BANKRUPTCY MINIMALISM

by

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INTRODUCTION

The Supreme Court set out a foundational principle of bankruptcy law in *Butner v. United States*.[1] State law creates and defines property interests and unless some federal policy requires changing them, these property interests should be respected in bankruptcy. Rights should not be altered merely because someone is in bankruptcy. The Supreme Court regularly embraces the spirit of *Butner* and rejects the idea that its provisions give debtors special privileges merely because of the happenstance of bankruptcy.[2]

At roughly the same time *Butner* was decided, a new generation of academics, most notably Thomas Jackson, argued that the law of corporate reorganizations should focus narrowly upon the collective action problem that arises when too many creditors face a debtor with too few assets.[3] The law of corporate reorganizations exists because creditors of a distressed debtor do better when their rights can be sorted out in a single forum.

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[1] 440 U.S. 48, 55 (1979).

[2] For example, the Court observed in *Mission Products Holdings v. Tempnology* that "Section 365 reflects a general bankruptcy rule: The estate cannot possess anything more than the debtor itself did outside bankruptcy." 587 U.S. 370, 381 (2019).

[3] *See, e.g.*, Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 860 (1982).

Hence, nonbankruptcy rights should be altered only to the extent necessary to solve the collective action problem, and no further.

When one looks at corporate reorganization law as a solution to a collective action problem, it appears that the law should be minimalist. A procedure that allows creditors as a group to chart a sensible course for the firm and bind holdouts is all that is needed. Only the procedure needs to be changed, not substantive rights. And the procedure should depart from the one outside of bankruptcy only to the extent necessary to solve the collective action problem.[4] Few, if any, trade-offs need to be made.

This minimalist account of corporate reorganizations has cast a long shadow. As we close in on almost a half century under the Bankruptcy Code, it is worth reflecting on how minimalist the law of corporate reorganizations can be, even if it is narrowly focused on solving a collective action problem. In this essay, I explore some of the challenges that the minimalist account of corporate reorganizations must face.

The value of the rights of each creditor and the value of the debtor's assets must be sorted out in the bankruptcy forum. When too many claims chase too few assets, sorting out the rights of the players requires competing rights to be assessed against one another. This valuation problem presents minimalism with its first challenge. To value assets, choices must be made. The way these choices are made reshapes substantive rights. A secured creditor might try to gain a security interest in all the debtor's assets, but often there are gaps in the collateral package. Chapter 11 may create value that the secured creditor could never have accessed outside of bankruptcy. Courts must measure the difference in the value of the assets inside of bankruptcy and the value of assets subject to the security interest outside

[4] Of course, the law governing individual bankruptcy is cut from an altogether different cloth. The honest, but unfortunate debtor is entitled to a fresh start, and this requires dramatic changes in nonbankruptcy rights. Individual bankruptcy is not and cannot be minimalist. Its origins and its rationale are utterly different. Indeed, it is an unhappy accident that individual bankruptcy and corporate reorganization law are fused together, as it leads many to assume that policies designed for one type of debtor are suitable for the other. Debt is "discharged" in both kinds of cases, but the discharge of corporate debtors is not about helping flesh-and-blood individuals. It is merely part of the mechanism that allows dispersed investors to create a new and more sensible capital structure. There is no reason to think that the exchange of one investment instrument for another should have much in common with giving a flesh-and-blood individual a fresh start. Given the distinct (and radically different) purposes each sort of "discharge" serves, there is no need to treat them the same. Indeed, it would seem most unlikely that they should be the same.

and then determine how to allocate this surplus.

There is another problem that arises from the need to value assets that is more troubling.[5] Volatility is a major component of the valuation rights outside of bankruptcy when one investor has priority over another, but asset volatility is ignored in bankruptcy valuations. Outside of bankruptcy the likelihood that the value of the debtor's assets will change over time affects how much a junior or senior interest in that asset is worth. The value of a junior investor's stake in a firm is different if the venture holds a Treasury Bill or a lottery ticket even if both trade for the same amount. There is an upside to the lottery ticket, but none to the Treasury Bill. The uncertainty associated with the lottery ticket increases the value of a junior interest in the lottery ticket relative to the same-sized junior interest in the Treasury Bill. It also produces a corresponding decrease in the value of a senior interest in the lottery ticket relative to the Treasury Bill. In bankruptcy, however, the assets are valued at a single moment in time. Volatility is ignored. The same-sized junior and senior interests in a lottery ticket and a Treasury Bill with the same expected value are treated identically. Those who deposit their cryptocurrency with an exchange end up with a claim for the value of their currency at the time of the petition, regardless of what happens to its value subsequently.

Bankruptcy is a day of reckoning in which all accounts are squared up. Valuing everything at a single moment in time (eliminating upside and downside in the process) produces an instantaneous change in the value held by junior and senior investors. Senior investors benefit at the expense of junior investors merely by happenstance of bankruptcy. Indeed, when the firm is insolvent, any value the equity interests had by virtue of asset volatility disappears completely. Now that private equity sponsors assume an outsized role in the life of distressed firms, this discontinuity has become much more manifest. Liability management exercises exist in large part because of the way a reorganization itself reduces the value of junior stakes in the firm.[6]

Another challenge to the minimalist account of corporate reorganizations is captured in Henry Maine's observation that the substance

[5] *See* Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 776–77 (2011).

[6] *See* Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporate Reorganization*, 90 U. CHI. L. REV. 1, 38 (2023).

of the law is secreted in the interstices of procedure.[7] Many substantive rights take their distinctive shape because of the procedure that is used to assess them. Change the procedure, and you necessarily change the substantive right. The substance of a right outside of bankruptcy can turn on the process used to vindicate it.

This connection between substantive rights and procedure has long been recognized when courts have wrestled with the intersection of bankruptcy and administrative law.[8] But the problem runs deeper. Every nonbankruptcy right undergoes a transformation when a bankruptcy judge reduces it to a pro rata claim against the debtor's assets. The transformation may be of little moment when it comes to funded debt, but virtually all legal rights fall within the ambit of a bankruptcy claim, and most are not so simple.

Transforming a nonbankruptcy right into a bankruptcy claim promotes the interests of the stakeholders as a group, but it comes at the cost of undermining the nonbankruptcy right. There is inevitably a trade-off between advancing the goals of corporate reorganizations and respecting nonbankruptcy rights, given the inseparable link between substance and procedure.

One can argue that bankruptcy's procedures significantly reshape only exotic and unusual substantive rights. It is not a problem worthy of much concern if the necessary trade-offs can usually be remitted to the bankruptcy judge's sound discretion. But it is possible to take a broad view of nonbankruptcy rights. One can argue that the trade-off between substantive rights and maximizing the value of the estate is omnipresent. At the extreme, substantive rights are implicated whenever bankruptcy procedures touch any nonbankruptcy rights beyond funded debt.[9]

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[7] SIR HENRY SUMNER MAINE, DISSERTATIONS ON EARLY LAW AND CUSTOM 389 (London 1891). Of course, the idea of procedure upon which this essay focuses are the various provisions of the Bankruptcy Code, such as the automatic stay, that change the dynamics of the litigation. The essay is not looking at the Federal Rules of Bankruptcy Procedure. They play a decisive role in many bankruptcy cases, but they cannot be at odds with the Bankruptcy Code itself. Under the Bankruptcy Rules Enabling Act, "[s]uch rules shall not abridge, enlarge, or modify any substantive right." 28 U.S.C. § 2075. Moreover, there is a cleanup provision providing that "[a]ll laws in conflict with such rules shall be of no further force or effect after such rules have taken effect." 28 U.S.C. § 2072(b).

[8] The classic account is Robert K. Rasmussen, *Bankruptcy and the Administrative State*, 42 HASTINGS L.J. 1567 (1991).

[9] For example, one can argue that changing the resolution of mass tort claims to the bankruptcy forum fundamentally changes the nature of the values that tort law is

The minimalist vision of corporate reorganizations must also identify exactly those collective action problems that the bankruptcy forum should resolve. When creditors are battling only over hard assets that an individual debtor owns, the collective action problem is easy to see. But a debtor's interactions with the world often create an elaborate web of interactions with other actors. These often create collective action problems that stand apart from the debtor's own assets.

