. Yet, bankruptcy practice has taken contracting even further, permitting parties also to contract around provisions whose language is not permissive in this sense. Parties present consent orders for approval by the court, and these are given considerable deference.[13] Indeed, this practice has evolved even when the Code explicitly gives the discretion to the court, such as in the authorization of DIP financing.[14]

While the Code and bankruptcy practice allow for ex post contracting, they provide little encouragement for ex ante contracts. This has presented a stark contrast to related areas of business law that had become increasingly permissive in the years before the Code was enacted. Delaware's sweeping overhaul of its General Corporation Law in 1967 made corporate law principally a set of default rules that a firm can contract around if it wishes. Similarly, the Uniform Commercial Code is replete with provisions that apply "unless the parties otherwise agree." There are very few provisions in the Bankruptcy Code inviting the parties to "otherwise agree" by contract,[15] and in some contexts the Code explicitly overrides ex ante contracts.[16] Bankruptcy courts also view ex post contracting more favorably than ex ante contracts. We present examples of the bias toward ex post contracting in Part III by noting that, while courts have been quite skeptical of (ex ante) intercreditor agreements[17] and have sometimes declined to honor the corporate boundaries established by the parties,[18] they have usually been willing to approve (ex post) restructuring support agreements[19] and the terms of new DIP loans that purport to regulate the restructuring process.

13 Bankruptcy Rule 9019(a) provides that "[o]n motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement." FED. R. BANKR. P. 9019(a). The Rule is silent as to the standard that courts should apply in deciding whether to approve an agreement. The case law focuses the court's attention to the probabilistic outcomes in litigation and the complexity and cost of litigation, as well as more generally, what is in the prospective best interests of the creditors. Myers v. Martin (*In re* Martin), 91 F.3d 389, 393 (3d Cir. 1996). This standard omits the important consideration that, while the parties' ex post interests may converge, their joint ex ante interest was different. *See infra* Part II.

14 *See* 11 U.S.C. § 364 (2012) (requiring court approval of DIP financing terms).

15 One exception is § 510(a), which enforces subordination provisions. *Id.* § 510(a).

16 For example, § 365(e) and § 541(c) each override ipso facto provisions in prebankruptcy contracts—that is, provisions that make insolvency or a bankruptcy filing a condition of default. *Id.* §§ 365(e), 541(c).

17 *See, e.g.*, *In re* Bos. Generating, LLC, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010) (declining to enforce intercreditor agreement because it was not "clear beyond peradventure").

18 *See, e.g.*, *In re* Gen. Growth Props., Inc., 409 B.R. 43, 62 (Bankr. S.D.N.Y. 2009) (permitting debtor to put solvent subsidiaries in bankruptcy over creditors' objections).

19 *See generally* Baird, *supra* note 12, at 605-06 (discussing why "most bankruptcy judges find that postpetition agreements in which parties commit to support a particular plan are permissible").

The enforcement of ex post contracts yields important benefits. Contracts are incomplete in that they usually cannot anticipate the optimal obligations in each possible future contingency. Precise (rule-like) contract terms may become inefficient in unanticipated states of the world. One design response to incompleteness is the use of standards that delegate authority to a court, which will have the benefit of hindsight and knowing what state has materialized ex post. This explains why contracts in risky environments and statutes like the Bankruptcy Code are replete with standards (such as "good faith," "reasonable care," and "material"). Another approach is to allow the parties to contract more specifically after uncertainty is resolved, recognizing that the parties have even better information ex post than courts.[20] Whereas an ex ante contract faces the challenge of providing for many possible future states of the world, the ex post contract can provide for the one that materialized.

Ex ante contracting, however, has distinct and important benefits despite its incompleteness. The legal protection provided by an ex ante contract encourages reliance on investments by the parties, efficiently allocates risk, and establishes incentives.[21] These benefits may be undermined if an incomplete contract is renegotiated ex post, particularly when the debtor is insolvent. Given that it is often impossible to achieve perfectly the benefits of both ex ante and ex post contracting, lawmakers and courts should devote more attention to trading off the costs and benefits of each. While we generally endorse the argument that bankruptcy should be more receptive to ex ante contracts, our analysis raises a more novel point: in several respects, bankruptcy law also may be too permissive in enforcing ex post bargains.

Scholarly attention has previously focused on the tradeoffs between ex ante and ex post efficiency. A significant body of scholarship has explored this issue in a variety of bankruptcy contexts, including debates about the absolute priority rule and timely initiation of Chapter 11 cases.[22] Our focus here, by

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20 In fact, the right way to think about ex post is ex post the revelation of information. These benefits are discussed more fully. *See infra* Part II.

21 *See* Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RES. L. REV. 187, 192-94 (2005) (discussing the tension between ex ante and ex post contracting, and the related tension between commitment and flexibility).

22 *See, e.g.*, Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 473 (1992) (pointing out perverse ex ante consequences of ex post deviations); Barry E. Adler & George Triantis, *Debt Priority and Options in Bankruptcy: A Policy Intervention*, 91 AM. BANKR. L.J. 563, 589-90 (2017) [hereinafter Adler & Triantis, *Debt Priority*] (criticizing the American Bankruptcy Institute proposal to require, in cramdown, payment of a redemption option value to subordinated creditors); Barry E. Adler & George G. Triantis, *The Aftermath of* North LaSalle Street, 70 U. CIN. L. REV. 1225, 1236-38 (2002) (refuting alleged benefits of relative priority); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 194 (1989) (defending ex post deviations from absolute priority); David A. Skeel, Jr., *Markets, Courts and the Brave New World of Bankruptcy Theory*, 1993 WISC. L. REV. 465, 481-91 (identifying costs and benefits of preplanned adjustments).

contrast, is not on the hazard to efficiency that is posed by ex post adjustments triggered by bankruptcy law's mandatory or default rules, but by the dangers of ex post renegotiation. This is somewhat counterintuitive to bankruptcy experts because it questions the value of ex post consent—even universal consent. After all, the Creditors' Bargain underscored that bankruptcy law is motivated by the inability of creditors to contract. This could be taken to imply that the parties' consent should always prevail where they do reach a contractual agreement. Yet, even in cases in which the creditors with meaningful stakes in the debtor are relatively few and sophisticated, their agreement to renegotiate may nevertheless be inefficient if it undermines the benefits of the ex ante entitlements. In other words, it may well be in their ex ante interests to preclude the possibility of renegotiation. This insight has significant implications for several areas of current practice, such as substantive consolidation, which bankruptcy courts routinely approve if every major group of creditors consents.[23]

The Article proceeds as follows. In Part I, we describe the structure of the current Bankruptcy Code, which significantly increased contractual flexibility as compared to the prior Bankruptcy Act but reflects an incoherent policy toward contracting. In Part II, we draw from contract theory to analyze the Code and current practices of contracting during bankruptcy. We introduce the waiver of the debtor's rights to avoid prebankruptcy preferences as an example.[24] This discussion lays the groundwork for Part III, where we consider three other examples of the contracting paradigm under the Code in more detail: the ex post contracting facilitated explicitly by the voting and confirmation rules of the Code itself; the use (and contrasting judicial treatment) of intercreditor and restructuring support agreements to contract around ostensibly mandatory Chapter 11 provisions; and substantive consolidation of the cases of a debtor and its affiliates. We summarize the analysis in a brief Conclusion.

I. THE MANDATORY (AND PERMISSIVE) STRUCTURE OF THE BANKRUPTCY CODE

From a contractual perspective, the 1978 Code—the last complete overhaul of the bankruptcy laws—sent mixed messages. The Code replaced a framework under the 1898 Bankruptcy Act that had sharply limited the parties' ability to address bankruptcy issues by contract with more flexible

23 *See In re* Owens Corning, 419 F.3d 195, 211 (3d Cir. 2005) (suggesting that courts should approve substantive consolidations if there is consent).

24 *See infra* Part II.

reorganization rules. But the overall structure consisted of what has been regarded as predominantly mandatory provisions.

Prior to 1978, bankruptcy law had consisted almost entirely of mandatory rules, with little room for private ordering by contract. The constraints were especially notable in the context of large scale corporate reorganization because the reorganization of railroads and other large corporations traditionally had involved extensive ex post contracting.[25] Under the Bankruptcy Act, the managers of a large corporation that filed for bankruptcy were replaced by a court-appointed trustee, and the debtor's prebankruptcy bankers and lawyers were not permitted to represent the debtor in bankruptcy.[26] These rules displaced the freedom that parties had previously to contract over the terms of a potential reorganization plan. As construed by the Supreme Court, the Bankruptcy Act also significantly restricted the range of potential ex post contracting by insisting on rigid adherence to the absolute priority rule, which prohibits the debtor from offering any recovery to lower priority creditors or equity holders unless higher priority creditors are paid in full.[27] Plans that deviated from absolute priority were not permitted, no matter how robust the creditor support.[28] Although the Bankruptcy Act did not preclude ex post contracting altogether, it significantly limited the range of potential bargaining, within an overall structure of bankruptcy rules that were mandatory in form.

In 1978, Congress removed nearly all of these restrictions, and put ex post bargaining by the debtor and its creditors back at the heart of the large scale reorganization process.[29] The Bankruptcy Code assumes that the debtor's existing managers will continue to run the business and will negotiate the terms of a restructuring with the firm's creditors. The Code facilitates this restructuring by replacing the contractual requirement of individual consent for modification that would otherwise govern debt contracts with voting rules that are similar to corporate law's reliance on majority voting among shareholders.[30] Under Chapter

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25 For an overview of the receivership process, see DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 62-69 (2001). Congress allowed more flexibility under Chapter XI, the provisions that governed reorganization of smaller businesses. *See id.* at 162 (noting that a debtor's managers were able to retain control throughout the bankruptcy process rather than having a trustee in place).

26 *Id.* at 119-22.

27 Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 123 (1939).

28 The case that established this principle was a striking example. *See* Robert K. Rasmussen, *The Story of* Case v. Los Angeles Lumber Products*: Old Equity Holders and the Reorganized Corporation* (noting that the Court in *Case v. Los Angeles Lumber Products* held that deviation from the absolute priority rule precluded confirmation of the reorganization plan, despite overwhelming bondholder support, and characterizing the case as rejecting "the notion that the decision about whether to retain old investors rests with bondholders"), *in* BANKRUPTCY LAW STORIES 147, 168 (Robert K. Rasmussen ed., 2007).

29 *See, e.g.*, SKEEL, *supra* note 25, at 176-81 (discussing the legislative history of the reforms in 1978).

30 *See, e.g.*, DEL. CODE ANN. tit. 8, § 242 (2017) (requiring shareholder vote to amend the corporate charter).

11, the parties can agree to any arrangement they wish, as long as the debtor or other plan proponent divides the creditors and equity holders into properly constituted classes, and two-thirds in amount and a majority in number of each class votes in favor of the proposed plan.[31] The absolute priority rule only comes into play if one or more classes vote to reject the plan, and it only applies to the class or classes that have voted against the plan.[32] Thus, unlike the Bankruptcy Act regime, the new Bankruptcy Code permitted the required majority in a class of creditors to waive its members' priority rights in a reorganization plan. If an unsecured creditor's class accepted a plan, for example, it could give value to the stockholders without paying the unsecured claims in full.

Reflecting its aversion to ex ante contracting, bankruptcy law does not allow a debtor to waive its right to file a bankruptcy petition.[33] However, the filing of a petition by a corporate entity must be properly authorized, and this raises a clash between this mandatory feature of bankruptcy law and the permissiveness of state corporate law. Under corporate law, firms may constrain and condition the authority of agents, particularly directors, to make significant decisions on behalf of their firm. In order to obtain more favorable borrowing terms, a limited liability corporation (LLC) might agree to amend its operating agreement to prohibit the filing of bankruptcy. Some courts regard the effect of such prohibition as a matter of state law and are willing to enforce the provision if it is not the product of undue creditor coercion.[34] Instead of an outright prohibition, the governing corporate documents might require unanimous consent of all directors (or members in the case of an LLC) and the appointment of an independent director or one approved of by the lender. In enforcing this provision, the courts have diverged as to whether this is a matter of state or federal law. A bankruptcy court in Illinois, for instance, held that the attempt to waive fiduciary duties in a special purpose LLC was ineffective and those duties required each member—including the one appointed by the lender—to vote for the initiation of bankruptcy proceedings when it was in the best interests of the

31 *See* 11 U.S.C. §§ 1126(b), 1129(a)(8) (2012) (setting forth the voting requirement and the requirement that every class vote to approve the proposed reorganization). In addition, each claimant must receive value at least equal to its distribution entitlement under Chapter 7, unless it consents otherwise. *Id.* § 1129(a)(7).

