The Janus Faces of Reorganization Law

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The Supreme Court's judgment in Czyzewski v. Jevic Holding Corporation exposes a curious fact about modern reorganization law. In large measure, two distinctive paradigms now color interpretation of the Bankruptcy Code. One paradigm governs during the early stages of a case and is oriented toward the importance of debtor and judicial discretion to use estate assets for the general welfare. The other paradigm governs a bankruptcy's conclusion and is oriented toward the sanctity of creditors' bargained-for distributional entitlements. In combination, they produce practical uncertainty as well as what appears to be policy incoherence. After identifying the Janus faces of reorganization law, this essay explores their significance for modern bankruptcy practice and theory. Most strikingly, it argues that, under the conditions of modern corporate finance, the two paradigms might actually cohere in service of a more general norm of investor wealth maximization. What appear on one level of analysis to be contradictory postures may prove, upon reflection, to be but two faces of a single god.

I. INTRODUCTION 2

II. TWO TAKES ON REORGANIZATION POLICY 5

III. BANKRUPTCY'S TWO FACES 9

A. The End: Looking to the Past 10

B. The Beginning: Looking to the Future 16

C. An Unstable Boundary 19

IV. RECONCILING BANKRUPTCY'S JANUS FACES 22

A. Diminishing Signal Quality 23

B. Diminishing Magnitude of Gains from Efficient Redistributions 27

V. CONCLUSION 28

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I. INTRODUCTION

The Supreme Court's most recent foray into the world of corporate reorganization, in *Czyzewski v. Jevic Holding Corporation*,[1] reveals as much about the conceptual underpinnings of modern bankruptcy law as any case has done in decades.[2] At stake in *Jevic* was the legality of a recent innovation in bankruptcy practice—the so-called "structured dismissal"[3]—when used to sidestep rules of distributional priority that govern liquidations and plans of reorganization. The Bankruptcy Code appears on its face to vest bankruptcy judges with the power to order these dismissals, but the Court condemned them on the ground that priority norms, being central to bankruptcy, must not be subverted absent clear permission from Congress.[4] Neither the Court's judgment in the case nor its logic came as a surprise to seasoned observers. At the same time, however, the Court struck a different note with respect to techniques debtors routinely use to pay low-priority claims early in a case.[5] These techniques lack clear textual warrant and can undermine priorities as surely as a structured dismissal can, yet *Jevic* went out of its way to distinguish and seemingly bless them.[6] The contrast in attitude toward economically similar transactions is remarkable. At least as puzzling is just how *unremarkable* the contrast seemed to students of bankruptcy. What this state of affairs says about the structure of reorganization law, and what we ought to make of it, are the subjects of this essay.

More specifically, this essay seeks to do two things—to characterize and elaborate on a doctrinal tension *Jevic* exposes and to advance a claim about this tension's significance for bankruptcy policy. The doctrinal observation is that reorganization law is two-faced. *Jevic*'s holding and dictum were unsurprising because two rival interpretive paradigms have come to shape judicial understanding of the Bankruptcy Code. By this I do not mean simply that the Code is a result of uncomfortable compromises between legislative coalitions with distinctive viewpoints (although of course it is). Nor do I mean that different judges understand bankruptcy's animating aims differently (although perhaps they do). I mean rather that what appear to be two very different sets of assumptions and values, two conflicting frameworks, coexist with relative purity within the body of orthodox doctrine—and that their conflict is mediated by a kind of truce. One paradigm orients interpretation

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1. Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017).

2. Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999), discussed *infra* note 57, comes to mind. The cases on bankruptcy court jurisdiction, *e.g.,* Stern v. Marshall, 564 U.S. 462 (2011), might have done more to shake up the bankruptcy bar, but they have little to say about the normative foundations of reorganization law.

3. The structured dismissal is discussed *infra* Part III. In brief, the structured dismissal is an order resolving a bankruptcy on terms acceptable to the court that does not comply with the strictures governing liquidations or plans of reorganization. For more on the background of structured dismissals and the contexts in which they are used, see Jonathan C. Lipson, *Bargaining Bankrupt: A Relational Theory of Contract in Bankruptcy*, 6 HARV. BUS. L. REV. 239, 251–60 (2016). *See generally* Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative After Asset Sales*, 29 AM. BANKR. INST. J. 1 (2010).

4. *Jevic*, 137 S. Ct. at 984 ("The importance of the priority system leads us to expect more than simple statutory silence if, and when, Congress were to intend a major departure.").

5. *See infra* Part III.A.

6. *See Jevic*, 137 S. Ct. at 985–86. For an argument that the payment of prepetition debts is not most profitably understood in terms of distributional entitlements, see generally Douglas G. Baird et al., *The Bankruptcy Partition*, 166 U. PA. L. REV. (forthcoming 2018). *See also* Vincent S.J. Buccola, *The Bankruptcy Firm*, 166 U. PA. L. REV. ONLINE (forthcoming 2018).

during the early stages of a reorganization case; the other orients interpretation at its conclusion. The two paradigms are defined by their radically opposed positions on the inevitable trade-off between the value of discretion, on one hand, and the sanctity of entitlements, on the other. Early in a bankruptcy case, ambiguity in the Code is understood to vest the debtor, under judicial supervision, with authority to use the estate's property as it sees fit in a bid to preserve the going concern, irrespective of the implications for distributional priorities. I call this the discretion paradigm. At bankruptcy's close, on the contrary, ambiguity in the Code is understood to vindicate creditors' distributional priorities, irrespective of their effect on the estate's value as a whole. I call this the entitlement paradigm.

Jevic did not create the order of divided rule. That has developed over a quarter century or more. Rather, *Jevic* at once reflects and deepens the prevailing order. As we shall see, the decision's rationale depends on fidelity to a particular distributional scheme—"absolute priority"—over and above what the Bankruptcy Code's plain text demands.[7] Indeed, a straightforward textual analysis would have yielded a judgment going the other way. The Court's opinion reads naturally only if one first posits the normative primacy of distributional entitlements. But *Jevic* confines its own logic to the end of a bankruptcy case, disclaiming any negative implications for the legality of critical vendor orders and other, similar staples of modern bankruptcy practice whose textual authority is dubious and whose effect on distribution can be profound.[8]

The dual-paradigm regime raises an obvious practical question: How should a lawyer or judge know when one paradigm has given way to the other? The conceptual difficulty is clear. Time is continuous but doctrinal categories are not. A line must be drawn somewhere, even if arbitrarily, and a good lawyer would like to know where. For reasons to be made clear, however, no straightforward answer is likely forthcoming. The two paradigms can coexist only if a vague standard, as yet unannounced, defines the boundary between them.[9]

For many observers, reorganization law's two paradigms will call to mind two visions of bankruptcy that defined scholarly debate during the 1980s and 1990s. Douglas Baird once described that debate as pitting "traditionalists" against "proceduralists."[10] The traditionalist perspective is forward-looking. Its fundamental question is how, all things considered, losses ought to be shared now that a debtor has proved unable to pay its creditors in full. Pre-bankruptcy arrangements factor into the calculus, but the prospective effects on all parties of one or another resolution are important. In striking the appropriate balance, the bankruptcy judge plays an important discretionary role. The proceduralist perspective, by contrast, is backward-looking. Its fundamental question is how a debtor's

7. *See infra* Part III.A.

8. *See Jevic*, 137 S. Ct. at 985–86 (noting the importance of the fact that "the priority-violating distribution is attached to a final disposition"); *infra* Part III.B.

9. Stephen Lubben has pointed to this unsettling implication of *Jevic* in a column in the *New York Times*. *See* Stephen J. Lubben, *Supreme Court Ruling Draws a Vague Line in Bankruptcy Cases*, N.Y. TIMES (Apr. 14, 2017), https://www.nytimes.com/2017/04/14/business/dealbook/supreme-court-ruling-draws-a-vague-line-in-bankruptcy-cases.html?mcubz=2&_r=0. As we shall see, however, the dynamic is far from unique in the law of corporate decision making.

10. Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 576–77 (1998) [hereinafter Baird, *Bankruptcy's Uncontested Axioms*].

pre-bankruptcy investors would divvy up control rights were they able to do so cheaply. Ordinary principles of contract and property law establish investors' relative status. Clear priority rules are preferred to judicial discretion, because rules establish expectations against which investors can contract before bankruptcy.

On the surface, then, my account of bankruptcy doctrine seems to suggest policy incoherence in addition to practical difficulty. Reorganization law centers on discretion, except when it does not; and distributional entitlements orient bankruptcy, except when they do not. But incoherence is not the only possibility. Janus has two faces, according to Ovid, so that he can at once look forward in time and back.[11] The god himself occupies the moment of transition. In placing him there, at the juncture between past and future, the Roman iconography gestures toward a deep unity in what appear on the surface to be contradictory postures. Likewise, I hope to show, bankruptcy's evident doctrinal tension may in fact reflect a singular attitude toward the aims of reorganization law.

From this perspective, the right question to ask is not whether dueling paradigms can yield uncertainty or confusion in the marginal case, but whether a more general principle can harness their conflict to produce systemic coherence at a policy level. Here I argue that, given prevailing patterns of corporate finance, the discretion and entitlement paradigms indeed may work together roughly in service of a wealth-maximization norm.[12]

The argument rests on a basic observation about priority deviations (or redistributions) and two complementary mechanisms at work in modern bankruptcies. The observation is that some but not all redistributions tend to maximize investor wealth. In general, there are two reasons a debtor's managers might seek to make a redistribution: to increase the total value of the estate (efficient redistributions), or to benefit favored creditors—and perhaps the managers themselves—at the expense of the estate (rent-seeking redistributions). If bankruptcy judges were capable of distinguishing between these motivations with perfect accuracy, the law would maximize investor wealth by simply directing the judge to permit efficient but not rent-seeking redistributions. Judges are not omniscient, however, and it follows that a pure discretionary regime is not obviously wealth-maximizing. To the contrary, the optimal model might withdraw judicial discretion over the course of a case, which is precisely what the dual-paradigm model accomplishes.

Why might this be so? First, the accuracy with which bankruptcy judges distinguish between efficient and rent-seeking redistributions is likely to decline over the course of a case. This is because a senior creditor's acquiescence in a proposed redistribution produces a signal, of diminishing quality over time, about its desirability. Early in a bankruptcy, senior creditors are biased toward reducing risk even where doing so jeopardizes the expected value of the debtor's business.[13] To an oversecured creditor, time is the enemy. Given the prevailing incentives, senior creditor acquiescence in a proposed priority deviation, aimed as it typically will be at continuing debtor operations (and hence increasing volatility), is strong evidence of the deviation's capacity to increase the debtor's total value. But by the end of a bankruptcy things are changed. The senior creditor typically

11. OVID, FASTI 12–13 (James G. Frazer, trans., Loeb 1931) ("[L]est I should lose time by twisting my neck, I am free to look both ways without budging.").

12. If this is right, then it suggests that the "traditionalist" position depends on a particular kind of judicial discretion. The "proceduralist" position is at least consistent with a different kind.