Consider a debtor who defrauds multiple victims and passes along some of the fruits of this defalcation to a confederate who aided the debtor in perpetrating the fraud. Outside of bankruptcy, each creditor has both a fraudulent conveyance action and an aiding and abetting action against the confederate.[10] The creditors face a collective action problem with respect to both. Both the fraudulent conveyance action and the aiding and abetting action may be too costly for any individual creditor to bring. Because both causes of action arise out of the creditors' interactions with the same debtor and involve largely overlapping facts, the creditors as a group may be better off if the trustee can act on behalf of the creditors with respect to both actions. Chapter 11, however, empowers the trustee to bring only the fraudulent conveyance action. Creditors must pursue the aiding and abetting actions on their own.[11] Existing law may or may not draw the line in the correct place, but some line needs to be drawn.

This essay further explores these difficulties associated with translating nonbankruptcy rights to the bankruptcy forum. Part I of this essay connects the minimalist account of corporate reorganization law with its roots in nineteenth century equity receiverships. The next three parts explore these complications in turn.

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vindicating. *See, e.g.*, Abbe R. Gluck, Elizabeth Chamblee Burch & Adam S. Zimmerman, *Against Bankruptcy: Public Litigation Values Versus the Endless Quest for Global Peace in Mass Litigation*, 133 Yale L.J. Forum 525, 528–29 (2024).

[10] Aiding and abetting actions ordinarily do not lie for the typical fraudulent conveyance, but in this hypothetical, I am positing that the debtor and the confederate engaged in actual common law fraud, an arena where aiding and abetting liability is uncontroversial.

[11] *See* Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 431–32 (1972); Harrington v. Purdue Pharma L.P., 144 S. Ct. 2071, 2081 (2024).

I. THE ORIGINS OF CHAPTER 11 AND THE (SLIGHTLY) COERCIVE EXCHANGE OFFER

The minimalist account of corporate reorganizations is most compelling when only funded debt is being restructured. For this reason, a minimalist is naturally drawn to the origins of reorganization law: the great, continent-spanning railroads that were built in the second half of the nineteenth century.[12] These railroads were the first giant corporations. They typically had few general creditors. They were cashflow positive, and meeting operating expenses was rarely a problem. The problem was dealing with the mountain of funded debt. There was massive overbuilding, and these railroads often had trouble meeting their obligations to bondholders. Making matters worse, these railroads were financed haphazardly over time, and many of the investors were scattered across Europe.

Bondholders faced the grim reality that the railroad in which they invested would not be able to repay everyone in full. In the wake of default, each bondholder had a theoretical right to resort to traditional avenues of debt collection, but even if a bondholder could act more quickly than others, the traditional methods of debt collection were unattractive. The bondholders' collateral was often just a discrete section of rail track. A foreclosure sale of a ten-mile strip of land fifteen-feet wide between nowhere and nowhere would yield virtually nothing.

The railroad had value because each segment of track was linked with all the others. As a network, the railroad produced a substantial revenue stream over and above its operating costs. This was the asset to which the bondholders looked, not discrete pieces of collateral. The challenge arose because this asset is shared.

A sole owner of a railroad would simply run the railroad efficiently. That the railroad would never return the amount invested in it was neither here nor there. The best had to be made of a bad situation, but no special legal regime was necessary. When there was a sole owner, there was no debt. The sole owner controls the entire revenue stream. The revenue stream might have been unexpectedly small, but there were no fights over it.

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[12] For an excellent discussion of equity receiverships, see DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 48–70 (Princeton University Press 2001).

To be sure, the nineteenth century railroads faced operational challenges and regulatory hurdles that made it hard to make a profit. Some of the rail lines needed to be abandoned; operations needed to be scaled back; some managers had to be fired; and fiscal controls needed to be put in place. None of these difficulties, however, required any special laws.

Problems arose, however, when many investors shared the revenue stream. When interest and principal payments outpaced revenues, managers cut corners to avoid defaults. The operations of the railroad became compromised, and the revenue stream itself became imperiled. The capital structure needed to be fixed in order to maximize the value of the revenue stream and each bondholder's piece of it. Old investment instruments needed to be exchanged for new ones.

Again, only the suppliers of capital had to confront the railroad's financial distress. The bondholders faced a collective action problem because the railroad had multiple owners. If a single individual owned the entire railroad, there would have been no threat to the revenue stream. A sole owner pocketed all the revenues after expenses are paid.

If there were just a handful of investors, there might have been no collective action problem either. The investors needed only to sit down with each other and reconfigure the rights each held against the railroad. Their common goal was to recover as much as they could. They were transforming an enterprise with a bad capital structure into an identical enterprise with a good capital structure. With old investment instruments exchanged for new ones, the struggle to make interest payments would have been over. With a better capital structure, the firm was worth more. Decisions that were penny-wise and pound foolish would no longer be made. For this reason, the bondholders should have been able to strike a mutually beneficial deal that left each set of bondholders better off.

Bondholders should not have cared about the flavor of the new investment instruments they received in return for their old ones as long as the new instruments were worth as much or more than the ones they were giving up. An investor with a diversified portfolio cares only about how much the investment instrument is worth. An investor prefers a piece of paper for a fixed sum from a business with a sound capital structure than a somewhat larger sum from the same business with an unsound structure. Investors care both about how much they are owed and about how likely they are to be paid.

As it happened, even though there were thousands of bondholders of these nineteenth century railroads, only a handful of investment bankers represented most of them, and these investment bankers could bargain with each other at low cost. To put a railroad's fiscal house in order, J.P. Morgan and other investment bankers chose the exchange offer as their first line of attack. When an exchange offer worked, bondholders from all parts of the capital structure found it in their interest to trade their old bonds for new ones. The simpler and more realistic capital structure invariably left everyone better off.

Sometimes, however, the investment bankers could not get everyone to come along. When the bondholders were especially diverse and the condition of a railroad was especially grim, some coercion was necessary to prevent a few malcontents from gumming up the works. Or, to say the same thing, some mechanism was needed to solve the collective action problem. All were better off when everyone took new bonds that the debtor could pay instead of the old ones that it could not. An individual bondholder, however, might turn down the exchange. The bondholder would be better off if everyone else took the new bonds, and it retained the old one. With everyone else taking a haircut, this recalcitrant bondholder might hope to find a debtor on a sound financial footing and able to pay its old bond in full. But as soon as too many people reasoned this way, the deal would fall apart. No one would have been willing to compromise.

Some legal mechanism was needed to provide the necessary friendly persuasion to bring the holdouts on board. To find such a legal mechanism, the investment bankers appropriated the equity receivership. In a traditional equity receivership, a general creditor asks a court of equity to appoint a receiver to take over all the assets of its debtor and sell them to third parties. The investment bankers for these railroads had no interest conducting an actual sale or turning control over to a receiver, but they discovered they could use that procedure without having to suffer the consequences that usually came with it.

The investment bankers would find some cooperative general creditor (someone who was going to be paid in full in any event) to trigger the proceeding and ask the judge to appoint someone of the investment bankers' choosing as receiver, quite often the existing manager. The receiver would prepare for a "sale" of the railroad. While planning the "sale," the receiver would continue to run the railroad as before.

As the receiver was preparing for the "sale," the investment bankers would bargain among themselves and agree to a new capital structure that looked very much like the one that they would have put in place had all the bondholders been willing to participate in an exchange offer. The investment bankers then crafted a plan of reorganization around this new capital structure. The plan set out the way the investment bankers would divide up the railroad after the "sale."

At the foreclosure sale, the investment bankers would be the only ones who bid. Their winning bid would be just above an "upset price" that the judge imposed. The upset price was typically a small fraction of the value of the assets. Moreover, the investment bankers asked senior creditors who wanted to participate in the plan to turn over their bonds to them so they could include them as part of their bid. Because the investment bankers could thereby credit bid, the cash they had to put up was only a fraction of the upset price. No one else could compete with them and no one else would even appear at the sale.

Because the investment bankers were the high bidders, they would acquire the entire railroad at the "sale." They would then allocate rights in the railroad to participating bondholders just as they would have in an exchange offer. Few would fail to participate, as those who did not accept the plan would receive only their small portion of the proceeds of the "sale," the trivial amount of cash the investment bankers needed to top off the credit bid. Far from having the holdup power recalcitrant creditors have in an exchange offer, those who refused to go along were financially wiped out.