32 *Id.* § 1129(b).

33 *See, e.g.*, *In re* Weitzen, 3 F. Supp. 698, 698 (S.D.N.Y. 1933) ("It would be repugnant to the purpose of the Bankruptcy Act to permit the circumvention of its object by the simple device of a clause in the [parties'] agreement . . . .").

34 *See, e.g.*, DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (*In re* DB Capital Holdings, LLC), Nos. 10-046, 10-23242, 2010 WL 4925811, at *3 (B.A.P. 10th Cir. Dec. 6, 2010) (enforcing waiver because court did not find evidence of lender coercion). *But see In re* Bay Club Partners–472 LLC, No. 14-30394, 2014 WL 1796688, at *5 (Bankr. D. Or. May 6, 2014) (declaring unenforceable a bankruptcy waiver in the debtor's operating agreement that was inserted at lender's request).

firm.[35] By contrast, a Delaware bankruptcy court found that the general federal bankruptcy prohibition against waiver trumped the requirement of unanimity that was permitted under state law.[36] The court allowed the filing over the dissent of the member designated by the lender.[37]

At least partly because of the nonwaivable character of bankruptcy, it is sometimes referred to as a *compulsory* collective procedure.[38] Yet it operates increasingly like a set of defaults in practice.[39] To be sure, the Code embraces legal standards (notably, "adequate protection" of liens) and judicial ex post discretion to address the heterogeneity of circumstances that lead debtors into bankruptcy.[40] Some Bankruptcy Code provisions also provide explicitly for the parties' ex post consent as an alternative to the exercise of judicial discretion. For example, § 363(c)(2) provides that a debtor may use cash collateral by either court authorization or secured party consent.[41] Or, a collateral asset may be sold under § 363(f) free and clear of its security interest if the secured party consents.[42] Other provisions are not explicit, but they contemplate an adversarial hearing and thereby the prospect that the dispute may be settled by the parties through an ex post contract. The courts generally defer to consent motions (363 sales, cash collateral use, DIP financing arrangements) and thereby give the parties leeway to shape the bankruptcy process by contract. As one court put it, "While the desires of the creditors are not binding, a court should carefully consider the wishes of the majority of the

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35 *In re* Lake Mich. Beach Pottawattamie Resort LLC, 547 B.R. 899, 914 (Bankr. N.D. Ill. 2016); *see also In re* Gen. Growth Props., Inc., 409 B.R. 43, 68 (Bankr. S.D.N.Y. 2009) (upholding the authorization of bankruptcy filing under state law even though management had terminated and replaced the independent directors to obtain unanimity).

36 *In re* Intervention Energy Holdings LLC, 553 B.R. 258, 265-66 (Bankr. D. Del. 2016).

37 *Id.*

38 *E.g.*, JACKSON, *supra* note 1, at 12-13. Critics of law and economics and the Creditors' Bargain Model also characterized the Code as mandatory. *See, e.g.*, Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197, 1199 (2005) ("Bankruptcy law, as currently formulated, is a mandatory system. A debtor in trouble may file for bankruptcy following a predetermined set of federal rules; most courts will not enforce prebankruptcy contractual agreements not to file, nor will they permit the parties to vary the applicable rules.").

39 For an analogous argument that even ostensibly mandatory provisions of corporate law can often be contracted around, see Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544 (1990). The important difference for the purpose of this Article is that bankruptcy law is more encouraging of ex post than ex ante contracting, while corporate law broadly invites ex ante opt outs. These approaches can clash, as described earlier. *See supra* notes 33–38 and accompanying text.

40 Adequate protection is required, for example, to defeat a motion to lift the stay, 11 U.S.C. § 362(d)(1) (2012); the authorization of the use, sale or lease of collateral, *id.* § 363(e); and the authorization of a priming DIP financing lien, *id.* § 364(d)(1)(B). Adequate protection is given a standard-like definition in § 361, especially relief that would result in the realization of the "indubitable equivalent" of the lien interest. *Id.* § 361(3).

41 *Id.* § 363(c)(2).

42 *Id.* § 363(f)(2).

creditors. Indeed, under the right circumstances, creditor support for a proposed settlement is an integral component of the court's inquiry . . . ."[43] The Code facilitates consensual decisions by requiring disclosure before important decisions,[44] and in the case of the confirmation of a plan, permitting majorities to bind minorities within creditor classes.[45] Although courts have the authority to reject consent orders or to deny confirmation of reorganization plans that are accepted by the required majorities within classes, they usually defer to them.

As bankruptcy practice evolves to accept more bargaining, ex post agreements have emerged also under Code provisions whose language contemplates no contracting. For example, § 364(d) provides that the court may authorize a DIP loan that is secured by an interest equal or higher in priority to a prebankruptcy secured claim.[46] Unlike § 363(b), for example, which says that "[t]he trustee, after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate,"[47] § 364(d) explicitly gives the discretion to the court:

> *The court*, after notice and a hearing, *may authorize* . . . *only if* (A) the trustee is unable to obtain such credit otherwise; and (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.[48]

Despite language reserving discretion to the court and not the parties, unopposed or consent motions are given deference here as well, often with slim evidence that statutory conditions have been satisfied.[49]

A fully contract-oriented Bankruptcy Code would have fitted nicely a historical pattern of business law reform that had emerged in the few decades before the Code was adopted. Lawmakers increasingly recognized the

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43 *In re* Vazquez, 325 B.R. 30, 36 (Bankr. S.D. Fla. 2005); *see also* Conn. Gen. Life Ins. Co. v. United Cos. Fin. Corp. (*In re* Foster Mortg. Corp.), 68 F.3d 914, 918 (5th Cir. 1995) ("We believe a bankruptcy court should consider the amount of creditor support for a compromise settlement as a 'factor bearing on the wisdom of the compromise,' as a way to show deference to the reasonable views of the creditors.").

44 *See, e.g.*, 11 U.S.C. § 363(b) (requiring notice and hearing as prerequisite to assets sales); *id.* § 364 (authorizing court approval for debtor-in-possession financing terms after notice and hearing).

45 *See id.* § 1126(c) (defining acceptance of a plan by a class of creditors as requiring that two-thirds in amount and a majority in number vote in favor).

46 *Id.* § 364(d).

47 *Id.* § 363(b).

48 *Id.* § 364(d) (emphasis added).

49 For explanations of the importance of judicial discretion, see George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 918-27 (1993), which suggests that courts use this discretion and their information about the economic conditions of debtors to optimize across the overinvestment and underinvestment problems caused by insolvency, and George G. Triantis, *Financial Slack Policy and the Laws of Secured Transactions*, 29 J. LEGAL STUD. 35, 57-58 (2000), which contrasts the reliance on judicial discretion in bankruptcy with the rule-based approach to later-in-time priority under state law.

heterogeneity of business transactions and organizations, and the corresponding need for default provisions around which parties could contract to fit their circumstances. Two statutes quite closely related to bankruptcy—the Uniform Commercial Code and Delaware corporate law—each had undergone profound, contract-oriented innovation during this period.[50] Numerous provisions of the Uniform Commercial Code begin with the words "unless otherwise agreed," explicitly inviting the parties to craft their own arrangements.[51] Similarly, many provisions in Delaware corporate law start with variations on the phrase "unless otherwise stated in the certificate or bylaws."[52]

The drafters of the Bankruptcy Code charted a different course, however, by implicitly inviting the parties to contract ex post in various contexts but shutting the door to ex ante agreements, such as waivers of the right to file for bankruptcy. So, while one can say that bankruptcy practice has become more contractarian, this is decidedly not accurate in the ex ante sense that prevails in other areas of business law. This shortfall has been criticized by several scholars who have argued that bankruptcy should be more accommodating of contracting and more in line with the regime in commercial or corporate law.[53] They have focused in particular on the decision in bankruptcy to either reorganize the debtor's capital structure and continue the going concern, or sell its assets (or some combination of the two).[54] The optimal choice depends on the characteristics and condition of the debtor. Bankruptcy gives debtors the choice between these alternatives during

50 Major drafts of the full Uniform Commercial Code were completed in 1952 and 1957, and adopted by many states thereafter. *See generally* Robert Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798 (1958) (summarizing drafting and legislative process of the Uniform Commercial Code). For discussion of the emphasis on flexibility to vary terms by contract in the 1957 draft, see *id.* at 807-08. Delaware dramatically revised its corporate laws in 1967. *See, e.g.*, Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1772, 1782-83 (2006) (noting the importance of the 1967 reforms and discussing Delaware's emphasis on flexibility).

51 *See, e.g.*, U.C.C. § 2-312(3) (AM. LAW INST. & UNIF. LAW COMM'N 2017) ("Unless otherwise agreed a seller who is a merchant regularly dealing in goods of the kind warrants that the goods shall be delivered free of the rightful claim of any third person by way of infringement or the like . . . .").

52 *See, e.g.*, DEL. CODE ANN. tit. 8, § 228 (2017) (providing that "[u]nless otherwise provided in the certificate of incorporation," shareholders may act through written consents rather than an annual or special meeting).

53 Robert Rasmussen was an early proponent of giving more freedom to contract. *See* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 54 (1992) ("[H]eterogeneity [of firms] implies that firms should be offered a choice of bankruptcy options.").

54 *Id.* at 101-03; Robert K. Rasmussen, *Free Contracting in Bankruptcy at Home and Abroad*, *in* THE FALL AND RISE OF FREEDOM OF CONTRACT 311, 315 (F.H. Buckley ed., 1999); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1808 (1998); Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343, 346 (1999); Alan Schwartz, *Contracting About Bankruptcy*, 13 J.L. ECON. & ORG. 127, 128 (1997); Alan Schwartz, *Contracting for Bankruptcy Systems*, *in* THE FALL AND RISE OF FREEDOM OF CONTRACT 281, 290 (F.H. Buckley ed., 1999).

bankruptcy and the creditors may—and often do—reach an agreement with the debtor to sell some or all assets.[55]

The fundamental question in this respect is not *whether* the law permits parties to contract over the decision to liquidate or reorganize, but *when* they can do so. This question applies to a large set of bankruptcy provisions beyond the basic sell-versus-reorganize choice.[56] As described above and discussed more fully below, bankruptcy law sends inconsistent signals about contracting, reflecting an uneasy shift over time toward a contractarian framework.

II. Ex Ante and Ex Post Contracting: Theory and Current Practice

As described in the previous Part, bankruptcy law is much more skeptical of ex ante than ex post contracting, even as parties have tried to contract away from bankruptcy rules in order to fit their circumstances. A well-known example is that the debtor cannot commit at the time of financing not to file for bankruptcy or to waive the automatic stay against a particular creditor.[57] By contrast, courts sometimes will enforce a stay waiver that is negotiated ex post.[58] An even more striking example of the contrasting judicial attitude toward ex ante and ex post contracting is the amount of influence a DIP secured financer has been allowed to establish and exercise in Chapter 11 cases, compared to the virtually complete stay on the contract rights of a

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55 In Alan Schwartz's analysis, the ex post renegotiation that leads to efficient liquidation entails a bribe paid by creditors to the debtor who would otherwise enjoy private benefits from reorganization. Anticipating the bribe, creditors charge more for credit and this leads to underinvestment. In his model, promising the debtor a share in the liquidation payoff can reduce the underinvestment especially if the payment is conditioned on a signal correlated with circumstances in which liquidation would be efficient. Schwartz, *A Contract Theory Approach to Business Bankruptcy*, *supra* note 54, at 1829-31; Schwartz, *Contracting About Bankruptcy*, *supra* note 54, at 138-39.