13. *See generally* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511 (2009).

is looking at a known, fixed return. The risk it once faced has been liquidated, and, consequently, the creditor no longer has reason to police the debtor's proposed redistributions.

Second, there is reason to believe the kinds of redistributions that occur early in a case have the greatest capacity to generate wealth. Deviating from priorities early in a case can make the difference between a reorganization or orderly sale of the business as a going concern and a liquidation producing meager recoveries. If operations are halted too soon, going-concern value can be difficult to restore. Humpty Dumpty is not easily put back together again. On the other hand, to the extent redistributions that occur late in a case can create value—and they can—efficiency gains are likely to be modest. Under these conditions, the law may maximize investor wealth by withdrawing judicial discretion to approve redistributions over time.

In Part II, I briefly recount the terms of a longstanding normative debate among students of corporate bankruptcy. By doing so, I hope to make clear why the doctrinal tension exposed by *Jevic* can so easily be read to transpose a normative conflict about the basic functions of reorganization law. Part III identifies the doctrinal tension, and Part IV argues that it need not be evidence of policy or normative incoherence.

II. Two Takes on Reorganization Policy

The equity receivership, from which modern reorganization law descends, developed in the courts without reference to any grand teleological theory. In the best tradition of Anglo-American commercial law, the reorganization bar proceeded on an essentially ad hoc and pragmatic basis, adapting settled legal rules and institutions to achieve what its leaders regarded as commercially reasonable results.[14] For much of the 20th century, academic writing on reorganization law followed suit. Some analysts proceeded forensically, seeking to clarify doctrine where it was confused and refine it where incongruous.[15] Others railed against perceived abuses and pursued legislative change to root them out.[16] But to the extent scholarly approaches to reorganization were guided by generalized value schemes, these schemes were implicit and ill-defined.

The tone of commentary changed decisively in the 1980s, when the insights of the law and economics movement were first applied to bankruptcy. Most conspicuously, Douglas Baird and Thomas Jackson proposed and defended a parsimonious normative

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14. This, in any event, was how the elite reorganizers saw their own work. *See generally* Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade (Part I)*, 27 COLUM. L. REV. 901 (1927); Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade (Part II)*, 28 COLUM. L. REV. 29 (1928). For a retrospective account of the reorganization bar's influence on the receivership, see DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 48–70 (2001).

15. Walter Blum was a leading exponent of this type. Characteristic works include Walter J. Blum, *Full Priority and Full Compensation in Corporate Reorganizations: A Reappraisal*, 25 U. CHI. L. REV. 417 (1958); Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651 (1974); Walter J. Blum, *Treatment of Interest on Debtor Obligations in Reorganizations Under the Bankruptcy Code*, 50 U. CHI. L. REV. 430 (1982).

16. The best example in this category was the preeminent bankruptcy scholar of the first half of the twentieth century, the future Justice William O. Douglas. For discussion of Douglas's sweeping influence on the path of bankruptcy law, see David A. Skeel, Jr., *Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship*, 113 HARV. L. REV. 1075, 1079–93 (2000); SKEEL, *supra* note 14, at 101–27.

framework—the creditors' bargain—within which the bulk of reorganization law could be understood and against which its particular features could be assessed.[17] According to this framework, bankruptcy justifiably alters creditor rights, as defined by ordinary commercial law, only to the extent creditors and other investors would agree to such changes in a hypothetical world of costless bargains.[18] The ideal of the creditors' bargain was thus explicitly contractarian and concerned exclusively with remedying market failure. Its Coasean prescription might be complex to work out in detail but was easy to state in principle: Nonbankruptcy entitlements should be impaired "only when necessary to maximize net asset distributions to the creditors as a group, and never to accomplish purely distributional goals."[19]

In the years to come, many were to adopt the creditors' bargain as a useful heuristic with which to think about bankruptcy law. Not all were persuaded, however. Elizabeth Warren, among others, articulated a countervailing perspective.[20] Not only was existing law inconsistent in important respects with the demands of the creditors' bargain, but more importantly, there was no reason to think the law *should* reflect such a parsimonious vision. Bankruptcy law has always vindicated multiple, at times conflicting, policy aims.[21] Preserving the estate for the benefit of creditors is one such aim, but there are others, including mitigation of the suffering felt by those affected by but lacking contractual claims against the debtor.[22] On this view, the creditors' bargain represented a reduced perspective, blind to the virtues of collective reorganization efforts and resembling, in one critic's uncharitable but evocative phrase, "the stereotypical ugly American abroad."[23] Bankruptcy policy, on this view, is and ought to be explicitly distributional.

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17. Baird and Jackson developed their ideas individually and in jointly authored work. Early pieces articulating and applying the creditors' bargain model include: Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982) [hereinafter Jackson, *The Creditors' Bargain*]; 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 (1984) [hereinafter Baird & Jackson, *Adequate Protection*]; Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725 (1984); Douglas G. Baird & Thomas H. Jackson, *Kovacs and Toxic Wastes in Bankruptcy*, 36 STAN. L. REV. 1199 (1984); Thomas H. Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 J. LEGAL STUD. 73 (1985); Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); 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) [hereinafter Baird & Jackson, *Bargaining After the Fall*].

18. *See* Jackson, *The Creditors' Bargain*, *supra* note 17, at 860 (calling for bankruptcy to be viewed "as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an ex ante position").

19. Robert E. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U. CHI. L. REV. 690, 692 (1986) (reviewing DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY (1985)).

20. *See generally* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717 (1991); KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM (1997).

21. Warren, *supra* note 20, at 777 ("I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing—and sometimes conflicting—values in this distribution.").

22. *Id.* at 787–89.

23. Korobkin, *supra* note 20, at 740.

In an essay published shortly before the turn of the millennium, Baird sought to lay out the terms of the normative debate.[24] More precisely, he sought to show why debate had failed to broker consensus among experts proceeding in good faith. The thesis was simple: There were, roughly speaking, two camps of thinkers, each of which operated on the basis of more or less coherent assumptions about human behavior—assumptions that were, moreover, hard to prove or disprove.[25] The first group of thinkers, "proceduralists," prioritized an *ex ante* perspective. What was bound to happen under conditions of financial distress would shape creditor behavior in calmer waters—that is, a prospective lender's willingness to extend credit depends on her expectations about what will happen in the event of bankruptcy—so an efficient set of reorganization rules would ultimately contribute to the general welfare. The question whether a given firm should be reorganized or liquidated was, it followed, a question simply of going-concern value, and all bankruptcy could do was ameliorate the costs of creditor negotiation on that issue. The bankruptcy judge existed to adjudicate disputes about the creditors' relative entitlements, but little else. "Traditionalists," meanwhile, prioritized an *ex post* perspective. On their view, incentive effects were mainly doubtful, so the law could afford not to worry overly about how bankruptcy law would affect access to credit. The important question was this: Now that a company is in distress, how should losses be distributed to achieve the best for the most who have relied on the company—including its employees and others in the communities where its influence is felt most directly? Judicial power, personified in the bankruptcy judge, would need to play an important role in answering that question.[26]

The most important site of contest between the two camps concerned the emphasis to be placed on distributional entitlements: the degree to which the bankruptcy process ought to honor creditors' bargained-for rights, both against the debtor and relative to one another. The more thoroughly bankruptcy vindicates distributional expectations, the less flexibility it necessarily leaves to debtors and the court. Put in doctrinal terms, the key question is to what extent "absolute priority" ought to shape the contours of the rest of the bankruptcy landscape. In general terms, absolute priority refers to a waterfall method of distributing the value of a bankrupt estate. The highest priority creditors receive their share, and so on until a class of claims is impaired, after which no more junior claimants take anything.[27] Absolute priority has been part of American reorganization law since the New Deal, when Justice Douglas implausibly asserted that it had been encoded in the recently enacted reorganization statute.[28] Yet, its normative significance is still in question because absolute

24. *See generally* Baird, *Bankruptcy's Uncontested Axioms*, *supra* note 10.

25. *Id.* at 577.

26. *Id.* at 576–80 (summarizing the competing commitments). For a discussion of conflicting views on the judicial role in bankruptcy, see generally Melissa B. Jacoby, *What Should Judges Do in Chapter 11?*, 2015 U. ILL. L. REV. 571 (2015).

27. This statement is incomplete but will do for present purposes. The rule as instantiated in the Bankruptcy Code is more complicated, as Part III will discuss.

28. Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 115 (1939) ("The words 'fair and equitable' as used in s 77B, sub. f are words of art which prior to the advent of s 77B had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations."). For accounts of the rule's origin and evolution, see generally John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963 (1989); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991); Douglas G. Baird & Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393 (1999) [hereinafter Baird & Rasmussen, *Boyd's Legacy*].

priority can be imagined either as a narrow rule or as a general principle. The absolute priority *rule* is found in the Bankruptcy Code only as a condition to the confirmation of nonconsensual plans of reorganization (known as "cramdowns").[29] The absolute priority *principle* is found nowhere but is thought to pervade the Code everywhere, informing the proper interpretation of doubtful language.[30] For proceduralists, absolute priority more than any other doctrine stands for the continuity of creditor rights in and out of bankruptcy, and consequently they imagine it to be the polestar of reorganization law—that around which all else rotates.[31] For traditionalists, on the other hand, the absolute priority rule lacks foundational significance. It is but one tile in the intricate mosaic of substantive and procedural rules that jointly define bankruptcy.[32] In no sense does it have a claim to lexical priority over other, equally valid rules of law.[33]

It is understandable that observers should differ on the importance of creditor entitlements. The essence of any insolvency law is a tradeoff between two sources of underinvestment that manifest at different times in a company's financial lifecycle: opportunistic non-repayment (which makes credit expensive *ex ante*) and debt overhang (which makes credit expensive *ex post*).[34] Depending on one's standpoint and one's assumptions about the relative efficacy of markets and courts, either problem can appear to be more acute. Both invite myopic focus. Consider two hypothetical insolvency regimes that take only one or the other problem into account. One regime would simply discharge all outstanding liabilities when a debtor could prove to a judge's satisfaction that its old obligations were precluding new, valuable investments. This would cure debt overhang

29. 11 U.S.C. § 1129(b)(2) (2010).

30. *See, e.g.*, Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235, 1243 (2013) ("The Bankruptcy Code's core principle is that distribution conforms to predetermined statutory and contractual priorities, with creditor equality within each priority class."); Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 786 (2017) [hereinafter Baird, *Priority Matters*] ("The absolute priority rule is the organizing principle of the modern law of corporate reorganizations.").

31. In saying this, I do not mean to slight the ongoing debate about whether a system of relative priority would better approximate a Coasean bargain than absolute priority. *See generally* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930 (2006); Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2011) [Hereinafter Casey, *The Creditors' Bargain*]; Anthony J. Casey & Edward R. Morrison, *Beyond Options*, *in* HANDBOOK ON CORPORATE BANKRUPTCY (Barry E. Adler, ed., forthcoming); Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014); Baird, *Priority Matters*, *supra* note 30; Barry E. Adler & George Triantis, *Debtor Priority and Options in Bankruptcy: A Policy Intervention*, 91 AM. BANKR. L.J. 563 (2017). For present purposes, the important point is the centrality of *some* distributional rule, whatever it might be.