Everyone understood that the "sale" at the heart of the equity receivership was a sham. The foreclosure sale was merely a useful legal fiction. The equity receivership solved the holdout problem. It was in effect a consensual and mutually beneficial exchange offer, supplemented with a little arm twisting. It gave business enterprises sensible capital structures without lowering the value of anyone's stake in the enterprise.

Seen through this lens, the equity receivership took the form of a sale, but did not have the consequences of an actual sale. In an actual sale, cash is divided among the various investors in order of their nonbankruptcy priority rights. The equity receivership, like an exchange offer, allowed the bondholders to trade old investment instruments for new ones. No matter where they stood in the capital structure, investors gave up their old rights against the railroad for new and more valuable rights in the same railroad, but more valuable than before on account of its improved capital structure.

Because even the equity of an insolvent business traded for a positive price, the shareholders were not wiped out completely.

It might seem investment bankers could use the equity receivership to take advantage of investors. Once they controlled enough of the senior bonds, the investment bankers faced few constraints. Nothing forced them to make sure that each group of bondholders was better off, and no doubt abuses did occur. But the investment bankers were limited in their ability to exploit their advantage. Investment bankers cared about their reputations. They had to return to the same investors to raise capital for new projects. They were playing a long game. Their clients had to feel confident that their banker would look out for their interests in bad times as well as good ones.[13]

The equity receivership differed from modern reorganizations across several dimensions. When the only debt being restructured was secured debt held by sophisticated investors, there was little for reorganization law to do other than create a bargaining environment. Investment bankers and their lawyers could bargain with each other and ensure that a handful of dissidents did not prevent a sensible restructuring. But this paradigm no longer captured the dynamics of reorganizations even when reorganization law first took statutory form in the 1930s.

By the 1930s, investors in railroads, utilities, and other large enterprises were no longer exclusively sophisticated European investors. Much of the world's capital was then held in the United States. Moreover, investors now included a rising upper middle class. Doctors, lawyers, and small business owners across the country had savings they needed to invest for their retirements. The bonds came in large denominations, so each investor entered the market infrequently. Unlike European banking houses and large insurance companies, this new type of investor had no long-term relationship with an investment banker. When they bought bonds, they could not count on investment bankers like J.P. Morgan to protect their interests. Moreover, because these bonds came in large denominations, it was hard for small investors to hold diversified portfolios.[14]

These small investors enjoyed few protections if one of the businesses whose bonds they held entered into an equity receivership. The equity

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[13] Carlos D. Ramirez, *Did J.P. Morgan's Men Add Liquidity? Corporate Investment, Cash Flow, and Financial Structure at the Turn of the Twentieth Century*, 50 J. FIN. 661, 664 (1995) (finding that Morgan's participation likely lowered the cost of capital).

[14] *See* Stephen Lubben, *Protecting Ma and Pa: Bond Workouts and the Trust Indenture Act in the 21st Century*, 44 CARDOZO L. REV. 81, 117 (2022).

receivership did little more than provide a bargaining environment. Judges set an arbitrary upset price that had little relationship with the value of the firm and took some modest steps to ensure that everyone had a seat at the bargaining table. But judges did little else to look out for small investors. In particular, judges were not called upon to decide how much anyone's rights were worth. In this largely norm-based regime, there were no valuations to speak of.

When New Deal reformers looked at the capital structure of large industrial enterprises and utilities that were being reorganized during the Great Depression, they did not see the investors as a single homogeneous group who faced only a collective action problem. They saw well-heeled insiders on the one hand and members of the general public on the other. From their point of view, the law of corporate reorganizations had to do more than help investment bankers overcome a collective action problem. It had to have procedures that protected relatively unsophisticated investors who lived far away from Wall Street.

The New Deal reformers wanted a reorganization law that went beyond providing a forum that made bargaining possible. They wanted the judge to value assets and liabilities and ensure that no one was shortchanged. This effected a tectonic shift in reorganization law. The mere act of valuing a nonbankruptcy right changed it.

Moreover, the New Deal reformers decided on a form of valuation that both took the form of the equity receivership (a foreclosure sale) seriously and protected the outside investors, who during this period tended to hold senior instruments.[15] They insisted on valuing the firm at a single moment in time. Their reforms treated the reorganization as a day of reckoning. Whatever value existed on that day went to the senior investors first. Decisions now needed to be made about how to value senior rights. Moreover, because the reorganization was now treated as a sale, the relative value of senior and junior nonbankruptcy rights now changed upon filing a

[15] For accounts of the evolution of the absolute priority rule, see John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963, 969–79 (1989); Randolph J. Haines, *The Unwarranted Attack on New Value*, 72 AM. BANKR. L.J. 387, 397–416 (1998); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 84 (1991); David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1353–76 (1998).

petition.

In contrast to the equity receivership, in this new reorganization regime the value of a business was reduced to a single number. If the expected value of the business was not enough at that moment to pay the senior investors in full, the junior investors received nothing. They no longer benefited from the possibility that the firm might do better than expected. This combining of all future possibilities into a single number introduced a discontinuity that did not exist with the equity receivership. It dramatically changed the behavior of parties in advance of bankruptcy, especially when the parties were sophisticated and held the levers of corporate control. The essay turns to these challenges in the next part.

II. SCHRÖDINGER'S CAT IN BANKRUPTCY

Bargaining is driven by the alternatives each party faces if no deal is reached. In the equity receivership, there was often little arms' length bargaining in the traditional sense. Bondholders often occupied multiple tranches in the capital structure; lawyers represented junior and senior creditors at the same time. These alignments of interest and deeply embedded norms operated in an environment where there were also well-established focal points. Everyone understood the sort of haircut that each sort of bondholder and equityholder should suffer. In such an environment, it was relatively easy to form restructuring plans.

Contemporary reorganizations are a different matter altogether. They very much depend on hard-nosed bargaining between different investor groups. The exit option that colors much of the bargaining is the judicial valuation that the New Dealers put in place and that continues under the Bankruptcy Code. The way in which such valuations are done necessarily alters nonbankruptcy rights even though, in the vast majority of cases, parties bargain in the shadow of the judicial valuation, and the judge is not forced to hold a cramdown hearing. The prospect of the judicial valuation casts a long shadow on the process.

The modern reorganization paradigm, one that has been in place since the New Deal reforms, posits that a reorganization is a virtual sale of the entire business. If called upon to value the business, the job of the judge is to take a snapshot of the business, imagine how much cash a buyer would pay for itat that moment in time, and then line up the various stakeholders according to their nonbankruptcy rights. If only funded debt is being restructured, it might seem that the task confronting the bankruptcy judge is straightforward. To be sure, nonmarket valuations are hard and necessarily uncertain. All estimates of value are noisy.[16] But when asked to value assets and liabilities, bankruptcy judges provide unbiased estimates.[17] If the stakeholders themselves hold diversified portfolios, it might seem they would care only about their expected return. Valuation uncertainty, however, makes the challenge of translating nonbankruptcy rights to the bankruptcy forum problematic over at least two dimensions. This part of the analysis unpacks these problems with a hypothetical.

Imagine that we have a fine-dining restaurant in a ski resort town. As with most such restaurants, its revenues turn on being able to sell cocktails, beer, and wine. There are many suppliers and other small general creditors. There is also a large institutional lender with a security interest in almost everything. The exception is the liquor license. Under state law, a buyer of the restaurant can assume the existing liquor license without applying for a new one, but state law does not allow a secured creditor to have a security interest in the liquor license. If a secured creditor foreclosed on the restaurant, the new owner would have to apply for a new liquor license to reopen the restaurant.

A liquor license, however, is usually easy to obtain under state law. The application process is usually perfunctory and proceeds quickly at little cost. The restaurant might have to close temporarily but nothing more. There is, however, a remote possibility that the application for a new license could fall into a bureaucratic abyss and take so long that the restaurant would never reopen. In that event, anyone moving into the space would have to start from scratch. The assets of the restaurant would consist of little more than an empty store front and a collection of used furniture and kitchen equipment.

