Bankruptcy's Redistributive Policies: Net Value or a "Zero-Sum Game"?

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Abstract

Although federal bankruptcy law, epitomized by Chapter 11, has a pro-debtor—or at least, anti-liquidation—bias, no scholarship analyzes whether that bias creates net value or merely results in a zero-sum game that redistributes value from creditors to debtors. This Article shows that the bias is due more to accidents of history and self-interested lobbying than to any reasoned analysis of value creation. The bias also is inconsistent with many foreign insolvency laws.

The Article analyzes whether bankruptcy law should have such a pro-debtor bias. An empirical analysis of that question is not generally feasible because debtor and creditor costs and benefits in bankruptcy cannot be accurately quantified and compared. The Article therefore engages in a second-best methodology: it builds on the pro-debtor shareholder-primacy model of corporate governance, which is widely viewed as maximizing value, by stressing that model under the circumstances of bankruptcy. This reveals two critical differences. First, creditors become the primary residual claimants of the firm, whereas shareholders are relegated to secondary residual claimant status. This changes the identity of the beneficiary of the "shareholder" primacy model, whose goal is to favor the firm's primary residual claimants. Second, the covenants that normally protect creditors become unenforceable in bankruptcy, suggesting the need for additional creditor protection.

Utilizing these differences, the Article proposes and assesses a "creditor-primacy" governance model for debtors in bankruptcy. It also examines how such a model could be applied to maximize bankruptcy value. The Article recommends, for example, a threshold viability test that would require debtors that are unlikely to successfully reorganize, and therefore likely ultimately to liquidate, to be liquidated at the outset of a Chapter 11 case. That would save the considerable expenses of proceeding through bankruptcy, which can severely reduce creditor recovery. Such a test also should reduce agency costs and moral hazard. Furthermore, it should help to avoid the sunk-cost fallacy that leads to a disproportionately high number of supposedly reorganized debtors having to subsequently re-file Chapter 11 cases.

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INTRODUCTION

Federal bankruptcy law, epitomized by Chapter 11 of the Bankruptcy Code, is generally said to have a pro-debtor—or at least, anti-liquidation[3]—bias.[4] No scholarship, however, analyzes whether bankruptcy law should have such a bias.[5] The evolution of federal bankruptcy law indicates that the pro-debtor bias is due more to accidents of history and self-interested lobbying than to any reasoned analysis of value creation.[6] That unsystematic development invites skepticism of whether the pro-debtor bias actually creates net value or, instead, merely results in a zero-sum game that redistributes value from creditors to debtors.[7]

This Article attempts to answer that question by combining comparative law perspectives and analytical methodology. The methodology begins with the shareholder-primacy model of corporate governance, which is widely viewed as creating net value. It then stresses that model under the circumstances of Chapter 11 bankruptcy, taking into account differences such as the primary residual claimants of the firm becoming creditors rather than shareholders and the reality that covenants, which normally protect creditors, are generally unenforceable in bankruptcy.

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[3] *See, e.g.*, 11 U.S.C. § 706(a) ("The debtor may convert a case under this chapter [7 liquidation] to a case under chapter 11 [reorganization] . . . at any time . . . ."); §706(b) ("On request of a party in interest and after notice and a hearing, the court may convert a case under this chapter [7 liquidation] to a case under chapter 11 [reorganization] at any time."). During a fireside chat at the Second Annual Harvard-Wharton Insolvency and Restructuring Conference (Sep. 20, 2024 at Harvard Law School) between Harvard Law Professor Mark Roe and nationally prominent bankruptcy lawyer Jamie Sprayregen, the latter stated that the federal Bankruptcy Code may be better framed as anti-liquidation than as pro-debtor.
[4] Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 780-82 (1987); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1048-50 (1992). *Cf*. Todd J. Zywicki, *The Past, Present, and Future of Bankruptcy Law in America*, 101 MICH. L. REV. 2016, 2032 (2003) (discussing pro-debtor bankruptcy advocacy). References in this Article to a "pro-debtor" bias hereinafter will include an anti-liquidation bias unless otherwise specified.
[5] [cite1]
[6] DAVID SKEEL, DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 23-25 (2001).
[7] *Cf*. Bradley & Rosenzweig, *supra* note 4, at 1048-49 (arguing that bondholders of Chapter 11 debtors, as well as shareholders, lose value in bankruptcy).

Based on the foregoing, the Article proposes a new "creditor-primacy" governance model for Chapter 11 debtors. It also examines how such a model could be applied to increase Chapter 11's net-value creation. In the context, among other things, the Article proposes a "threshold viability test" that would require debtors that are unlikely to successfully reorganize, and therefore ultimately likely to liquidate, to be liquidated at the outset of a Chapter 11 case. That would save the considerable expenses of proceeding through bankruptcy, which can seriously reduce creditor recovery. It also would help to avoid the sunk-cost fallacy that can drive false findings of viability at plan confirmation hearings, accounting for the all-too-many examples of post-confirmation debtors having to re-file Chapter 11 cases. Furthermore, a threshold viability test should help to reduce agency costs and moral hazard because a firm's managers cannot confidently take unnecessary pre-bankruptcy corporate risks to try to avoid Chapter 11, assured they could fall back on Chapter 11 to enable them to keep their jobs.

The Article also demonstrates how a creditor-primacy governance model should improve Chapter 11 debtor risk-taking. Moreover, the Article proposes certain specific changes to provisions of Chapter 11 that would help to facilitate the creditor-primacy model.

This approach—grafting a normative analysis to improve net-value creation onto Chapter 11's otherwise widely accepted positive framework—is both pragmatic and has theoretical justification and precedent. Professor Bebchuk has used it, for example, by taking the existence of Chapter 11 corporate reorganizations as a given to put forth a suggestion to improve the reorganization process.[8]

The Article proceeds as follows. Part I discusses the evolution of the pro-debtor bias, starting with the pro-creditor bias of medieval bankruptcy law, then progressing to reforms based on commercial expansion and economic experimentation and finally to more modern bankruptcy laws focused on debtor rehabilitation. Part II discusses comparative law perspectives, including European Union insolvency laws that include more pro-creditor biases. Part III then examines the legal, financial, and economic scholarship. It shows that no such scholarship attempts to

[8] Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 776–77 (1988).

assess whether a pro-debtor bias creates net value or merely results in a zero-sum game that redistributes value from creditors to debtors.

Part IV of the Article engages in an analysis of that question. It acknowledges the limits of an empirical analysis: one simply cannot quantify, much less accurately compare, debtor and creditor costs and benefits in bankruptcy. Part IV then proposes a second-best analytical methodology, starting by recognizing the existence of an almost universally accepted model for balancing the interests of debtors and creditors: the shareholder-primacy model of corporate governance. The analysis stresses this pro-debtor governance model under the realities of bankruptcy and tests how, if at all, that should change the model. Based thereon, Part IV then derives a normative bankruptcy-governance model, demonstrating that such a model should be more pro-creditor biased than existing law. Thereafter, Part IV pragmatically assesses the pro-creditor model, showing that it would add important positive benefits by reducing the cost of credit without undermining the fundamental benefits of a pro-debtor model.

Finally, Part V applies this pro-creditor bankruptcy-governance model to Chapter 11 of the Bankruptcy Code, following the precedent of applying a normative analysis to assess positive bankruptcy law. Based thereon, Part V proposes a threshold viability test that should increase creditor recovery without unnecessarily jeopardizing shareholder return. This Part also shows how the Article's normative model should apply to corporate risk-taking in bankruptcy. Additionally, this Part critiques and suggests improvements to several provisions of the Bankruptcy Code in light of that model.

I. Evolution of the Pro-Debtor Bias

As next shown, the evolution of the pro-debtor bias reflects a gradual shift from a strongly pro-creditor bias, involving debtor punishment and creditor dominance, toward debtor rehabilitation and an aversion to liquidation, sometimes at the expense of creditors.

A. Medieval Bankruptcy Law.

Bankruptcy law as we know it has medieval antecedents.[9] Medieval bankruptcy law generally was punitive to debtors, rooted in the belief that financial failure was a moral failing deserving of retribution.[10] In England, the common law allowed creditors to imprison debtors indefinitely, with debtor prisons functioning as a coercive mechanism to compel repayment.[11] This practice prioritized creditor recovery over economic continuity or rehabilitative goals, often consigning debtors to lifelong financial ruin.[12]

The Statute of Bankrupts, enacted in 1542, represented the first formal codification of bankruptcy law in England. It introduced collective proceedings for liquidating a debtor's estate and distributing the proceeds among creditors.[13] The statute treated bankruptcy as a quasi-criminal offense, offering no discharge or relief to debtors. [14] This approach reinforced the stigma of insolvency without regard for possible harm to debtors and the broader economy.[15]

Nonetheless, despite its harshness, the Statute of Bankrupts introduced the principle of collective creditor action, laying the groundwork for more sophisticated bankruptcy systems.[16] This principle recognized the inefficiencies of creditors individually pursuing remedies, which often led to inequitable recoveries and dissipation of the debtor's estate.[17] The Statute empowered authorities, including the Lord Chancellor and other high-ranking officials, to seize debtor assets on behalf of the creditors. The officials then liquidated the assets and distributed the proceeds to creditors on a proportional basis, embodying the pari passu principle.[18]

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[9] BRUCE H. MANN, REPUBLIC OF DEBTORS: BANKRUPTCY IN THE AGE OF AMERICAN INDEPENDENCE 79 (2002).
[10] Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 330–31 (1991).
[11] MANN, *supra* note 9, at 80.
[12] *Id*. at 79.
[13] *Id*. at 46.
[14] *Id*.
[15] *Id*.
[16] W. J. JONES, THE FOUNDATIONS OF ENGLISH BANKRUPTCY: STATUTES AND COMMISSIONS IN THE EARLY MODERN PERIOD 8-15 (1979).
[17] *Id*.
[18] Statute of Bankrupts 1542, 34 & 35 Hen. 8, c. 4 (Eng.).