32. Stephen J. Lubben, *The Overstated Absolute Priority Rule*, 21 FORDHAM J. CORP. & FIN. L. 581, 583 (2016) ("In chapter 11, under federal law, the absolute priority rule only comes into play at plan confirmation, and then only when the plan is rejected by some class. . . . Moreover, by the time the rule appears at the end of a chapter 11 case, it has already been breached so often that its entrance no longer matters.").

33. *Compare, e.g.*, Roe & Tung, *supra* note 30 (arguing that pre-plan distributions "undermine" the absolute priority rule), *with* Lubben, *supra* note 32 (arguing that these distributions show the rule's insignificance).

34. Debt overhang describes one effect of debt on a firm's investment policy. Put crudely, the idea is this: as a firm's debt burden increases, an increasingly high proportion of its income must go to pay down the debt—leaving less for equity and other junior investors. Consequently, equity's incentive to invest in new projects diminishes as the debt burden increases. If a firm's investment policies are oriented toward stockholder wealth, the firm will tend to forgo even positive-value investments. Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 149 (1977).

outright while exacerbating the threat of debtor opportunism. An alternative regime would lack a debt composition mechanism altogether. It would be a "no bankruptcy" system. Credit might be easier to come by in healthy states of the world, but in distressed states of the world the prospect of recapitalization would be left to the vagaries of negotiation. Neither extreme is likely to be optimal, but one can see how each corresponds to a plausible way of thinking about the world.[35] What is remarkable, then, is not the existence of two conflicting perspectives on the appropriate premises of reorganization law, but the unique way both perspectives have come to shape interpretation of the Bankruptcy Code.

III. BANKRUPTCY'S TWO FACES

In the 20 years since Baird characterized the proceduralist and traditionalist views, reorganization doctrine appears to have instantiated the intuitions underlying both perspectives—although not at the same time.[36] What I call the entitlement paradigm colors interpretation of the Bankruptcy Code during a case's concluding phases. Under the entitlement paradigm, ambiguity in the Code is resolved so as to protect the substance and not just the form of creditors' distributional priorities. Practices that can undermine these priorities are condemned where not clearly authorized, even if in some instances they might yield greater total recoveries for the debtor's investors.[37] What I call the discretion paradigm colors interpretation of the Code during a case's beginning phases. Under the discretion paradigm, ambiguity is resolved so as to promote debtor and judicial discretion. Practices that might facilitate a value-maximizing reorganization are approved where not clearly prohibited, even if in some instances they can undermine priority expectations.[38]

The coexistence of the discretion and entitlement paradigms poses no technical conflict. Because only one paradigm governs at a time, the law never simultaneously points in inconsistent directions. Discretion and entitlement do, however, seem to bespeak policy tension, because facially they reflect differing views about the significance of distributional expectations. Consider the treatment of a debtor's attempt to pay in full one of its prepetition unsecured debts.[39] At the end of the case, under the entitlement paradigm, the analysis is easy. The two relevant questions are (i) whether all senior claims are also being paid in full and, if not, (ii) whether the impaired claimants consent to their treatment.[40] In

35. For an argument that mandatory liquidation might be optimal, *see* Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 367–75 (1997).

36. This is so for Chapter 11. Interestingly, other chapters of the Bankruptcy Code lack this dual-paradigm structure. Chapter 7, which mandates liquidation of the debtor's assets followed by a distribution of proceeds, focuses on creditor entitlements. Chapter 9, meanwhile, is understood to vest the debtor and bankruptcy judge with broad discretion throughout proceedings and even with respect to plan confirmation. *See* Vincent S.J. Buccola, *Law and Legislation in Municipal Bankruptcy*, 38 CARDOZO L. REV. 1301, 1304 (2017).

37. The entitlement paradigm can be associated with the Pareto efficiency norm. An insolvent debtor's assets might be most valuable in the hands of old equity or management; but if so, junior investors must buy senior investors' rights. Two features of plan confirmation—voting by class (majority of claims and two-thirds by value) and the cramdown power—are aimed at mitigating holdout problems.

38. The discretion paradigm can be associated with the Kaldor-Hicks efficiency norm. Creditor entitlements are undermined if necessary to maximize the debtor's total value to all constituents, including those who lack a legal claim on the firm. Compensation for the creditor's loss is not required.

39. This is an important issue to be considered in detail below. *See infra* Part III.B.

40. Consent as used here is given by a vote of similarly situated claimants. Unanimity is not required, provided that each creditor receives at least as much as in a hypothetical liquidation. *See* 11 U.S.C. §§ 1126,

other words, the absolute priority rule supplies the sole consideration. At the beginning of the case, under the discretion paradigm, things are not so simple. The payment of a prepetition debt offends no concrete rule of bankruptcy. It does not offend the absolute priority rule, understood *as a rule*, because, at the risk of repetition, that rule operates only when a debtor seeks to cram down a plan of reorganization or when the estate's assets are to be liquidated.[41] As I say, the approach taken under the discretion paradigm does not technically conflict with the approach taken under the entitlement paradigm. On the other hand, the payment of an unsecured claim at the beginning of bankruptcy is surely at odds with the weight ascribed to priority entitlements at bankruptcy's end, because early distributions can cause a state of affairs in which total bankruptcy recoveries deviate substantially from what priority norms would prescribe.

To make the intuition clear before we continue, compare two variations on a simple case. Both feature a Debtor who enters bankruptcy with $200 worth of assets and $300 of liabilities. Bank, which has a security interest in all of Debtor's assets, is owed $150. C_1 and C_2 are unsecured creditors owed $75 each, but C_1 has a priority claim. In the first variation, the case proceeds immediately to a plan of reorganization or a liquidation, and absolute priority defines the creditors' relative shares.[42] Bank, being fully secured, takes $150. C_1 takes the remaining $50, for a recovery of 67 cents on the dollar, and C_2 takes nothing. In the second variation, Debtor transfers $25 to C_2 on the first day of bankruptcy, long before a plan is to be proposed or Debtor's assets liquidated. Absolute priority continues to govern distributions at the case's eventual conclusion; but now, all else remaining the same, the rule applies to an estate worth only $175. Bank is again paid in full, and C_2 still takes nothing under the final distribution. But now C_1 takes only $25, a return of 33 cents on the dollar, and C_2, unlike in the first variation, ends up with a positive return from the bankruptcy if not from the final distribution.

A. The End: Looking to the Past

The entitlement paradigm is a creature of the Supreme Court's reorganization jurisprudence. The Justices have struck a consistent stance since the Bankruptcy Code went into effect in 1979.[43] In what follows, I describe each of the four cases decided under the Code in which the Court has wrestled with the conditions on which bankruptcy may conclude. The cases deal with three basic issues: the scope of the "new value corollary" to the absolute priority rule, the place of credit bidding in plan-based auctions, and the legality of the priority-sidestepping structured dismissal (that is, *Jevic*). The common thread is this: in each instance, the Justices confronted the legality of a practice with some textual warrant but also with the capacity to erode distributional entitlements, and in each instance the Justices showed solicitude for the absolute priority norm as an end meriting protection beyond or in addition to the Code's narrow textual commands.[44]

1129(a)(7) (2010).

41. *See supra* note 29 and accompanying text.

42. For convenience, assume that Debtor's going-concern surplus is exactly zero.

43. Bankruptcy Reform Act, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

44. The cases also suggest that, were the justices to weigh in on the propriety of "gifting" plans, they would agree with the skeptical approach of the Second and Third Circuits. *See In re* DBSD N. Am., Inc., 634 F.3d 79, 100 (2d Cir. 2011) (holding that plan allocating some of secured creditors' collateral to junior creditor may not be crammed down over objection of "skipped," intermediate priority creditor); *In re* Armstrong World Indus.,

The new value corollary—The pattern began to emerge in the Court's two decisions on the scope of what is called the "new value corollary." Above, I described the absolute priority rule as mandating the waterfall distribution of debtor property absent the consent of senior creditors to worse treatment. We must now confront one complication. As codified, the absolute priority rule declares that a proposed plan of reorganization may not be crammed down if it both (i) impairs a senior investor's claim and (ii) grants a junior investor value "on account of" her prebankruptcy interest in the debtor.[45] A corollary to the rule, then, is that a plan granting value to a junior investor *might be* crammed down, even if it impairs a senior claim, if the junior investor takes not on account of her prebankruptcy interest, but on account of some new value she provides the debtor.[46]

What it means to receive a new interest "on account of" an old one remained an open question under the Code for a decade after its enactment. Multiple understandings were plausible.[47] At one extreme, the phrase could be understood to prohibit only the exchange of old securities for new. On this understanding, "on account of" means only that the old security cannot be the *sole* consideration for the new security. The junior investor must provide *something* new. At the other extreme, the phrase could be read to condemn any plan proposing to give a junior investor value that is conditioned on the fact of her prebankruptcy investment. On this reading, "on account of" means that the old security cannot be any part of the consideration for the new security. A broad interpretation of the new value corollary would confer on the bankruptcy judge relatively wide latitude to confirm plans that write down debts while giving a stake in the reorganized company to old equity and old management. A narrow interpretation, by contrast, would allow senior creditors to lean on their distributional entitlements irrespective of their effect on the enterprise's fate.

The scope of the new value corollary first reached the Court in an easy case, *Norwest Bank Worthington v. Ahlers*.[48] The husband-and-wife debtors in *Ahlers* were proprietors of a small farm whose fortunes had declined sharply during the farm financial crisis of the 1980s.[49] After the couple defaulted on loan payments owed to the Bank, they filed a petition under Chapter 11 to forestall collection activities.[50]

Inc., 432 F.3d 507, 509–10 (3d Cir. 2005) (same).

45. 11 U.S.C. § 1129(b)(2)(B) (2010) ("[T]he condition that a plan be fair and equitable with respect to a class includes the following requirements. . . . With respect to a class of unsecured claims—(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . .").

46. The idea that junior investors, typically equity, might retain an interest in the debtor by contributing "money or money's worth" is as old as the absolute priority rule itself. *See* Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 122 (1939) ("[W]e believe that to accord 'the creditor his full right of priority against the corporate assets' where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.").

47. For a discussion, see generally Baird & Rasmussen, *Boyd's Legacy*, *supra* note 28.

48. Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 210 (1988).

49. *Id.* at 199–200. For more on the macroeconomic context, see generally Barry J. Barnett, *The U.S. Farm Financial Crisis of the 1980s*, 74 AGRIC. HIST. 366 (2000). The farm crisis spurred Congress to enact what is now Chapter 12 of the Bankruptcy Code. Family Farmers Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3105 (1986).

50. *Ahlers*, 485 U.S. at 199–200.