56 *See* Rasmussen, *supra* note 54, at 314 ("Schwartz's model posits contracting over a binary choice—liquidate or reorganize . . . , [but] contracts concerning bankruptcy procedure could focus on isolated provisions of the Bankruptcy Code rather than on simply the choice of reorganization or liquidation."). While most of the scholarship focuses on this basic choice, there has been some discussion of other specific issues. *See, e.g.*, Yeon-Koo Che & Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 J.L. ECON. & ORG. 441, 454-55 (1999) (criticizing the mandatory anti–ipso facto provision); Rasmussen, *supra* note 53, at 108-11 (discussing the time-value compensation of undersecured creditors after *United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd.* and whether a plan can allow old shareholders to get equity in the reorganized firm in exchange for new value of money or money's worth, after *Norwest Bank Worthington v. Ahlers*); Rasmussen, *supra* note 54, at 314 (discussing contracts providing for automatic termination or exemption from stay).

57 *In re* Weitzen, 3 F. Supp. 698, 698-99 (S.D.N.Y. 1933).

58 *See, e.g.*, *In re* Bryan Rd., LLC, 389 B.R. 297, 302 (Bankr. S.D. Fla. 2008) (enforcing stay waiver); *see also* Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 349 (1997) (defending stay waivers where creditors have notice).

prebankruptcy secured creditor.[59] A key motivating concern in the latter case is that unsecured creditors are unlikely to be aware of all the contract rights that a debtor might give to its secured lender before bankruptcy.[60] By contrast, such terms are disclosed in a motion to authorize DIP financing, and unsecured creditors at large are represented in bankruptcy by a committee that can object to the proposed financing arrangement.[61]

Another important concern, elaborated below, is the incompleteness of the ex ante contract: although it contemplates insolvency and bankruptcy, it may not anticipate the specific contingencies that materialize before bankruptcy. As we noted earlier, the use of standards in the Code (such as adequate protection) delegates ex post rulemaking to the court in light of the materialized conditions. Recognizing that courts are reluctant to enforce ex ante contracts that seek to opt out of either bankruptcy rules or the judicial application of standards, parties turn to property rights to modify bankruptcy rules, particularly through capital structures. These are more likely to be honored in bankruptcy than simple contract terms, but as discussed below, even these property rights are not immune to alteration.[62]

To be sure, the line we defined between ex ante and ex post contracting oversimplifies the issue, and one might distinguish between several stages within these two categories during which the parties might contract. For example, courts are generally receptive to commitments made in workouts after default but before a bankruptcy filing.[63] As another example, courts would be less receptive to an agreement among creditors made even upon filing as to how they will vote on a subsequent plan that is not in prospect.[64]

59 *See generally* Baird & Rasmussen, *supra* note 11, at 784-85 (discussing the influence of secured creditors); David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905, 1907 (2004) (same).

60 We address below the concern over notice outside of bankruptcy. *See infra* notes 80–82, 87–89 and accompanying text.

61 *See* 11 U.S.C. § 1102(a) (2012) (providing for unsecured creditors committee). Moreover, as a formal matter, the debtor in an ex ante contract would be purporting to bind a different entity (albeit a successor), the bankruptcy estate, or the DIP; the estate or DIP can, in contrast, enter into its own agreements.

62 An interesting case study in this regard is the path of special purpose entities and structured finance. *See infra* note 156 (discussing the use of special purpose entities). We might ask whether a more receptive attitude toward ex ante contracts would have avoided the significant transaction costs incurred to maximize the resilience of the intended bankruptcy remoteness.

63 *See, e.g.*, *In re* Colonial Ford, Inc., 24 B.R. 1014, 1023 (Bankr. D. Utah 1982) (holding that where parties entered into a comprehensive workout after default that provided for foreclosure if the debtor did not sell or refinance in nine months, the court may dismiss the case under § 305(a)(1) if the debtor filed for bankruptcy at the end of this period).

64 *See, e.g.*, Bank of Am., Nat'l Ass'n v. N. LaSalle St. Ltd. P'ship (*In re* 203 N. LaSalle St. P'ship), 246 B.R. 325, 331-32 (Bankr. N.D. Ill. 2000) (declining to enforce a consent and subordination agreement signed over two years before bankruptcy). The court explained that

> "[i]t is generally understood that prebankruptcy agreements do not override contrary provisions of the Bankruptcy Code. . . . [S]ince bankruptcy is designed to

Our objective in this Article is to consider the factors that should apply generally in thinking about the significance of the timing of contracting out, beyond the reorganization versus liquidation choice that has been the focus of scholarly work.[65] We start by focusing on relatively simple examples that contrast contracting at the time of financing (ex ante) with contracting after multiple defaults and insolvency (ex post).

Contract theory provides insight into the merits of ex ante and ex post contracting. Contracts are typically entered into while there is some uncertainty about the future state of the world (what will be the cost of inputs, the market for outputs, the regulation of the debtor's operations, the state of capital markets, and so on). The principal advantage of ex post contracting is that the state of the world has materialized and the parties have better information on which to contract. Ex ante contracts are incomplete in that they cannot provide for the optimal exchanges in all states of the world because of the bounded rationality of the parties, the cost of enumerating contingencies, and also the difficulty that a court may have in verifying which state has in fact materialized.

While vague provisions or standards may address unanticipated contingencies, they have downsides of uncertainty and litigation costs.[66] Alternatively, parties may reduce contracting costs by keeping their initial contract simple and renegotiating when they learn of the materialized contingencies. This advantage of ex post contracting is present in bankruptcy across many issues; the relevant circumstances are often too varied in relevant ways to provide for optimal rules ex ante. If there were no countervailing advantage in ex ante contracting, we would observe only spot exchanges and no executory contracts. The complexity of many loan and other financing contracts suggests that the parties see value in providing for future contingencies up front. The advantage of ex ante contracting is that the parties can allocate risks, set incentives, and protect specific investments in relationships.

It is a little too simple to assert that parties could achieve the best of both worlds through an elaborate ex ante contract that they later update through renegotiation and modification ex post. Even if there are no transaction costs that impede renegotiation, an ex post agreement can unravel the benefits of ex ante contracting, including risk allocation and the related incentives. In one

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> produce a system of reorganization and distribution different from what would obtain under nonbankruptcy law, it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply."

Id. at 331.

65 *See supra* note 54 (listing scholarly work that focuses on this choice).

66 *See generally* Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848 (2010); Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006).

well-known example in contract theory, a risk neutral principal contracts with a risk averse agent to do a task (say, market a product), and because effort is difficult to observe and verify to a court, the principal agrees to pay compensation contingent on output (say, revenue).[67] Such output-based payment is risky even with optimal effort by the agent because of exogenous factors that affect revenue. After the agent exerts effort and before the output is realized, the parties therefore have an incentive to agree to protect the agent from the risk by paying the average output (unconditioned on effort, which is unobservable) less a risk premium. The principal profits from the risk premium without incurring a downside (ex post) because the agreement no longer can affect the effort, which has already occurred. Anticipating this renegotiation, however, the agent will not exert the desired effort and the incentive of the initial contract is undermined. Given cases such as this, contract theorists then speculate as to what institutional tools might minimize the prospect of renegotiation, to allow ex ante contracts to achieve their goals (in this example, incentive for efficient effort). Some authors have suggested that increasing the number of persons whose consent is required for modification might achieve this objective. An example would be a unanimous action clause in a debt contract.[68] In general, one could imagine a case in which a debtor opts for a more complex capital structure to precommit against renegotiation.

Contract law itself evidences concern about contract modifications, particularly the potential for coercion and opportunism when one party has incurred significant reliance costs on the original contract. The longstanding preexisting duty rule in contract doctrine required fresh consideration for the modified promise. That rule was relaxed when an alternative basis for enforcement emerged: modification can be justified by a material change in circumstances. Notably, even if circumstances have changed materially, most courts also require that the risk of those changes was not allocated in the initial contract.[69] For example, if the parties have contracted for the delivery

67 *See* Drew Fudenberg & Jean Tirole, *Moral Hazard and Renegotiation in Agency Contracts*, 58 Econometrica 1279, 1282-83, 1305 (1990) (showing that an ex ante contract that pays the agent the highest compensation for the desired level of effort—less for lower effort but no more for higher effort—can lead to an optimal contract that is free from renegotiation).

68 *See, e.g.*, Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1, 3 (1996) (arguing that borrowing from multiple creditors discourages the borrower from defaulting and renegotiating).

69 *See* RESTATEMENT (SECOND) OF CONTRACTS § 89(a) (AM. LAW INST. 1981) ("A promise modifying a duty under a contract not fully performed on either side is binding . . . if the modification is fair and equitable in view of circumstances not anticipated by the parties when the contract was made . . . ."); *see also* Linz v. Schuck, 67 A. 286, 289 (Md. 1907) (holding that modifications may be enforceable even without fresh consideration "where the refusal to perform [the original contract] was equitable and fair; and the difficulties were substantial, unforeseen and not within the contemplation of the parties when the original contract was made"). The language of the corresponding Uniform Commercial Code does not include this requirement. *See* U.C.C. § 2-209

of a given quantity of goods at a fixed price and the cost of manufacturing them rises, threatening to render the seller insolvent, the court will not enforce a modified agreement at a higher price if the initial contract assigned the risk of the cost increase to the seller. In other words, the consensual modification should not upset risk allocation of the earlier contract or permit opportunistic holdup of investments specific to the relationship. Despite their concerns about modification, courts do not permit the parties to agree to ban modifications outright. Although the courts will enforce a requirement that consent to modification must come from a particular agent or must be in writing,[70] the common law does not enforce an express ban on modification.[71]

It follows that allowing ex post agreements to alter the parties' ex ante contract (including the terms in bankruptcy law) might be inefficient.[72] Many scholars have identified bankruptcy law provisions that distort risk allocation and incentives set by parties in their contracts.[73] We share their concerns about the ex ante impact of bankruptcy provisions, and they are essential considerations in normative assessments of bankruptcy law. Until bankruptcy law is amended, however, these provisions are part of the ex ante contract and largely nonwaivable. The hazard that we focus on is allowing the parties to renegotiate contracts in bankruptcy, which may be inefficient even though the

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cmt. 2 (AM. LAW INST. & UNIF. LAW COMM'N 2017) ("[M]odifications . . . must meet the test of good faith imposed by [the UCC]. The effective use of bad faith to escape performance on the original contract is barred, and the extortion of a 'modification' without legitimate commercial reason is ineffective as a violation of the duty of good faith.").

70 *E.g.*, U.C.C. § 2-209(2) (AM. LAW INST. & UNIF. LAW COMM'N 2017).

71 This has been criticized by a number of commentators. *See, e.g.*, Gur Huberman & Charles Kahn, *Limited Contract Enforcement and Strategic Renegotiation*, 78 AM. ECON. REV. 471, 482 (1988) (noting that "the possibility of renegotiation restricts the achievable outcomes" of contracts); Christine Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203, 211 (1997) (arguing that in certain cases allowing ex post profitable modifications reduces contracting parties' ex ante welfare); Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 J.L. ECON. & ORG. 2, 5 (2004) ("[T]he economic approach implies that courts should enforce contractual bans on renegotiation."). *But see* Patrick W. Schmitz, *Should Contractual Clauses that Forbid Renegotiation Always Be Enforced?*, 21 J.L. ECON. & ORG. 315, 321-22 (2005) (arguing that not enforcing nonrenegotiation clauses is socially beneficial, if not optimal, on a case-by-case basis); Jean Tirole, *Incomplete Contracts: Where Do We Stand?*, 67 ECONOMETRICA 741, 752-53 (1999) (reviewing the debate between "complete contract" theorists and "incomplete contract" theorists).

72 In this sense, this point is opposite to Schwartz's suggestion that bankruptcy is needed to facilitate ex post agreements. He argues that parties to commercial contracts do not need the law to ensure ex post efficiency because the parties can renegotiate in view of new events, and by contrast, "[b]ankruptcy law differs from other areas of commercial law because renegotiation after insolvency is difficult. . . . A bankruptcy system is necessary to facilitate the parties' ability to renegotiate to ex post efficient outcomes." Schwartz, *Contracting for Bankruptcy Systems*, *supra* note 54, at 287; *see* Schwartz, *A Contract Theory Approach to Business Bankruptcy*, *supra* note 54, at 1809 ("Bankruptcy systems create mechanisms to facilitate Coasean bargaining.").