B. Eighteenth-Century Reforms: Commercial Expansion and Economic Rationality.

The rise of trade and commerce during the 18th century exposed the inadequacies of punitive bankruptcy laws. Financial failures were increasingly understood as exogenous consequences of market forces rather than endogenous moral failings, prompting lawmakers to adopt more debtor-rehabilitative approaches.[19] The Bankruptcy Act of 1705 (England) was a significant milestone, introducing discharge provisions for cooperative debtors who surrendered their assets for distribution among creditors.[20] This innovation marked a shift toward recognizing the economic value of allowing debtors to reenter the productive economy rather than languishing in prison.[21]

The Bankruptcy Act of 1706 (England) introduced even further innovation by allowing honest but insolvent debtors to obtain a discharge of their debts upon full disclosure of assets and compliance with procedural requirements.[22] This statute marked a departure from earlier punitive frameworks that treated bankruptcy primarily as a criminal offense.[23] However, the Act maintained a strong emphasis on creditor protection by imposing rigorous standards for debtor honesty and cooperation.[24]

The Commonwealth of Pennsylvania's 1730 insolvency statute reflected early American adaptations of English bankruptcy principles. The statute permitted insolvent debtors to obtain a discharge upon the surrender of their assets, provided they demonstrated good faith in their dealings with creditors.[25] Like the 1706 Act, Pennsylvania's statute balanced relief for honest debtors with safeguards to protect creditor interests.[26]

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[19] MANN, *supra* note 9, at 46, 47, 56.
[20] Nedim Peter Vogt, *The Debtor's Discharge from Bankruptcy: Historical Origins and Evolution*, 21 MCGILL L.J. 639 (1975).
[21] Edouard Martel, *The Debtor's Discharge from Bankruptcy*, 17 MCGILL L.J. 719, 729 (1971).
[22] *See* MANN, *supra* note 9, at 18.
[23] *See* Martel, *supra* note 21, at 720.
[24] MANN, *supra* note 9, at 18.
[25] *Id*. at 20. Martel, *supra* note 21, at 729.
[26] MANN, *supra* note 9, at 20.

These statutory reforms were groundbreaking in introducing limited discharge provisions for cooperative debtors, reflecting a nascent recognition of economic misfortune as distinct from moral failure.[27] However, they continued to privilege creditor interests through restrictive provisions and high evidentiary burdens.[28] For instance, the 1706 Act required debtors to surrender all their property and prove compliance with statutory requirements, ensuring creditors retained significant leverage over debt recovery processes.[29] Similarly, Pennsylvania's 1730 statute permitted discharge only for debtors who could convincingly demonstrate honesty and a complete lack of fraud.[30] Nevertheless, they signaled a growing recognition of the need for a more balanced debtor-creditor approach to bankruptcy.[31]

C. Early U.S. Bankruptcy Law: Experimentation and Adaptation.

The United States inherited English bankruptcy-law traditions, adapting them to its own economic conditions. Early federal bankruptcy statutes, such as the Bankruptcy Act of 1800, of 1841, and of 1867, emphasized debtor liquidation and creditor recovery, mirroring the creditor-centric principles of their English predecessors. These laws provided creditors with significant power to initiate bankruptcy proceedings and seize debtor assets.[32] They offered little relief or discharge for debtors, reflecting a continuing skepticism of bankruptcy as anything other than a personal failing.[33]

Public dissatisfaction with these laws ultimately led to their repeal, however. Critics argued that liquidation-focused frameworks failed to address the increasingly systemic economic risks posed by the sudden failure and liquidation of huge firms.[34] These risks included

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[27] MANN, *supra* note 9, at 18; (2003); Martel, *supra* note 21, at 729.
[28] MANN, *supra* note 9, at 18.
[29] Martel, *supra* note 21, at 729.
[30] MANN, *supra* note 9, at 20.
[31] Adam Smith, *The Wealth of Nations*, 1776.
[32] MANN, *supra* note 9, at 223-29; Charles Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 10-12 (1995).
[33] Tabb, *supra* note 32, at 5, 10-17.
[34] MANN, *supra* note 9, at 248; Tabb, *supra* note 32, at 15, 17.

widespread unemployment, supply-chain disruptions, and community destabilization.[35] To try to reduce these risks, states experimented with their own bankruptcy statutes, creating a fragmented, inconsistent, and unpredictable legal landscape that underscored the need for comprehensive federal bankruptcy reform.[36]

In the late 19th century, these concerns gained prominence with a series of large-scale railroad failures.[37] Railroads were the lifeblood of the industrializing American economy, connecting vast regions and enabling the efficient movement of goods, people, and resources.[38] Many railroads struggled under crushing debt loads caused by overexpansion and speculative financing.[39] Their cessation of operations threatened to disrupt supply chains, undermine regional economies, and paralyze industries reliant on reliable transportation.[40]

The liquidation offered under federal bankruptcy laws was not a viable option. Dismantling and selling off railroad assets piecemeal would destroy the value of the rail network.[41] Furthermore, liquidation would complicate creditor repayment because many railroad companies were amalgamations of smaller railroads, each with its own creditor groups.[42]

Responding to these challenges, Paul Cravath, a prominent lawyer of the era, pioneered the concept of the railroad receivership.[43] Receivership allowed financially distressed railroads to continue operating while attempting to restructure their debts. Under the receivership model, a court-appointed trustee—often with the consent of major creditors—took over the management of the debtor's operations.[44] The trustee preserved the railroad's assets, maintained essential

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[35] MANN, *supra* note 9, at 250; Tabb, *supra* note 32, at 17.
[36] MANN, *supra* note 9, at 255; Tabb, *supra* note 32, at 18-20. *Cf. supra* notes 25-26 and accompanying text (discussing Pennsylvania's bankruptcy statute).
[37] SKEEL, *supra* note 6, at 61-64.
[38] *Id*. at 62.
[39] *Id*. at 63.
[40] *Id*.
[41] *Id*. at 63-64.
[42] *Id*. at 64.
[43] *Id*. at 58-60.
[44] *Id*.

services, and negotiated settlements with creditors, all with the goal of attempting to keep the enterprise viable as a going concern.[45]

This approach was groundbreaking because it focused on reconciling the competing interests of creditors, debtors, and, by minimizing the risks of mass unemployment and economic disruptions and keeping rail systems operational, the public. Railroad receivership effectively created a template for modern corporate reorganization, shifting the focus from liquidation to rehabilitation and demonstrating the economic advantages of preserving going-concern value.[46]

D. <u>Bankruptcy Laws Focused on Debtor Rehabilitation</u>.

The lessons learned from railroad receiverships heavily influenced the drafting of the Bankruptcy Act of 1898, the first federal statute focused on rehabilitating business entities.[47] Drawing directly from the receivership model, this Act introduced provisions for corporate reorganization generally with the goal of allowing debtors to restructure their indebtedness while preserving the value of their businesses.[48]

The Bankruptcy Reform Act of 1978[49] has now codified U.S. bankruptcy law—in what is known as the "Bankruptcy Code"—including its focus on rehabilitating business entities, represented by Chapter 11.[50] Chapter 11 is said to have a pro-debtor bias,[51] allowing firms to continue operating in bankruptcy while attempting to restructure their indebtedness. Proponents argue that this approach preserves jobs, stabilizes supply chains, and preserves economic stability, thereby avoiding the destructive consequences of liquidation.[52]

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[45] SKEEL, *supra* note 6, at 58-60.
[46] *Id*. at 59-61.
[47] *Id*. at 62.
[48] *Id*. at 61-63.
[49] Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1532).
[50] DOUGLAS BAIRD, ELEMENTS OF BANKRUPTCY 223 (6th ed. 2014).
[51] *See supra* notes 3-4 and accompanying text.
[52] Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 339 (1993). *Cf*. SKEEL, *supra* note 6, at 35-36 (discussing the pro-debtor bias as essential for maximizing the value of distressed firms and preserving economic stability).

Critics of Chapter 11 contend, however, that its approach is inefficient, incentivizing mismanagement and delaying necessary liquidations, often to the detriment of creditors. They argue, for example, that Chapter 11 creates agency costs because a firm's managers can use it to keep their jobs, even in bankruptcy.[53] They also argue that Chapter 11 fosters moral hazard because it incentivizes managers to take unnecessary pre-bankruptcy corporate risks to try to avoid bankruptcy, confident they could keep their jobs if the risks fail.[54] Additionally, critics contend that the pro-debtor bias can benefit insiders—managers and equity holders—at the expense of creditors.[55]

The enactment of the Bankruptcy Code was heavily lobbied by self-interested parties, including lawyers and other members of the bankruptcy bar.[56] Some of the Code's pro-debtor provisions may actually be intended to benefit those lawyers. For example, lawyers advocated for the automatic stay provision (§ 362), ostensibly to protect debtors and preserve the status quo during reorganizations; the real purpose, however, may have been to require creditors to initiate costly litigation to modify or lift the stay, ensuring greater demand for legal services.[57] The debtor-in-possession framework under Chapter 11 was justified on the grounds of operational continuity, claiming that existing management could better guide a struggling firm through reorganization; in practice, though, it allowed debtor-side lawyers to maintain lucrative relationships with entrenched management.[58]

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[53] Bradley & Rosenzweig, *supra* note 4, at 1044. *But cf.* [cite1] (more recent data indicating that managers often do lose their jobs in a Chapter 11).
[54] Bradley & Rosenzweig, *supra* note 4, at 1052.
[55] Bradley & Rosenzweig, *supra* note 4, at 1044-45 (arguing that managers and equity holders avoid liquidation to preserve their positions and chance at residual value, with creditors shouldering losses that may result from erosion of debtor's estate).
[56] SKEEL, *supra* note 6, at 35-36 (defining the "bankruptcy bar" as "a cohesive group of bankruptcy specialists who advocated for the development and reform of bankruptcy laws, leveraging their expertise and influence to shape policy decisions, including the Bankruptcy Reform Act of 1978"). *Cf.* BAIRD, *supra* note 50, at 222-25 (discussing the path-dependent nature of American bankruptcy law, shaped by lobbying influences, institutional inertia, and historical contingencies); ROBERT JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7-8 (1986) (same).
[57] Bradley & Rosenzweig, *supra* note 4, at 1048-50.
[58] *Id*.

Similarly, the debtor exclusivity period to file a plan of reorganization (§ 1121) was initially proposed as necessary to give debtors time to craft viable reorganization plans without interference from competing creditor proposals.[59] Some suggest, however, that this provision was intended to significantly shift leverage to debtors, enabling them to delay negotiations and prolong bankruptcy proceedings at the expense of creditors.[60] Extending that timeline would give debtor-side lawyers the opportunity to increase their billable hours and overall fees.[61]

In short, the parties lobbying for Chapter 11 often argued that its pro-debtor provisions were crafted for economic efficiency,[62] masking the professional and financial benefits those provisions conferred on the bankruptcy bar.[63]

II. COMPARATIVE LAW PERSPECTIVES

The foregoing transformation from pro-creditor to pro-debtor bias does not necessarily reflect the development of bankruptcy law outside of the United States. Many advanced economies have developed bankruptcy—often called "insolvency"[64]—regimes that balance debtor and creditor interests. A comparative law perspective calls into question the legitimacy of the U.S. pro-debtor bias.