The Bank sought relief from the automatic stay, on the ground that no plan of reorganization was feasible.[51] The debtors were too far underwater and had no prospect of alternative financing, the Bank argued; any plan that would allow them to stay in possession of the farm would, therefore, necessarily violate the absolute priority rule. The case reached the Supreme Court when, after a remarkable series of opinions in the lower courts, the Eighth Circuit drafted its own plan of reorganization and sent it to the bankruptcy judge with instructions to confirm.[52] In the Eighth Circuit's view, the Ahlers family could retain an equity interest in the farm by providing the enterprise with new value—to wit, their deep reservoirs of "labor, experience, and expertise."[53]

The Justices would have none of it, reversing in a unanimous decision.[54] A junior investor seeking to retain an interest over the objection of a senior class of impaired claimants must, the Court declared, provide "money or money's worth."[55] To be sure, a vague promise to provide labor or expertise likely has value, but not value of the kind that can be measured easily or reliably.[56] If "new value" were understood to comprehend much more than cash, the rule would vest too much discretion in the bankruptcy courts and grant too little certainty to senior creditors.

A decade later, a more difficult question about the new value corollary's scope reached the Court, and the Justices narrowed judicial discretion further, giving the absolute priority rule about as broad a reading as it can stand. In *Bank of America National Trust & Savings Ass'n v. 203 N. LaSalle Street Partnership*,[57] the debtor, a limited partnership, proposed a plan of reorganization under which an unsecured claim belonging to the Bank would be paid 16 cents on the dollar while some of the debtor's former partners, in exchange for investing new capital, would own all of the reorganized entity's equity.[58] The Bank cried foul. Under the plan, the opportunity to "buy" new equity was limited to old partners. This meant that the old partners got *something* not open to the public at large, even if only an option to invest, notwithstanding the Bank's deep haircut. The bankruptcy judge approved the plan, and the district court and Seventh Circuit affirmed.[59] In their view, the plan assigned new ownership in exchange for new capital contributions, not "on account of" the participants' status as partners in the bankrupt partnership.[60]

The Supreme Court reversed. The Justices identified what they termed a "practical" problem with interpreting the new value corollary as broadly, and hence the absolute priority rule as narrowly, as the lower courts did.[61] Allowing old equity to participate in the reorganized business whenever they contribute substantial new funds would invite measurement "by the Lord Chancellor's foot."[62] An absolute priority rule easily evaded

51. *Id.* at 200.
52. *Id.*
53. *Id.* at 203.
54. Justice Kennedy did not participate in the case's decision.
55. *Ahlers*, 485 U.S. at 203–04 (quoting Case v. L.A. Lumber Products Co., 308 U.S. 106, 122).
56. *Id.* at 204.
57. Bank of Am. Nat'l Trust & Savings Ass'n v. 203 N. LaSalle St., 526 U.S. 434, 450 (1999).
58. *Id.* at 440.
59. *Id.* at 442.
60. *Id.*
61. *Id.* at 450.
62. *203 N. LaSalle St.*, 526 U.S. at 450.

"would not be much of an absolute."[63] At the least, the Court held, a plan must provide for a market check on the relationship between the amount of capital old owners contribute and the new ownership interest they receive.[64]

The Court's view of the new value corollary is not unreasonable. On the contrary, *203 N. LaSalle Street* represents an eminently plausible interpretation.[65] But two things are notable. First, the Code's text could have supported much more debtor and judicial leeway.[66] Second, the Court's reasoning relied on the premise that creditors' priority rights must not be susceptible to abridgment, even where a bankruptcy judge thinks modification commercially sensible on the facts before her. The Court understood the Code's policy to protect rule-like distributional priorities even where the Code's text was ambiguous about the matter.

Credit bidding—In *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*,[67] the Court confronted the question whether secured creditors have a right to credit bid at an auction conducted under a plan of reorganization. A credit bid is a secured creditor's offer to offset its claim, instead of or in addition to paying cash, as consideration for the assets on sale. It is designed to protect the secured creditor's priority in the value of its collateral. The creditor is entitled to the proceeds of the collateral's sale, up to the amount of its secured claim. But a sale can effectively reduce the claim's value if the collateral is sold for below market price, as might happen, for example, when an auction's procedures are designed to favor the debtor's preferred buyer. Credit bidding allows the secured creditor to protect its claim by simply taking the collateral if, in its view, the collateral is worth more than the highest cash bid.

The Bankruptcy Code provides that a plan of reorganization can be crammed down over the objection of a secured creditor class if the plan has one of three features: (i) the plan disposes of collateral subject to existing liens; (ii) the plan calls for the sale of collateral free and clear of existing liens and provides that the secured creditor may credit bid; or (iii) the plan provides the secured creditor with "the indubitable equivalent" of its secured claim.[68] In *RadLAX*, the debtors sought to cram down a plan under which collateral would be sold free and clear of liens, but in which the secured creditor would have no credit bidding rights.[69] The debtors proposed to satisfy the cramdown strictures by providing the indubitable equivalent of the secured claim. A unanimous Court rejected the debtors' theory as a nonstarter.[70] Despite the linguistic plausibility of their argument,[71] the Court held that every plan-sponsored auction must permit credit bidding if assets are to be sold free and clear of liens.

Structured dismissals—The latest and most vivid example of the entitlement

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63. *Id.*

64. *Id.* at 454–56.

65. *Id.*

66. Certainly some commentators understood it more broadly. *See generally* Randolph J. Haines, *The Unwarranted Attack on New Value*, 72 AM. BANKR. L.J. 387 (1998); Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9 (1992).

67. RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. 639, 639 (2012).

68. 11 U.S.C. § 1129(b)(2)(A) (2010).

69. *RadLAX*, 566 U.S. at 642.

70. *Id.* at 649.

71. For discussion of the scalar implicature problem at the heart of the linguistic analysis, see Douglas G. Baird & Anthony J. Casey, *Bankruptcy Step Zero*, 2012 SUP. CT. REV. 203 (2012).

paradigm at work is found in *Jevic*, which holds that the Bankruptcy Code forbids "structured dismissals" that sidestep distributional priority rules.[72] What is so striking about *Jevic* is that, unlike in the previous examples, the Justices reach a result seemingly contrary to the Code's text in order to protect the sanctity of creditor priorities at bankruptcy's end.

Some background.[73] There are three ways for a case filed under Chapter 11 to conclude: with confirmation of a plan of reorganization;[74] with conversion to Chapter 7, followed by liquidation of the debtor's assets and distribution of proceeds;[75] or with dismissal.[76] The Code specifies adherence to distributional priorities in the case of plan confirmation and liquidation. For the bankruptcy judge to confirm a plan over the dissent of even a single impaired creditor class, the plan must distribute value according to absolute priority.[77] If a case is converted to Chapter 7 and the debtor's assets liquidated, proceeds are likewise distributed according to defined priorities.[78] This leaves dismissal. When a bankruptcy case is dismissed, as a matter of course the dismissal order unwinds any changes in the claimants' relative positions effected during the case's pendency, restoring the parties as nearly as possible to the status quo ante.[79] But the Code allows the bankruptcy judge to stipulate in the dismissal order, "for cause," that changes will not be unwound.[80] Transfers made during the bankruptcy, liens destroyed, preferences avoided, settlements entered—all stick upon the bankruptcy judge's say-so. A structured dismissal is, then, a dismissal designed to change the relative positions of a debtor's claimants using the distinctive attributes of the bankruptcy forum, but without needing to comply with the requirements of a plan confirmation or liquidation process.

Which brings us to the facts of *Jevic*. The affiliated debtors—which, to avoid unnecessary confusion, I will call simply "Jevic"—were in the trucking business. In 2006, the company was the subject of a leveraged buyout financed by Sun Capital Partners (which acquired the equity) and CIT Group (which took on the senior debt).[81] Business fared poorly as the financial crisis loomed, and within two years the company filed a petition under Chapter 11 and wound down business.[82]

To understand the dispute that reached the Supreme Court, two post-filing developments are important to note. First, a group of former Jevic employees—truck drivers who were laid off when the company wound down operations—filed WARN Act

72. Czyzewski v. Jevic Holding Corp, 137 S. Ct. 973, 986–87 (2017).

73. For a more extensive statement of the case's facts and a critique of decision-making processes in the bankruptcy court, see Melissa B. Jacoby, *Corporate Bankruptcy Hybridity*, 166 U. PA. L. REV. (forthcoming 2018) (manuscript at 30–39).

74. Plan confirmation is governed by 11 U.S.C. § 1129.

75. 11 U.S.C. § 1112 (2010); 11 U.S.C. § 726 (2010).

76. *Id.* at § 1112(b) (2010).

77. *See id.* § 1129(b)(1)–(2). It is not uncommon for consensual plans to violate absolute priority. *See, e.g.*, Ayotte & Morrison, *supra* note 13, at 513 (finding that equity received a payout in 18% of large-company bankruptcies filed in 2001). When equity holders receive value in a consensual plan, it signals either or both of two possibilities: there is nuisance value in extinguishing the equity's procedural rights, or there is a consensus view that the debtor's assets will be most valuable if old equity remains invested going forward.

78. 11 U.S.C. §§ 507, 726 (2010).

79. 11 U.S.C. § 349(b) (1994).

80. *Id.*

81. Czyzewski v. Jevic Holding Corp, 137 S. Ct. 973, 980 (2017).

82. *Id.*

claims against the company and Sun Capital for firing them without sufficient notice.[83] This litigation resulted in a judgment against Jevic and, importantly, an $8.3 million priority unsecured claim against the estate.[84] Second, the Creditors' Committee won permission from the bankruptcy judge to pursue fraudulent transfer claims against Sun Capital and CIT Group, on behalf of the Jevic estate, on the theory that the 2006 buyout had rendered the company insolvent and hence expropriated value from its creditors.[85]

Here things get interesting. Because Jevic had few assets available for distribution, the proceeds of any plausible fraudulent transfer settlement would flow to the Drivers, on account of the priority of their claims (after paying the administrative expenses of the bankruptcy). So the Creditors' Committee hatched a plan with Sun Capital and CIT Group. Instead of paying settlement money into Jevic's estate, as settling defendants ordinarily would do, Sun Capital and CIT Group would direct funds into a newly formed trust, the beneficiaries of which included unsecured creditors other than the Drivers. The bankruptcy judge would then bless the settlement—extinguishing the fraudulent transfer claims—and order the case dismissed with stipulation. The plan worked. The Drivers objected that their priority was being subverted, but the bankruptcy judge entered an order implementing the structured dismissal, and the district court and Third Circuit affirmed.[86]

To the surprise of almost no one, the Supreme Court reversed, reading the Code to prohibit structured dismissals that sidestep otherwise prevailing priority rules.[87] The Court's opinion did not, however, rely on anything in the Code's text affirmatively prohibiting such dismissals. Nor could it. Formally, a structured dismissal is nothing more than an order achieving three ends simultaneously: the approval of a settlement, the dismissal of the bankruptcy case, and a stipulation that dismissal not unwind the settlement's effect. As *Jevic* acknowledged, a bankruptcy judge's authority to do each of these three things is textually assured—and nothing in the Code stops the judge from combining them in a single order.[88] Rather, the Justices relied on the normative importance of distributional entitlements.[89] As they put it (in an appropriately obscure, passive

83. *Id.* at 980–81. The Drivers sought to "pierce the veil" and hold Sun Capital, as Jevic's sole stockholder, liable for the company's statutory violation. Sun ultimately prevailed, but not until after the structured dismissal was negotiated and ordered.