73 *See infra* note 104 (discussing literature exploring the effect on ex ante contract rights of deviations from absolute priority).

parties have the benefit of superior information ex post. Bankruptcy courts have a split view of the nature of bankruptcy's background rules and the ability of parties to contract around them. They apply a combination of flexible legal standards and the enforcement of ex post contracting to address the reality that one size does not fit all when it comes to financial distress and reorganization. At the same time, the courts are disinclined toward enforcing ex ante contracts that deviate from bankruptcy's background rules. We suggest that, in some contexts, this might be 180-degrees wrong: it would be optimal in these cases to strictly enforce ex ante contracts and reject ex post renegotiation attempts.

Consider the bankruptcy provisions for avoidable preferences. They appear intended to correct inefficient incentives of creditors and insolvent debtors on the eve of bankruptcy. Some form of preference rule is therefore likely to be a desirable default rule. For example, securing antecedent debt rarely has any beneficial effect on the value of the firm and should be deterred. The threat of preference action also may promote earlier acceleration and enforcement of unsecured debt because a transfer before the distressed debtor becomes insolvent is immune from challenge, and thereby brings about an earlier correction to economic distress.[74] To be sure, these provisions are not optimal for all debtors, and we could imagine some debtors wishing to contract out of part or all of the preference rules ex ante. Yet, bankruptcy law does not permit such ex ante waiver. On the other hand, courts sometimes do permit the trustee or debtor-in-possession to agree during bankruptcy not to pursue a preference challenge, such as in a DIP loan agreement with a prebankruptcy lender. And they often agree to DIP financing agreements that achieve the same effect indirectly, such as "roll-ups" that secure both prepetition and postpetition lending.[75] Such an agreement might be inefficient in that it is extracted by the powerful DIP lender. However, it might be also ex post efficient in the same way that the principal–agent modification was efficient ex post in the earlier example. By agreeing, the parties can save the costs of litigation and the uncertainty of outcome. But it undermines the incentive benefits of preference rules.[76]

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74 *See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1094-96 (1995) ("The voidable preference rule encourages timely monitoring and pre-insolvency action by threatening to reverse any attempt to exit after the debt has become insolvent."); *see also* David A. Skeel, Jr., *The Empty Idea of "Equality of Creditors*," 166 U. PA. L. REV. 699, 726 (2017) (arguing for a narrow preference provision focusing on policing insider self-dealing).

75 For a critique of roll-ups, see, for example, Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 707-09 (2009).

76 Alan Schwartz takes the opposite point of view, that preference avoidance rules are inefficient ex ante but efficient ex post. Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199, 1224-31 (2005). We are skeptical of Schwartz's claim that preference rules are not needed to deter grabbing of assets or the payment of a pressuring creditor given that "the debtor

In a growing number of cases, the conditions for efficient contracting deteriorate during bankruptcy compared to the ex ante context. In the decades since 1978, bankruptcy practice has been transformed by the emergence and expansion of new types of creditors. They include hedge funds and private equity investors who acquire claims and provide fresh DIP financing with a view to acquiring ownership or control of the debtor's operations through bankruptcy.[77] They also include investors who purchase claims to get a quick return by either speculating on risks or by influencing the process. One particularly perverse example might be a creditor who participates in a class of claims while holding—unbeknownst to the other creditors—a larger economic stake in another class with conflicting interests. These new types of investors are well versed in bankruptcy practice. Moreover, trading of claims agaisnt a debtor is increasingly common and their ownership may change during a bankruptcy case. The heterogeneity, fragmentation, and liquidity of claims and creditor interests led Baird and Rasmussen to wonder whether consensual bankruptcies will become less common.

> The current environment is one in which there are no natural leaders (or followers) among the creditors to perform the shuttle diplomacy required to build a consensus. Without familiar benchmarks, there is no shared understanding of what form a plan should take. Coalition formation is harder. Worse yet, in some cases there may be no stable equilibrium at all.[78]

In some cases, a different problem arises when a dominant creditor can bully others to contract ex post on its terms, whether in the plan or the course of the bankruptcy. Here again, one can contrast the hazards of ex post contracting against those of ex ante contracting. The savvy and activist parties, such as hedge funds, are much less likely to be present at the front end of financing, and ex ante contracting can reassure other creditors that the terms of bankruptcy will not be skewed by the activities of such opportunistic parties. Routinely permitting the parties to renegotiate their ex ante arrangements, by contrast, may invite rent seeking by these late-arriving players.

Before proceeding to examine other examples from bankruptcy law, we should address what has been identified as the principal obstacle to enforcing ex ante contracts in bankruptcy: debtors have numerous creditors who extend

can respond by credibly threatening to file, which would stay all attachments." *Id.* at 1225. Bankruptcy filings are costly to debtor enterprises, and the debtor may well find it cheaper to pay off a small creditor rather than incur the cost of bankruptcy. Schwartz also believes that securing antecedent debt may be necessary to induce an existing unsecured creditor to finance a viable but distressed firm. *Id.* at 1229-30. We suggest that the securing of the new advance alone, with a market rate of interest, should be sufficient, and are similarly skeptical of cross-collateralization of DIP loans.

77 *See generally* Baird & Rasmussen, *supra* note 9, at 669-71 (discussing the role hedge funds can play in a reorganization).

78 *Id.* at 652 (footnote omitted).

credit at different times under different terms.[79] The core problem addressed by the Creditors' Bargain is that it is difficult, if not impossible, for the debtor to obtain consent to rules that govern insolvency from each creditor. And creditors are unwilling to consent if the proposed agreement does not bind all significant creditors. Of course, what constitutes adequate consent is complicated, but notice is essential.[80]

One solution is for the debtor to contract around bankruptcy defaults through the granting of property rights. The fundamental distinction between a property right and contract right is that a contract right is enforceable only against a party to the contract while a property right is enforceable against the world. Policy dictates accordingly that property rights must be disclosed more publicly than contract rights and be more easily understood. As Tom Merrill and Henry Smith have described, this explains why the configuration of property rights is constrained by a limited number of available and standardized forms ("numerus clausus").[81] Property rights can be given in the form of ownership, leasehold, and security interests, but one cannot grant an ownership in an asset for only Mondays and Fridays, for example. In the case of many types of property interests, they must be publicized in order to be effective. In the case of security interests, the law requires filing or registration of the interests unless the secured party takes possession of the personal property in question. Given this public notice and the inherent nature of in rem interests, bankruptcy courts should pay much greater deference to property than contractual rights.[82]

Bankruptcy law, however, systematically impinges on the property rights of creditors and other third parties, notwithstanding express language in both the Code and leading judicial opinions indicating that the property interests of the bankruptcy estate should be those of the debtor, subject to the limitations that exist outside of bankruptcy. The Code itself suspends or alters the terms of security interests in order to preserve going concern value and

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79 *See* Rasmussen, *supra* note 53, at 116-17; Schwartz, *Contracting About Bankruptcy*, *supra* note 54, at 140-41.

80 *See, e.g.*, Rasmussen, *supra* note 53, at 100-07 (arguing for a menu approach requiring that the debtor's choice of bankruptcy rules be included in its charter, thus providing notice to creditors).

81 Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The* Numerus Clausus *Principle*, 110 YALE L.J. 1, 4 (2000)

82 Indeed, various statements in the Code and leading cases would suggest that the Code and courts do. *E.g.*, 11 U.S.C. § 541(a)(1) (2012) (providing that the estate comprises "all legal or equitable interests of the debtor in property as of the commencement of the case"); Butner v. United States, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.").

create liquidity,[83] but it promises adequate protection of those interests in return. Yet, protection is often inadequate in practice.[84] There is an ongoing debate among scholars and practitioners as to the merits of this policy.[85] Setting aside this debate for the moment, we note that where protection is inadequate, bankruptcy courts treat security interests as they would contractual rights: by imposing different terms upon the filing of bankruptcy. To be sure, one might argue that the parties anticipate this in their contract and assent to it, along with all of bankruptcy law. This does not justify the mandatory nature of the modifications on property rights imposed by the bankruptcy process, especially when the parties clearly seek to reject bankruptcy law's alteration of the debtor's priority structure. For example, secured loan agreements regularly provide that the bankruptcy filing is itself an event of default, despite the fact that the Code's provisions render this term unenforceable.[86]

Our focus in this Article is not only on the mandatory provisions that effectively alter both the substance and value of security interests, but also on the consensual ex post modifications that the parties themselves agree to and the courts authorize. In Section III.C, we discuss the ex ante partitioning of enterprise assets among different legal entities. Each entity is a distinct legal person with property interests in distinct pools of assets. Yet, their boundaries can be disregarded in bankruptcy under substantive consolidation in a plan. Although courts are reluctant to order substantive consolidation, they are

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83 *See* Kenneth Ayotte & David A. Skeel Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1589-92 (2013) (focusing on the bankruptcy court's tools to provide liquidity to firms in bankruptcy); George G. Triantis, *Financial Slack Policy and the Laws of Secured Transactions*, 29 J. LEGAL STUD. 35, 46 (2000) (proposing reasons for observed authority of bankruptcy court to adjust security interests).

84 Two U.S. Supreme Court decisions illustrate this point: *United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365 (1988), which held that secured creditors are not entitled to compensation for the suspension of their enforcement rights except to the extent they are oversecured, and *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), which endorsed the "formula"-adjusted prime rate of interest in a cramdown of secured claims, over the alternative contract rate or a "coerced loan" rate. *But see* Momentive Performance Materials Inc. v. BOKF, NA (*In re* MPM Silicones, L.L.C.), 874 F.3d 787, 800 (2d Cir. 2017) (holding that, consistent with *Till*, the bankruptcy court should use evidence of the market rate in a Chapter 11 cramdown if an efficient market is available).

85 *See, e.g.*, Baird & Jackson, *supra* note 1, at 121 (arguing that adequate protection of property rights in bankruptcy should be viewed in terms of whether it would "prevent a firm from staying together when a sole owner would keep it together"); Charles J. Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, 2015 U. ILL. L. REV. 765, 766 (suggesting that greater interference with property rights is both permissible and desirable); James J. White, *Death and Resurrection of Secured Credit*, 12 AM. BANKR. INST. L. REV. 139, 148-49 (2004) (attributing strong protection of property rights to changes in courts' attitudes, securitization, early liquidation, creditor protecting provisions, and debtor–creditor agreements).

86 *See* Adler & Triantis, *Debt Priority*, *supra* note 22, at 581 (rebutting the argument that parties would have contracted for relative priority in bankruptcy, rather than absolute priority, if given the chance).

willing to approve of it if the parties assent. In some cases, the parties' ex post recontracting might unwind the benefits from the initial structure.

Another way that has been suggested to publicize prebankruptcy contracting (other than the use of property interests) is in the governing documents of the debtor organization, such as a corporate charter, that can be observed by any counterparty who enters into a significant investment or commitment with the debtor.[87] Unlike property rights, charter provisions would be susceptible to being amended without the consent of all the affected parties, so controls would need to be placed on such midstream changes.[88] As noted above, the virtue of a property interest is that it can be conveyed only in a limited number of standardized forms so that third parties may understand the interest. One could imagine a similar constraint on attempts to contract out of bankruptcy rules in a corporate charter by standardizing the available options. Indeed, Robert Rasmussen proposed a menu of options that a debtor could choose from: no-bankruptcy (relying exclusively on contract and state-collection system); auctions in Chapter 7; the current system with Chapter 11; a (former) UK-style system that stays creditors other than financial creditors; or a customized regime.[89] The option of a customized regime, of course, undermines the benefits of having a limited set of well-understood alternatives until it becomes adopted by a sufficient number of firms.

Although the concerns about notice and consent may explain the reluctance of bankruptcy courts to enforce ex ante contracts over bankruptcy, our focus is also on their readiness to enforce ex post contracts. Of course, most of the concerns about notice and consent are not present in dealmaking during bankruptcy: the creditors are represented by committees, counsel, or both. The objection to the enforcement of ex post contracts is based on the fact that they can undermine the goals of the initial contracts. Therefore, as in the common law of contracts, courts should be cautious in enforcing them, particularly when they displace judicial discretion provided for in the Code. We now turn to presenting several examples in greater detail.

