Foreword: The creditors' bargain – past, present and future

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This collection of essays is in many ways a celebration of the work of Thomas Jackson, and this foreword attempts to put his work into its proper context.¹ Jackson's ideas first took shape just after the 1978 Bankruptcy Code was enacted. Much of his focus was upon making sense of its provisions. The bankruptcy landscape has much changed since that time. Practices have emerged that the drafters of the Code never contemplated, and modern bankruptcy scholars have shifted their focus from provisions of the statute itself to more general principles. But Jackson's insights have become part of the way that the best practitioners think about bankruptcy, and they continue to be the starting place for modern bankruptcy scholars.

In his seminal paper on the creditors' bargain,² Jackson showed that although the creditors of a common debtor cannot negotiate with each other in advance, it makes sense to imagine the sort of bargain they would strike if they could. When a corporate debtor becomes insolvent, its creditors each have an incentive to advance her own interests at the expense of everyone else. Bankruptcy law exists to solve this collective action problem.

Jackson's work was revolutionary. His core idea—that bankruptcy solved a collective action problem by forcing creditors to work together—was not new. His innovation lay rather in his strikingly novel approach. Before Jackson, bankruptcy scholars focused on the mechanics of bankruptcy law. Instead of talking about theoretical problems, the leading academics focused on judicial opinions and statutory text. Jackson began with first principles.

Moreover, Jackson differed from previous bankruptcy scholars in his style and tone. His predecessors saw themselves as part of a fraternal organization like the Free Masons, Rotarians, or Shriners. They were part of a closely-knit community whose members believed that bankruptcy law worked for the social good and helped creditors and debtors alike. Even when these scholars talked about the great principles of bankruptcy, they sounded like they were giving after-dinner speeches. Jackson spoke the language of economics and finance. He cast a cold eye on the bankruptcy landscape. Gone were heartfelt homilies. Even when he talked about individual debtors, it was through the lens of behavioral economics.³

In this foreword, I try to make sense of the impact of Jackson's work, in the academy and elsewhere. On its face, this brand of scholarship was far removed from the rough-and-tumble world of practice. Indeed, to many bankruptcy lawyers and judges, it looked decidedly odd. A fine bankruptcy judge of the old school described the scholarship that followed in Jackson's wake as having "an eerie sort of abstraction." This judge felt about this new direction in bankruptcy scholarship, "a little like I feel about Henry James on love: remarkable stuff, but can you trust an author who doesn't seem to know how babies are made."⁴

In the end, however, Jackson's ideas resonated with judges and practitioners. He might not have seemed like someone who would be completely comfortable with the fraternal rituals of the National Bankruptcy Conference, but he was invited to join nevertheless.⁵ His ideas have long since become part of the warp and woof of modern bankruptcy practice.

Jackson organized his bankruptcy work around two core ideas. First, he believed that bankruptcy law was largely procedural. It solved a collective action problem that creditors face, but did not otherwise change their nonbankruptcy rights. Second, he showed that, to understand the creditors' bargain, it was necessary to use the same tools of modern finance that others were bringing to the study of corporate law. These two ideas are the subject of this foreword's first two parts. The final part explores how modern discussions of bankruptcy rely on Jackson's work while at the same time it takes a critical look at both bankruptcy law and Jackson's understanding of it.

I. NONBANKRUPTCY RIGHTS

Earlier generations of bankruptcy judges, practitioners, and scholars were sometimes too willing to view bankruptcy courts as courts of equity. Rigorous adherence to principle gave way to softer notions of fairness, even as lip service was paid to such concepts as absolute priority. Jackson had none of this. His analysis always possessed hard edges.

Jackson began with the idea that bankruptcy law should respect nonbankruptcy rights unless some bankruptcy policy requires a different result. He based his argument on the Supreme Court's opinion in *Butner v. United States*.⁶ On its face, this opinion was not particularly remarkable. The Court was interpreting an obscure provision of North Carolina real estate lien law in a case under the 1898 Act. It was handed down just a few months before the entirely new Bankruptcy Code was to go into effect and the old law would become a dead letter. But during the course of his opinion, Justice Stevens observed that "[p]roperty 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 analysed differently simply because an interested party is involved in a bankruptcy proceeding.”⁷ Jackson’s work did much to elevate this passing observation into a foundational principle. Bankruptcy lawyers today routinely invoke the *Butner* principle, something they never did until Jackson’s work took hold.

Jackson’s basic insight into the primacy of nonbankruptcy rights provides a set of intuitions that helps one to think about concrete problems. One can start with an easy example. Imagine that, before its bankruptcy, a debtor, acting in good faith, acquired a piece of property that had been stolen from its original owner. The original owner appears and asserts her right to the stolen property. Can the original owner reclaim her property? Most have the intuition that bankruptcy should not interfere with the original owner’s ability to retrieve the property. Jackson offered an easy way to explain exactly why this was so.

One of the most firmly established principles in Anglo-American law is *nemo dat*. A person’s title to a piece of property is no better than that of her transferor. This, of course, is only a starting point. There are exceptions. A bona fide purchaser for value can keep property bought from someone who acquired it by fraud. But these are the exceptions. No one, not even a good faith purchaser, can keep property that has been stolen from someone else. There is no bankruptcy policy that suggests that the outcome should be different merely because such a good faith purchaser finds herself in bankruptcy.