84. *See* 11 U.S.C. § 507(a)(4)(A) (2016) (listing types of expenses and claims to be paid in order by priority).

85. *Jevic*, 137 S. Ct. at 981. For discussion of the theoretical merits of such claims, see generally Baird & Jackson, *supra* note 17. *See also* Vincent S.J. Buccola, *Beyond Insolvency*, 62 U. KAN. L. REV. 1, 29–37 (2013) (arguing that fraudulent transfer, in conjunction with the fiduciary norms of corporate law, point to a managerial norm of asset-value maximization).

86. *Jevic*, 137 S. Ct. at 981–82.

87. *Id.* at 978.

88. *Id.* at 984–85. The Federal Rules of Bankruptcy Procedure empower the bankruptcy judge to approve settlements. FED. R. BANKR. P. 9019. The Code empowers the judge to dismiss cases and stipulate the effect of dismissal under 11 U.S.C. § 349(b).

89. Because the Code affirmatively grants the bankruptcy judge power to do these things, the legality of her decision to do them in a given case is arguably better described as a matter of discretion. It is plausible to say that combining the powers to sidestep priority norms is an abuse of discretion per se. This line of argument would not have helped the Drivers in the Supreme Court, however, as they had already forfeited arguments about discretion. In any event, the Justices seem disinclined toward discretion-based limitations on bankruptcy judge authority. *Compare* Vincent S.J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 GEO. MASON L. REV. 99, 117 (2010) (arguing that refusal to permit credit bidding constitutes a per

construction), the waterfall priority scheme "has long been considered fundamental."[90] Priorities, they reminded readers, constitute "a basic underpinning of business bankruptcy law."[91] This being so, nothing less than a clear statement from Congress authorizing priority-sidestepping structured dismissals would do. In short, *Jevic* condemned the structured dismissal not because the order in question violated any textual prohibition or command, but because, in the Court's view, any resolution of a bankruptcy that undermines creditor entitlements is inherently suspect.

B. The Beginning: Looking to the Future

A radically different framework colors interpretation of the Bankruptcy Code during the early stages of a reorganization case. The discretion paradigm's foothold is section 363(b)(1) of the Code, which provides 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 . . . ."[92] The courts have read section 363 capaciously to confer sweeping discretion on the debtor, under the bankruptcy judge's watchful eye. Of particular note, the debtor is understood to able to pay prepetition claims if doing so might foster a successful reorganization, even where the effect, inevitably, is to risk undermining distributional priorities.[93] Paying claims is, after all, one "use" of the estate's property. It is not that creditor priorities are to be ignored under the discretion paradigm. Priorities matter. But they do not stand on their own ground. The risk that a creditor's priority might be effectively frustrated is alone no reason to block credible business decisions aimed at helping the debtor maintain operational continuity while restructuring its balance sheet.

As reorganization practice exists today, debtors have a number of mechanisms at their disposal to prefer one or another set of creditors. Each has been the subject of extensive debate, and I am not the first to recognize that they combine to erode the force of absolute priority.[94] It will thus do simply to sketch three oft-used means by which debtors can pay prepetition debts in a priority-sidestepping manner: critical vendor orders, debt roll ups, and legal settlements.[95] In combination, they illustrate the discretion paradigm's broad reach.

Critical Vendor Orders—Early in reorganization proceedings, often on bankruptcy's first day, debtors sometimes file a motion seeking court permission to pay prepetition debts

se abuse of discretion), *with* RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. 639, 644–47 (2012) (finding a requirement to allow credit bidding in the text of 11 U.S.C. § 1129).

90. *Jevic*, 137 S. Ct. at 983.

91. *Id.*

92. 11 U.S.C. § 363(b)(1) (2010).

93. *See infra* Part IV.B (discussing the diminishing signal quality of efficient redistributions).

94. For dueling interpretations of the phenomenon, compare Roe & Tung, *supra* note 30, with Lubben, *supra* note 32.

95. The most obvious way a debtor can privilege low-priority obligations is by assuming favored leases or executory contracts. *See* 11 U.S.C. § 365(a) (2005) (stating that a trustee may "assume or reject any executory contract or unexpired lease of the debtor"). To do so, the debtor must cure any defaults. 11 U.S.C. § 365(b) (2005). The counterparty is paid in full (minus the time-value of money) for what, if the contract were rejected, would amount only to a general unsecured claim. The prospect of strategic behavior is easy to see. *See, e.g.*, Lubben, *supra* note 32, at 596–98. But I omit contract assumption from my analysis because the Code explicitly authorizes it. 11 U.S.C. § 1124(2) (2005). Normative paradigms are characterized instead by the practices that are simply assumed under it or else understood to be authorized by dubious or vague texts.

owed to "critical vendors"—trade counterparties without whose goods or services, it is claimed, operations would halt.[96] These debts are typically general unsecured obligations that would face a deep discount or be wiped out entirely if the vendors were obliged to wait in line with the rest of the claimants. Instead, by threatening to cut off resources—or, more accurately, by encouraging the debtor to *represent* such a threat to the court—critical vendors receive 100 cents on the dollar.[97]

Debtors routinely file critical vendor motions, and courts routinely grant them. One recent study examined a sample of 63 cases filed in 2013. It found that debtors sought to pay critical vendors in approximately 75% of the cases and that the debtors' motions were approved in every case.[98]

Debt Roll Ups—The Code authorizes debtors to procure liquidity on favorable terms.[99] In particular, section 364(d) allows the bankruptcy judge to approve debtor-in-possession (or "DIP") financing arrangements under which a newly advanced loan takes priority on par with, or even ahead of, the most senior prepetition secured claimants.[100] In cases where the DIP lender was also the debtor's secured lender before bankruptcy, as is common, the lender may also seek a roll up—an order that the proceeds of the DIP loan be used first to pay off the lender's *prepetition* loan.[101] If it were always clear that the DIP

96. Critical vendor orders have been the focus of sustained scholarly attention. A related and ubiquitous first-day motion seeks to honor prepetition obligations to employees. Wage claims have priority over general unsecured claims, 11 U.S.C. § 507 (2016), so orders allowing their payment are less controversial than are critical vendor orders, even if formally they look quite similar.

97. In a 2004 opinion authored by Judge Easterbrook, the Seventh Circuit famously condemned uncritical rubber-stamping of a debtor's critical vendor motions. *In re* Kmart, 359 F.3d 866, 873–74 (7th Cir. 2004). *In re Kmart* stopped short of barring critical vendor orders outright, however. In the 19th century, the Supreme Court had greenlighted payments to trade creditors under two judge-made equitable principles: the six-month rule and the doctrine of necessity. *Id.* at 871 (citing Miltenberger v. Logansport Ry. Co., 106 U.S. 286 (1882) (doctrine of necessity); Fosdick v. Schall, 99 U.S. 235 (1878) (six-month rule)). Although the Seventh Circuit declined to read the Bankruptcy Code as having implicitly adopted those principles, it acknowledged that section 363(b)(1) might provide a textual basis for critical vendor payments in at least some cases. *In re Kmart*, 359 F.3d at 872. After all, section 363 does not limit the uses to which debtor property may be put "outside the ordinary course of business"; it requires only that the judge sign off on the disposition. 11 U.S.C. § 363 (2005).

98. Elizabeth Shumejda, *Critical Vendor Trade Agreements in Chapter 11 Bankruptcy*, 24 AM. BANKR. INST. L. REV. 159, 170–73 (2016). Rich Hynes and Steven Walt provide evidence that critical vendor motions are somewhat less common than Shumedja's study would suggest, but finds that the frequency of critical vendor payments increases with the size of the debtor firm. *See* Richard M. Hynes & Steven D. Walt, *Inequality and Equity in Bankruptcy Reorganization*, 66 U. KAN. L. REV. 865, 889–91 (2018).

99. 11 U.S.C. § 364 (2012).

100. 11 U.S.C. § 364(d) (2012).

101. For recent evaluative and empirical work on roll ups, see Frederick Tung, *Do Economic Conditions Drive DIP Lending?: Evidence from the Financial Crisis* 11–12, 25–28 (Bos. Univ. Sch. Of Law, Working Paper No. 16-38, 2017) (on file with author); George Triantis, *Debtor-in-Possession Financing in Bankruptcy*, *in* RESEARCH HANDBOOK ON CORPORATE BANKRUPTCY LAW 8–9 (Elgar forthcoming); Stuart Gilson et al., Cashing Out: The Rise of M&A in Bankruptcy 17 (Mar. 6, 2016) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2547168. In its 2014 report on the future of Chapter 11, the American Bankruptcy Institute proposed reducing debtor reliance on extraordinary loan provisions such as the roll up. AM. BANKR. INST. COMM. TO STUDY THE REFORM OF CHAPTER 11, FINAL REPORT AND RECOMMENDATIONS 73 (2014) [hereinafter ABI FINAL REPORT AND RECOMMENDATIONS]. But roll ups have been a subject of academic criticism for more than a decade. *See* David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 941–42 (2003) [hereinafter Skeel, *Creditors' Ball*]; David A. Skeel, Jr., *The Past, Present, and Future of Debtor-in-Possession Financing*, 25 CARDOZO L.

lender's prepetition claim was bona fide, fully secured, and first-priority, then a roll up would be of little moment.[102] But DIP lenders value the roll up precisely because these conditions may not hold. As Fred Tung aptly puts it, the roll up "effectively transforms the DIP lender's pre-bankruptcy claim into a fully secured, interest-bearing, high priority post-bankruptcy claim, which will effectively get cashed out at the end of the case."[103]

Authorization of the roll up is doubtful. Section 364 offers a way to assure DIP lenders that post-petition funds will be repaid. But it says nothing about the status of pre-petition claims that happen to belong to the same lender.[104] Section 364 authorizes debtors to obtain new capital. But it says nothing about how capital in the debtor's hands is to be deployed. Only an understanding of section 363 underwritten by the discretion paradigm can justify the roll up.[105] The logic is that of the critical vendor order. Indeed, one can think of the roll up as a species of critical vendor order, specifically one in which the "critical" input is working capital rather than enterprise-specific goods or services and in which the "vendor" is a financial institution.

Settlements.—Litigation about the validity, type, and amount of a debtor's obligations is common in bankruptcy. If vindicating distributional priorities were always of central concern to reorganization law, one would expect resolutions to involve two steps: first, settle the dispute on terms the bankruptcy judge deems reasonable in light of the facts and applicable law; second, determine what kind of recovery the claimant receives on account of the settlement under the ordinary rules of plan confirmation or liquidation. Only by subjecting settling parties to the same distributional scheme as all the other claimants can one ensure that priorities are respected.