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87 *See* Rasmussen, *supra* note 53, at 100-07 (envisioning bankruptcy as a "menu system" under which firms, in their corporate charters, identify their putative approach to bankruptcy); Rasmussen, *supra* note 54, at 318 ("Such charters have the advantage over contracts of being publicly available to all creditors. In a world where corporate charters contain provisions that describe the mechanism by which a firm can be taken over, it is not difficult to imagine such charters describing the mechanism by which a firm deals with financial distress.").

88 Rasmussen, *supra* note 53, at 111-21; *see also* Rasmussen, *supra* note 54, at 319 (suggesting that later amendments to charter be constrained by combinations of requiring unanimous consent from creditors for some amendments and notice periods for others, to address potential for expropriation by shareholders).

89 Rasmussen, *supra* note 53, at 100-07.

III. Assessing the New Contract Paradigm in Practice

In Part II, we described the partially mandatory structure of current bankruptcy law, introduced the analytical contrast between ex ante and ex post contracting, and provided bankruptcy examples in which parties' ex post contracting can undermine the incentives set by ex ante provisions such as avoidable preferences. We now consider in greater detail several other features of ex post bankruptcy agreements that are in tension with the parties' attempts to contract ex ante: the reorganization plan, differences in the enforceability of ex ante intercreditor agreements and ex post restructuring support agreements, and consensual substantive consolidation.

A. *Chapter 11's Voting and Cramdown Rules*

The most fundamental and explicit commitment to ex post contracting in the Code is the confirmation process for reorganization. Chapter 11 addresses the collective action obstacles to financial restructuring that exist outside of bankruptcy, principally by allowing majorities of claimholders in a class to overcome the dissent of minorities and allowing the court to bind a dissenting class. We discuss three sets of concerns raised by this framework. First, in some cases, these measures may go too far and allow opportunistic debtors and creditors to coerce minority claimholders. This raises the question as to whether the parties should be permitted to vary voting thresholds ex ante. Second, the Chapter 11 confirmation process also creates a setting in which modification of financial contracts can be obtained not only by coercion in a vote or cramdown, but also by consent in their shadow. We describe below this phenomenon particularly in agreements to alter ex post the priority structure of the debtor's liabilities. Third, the parties have very little freedom to tailor ex ante either the rules governing plan confirmation or their latitude to enter into a consensual ex post agreement.

As we discussed earlier, the Bankruptcy Code replaced the rigid confirmation requirements of the former Bankruptcy Act with more flexible rules that allow the parties to negotiate the terms of the reorganization plan in light of the circumstances existing at the time of distress.[90] Indeed, the plan confirmation rules of Chapter 11 also provide the means to bind dissenters and thereby tackle the hold-out obstacles to purely consensual restructuring. The lynchpin of the scheme to bind dissenters is the requirement that a majority in number and two-thirds in amount of the claims voting in each class of creditors accept the proposed plan.[91] In addition, the cramdown provision allows the court to confirm a plan over the objection of a class if the court finds

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90 *See supra* Part I.

91 11 U.S.C. §§ 1126(c), 1129(a)(8) (2012).

that the plan is fair and equitable and does not discriminate unfairly. The provision prevents a dissenting class—such as a secured creditor or one or more unsecured creditors holding more than one-third of the amount of claims in a class—from holding out opportunistically.

The Code provides procedural protections and substantive guardrails to address concerns about the coercive use of majority voting and cramdown to bind dissenters opportunistically. For example, only substantially similar claims can be combined in a given class[92] and they must all receive the same treatment under the plan.[93] A class whose contract rights are unaltered and thereby unimpaired is deemed to have accepted the plan.[94] The court may "designate" a claimholder who does not vote in good faith and thereby disallow its vote.[95] Each dissenting creditor cannot be denied at least the payoff that it would have received in a distribution under Chapter 7.[96] And, in a cramdown proceeding, the priority of each dissenting class is protected in the distribution of value under the plan.[97]

This set of protections against coercive votes or cramdown, however, provides sophisticated creditors the ability to block plans (or threaten to). The advent of derivatives and other financial contracts, together with dramatically increased liquidity in claims trading, has increased the possibility of distortions in the voting process. A creditor that wishes to acquire control of the debtor or its strategic assets, for instance, can purchase a blocking position in a key class of claims that makes it difficult for the debtor to confirm its reorganization plan. The Code gives the bankruptcy court authority to police opportunism by "designating"—that is disqualifying—the creditor's vote, but courts have used this authority sparingly.[98] There have been proposals to address this danger by also improving transparency. Although creditors that participate in an ad hoc group are now required to disclose their economic stake,[99] individual creditors are not. Requiring significant creditors to disclose their true economic stake would make it easier to detect potential opportunism.

92 *Id.* § 1122(a).

93 *Id.* § 1123(a)(4).

94 *Id.* §§ 1124, 1126(f).

95 *Id.* § 1126(e).

96 *Id.* § 1129(a)(7).

97 *See id.* § 1129(b)(2) (including protection of the priority of secured and unsecured claims as part of the "fair and equitable" requirement).

98 Bankruptcy courts are more likely to designate votes by parties who have interests distinct from those of a creditor: particularly, when they acquire claims with the intent to acquire an asset or control of the debtor. *E.g.*, Dish Network Corp. v. DBSB N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 104 (2d Cir. 2011) (disqualifying the vote of DISH Network, who had acquired first and second lien debt to control the process and acquire the wireless spectrum right owned by the debtor).

99 FED. R. BANKR. P. 2019.

The risk of opportunism by a creditor holding sufficient claims to veto a plan is determined by the voting thresholds. The current supermajority requirement (two-thirds in amount of claims voting in a class) permits an opportunistic investor to have veto power over a key class of creditors by purchasing one-third in amount of the claims. Therefore, lowering the requirement for acceptance would raise the cost of acquiring a blocking position and deter such opportunism. However, the optimal threshold is a complicated issue that involves balancing competing dangers: too low of a threshold would permit the debtor indiscriminately to overcome both opportunistic and legitimate dissent within a class of creditors. The optimal voting threshold—and indeed, the related issue of optimal classification of claims—seems very much contingent on context. This suggests that allowing the parties themselves to agree ex ante on at least some of the confirmation rules might be desirable, although not currently enforceable.

While cramdown requirements are more or less sufficient to guarantee the priority rights of a dissenting class, they do not prevent a class from consenting to compromise their priority. Deviations from absolute priority do not generally occur because of judicial action; there are relatively few and narrow exceptions in cramdown proceedings. Rather, they have arisen predominantly from the consent of the required supermajority of creditors in the affected class. The modification creates value ex post by restoring financial solvency in an economically viable firm and reducing the transaction costs of doing so. However, it can reduce value ex ante by undermining incentives and risk allocation of the initial contract.

One way that plans have deviated from absolute priority is in giving the shareholders of the insolvent debtor an equity stake in the reorganized entity. In bankruptcy, shareholders can influence the debtor-in-possession's control over the operations of the debtor and the agenda of bankruptcy proceedings, including the exclusive right of the debtor-in-possession to propose a plan during the first 120 days of the case.[100] The debtor-in-possession can use this control to delay the case, thereby extending the shareholders' implicit option on firm value[101] and also potentially dissipating value.[102] It is ex post rational

100 11 U.S.C. § 1121(b).

101 It has become common parlance, often traced back to Fischer Black and Myron Scholes, to refer to the interests of shareholders as a call option on the assets of the firm, exercisable by paying off the firm's liabilities. Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 637 (1973).

102 *See, e.g.*, Yaacov Z. Bergman & Jeffrey L. Callen, *Opportunistic Underinvestment in Debt Renegotiation and Capital Structure*, 29 J. FIN. ECON. 137, 151 (1991) (arguing that unless "shareholders have very little bargaining power" or "debt renegotiations are conducted in an environment of near-complete information . . . the value of the firm would be deliberately dissipated until agreement is reached, if ever" (italics omitted)); Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 748 (1989) ("[S]tockholders may exercise an important

for the creditors to share their interest to induce the debtor-in-possession to propose and confirm a plan without avoidable costly delay.[103] Ex ante, however, the parties anticipate this opportunism, thereby raising the cost of debt and preventing investment in some profitable projects.[104]

In other respects, the efficiency consequences are a close call even ex ante. When equity holders are out of the money (because of their firm's insolvency), their incentive is to induce the debtor to overinvest in high-risk ventures and underinvest in low-risk ones.[105] The cost of the inefficiency is borne by the creditors, who may therefore have the ex post incentive to mitigate the overinvestment incentive by giving some of their stake to shareholders. However, anticipating that this might happen, shareholders have incentives ex ante to exert less effort and to take excessive risks because they

influence on the reorganization plan that in large part stems from their . . . exclusive albeit temporary right to propose a reorganization plan. As a result senior claimholders may be encouraged to give up some of the value of their claims to stockholders."); William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS. 13, 34 (1977) ("[A] debtor through intermanipulation may destroy or diminish the value of the business if creditors do not acquiesce to the debtor's Chapter XI plan." (quoting *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong. 1875 (1976) (statement of Harvey R. Miller, William J. Rochelle, and J. Ronald Trost))).

103 *See, e.g.*, Maria Carapeto, *Explaining Deviations from Absolute Priority Rules in Bankruptcy*, 3 J. EMPIRICAL LEGAL STUD. 543, 545-49 (2006) (reviewing why deviations from absolute priority rule occur); Allan C. Eberhart, William T. Moore & Rodney L. Roenfeldt, *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1459 (1990) ("[M]anagement has considerable leverage in having a plan confirmed that results in deviations from [absolute priority]."); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 689 (1993) ("[Small] companies depend on the managers for their survival. When these managers are also shareholders, they can often demand creditor acquiescence in a plan distributing value to equity—in violation of the absolute priority rule—as their price for remaining with the company." (footnote omitted)); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 292 (1990) (explaining that creditors will compromise their priority to avoid "costly valuation hearings," "obtain their proceeds in a timely manner," "avoid losing additional interest," and "reduce the risk of decay in the value of their collateral"). Through managers, shareholders can also exploit their information advantage.

104 *E.g.*, Adler, *supra* note 22, at 440 (explaining that deviations from absolute priority have been criticized "as an impediment to efficient business practice"); Lucian Arye Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 J. FIN. 445, 447 (2002) ("[Ex post] deviations have an adverse effect on ex ante management decisions made prior to the onset of financial distress. In the presence of debt, equityholders might make 'inefficient' management decisions concerning investment, distribution of dividends, and financing.").

105 *See, e.g.*, Allan C. Eberhart & Lemma W. Senbet, *Absolute Priority Rule Violations and Risk Incentives for Financially Distressed Firms*, 22 FIN. MGMT. 101, 102-03 (1993) ("[T]he positive relationship between stock value and underlying asset volatility creates an incentive for shareholders to expropriate wealth from bondholders by moving the firm's assets into high risk projects."); Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law,* 46 J. FIN. 1189, 1191 (1991) ("[A] distressed company may actually overinvest because shareholders receive much of the upside benefits of risky investment but bear little of the downside costs.").

know that creditors will have the ex post incentive to renegotiate.[106] Although deviations favoring shareholders are less common in current cases than during the early years of the 1978 Code,[107] a similar dynamic may occur with creditors, with higher priority creditors agreeing to deviations favoring junior creditors.

Another type of consensual ex post deviation from absolute priority—"gifting" transactions—falls more directly within the reorganization rules. In a gifting transaction, a senior creditor purports to donate a portion of its recovery to a junior class of creditors, who receives a payout even though an objecting intervening class is not paid in full.[108] Although the payment to the junior class appears to violate the absolute priority rule,[109] the senior and junior classes would argue that the junior class has not received anything that would otherwise have gone to the intervening class. The gift comes entirely from value that otherwise belonged to the senior class.[110]

Courts have struggled to resolve this tension between gifting and the absolute priority rule. After the First Circuit upheld a gifting transaction,[111] the Second and Third Circuits adopted a more critical stance.[112] Even in circuits that frown on gifting, however the transactions are sometimes permitted.[113]

In our view, careful scrutiny of gifting transactions is more fully consistent with the concerns about undermining benefits of ex ante contracts described earlier than the broad deference shown to ex post contracting in other contexts.[114] If gifting reflects an implicit extortion of the senior class or an attempt to exploit valuation uncertainty to the detriment of the intervening class, it should be forbidden. Gifting may sometimes serve a more beneficial

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106 These deviations are the product of renegotiation and can also occur in workouts outside of bankruptcy. *See, e.g.*, Julian R. Franks & Walter N. Torous, *A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Reorganizations*, 35 J. FIN. ECON. 349, 362-63 (1994) (studying deviations from absolute priority in distressed exchanges).