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[59] *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179.
[60] Bradley & Rosenzweig, *supra* note 4, at 1048-50.
[61] *Id*.
[62] Additional provisions of the Bankruptcy Code that exemplify a pro-debtor bias which may be intended to maximize debtor-side lawyering include § 1112(b), which allows debtors to convert Chapter 7 liquidation cases into Chapter 11 reorganizations. Similarly, § 364 enables debtors to borrow during bankruptcy by giving lenders priority of repayment over the claims of pre-bankruptcy ("pre-petition") creditors. More generally, allowing debtors to retain operational control of their business during reorganization gives them significant leverage in negotiations with creditors. JACKSON, *supra* note 56, at 89-91.
[63] BAIRD, *supra* note 50, at 223-25.
[64] [cite]

For example, Germany and the United Kingdom adopt balanced approaches that prioritize early intervention and creditor protection. Germany's recently enacted Act on the Stabilization and Restructuring Framework for Companies[65] allows for preventative restructuring measures outside formal insolvency proceedings.[66] This framework emphasizes early creditor engagement, enabling parties to address financial distress proactively while avoiding court-imposed resolutions. By shifting the focus toward negotiated solutions, it seeks to preserve value without granting debtors undue advantages.[67]

Similarly, the UK's Corporate Insolvency and Governance Act 2020 introduces restructuring mechanisms that blend debtor flexibility with creditor oversight.[68] The cross-class cramdown provision[69] allows restructuring plans to bind dissenting creditor classes, but only if the plan satisfies rigorous judicial scrutiny.[70] The "no creditor worse off" test ensures that dissenting creditors receive at least as much as they would in liquidation.[71] These requirements prevent debtors from exploiting the restructuring process, while still allowing for value-maximizing reorganizations.[72] The UK Act thus illustrates a middle ground, prioritizing equitable treatment for creditors while recognizing the potential benefits of reorganization.[73]

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[65] StaRUG, Gesetz zur Fortentwicklung des Sanierungs- und Insolvenzrechts [Act on the Further Development of Restructuring and Insolvency Law], Dec. 22, 2020, BGBl. I at 3256 (Ger.).
[66] Ilya Kokorin, *The Rise of "Group Solution" in Insolvency Law and Bank Resolution*, 22 EUR. BUS. ORG. L. REV. 781 (2021); Horst Eidenmüller, *The Rise of 'Group Solution' in Insolvency Law and Bank Resolution*, 22 EUR. BUS. ORG. L. REV. 231, 240-242 (cite to year).
[67] Kokorin, *supra* note 66, at [pin-cite].
[68] Corporate Insolvency and Governance Act 2020, c. 12 (UK).
[69] The ability of courts to sanction a restructuring plan that binds dissenting creditors, if the plan is "fair and equitable," is known as "cross-class cram down." *See* https://commonslibrary.parliament.uk/research-briefings/cbp-8971/#:~:text=The%20permanent%20measures&The%20new%20permanent%20measures%20are,companies%20struggling%20with%20debt%20obligations.
[70] Corporate Insolvency and Governance Act, *supra* note 68, § 901G.
[71] Although this protection is also in Chapter 11 (*see* 11 U.S.C. § 1129(a)(7)),
[72] Kokorin, *supra* note 66, at [pin-cite]; Eidenmüller, *supra* note 66, at 240-41.
[73] [cite1]

The European Union's Restructuring Directive (Directive 2019/1023)[74] also provides EU member states with significant flexibility to tailor insolvency restructuring frameworks based on their legal traditions and economic needs.[75] This flexibility underscores a core difference between the U.S. and European approaches: whereas U.S. bankruptcy law tilts heavily in favor of debtors, the EU promotes more flexibility to balance creditor and debtor interests.

III. EXISTING SCHOLARSHIP

As next discussed, no scholars have seriously attempted to analyze whether U.S. bankruptcy law's policies, which favor debtor rehabilitation over creditor recovery, create net value or instead result in a zero-sum game that merely redistributes value from creditors to debtors.

A. Legal Scholarship.

Bankruptcy scholars have long grappled with the competing priorities of liquidation and reorganization, examining such normative objectives as promoting efficiency, fairness, and economic stability.[76] The literature is largely confined, however, to describing those objectives and other relevant considerations and examining how bankruptcy might affect them. No legal scholars have analyzed whether favoring debtor rehabilitation over creditor recovery actually creates net value.

Professor Warren, for example, emphasizes that debtor rehabilitation can preserve jobs, stabilize communities, and mitigate the broader economic consequences of firm failure.[77] She frames corporate reorganization as a societal imperative, claiming that its benefits often extend

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[74] Directive 2019/1023, of the European Parliament and of the Council of 20 June 2019 on Restructuring and Insolvency, 2019 O.J. (L 172) 18 (EU).
[75] [cite1 & explain]
[76] *See, e.g.*, David Skeel, *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 470-471.
[77] Warren, *supra* note 52, at 340-45.

beyond the immediate stakeholders to include local economies and national economic stability.[78] Her work, however, assumes that these benefits can outweigh the costs to creditors without providing any proof.

Professor Baird critiques bankruptcy law's emphasis on debtor rehabilitation, arguing that liquidation often can reallocate corporate resources to more productive uses.[79] He contends that by entrenching failing firms, Chapter 11's pro-reorganization policies can waste valuable resources that should be redirected to more viable enterprises.[80] As with Warren, however, Baird's arguments are descriptive without rigorously weighing costs and benefits.

B. Financial and Economic Scholarship.

Although financial and economic scholars have also contributed to the debate over the pro-debtor bias of U.S. bankruptcy law, their analyses often focus narrowly on specific policy outcomes. Professor Jackson, for instance, has studied the importance of bankruptcy law in resolving collective action problems among creditors.[81] Other financial and economic scholarship has attempted to quantify the costs associated with protracted corporate reorganizations but fails to assess whether any benefits offset, much less exceed, those costs.[82]

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[78] *Id*. at 367–68. *Cf*. Warren, *supra* note 4, at 780-82 (making similar arguments).
[79] Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 577-578 (1998).
[80] *Id*. at 578-79. *Cf*. BAIRD, *supra* note 50, at 23-25 (arguing that Chapter 11's pro-reorganization policies can waste valuable resources that should be redirected to more viable enterprises).
[81] JACKSON, *supra* note 56, at 7-8. Professor Jackson is both a legal scholar and a business scholar.
[82] *See, e.g.*, Arturo Bris, Ivo Welch, & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 61 J. FIN. 1253, 1253–66 (2006) (comparing direct and indirect costs under Chapter 7 liquidation and Chapter 11 reorganization, while noting the lack of a comprehensive evaluation of Chapter 11's broader benefits).

Similarly, the scholarship on job preservation and economic stability focuses on benefits without attempting to compare costs.[83] Moreover, that scholarship tends to examine localized effects.[84]

Some financial and economic scholarship offers additional perspectives on the pro-creditor biases of foreign bankruptcy regimes. For example, studies on Germany's Act on the Stabilization and Restructuring Framework for Companies[85] and the UK's Corporate Insolvency and Governance Act[86] highlight the economic benefits of early intervention and creditor engagement.[87] However, these studies focus primarily on quantifying creditor recoveries without attempting to assess whether those recoveries justify the pro-creditor bias.[88] Moreover, these German and UK statutes appear to be moving to more of a pro-debtor bias,[89] so any comparison of those laws with Chapter 11 is imprecise at best.

In short, the existing legal, financial, and economic scholarship fails to address whether U.S. bankruptcy law's pro-debtor bias, or even whether foreign insolvency law's occasional pro-creditor bias,[90] creates net value or instead results in a zero-sum game that merely redistributes value from creditors to debtors. This Article next seeks to engage that analysis.

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[83] *See, e.g.*, Zachary Liscow, *Counter-Cyclical Bankruptcy Law: An Efficiency Argument for Employment-Preserving Bankruptcy Rules*, 116 COLUM. L. REV. 1461, 1470–74, 1480–82 (2016) (emphasizing the employment-preservation benefits of reorganization during economic downturns while not comparing the broader costs of a pro-debtor-biased bankruptcy system).
[84] *Cf. id*. at 1480–83, 1489–90 (focusing on localized effects such as regional unemployment and industry-specific conditions, while not addressing broader systemic impacts of pro-debtor policies).
[85] *See supra* note 65 and accompanying text.
[86] *See supra* note 68 and accompanying text.
[87] Kokorin, *supra* note 66, at 794–96, 801–02.
[88] *Id*. at 794–96, 801–03 ((examining mechanisms for creditor recovery under foreign insolvency frameworks but not addressing whether those recoveries justify the pro-creditor biases of those frameworks).
[89] *See, e.g.*, https://commonslibrary.parliament.uk/research-briefings/cbp-8971/#:~:text=The%20permanent%20measures&The%20new%20permanent%20measures%20are,companies%20struggling%20with%20debt%20obligations (UK Parliament research briefing stating that the Act "marks a major change in UK insolvency law towards a business rescue culture more in line with U.S. insolvency (chapter 11)").
[90] *But cf. infra* note 93 (discussing recent examination of that question in Poland).

IV. ANALYSIS

As subpart A below shows, there is a reason why scholars have not quantified the costs and benefits of bankruptcy law's pro-debtor bias: there are practical limits to performing such an empirical analysis. This Part IV therefore focuses more obliquely by analyzing how to design a bankruptcy-governance model that maximizes the expected value of corporate reorganizations. This focus accords with normative decision theory, that good social policy should maximize expected value—in this case, monetary value.[91]

This analysis proceeds by a second-best methodology. The Article recognizes the existence of an almost universally accepted model, "shareholder primacy," for generally balancing the interests of debtors and creditors. It then stresses that model under the realities of bankruptcy. This methodology shows, at least in theory, that a pro-creditor bankruptcy-governance model should maximize the expected value of corporate reorganizations more than a pro-debtor model. The Article then pragmatically assesses the pro-creditor model, showing that it should provide important positive benefits by reducing the cost of credit without undermining the fundamental benefits of a pro-debtor model.

A. Limits to an Empirical Analysis.

A perfect analytical methodology would be empirical.[92] The problem, though, is that it is impossible generally to quantify, much less accurately to compare, debtor and creditor costs and benefits in bankruptcy.[93] One cannot even compare the costs and benefits of debtors and

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[91] *See, e.g.*, "Decision Theory," STANFORD ENCYCLOPEDIA OF PHILOSOPHY, available at https://plato.stanford.edu/entries/decision-theory/.
[92] JACKSON, *supra* note 56, at 170-74.
[93] *But cf*. Przemysław Banasik, Małgorzata Godlewska, Piotr Kędzierski, Sylwia Morawska, & Jolanta Turek, "The pro-debtor and pro-creditor models – comparison of the effectiveness of bankruptcy law" (Apr. 2022), available at file:///C:/Users/schwarcz/Downloads/ijastrz,+089_02_Banasik_.pdf (attempting empirically to analyze the effect of a recent change in bankruptcy proceedings in Poland from pro-creditor to pro-debtor). The authors attempted to assess what they identify as "the major determinants connected with the effectiveness of bankruptcy law," including the rate of debt recovery, funds obtained by the receiver, costs of bankruptcy proceedings, and efficiency ratio measured by

creditors that go through Chapter 11 bankruptcy with those of debtors and creditors that go through a more pro-creditor-biased bankruptcy proceeding: such a more pro-creditor-biased but otherwise comparable bankruptcy system simply does not exist.