This intuition is useful to practitioners as well as to academics. It helps them orient themselves within the provisions of the Bankruptcy Code. The stolen property is not property of the estate within the meaning of §541 because it is not the debtor’s outside of bankruptcy. Nor does it become part of the estate by virtue of §544, as outside of bankruptcy the creditors, after they reduced their claims to judgment and tried to levy on the debtor’s property, would not have been able to seize the stolen property in the face of the original owner’s claim.

Nor does §101(5) transform this right into a claim that is subject to discharge. To be sure, the original owner’s conversion action against the debtor is discharged. It is a “claim” within the meaning of §101(5). But the original owner also has a replevin action, the right to compel the debtor to turn over the stolen property to her. A replevin action is not a claim, as it is not “an equitable remedy for breach of performance.” Thus, the replevin action is not a “claim” and this is not discharged. The original owner can still assert it even after the bankruptcy is over.

This methodology is especially useful when one cannot rely on an idea as powerful as *nemo dat*. For example, imagine that a buyer pays the debtor

for a picture, but the debtor files for bankruptcy before delivering it. The buyer has a right to specific performance outside of bankruptcy. Is she able to retrieve the painting in bankruptcy or is she merely a general creditor?

Jackson's methodology provides a straightforward way to think about the issue, one that is much easier than relying on intuition alone. The question is whether the creditors could reach the picture outside of bankruptcy. Even if the buyer had a right of specific performance, this right might give way under nonbankruptcy law. The relevant test is whether, notwithstanding the buyer's right of specific performance, a creditor outside of bankruptcy could have reduced her claim to judgment and levied on the painting notwithstanding the buyer's specific performance right.

As a matter of state law, much may turn on the picture still being in the buyer's possession. But, in any event, it is state law that determines the issue, not by abstract ideas about balancing competing equities.⁸ In contrast to an earlier generation, Jackson did not believe that there was any bankruptcy policy that dictated whether the buyer received the painting or not. It turned on state law, and state law might vary from one jurisdiction to another.

This methodology did much to unscramble initial confusion about environmental tort liability and bankruptcy. Consider a debtor who runs a factory. The debtor allowed lubricating oil to leech into the ground. State environmental law requires the debtor to remediate the environmental damage it has caused. The debtor, facing other financial difficulties, files for bankruptcy. One of the creditors is a bank that has a security interest on the factory and the land beneath it. The bankruptcy must confront the question of how to sort out the environmental liability. The problem is hard because the state can impose liability in a number of different ways simultaneously.

Armed with Jackson's insights, one resists the temptation to go first to §554, a provision of the Bankruptcy Code that allows the trustee to abandon property. Being able to abandon an asset does not affect the liability of the estate for prepetition obligations. Disposing of an asset does not change a debtor's liability outside of bankruptcy, and nothing about bankruptcy changes this. The debtor remains liable to clean-up the land, just as the debtor would remain liable to an accident victim if its delivery truck had caused an accident and the debtor subsequently took the truck to the wrecking yard. Both are claims against the estate. Whether the state or the accident victim enjoys priority over other creditors against the assets of the debtor is a question of nonbankruptcy law.

But quite apart from the state's rights as a prepetition creditor, the state is also a postpetition regulator. The trustee in bankruptcy is obliged to follow state law. In that capacity, she (or the debtor in possession) may be

obliged to clean up the polluted site by virtue of its status as a postpetition owner of the land. Environmental liability, unlike other sorts of liability, can arise from the fact of ownership. The fact that the debtor continues to own the land the moment after the bankruptcy is filed is sufficient to impose a postpetition obligation on the trustee to clean it up.

Such postpetition obligations are administrative expenses that must be paid before general creditors. The clean-up obligation takes precedence over the claims of the secured creditor as well. The secured creditor has no ability to reach the land without also being subject to the clean-up obligation outside of bankruptcy and should have none inside either. Debtors in bankruptcy and all who claim through them have to play by the same rules as everyone else.⁹

This part of Jackson's work, the one focused on the Bankruptcy Code itself, even as it discovered first principles, still had its foot firmly planted in the world of traditional bankruptcy scholarship, as it was tightly connected to disputes that were actively litigated. Much of it has been internalized by judges and the practicing bar, often without understanding his influence. The second aspect of Jackson's work—the part that connected bankruptcy to corporate finance—is the part that may have had the greatest influence in the academy.

II. CORPORATE REORGANIZATIONS, CORPORATE LAW, AND MODERN FINANCE

A. Bankruptcy and Its Related Disciplines

In addition to insisting that bankruptcy was in the first instance a procedure that vindicated rights based on nonbankruptcy law, Jackson looked at bankruptcy through the lens of corporate law and modern finance to understand its foundational principles. Earlier generations of academics came to bankruptcy as a result of their interest in fields such as consumer and debtor-creditor law. Their paradigm was the individual consumer debtor and the small-business owner, and their instincts were to apply this paradigm, centered as it was on the idea of the fresh start, to large corporations.

Jackson, by contrast, was grounded in corporate finance, and this provided a different perspective. When seen through the lens of corporate finance, a corporate debtor is merely an artifact of state law. It is a juridical entity, not a flesh-and-blood creature. This perspective subjected the homilies of the previous generation to tough interrogation.