107 *See, e.g.*, Carapeto, *supra* note 103, at 544 (recognizing that "priority violations have been decreasing over time").

108 *See generally* Michael Carnevale, Comment, *Is Gifting Dead in Chapter 11 Reorganizations? Examining Absolute Priority in the Wake of the Second Circuit's No-Gift Rule in* In re DBSD, 15 U. PA. J. BUS. L. 225, 230-31 (2012) (describing gifting).

109 11 U.S.C. § 1129(b)(2)(B) (2012) prohibits confirmation of a reorganization plan that gives value to a lower priority class of creditors or shareholders when an objecting higher priority class is not paid in full.

110 Carnevale, *supra* note 108, at 230-31.

111 Official, Unsecured Creditors' Comm. v. Stern (*In re* SPM Mfg. Corp.), 984 F.2d 1305 (1st Cir. 1993).

112 Dish Network Corp. v. DBSB N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79 (2d Cir. 2011); *In re* Armstrong World Indus., Inc., 432 F.3d 507 (3d Cir. 2005). The Second Circuit pointed out that the secured creditor in *In re SPM Manufacturing Corp.* had control of the property in question, because the stay had been lifted, and that it was a Chapter 7 case, so the absolute priority rule did not explicitly apply. *In re DBSD*, 634 F.3d at 98.

113 *See, e.g.*, *In re* 56 Walker LLC, No. 13-11571, 2014 WL 1228835, at *4 (Bankr. S.D.N.Y. Mar. 25, 2014) (allowing transaction because of prior state court decision that ruled in favor of the transaction).

114 *See infra* Sections III.B–C.

purpose, however, such as resolving legitimate objections or circumventing holdouts that might otherwise interfere with the best reorganization option.[115]

The concern with policing the alteration of priority has arisen recently in a new form of consensual bankruptcy exit: structured settlements.[116] The parties to these agreements agree to the dismissal of the bankruptcy case and settle a variety of issues in the bankruptcy, such as entitlements and distributions to creditors and third-party releases. Although such settlements are not expressly subject to the safeguards in the reorganization process, the dismissal of a bankruptcy case is subject to the approval of the court. A recent U.S. Supreme Court opinion held that the parties could not agree to violate absolute priority without consent of all affected parties.[117] This ruling, of course, leaves open the question of what constitutes consent and whose consent is required in a structured dismissal, in contrast to the well-specified voting rules in reorganization.[118]

Whether the modification of financial contracts is ex ante efficient or not is context dependent; it varies with the characteristics and condition of the debtor. When it is efficient, the encouragement provided by the Code's plan confirmation rules is desirable. However, when modification is ex ante inefficient—however well-informed and rational at the time—it would be beneficial to make renegotiation more difficult, such as by raising the voting threshold.[119] The likelihood that stricter procedural rules governing reorganization may be efficient for some firms suggests that the Chapter 11 voting rules should be a default rule rather than mandatory.

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115 The use of gifting in the Detroit bankruptcy could plausibly be viewed as having constituted beneficial gifting, although many observers view the mediation process that produced the gifting arrangement and other settlements in the case as having been problematic. In the Detroit bankruptcy, a class of senior creditors agreed to transfer some of their recovery to Detroit's pension beneficiaries. *See In re* City of Detroit, 524 B.R. 147, 171, 189 (Bankr. E.D. Mich. 2014) (explaining that $43 million of the "UTCO" bondholders' recovery would be used to fund an income stabilization program for pension beneficiaries). This transfer was part of a series of transactions that facilitated the Detroit restructuring.

116 *See, e.g.*, Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative After Asset Sales*, 29 AM. BANKR. INST. J., June 2010, at 1, 57 (2010) ("Orders entered approving structured dismissals in various jurisdictions have proven one thing: A number of courts have been willing to date to sign structured-dismissal orders that arguably go well beyond earlier plain-vanilla dismissal orders, although most have been entered consensually.").

117 Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 978 (2017), *rev'g* 787 F.3d 173 (3d Cir. 2015).

118 *See, e.g.*, Bussel & Klee, *supra* note 75, at 689 ("With respect to settlements, the established doctrine is that the paramount interest of creditors with respect to the proposed settlement is a primary consideration in obtaining the court approval necessary to bind the bankruptcy estate."); Jonathan C. Lipson, *The Secret Life of Priority: Corporate Reorganization After* Jevic, 93 WASH. L. REV. 631, 636 (2018) ("Is 'consent' merely the failure to object to some important action in the case, such as a structured dismissal? Or does it require something more, such as an affirmative vote?").

119 *See, e.g.*, Bolton & Scharfstein, *supra* note 68, at 17-19 (demonstrating that a supermajority voting requirement amongst creditors is optimal for renegotiations).

Courts therefore should not be as quick as some have been to reject voting assignments in intercreditor agreements.[120] Since these are often two-party agreements, they may impose externalities on a debtor's other creditors. But the risk of externalities does not justify treating them as presumptively invalid; the voting assignment may in some cases be an appropriate allocation of risk. Broader voting agreements—such as higher or lower voting requirements in a debtor's certificate of incorporation—are even more likely to reflect an assignment of rights that is tailored to a firm's particular circumstances. Permitting this tailoring would also bring the voting regime for debt claims in bankruptcy more closely in line with the permissive approach governing shareholder voting under corporate law. Even in the absence of an amendment explicitly shifting § 1126(c) to a default rule, courts could endorse voting rules that deviate from the current bankruptcy requirements.

B. *Contracting on Confirmation: Intercreditor and Restructuring Support Agreements*

As defined in § 1129 and accompanying provisions of the Code, Chapter 11 contemplates that the debtor will develop the terms of a reorganization plan, and once the plan has been devised, will prepare a disclosure statement for the bankruptcy court's approval.[121] If the court approves the disclosure statement as containing "adequate information," the debtor may submit the plan for a vote by its creditors and equity holders.[122] As described in the previous Section, if the requisite majority of each class of creditors or shareholders approves the plan, and a list of other requirements is satisfied, the court will approve the plan.[123] If one or more classes vote no, the plan can be approved under the "cramdown" rules if it does not discriminate unfairly and also satisfies the absolute priority rule with respect to each dissenting class.[124] While many of the substantive terms of a plan are subject to bargaining, the Code appears to frame the provisions that create this bargaining environment (the voting threshold, the judicial cramdown, etc.,) as mandatory.

In current practice, however, the parties regularly contract around these ostensibly mandatory provisions as well in several standard ways. One method is the use of intercreditor agreements. The most familiar intercreditor agreements define the relationship between first and second

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120 *Cf*. Bank of Am., Nat'l Ass'n v. N. LaSalle St. Ltd. P'ship (*In re* 203 N. LaSalle St. P'ship), 246 B.R. 325, 331-32 (Bankr. N.D. Ill. 2000) (refusing to enforce assignment of voting rights).

121 *See* 11 U.S.C. § 1121(a) (2012) (authoritizing debtor to propose a plan); *id.* § 1125(b) (requiring a disclosure statement before plan can be accepted or rejected).

122 *Id.* § 1125(b).

123 *Id.* § 1129(a).

124 *Id.* § 1129(b).

liens, but intercreditor agreements may involve more parties and take other forms as well.[125] Under a second method, many, and in some cases most, of a firm's creditors sign a restructuring support agreement (RSA) or plan support agreement that commits them to vote in favor of a reorganization plan advocated by the participants in the RSA.[126]

Although intercreditor agreements and restructuring support agreements contract around some of the same provisions of the Code—such as the disclosure statement requirements—courts have scrutinized the two sets of agreements differently. The emerging judicial treatment of intercreditor agreements views them skeptically, only enforcing those that are "clear beyond peradventure."[127] With restructuring support agreements, courts have been more accommodating. Unless there is strong evidence of opportunism, courts have generally upheld restructuring support agreements.[128]

After describing the current treatment of intercreditor and restructuring support agreements in more detail, the discussion that follows offers several possible explanations for courts' puzzlingly different attitude toward them and considers the degree to which this difference may be due to a bias in favor of ex post, relative to ex ante, contracting.

1. Intercreditor Agreements

Over the past decade or so, intercreditor agreements have become an increasingly common feature of large Chapter 11 cases. Like many recent developments, they appear to have arisen as a result of capital structure innovation—in this case, loan syndicates with both first and second liens.[129] Intercreditor agreements are used to allocate the rights of the two sets of liens. The agreements often prohibit the second lienholders from objecting to a plan that the first lienholders support; they may preclude the second lien creditors from providing DIP financing absent the first lienholders' approval; and they sometimes require the second lienholders to cast their votes for or against a proposed reorganization plan as instructed by the first lienholders.[130]

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125 The Radio Shack case is a particularly complex example. There were two groups of secured creditors in Radio Shack, agreements within each group, and another agreement between the two groups. Salus Capital Partners, LLC v. Standard Wireless Inc. (*In re* RadioShack Corp.), 550 B.R. 700, 704-07 (Bankr. D. Del. 2016).

126 *See, e.g.*, Bank of Am., Nat'l Ass'n v. N. LaSalle St. Ltd. P'ship (*In re* 203 N. LaSalle St. P'ship), 246 B.R. 325, 331-32 (Bankr. N.D. Ill. 2000) (refusing to enforce the assignment of voting rights).

127 *In re* Bos. Generating, LLC, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010).

128 *See, e.g.*, Isaac Sasson, Note, *Judicial Review of Plan Support Agreements: A Review and Analysis*, 9 N.Y.U. J.L. & LIBERTY, 850, 853 (2015) (suggesting that courts routinely approve the agreements).

129 One benefit of the bifurcated lien structure is that second liens serve as substitutes for bonds for small and medium sized public firms that cannot realistically access the bond market.

130 *See generally* Ayotte et al., *supra* note 10, at 264-73 (discussing the provisions and recent cases).

At least with respect to their signatories, intercreditor agreements contract around a variety of provisions of the Bankruptcy Code. A commitment by the second lienholders to refrain from objecting to a plan favored by the first lienholders sidesteps the disclosure statement and voting process, each of which is governed by a mandatory rule,[131] since it constrains the second lien creditors' ability to consider the disclosure statement and then make an independent decision whether to support the proposed plan. Provisions delegating control over the second lien creditors' vote go still further, requiring not just silence but affirmative support for a plan advocated by the first lienholders and opposition to plans the first lienholders oppose.

Courts' responses to intercreditor agreements have been mixed. Courts sometimes have enforced them and sometimes have not; on some occasions when courts have ostensibly upheld the agreements, they have done so in a way that falls short of true enforcement—by, for instance, upholding a provision barring a second lienholder from voicing an objection only after the court has heard and fully considered the objection.[132] The pattern that seems to be emerging reflects significant judicial hostility to the parties' attempts to allocate bankruptcy rights through these contracts. In *In re Boston Generating, LLC*, a leading recent case, the court held that intercreditor agreements should not be enforced unless they are "clear beyond peradventure."[133] Explicitly relying on *Boston Generating*, the court in *In re MPM Sillicones, LLC* (*Momentive*), another important new case, declined to construe the parties' agreement as precluding junior lienholders from supporting a reorganization plan the senior lien creditors opposed.[134]

2. Restructuring Support Agreements

Restructuring support agreements have some of the same features as intercreditor agreements and yet they have received a strikingly different reception from bankruptcy courts.

In the standard restructuring support agreement, the debtor contracts with many or most of its principal creditors over the terms of an anticipated reorganization plan. The agreement generally outlines the contours of the expected-but-not-yet proposed reorganization plan, including the treatment

131 *See* 11 U.S.C. § 1125(b) (2012) ("An acceptance or rejection of a plan may not be solicited . . . unless . . . there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved . . . by the court as containing adequate information."); *id.* § 1126(a) ("The holder of a claim or interest . . . may accept or reject a plan.").