The profits of the restaurant also turn on the amount of snowfall each year. Unfortunately, there has been little snow over the past few years. The

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[16] This is Fischer Black's well-known observation. *See* Fischer Black, *Noise*, 41 J. FIN. 529, 533 (1986). For Black, a market was efficient if the price at which a security traded is somewhere between half and twice its true value. Black, of course, was hardly hostile to efficient markets. He was one of the co-discoverers of the Black–Scholes option pricing model.

[17] *See* Mark J. Roe & Michael Simkovic, *Bankruptcy's Turn to Market Value*, 92 U. CHI. L. REV. — (forthcoming 2025).

restaurant is barely cashflow positive. It has fallen behind on payments to its suppliers as well as the tax collector. Default on the secured loan is in prospect as well. In the face of all this, the restaurant files a chapter 11 petition.

The future of the restaurant turns on the amount of snowfall over the next few years. If snowfalls remain below average, the restaurant will barely have any value as a going concern. If the average snowfalls return, the restaurant will have significant value as a going concern, but its value will be less than what the secured creditor is owed. There is also a possibility that there will be above-average snowfalls for several years in a row. In this event, the restaurant will be worth more than what the secured creditor is owed. Each of these possibilities is equally likely.

The decision of the New Deal reformers to treat a reorganization as a virtual sale to the old owners has consequences. First, the secured creditor is entitled only to the value of the restaurant without the liquor license, and the bankruptcy judge, if called upon, must fix this value. Because the sale in a traditional reorganization is a hypothetical one, we must imagine a counterfactual scenario—how much the assets would have been worth if the senior creditor exercised its nonbankruptcy rights.

The judge might make only a small discount for the gap in the secured creditor's collateral package. Getting a liquor license is usually easy, so the value of this restaurant without a liquor license should almost as much as its value with one. From this point of view, this gap in a secured creditor's collateral package is not of great consequence.

But one can characterize the secured creditor's nonbankruptcy right quite differently.[18] The secured creditor must accept the value of its nonbankruptcy rights with all its warts. The nonbankruptcy right of the secured creditor is the right to force a foreclosure sale. Foreclosure sales are hopelessly inefficient. A secured creditor stands in nothing like the same position as a buyer of an operating restaurant who merely faced the added burden of applying for a liquor license. It is unlikely that the secured creditor could go to a foreclosure sale and acquire the restaurant with cooks, waiters, customer lists, and vendors all intact, obtain the liquor license, and reopen the restaurant as if nothing happened.

Seen through this lens, the available state remedies might effectively give

[18] *See, e.g.*, Edward Janger, *The Logic and Limits of Liens*, 2015 U. ILL. L. REV. 589, 595–600.

the secured creditor only assorted kitchen and restaurant equipment that has no value as a going concern. That a hypothetical buyer would have paid nearly as much for the restaurant without the liquor license as a buyer would pay for one with the license is neither here nor there. The magic of chapter 11 is that it saves going concerns, and the hard, cold reality is that the value of the restaurant as a going concern is not an asset available to creditors outside of bankruptcy. A secured creditor's nonbankruptcy right is tied to specific assets, not to the going concern as a whole.[19] The surplus of the value of the restaurant as a going concern over the value of its discrete pieces and without the liquor license is not part of the secured creditor's collateral package.

The nineteenth century railroads that went through equity receivership faced this problem to some extent. The different bondholder groups had security interests in separate stretches of track, and the value of the railroad lay in the synergies that existed when the different stretches were tied together. But this issue was not of great moment. There were no general creditors to speak of. Each set of bondholders faced the same problem. The excess value that the railroad had over the value of its pieces belonged to the secured creditors as a group. This going-concern surplus needed to be divided among them in some fashion, but the norms that emerged avoided the need to confront the issue.

Matters are different, however, when there are many unsecured creditors. If there is value to be distributed that arises only by virtue of the reorganization process itself, the *Butner* principle says nothing about who should receive it. Hence, it is possible to argue that the going-concern surplus, the difference between the value of the going concern and the stand-alone value of the assets, should not belong to the secured creditor.

This question of how to allocate the going-concern surplus turns in large measure on how much one values a legal regime that allows parties to create

[19] Even when there are no gaps in secured creditor's collateral package, one can argue that the chapter 11 process itself creates value. One can argue that this is an asset that is part of the secured creditor's collateral package. *See* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 783–85 (1988); Douglas G. Baird, *The Rights of Secured Creditors After* ResCap, 2015 U. ILL. L. REV. 849, 858. But, of course, one can take a different view, especially if the value accrues during the bankruptcy itself. *See, e.g.*, Janger, *supra* note 18, at 606–07.

a capital structure in which one set of creditors has priority. Is it a regime that makes capital easier to raise? Is it a regime that allows for advantage-taking? Or is it both? How does one compare the two regimes? Answers to such questions shapes someone's vision of bankruptcy even if that person believes in bankruptcy minimalism.

Judges tend to treat a secured creditor as possessing a security interest in the going concern, less a small adjustment for any gaps that exist. This is easy to justify in many large reorganizations. Only funded debt is being restructured, and there is no virtue in ensuring that value goes to one hedge fund rather than another. Modern bankruptcy judges tend to avoid doing things that put recalcitrant out-of-the-money vulture investors in the money. They are not particularly inclined to feel sorry for them. What matters to the modern bankruptcy judge is creating a bargaining environment that will lead to a successful reorganization. Introducing new procedures to ensure a particular division of the going-concern surplus makes bargaining harder.

Moreover, if the bankruptcy judges paid much more attention to gaps in the collateral package, sophisticated parties could, at some cost, largely navigate around them. Even though plain vanilla security interests give priority on an asset-by-asset basis, sophisticated parties can obtain priority through manipulations in corporate structure. It is not even that hard with respect to large tranches of voluntary debt.[20]

In the case of the restaurant, the liquor license and any other necessary assets could be placed in a subsidiary, and the loan documents would ensure that this subsidiary held no debt. (All debt would be held by the parent—including all obligations owed to the trade creditors.) The senior creditor could take a security interest in all the assets of the parent, including its equity in the subsidiary. The secured creditor, by virtue of the security interest in this equity in the subsidiary, would unequivocally prime almost all general creditors of the restaurant. There seems little value in having a rule in bankruptcy that, rather than altering priorities in bankruptcy, simply forces those who want to enjoy priority to insist on a more complicated capital structure at the time they make their loans.

Nevertheless, some fervently believe that something should be left for junior creditors. Although this may not make much sense when all the debt is funded debt, junior debt is not always funded debt. Especially in smaller cases, it consists of trade claims, tort claims, and other claims of nonadjusting

[20] *See* Baird, *supra* note 19, at 857–58.

creditors.[21] Here, the minimalist model has less traction.

The restaurant hypothetical also presents a second and more fundamental difficulty. Even if the liquor license problem is ignored entirely, there is still a valuation issue, one that was not present during the equity receivership era. The New Deal reformers insisted that the judge treat the reorganization as a sale. When valuing the assets, the judge must imagine a sale of the firm as a going concern for cash and then imagine how the cash would be divided among the various creditors. Valuing the assets in this fashion has striking consequences for the creditors of the fine-dining restaurant, putting to one side the question of the liquor license.

An essential characteristic of any sale is that it converts the value of assets and liabilities into a fixed amount at a particular point of time. This is the day of reckoning on which stock is taken of gains and losses. This does not happen in the absence of a sale. The bankruptcy judge must average the value of the restaurant when the snowfall is low, normal, and high. When this amount is less than what the secured creditor is owed, the secured creditor is entitled to ownership of the restaurant outright (again putting to one side the gap in the collateral package). The junior creditor receives nothing in this paradigm.

This result comes from treating the reorganization like a sale. Junior debt and even the equity still have some value as long as there is no reckoning. But if everything is valued at the time of the reorganization the possibility that the fortunes of the firm will turn around is folded into all the other possibilities. The act of valuation itself extinguishes the option value that every junior ownership interest possesses.

Imagine that the debtor's only asset is a lottery ticket that has a one-in-ten chance of paying $1000. A senior investor is entitled to the first $100, and the junior investor is entitled to the balance. The value of the senior and junior stakes turns dramatically on whether there is a day of reckoning before or after the lottery drawing. If it is before, the senior creditor takes the entire lottery ticket. The ticket is worth only $100, and the secured creditor is entitled to the first $100 of value. The lottery ticket is worth only $100 because it can be sold for that amount and no more if it is sold before the drawing.