Why should we care about a corporate charter as one might care about

a human being? If one suggests that a corporate debtor deserves a fresh start, one cannot mean that preserving a particular corporate charter is a good thing in itself. Is one suggesting that a particular business continue? Rhetoric about the virtues of a fresh start might make this seem sensible for a flesh-and-blood individual, but why is a business like a person over this dimension? If a bad restaurant has poor food and surly waiters, why should it stay around?

One might want to help the owner of the business start again, but why is bankruptcy necessary? The owner of the corporation is not obliged for the debts of the business. This is the virtue of doing business in limited liability form. And if for some reason the individual debtor is liable for the debts of the business, is not the relevant bankruptcy that of the individual and not the corporation?

In addition, Jackson connected bankruptcy scholarship with what was happening in corporate law. In the 1980s, corporate law was undergoing a sea change. Traditional corporate scholars feared corporate raiders would prevent managers from doing their jobs. The new generation saw the market for corporate control as a force for good. The marketplace itself disciplined managers. Jackson followed a similar path. The players in a corporate reorganization were market actors who responded to incentives just like other market actors. And the tools of modern finance could be used to analyse what was going on.

A harbinger of the value of importing finance into thinking about bankruptcy came in a 1979 paper by Jackson and Anthony Kronman, an early collaborator (and later Yale Law School dean).¹⁰ The paper explored the institution of secured credit and the benefits it brought. The paper, like Jackson's later paper on the creditors' bargain, was methodologically different from previous work on secured credit. Most of the scholarship on secured transactions accepted the value of secured credit without question. Jackson and Kronman did not. They asked exactly what benefits secured creditors brought. It is all well and good to say that a secured loan is safer than an unsecured loan, but when giving collateral one creditor takes assets away from the general creditors. One loan becomes safer, but others become more risky. Why is the greater safety for the secured creditor not exactly offset by the greater risk borne by everyone else?

Jackson and Kronman drew on the work of Franco Modigliani and Merton Miller. Modigliani and Miller had shown that, once one makes a handful of simple assumptions, the value of a firm is independent of how much debt it carries relative to the amount of debt.¹¹ Jackson and Kronman applied the same logic to different layers of debt in the capital structure. If Modigliani and Miller irrelevance propositions held, a firm's value was independent of how much senior and junior debt it carried. To

explain why secured credit made creditors as a group better off, Jackson and Kronman attempted to identify which of those axioms did not hold and to suggest how secured credit was therefore able to bring net benefits to the creditors as a group. Quite apart from the success for their own explanation, they opened lines of inquiry for many others.¹²

Looking at bankruptcy through the lens of corporate finance provides a clearer window onto large reorganization practice far better than using the flesh-and-blood individual and the small business as paradigms. In the typical modern large reorganization, business with trade creditors goes on as usual, tort victims are fully compensated, and workers are paid as before.¹³ The only ones the reorganization affects are professional investors, most of whom acquired their positions only after the firm was already financially distressed. Importing the idea of sharing into cases in which hedge funds would be the only beneficiaries requires something more than homilies about fairness.

Senior creditors, junior creditors, and shareholders who hold diversified portfolios all receive the market return on their capital. This idea has taken hold among practitioners and judges. Consider the *Delphi* bankruptcy, where the bankruptcy judge pushed back against a debtor that favored a sale to a particular bidder. He asked, “What’s so special about Platinum? They’re just guys in suits. Why can’t the other guys in suits just pay more?”¹⁴ One would not have found this sort of language in an earlier era.

B. Agency Costs

Taking their cue from corporate finance, Jackson saw agency costs as one of the principal challenges a bankruptcy regime confronted.¹⁵ The problem was not exactly the same in the bankruptcy as in corporate law. In corporate law, the principal agency problem was the one between the shareholders of large corporations and the professional managers who ran them. In Chapter 11, the interests of managers and shareholders, at least in the 1980s, seemed aligned in bankruptcy. Instead, the tension in bankruptcy was between senior and junior investors.

Seen through this lens, the ambition of bankruptcy is to ensure that the assets of the bankruptcy estate are put to their highest-valued use even as individual investors groups push for courses of action that advance their own interests. There are several ways to go about solving this problem. The initial instinct of Jackson and others was to follow the lead of corporate law scholars and focus on the residual owner.

Easterbrook and Fischel’s pathbreaking work on corporate law argued that, when business is good, control over decision making ought to lie with shareholders. They usually stand to gain or lose from a given course of

action because, when the firm is solvent, they are the residual owners with respect to most decisions.¹⁶ The Bankruptcy Code is built around the idea that in the typical reorganization, the general creditors stand in a position analogous to the shareholders. The firm is worth enough to pay the senior creditors, but what remains is not enough to pay the general creditors in full. As a result, they are the firm's residual owners. They are the ones who stand to gain or lose, depending on whether the bankruptcy succeeds or fails.