132 For an overview of courts' divergent approaches, see Edward R. Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015 U. ILL. L. REV. 721, 723-25.

133 440 B.R. 302, 319 (Bankr. S.D.N.Y 2010).

134 BOKF, N.A. v. JPMorgan Chase Bank, N.A. (*In re* MPM Silicones, LLC) (*Momentive*), 518 B.R. 740, 750-51 (Bankr. S.D.N.Y. 2014).

of the classes of creditors and the terms on which essential disputes will be resolved.[135] The debtor or plan proponent commits to seek approval of a disclosure statement for the anticipated plan, and then to submit the plan for a vote. The creditor signatories bind themselves to support the plan, to refrain from objecting in any way, to put a halt to any ongoing bankruptcy litigation, and to vote to accept the plan.

As this description suggests, RSAs contract on many of the same bankruptcy provisions as intercreditor agreements. Like intercreditor agreements, RSAs contractually preempt the ostensibly mandatory rules governing disclosure statements, since they seek to obtain approval of a reorganization plan before the court has approved a disclosure statement.[136] Similarly, the signatories bind themselves to vote in favor of the contemplated plan, despite the requirement that a disclosure statement be approved and the plan formally submitted to the creditors before the creditors vote.

RSAs frequently are more sweeping and more fully contract around the traditional Chapter 11 process than a standard intercreditor agreement. Whereas intercreditor agreements often involve only two sets of creditors (albeit very important ones), RSAs may bind multiple groups of creditors. And whereas intercreditor agreements usually do not dictate the terms of the reorganization plan—they simply require second lienholders to follow the lead of the first lien creditors—RSAs often commit their signatories to the terms of a fully specified reorganization plan.

In contrast to their skeptical treatment of intercreditor agreements, courts have often approved quite sweeping RSAs, with little apparent angst about the tension between the RSA and the mandatory provisions governing the reorganization plan process.[137] RSAs seem to benefit from a strong presumption in their favor.

3. Why the Different Treatment?

Why such a different response to RSAs than to intercreditor agreements? The most obvious explanation is temporal. Whereas intercreditor agreements are executed in advance, RSAs are usually finalized ex post during the bankruptcy case. As we have seen, the structure of Chapter 11 invites contracting during the case itself, and courts have tended to look more favorably on ex post contracting.

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135 *See, e.g.*, Baird, *supra* note 12, at 603-08.

136 *See supra* note 130 and accompanying text (describing effect of intercreditor agreements).

137 *See, e.g.*, *In re* Indianapolis Downs, LLC, 486 B.R. 286, 296 (Bankr. D. Del. 2013) (stating that it would "grossly elevate form over substance" to invalidate a restructuring support agreement negotiated by sophisticated professionals as a violation of § 1125(b)); *In re* Heritage Org., LLC, 376 B.R. 783, 791 (Bankr. N.D. Tex. 2007) ("[I]t is absurd to think that the signing of a term sheet . . . is an improper solicitation of votes in accordance with § 1125(b).").

RSAs can increase the likelihood of a successful reorganization once the bankruptcy filing has occurred. RSAs often are negotiated in anticipation of bankruptcy or early in the case. The signatories to an RSA commit themselves and any future purchaser of their claim to support the proposed plan. The RSA thus prevents subsequent defections that could unravel a partially negotiated reorganization plan. To be sure, an intercreditor agreement—executed before the onset of financial distress—might make similar provisions committing the parties to cooperate. The allure of the RSA, in contrast to the intercreditor agreement, is that the parties are better able to tailor the process to the conditions of the debtor's financial distress. Indeed, from the ex post perspective of the bankruptcy judge, an RSA will often make reorganization more likely, while the terms of an intercreditor agreement may complicate a restructuring by, for instance, preventing a second lienholder from providing DIP financing to fund the process. To the extent bankruptcy judges tend to favor reorganization over other resolutions, RSAs may be inherently attractive, intercreditor agreements less so.

The comprehensiveness of RSAs may also weigh in their favor. A court may be more comfortable approving an agreement that has the support of nearly every major constituency in the case. To be sure, an RSA that maps out all of the contours of the anticipated reorganization plan stands in deeper tension with the mandatory disclosure statement and voting rules than a more limited intercreditor agreement. It is more than simply a shadow reorganization plan—it *is* the reorganization plan. But the Code's disclosure statement and voting provisions already authorize the parties to deviate from the formal requirements by negotiating the terms of a plan prior to the bankruptcy filing.[138] The Code seems to contemplate at least some contractual flexibility. Courts can be seen as simply extending the boundaries of that flexibility by enforcing RSAs.

Contract theory suggests that distinguishing between intercreditor and restructuring support agreements in this way is to some extent justifiable. The principal shortcomings of ex ante contracts such as intercreditor agreements are the limited information the parties have when they commit to the contract and the risk that the signatories will impose externalities on third parties. Intercreditor agreements are much more likely to have each of these downsides than a nearly comprehensive RSA. An intercreditor agreement may forbid junior lienholders from voicing their objections to a proposed reorganization that is supported by the senior lienholders, for instance, or it may preclude the second lienholders from providing DIP

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138 Section 1125(g) excepts prebankruptcy solicitation from the disclosure statement requirement, and § 1126(b) makes votes that were solicited prior to bankruptcy binding, so long as the solicitation was permissible under nonbankruptcy law. 11 U.S.C. §§ 1125(g), 1126(b) (2012).

financing that would support the debtor's operations in bankruptcy, to the benefit of the debtor's other creditors.[139]

Although the hostility to intercreditor agreements curbs their downsides, it also interferes with the benefits an ex ante contract can provide. Unlike ex post contracts, ex ante contracts encourage reliance by the parties. First lienholders may invest more in the relationship with the debtor, for example, if they can be confident that their intercreditor agreement will be enforced. Relatedly, an intercreditor agreement enables the parties to allocate monitoring and other responsibilities. Property rights can be used for the same purpose to some extent: the first lienholders' priority right to the collateral may encourage them to serve as the principal monitor, for instance. But the parties can use contractual provisions to allocate responsibility in a more nuanced fashion. To give a common example, intercreditor agreements sometimes preclude second lienholders from objecting to decisions made by the first lienholders with respect to the parties' collateral, but do not require silence on other issues.[140] This provision reduces the likelihood of duplicative monitoring of the collateral by the second lienholders.

These benefits of intercreditor agreements suggest that courts' hostility may be inefficient. This inefficiency could manifest itself in several different ways. If courts routinely decline to enforce intercreditor agreements, they may sacrifice the benefits of these agreements altogether, forcing the parties to rely on the cruder options available through allocation of property rights. Even if they do enforce some intercreditor agreements, courts may undermine the effectiveness of the agreements if they are not attentive to the agreements' costs and benefits. The emerging requirement that the agreements be "clear beyond peradventure" could have precisely this effect. It could induce future parties to include sweeping terms in their agreements and to forego a more nuanced allocation of responsibilities.[141]

Rather than subjecting the language of intercreditor agreements to searching scrutiny, and potentially constraining the parties' ability to devise nuanced allocations of responsibility, courts could focus on the likelihood of externalities. If the risk of harm to third parties is high, limiting the promisee

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139 *See* Ayotte et al., *supra* note 10, at 260 (describing the downsides of intercreditor agreements, such as stalling a value-maximizing sale). It is important to recognize, however, that the same provisions are sometimes beneficial. If the DIP financing provided by a second lienholder will be used primarily to extract value from the first lienholder, for instance, a court should not override the prohibition on second lienholder financing.

140 *See, e.g.*, BOKF, N.A. v. JPMorgan Chase Bank, N.A. (*In re* MPM Silicones, LLC), 518 B.R. 740, 751 (Bankr. S.D.N.Y. 2014) (concluding that the provision in question only precluded objections relating to the collateral).

141 *See* Ayotte et al., *supra* note 10, at 263 ("The parties, desiring an enforceable but narrow side agreement, may be compelled to draft something broader or all-encompassing to get courts to specifically enforce the agreement.").

of an intercreditor agreement to its expectation damages could minimize the potential spillover effects while preserving the benefits of the agreement.[142]

RSAs raise somewhat different issues. Although ex post contracting forgoes the monitoring and other incentive benefits of an ex post contract, it benefits from the greater information available ex post. RSAs often occur in a particularly information rich environment. Rather than committing the parties to support a reorganization plan whose terms are not yet set, RSAs usually outline the terms of a fully specified plan. The parties know precisely what they are agreeing to.

The principal risk of these ex post contracts is opportunism. An RSA that includes most of the key parties in a case may expropriate value from parties that are not part of the RSA. Unlike with an ex ante contract, the excluded parties are not in a position to adjust their own contracts with the debtor to reflect the costs to them of the RSA. RSAs are analogous to midstream amendments in corporate law in this regard; each can be used to expropriate value from other constituencies.[143]

Courts would presumably decline to approve an RSA that was clearly opportunistic.[144] Courts seem to be somewhat less alert to the risk that an RSA could chill the production of information. If creditors commit to support a potential reorganization plan, the parties who are not signatories to the plan lose the benefit of objections and analysis the signatories might otherwise provide.[145] The absence of this information is likely to make it harder to detect opportunism.

C. *Substantive Consolidation*

Many Chapter 11 debtors are affiliated entities within corporate groups of parents and subsidiaries. There are a number of reasons why the assets of a business enterprise might be partitioned among different entities.[146] As described below, these motivations range from tax and other regulatory

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142 *See id.* at 261 (proposing that the promisors be permitted to defect from an intercreditor agreement if there is a significant risk of externalities, and that the promisor be compensated with expectation damages).

143 For a discussion of the potential for opportunism with midstream amendments, see Lucian Arye Bebchuk, *Foreword: The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1402 (1989). For a more recent argument that bylaw changes pose a similar risk of opportunism, comparing bylaw changes to charter amendments, see Albert H. Choi & Geeyoung Min, *Contractarian Theory and Unilateral Bylaw Amendments*, 104 IOWA L. REV. (forthcoming 2018) (available at https://ssrn.com/abstract=3024873 [https://perma.cc/P5A8-FFNV]).

144 *See generally* Baird, *supra* note 12, at 609 (discussing creditors' objection to the restructuring agreement in *In re Caesars Entertainment Operating Co., Inc.*'s as coercive and offering an improper forbearance fee).

145 Baird also makes this point. *Id.* at 617.

146 *See* George Triantis, *The Personification and Property of Legal Entities* (describing businesses that are sometimes partitioned into multiple legally distinct entities), *in* RESEARCH HANDBOOK ON THE ECONOMICS OF PROPERTY LAW 190, 195-198 (Kenneth Ayotte & Henry E. Smith eds., 2011).

considerations to the carving of risk profiles that match investor preferences and, more generally, the tailoring of capital structures.[147] When an enterprise becomes insolvent, substantive consolidation can yield ex post benefits by avoiding the cost of determining which entity owns what assets and which claims can be asserted against which entity. Particularly when the entities have interrelated governance and interaffiliate transactions, this cost of unscrambling assets and claims can be substantial. Avoiding this cost for the benefit of all creditors is one of the two bases on which courts might order substantive consolidation.[148] If a corporate group is substantively consolidated, the entity boundaries created by property ownership are set aside and affiliate firms are treated as if they were a single entity, with all claims allowed against all the assets.

To order substantive consolidation of entities in a corporate group, most courts require not only that it be costly to disentangle claims and assets but that avoiding this cost makes all creditors better off. Consider two affiliate debtors, *A* and *B*, who file for bankruptcy. If the assets in and claims against each entity are clear, consolidating them will create losers (the creditors with the claims against the less insolvent entity) and winners (the creditors of the other entity) from redistribution. However, if the assets and claims are so intertwined that it would take considerable resources to determine ownership and liabilities, or if there are disputed interaffiliate obligations such as ones arising from avoidable preferential or fraudulent transfers, both creditors may be better off from consolidation. They would avoid the costs of disentangling assets and liabilities and resolving avoidance actions.