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[21] *See* Lucian Ayre Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 882–87 (1996).

Matters are entirely different, however, if the relative positions of the senior and junior investors are maintained until after the lottery drawing.[22] If their relative positions are maintained until after the drawing, the senior creditor's claim today is worth only $10. No buyer would pay more than that for it. There is only a one-in-ten chance that there will be any assets at all. In that event, the senior investor receives only the first $100.

By contrast, the junior investor's stake is worth $90 when rights between it and the senior investor are to be assessed after the drawing. Like the senior creditor, the junior investor will very likely receive nothing at all. But the junior creditor will enjoy a huge payday if the lottery ticket proves a winner. There is one chance in ten that the lottery ticket will be a winner; the senior creditor will receive $100 and there will be $900 left over.

Even if one accepts a minimalist account of corporate reorganizations, one still must adopt a technology to translate the nonbankruptcy right to the bankruptcy forum. Imagine that the future of every firm is like a lottery ticket. If a corporate reorganization is treated like a sale, there is a day of reckoning before the lottery drawing. If the reorganization is treated like an exchange offer as it was during the era of the equity receivership, the new securities preserve the relative positions of junior and senior parties until after the drawing. If the unsecured creditors could bring about a nonbankruptcy restructuring, such as an exchange offer that pushed out the maturities of the loan, they still have a chance of receiving something. There might be above-average snowfall.

But the outcome in chapter 11 is different. The unsecured creditors will receive nothing in a reorganization even if it later turns out that there is above-average snowfall. Measuring value at a discrete moment in time extinguishes option value. The decision to file for chapter 11 and the valuation that comes with it leaves junior parties worse off and senior creditors correspondingly better off. Contrary to *Butner*, the senior creditors enjoy a windfall by the happenstance of bankruptcy.

The New Dealers who imposed the virtual sale paradigm did not understand that they were making a choice.[23] To be sure, the equity receivership took the form of a sale, but the investment bankers did not

[22] *See* Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PENN. L. REV. 785, 791–93 (2017).

[23] Jerome Frank's particularly vitriolic attack on Robert Swaine illustrates this point vividly. *See* Jerome N. Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 VA. L. REV. 541, 541–42 (1933).

believe it should have the substantive effect of a sale. They saw a corporate reorganization as cut from the same cloth as an exchange offer. The whole idea was to replace old instruments with new ones of equal value. The new capital structure was supposed to leave everyone better off.

Of course, the investment bankers operated with norms that did not require an explicit articulation of how to implement such a regime of relative priority, but implementing it is simple enough. Indeed, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 sets out one way in which such option value could be implemented.[24]

It is also possible to explain the problem using the basic language of finance. Both regimes treat junior investment instruments as options on the senior debt with a strike price equal to the amount of the senior debt. The only difference is that the current regime accelerates the exercise date to the time of the reorganization.[25]

There are many reasons to support the status quo, but it is nevertheless important to understand that a choice is being made. And it is a choice with consequences. Again, the filing of a chapter 11 petition effects a sudden increase in the value of senior investment instruments and a corresponding decrease in the value of junior ones. Parties take this into account in the run up to bankruptcy. Junior creditors have an incentive to put off a chapter 11 filing even when such a delay is not the best course for the business.

This problem is one that parties were able to navigate in the first few decades under the Bankruptcy Code. Dispersed public shareholders were not the ones deciding whether to enter chapter 11. Secured creditors held

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[24] *See* AMERICAN BANKRUPTCY INSTITUTE COMMISSION TO STUDY THE REFORM OF CHAPTER 11, 2012–2014: FINAL REPORT AND RECOMMENDATIONS, 208–09 (2014). Under this scheme, the option value of the junior interest would be converted into a claim. Option value itself would be based on the evidence that the parties themselves introduce. As the report explains, "The parties may, for example, demonstrate the existence, or lack, of any redemption option value through generally accepted market-based valuation models, including the Black–Scholes option pricing model, using reasonable assumptions based on the facts of the particular case." *Id.* at 210.

[25] Indeed, identifying priority regimes using the language of options is sufficiently commonplace that there is a name for the options associated with absolute and relative priority—Bebchuk and Bernstein options respectively. *See* Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 786 (1988); Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1963–65 (2006).

the levers of control. They could orchestrate a reorganization in which they ended up with ownership of the firm, the junior debt could be squeezed, and the equity could be extinguished. The managers of the firm were willing to cooperate with the lenders. The prospect of receiving retention bonuses during the reorganization (and perhaps even keeping their jobs afterward) was enough to get the managers to help the secured creditors. Members of the board did not stand in the senior creditor's way either. Corporate directors are much more interested in protecting their reputations and ensuring that the business does not blow up on their watch than ensuring that the option value of the public shareholders is protected.[26]

In recent years, however, the discontinuity that arises under the absolute priority rule has become more of an issue. Increasingly, large businesses in economic distress are portfolio companies of a private equity firm. The private equity firm holds the levers of corporate control. Because the option value of their interest in their portfolio companies disappears with bankruptcy, a private equity firm will take enormous efforts to prevent a chapter 11 petition from being filed. Indeed, much of the action today in the restructuring space lies in liability management exercises that push out maturities on their loans and protect the option value that exists outside of chapter 11 but vaporizes inside it.

In short, the way that nonbankruptcy rights are converted into bankruptcy claims requires a stark choice, even for the bankruptcy minimalist. Absolute priority is easy to understand and implement. Before distress, it gives a powerful incentive to equityholders and those beholden to them to maximize the value of the business.[27] Moreover, as going-concern sales in bankruptcy become increasingly commonplace, giving a reorganization the same consequences as an actual sale makes increasing sense.[28]

On the other hand, a more recent line of thought embraces a different perspective. To be sure, providing incentives to equityholders matters, but providing incentives should not be front and center. The point of focus should instead be on the reorganization forum. The rules should not ignore

[26] *See* Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593, 608 (2017).

[27] *See* Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy*, 72 WASH. U. L.Q. 1213, 1224 (1994).

[28] For an examination of the increasing importance of sales in chapter 11, see Roe & Simkovic, *supra* note 17.

ex ante incentives, but the principal focus should be on whether reorganization law creates an effective bargaining environment in which the players can work to fix the firm's financial distress.[29] From this vantage point, chapter 11's valuation mechanism, one that introduces a discontinuity and produces winners and losers, should not be taken as immutable and inevitable.

III. SEPARATING THE DANCER FROM THE DANCE

Modern firms in reorganization often have much more than funded debt on their balance sheets. The characteristics of many nonbankruptcy rights make them hard to translate into bankruptcy claims. Sorting out all these rights is not as simple as converting one sort of funded debt instrument into another. This problem is another dimension over which bankruptcy minimalism needs to be examined, and it is the focus of this part of the essay.

Separating substantive rights from the procedures used to vindicate them seems sensible enough when the right in question is merely a right to recover money that the debtor has borrowed. The creditor's nonbankruptcy right is a right to recover a fixed amount of cash. But the Bankruptcy Code defines "creditor" expansively.[30] A creditor is someone who holds a "claim," and a claim includes virtually any legal right that comes with a monetary recovery.

When a bankruptcy court reduces many legal rights to a dollar amount, much is lost in translation. A large retail chain enters chapter 11 with many unpaid suppliers. These suppliers are effectively investors in the business. And there are leases. A large part of large retailer chapter 11s concern themselves with sorting out which leases to reject or assume and which ones to renegotiate. The way that the rights of the landlords are treated in the bankruptcy forum drives the dynamics of these reorganizations. The treatment of leases is not as simple or as straightforward as putting a value on and establishing the priority rights of a tranche of funded debt.

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[29] *See* Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709, 1751–53 (2020).

[30] A "creditor" includes any entity holding a "claim" against the debtor that arose at or before the order for relief. 11 U.S.C. § 101(10). A "claim" includes any right to payment even if unliquidated, contingent, unmatured, and disputed, as well as any right to equitable relief for breach of performance that gives rise to a right of payment. 11 U.S.C. § 101(5).

This part of the essay begins with an extreme example, and then confronts the question of whether this example is merely an exotic exception that proves the rule, or whether the problem is a more fundamental one that complicates a minimalist account of corporate reorganizations. If solving the collective action problem requires breaking a lot of china, then even the minimalist must confront the question of whether the bankruptcy policy of maximizing value should give ground to the policies that undergird the nonbankruptcy right.