For this reason, Jackson argued that the Bankruptcy Code should be interpreted to allow the general creditors to exercise control, provided that they take steps to ensure that those senior to them would be paid in full. By requiring general creditors to protect the senior creditors, bankruptcy law could ensure that, when the general creditors controlled the case, they were in fact the residual owners of the firm and thus possessed the right set of incentives.¹⁷

But the agency problem in bankruptcy cannot be solved merely by focusing on residual owners. The residual owners may be hard to identify, and, even if they can be identified, they will not necessarily be the general creditors. A particularly vivid example arose in the bankruptcy of the Central Ice Cream Co.¹⁸

The Central Ice Cream Company owed its general creditors about \$12 million. It had closed its doors, and its only asset was a lawsuit against McDonald's. Central Ice Cream prevailed at trial and received a \$52 million judgment. At this point, McDonald's made a settlement offer of \$16 million. This presented a conflict between the general creditors and the shareholders. The general creditors are senior in the capital structure to shareholders, and, as one might expect, the general creditors of Central Ice Cream wanted the settlement offer accepted post haste. If Central Ice Cream took the offer, the general creditors would be paid the entire \$12 million they were owed. By contrast, if Central turned it down, the judgment might be reversed on appeal and leave them with nothing.

The shareholders, again none too surprisingly, wanted the offer rejected. They would receive only \$4 million if the settlement offer were accepted, but they would get \$40 million if Central Ice Cream refused to settle and ultimately prevailed on appeal. Getting the \$40 million was not certain, but risking \$4 million to get \$40 million with reasonable odds was a good bet.

Neither group will act with the interest of the other in mind. There is a tension here that is inherent in any enterprise that has a hierarchical capital structure, and this tension is magnified in bankruptcy as, by definition, there is not enough money to pay everyone in full. In many contemporary bankruptcies, this problem of identifying a single residual owner manifests itself. The tension typically, however, is not between general creditors and

shareholders as in *Central Ice Cream*, but rather in other parts of the capital structure.

In many large corporations, there are multiple levels of secured debt. The residual claimant is somewhere among the secured creditors, but it is not clear exactly where. The general creditors should not be calling the shots, as they are out of the money, but it does not make sense to dismiss the bankruptcy entirely. Even though the Bankruptcy Code was not designed with such cases in mind, bankruptcy may be useful for sorting out problems among multiple tiers of secured creditors.

Indeed, bankruptcy's origins lie in part in equity receiverships of the nineteenth century, and these involved railroads that had almost exclusively secured debt in their capital structure. Having a reorganization that works exclusively for the benefit of the secured creditor is completely consistent with Chapter 11's roots. But one still needs to sort out the rights among the secured creditors and ensure that those in control have the right incentives.

These changes in capital structure became manifest by the start of the twenty-first century, and they had the effect of changing the way academics and lawyers thought about the agency problem. In the 1980s, it was assumed that the interests of the managers corresponded with the interests of shareholders even in bankruptcy. But in the typical large bankruptcy today, shareholders receive nothing at the end of the case, and managers have little incentive to pay any attention to them. Instead, the managers worry about their own reputations and pleasing those who will end up with control of the business at the end of the case.

Sorting out exactly how to think about this problem became an arena in which academics and practitioners engaged in vigorous debate.¹⁹ Instead of focusing on Jackson's notion of empowering the residual owner, however, the debate shifted to finding the best way to account for the various biases of the different parties who can exercise control over the debtor.

The bankruptcy judge faces the largest challenges at the start of the case. Not all the players have been assembled. The secured creditor might be willing to advance the funds that the debtor needs to make the next day's payroll in exchange for various protections for its prepetition loan. The judge is the only one who can push back. If she does not push back hard enough, the junior investors are worse off. But if she pushes too hard, the secured creditor might refuse postpetition lending and the business might collapse.

There is no magic formula for solving such problems. Nevertheless, the basic approach remains one of ensuring that the agency problem is overcome and that the value of the firm as a whole is maximized. The tools that are used remain those of corporate finance.

C. Going-concern Sales

Those who shaped the law of corporate reorganizations generally assumed that actual sales were not possible. At the time the law of corporate reorganizations emerged in the late-nineteenth century, it was a reasonable assumption. The firms being reorganized were giant railroads. Even though they were financially distressed, the railroads had considerable value as going concerns. They operated on thousands of miles of track and were worth many millions of dollars. The capital markets of the day were not equipped to handle the sale of such large enterprises.

There was also a separate strand of bankruptcy practice that focused on the problems of small businesses. These were on the other end of the spectrum, but here too going-concern sales were not in the cards. These firms often had no identity separate from the owner-managers who ran them. They could not be sold as going concerns. Separating the manager from the business was tantamount to liquidating it.

For the generation of scholars who linked corporate reorganizations with corporate law more generally and who, in the first instance, looked to the market as a disciplining force, it was natural enough to revisit the question of whether actual sales were possible. If there was an actual sale of the firm in bankruptcy, the sale would transform the debtor's assets into cash, and this cash would be distributed to the creditors in exchange for their old claims against the firm. In a reorganization, the same thing happens, except that instead of cash, old creditors receive interests in the reorganized firm. The recognition of the connection between reorganizations and sale opened a new line of thought for those who followed in Jackson's footsteps.²⁰

Once a reorganization is equated with an actual sale, it becomes clear that one of the central challenges in any reorganization is determining the value of the firm. When a firm is sold on the market, its value is the price that a buyer is willing and able to pay for it. The value of a firm sold in a hypothetical sale must be established through some other mechanism. One could, for example, value a firm by selling equity in the reorganized company in the marketplace.²¹ If one knows the price equity can fetch on the market, it is possible to value the firm as a whole.