In most bankruptcies, however, the law permits more flexible resolutions. In the Second and Third Circuits, where most large Chapter 11 cases take place, a debtor can distribute estate assets during a case's pendency, under the terms of a settlement blessed by the bankruptcy court, even if it might ultimately undermine distributional priorities.[106]

REV. 1905, 1926–27 (2004); Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219, 228 (2004); James J. White, *Death and Resurrection of Secured Credit*, 12 AM. BANKR. INST. L. REV. 139, 180–83 (2004); Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425, 464–65 (2006).

102. The importance of the validity and priority of the lender's security interest is self-evident. Doubt about the collateral's value is at least as significant because the lender is entitled to post-petition interest only if its claim is oversecured. *See* 11 U.S.C. § 502(b)(2) (2012); United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 372–73 (1988).

103. Tung, *supra* note 101, at 11.

104. *Cf. In re* Kmart, 359 F.3d 866, 872 (7th Cir. 2004) (explaining that section 364 "authorizes the debtor to obtain credit . . . but has nothing to say about how the money will be disbursed or about priorities among creditors").

105. For a discussion of the statutory basis of roll ups (and the related practice of cross-collateralization), see Hynes & Walt, *supra* note 98, at 883–85.

106. There is a circuit split on this issue. *Compare In re* Iridium Operating LLC, 478 F.3d 452, 467 (2d Cir. 2007) (holding the settlement had a proper business justification), *and In re* Jevic Holding Corp., 787 F.3d 173, 185 (3d Cir. 2015) (holding the settlement had a sufficient basis), *with In re* AWECO, Inc., 725 F.2d 293, 300 (5th Cir. 1984) (holding there were no sufficient facts to determine fairness). In fact, it is this split that prompted the Supreme Court to grant certiorari in *Jevic*, *see* Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 987–88 (Thomas, J., dissenting), but the Court resolved the case on narrower grounds as described in the text above. Because Delaware and New York are the site of so many major corporate bankruptcies, the prevailing rule is that of the Second and Third Circuits.

Just how an early distribution of settlement proceeds could be used to privilege favored creditors in a priority-sidestepping manner—or even to create claimants out of whole cloth—should by now be clear. To be sure, debtors face a constraint in their use of the settlement mechanism to undermine priority rules. It is almost surely more difficult to gin up a legal claim sufficiently plausible to snooker a bankruptcy judge than it is simply to protest that preferred vendors are "critical" or that financing without a roll up is impossible to obtain. Yet the courts' willingness even to entertain these motions illustrates just how comprehensively the discretion paradigm orients understandings of debtor and judicial power early in bankruptcy.[107]

The discretion paradigm has developed primarily in the lower courts, the Justices having had no occasion to weigh in. But in *Jevic*, the Court seemingly blessed early-case distributions such as those described above.[108] It might seem that if the Court were to condemn priority-sidestepping structured dismissals on the basis of a priority norm, despite the Code's text pointing the other way, then early-case distributions ought to meet the same fate.[109] But the majority opinion said otherwise. It distinguished distributions made under critical vendor and settlement orders precisely because, unlike the structured dismissal, they are made not at the end of bankruptcy but on an "interim" basis.[110] The contrast between two paradigms in a single opinion is striking.

C. An Unstable Boundary

The transition from the discretion to the entitlement paradigm presents a practical difficulty. My descriptive account implies that there are distributions a debtor can make on one day, with court approval, but not on the next. Arbitrariness is a necessary consequence of discontinuous legal rules operating in time. But arbitrary or not, bankruptcy practitioners and judges would like to know how to locate this moment of transition. Unfortunately, they are bound to be disappointed. Epistemic uncertainty is central to maintaining the dual-paradigm regime, and consequently the boundary must be unstable.

One clear line suggests itself as a plausible candidate. The entitlement paradigm might be taken to govern only a bankruptcy's concluding documents—orders to cram down a nonconsensual plan of reorganization, to disburse the proceeds of a liquidation, or to dismiss a case—and the discretion paradigm to govern all else. There is support for this kind of cleavage in both the Bankruptcy Code and the Supreme Court's decisions. Most clearly, as we have seen, the Code's priority rules apply by their own terms only to liquidation and cramdown, both of which conclude bankruptcy.[111] Likewise the structured dismissal condemned in *Jevic* was a case-concluding order and in that sense could be

107. As part of the Energy Future Holdings bankruptcy, EFH effected a settlement by repurchasing its notes from investors with whom the company was in dispute. *See In re* Energy Future Holdings Corp., 648 F. App'x. 277, 279 (3d Cir. 2016) (approving the first lien settlement between Chapter 11 debtors and noteholders). There is no reason to think the price EFH paid was unreasonable, and a repurchase of securities is a sensible way to settle. But the technology of the stock repurchase is exceptionally powerful and might yet be repurposed in another case.

108. *Jevic*, 137 S. Ct. at 985–86.

109. *Id.*

110. *Id.*

111. *See supra* notes 74–78 and accompanying text.

viewed as a near-perfect substitute for liquidation or a plan of reorganization.[112] Arguably, all earlier dispositions of debtor property could constitute "interim distributions"[113] subject to section 363 and the discretion paradigm.

Courts are unlikely to embrace such a clear rule, however, because the price of predictability would be the entitlement paradigm's vitality. To see why, we need only consider a slight variation on the facts of *Jevic*. Recall that the structured dismissal order in *Jevic* did three things: it approved a settlement of the estate's fraudulent transfer claim against Sun Capital and CIT Group; it dismissed the bankruptcy case; and it stipulated that the dismissal would not unwind the settlement.[114] The order thus concluded proceedings and, consistent with the rule under consideration, was rightly rejected as being inconsistent with the entitlement paradigm. Now consider the hypothetical case of *Jevic´*. It is identical to *Jevic* but for one difference. In *Jevic´*, the lawyers are aware of *Jevic*. They know that a bankruptcy-ending order will be scrutinized for fidelity to distributional priorities, and they arrange documentation accordingly. In particular, the lawyers decompose the dismissal order. They break it into constituent elements and sequence them to avoid the rule in *Jevic*. First they seek the court's approval of the settlement, *then* its order dismissing the case and stipulating that the settlement remain intact. The arrangement will of course undermine priorities in precisely the same way as *Jevic* did, but in *Jevic´* the priority-sidestepping distribution is made the day *before* the case is concluded. Under the rule offered above, it is therefore an "interim distribution" subject to the discretion paradigm.

No one thinks *Jevic* and *Jevic´* should come out differently, and it follows that a sharply defined boundary rule will not do.[115] One might defend such a boundary by recourse to judicial discretion. Although the Code authorizes the one-day-early move in *Jevic´*, one might reason, a bankruptcy judge would abuse her discretion in signing off on it. And so she would. Notice, though, that this way of explaining the case replicates under a different doctrinal heading the very ambiguity our clear rule was meant to resolve. Now the difficult question is when a bankruptcy judge abuses her discretion (rather than when she violates the Code) in allowing priority-sidestepping distributions under section 363. If discretion is to be gainsaid, it must be according to some aim toward which judges ought to direct their powers. Which aim? A bankruptcy judge would abuse her discretion if she permitted the sequence of events in *Jevic´* precisely because they are engineered to avoid application of the entitlement paradigm. But this judgment, which is clear, presupposes that the entitlement paradigm *ought* to control the case. But under just what conditions one paradigm ought to give way to the other is the very question our clear rule was designed to answer. Answers are likely to come case-by-case, through post hoc decisions that will inevitably yield an unpredictable and unstable borderland.

However unsatisfying the case-by-case approach may be, it is hardly unique in the law of corporate governance. In a number of business contexts, courts switch between analytical frameworks with sharply differing presumptions of scrutiny, even where the seemingly relevant variable is continuous rather than discrete. One example is found in the law of fraudulent transfer. When a firm is financially healthy, courts will not second-

112. *Jevic*, 137 S. Ct. at 979.
113. *Id.* at 985.
114. *Id.* at 981–82
115. More precisely, only those who reject the decision in *Jevic* itself think *Jevic´* should come out differently.

guess its managers' decision to part with company property. If investors get a raw deal from time to time, it's their tough luck; the big kids' playground is like that sometimes. But when a firm's financial prospects deteriorate sufficiently, the law directs judges to take a different approach. It tells them to intervene and set aside transactions in which, to the judge's eye, the beleaguered firm did not receive "reasonably equivalent value."[116] Crucially for our purposes, the trigger for the change in judicial attitude is not something lawyers (or managers) can easily identify. For example, the Uniform Voidable Transactions Act instructs judges to evaluate a deal's fairness only if at the time it was struck the debtor firm "was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were *unreasonably small* in relation to the business or transaction."[117] The law invokes reasonableness precisely because any more definite rule would invite mischief, but the choice also implies instability and unpredictability.

Another well-known example concerns the degree of scrutiny, under Delaware law, to which board decisions are subject in recapitalizations. In general, directors have a wide berth in deciding how to apply corporate assets in the ordinary course. This robust discretion paradigm is encapsulated doctrinally in the business judgment rule.[118] And it extends to at least some dealings in the company's own securities that can influence the outcome of control contests. But when a sale or change-of-control transaction becomes inevitable, the entire tone of inquiry changes.[119] Shareholders are entitled to top dollar when their firm is being sold, and so the courts go from seeing directors as "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[120] This change could be described as a shift to an entitlement paradigm, because it privileges one class of investor at the potential expense of aggregate value.[121] But the time at which a sale or change of control becomes inevitable is quite obviously a notion incapable of precise definition. Instead, *Revlon*'s application is determined from case to case,[122] and the difficulty courts and commentators alike have in describing its necessary and sufficient conditions suggests that paradigm prediction on the margins is a hazardous endeavor.[123]

116. 11 U.S.C. § 548(a)(1)(B)(i) (2005); UNIF. VOIDABLE TRANSACTIONS ACT (UVTA) § 4(a)(2) (UNIF. LAW COMM'N 2014).

117. UVTA § 4(a)(2)(i) (2014) (emphasis added). The Act also includes a subjective trigger not relevant to the discussion here. *See id.* at § 4(a)(2)(ii) (instructing courts to set aside unfair deals if when made the debtor "intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due").

118. In its most well-known articulation, the business judgment rule is defined as the "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

119. Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1289–90 (Del. 1994).

120. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

121. For the classic explanation of how this might be, see generally Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

122. And there have been many such cases. *See, e.g.*, Equity-Linked Inv'rs L.P. v. Adams, 705 A.2d 1040, 1055 (Del. Ch. 1997) (discussing *Revlon*'s application).