Consider the challenge presented if a screenwriter's nonbankruptcy right to screen credit were invoked in the bankruptcy forum. Given the number of writers who work on a movie, it is not always easy to tell which one among them deserves the credit. Nevertheless, screenwriters care intensely about getting the recognition they deserve. Moreover, producers want to be able to identify who wrote the screenplays of successful movies. Hence, everyone wants a mechanism that ensures that screen credit is awarded correctly. Outside of bankruptcy, disputes over screen credit are resolved through arbitration. The arbitration process, however, is most unusual.

The Writers Guild of America (WGA) oversees the process.[31] There are not the usual retired judges or veteran members of the American Arbitration Association. An officer of the WGA picks three screenwriters who are members of the WGA and who, if possible, have written comparable screenplays. The arbitrators are each given the drafts and full access to all the necessary materials. Significantly, their identity is concealed, both from the parties and from each other. Moreover, the arbitrators themselves do not know the names of the screenwriters whose work they are judging. There are appeals from the arbitrators' decisions, but the appeals focus only whether the procedures were followed. Those conducting the appeal have no access to the evidentiary record.

The process is designed to ensure that disinterested experts with access to all the relevant evidence determine screenwriting credit. The process ensures that the arbitrators will not play favorites. The arbitrators do not even know whose work they are judging. Nor do the arbitrators fear that powerful players in Hollywood will retaliate against them. Their identities are hidden. The procedure makes the screen credit itself more trustworthy.

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31 *See* WRITERS GUILD OF AMERICA, SCREEN CREDITS MANUAL (2021), https://www.wga.org/contracts/credits/manuals/screen-credits-manual.

Future producers can be confident that the person who received the screen credit for a film actually wrote the screenplay. Even when there is no dispute and no arbitration, the prospect of arbitration ensures that screen credit is given to the person who deserves it. The résumés of screenwriters can be taken at face value.

Consider now the following hypothetical. Imagine that Producer, a famous actor/director/producer, collaborates with Screenwriter. Screenwriter produces a draft, and Producer makes changes. Others are brought in and further change the screenplay in various ways before the film is shot. The film is finished except for the screen credits. At this moment, Producer files for bankruptcy relief. Screenwriter insists on being given screen credit. Screenwriter believes that he is responsible for more than half of the final shooting script. Under the rules of the WGA this amount of work entitles him to sole screen credit. Producer disagrees. Producer thinks that Screenwriter wrote less than 33 percent of the final shooting script and that he, Producer, wrote over half. Therefore, Producer believes he is entitled to sole screen credit.[32]

Under his contract with Screenwriter, Producer would owe a great deal of additional money to Screenwriter if he were entitled to screen credit. Producer, however, insists that he wrote the script and Screenwriter's contribution was trivial. Neither Screenwriter nor anyone else is owed additional royalties. The money that would otherwise go to Screenwriter is instead property of the bankruptcy estate. Screenwriter protests and demands arbitration, both for screen credit and the higher royalties that come with it. Let us assume that the WGA process will take time and might delay the release of the film.

Does the bankruptcy judge have the power to decide both the screen credit issue and estimate the royalties Screenwriter is owed? Producer argues that Screenwriter is just a creditor with a claim. In the alternative, even if the film is property that is potentially subject to Screenwriter's quasi-property right to have screen credit, Producer asserts it is a dispute about property of the bankruptcy estate. This too is something over which the bankruptcy court has jurisdiction. The bankruptcy judge has the power

[32] As a production executive and subsequent writer, Producer must contribute more than 50% to receive credit. Screenwriter is entitled to credit as the first writer for a contribution of more than 33%. *See* WRITERS GUILD OF AMERICA, *supra* note 31, at 22.

under § 1334 to determine whether Screenwriter is entitled to screen credit. Moreover, because time is of the essence, it promotes the reorganization process and maximizes the bankruptcy estate for the bankruptcy judge to make the call. Consistent with *Butner*, chapter 11 respects Screenwriter's rights, but these rights are adjudicated in the bankruptcy forum.

From this perspective, Screenwriter is no different than someone who claimed to be the original owner of a piece of jewelry that a debtor listed as property of the estate. If the jewelry now in the hands of the trustee had been stolen from the original owner, the original owner would be entitled to recover it from the bankruptcy estate under the rule of *nemo dat*, but whether someone is in fact the original owner is a matter for the bankruptcy judge to decide.[33] Whether the person purporting to be the original owner has a conversion action for damages or the right to get the piece of property back is something that the bankruptcy judge decides. The first is just a claim and the second is a question about property of the estate. Deciding both is what bankruptcy judges do.

Screenwriter takes a different view. Screenwriter asserts that the relevant rights are bound up in the nonbankruptcy procedure. In other words, the nonbankruptcy right is not merely screen credit per se, but a certification from disinterested experts that Screenwriter was the principal screenwriter. That is what screen credit means under state law. A determination by WGA arbitrators that Screenwriter deserves screen credit is career-altering. By contrast, a bankruptcy judge's determination that Screenwriter wrote the screenplay counts for nothing in this industry. One cannot separate the screen credit from the WGA arbitration from any more than one can separate the dancer from the dance.

To be sure, the bankruptcy court could exercise its discretion and allow the arbitration process to proceed. But there is a trade-off that must be made. By assumption, the arbitration process will delay the opening of the film and reduce its box office revenue. Allowing the arbitration process to go forward stands in tension with the goal of maximizing the value of the estate. Even a minimalist needs some way to make this balance.[34]

[33] "*Nemo dat*" is a shortened form of the Latin maxim, "Nemo dat quod non habet." No one can give what they do not have. It captures one of the core ideas of Anglo-American property law: a purchaser of property presumptively acquires only the rights of the transferor.

[34] For a minimalist account of arbitration and bankruptcy, see Anthony J. Casey & Joshua Macey, *The Bankruptcy Tribunal*, 96 AM. BANKR. L.J. 749 (2022). For two

There is a corresponding problem when the debtor enjoys a right and the question becomes the appropriate forum to assess and weigh that right. Running parallel to *Butner* is *Board of Trade of City of Chicago v. Johnson*.[35] The property the debtor enjoys in bankruptcy should be the same as the property the debtor enjoys outside of bankruptcy. A debtor's seat on the stock exchange enters bankruptcy with the same attributes and subject to the same limitations that it had outside of bankruptcy. But this still leaves open the question of whether disputes about the contours of the property right are appropriately adjudicated in the bankruptcy forum. Again, the procedural forum shapes the substantive right.

Consider a sports team that enters chapter 11. The team has value because it plays in a league. The ability to play in a particular league brings with it valuable television revenues and much else. The contract that gives the team the right to play in the league might provide that the team's right to continue as a member of the league turns on it following its rules, such as a cap on the amount of money it can spend on player contracts. The league asserts that the team has violated its financial fair play rules and wants to terminate the contract. The team argues that it has complied with the league's rules.

In its contract with each team, the league lays out the procedures it will use to determine whether a team is in or out of compliance with its rules. When a team is in bankruptcy, does the bankruptcy court determine whether the team has broken the rules, or can the league insist on its bespoke mechanism? Or to ask the same question differently, is the league's way of assessing compliance an attribute of a property interest that must be respected in bankruptcy?[36]

Of course, bankruptcy judges will ordinarily defer to nonbankruptcy mechanisms when they offer prompt and expeditious resolution of the question. No bankruptcy policy is advanced by having the bankruptcy judge interpret the contract instead of some other competent judge. But it is

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excellent, nonminimalist accounts, see Robert M. Lawless, *Reframing Arbitration and Bankruptcy*, 96 AM. BANKR. L.J. 701 (2022); Stephen J. Ware, *Arbitration Agreements as Executory Contracts in Bankruptcy after* Mission Prod. Holdings, Inc. v. Tempnology, LLC, 96 AM. BANKR. L.J. 769 (2022).

[35] 264 U.S. 1 (1924).

[36] *See* Jared I. Mayer, *Control Rights and Chapter 11's Expanding Scope*, 98 AM. BANKR. L.J. 341, 355–57 (2024).

possible that the nonbankruptcy mechanism will delay the case or otherwise interfere with goal of maximizing the bankruptcy estate (holding constant the underlying merits).