B. Proposing a Second-Best Analytical Methodology.

This Article therefore proposes a second-best analytical methodology. It starts by recognizing the existence of an almost universally accepted model for generally balancing the interests of debtors and creditors: the shareholder-primacy model of corporate governance.[94] Under that model, managers are expected to govern the firm solely for the best interests of its shareholders[95]—who stand in for the debtor.[96] Universal acceptance evidences a presumption that the model maximizes value.[97]

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recovered debts divided by costs of bankruptcy proceedings. They conclude that "the new pro-debtor model of bankruptcy proceedings implemented in Poland from 1 January 2016 is less effective than the pro-creditor model of bankruptcy proceedings was," and that "the pro-creditor model of bankruptcy proceedings had a higher efficiency ratio than the pro-debtor model of bankruptcy proceedings now has." Their analysis, however, has numerous limitations, and the authors caution that the "research undertaken in this area should be continued and further discussed, because the presented model of insolvency is quite new."

[94] *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (shareholder primacy's classical articulation). *Cf.* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 443–48 (2001) (discussing the ideological convergence on the shareholder-primacy model around the world).

[95] Leo E. Strine, Jr. & Nicholas Walter, *Conservative Collision Course?: The Tension Between Conservative Corporate Law Theory and* Citizens United, 100 CORNELL L. REV. 335, 346 (2015).

[96] One might argue that a "pro-debtor bias," which includes a bias against liquidation (*see supra* note 4), should mean more than a pro-shareholder bias. For example, it might also include keeping a debtor in business in order to protect employees and the local community. That expanded bias is not necessarily explicit in the Bankruptcy Code, however, because stakeholders of a debtor other than shareholders and creditors are not considered parties in interest and have no right to appear or to be heard. *See* 11 U.S.C. § 1109(b). As will be discussed, this Article grafts a normative net-value analysis onto bankruptcy's otherwise existing framework. *See infra* note 98 and accompanying text.

[97] *See, e.g.*, Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, 102 MINN. L. REV. 1951, 1963 (2018) (arguing that shareholder primacy operates as a Hartian obligation in corporate law, where its universal acceptance as a normative standard reflects an internalized presumption of value maximization). That presumption could be rebuttable. For example, some early societies may have widely believed that slavery created net value.

In subpart C below, the Article stresses this governance model under the realities of bankruptcy and tests how, if at all, that should change the model. The changed model arguably would balance the interests of debtors and creditors to maximize value. This approach of grafting a normative analysis onto a widely accepted positive framework has important precedent.[98]

C. Using the Methodology to Derive a Bankruptcy-Governance Model.

The realities of bankruptcy would stress the shareholder-primacy governance model in several ways. As next shown, these stresses remove both justifications—that shareholders are the firm's primary residual claimants, and that creditors are protected by covenants—for favoring a firm's shareholders over its creditors. Furthermore, these stresses cause creditors to become the debtor-firm's *primary* residual claimants by subordinating shareholder residual claims to creditor residual claims.

1. *In bankruptcy, creditors become the firm's primary residual claimants*. A significant justification for the shareholder-primacy governance model is that shareholders are the firm's primary residual claimants.[99] This means that shareholders are primarily motivated to engage the firm in positive expected-value projects because every dollar of profit would first redound to their benefit.[100] The realities of bankruptcy would remove, indeed reverse, that justification.

Because virtually all firms in bankruptcy are either insolvent or illiquid, or both,[101] creditors replace shareholders as the firm's primary residual claimants. Creditor claims—to

[98] Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 776–77 (1988) (grafting a normative analysis onto a positive assumption, in this case taking the existence of corporate reorganizations in bankruptcy law as a given to put forth a suggestion to improve the reorganization process).
[99] [cite1]
[100] *See, e.g.*, Steven L. Schwarcz, *Corporate Governance and Risk-taking: A Statistical Approach*, 3.1 U. CHI. BUS. L. REV. 149, text accompanying notes 130-31 (2023) (observing that "the shareholder-primacy model of corporate governance encourages SIFI risk-taking that has a positive expected value to the firm and its shareholders").
[101] *Cf*. Bris, Welch, & Zhu, *supra* note 82, at 1257–58, 1264 (analyzing corporate bankruptcies filed in Arizona and the Southern District of New York from 1995 to 2001, using a hand-coded

which shareholder claims are subordinated[102]—become residual claims until the debtor regains solvency and liquidity,[103] which normally does not occur until confirmation (that is, the end) of the bankruptcy case.[104] Until then, creditors are the parties primarily motivated to engage the firm in positive expected-value projects because every dollar of profit would first redound to their benefit.[105]

2. *In bankruptcy, creditors are no longer protected by covenants*. The other important justification for the shareholder-primacy governance model is that creditors are protected by covenants.[106] The realities of bankruptcy would also remove that justification.

Bankruptcy excuses firms from complying with financial covenants, such as covenants to maintain solvency or otherwise achieve a targeted financial condition.[107] Firms in bankruptcy also no longer need comply with covenants in loan or other financing agreements.[108] Absent covenant protection—again, this Article's normative analysis starts with certain positive assumptions as to bankruptcy[109]—a bankruptcy-governance model should treat shareholders and creditors neutrally as investors, other than regarding their status as residual claimants of the debtor.

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dataset representative of Chapter 7 and Chapter 11 cases, and finding that most firms exhibit debt-to-asset ratios exceeding 1 or have fully dissipated their assets).

[102] Shareholders always are subordinated to creditors in payment priority. *See* 11 U.S.C. § 726(a) (stating the absolute priority rule of payment under which creditors are paid first (under § 726(a)(1)-(4)) before shareholders are paid (under § 726(a)(6)).

[103] Although insolvency ordinarily explains why creditors replace shareholders as the firm's primary residual claim, illiquidity should have that same effect. Liquidity means that the debtor is not paying its debts as they come due; the debtor therefore will need to generate more income in order to pay those debts.

[104] *See infra* notes 135-138 and accompanying text.

[105] *Cf. supra* note 100 and accompanying text (comparing the shareholder-primacy model). *See infra* notes 163-167 and accompanying text.

[106] *Cf*. D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 280–82 (1998) (explaining that shareholder primacy is essential because shareholders, unlike creditors who can protect their interests with covenants, lack contractual mechanisms to safeguard their investments and must instead rely on fiduciary duties to ensure their interests are prioritized).

[107] *See, e.g.*, 11 U.S.C. § 365(b)(2) (providing that a debtor may assume a contract notwithstanding being in default under such types of financial covenants).

[108] *See* 11 U.S.C. § 365(c)(2).

[109] *See supra* note 98 and accompanying text.

As subparts 1 and 2 above show, bankruptcy removes both justifications for the shareholder-primacy governance model and replaces shareholders with creditors as the primary residual claimants and the parties needing protection. In theory, therefore—and as this Article later shows, in practice too[110]—creditor-primacy should be the appropriate bankruptcy-governance model.

D. Articulating a Creditor-Primacy Bankruptcy-Governance Model.

Under a creditor-primacy bankruptcy-governance model, directors should manage the debtor to engage in positive-expected-value risk-taking that increases creditor recovery (creditors being the primary residual claimants) without unnecessarily jeopardizing shareholder return (shareholders being the secondary residual claimants). In a different but related context—balancing director duties to shareholders and creditors for a firm in the "vicinity of insolvency"—the author argued for this balance: the firm's directors should "scrutinize actions that increase shareholder return by impairing creditor claims," the "more insolvent the corporation is or would become, the more the fiduciary obligation shifts from shareholders to creditors, in a continuum," and in "balancing this fiduciary obligation, directors should have latitude to make their own good faith balancing of benefit and harm, recognizing that harm to creditors may well be more significant than benefit to shareholders; and therefore the benefit might have to considerably outweigh the harm, or at least provide a compelling case, to be justified."[111] In a bankruptcy context, that balance should shift even more to creditors.

Applying that balancing to the bankruptcy context yields this model:

1. Directors should manage the debtor to engage in positive-expected-value risk-taking that increases creditor recovery.[112]

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[110] *See infra* notes 113-130 and accompanying text.
[111] *Rethinking A Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 678 (1996).
[112] In other words, simple Kaldor-Hicks net value, which does not differentiate who benefits and who loses, would be insufficient because the primary duty should be to creditors.

2. Directors should nonetheless give regard to protecting shareholders by scrutinizing actions that could increase creditor recovery by unduly impairing shareholder return. This recognizes that, if and when creditors are paid, shareholders again become the residual claimants.

3. Directors should have latitude provided by the business-judgment rule to make their own good faith balancing of benefit to creditors and harm to shareholders. Directors nonetheless should recognize that human nature tends to weigh harm more heavily than benefit. They therefore may wish to demonstrate that the expected benefit of an action should at least materially exceed the harm.

E. <u>Pragmatically Assessing the Model</u>.

This Article has theoretically derived a creditor-primacy bankruptcy-governance model. Theory may be inadequate, though, if using this model could be harmful in practice, such as by causing unnecessary job loss. This subpart E pragmatically assesses the model, showing that it should provide important positive benefits by reducing the cost of credit without undermining the fundamental benefits of a pro-debtor biased model.

1. *The Model should help to reduce the cost of credit*. A creditor-primacy bankruptcy-governance model should help to reduce the uncertainty created by bankruptcy law's pro-debtor bias.[113] Under that bias, pre-petition creditors cannot always expect to be able to enforce their contractual and commercial law rights.[114]

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[113] *Cf*. Baird, *supra* note 79, at 578 (discussing the harmful uncertainty that bankruptcy law can create for pre-petition creditors); Steven L. Schwarcz, *The Inequities of Equitable Subordination*, 96 AM. BANKR. L.J. 29 (2022) (examining the uncertainty created by bankruptcy judges' pro-debtor equitable biases).

[114] Commercial law, which is codified in the state-law Uniform Commercial Code, is preempted by federal bankruptcy law to the extent inconsistent. The Supremacy Clause of the Constitution, provides that the Constitution and federal law are the supreme law of the land. U.S. CONST. art. VI, § 2.

Uncertainty can increase the cost and reduce the availability of credit.[115] The National Bureau of Economic Research has found, for example, that "uncertainty has a direct effect on investment" and that "greater uncertainty tends to make investment less desirable"[116] and "exerts a strong negative influence on investment."[117] Courts also have expressed concern. The Southern District of New York has observed that uncertainty "would both impair bank financing and increase the costs of obtaining such financing."[118] The Seventh Circuit likewise has observed that investors influenced by the uncertainty of debt recovery might prefer not "to lend or invest in the future," causing "the cost of credit [to] rise for all."[119] Uncertainty also creates a deleterious impact on "households' access to small credit"[120] and "leads to higher loan interest rates and default probabilities."[121]

A creditor-primacy bankruptcy-governance model should reduce uncertainty by making it more likely that pre-petition creditors can enforce their contractual and commercial law

[115] *Cf.* Dan S. Schecter, *Judicial Lien Creditors Versus Prior Unrecorded Transferees of Real Property: Rethinking the Goals of the Recording System and Their Consequences*, 62 S. CAL. L. REV. 105, 125-26 (1988) (observing that creditor behavior is "necessarily influenced by the general reliability of the debt collection remedies which will be available in the event of default" and that collection risk "will be passed along to all debtors because there is no way to tell whether any individual debtor will trigger these sorts of systemic problems"); John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 267-68 (1981) (observing that uncertainty whether creditors who receive a potentially preferential transfer may have to return it imposes "costs to their debtor-customers by increasing the cost of credit").