123. One observer recently summarized the situation this way: "In reality, the boundaries of *Revlon*-land are murky. Left uncertain by Delaware Supreme Court precedent, the scope of the *Revlon* doctrine has been purposefully, but cautiously, defined by the Delaware Chancery Court through the use of dictum." Mohsen

As in these examples, so in bankruptcy. The boundary between paradigms is not to be defined with precision. But if lawyers can hope even for *accuracy*, they need a general norm, a principle or set of considerations that guide courts in selecting between the competing paradigms. Whether such a norm exists is the question to which we now turn.

IV. RECONCILING BANKRUPTCY'S JANUS FACES

It would be easy sport to declare bankruptcy law normatively incoherent and end the inquiry. A statute can of course call for concrete actions with countervailing effects. Maybe the Bankruptcy Code is at odds with itself. And judges are as apt to produce normatively inconsistent rules as legislators are. Maybe prevailing interpretations of the Code are path-dependent artifacts of past, ambivalent judicial impulses. But there is another possibility. Maybe the paradigms of discretion and entitlement can be reconciled by reference to a more general norm. In what follows, I pursue this last possibility. In particular, I sketch an argument that the dual-paradigm system is roughly consistent with a wealth maximization norm.[124]

To see how the argument works, we first need to set out some common understandings. In general, there are two reasons a debtor might seek to distribute assets in a priority-sidestepping manner (for convenience, a redistribution).[125] One possibility is that the debtor's managers believe the redistribution will enhance the value of the estate, typically on the ground that valuable operations would grind to a halt but for the redistribution. Call this an efficient redistribution. The other possibility is that the managers might expect the redistribution to have a null or negative effect on the estate's total value, but to yield them private benefits by increasing the recovery of one or more favored parties. Call this a rent-seeking redistribution.[126] A bankruptcy regime increases wealth to the extent it distinguishes between efficient and rent-seeking redistributions, allowing the one and blocking the other.

Because of judicial uncertainty, however, this objective is not so easily accomplished. *Ex ante*, investors are on the same page. They want the debtor to make efficient but not rent-seeking redistributions precisely because efficient redistributions (by definition) increase the size of the pie, and those who expect to lose (win) from redistributions on a systematic basis can simply demand a higher (lower) rate of return up front. Even if the investors themselves can observe which type a proposed redistribution is, their *ex ante* preference is noncontractible because the bankruptcy judge cannot directly verify the type. *Ex post*, investors' private interests diverge. Risk has now been priced and paid for, and, consequently, each investor has an incentive to chase the biggest recovery it can get. Those who stand to benefit from a given redistribution will clamor for it whether or not it is

Manesh, *Defined By Dictum: The Geography of* Revlon-*Land in Cash and Mixed Consideration Transactions*, 59 VILL. L. REV. 1, 3 (2014); *see also* Stephen M. Bainbridge, *The Geography of* Revlon-*Land*, 81 FORDHAM L. REV. 3277, 3320–37 (2013) (taking issue with chancery court elaborations).

124. To be clear, my argument is not that the bankruptcy process is wealth-maximizing *in toto*. There is much in the Bankruptcy Code to prevent that. My argument is only that the coexistence of two interpretive paradigms may increase creditor recoveries *conditional on* the Code's explicit rules being what they are.

125. I use the term "redistribution" for economy of expression only. To be clear, the existence of an entitlement baseline away from which property could be *re*distributed is the very matter in question.

126. *See* Roe & Tung, *supra* note 30, at 1242–43 (assuming that rent-seeking explains most priority-sidestepping redistributions, but disclaiming final judgment on the matter).

efficient, and those whom the redistribution promises to harm, or those who see a holdout advantage in *feigning* harm, will decry it in equally undiscriminating fashion.

In this uncertain world, there are two complementary reasons to think withdrawing judicial discretion over time may be a wealth-maximizing strategy. First, judges' accuracy at distinguishing between efficient and rent-seeking redistributions is likely to decline over the course of a case. Although judges cannot directly observe the character of a proposed redistribution, they can observe signals about its character, and the quality of these signals diminishes with time.[127] Second, the magnitude of wealth gains attributable to efficient redistributions is likely to decrease over a case, because the difference between liquidation and an orderly sale is typically more significant than the difference between two alternative dispositions both of which maintain going-concern value. These effects alone do not, of course, prove the optimality of current law—nothing of the sort. My more modest aim is to show how two seemingly inconsistent approaches to the tradeoff between entitlement and discretion may in fact cohere relatively comfortably.

A. Diminishing Signal Quality

A bankruptcy judge is able to some extent to differentiate directly between efficient and rent-seeking proposed redistributions. Some cases will be obvious and others doubtful. But the judge also observes signals produced by investors' reactions to a proposed redistribution. These signals can improve her accuracy. In particular, as I will show, the judge may glean valuable information from the fact of a senior creditor's acquiescence in a debtor's proposed redistribution. Critically, however, the informational value of acquiescence diminishes over the course of a bankruptcy. This effect suggests that a bankruptcy judge's error rate in distinguishing between efficient and rent-seeking redistributions is likely to increase over time and, consequently, that the wealth-maximizing argument for judicial discretion weakens over time.

The conventional model of reorganization dynamics—the model that gave vigor to the normative debate described in Part II—posits an antagonistic relationship between a debtor's managers and its senior creditors.[128] The source of antagonism is traced to the effect of risk on their respective payouts. A senior creditor whose loan is fully secured, such that it will be made whole in the event of a liquidation, has no financial interest in seeing the debtor's operation continue.[129] Such a creditor can only lose if the business deteriorates; it gains nothing if the debtor's fortunes improve. To maximize its recovery,

127. The notion that the quality of a bankruptcy judge's information declines as she becomes more familiar with a debtor's case will strike some readers as curious, if not farfetched. As Jacoby and Janger, for example, point out, the judge has very little direct knowledge of a debtor's affairs at a case's outset, when she is typically confronted with important, often case-dispositive motions (such as for DIP financing). *See* Jacoby & Janger, *supra* note 31, at 896–99. It stands to reason that the quality of judicial information should increase with time. And that may be true of directly observed information. But as I shall explain, it is *not* necessarily true of indirect information—that is, information deduced by inference from observed third-party behavior; and given the asymmetry of knowledge between the senior creditor and judge in the typical case, indirect information may tend to be the more important kind.

128. *See, e.g.*, Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganizations*, 83 COLUM. L. REV. 527, 538–45 (1983); Baird & Jackson, *Adequate Protection*, *supra* note 17, at 106–07; 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, 158–59 (1989).

129. There are exceptions to this general rule. *See supra* notes 78–79.

then, the senior creditor agitates for a speedy resolution, perhaps through liquidation, even if a bona fide reorganization would maximize the estate's expected value.[130] Conversely, a debtor's stockholders—at whose sufferance managers are employed and with whom they are ordinarily thought to identify—are underwater at the outset of bankruptcy and will be wiped out in case of liquidation. They can only gain if fortunes improve; they lose nothing if business deteriorates. To maximize their recovery, managers do what they can to delay a final reckoning, even if a speedy sale would maximize the estate's expected value.[131]

A consequence of the conventional model is that the bankruptcy judge can infer little from the fact of a debtor's proposal to sidestep priority norms. *Of course* the incumbent managers, who have agenda control, are happy to undermine financial creditors' distributional expectations. And this is especially so if a redistribution could in effect buy the debtor an option to reorganize rather than liquidate, as for example critical vendor payments are said to do.[132] On the other hand, the objection of a senior creditor to a proposed redistribution is likewise barren of informational content. *Of course* the senior creditor wants to keep assets in the estate, and especially so if frustrating the redistribution will also make a speedy sale more likely.

The conventional model may have accurately described the standard large bankruptcy of the 1980s and 1990s. By around 2000, though, the antagonism at its core had given way, at least with respect to large debtors.[133] In the new model, senior creditors exercise profound influence over the debtor's choices long before and all the way through bankruptcy.[134]

The basic mechanisms of creditor control are well understood. Senior lenders initially obtain governance influence, outside bankruptcy, when a firm's financial condition deteriorates such that it needs to borrow on a secured basis. Covenants in the loan documents act as trip wires that give the lender the whip hand if the borrower's financial condition continues to deteriorate.[135] In the event that a covenant breach cannot be timely cured, the borrower's default allows the lender to demand immediate repayment of its

130. Side payments could induce the senior creditor to acquiesce in value-maximizing dispositions, of course. But insolvencies, especially those of large firms, are fraught with bargaining frictions that make side payments difficult to arrange.

131. In recent years, a number of scholars have proposed changes to Chapter 11 practice aimed at eliminating the discontinuity associated with bankruptcy sales, which drives not only the conventional antagonism described here but also a conflict between senior and junior creditors. *See, e.g.*, Casey, *The Creditors' Bargain*, *supra* note 31; Jacoby & Janger, *supra* note 31.

132. For discussion of continuation as a real option, see generally Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision Making*, 17 J.L. ECON. & ORG. 356 (2001); Douglas G. Baird, *Bankruptcy from Olympus*, 77 U. CHI. L. REV. 977 (2010) (describing critical vendor payments in the same light).

133. Small-business bankruptcies present very different dynamics. Because capital structure and operations tend to be so much simpler in small-business cases, they are marked by less uncertainty and presumably make judicial decision making more accurate. *See* Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 50 J.L. & ECON. 381, 382 (2007) (finding that bankruptcy judges in small-business cases do a good job "filtering failing businesses from viable ones").

134. Barry E. Adler et al., *Value Destruction in the New Era of Chapter 11*, 29 J.L. ECON. & ORG. 461, 462 (2013) ("At or about the turn of the new century, a shift from debtor to creditor control was largely accomplished and widely reported.").

135. Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 135–39, 150–52 (2009); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1211–12 (2006).

principal. Because distressed companies lack liquidity (almost by definition), this right to accelerate repayment obligations acts as a de facto power to force the filing of a bankruptcy petition. This power, in turn, gives the lender immense leverage to force changes, whether to investment policy or personnel. Research shows, for example, that covenant violations lead borrowers to reduce their net debt.[136] Covenant violations are likewise associated with declining capital expenditures and an increase in CEO turnover.[137] As a borrower's financial condition deteriorates, the conditions on which liquidity is extended tighten. Bankruptcy, if it becomes necessary, does little to resolve the debtor's liquidity constraints—at least if, as is typical, the senior lender has taken a lien on the cash proceeds of the debtor's operations.[138] The debtor needs liquidity to avoid an immediate shutdown. Its prebankruptcy senior lender is usually in the best position to provide it, but in any event a new loan is advanced, and judicially blessed, only on conditions at least as tight as those in effect before bankruptcy.[139] The debtor can hardly make a move without the senior lender's consent.[140]

There are multiple, possible explanations for the change in bankruptcy power dynamics: amendments to Article 9 of the Uniform Commercial Code, the rise of syndicated lending, developments in modern cash-management systems, and more. No one has written a decisive history of the shift. For present purposes, though, the fact itself is what matters. Leading scholars and bankruptcy practitioners from across the political spectrum began to notice the new empirical reality by the early 2000s.[141] Statistical

136. Michael R. Roberts & Amir Sufi, *Control Rights and Capital Structure: An Empirical Investigation*, 64 J. FIN. 1657, 1658 (2009).