It might seem that the screen-credit hypothetical and the sports league controversy are exotic sorts of rights. If these sorts of problems were confined to them, the difficulties posed to a minimalist version of corporate reorganizations might be modest. It is possible, however, to argue that the forum in which a right is adjudicated is often an essential attribute of the right. Again, when there is funded debt and hard assets, it may not matter much. There is no dispute about the debtor's obligation or property, only whether the property is worth enough to satisfy the debt. Again, the railroad cases provide a relatively easy case for minimalism. But many rights in bankruptcy are contested, and the forum makes a difference.

The matter is especially salient with simple tort claims. A tort victim outside of bankruptcy has the right to confront her tortfeasor in open court, have damages assessed by a jury of her peers, obtain a judgment, and seek out whatever assets the debtor owns including various insurance policies. This is not the same thing as being able to file a claim with a litigation trust and only a constrained ability to demand a jury trial. To be sure, the latter course might bring the most value to the creditors as a group, but the translation to the bankruptcy forum nevertheless dramatically alters the nature of the substantive nonbankruptcy right.

IV. THE GLOBAL PEACE PROBLEM

During the reorganizations of the great nineteenth century railroads, the collective action problem that the creditors faced was plain. Too many creditors were chasing the same hard assets. It made no sense for some creditors of a railroad to seize the lefthand rails while others seized the righthand ones. But this is not the only collective action problem that creditors of modern businesses face. Large businesses have tentacles that reach far and wide. A debtor's creditors may also have claims against third parties by virtue of their claims against the debtor. Even if reorganization law should focus on problems that arise when many creditors of a common debtor cannot act as one, the question still remains whether reorganization law should focus narrowly on the creditors' efforts to recover assets from the debtor or whether the law should include other collective action problems that creditors face by virtue of their dealings with a common debtor.

For example, consider a debtor with an insurance policy. In addition to being able to sue the debtor, individual tort victims might also have the right to sue the insurance company up to the policy's cap. The insurance policy might be the only unencumbered asset that the debtor possesses. Each individual creditor has an incentive to sue the insurance company before the policy cap is reached. This too is a collective action problem.[37]

It makes little sense to say that the creditors' collective action problem with the insurance company should be sorted out in a bankruptcy of the insurance company. Even if the insurance company were eligible for bankruptcy, rather than limited to the state procedures for wrapping up distressed insurance companies, the problem has nothing to do with the financial condition of the insurance company. The collective action problem exists because of the cap on the debtor's insurance policy.

The creditors as a group might prefer a single settlement in the debtor's restructuring that includes a payout from the insurance company into a fund in which they all share. The trustee could act on their behalf. This prospect might be more attractive than if each creditor, in addition to sharing whatever assets the debtor owned, had to rely on its own devices to sue the insurance company. Each creditor would face the substantial costs of bringing discrete actions. Of course, the creditors could join forces and pursue the insurer independent of the debtor, but there might be holdouts who sought to bring individual actions against the insurance company. Binding would-be defectors is essential to solving any collective action problem.

It might seem that solving all the collective action problems that creditors of a common debtor have by virtue of their relationship with a common debtor is properly the business of reorganization law. Achieving global peace may be essential to putting the debtor's financial house in order. Having the trustee sort out the creditors' rights against the insurance company might make the creditors as a group better off. Litigation expenses might be dramatically lower. Moreover, if the trustee were empowered to make a settlement on behalf of all the creditors, the bargaining position of the creditors as a group might be stronger. The insurance company could not engage in any divide-and-conquer strategies.

[37] *See, e.g.*, *In re* OGA Charters, LLC, 901 F.3d 599, 604 (5th Cir. 2018).

But it is possible to take a different view. Perhaps reorganization law should focus only on the rights that creditors have against a debtor. Bankruptcy is about the rights of creditors against a debtor that is financially distressed. The creditors might have rights against third parties by virtue of this relationship, but this is neither here nor there. If that third party is insolvent and eligible for bankruptcy, the creditors can put the third party into bankruptcy. And even if the trustee could not bring the action, the trustee might still be able to solve some of these problems without bringing litigation against the third party on behalf of the creditors. In the insurance case, for example, the trustee could argue that the policy is property of the estate. Alternatively, the trustee might have the power to sell the policy back to the insurance company. Recovery against the insurance company could still rest exclusively in the hands of the trustee even if actions against third parties are ordinarily out of bounds.

Even if the trustee cannot solve the collective action problem, the creditors can turn to a class action or multi-district litigation. To be sure, if these other procedures do not work effectively, there is a need for law reform, but not for bankruptcy reform. Rights that creditors enjoy against solvent third parties are not the province of the law of corporate reorganizations.

Demarcating the domain of the collective action problems that reorganization law should solve requires taking multiple steps back. As *Purdue* made its way to the Supreme Court, much of the debate centered on whether a plan can include a settlement of the rights that creditors of a common debtor have against third parties on the ground that including such a release in a plan is an "appropriate provision not inconsistent with the applicable provisions" of the Bankruptcy Code.[38] But this itself was somewhat puzzling. It was odd that the trustee's power to settle the action should be located only in chapter 11. Creditors of a common debtor can face the same collective action problem even when the firm is liquidating. The questions that arise in the wake *Purdue* are not likely to be so narrowly focused. Asking, for example, what constitutes consent on the part of creditors to the release of third parties is not a question of plan voting, but rather turns critically on what it takes for a party as a matter of nonbankruptcy law to give up a legal right.[39]

[38] 11 U.S.C. § 1123(b)(6).

[39] *See* In re Smallhold, Inc., No. 24-10267 (CTG), 2024 WL 4296938, at *2 (Bankr.

It was also a mistake for the advocates in *Purdue* to frame the issue of nonconsensual third-party releases in terms of whether the third party should be able to "discharge" obligations without having to file for bankruptcy. A third-party release in bankruptcy is nothing more or less than a settlement of a lawsuit by the trustee on behalf of a group of creditors. Part of any settlement is the release of rights by the plaintiffs against the defendant. The party who is released in return for a monetary settlement is in the same position as anyone else who is willing to pay something to make a lawsuit go away. The question is whether the defendant, however despicable, is paying enough, not whether it is honest, but unfortunate. Calling such a release a discharge confuses two radically different ideas.[40]

The debate should properly focus on whether the trustee should have this power to act on behalf of creditors. Moreover, if the trustee pursuing a third-party release on behalf of the creditors is merely settling a lawsuit, the decision of the Supreme Court in *Purdue* is relatively easy to explain. It would be odd if someone had the power to settle a piece of litigation but lacked the power to litigate in the first instance, and the Supreme Court has long held that the trustee cannot bring actions that creditors have against a third party by virtue of their relationship with a common debtor.[41]

It is mystifying that none of the litigants confronted this oddity, especially because the law is so well-settled that the trustee lacks the power to bring these actions on behalf of creditors. Indeed, Congress expressly considered overruling this principle when it enacted the Bankruptcy Code and chose not to do so.[42] In the face of this principle, anyone arguing that trustees under current law had the power to settle actions that they cannot bring should have had a tough row to hoe.

This part of the essay, however, does not focus on the mystery of why

D. Del. Sept. 25, 2024).

[40] For example, some debts, such as claims for fraud, are nondischargeable in chapter 7. It makes little sense, however, to have any action that the trustee brings against an individual be treated as if it were a nondischargeable debt. If the individual cannot be freed of the "nondischargeable" debt, no settlement is possible. Parties are induced to settle only because settlements release them from liability. Absent the ability to settle, the trustee can recover nothing for the creditors until their claims are reduced to a final judgment. This makes no sense. Dischargeability should have nothing to do with the ability of the trustee to compromise claims.

[41] *See* Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972).

[42] *See* H.R. 8200, 95th Cong. § 544(c) (1977).

the litigants (and the Supreme Court itself) failed to rely on or even to cite a precedent that held that the trustee had no power to bring actions creditors had against third parties. Instead, the essay tries to explore the problems inherent in expanding the scope of the collective problems that reorganization law solves beyond a limited domain.