Alternatively, one could simply require a sale of the business outright for cash.²² In the 1980s, in contrast to the late-nineteenth century, the capital markets were sufficiently robust to enable buyers to raise the necessary funds. Sales of firms as going concerns regularly took place outside of bankruptcy. If a large firm had value as a going concern, someone should be willing to buy it. Traditional bankruptcy lawyers feared that many firms would not find buyers if they were put up for

auction. No one would be willing to buy them as going concerns, and they would have to be liquidated. But the inability to sell a firm as a going concern might simply show instead that the firm in fact had no value as a going concern.

If equity could not be floated or if the sale of the business was not possible, market mechanisms could still be used. The creditors could bid for the firm themselves. A junior creditor has what is, in effect, a right to buy out the senior creditor for the amount that the senior creditor is owed. The right to buy a piece of property at a fixed price at a fixed time is a right well understood in finance. It is a call option, and such call options are a component of every financial instrument. One can argue that, when a firm is in bankruptcy, the call option is the only attribute of a junior creditor's investment instrument that matters.

The junior creditors are entitled to the firm only if it is worth more than the senior creditors are owed. They have, what is in effect, a call option, and the exercise date of the call option is the date of the petition. It makes sense, therefore, to put junior creditors to their proof. If they are unwilling to buy out the senior creditors, their reluctance is powerful evidence that their claims on the firm have no value. Their call options are out of the money. One could structure reorganization law along these lines. The hypothetical sale mechanism, which required a judicial valuation, could be replaced with a process in which the junior investors had an opportunity to exercise their options.²³

This mechanism relies on the forces of the market, but does not require a sale of the entire firm. There are a number of ways to import market mechanisms into valuations in Chapter 11, and quite a number were proposed.²⁴ Quite apart from whether these proposals were feasible as a practical matter, they had the effect of introducing the language of finance to discussions of bankruptcy policy.

At the same time that academics looked towards bringing market mechanisms into bankruptcy law, the number of going-concern sales in bankruptcy practice exploded. Bankruptcy practice became a mergers-and-acquisitions practice.²⁵ In part due to what seemed at the time a minor change in the Bankruptcy Rules, it became much easier to acquire claims in bankruptcy. Someone who wanted to become owner of a firm could acquire control of the class of debt that would allow it to gain control of the reorganization and put through a plan in which it would end up as the equityholder of the reorganized firm. Once the dust settled, there was little difference between such a person and someone who acquired a solvent company by making a tender offer for its equity.

The changes transformed bankruptcy by the end of the 1990s. Going-concern sales became commonplace in large Chapter 11 practice. Just

as M&A lawyers became more familiar with modern finance, so too did Chapter 11 lawyers. The link between options and junior investors that became part of academic conversation in the 1980s became the lingua franca of reorganization lawyers by the end of the century.

Instead of debating whether going-concern sales were possible, the ground shifted to debating how they should be conducted. Nonbankruptcy sales of going concerns are far from being either instantaneous or costless. Sales in bankruptcy might be sometimes desirable, but not always. The market may be illiquid. The most likely purchasers of the firm may be other businesses in the same industry. When a firm is distressed, these other firms may be distressed as well. They may not have the resources to take part in an auction. When those who value the firm the most are not able to bid, the auction will not yield what the firm is worth.²⁶

Even if an industry is flourishing and the potential buyers lie outside the industry, there is another problem that limits one's ability to sell a firm.²⁷ By the time a distressed firm is sold, the investors have organized themselves. They have hired experts and spent time reviewing and assessing the quality of the managers and their plans for the business going forward. As a result, they may know much more about the value of the business than any potential buyer. Buyers may fear that the firm is being sold only because the current owners know it is going to fail and want to rid themselves of a lemon.²⁸

The illiquidity of the market and the presence of private information suggests that reorganization regimes should accommodate both going-concern sales as well as reorganizations. The Bankruptcy Code is sufficiently open-ended that it allowed such a dual regime to emerge, but little in the text of the Bankruptcy Code or traditional legal analysis offers much in the way of specific guidance. This has pushed academics and practitioners further from the doctrinal analysis that was the hallmark of traditional bankruptcy scholarship. When a firm is to be sold in Chapter 11, the answers to the question of which sale procedures were appropriate lie not in statutory interpretation of the Bankruptcy Code, but rather in the application of auction theory. Many controversies, such as whether there are fire sales in bankruptcy, become empirical questions.²⁹

III. REASSESSING THE CREDITORS' BARGAIN

The contemporary bankruptcy judge is economically sophisticated. She is completely open to the possibility of market sales and completely at ease with how the tools of finance can be used to value firms. She is familiar with auction theory. Nevertheless, she must confront the reality that

markets are imperfect and valuations are always approximate. The costs of bankruptcy itself can be staggering. In a large case such as *Energy Future Holdings*, the direct costs alone can exceed a billion dollars. For the latest generation of bankruptcy scholars, ensuring that the value of the estate's assets is maximized at the lowest cost is the major institutional objective of the law of corporate reorganizations.