137. Greg Nini et al., *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 REV. FIN. STUD. 1713, 1715 (2012).

138. *See* Ayotte & Morrison, *supra* note 13, at 522–23 (finding, in a sample of large debtors filing bankruptcy petitions in 2001, that 97% of those with revolving debt facilities in place had granted a lien on all assets).

139. A cash collateral order is an alternative to a new DIP loan in some bankruptcies, especially those in which the debtor's business model throws off a lot of cash. But such an order must provide "adequate protection" of a creditor's lien on cash. 11 U.S.C. § 363(e) (2010). In practice, this typically means conditions on the use of cash roughly the same as those found in DIP loan agreements. *See, e.g.*, Ayotte & Morrison, *supra* note 13, at 523–24.

140. Where there are multiple tranches of debt, the institutional creditors have often agreed among themselves not to get in the way of the senior lender's agenda. With the rise of second-lien lending over the past fifteen years, the treatment of such intercreditor agreements has become a hot topic both among the bar and in the academy. *See, e.g.*, Seth Jacobson et al., *Enforcement of Intercreditor Agreements in Bankruptcy*, 20 NORTON J. BANKR. L. & PRAC. 343, 354 (2011); Edward R. Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015 U. ILL. L. REV. 721, 727–28 (2015); Kenneth Ayotte et al., *Bankruptcy on the Side*, 112 NW. U. L. REV. 255, 269–70 (2017); David A. Skeel, Jr. & George G. Triantis, *Bankruptcy's Uneasy Move to a Contract Paradigm*, 166 U. PA. L. REV. (forthcoming 2018).

141. Early markers of what was a fundamental change include Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 757 (2002); Skeel, *Creditors' Ball*, *supra* note 101, at 941–42; Elizabeth Warren & Jay Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 12, 12 (2003); 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). Of course, the modern dynamics were not entirely new to the 2000s. The increased likelihood of manager turnover associated with bankruptcy, and managers' concomitant identification with creditor interests, had been noted long before. *See* Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 612 (1993) (finding that managers are frequently replaced before the end of a bankruptcy); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 745 (1993) (finding signs of managerial alignment

analyses have since confirmed their account. Debtors' reliance on secured financing has become more frequent. In a sample of large cases filed in 2001, for example, 75% of debtors had obtained senior secured financing before bankruptcy, and 50% obtained new financing in bankruptcy.[142] Recent studies show that the prevalence of DIP financing has only increased. In a sample of public companies that filed bankruptcy petitions between 2002 and 2011, for example, one study found that 71% of debtors obtained a DIP loan.[143]

What does this picture mean? For our purposes, there are two things to see. First, when a debtor proposes a redistribution, creditor control provides a signal about the redistribution's type—that is, whether it is efficient or rent-seeking. Second, the quality of the signal should diminish over time.

Creditor control produces useful information precisely because of the senior creditor's payoff incentives described above. If at the outset of bankruptcy a senior creditor is substantially undersecured, then, because it is the residual investor, it has reasonably good incentives to maximize estate value. If, on the other hand, a senior creditor is oversecured (or modestly undersecured), then, as we have seen, it tends to prefer liquidation even where continuation would maximize investors' total recovery. Risk, and therefore time, is the oversecured creditor's enemy. That being so, a controlling creditor's willingness to suffer a redistribution—for example, a critical vendor payment—which simultaneously removes assets from the estate and decreases the likelihood of a speedy liquidation, is a credible signal that the redistribution is efficient. Bankruptcy judges called on to decide a redistribution motion under these circumstances are able to harness this information. Thus, in the few critical vendor cases where a junior creditor protests, a judge is entitled to infer that the objector is a crank or holdout.[144]

One of course needs to be careful not to exaggerate the quality of the signal. There is noise. Most obviously, in the case of a proposed roll up, the senior creditor (and proposed DIP lender) has no reason to object. It is after all the direct beneficiary of any redistribution.[145] More generally, even apart from the roll up context, a senior lender can have reasons for wanting to see the debtor continue inefficiently.[146] If the DIP lender is comfortably secured, and especially if its loan is receiving an above-market interest rate, it

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with creditor rather than stockholder interests). The degree of creditor control in modern cases is also a matter of debate. *See* Jay L. Westbrook, *Secured Creditor Control and Bankruptcy Sales: An Empirical View*, 2015 U. ILL. L. REV. 831, 834 (2015) (finding, in a 2006 sample of cases of all sizes, that secured creditor control is "important but not as pervasive as many have assumed").

142. Ayotte & Morrison, *supra* note 13, at 514. Two-thirds of this group received explicit DIP financing. The remainder received liquidity through cash collateral orders, which are functionally quite similar to DIP financing and involve similar constraints on debtor behavior.

143. Gilson et al., *supra* note 101, at 16. In a sample of cases ranging from those filed immediately after the Bankruptcy Code went into effect and 2014, another study finds DIP loans in close to three-quarters of all public company bankruptcies. Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Survival*, 62 UCLA L. REV. 970, 983 (2015).

144. *See* Shumejda, *supra* note 98, at 170–73 (finding objections to four of a sample of 60 critical vendor motions, all of which motions were granted).

145. This fact probably accounts for the greater skepticism roll ups garner compared to critical vendor payments. For example, the American Bankruptcy Institute's recent report on Chapter 11 recommended curtailing roll ups while generally preserving current critical vendor law. *Compare* ABI FINAL REPORT AND RECOMMENDATIONS, *supra* note 101, at 73 (roll ups), *with id.* at 88–91 (critical vendor orders).

146. For further discussion, see Roe, *supra* note 128, at 542–43; Adler, *supra* note 101, at 227–31 (2004); Triantis, *Debtor-in-Possession Financing in Bankruptcy*, *supra* note 101, at 8–9.

may prefer a slow bleed to a prompt resolution because junior creditors bear the losses. These conditions seem to be rare, however.[147] So, without pretending that a senior creditor's acquiescence at the outset of a case is per se evidence of a redistribution's efficiency, we can conclude that acquiescence at least provides a valuable signal.

When a debtor seeks to make a redistribution later in a case, the dynamics are changed. The signal associated with a senior creditor's acquiescence has deteriorated in quality, because the effect of volatility on the creditor's distribution of potential payoffs has diminished. In other words, the senior creditor's payoff has become more certain. This is easiest to see at the limit, at bankruptcy's conclusion. A plan of reorganization declares on its face what treatment each claimant will receive. This need not be a sum certain. A plan can call for a subsequent auction, for example; and the value of some assets, such as legal claims, may not be realized until after confirmation. But senior creditors' payments often are specified. If the business has been sold, the proceeds of sale can be applied mechanically. If, alternatively, the debtor is to be reorganized with a new capital structure, the plan can either pay the secured claim in full—many DIP loans are classified as administrative expenses that *must* be paid before a plan can be confirmed[148]—or roll over the lien into a new credit facility.[149] The details are not important. What is important is that the senior creditor, if it is paid in full or otherwise satisfied with its recovery, no longer has an incentive to resist rent-seeking redistributions. Why would such a creditor care if the debtor's managers want to reward themselves or favored allies at the expense of junior creditors? Indeed, a senior creditor who contemplates doing business with the debtor or its managers going forward might have its own preferred winners.

I want to be careful not to paint with too broad a brush. The dynamics of conflict can vary substantially across cases, and coalition formation is not always predictable. But my goal is not to make a claim about how information is produced in *every* case, but rather about patterns of information production. And with respect to the average case it is at least plausible to presume diminishing accuracy over time of judicial determinations about the efficiency of proposed redistributions.

B. Diminishing Magnitude of Gains from Efficient Redistributions

There is another reason to think judicial discretion ought to decline over the course of a bankruptcy. It is conceptually less interesting but may be at least as important practically. In particular, the value of efficient redistributions to investors as a group is likely greatest at the beginning of a case. Put differently, conditional on the efficiency of a given redistribution, the magnitude of its wealth effect is likely to be greatest at the outset of a case and to diminish thereafter. Dislocations at the beginning of bankruptcy have the capacity to halt operations outright, forcing liquidation and potentially destroying going-concern value that could be realized either in an orderly sale of the business under section 363 or in a bona fide reorganization.[150] Indeed, early redistributions, such as critical vendor

147. For example, Ayotte and Morrison find that senior lenders object to a sale motion in only 13% of cases. Ayotte & Morrison, *supra* note 13, at 527. Only a fraction of these objections is likely to stem from the creditor's preference for a drawn-out bankruptcy.

148. 11 U.S.C. § 364(b)–(d) (2010).

149. 11 U.S.C. § 1129(b)(1) (2010).

150. There is disagreement about whether section 363 sales capture as much value for a debtor's investors

orders and roll ups, are justified by a finding that liquidation would follow inevitably (or at least with an unacceptably high probability) but for the redistribution.[151]

Just how big a difference efficient early distributions make is a question on which reasonable minds can differ. The answer depends both on the degree to which suppliers (of goods, services, or liquidity) can hold up debtors and on the extent of going-concern value among financially distressed firms, two matters on which no conclusive evidence exists. But there is a case to be made that the wealth effects of early, efficient redistributions is large.

By contrast, efficient redistributions that might occur later in a case stand on a different footing. They might generate a modestly positive wealth effect, but they are unlikely to be the difference between a viable enterprise's continuation and shutdown. Consider, for example, the standard instance, an award of value to old equity in violation of absolute priority. Such awards can plausibly increase the value of the company—perhaps the prebankruptcy managers are the best managers and giving them equity will encourage their best performance going forward.[152] But the stakes are smaller. Error costs might, then, swamp the benefits of judicial discretion late in a case but not in its beginning.

V. CONCLUSION

Two paradigms color interpretation of the Bankruptcy Code today. Facially, they appear to reflect conflicting visions of the relative importance to reorganization law of flexibility, on the one hand, and certainty of entitlements, on the other. This conflict is bound to sow confusion in some cases. But the coexistence of discretion and entitlement paradigms does not obviously reflect policy incoherence. On the contrary, there are reasons to think that the value to investors of judicial discretion diminishes over the course of a case. If this is so, doctrinal tension and local uncertainty may be the price investors have to pay for a value-maximizing reorganization regime.

as reorganizations capture. *Compare, e.g.*, Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 44 (2007) (finding that choice to reorganize results in significantly greater recoveries), *with* James J. White, *Bankruptcy Noir*, 106 MICH. L. REV. 691, 692 (2008) (disputing methodological validity). But even assuming a difference in recoveries, the difference represents a wealth transfer rather than loss insofar as both methods preserve the going concern. A liquidation forced by untimely cessation of business, by contrast, results in a social loss as well as reduced recoveries for the debtor's investors.

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

152. *See, e.g.*, Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 149 (1990) (noting the importance of maintaining managers in small business); Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 923–24 (2001) (noting that shareholders and managers tend to be the same people in small firms). *But see* Casey & Morrison, *supra* note 31, at 577–78 (arguing that talented managers can be retained without equity grants under a plan).