[116] John V. Leahy & Toni M. Whited, *The Effect of Uncertainty on Investment: Some Stylized Facts* 2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 4986, 1995).

[117] *Id.* at 3.

[118] Worldwide Sugar Co. v. Royal Bank of Can., 609 F. Supp. 19, 22, 27 (S.D.N.Y. 1984) (ruling that allowing "recovery from an advising bank on the basis of a terminated letter-of-credit arrangement would" impose uncertainty and increase financing costs).

[119] *In re* Lifschultz Fast Freight, 132 F.3d 339, 347 (7th Cir. 1997).

[120] Xiang Li, Bibo Liu & Xuan Tian, *Policy Uncertainty and Household Credit Access: Evidence from Peer-to-Peer Crowdfunding* 28 (PBC School of Fin., Mar. 2018), https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID3141066_code970411.pdf?abstractid=3084388&mirid=1 (on file with author) (reporting on the peer-to-peer lending market).

[121] *Id. Cf.* Diana Olick, *Here's Why it's Suddenly Much Harder to Get a Mortgage, or Even Refinance*, CNBC (Apr. 13, 2020), https://cnbc.com/2020/04/13/coronavirus-why-its-suddenly-much-harder-to-get-a-mortgage-or-even-refinance.html (reporting that economic uncertainty arising from the coronavirus pandemic made mortgage loans more expensive and difficult to get).

rights.[122] That, in turn, should help to reduce the cost and possibly also increase the availability of credit.

2. *The Model should not undermine the fundamental benefits of a pro-debtor bias*. A creditor-primacy bankruptcy-governance model would reverse bankruptcy law's pro-debtor bias. Proponents of that bias argue, however, that it helps to preserve jobs and economic stability by avoiding the liquidation of firms.[123]

Admittedly, avoiding the liquidation of a firm would help, at least temporarily, to preserve the jobs associated with the firm. The problem, though, is that if the firm is not otherwise economically viable, it is likely ultimately to fail (causing a loss of those jobs).[124] Furthermore, as Professor Baird observes, avoiding, or perhaps even delaying, the liquidation of a non-viable firm could waste valuable resources that should be redirected to more viable and productive enterprises.[125]

Nor would avoiding the liquidation of firms help to preserve economic stability. In response to the global financial crisis of 2008, Congress enacted the Dodd-Frank Act,[126] which mandates the designation of systemically important financial institutions ("SIFI"s).[127] It also exempts SIFIs from the Bankruptcy Code and provides alternative resolution mechanisms that are intended to preserve systemic economic stability.[128] This Article's proposal for a creditor-primacy bankruptcy-governance model would therefore have no immediate application to SIFIs.

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[122] Under a creditor-primacy model, for example, judges should be less inclined to equitably subordinate legitimate pre-petition claims. *Cf. The Inequities of Equitable Subordination, supra* note 113 (examining the abuses of "equitable" subordination). Judges also should be less inclined to ignore debtor burdens of proof (*see infra* notes 189-190 & 197 and accompanying text) and to refuse to convert non-viable Chapter 11 reorganizations to Chapter 7 liquidation if the debtor objects (*see infra* note 137).

[123] *See supra* note 52 and accompanying text.

[124] *See infra* note 146 and accompanying text (observing that a debtor with an inherently bad business ultimately will be likely to fail even if it is temporarily able to reduce its debt).

[125] *See supra* notes 79-80 and accompanying text.

[126] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010) ("Dodd-Frank Act").

[127] Dodd-Frank Act § 113, 124 Stat. 1376, 1398–1402 (codified at 12 U.S.C. § 5323).

[128] Dodd-Frank Act, § 204, 124 Stat. 1376, 1454–58 (codified at 12 U.S.C. § 5384).

Indeed, this Article does not purport to critique the merits of the Dodd-Frank Act's SIFI-resolution mechanisms, nor does it examine whether a creditor-primacy governance model should apply to those mechanisms.[129]

V. APPLYING THE CREDITOR-PRIMACY BANKRUPTCY-GOVERNANCE MODEL

This Article has shown that a creditor-primacy bankruptcy-governance model should have both theoretical and pragmatic justification. Next, consider how such a model should apply in practice. To that end, subpart A introduces a new concept, a "threshold viability test," which could significantly facilitate the goals of a creditor-primacy bankruptcy-governance model. Subpart B examines how creditor-primacy should apply to a debtor's risk-taking in bankruptcy. Finally, Subpart C examines specific provisions of the Bankruptcy Code that should be reconsidered in light of creditor-primacy.

A. Threshold Viability Test.

This subpart's proposal for a threshold viability test could significantly facilitate the goals of a creditor-primacy model. If (as this Article argues) the purpose of bankruptcy law should be to increase creditor recovery without unnecessarily jeopardizing shareholder return,[130] debtors that are unlikely to successfully reorganize should be forced to liquidate at the outset of a bankruptcy case. That would save the considerable expenses of proceeding through bankruptcy, of which the direct costs alone have been estimated at "1-2 percent the value of a debtor's assets in larger cases and 4-5 percent in smaller cases."[131] The debtor directly or indirectly pays virtually all of these expenses, which seriously reduces creditor and, if applicable, shareholder recovery.[132] Although requiring such liquidation would undercut bankruptcy's current anti-

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[129] This approach is consistent with the Article's general approach of applying a normative analysis to certain positive law realities. *See supra* note 8 and accompanying text.
[130] *See supra* Part III.D.
[131] Kenneth A. Rosen, *What Does Chapter 11 Really Cost?*, BLOOMBERG LAW, Apr. 20, 2016, available at https://news.bloomberglaw.com/bankruptcy-law/what-does-chapter-11-really-cost. [Insert additional data on the direct and indirect costs of Chapter 11 cases. cite1]
[132] *See, e.g.*, Rizwaan Jameel Mokal, *Priority as Pathology: The Pari Passu Myth*, 60 CAMBRIDGE L.J. 581, 586 (2001) (explaining that administrative expenses, such as post-

liquidation bias,[133] that requirement would be reasonable if (as above proposed) it is limited to debtors that are ultimately likely to liquidate.[134]

To implement a threshold viability test, bankruptcy law could require Chapter 11 debtors to demonstrate at the outset of the case that they are likely—or at least, not unlikely—to successfully reorganize. The Bankruptcy Code already has a weak viability test as a condition precedent to plan confirmation.[135] However, confirmation occurs at the end of the case, which can be extremely costly if the debtor, in retrospect, is not viable.[136] A threshold viability test should help to avoid these costs.[137]

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liquidation costs, are prioritized and paid directly from the debtor's estate before creditor distributions); *id*. at 588 (observing that administrative expenses frequently consume the majority of the debtor's estate, often leaving nothing for general unsecured creditors and substantially reducing overall recoveries).

[133] *Cf. supra* notes 3-4 and accompanying text.

[134] If Congress were to consider enacting a threshold viability test, they might contemplate coupling it with a weak precautionary principle that gives a rebuttable presumption to the debtor to oppose liquidation. *Cf*. Cass R. Sunstein, *Beyond the Precautionary Principle*, 151 U. PA. L. REV. 1003, 1014 (2003) (discussing a precautionary principle under which "[r]egulation should include a margin of safety").

[135] *See* 11 U.S.C. § 1129(a)(11) ("Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor . . . .").

[136] *See supra* note 131 and accompanying text.

[137] The Bankruptcy Code technically allows bankruptcy judges to convert a Chapter 11 reorganization to a Chapter 7 liquidation at any time during the bankruptcy case, for "cause." *See* 11 U.S.C. § 1112(b)(1). "Cause" includes "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation." 11 U.S.C. § 1112(b)(4)(A). In theory, therefore, § 1112(b) already should help to avoid the costs of a non-viable debtor continuing to operate in Chapter 11. In practice, though, judges are highly reluctant to exercise this conversion if the debtor objects. *See, e.g.*, *In re* Economy Cab & Tool Co., 44 B.R. 721, 724 (Bankr. E.D. Mo. 1984) (court declined to convert a failing Chapter 11 case to a liquidation, citing the speculative potential for reorganization despite mounting creditor losses); *In re* Creekside Sr. Apts., L.P., 489 B.R. 51, 60 (B.A.P. 6th Cir. 2013) (observing that "The party seeking [conversion] carries the burden of proof and must satisfy that burden by a preponderance of the evidence.") (citing Loop Corp. v. U.S. Tr. *(In re* Loop Corp.*)*, 379 F.3d 511, 517–18 (8th Cir. 2004) (in turn citing *In re* Woodbrook Assocs., 19 F.3d 312, 317 (7th Cir.1994)); Mark G. Douglas, *Second-Guessing a Chapter 11 Debtor's "Absolute" Right to Convert*, JONES DAY (Nov./Dec. 2006) ("Even upon a showing of 'cause' to convert or dismiss, the debtor or any other party opposing the request can defeat it by demonstrating that (i) there is a reasonable likelihood that a chapter 11 plan will be timely confirmed . . . .").

Furthermore at the time of plan confirmation, which is the final stage at which the court decides whether to approve the plan,[138] the already invested costs can create a sunk-cost fallacy: the "tendency to continue investing in a losing proposition because of what it's already cost us."[139] This fallacy can distort findings of viability, accounting for the disproportionately high number of post-confirmation debtors having to re-file Chapter 11 cases (jokingly often called "Chapter 22s" or, in the rare example (like Continental Airlines) of filing for a third time, "Chapter 33s").[140] A threshold viability test also should help to avoid that fallacy.[141]

Moreover, a threshold viability test should help to reduce agency costs and moral hazard.[142] It should reduce agency costs because a firm's managers cannot, as Bradley & Rosenzweig suggest,[143] be confident in using Chapter 11 to keep their jobs. It should reduce moral hazard because managers would be reluctant to take unnecessary pre-bankruptcy corporate risks to try to avoid bankruptcy if their jobs would be likely to be lost at the outset of a Chapter 11 bankruptcy filing that fails the test.