Once one fixes on the cost of bankruptcy itself as the central problem, one might question the importance that Jackson and others gave to the nonbankruptcy baseline and the absolute priority rule.³⁰ Shifting the focus to the costs of bankruptcy, however, is completely consistent with the spirit of Jackson's creditors' bargain model. If bankruptcy costs loom large enough, creditors as part of the *ex ante* bargain will care about minimizing them, perhaps to the exclusion of other concerns.

A. Nonbankruptcy Priority

Jackson's approach to bankruptcy begins, as noted, with the idea that bankruptcy's first ambition is to recognize nonbankruptcy rights in bankruptcy's collective proceeding. But there is no exact parallel to bankruptcy in ordinary debt collection procedures, and this makes it hard to identify exactly what the nonbankruptcy rights are.

The common law made it hard for creditors to take priority over a debtor's assets. Before the Uniform Commercial Code, a creditor that wanted to take priority over another had to navigate multiple legal regimes for equipment, inventory, and accounts receivable. Even at the time the 1978 Bankruptcy Code was enacted, the typical firm did not have an institutional lender with a blanket security interest over all of its assets. There might be multiple secured creditors, each of whom held priority with respect to different assets. One secured creditor might have financed the purchase of a piece of equipment. Another might have made a loan on the basis of accounts receivable.

In such a world, each secured creditor enjoys a right to its collateral, but is not a stakeholder in the firm as a going concern. A secured creditor whose collateral is a discrete asset should not receive anything less than the value of this asset, but she should not receive anything more either. The value that the firm has as a going concern is not something to which she lays claim. The general creditors are entitled to the synergy created by bringing the various assets together, and, as long as they protect the secured creditor from declines in the value of her collateral, the general creditors are the ones entitled to whatever incremental value the firm has over and above the piecemeal liquidation value of the assets.

But in the four decades since the Bankruptcy Code was enacted, secured

credit has been radically transformed. Lenders commonly attempt to take first priority positions in all of a firm's assets. From the perspective of finance, hierarchical capital structures are perfectly ordinary. That they need to be assembled in pieces is a bug, not a feature of nonbankruptcy law.

Creating priority by bundling security interests together presents a problem, however. There are always some assets in which secured creditors fail to take security interests. Mistakes are easy to make and obtaining priority in some types of assets is especially hard—intellectual property and government licenses being two conspicuous examples. In a nontrivial minority of cases, perhaps as much as twenty percent, there is an important asset in which the senior creditor does not have priority.

A key issue is what to do when these gaps appear. If one is tied to nonbankruptcy entitlements, it might seem that the structure of Anglo-American law reveals something fundamental about the nature of the senior position. For practitioners and academics of the old school, it validates their intuition that bankruptcy should not make life easy for those who seek seniority.³¹ They remain tied to old notions that bankruptcy proceedings are equitable in nature, and they are pulled towards the idea that equality is a good in its own right.

For someone steeped in corporate finance, the defects in the collateral package are a sideshow. They should not play a role in how one thinks about how a sensible bankruptcy law should operate. Of course, if a senior creditor wants to acquire the entire firm in Chapter 11, she must contribute cash to make up for gaps in her collateral package. But the fact that her senior position is incomplete in one respect is not a justification for real-locating the going-concern value of the firm—the value that it has over-and-above the value of each of the discrete assets—to the junior creditors.

This gap between the way that seniority is conceived in finance and the way it plays out on the ground as a technical matter is of no great moment to the latest generation of bankruptcy academics, even if it does stand in tension with Jackson's emphasis on nonbankruptcy entitlements. For them, the problem of corporate restructuring is not tied to specific features of Anglo-American law. It makes more sense to start with a coherent theory of the firm and of corporate finance. The challenge that still remains is reconciling Modigliani and Miller's irrelevance propositions with Coase's theory of the firm.

B. Absolute Priority and the Creditors' Bargain

The original purpose of the absolute priority rule was to protect unsophisticated outside investors. It was put in place in the 1930s over the

objection of investment bankers and the lawyers who represented them. In those days, outsiders held the most senior positions. Government regulators at the SEC believed that these investors were subject to the mercy of insiders and investment bankers. To protect them, the law should ensure these investors were paid first in full, before anyone junior received anything. Only in this fashion would outsiders enjoy a fair return on their investment. The SEC tried to persuade the Supreme Court to interpret the bankruptcy law in this fashion, and it was successful in large part because the Court's newest Justice came from the SEC and had indeed pushed for this form of priority, absolute priority, while he was there.³²

The rationale that absolute priority protects unsophisticated senior investors from advantage-taking makes no sense when one approaches reorganization law with an awareness of how well-functioning capital markets work. Investors take into account how they will be treated in bad states of the world and will demand an interest rate that protects them. As long as they buy and hold a diversified portfolio over the long term, they will enjoy at least the market rate of return, even if investment bankers and insiders appropriate assets during a restructuring. Indeed, the bondholders of the 1930s that the SEC thought needed protecting enjoyed above-market returns.³³

Given its origins, the enthusiasm that Jackson and others had for the absolute priority might seem hard to fathom. But there are several reasons why they embraced it. The absolute priority rule follows naturally from their assumption that a bankruptcy reorganization is the equivalent of a nonbankruptcy sale. A sale by its nature is a recognition event. It collapses all future possibilities to the present and requires all positions to be cashed out and all accounts squared.