Begin again with a simple hypothetical. Imagine that a debtor that runs a decent business. One of its managers embarks on a new venture promising it will earn the firm handsome profits. It turns out that the venture does not work as promised. Indeed, it fails utterly, and before it failed, this manager may have veered from an aggressive business plan to outright fraud. This manager claims innocence and asserts that the venture would have been profitable for the debtor if only the chips had fallen a little differently. The injury varies from one victim to the next, and most were damaged only to the extent of a few hundred dollars, but there are many thousands of these victims and the total liability to them is likely in the millions.

The debtor is carrying a large amount of funded debt that is unsecured. As a result, the victims will recover only a few cents on the dollar unless the trustee can enhance the value of the estate. It happens that the now-disgraced and newly-fired manager employed the services of an accounting firm to give the venture the appropriate respectability. Exactly what the partner at the accounting firm who did the work was doing is not clear. He might have been duped, looked the other way, or actively participated in what might have been an outright fraud. In all events, the accounting firm was handsomely rewarded, and the partner earned substantial bonuses for the work done at the behest of the manager. The accounting firm is, in other words, a potential deep pocket.

The debtor files a bankruptcy petition. The bankruptcy judge quickly appoints a trustee. In addition to trying to salvage the legitimate parts of the business, the trustee must confront what may have been a massive fraud that the former manager perpetrated with the help of the accounting firm.

The trustee has a potential fraudulent conveyance action against the accounting firm. The manager might have paid the accounting firm as part of a scheme to hinder, delay, or defraud the victims. To be sure, the accounting firm provided value in return for the fees it charged, but this is irrelevant if it did not act in good faith. Even if the partner was merely duped, the accounting firm may be obliged to return the money. Good faith requires more than honesty in fact, and if the accounting firm saw enough red flags, it did not act in good faith.[43] This sort of fraudulent conveyance problem is regularly litigated and typically settled.

There is also the possibility that the partner at the accounting firm was, far from being duped, quite aware of the mischief that the debtor's former manager was perpetrating. The key issues—what exactly the accounting firm knew about the potential fraud—closely parallel the issues that arise in the fraudulent conveyance action. Of course, the fraudulent conveyance action is likely the main event. It is much easier to bring a fraudulent conveyance action than one for common law fraud, but the accounting firm must worry about its exposure to both causes of action.

The trustee has the unequivocal power to bring the fraudulent conveyance action against the accounting firm, but the trustee cannot assert the aiding and abetting action against the accounting firm on behalf of the debtor. To be sure, the accounting firm contributed to the debtor's large losses, but the debtor's own manager was the principal wrongdoer, and this manager was not stealing from the debtor. Even though the outcome was most unfortunate from the debtor's perspective, the manager was acting at least in part to benefit the debtor's business as a whole. This is enough to prevent the debtor from bringing the action. The debtor is in pari delicto.[44] And under *Caplin* the trustee has no ability to bring the action on behalf of the creditors, nor can the trustee extract a settlement, at least not without the consent of each creditor.

With respect to the aiding and abetting action, the creditors face a collective action problem that arises out of their dealings with a common debtor. Each suffered only a few hundred dollars in damages. As with the fraudulent conveyance action, no single victim would find it worthwhile to bring the aiding and abetting action. Moreover, each of the victims suffered from a slightly different sort of harm. These differences may limit the availability of an ordinary class action.

If the trustee were able to bring both the fraudulent conveyance and the aiding and abetting actions, the litigation costs would be much lower. Moreover, the accounting firm might be more willing to settle and for more.

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[43] *See* Picard v. Citibank, N.A. (*In re* Bernard L. Madoff Inv. Sec. LLC), 12 F.4th 171, 186–87 (2d Cir. 2021).

[44] *In pari delicto* is an equitable doctrine that prevents one wrongdoer from seeking redress from a fellow wrongdoer. *See* Kirschner v. KPMG LLP, 938 N.E.2d 941 (N.Y. 2010).

If the accounting firm can settle all causes of action with the trustee, the accounting firm can put the entire exposure behind it. The accounting firm may be unwilling to settle the fraudulent conveyance action by itself, given that it faces the same exposure again from the suits of the individual creditors. The accounting firm might prefer to force the trustee to litigate. There is a chance that the accounting firm can persuade a jury that it acted in good faith or that the payments to it were not part of an effort by manager to hinder, delay, or defraud.

There are, of course, differences between the aiding and abetting action and the fraudulent conveyance action. The latter is an in rem action. The trustee is attempting to recover cash paid to the accounting firm as part of an effort to hinder, delay, or defraud. Before being turned over to the accounting firm, the cash was an asset on which the creditors could levy. The trustee is recovering property that once belonged to the debtor. By contrast, when the trustee brings an action against the confederate for aiding and abetting common law fraud, the trustee is not recovering any assets that ever belonged to the debtor.

But if one conceives of corporate reorganizations as a procedure that solves a collective action among creditors, the traditional bankruptcy distinction between in rem and other actions that creditors have by virtue of their relationship with a common debtor may not be relevant. There is the same collective action problem in both cases. The in rem distinction does not explain why bankruptcy should solve one collective action problem, but not another.

It would be a simple matter to add a new subsection to § 544 to allow the trustee to bring actions such as the aiding and abetting action. Such a § 544(c) would be consistent with a general movement in commercial law away from making legal rights turn on traditional notions of asset ownership.[45] But there is no such provision in the Bankruptcy Code. Such a provision was in early versions of the bill that became the Bankruptcy Reform Act of 1978, but it was dropped. The omission of this hypothetical § 544(c) was not an oversight, but rather a deliberate decision.

A possible reason for Congress's decision to deny the trustee this power

[45] For example, the 2001 revision of Article 9 no longer requires the debtor to have rights in the collateral in order for the security interest to attach. Power over the collateral suffices as well. *See* U.C.C. 9-203(b)(2).

may have been its unwillingness to extend or to limit *Moore v. Bay*.[46] *Moore v. Bay* has long been a source of trouble.[47] Among other things, *Moore v. Bay* provides that whenever the trustee brings an avoidance action, the recovery is shared among all the general creditors, not merely those who could bring the action under nonbankruptcy law.

Proposed § 544(c) provided that any recovery that the trustee recovered (including from any settlement from the accounting firm for the aiding and abetting action) would not be shared between those who could bring the action outside of bankruptcy and the other creditors (in this example, the tort victims and the holders of the funded debt). This makes good sense, but this part of proposed § 544(c) stood in tension with § 544(b). It also complicates the trustee's job in the example. Instead of a single lump sum, the trustee would have to determine how much of what the accounting firm offered to gain its release was on account of the fraudulent conveyance action (and hence shared among all the creditors) and how much was due to the aiding and abetting action (and hence shared only among the fraud victims).

If the trustee recovered only on behalf of the affected creditors under § 544(c), it naturally raises the question of why the trustee should not have to do so as well under § 544(b). The debate about adding § 544(c) might have not so much been that empowering the trustee to act on behalf of creditors was inconsistent with the first principles of bankruptcy, but rather that it was at odds with *Moore v. Bay.*

The complications of *Moore v. Bay* might be resolved, and the connection between the power to bring actions on behalf of creditors and the power to settle them might be squarely confronted. But even if this were done, the underlying challenge remains of demarcating the boundaries of the collective action problem that reorganization law ought to solve. Drawing the boundary at the debtor's transfers of property might be sensible, not so much because this boundary possesses any magic, but because it is, in the grand scheme of things, relatively clear.

[46] 284 U.S. 4 (1931).

[47] *See* Thomas H. Jackson, *Avoidance Powers in Bankruptcy*, 36 STAN. L. REV. 725, 742–50 (1984); Emil A. Kleinhaus, *Let's Rethink* Moore v. Bay, 34 AM. BANKR. INST. J. 28 (Sept. 2015).

V. CONCLUSION

This essay has revolved around hypotheticals that present hard puzzles for the now-dominant account of complex corporate reorganizations: chapter 11's discontinuity at the moment of valuation; the tight connection between substantive rights and the procedures that vindicate them; and the extent the trustee should be empowered to act on behalf of creditors. Much of the success of the minimalist account of reorganization law comes from the way that these problems rarely surface. Negotiations are the lifeblood of reorganization law, and during negotiations the rough edges that these puzzles might present can be sanded away. As a result, they tend not to stand in the way of a restructuring plan. But it might be that they should not be brushed to one side so easily.

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