Debtors that represent a "good company, bad balance sheet" should successfully pass a threshold viability test. This means that the debtor has an inherently good business but too much debt.[144] Chapter 11 is a valuable tool to help financially troubled firms reorganize their capital

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[138] See 11 U.S.C. §§ 1129(a) & 1141(a).
[139] Margie Warrell, *Sunk-Cost Bias: Is it Time to Call it Quits?*, FORBES (Sep. 15, 2015), https://www.forbes.com/sites/margiewarrell/2015/09/14/sunk-cost-bias-is-it-time-to-move-on.
[140] The joke, of course, is that 11 + 11 = 22 and 11 + 11 + 11 = 33.
[141] *Cf*. Kris Boudta, Florencio Lopez-de-Silanesd, Rafael Mattad, & Shilin Zhang, "Pro-Debtor Bias, Court Shopping, and Bankruptcy Outcomes," June 2024 working paper, Ghent Univ. Dep't Econ. (arguing that pro-debtor bias is detrimental for bankruptcy outcomes because cases with more pro-debtor bias tend to have a higher refiling rate), available at https://wps-feb.ugent.be/Papers/wp_24_1088.pdf.
[142] *See supra* notes 53-54 and accompanying text (discussing how Chapter 11 can foster agency costs and moral hazard).
[143] Bradley & Rosenzweig, *supra* note 4, at 1050 ("[T]he data show that Chapter 11 preserves and protects the jobs of corporate managers, not corporate assets.").
[144] *See, e.g.*, Debtor-in-Possession Loan Rating Criteria, Debtor-in-Possession Loans Special Report (Fitch Investors Service Inc., New York, N.Y.), Mar. 25, 1991, at 4 (stating that Fitch favors rating loans to debtors in bankruptcy that it deems to be a "good company, bad balance sheet"). *Cf*. FITCH RATINGS, DIP (DEBTOR-IN-POSSESSION) RATING CRITERIA 1–2 (2020), https://www.fitchratings.com/research/corporate-finance/dip-debtor-in-possession-rating-criteria-

structure—for example, reduce their debt in exchange for issuing new equity—in order to become financially viable.[145] In contrast, a debtor with an inherently bad business ultimately will be likely to fail even if it is temporarily able to reduce its debt.[146]

That raises at least two questions: (i) Who should perform the threshold viability test?; (ii) Who should assess the outcome of the test? For the first question, private for-profit valuation firms like Houlihan Lokey may well be able to perform a viability test. [Explain why.[147] Also, examine and compare how the 1129(a)(11) (weak) viability test is performed.[148]] Experience shows that parties are often able to assess a debtor's viability at the outset of a Chapter 11 case. For example, rating agency Fitch recommends that a lender consider providing debtor-in-possession ("DIP") financing only if the lender determines, at the outset of the bankruptcy case when DIP financing is needed, that although the debtor has a bad balance sheet, it has an inherently good business—in other words, the "good company, bad balance sheet."[149]

One might ask why markets themselves do not effectively provide a threshold viability test. After all, according to the Fitch criteria, a bad-company, bad-balance-sheet debtor should

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30-11-2020 (describing Fitch's methodology for assessing credit risk for DIP loans that considers the company's projected cash flow, likelihood of emergence as a going concern, and value of assets pledged as collateral); Bruce Karsh, Pedro Urquidi, & Robert O'Leary, *Global Opportunity Knocks: The Evolution of Distressed Investing*, OAKTREE (discussing "Good Company, Bad Balance Sheet": "Distressed debt investors have traditionally bought the liabilities of companies that are in bankruptcy or otherwise appear unlikely to meet their financial obligations. The preferred target is a business with too much debt but also a strong underlying business, valuable assets, and/or the ability to generate cash. . . . These overleveraged companies often reduce their debt by going through a restructuring either within or outside of bankruptcy court . . . .") (Nov. 12, 2021), available at https://www.oaktreecapital.com/insights/insight-commentary/market-commentary/global-opportunity-knocks-the-evolution-of-distressed-investing.

[145] *See, e.g.*, Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 528 (1983).

[146] [cite1] *Cf.* Randall A. Heron, Erik Lie, & Kimberly J. Rodgers, *Financial Restructuring in Fresh-Start Chapter 11 Reorganizations*, 2009 FIN. MGMT. 727, 742 (2009) ("[P]ost-reorganization debt ratios are positively related to pre-reorganization debt ratios, suggesting that the debt is sticky.").

[147] [cite1]

[148] [cite1]

[149] *See supra* note 144 and accompanying text.

not qualify for DIP financing.[150] Absent that financing, the debtor likely could not continue operating in bankruptcy and would have to liquidate.[151] At least part of the answer is that lenders do not always hew to the good-company, bad-balance-sheet DIP-lending ideal. The Bankruptcy Code offers lenders high degrees of repayment priority, including superpriority claims and liens, to induce them to extend DIP financing.[152] The Bankruptcy Code also assures DIP lenders, if acting in good faith, that these superpriority claims and liens cannot be compromised.[153] DIP lenders thus have strong repayment protection, even if the debtor ultimately liquidates. Furthermore, a bad-company, bad-balance-sheet debtor may well be able to obtain DIP financing if it pays a high enough interest rate to offset the liquidation risk.[154]

For the second question, who should assess the outcome of the threshold viability test, the bankruptcy judge is likely best situated and, by experience, most able to make that determination. There is, however, a possible conflict. Bankruptcy judges are not Article III judges appointed for life; rather, they are appointed for 14-year terms.[155] Their reappointment (by their federal circuit court of appeals[156]) often turns on the judge's success in keeping firms

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[150] *See id*.
[151] *See* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEG. ANALYSIS 511, 515 (2009) (discussing prior literature that indicates that "relative to debtors without DIP financing, those with financing had faster cases and were more likely to reorganize or merge with another firm than undergo piecemeal liquidation"); B. Espen Eckbo, Kai Li, & Wei Wang, *Loans to Chapter 11 Firms: Contract Design, Repayment Risk, and Pricing*, 66 J. L. & ECON. 465, 468 (2023) ("[A] DIP loan in many cases is needed to prevent a more costly liquidation outcome . . .").
[152] 11 U.S.C. § 364(c)(1) & (c)(2).
[153] 11 U.S.C. § 364(e).
[154] [cite1] *Cf. An Overview of Debtor-in-Possession Financing*, Fried Frank Harris Shriver & Jacobson LLP (2019), *https://www.friedfrank.com/uploads/siteFiles/Publications/An%20Overview%20of%20Debtor%20Possession%20Financing.pdf* (describing examples of DIP loans provided to financially distressed companies, including Remnant Oil and Generation Next Franchise, which secured financing at interest rates as high as 20%, and retail companies obtaining rates from 5% over LIBOR to fixed rates of up to 12% to offset liquidation risk).
[155] *See* 28 U.S.C. § 152(a)(1) ("Each bankruptcy judge shall be appointed for a term of fourteen years . . . .").
[156] *See* REGULATIONS OF THE JUDICIAL CONFERENCE OF THE UNITED STATES FOR THE SELECTION, APPOINTMENT, AND REAPPOINTMENT OF UNITED STATES BANKRUPTCY JUDGES, Chapter 5 (Reappointment of United States Bankruptcy Judges), (available at http://www.ca5.uscourts.gov/docs/default-source/default-document-library/qualif.pdf?sfvrsn=0:

operating.[157] That metric needs re-evaluation. Empowering bankruptcy judges to assess the outcome of the threshold viability test would need to address that conflict. One possible solution, for example, would be for courts of appeal to disfavor the reappointment of bankruptcy judges who regularly uphold threshold viability tests for debtors that ultimately fail to reorganize or whose confirmed plans are followed by liquidation or the need for further financial reorganization.[158]

Finally, the implementation of a threshold viability test would almost certainly face political challenges. Lawyers and other members of the bankruptcy bar[159] might oppose it because it would reduce the number of active Chapter 11 cases, and thus impact their livelihood. Strict traditionalists might oppose it if they believe that even economically non-viable debtors should be kept operating in order to preserve jobs and support local communities.[160] From a social policy standpoint, however, that political opposition would be unjustified to the extent it protects net *negative value* bankruptcy outcomes.

B. Corporate Risk-taking.

Next consider how the creditor-primacy bankruptcy-governance model would apply to a debtor's risk-taking in bankruptcy. A Chapter 11 debtor operates in bankruptcy as a going

Sec. 5.01. Methods. (a) . . . a bankruptcy judge who is willing to accept reappointment shall provide written notification of willingness in official forms to the chief judge of the circuit. . . . . (b) The court of appeals shall decide whether or not to reappoint the incumbent judge before considering other potentially qualified candidates. In making this decision, the court of appeals shall take into consideration the professional and career status of the incumbent, and whether the incumbent has performed the duties of a bankruptcy judge according to the high standards of performance regularly met by United States bankruptcy judges and demonstrated those characteristics and qualifications specified in Sec. 1.01 and Sec. 1.02(b) of these regulations."

[157] [cite1A]

[158] *Cf. supra* note 135 and accompanying text (discussing the plan-confirmation viability standard). Courts of appeal should be wary, however, of unintended consequences, such as inadvertently motivating bankruptcy judges to find that even viable debtors fail the threshold viability test.

[159] *Cf. supra* note 56 (discussing the bankruptcy bar and their lobbying influence).

[160] See Baird, *supra* note 79, at 577–78 (arguing that bankruptcy law's emphasis on reorganization often reflects societal goals, such as job preservation and community stability, even when liquidation might more efficiently allocate resources to viable enterprises).

concern,[161] with the ultimate goal of becoming financially viable.[162] It therefore should consider taking business risks—not unlike a firm outside of bankruptcy—in order to gain profitability.[163] This can create difficult choices depending on the chances of success and failure and the benefits and costs of each risk-taking engagement.

A firm outside of bankruptcy should consider engaging in a risk-taking project that has a positive expected value to its shareholders, the primary residual claimants.[164] In bankruptcy, though, the debtor-firm's creditors are its primary residual claimants. Logically, therefore, as articulated in Part IV.D, a debtor-firm should consider engaging in a risk-taking project that has a positive expected value to its creditors. Nonetheless, because the debtor-firm's shareholders are also residual claimants (albeit with secondary priority), fairness should require the project to either benefit or at least not impair the firm's shareholders.

For example, consider an insolvent Chapter 11 debtor with $100 of assets and $150 of liabilities. The debtor is considering investing $75 in a project that has a 60% chance of success,

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[161] *See* 11 U.S.C. § 1108 (Authorization to operate business).
[162] [cite1]
[163] Prudent corporate governance requires managers to take business risks. *Cf*. William T. Allen, Jack B. Jacobs & Leo E. Strine Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 455 (2002) (discussing management decisionmaking about risk). A firm's residual claimants, who outside of bankruptcy are ordinarily its shareholders, benefit from the firm's profitability. *See, e.g.*, E. Merrick Dodd Jr., *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932). However, "potential profit often corresponds to potential risk." Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982). Creditors, like shareholders, should be able to diversify, and thereby help to control, their investment risk.
[164] *See, e.g.*, Dodge v. Ford Motor Co., 204 Mich. 459, 507 (1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."). To determine expected value, one must attempt to identify each possible outcome that may result from a given decision, estimate the probability that each such outcome will occur, and then assess such outcome's likely benefit or harm. This determination "gives decision makers a way to make rational, quantifiable decisions when facing uncertain outcomes." Robert M. Lloyd, *Discounting Lost Profits in Business Litigation: What Every Lawyer and Judge Needs to Know*, 9 TRANSACTIONS: TENN. BUS. L.J. 9, 17 (2007). *Cf. id*. at 19 ("Expected value analysis . . . has become a foundation of business decision making."). It has "become essential to business decision making." Nicole Liguouri Micklich, Michael W. Lynch, & Ingrid C. Festin, *The Continuing Evolution of Franchise Valuation: Expanding Traditional Methods*, 32 FRANCHISE L.J. 223, 227 (2013).

which would yield a $120 return. The project's failure would lose the full $75. The expected-value calculation would be as follows[165]:

Expected Value (EV) = (0.60 x $120) + (0.40 x $-75) = $72 - $30 = $42.