Absolute priority has other important virtues. It is simple. Moreover, it aligns *ex ante* incentives correctly. When junior investors have control and there is private information, they should bear the maximum losses in bad states of the world.³⁴ For these reasons, the absolute priority rule was a natural starting place.

At the time Jackson wrote, arguments against absolute priority tended to be oblique and sloppy. Rather than asking whether absolute priority was indeed part of the creditors' bargain, its critics offered what were ungrounded and sentimental arguments that gave lip service to absolute priority, but undermined it in practice. Many of these arguments were too clever by half, and were often made with a smug satisfaction that their cleverness had once again secured a win for the good guys against the forces of evil. Through the lens of finance, the impulse behind this style of argument was mystifying. In a world of professional investors holding

diversified portfolios, it is incoherent to think that sharing losses equally is a good idea in its own right.

With respect to all of this, Jackson and contemporary bankruptcy scholars share common ground. Nevertheless, there are reasons not to accept absolute priority uncritically. Many nonbankruptcy restructurings are not treated as recognition events by those involved. When venture capitalists need to refinance a start-up, underwater interests are not cashed out. Venture capital contracts provide for dilution of junior interests in bad states of the world, not their extinction. Intercreditor agreements involving loans to mature corporations can and do provide for payments to such junior interests in the event of a restructuring through what are known as x-clauses.³⁵ One can make a respectable argument, firmly grounded in the creditors' bargain, in favor of a reorganization regime that recognizes the option value of junior interests.³⁶ This idea emerged from the academy in recent years and has quickly become part of the law reform agenda among judges and practitioners.³⁷ And all speak the language of finance.

CONCLUSION

Contemporary bankruptcy scholarship finds itself moving in two strikingly different directions. On the one hand, it is trying to sort out the dynamics of bankruptcy cases and understand the effects on the ground. It models new practices and engages in empirical inquiry. This approach is deeply connected to the day-to-day practice even though it is relatively removed from doctrine. At the same time, contemporary scholarship has returned to foundational debates. The law journals of the 1920s and 1930s were filled with arguments about optimal priority rules in bankruptcy. The difference, however, is that instead of informal discussion of vague ideas, it is now captured formally in the language of options and is firmly rooted in the creditors' bargain. In both enterprises, there is engagement with the practicing bar and the origins can be traced back to Thomas Jackson.

NOTES

1. Jackson's conception of bankruptcy is set forth in a one-volume monograph, a classic that still bears careful reading. See Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press 1986). Nothing in this retrospective look at Jackson's work, however, is intended to suggest that Jackson's contributions to bankruptcy are behind him. Among other things, he has been among the most compelling voices in debates about how bankruptcy law should govern the insolvency of systemically important financial institutions. On a personal note, I would be remiss not to acknowledge my own debt to Jackson, who first became my mentor while I was in law

school and whose insight and generous spirit has done much to illuminate my own work in the decades since. I also want to thank The Frank Greenberg Fund and the John M. Olin Fund for their research support.

2. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 *Yale L.J.* 857 (1982).
3. Indeed, Jackson's paper on the individual discharge in bankruptcy is one of the first examples of behavioral law and economics. See Thomas H. Jackson, *The Fresh Start Policy in Bankruptcy Law*, 98 *Harv. L. Rev.* 1393 (1985).
4. John D. Ayer, *The New Face of Douglas Baird*, 12 *Am. Bankr. Inst. L. Rev.* 101 (2004).
5. The National Bankruptcy Conference is a small group (never more than seventy) of bankruptcy lawyers, judges, and academics dedicated to bankruptcy reform. It meets at least once a year, and it has had a hand in all major bankruptcy legislation since the 1930s.
6. *Butner v. United States*, 440 U.S. 48 (1979). Some have questioned whether the case itself can bear the weight that Jackson and others placed on it. See, e.g., Barry E. Adler, *The Questionable Axiom of Butner v. United States*, in *Bankruptcy Law Stories* 11 (Robert K. Rasmussen, ed. 2007).
7. *Id.* at 55.
8. This approach, one that uses state law as its benchmark, now permeates judicial opinions. For an example of a court applying this methodology in the context of a common-law bailment, see *In re Mississippi Valley Livestock, Inc.*, 745 F.3d 299 (7th Cir. 2014).
9. *In re CMC Heartland Partners*, 966 F.2d 1143 (7th Cir. 1992).
10. Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 *Yale L.J.* 1143 (1979).
11. Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 *Am. Econ. Rev.* 261, 268–71 (1958).
12. See, e.g., Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 *J. Legal Stud.* 73 (1993); George Triantis, *Secured Debt under Conditions of Imperfect Information*, 21 *J. Leg. Stud.* 225 (1992).
13. There are, of course, some bankruptcy cases, particularly those involving mass torts, in which the players are not financial professionals. The appropriate treatment of such creditors spawned considerable debate. There is, however, more or less agreement on the need to provide tort victims and the like with priority. The fighting issue is whether the priority should be located in nonbankruptcy law or should be a special bankruptcy policy. For Jackson and those who followed him, the former course made the most sense. For a lively debate joining this issue, see Elizabeth Warren, *Bankruptcy Policy*, 54 *U. Chi. L. Rev.* 775 (1987); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 *U. Chi. L. Rev.* 815 (1987). The fighting issue in Delaware has been the conditions under which creditors can challenge the decision making of the board.
14. See Peter Lattman, *Judge Orders Auction in a Rebuke to Delphi Plan*, *Wall Street Journal*, June 12, 2009.
15. The foundational paper in corporate finance on agency costs remains Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305 (1976).
16. These are set out in Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991). The book brings together the core insights laid out in a series of articles in the early 1980s.
17. 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, 108 (1984).
18. *In re Central Ice Cream Co.*, 836 F.2d 1068 (7th Cir. 1987). The same tension can exist in corporate law as well, and it is for this reason that Central Ice Cream led the courts in Delaware to revise the standard view that directors were obliged to maximize the value of