147 *See* Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515, 560 (2007) (explaining how the legal boundaries of firms enables the tailoring of capital structure to asset type).

148 The other basis is analogous to piercing the corporate veil under corporate law and is satisfied when creditors have treated the corporate group as one entity and not relied on the separate identity of the affiliates. Substantive consolidation is not explicitly contemplated in Chapter 11 of the Bankruptcy Code. Instead, the doctrine has been developed judicially and the requirements differ among jurisdictions. *See In re* Owens Corning, 419 F.3d 195, 211 (3d Cir. 2005) (requiring either that debtors disregarded separateness so significantly that creditor treated them as one legal entity or the assets and liability are so scrambled that separating them is prohibitive and hurts all creditors); Union Sav. Bank v. Augie/Restivo Baking Co., Ltd. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988) (conditioning consolidation order on finding that either creditors had dealt with entities as single economic units and not relied on their separate entities or that the debtors' affairs were so entangled that consolidation would benefit all creditors); Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987) (conditioning consolidation order on finding that there is substantial identity between the entities, that consolidation is necessary to avoid harm of realize benefit, and that no claimant would be excessively prejudiced by consolidation because it had relied on the separate credit of an entity); *see generally* Douglas G. Baird, *Substantive Consolidation Today*, 47 B.C. L. REV. 5 (2005) (reviewing various courts' approaches to substantive consolidation in Chapter 11).

The ex post saving of costs, however, might come at the expense of compromising ex ante efficiencies of the creating of separate legal entities, depending on the motivation for the partitioning of assets among affiliates. Ex ante efficiencies come from a variety of sources. If the partitioning of assets is motivated by tax or regulatory avoidance, for example, then the subsequent consolidation of assets is unlikely to jeopardize those savings. Substantive consolidation only deems the entities to be consolidated for the purposes of the reorganization plan; they otherwise retain their distinct legal identity. To take another example, if a parent acquires a new subsidiary, it may preserve the firm as a subsidiary rather than legally transferring the assets into the parent in order to minimize the additional cost of asset transfers at the time of the acquisition, as well as to facilitate a potential future sale of those assets as a group.[149] Often, creditors will deal with such a corporate group on the understanding that, in the event of insolvency, all assets in the group will be available to satisfy all third-party liabilities. Indeed, if all creditors treat the group as one debtor, courts will order substantive consolidation on that basis, and this would not undermine ex ante benefits.

A more prominent set of motivations for separating assets into distinct legal entities comes from what might be termed "capital-structure tailoring."[150] Briefly stated, many elements of capital structure must be determined on an entity-wide basis[151] while optimal capital structure often depends on the type of assets being financed.[152] To the degree that the capital structure demands of asset types within an enterprise diverge, the cost of capital may be lowered by segregating asset types into distinct entities. The use of separate entities provides the flexibility to tailor, for example, the debt–equity ratio, the concentration of ownership in the controlling

149 William Widen observes that legal entities are convenient vessels by which to transfer groups of assets because transfers of stock can often be completed at lower cost than the discrete transfers of individual firms' assets. *See* William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 237, 256-57 (2007) (explaining why stock transfers can have lower transaction costs than asset transfers); *see also* Kenneth Ayotte & Henry Hansmann, *Legal Entities as Transferable Bundles of Contracts*, 111 MICH. L. REV. 715, 717-18 (2013) ("Legal entities provide a low-cost means of assembling complementary contracts into discrete bundles that can be freely transferred to a new owner . . . .").

150 Iacobucci & Triantis, *supra* note 147, at 522.

151 This results from the fact that the division of assets into separate affiliate entities is an allocation of property rights among legal persons. This means that (a) one entity cannot encumber the assets of another without the latter's consent, (b) all assets in an entity are generally available to satisfy that entity's debts, and (c) the law imposes formalities and restrictions on transactions and dealings between related firms. In bankruptcy cases involving corporate groups of affiliates, these formalities and restrictions have often been at least partly ignored by the parties, giving rise to claims for settling up, whether through fraudulent transfer, veil piercing, equitable subordination, or other actions. *See id.* at 525 (explaining these formalities).

152 Some of the important characteristics in this respect are whether assets are growth opportunities or assets in place, liquid or illiquid, and subject to exogenous risks and systemic volatility. *Id.* at 545.

shareholder, the choice between bank loan or public debt, the marketing of stock to niche investors, and more targeted performance-based compensation through managerial stock grants. Governance features must similarly be chosen on a firmwide basis—for example, the number of independent directors on the board, takeover defenses, or debt covenants that trigger lender enforcement action against all assets of the entity. Where the capital structure tailoring concerns financial or control rights of shareholders, the ex ante effects of substantive consolidation in bankruptcy may be small, given that shareholders are often far out of the money by then. However, consolidation may have deleterious ex ante effects if the capital structure motivation concerns the firm's liabilities.

Assets may be split between affiliates to exploit comparative advantages in screening or monitoring the borrower, or enforcing debt claims against its assets. The creditor to firm *A* and the creditor to firm *B* may have comparative advantages in lending to different types of assets, and this benefit can be exploited if the enterprise splits those assets into two entities, dedicated to each type.[153] This division might also be efficient if one creditor can better diversify or otherwise accommodate the risk of one asset type. The debtor benefits by reducing its aggregate cost of borrowing. For a variety of reasons, the tailoring of debt claims against specific types of assets is more effectively accomplished through separate legal entities than through security interests (indeed, this has prompted the use of special purpose entities in structured finance and securitizations).[154] Asset partitioning might alternatively be used in a corporate group to give structural priority to one creditor over others. The creditor with a claim against a subsidiary holding real assets has structural seniority over a creditor of the parent whose asset is stock in the subsidiary. Or, a lender enjoying cross guaranties from multiple entities enjoys structural priority over creditors with discrete claims against single entities.

If courts focus only on the ex post savings from consolidation when authorizing substantive consolidation, they may undermine the incentive benefits from separating assets into distinct entities. This is true even if they require that

153 Henry Hansmann and Reinier Kraakman use an example in which hotel and oil refining operations are held in separate corporations, so that the respective assets can be pledged to back the obligations to different lenders. The borrower can thereby exploit the specialized screening and monitoring of one or both lenders. The lender to the hotel business can concern itself only with monitoring the hotel assets. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 399-400 (2000); *see also* Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434, 466 (1998) (describing the use of trusts to partition assets).

154 *See* Iacobucci & Triantis, *supra* note 147, at 567 (discussing the use of special purpose entities).

all creditors must be better off because of the cost savings.[155] Yet, the judicial doctrine does not appear to take into account the hazard to ex ante efficiency.[156]

While substantive consolidation is common, it is much more frequently the product of bargaining on the plan: the parties approve with large majorities plans that substantively consolidate the entities.[157] Indeed, if all creditors benefit from consolidation ex post (as required by the doctrine), they would likely be able to agree to it without judicial intervention. Even if some creditors would be worse off by consolidation—the loss from sharing with creditors of more deeply insolvent entities outweighs their pro rata share of the gain from avoiding unscrambling costs—the bargain can make them whole. For example, the creditors of the less insolvent ("richer") entities might be placed in a different class and given a larger distribution from the consolidated pool.

In the ex post world of insolvency, the creditors no longer have an interest in preserving the partitioning of assets. Any ex ante benefits from separation have been realized. Suppose, however, that those benefits would have come from encouraging more efficient patterns of monitoring, as described above. Anticipating the likely ex post agreement to consolidate, the creditors would lose their incentive to focus monitoring on their discrete debtors. Without the ability to commit to keeping the entities distinct, the debtor would not be able to enjoy the interest cost savings from monitoring efficiencies.

The impact on the monitoring incentive would exist even if the parties bargained to a consolidated plan that gave the creditors of the richer entity a larger share of the distribution than the creditor of the poorer entity. Consider two debtor entities, *A* and *B*, each with one creditor, *CA* and *CB*, respectively. *CA* and *CB* are each owed $40. The debtor group assigned discrete claims to the separate entities in order to encourage efficient monitoring under which *CA* would focus on *A*'s assets and *CB* would focus

155 In the leading opinion *In re Owens Corning*, the Third Circuit wrote that "[m]ere benefit to the administration of the case (for example, allowing a court to simplify a case by avoiding other issues or to make postpetition accounting more convenient) is hardly a harm calling substantive consolidation into play." 419 F.3d 195, 211 (3d Cir. 2005).

156 Special purpose entities in structured finance or securitizations are rarely consolidated, probably because their assets and liabilities are kept clearly distinct from those of their originator and there are not messy inter-entity transactions. In these structures, valuable assets, typically receivables, are sold to a separate special purpose entity rather than financed within the operating firm. The doctrine has evolved so that if the structure is done properly (including a demonstrably "true" sale), the bankruptcy process will respect the partitioning of assets, although the separate entity might itself file for bankruptcy. *E.g.*, *In re* Gen. Growth Props., Inc., 409 B.R. 43, 69 (Bankr. S.D.N.Y. 2009) (stating that "the principal goal of the SPE structure is to guard against substantive consolidation"). If the transferred assets and claims against the special purpose entity are well-defined, it is unlikely that there will be incentive for an ex post agreement to consolidate.

157 *See* William H. Widen, *Prevalence of Substantive Consolidation in Large Bankruptcies from 2000 to 2004: Preliminary Results*, 14 AM. BANKR. INST. L. REV. 47, 53 (2006) (discussing how frequently large companies use a substantive consolidation strategy).

on *B*'s assets. The parties anticipate that after administrative expenses of $10 (on an examiner, for instance), the assets and interaffiliate transactions can be disentangled to reveal to the court that *A* and *B* have values of $20 and $40, respectively. As an administrative expense, $10 will be paid out of *A* and *B*'s assets—$5 from each entity—before *A* and *B* receive any distribution. Therefore, *A* would receive $15 and *B* would receive $35. If *A* has bargaining power (for example, because the debtor has the right to propose a plan and favors *CA*), the parties could reach an agreement to consolidate in a plan that gives *CA*'s class $25 and *CB*'s class $35. In anticipation of this improved recovery, *CA*'s incentive to monitor the assets of *A* is diluted.

The deference to ex post agreement to consolidate in a plan, even if unanimous, may be inefficient unless the court either takes into account the likely ex ante motivation for the separation of assets into legal entities or enforces ex ante commitments to preserve the separation. Although a court could distinguish between motivations for partitioning in either ordering consolidation after a hearing or confirming a consensual plan that deems consolidation, the motivations may not be verifiable at the time of bankruptcy. Indeed, motivations are often complex and obscure in hindsight, particularly when assets and claims have been intermingled along the path to insolvency. The better approach, regardless of the bankruptcy default, would be to enforce the debtor group's ex ante choice—if clearly made—whether to preserve its asset partition through bankruptcy.

CONCLUSION

In this Article, we have analyzed the contractual structure of bankruptcy, as reflected both in the Bankruptcy Code and in current bankruptcy practice. Although the Code is often described as mandatory in nature, a closer look at its structure reveals that the Code is considerably less mandatory than these general characterizations suggest, particularly as compared to the former Bankruptcy Act.

Bankruptcy's embrace of a contractual paradigm is somewhat inconsistent, however. Both bankruptcy courts and the Code itself are far more sympathetic to ex post than to ex ante contracting. Our analysis of the tradeoffs between ex ante and ex post contracting suggests that privileging ex post contracting can prove costly. Ex ante contracts provide important benefits—such as incentives to invest in the parties' relationship and tailored allocations of risk—that can be jeopardized when courts or the Code invite ex post renegotiation of the parties' entitlements. Although ex post contracting takes place in an information rich environment and is often beneficial as a result, ex post contracts that alter ex ante entitlements are sometimes inefficient even if every party assents to their terms. The costs of renegotiation are particularly serious when the ex post contracting interferes with the parties' property rights.

A generation ago, one of the central objectives of corporate bankruptcy was to solve traditional collective action problems. In current bankruptcy practice, these issues are much less pressing, given the parties' increased ability to contract. We have sought to shed light on a key new issue that has now come to the fore—the need to better manage the tradeoff between ex ante and ex post contracting. In our view, courts and the Code should be less hostile to ex ante contracting and more critical of ex post renegotiation.

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