This project yields a positive expected value overall. Thus, it would primarily benefit the debtor's creditors, being the primary residual claimants. Furthermore, the project either should benefit or at least not directly impair the debtor's shareholders. If the project is successful, it would benefit those shareholders because the $120 return would make the debtor solvent.[166] If the project fails, it should not directly impair those shareholders because the debtor was insolvent to begin with. This analysis—that a project that yields a positive expected value overall should benefit, or at least not directly impair, the debtor's shareholders—should obtain for most debtors because virtually all firms in bankruptcy are either insolvent or illiquid, or both.[167]

That raises a question, though, whether—and if so, the extent to which—making the debtor more insolvent should be regarded as indirectly impairing shareholders.[168] Prior to the project, the debtor was $50 insolvent ($100 assets minus $150 liabilities). If the project fails, the debtor would become $125 insolvent ($100 assets minus $75 loss on the project minus $150 liabilities). This Article proposes that managers should have discretion to balance the benefit to creditors and potential benefit to shareholders with any such impairment of shareholders, and that they should be protected by the business-judgment rule so long as they act in good faith.[169]

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[165] *Cf. supra* note (describing how to calculate expected value).
[166] Shareholders directly benefit once the debtor reaches solvency—that is, if and when the creditor primary residual claims are paid.
[167] *See supra* note 101 and accompanying text.
[168] Correlatively, that also raises a question whether making the debtor less insolvent should be regarded as benefiting shareholders. *Cf.* text accompanying note 177, *infra* (observing that one could argue that shareholders indirectly benefit from every dollar that creditor claims are paid because that *pro tanto* reduces the insolvency).
[169] *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (defining the business-judgment rule as a presumption that directors act on an informed basis, in good faith, and in the honest belief that their actions are in the company's best interests, with the burden on plaintiffs to rebut this presumption by showing a lack of good faith, gross negligence, or a conflict of interest).

In exercising that discretion, some managers might wish to compare the expected value of the project to the shareholders alone, taking into account any direct or indirect impairment. A positive expected value would then even more clearly justify the project. For the above example, the expected value of the project to the shareholders could be calculated as follows:

EV to Shareholders = (0.60[170] x ($120[171] - $50[172])) + (0.40[173] x $-75[174]) = $42 - $30 = $12.

That positive expected value to the shareholders should clearly justify the project.

For another example, consider a slightly solvent Chapter 11 debtor with $100 of assets and $95 of liabilities. The debtor is again considering investing $75 in a project that has a 60% chance of success, which would yield a $120 return, but the project's failure would lose the full $75. The overall expected-value calculation would yield the same result:

Expected Value (EV) = (0.60 x $120) + (0.40 x $-75) = $72 - $30 = $42.

Again, this project yields a positive expected value overall and thus would primarily benefit the debtor's creditors. However, the project's failure would actually impair the debtor's shareholders because it would wipe out their $5 residual claim ($100 assets minus $75 loss on the project minus $95 liabilities = $-70). It also could be regarded as indirectly impairing those shareholders by making the debtor $70 insolvent. In contrast, though, the project's success would benefit those shareholders by increasing their equity value from $5 to $125 ($100 assets plus $120 return minus $95 liabilities = $125). As before, this Article proposes that managers should have discretion to balance the benefit to creditors and potential benefit to shareholders with any direct or indirect impairment of shareholders, and that they should be protected by the business-

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[170] Recall that 0.60 = chance of the project's success.
[171] Recall that $120 = return if the project succeeds.
[172] Recall that $50 = the creditor primary residual claims, which must be paid before shareholders directly benefit from the project's success.
[173] Recall that 0.40 = chance of the project's failure.
[174] Recall that $75 = loss of assets from the project's failure, creating $75 of further insolvency.

judgment rule so long as they act in good faith.[175] Furthermore, in exercising that discretion, some managers might wish to compare the expected value of the project to the shareholders alone, taking into account any impairment. For this example, the shareholder expected value would be calculated as follows:

EV to Shareholders = (0.60 x ($120 return - $0[176])) + (0.40 x $-75 loss of assets) = $72 - $30 = $42.

That positive expected value to shareholders should justify the project.

In addition to considering possible indirect *impairment* of shareholders (by making the debtor more insolvent), managers might also consider possible indirect *benefit* of shareholders (by making the debtor less insolvent). Although shareholders do not directly benefit until the debtor gains solvency, they could be said to indirectly benefit from every dollar that creditor claims are paid because that *pro tanto* reduces the insolvency.[177] Managers should have discretion not only to take indirect impairment but also indirect benefit into account.

Managers also should exercise discretion in assessing the impact of an expected-value calculation. For example, unless a positive expected-value project makes the debtor more of a "good company,"[178] any profit from a project might merely improve the debtor's balance sheet, which would be restructured anyway in a Chapter 11 plan.[179] Profit from a project should

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[175] *See supra* note 169 and accompanying text.
[176] Because the debtor is slightly solvent, no creditor primary residual claims must be paid before shareholders benefit from the project's success.
[177] One cannot fairly compare the above expected-value calculations for shareholders of a solvent firm with expected-value calculations for shareholders of an insolvent firm. Among other things, shareholders of a solvent firm, as the firm's primary residual claimants, would benefit from every dollar of profit without limit. In contrast, creditors of an insolvent firm, as the firm's primary residual claimants, would only benefit from profits until they are paid their claims, whereupon the shareholders would benefit.
[178] *See supra* note 144 and accompanying text (referencing a "good company" as one that has an inherently good business).
[179] *Cf. supra* notes 144-149 and accompanying text (discussing "good company, bad balance sheet").

nonetheless provide more direct value to the extent it reduces the amount of DIP financing that the debtor needs to borrow. This is because the debtor must repay DIP financing as a priority obligation.[180]

The need for managers to exercise these discretions provides all the more reason why they should be protected by the business-judgment rule so long as they act in good faith in the exercise thereof.[181]

C. Statutory Changes.

This subpart C examines specific provisions of the Bankruptcy Code that should be reconsidered in light of the creditor-primacy bankruptcy-governance model. This Article does not, however, disagree with all provisions of the Bankruptcy Code that exemplify a pro-debtor bias.[182]

Section 362.[183] Section 362 of the Bankruptcy Code[184] automatically stays, or suspends, all enforcement and related actions against the debtor or its property in bankruptcy. Although this stay prevents creditors from enforcing their claims, it generally is needed to avoid so-called creditor "grab races," which not only can wastefully eviscerate the debtor's assets but also unfairly favors the first-mover enforcers.[185]

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[180] *See supra* notes 152-153 and accompanying text.
[181] *See supra* note 169 and accompanying text.
[182] *Cf. supra* notes 56-63 and accompanying text (discussing certain pro-debtor provisions, only two of which, § 362 and § 364, are reconsidered in subpart C above). This Article does not, for example, disagree with § 1121, the debtor exclusivity period to file a plan of reorganization (*see supra* notes 59-61), because the author's experience is that terminating exclusivity would allow all parties in interest to submit competing plans, making it practically difficult for a debtor's managers to consider and respond to all such plans while attempting to operate the debtor as a going concern.
[183] *Cf.* JACKSON, *supra* note 56, at 7-8 (arguing that § 362 intensifies the structural imbalance between debtor and creditor rights).
[184] 11 U.S.C. § 362.
[185] *See, e.g.*, David A. Skeel, Jr. & George Triantis, *Bankruptcy's Uneasy Shift to a Contract Paradigm*, 166 U. PA. L. REV. 1777, 1778 (2018) (observing that "earlier commentators had recognized that bankruptcy law can prevent a 'grab race' or 'race to the courthouse' by creditors

Nonetheless, on a case-by-case basis, creditors should have the right to enforce their claims notwithstanding bankruptcy if such enforcement is neither wasteful nor unfair. Subsection (d)(2) of § 362 technically gives creditors this right: "On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay . . . if— (A) the debtor does not have an equity in such property [that is the subject of the enforcement request]; and (B) such property is not necessary to an effective reorganization." In practice, however, the problem with this exception from the stay is that debtors routinely respond that they will not know, until the end of the case when there is a plan of reorganization, whether the property will be "necessary to an effective reorganization."[186] It therefore is rare for bankruptcy courts to grant this relief from the stay,[187] especially in the early stages of a case.[188]

A compromise would be for § 362(d) to clearly give debtors the burden of proof to show that the property that is the subject of the enforcement request will be "necessary to an effective reorganization." Ironically, although § 362(g)(2) already technically imposes that burden on the debtor, bankruptcy courts tend to ignore it.[189] That tendency may well reflect the general viewpoint of bankruptcy judges that, as courts of equity, they can vary provisions of bankruptcy

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of a financially troubled debtor as they attempt to collect what they are owed, and that bankruptcy can provide a less chaotic and more even-handed distribution of the debtor's assets than might otherwise be the case" and that "Although a few creditors might fare better in a grab race, creditors as a whole would suffer because the creditors' collection efforts could dismember an otherwise viable business").

[186] This observation is based on the author's extensive bankruptcy-practice experience as an associate and later partner with Shearman & Sterling (now A&O Shearman).

[187] *Cf*. Katharine E. Battaia & Cassandra Ann Sepanik, *§ 362(d)(3): Codification of Extend and Pretend?*, BLOOMBERG LAW REPORTS, BANKRUPTCY LAW (2011) (discussing a court's "mistakenly substitut[ing] a § 362(d)(2) analysis for the heightened standard that Congress intended for § 362(d)(3)").

[188] John D. Ayer, Michael Bernstein, & Jonathan Friedland, *An Overview of the Automatic Stay*, 22 AM. BANKR. INST. J. issue no. 10 (Dec./Jan. 2004) (observing that although "creditors often want to obtain relief quickly so as to minimize the delay and inconvenience resulting from bankruptcy," judges "tend to be more concerned with the debtor's rights early in the case and correspondingly less sympathetic to a [creditor's] desire to immediately extricate itself from the bankruptcy").

[189] *Cf. id*. (observing that although the debtor "has the burden of proof on" this issue, "[a]s a practical matter, . . . both the movant and the responding party are well-advised to be prepared to present evidence on all of the relevant issues").

law to reach what they regard as equitable outcomes.[190] Reinterpreting bankruptcy law under a creditor-primacy model should make it more likely that courts would respect the § 362(g)(2) burden of proof.