- the shareholders' stake in the firm to the modern view that they are obliged to maximize the value of the firm for the benefit of all the stakeholders. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991); *Quadrant Structured Products Co. v. Vertin*, 102 A.3d 155 (Del. Ch. 2014).
19. Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 Stan. L. Rev. 751 (2002); Harvey R. Miller, Shai Y. Waisman, Does Chapter 11 Reorganization Remain A Viable Option for Distressed Businesses for the Twenty-First Century?, 78 Am. Bankr. L.J. 153, 153 (2004).
 20. The idea of using a hypothetical sales as a paradigm for thinking about corporate reorganizations advanced by Jackson can be traced to Robert C. Clark, The Interdisciplinary Study of Legal Evolution, 90 Yale L.J. 1238, 1250–54 (1981).
 21. Mark J. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 Colum. L. Rev. 527 (1983).
 22. Douglas G. Baird, The Uneasy Case for Corporate Reorganizations, 15 J. Legal Stud. 127 (1986).
 23. Lucian Bebchuk, A New Approach to Corporate Reorganizations, 101 Harv. L. Rev. 775 (1988).
 24. See, e.g., Philippe Aghion, Oliver Hart & John Moore, The Economics of Bankruptcy Reform, 8 J.L. Econ. & Org. 523 (1992); Barry E. Adler & Ian Ayres, A Dilution Mechanism for Valuing Corporations in Bankruptcy, 111 Yale L.J. 83 (2001).
 25. For a colorful account of the battle for Marvel Entertainment between Ronald Perelman and Carl Icahn while it was in Chapter 11, see Dan Raviv, *Comic Wars: How Two Tycoons Battled over the Marvel Comics Empire—And Both Lost* (Broadway 2002).
 26. Shleifer and Vishny developed this explanation for the way in which illiquidity can limit the effectiveness of sales. Andrei Shleifer & Robert W. Vishny, Liquidation Values and Debt Capacity: A Market Equilibrium Approach, 47 J. Fin. 1343 (1992).
 27. This justification for reorganizations sometimes being superior to sales is put forward in Douglas G. Baird & Donald S. Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain, 115 Yale L.J. 1930, 1949 (2006).
 28. For the iconic discussion of this problem, using the example of used cars that are “lemons,” see generally George A. Akerlof, The Market for “Lemons”: Quality Uncertainty and the Market Mechanism, 84 Q.J. Econ. 488 (1970).
 29. Kenneth Ayotte & Edward R. Morrison, Creditor Control and Conflict in Chapter 11, 1 J. Legal Analysis 511 (2009).
 30. See, e.g., Douglas G. Baird & Thomas H. Jackson, Bargaining After the Fall and the Contours of the Absolute Priority Rule, 55 U. Chi. L. Rev. 738 (1988).
 31. See, e.g., Edward J. Janger, The Logic and Limits of Liens, 2015 U. Ill. L. Rev. 589, 612.
 32. For a discussion of this history, see Douglas G. Baird, Present at the Creation: The SEC and the Origins of the Absolute Priority Rule, 18 Am. Bankr. L. Rev. 591 (2010).
 33. W. Braddock Hickman, Corporate Bond Quality and Investor Experience 338, 509 (Princeton Univ. Press 1958).
 34. See, e.g., Alan Schwartz, Bankruptcy Contracting Reviewed, 109 Yale L.J. 343 (1999).
 35. See, e.g., *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 139–40 (2d Cir. 2005).
 36. See Anthony J. Casey, The Creditors' Bargain and Option-Preservation Priority in Chapter 11, 78 U. Chi. L. Rev. 759, 765 (2011).
 37. See Am. Bankr. Institute, Commission to Study the Reform of Chapter 11 2012–2014: Final Report and Recommendations, 207–24 (2014).

EDITOR'S NOTES

Professor Baird's foreword attributes much of modern bankruptcy scholarship, including the contributions of this volume, to a paradigm created

by Thomas Jackson. This observation is proper and is echoed by the Introduction that follows. But Baird is too modest.

In addition to his redoubtable individual work in bankruptcy law, contracts law, and beyond, Baird was a frequent co-author with Jackson of articles that established and inhabited the Jacksonian bankruptcy framework. One needs no more evidence of Baird's importance to the field than the numerous citations to Baird's work in the chapters of this book.