Section 364. Section 364 of the Bankruptcy Code[191] facilitates so-called DIP financing to a debtor in bankruptcy. It incentivizes lenders to consider extending credit by giving them priority of repayment over the claims of pre-petition creditors. In general, this is a fair balance; DIP financing enables otherwise viable debtors to successfully reorganize,[192] and pre-petition creditors have the right to notice and a hearing to oppose an inappropriate extension of DIP financing.[193]

A problem can arise, though, when a debtor needs DIP financing to reorganize but lacks sufficient unencumbered assets to borrow the amount needed. In these cases, the court "may authorize the [DIP financing to be] secured by a senior . . . lien on property of the [debtor] that is subject to a [pre-petition] lien only if— (A) the [debtor] is unable to obtain such credit otherwise; and (B) there is adequate protection of the" pre-petition lienholder. This sounds fair, but the ambiguous definition of what constitutes "adequate protection" can undermine creditor protection.

Section 361(3) of the Bankruptcy Code[194] defines adequate protection to include "the realization by [the pre-petition lienholder] of the "indubitable equivalent" of its pre-petition lien.

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[190] *See, e.g.*, Jonathan M. Seymour, *Against Bankruptcy Exceptionalism*, 89 U. CHI. L. REV. 1925 (2022) (arguing that bankruptcy judges should not have that equitable discretion). As an example of how bankruptcy judges can abuse their discretion, the author once argued a motion in the White Motors bankruptcy before Judge Schlachet in the Northern District of Ohio. After the judge decided the motion directly contrary to the language of the Bankruptcy Code, the author asked the judge in chambers to please explain his decision. The judge replied, "I'm a court of equity and I'll damn well do what I please."
[191] 11 U.S.C. § 364.
[192] *See supra* notes 152-154 and accompanying text.
[193] *See* 11 U.S.C. §§ 364(b), (c), & (d).
[194] 11 U.S.C. § 361(3).

Coined by Judge Learned Hand in a different context,[195] the term indubitable equivalent sometimes has been used by bankruptcy judges to provide very poor substitutes to formally satisfy the adequate protection standard.[196]

As with the exception to the automatic stay, § 364(d)(2) technically imposes the burden of proof on the debtor to demonstrate that the pre-petition lender receives adequate protection but bankruptcy courts tend to ignore it.[197] Reinterpreting bankruptcy law under a creditor-primacy model should make it more likely that courts would respect the § 364(d)(2) burden of proof.

Section 363. Section 363 of the Bankruptcy Code[198] authorizes bankruptcy judges, "after notice and a hearing," to authorize a debtor to sell assets. Originally envisioned to authorize the occasional sale of assets and broadened in interpretation to reasonably authorize emergency asset sales,[199] bankruptcy courts have used § 363 to facilitate the sale of all or substantially all of a debtor's assets outside of a plan of reorganization. That type of sale should be effectuated as part of a formal plan of reorganization.[200] Using § 363 to effectuate that sale bypasses the procedural

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[195] *See* Met. Life Ins. Co. v. Murel Holding Corp. (*In re* Murel Corp.), 75 F.2d 941, 942 (2d Cir. 1935) (referring to "indubitable equivalence" in a bankruptcy cram down context).

[196] *See, e.g.*, *In re* Arnold & Baker Farms, 85 F.3d 1415, 1419–21 (9th Cir. 1996) (reversing bankruptcy court's confirmation of a "dirt-for-debt" plan that proposed substituting subdivided real estate for the creditor's original secured claim, finding that proposed substitute undervalued and subject to speculative market risks, thereby failing to satisfy the "indubitable equivalent" standard and inadequately protecting the secured creditor's interest). *Cf*. Lisa Hill Fenning & Michael Levin, *Philadelphia Newspapers: The Unanswered Questions for Secured Creditors*, 4 BLOOMBERG L. REP. issue no. 33 (2010) (observing that "[c]reating an opportunity to fight about indubitable equivalence inherently gives more leverage to debtors"), available at https://www.arnoldporter.com/-/media/files/perspectives/publications/2010/08/philadelphia-newspapers-the-unanswered-questions__/files/publication/fileattachment/arnoldporterllpbloombergbankruptcylawreport082010.pdf?rev=c9bd3d68241147fe92337855662a4690&sc_lang=en&hash=ECF82E6B9D0DA0D3805D791FF89DF397.

[197] *Cf. supra* note 189 and accompanying text (observing that bankruptcy courts tend to ignore that, under § 362(g)(2), the burden of proof is on the debtor).

[198] 11 U.S.C. § 363.

[199] [cite to the case using § 363 to authorize the emergency sale of meat, which would otherwise go bad and become worthless]

[200] *See* 11 U.S.C. § 1123(a)(5)(D) (discussing the "Contents of [a] Plan" as including the "sale of all" of the debtor's property).

creditor protections that are contemplated by § 1129 of the Bankruptcy Code, which governs confirmation of a reorganization plan.[201]

The General Motors and Chrysler bankruptcies demonstrate these risks. In the Chrysler bankruptcy, the court approved a § 363 sale transferring Chrysler's key assets to a new entity, heavily influenced by government intervention. The transaction disproportionately benefited certain unsecured creditors, including labor unions, while allowing secured creditors to receive only a fraction of their claims, undermining the Bankruptcy Code's priority rules.[202] In the GM bankruptcy, the § 363 sale of substantially all of GM's assets bypassed the § 1129 creditor protections to leave secured creditors with significant losses while prioritizing other stakeholders, including labor unions.[203]

To address these concerns, courts should adopt more rigorous standards for evaluating § 363 sales. Some advocate, for example, a stricter "sound business purpose" test that requires detailed factual findings from courts to ensure that § 363 sales align with creditor protections and do not circumvent the priority rules established under § 1129.[204] Furthermore, § 363 sales should only be authorized when the debtor demonstrates a compelling business purpose and the sale does not unduly harm creditors' statutory entitlements.[205]

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[201] These protections include 11 U.S.C. § 1129(a)(7) (requiring impaired creditors to receive in a reorganization plan at least as much as they would receive in a liquidation) and 11 U.S.C. § 1129(a)(8) (enabling each impaired class of creditors to veto the plan if, by supermajority vote, they disagree with it).

[202] *In re* Chrysler LLC, 576 F.3d 108, 114–16 (2d Cir. 2009). [Cite1 to Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of* Chrysler *and* GM, 2010 U. ILL. L. REV. 1375 and David A. Skeel Jr., *From Chrysler and General Motors to Detroit*, 24 WIDENER L.J. 121 (2015).]

[203] *See In re* Gen. Motors Corp., 407 B.R. 463, 493–95 (Bankr. S.D.N.Y. 2009).

[204] Jessica Uziel, S*ection 363(B) Restructuring Meets the Sound Business Purpose Test with Bite*, 159 U. PA. L. REV. 1189, 1210–13 (2011).

[205] *Id*. at 1212-13.

Section 1124. Section 1124 of the Bankruptcy Code[206] defines what it means for a claim to be impaired.[207] The significance is that holders of impaired claims are protected under § 1129 of the Bankruptcy Code, which governs confirmation of a reorganization plan.[208] Holders of claims that are not impaired[209] have no such protection.[210]

Debtors have used § 1124 to prejudice creditors whose contractual interest rates have declined below market interest rates. In many cases, debtors, who normally have the exclusive right to propose a plan of reorganization,[211] write plans that keep those below-market interest rates in place even after the debtor reorganizes and exits bankruptcy:

> Section 1124(2) of the Bankruptcy Code gives chapter 11 debtors a valuable tool for use in situations where long-term prepetition debt carries a significantly lower interest rate than the rates available at the time of emergence from bankruptcy. Under this section, in a chapter 11 plan, the debtor can "cure" any defaults under the relevant agreement and "reinstate" the maturity date and other terms of the original agreement, thus enabling the debtor to "lock in" a favorable interest rate in a prepetition loan agreement upon bankruptcy emergence.[212]

Under a creditor-primacy bankruptcy-governance model, Congress might consider amending § 1124 to include defining a claim with such a below-market interest rate as being impaired.

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[206] 11 U.S.C. § 1124.
[207] Certain sections of the Bankruptcy Code, such as § 1124 ("Impairment of claims or interests") and § 361 (Adequate protection"), are purely definitional. In principle, those definitions could have been included in § 101 ("Definitions") of the Bankruptcy Code.
[208] *See supra* note 201 and accompanying text.
[209] In the author's experience (*cf. supra* note 186 describing that experience), these claims are often called "unimpaired."
[210] *See* 11 U.S.C. § 1129(a)(7) (applying only to "each impaired class of claims . . .") and 11 U.S.C. § 1129(a)(8)(B) (excluding "each class of claims [that] is not impaired under the [reorganization] plan").
[211] 11 U.S.C. § 1121.
[212] Jones Day, *Cure and Reinstatement of Defaulted Loan Under Chapter 11 Plan Requires Payment of Default-Rate Interest* (Dec. 8, 2023), available at https://casetext.com/analysis/cure-and-reinstatement-of-defaulted-loan-under-chapter-11-plan-requires-payment-of-default-rate-interest?sort=relevance&resultsNav=false&q=.

CONCLUSIONS

This Article is the first to attempt to analyze whether federal bankruptcy law's pro-debtor bias creates net value or merely results in a zero-sum game that redistributes value from creditors to debtors. Because an empirical analysis of that question is not generally feasible,[213] the Article engages in a second-best methodology, building on the pro-debtor shareholder-primacy model of corporate governance which is widely viewed as maximizing value. The Article stresses that model under the circumstances of bankruptcy, revealing two critical differences: creditors become the primary residual claimants of the firm whereas shareholders are relegated to secondary residual claimant status, and the covenants that normally protect creditors become unenforceable.

The Article utilizes these differences to derive a creditor-primacy governance model for debtors in bankruptcy. It then pragmatically assesses this model, showing that it would add important positive benefits by reducing the cost of credit without undermining the fundamental benefits of a pro-debtor biased model.

The Article also shows how the creditor-primacy model could be applied to maximize bankruptcy value. For example, a threshold viability test would require debtors that are unlikely to successfully reorganize to be liquidated at the outset of a Chapter 11 case, thereby significantly increasing creditor recovery without realistically impairing debtor rehabilitation. Such a test should also reduce agency costs and moral hazard and help to avoid the sunk-cost fallacy that wastefully causes numerous supposedly reorganized debtors to have to refile bankruptcy cases.

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[213] *But cf. supra* note 93 (discussing an attempt empirically to analyze the effect of a change in bankruptcy proceedings in Poland from pro-creditor to pro-debtor; and finding, subject to numerous limitations and cautions, that "the new pro-debtor model of bankruptcy proceedings implemented in Poland . . . is less effective than the pro-creditor model of bankruptcy proceedings was").