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BANKRUPTCY ON THE SIDE

*Kenneth Ayotte, Anthony J. Casey,
& David A. Skeel, Jr.*

ABSTRACT—This Article provides a framework for analyzing side agreements among stakeholders in corporate bankruptcy, such as intercreditor and “bad boy” agreements. These agreements are controversial because they commonly include a promise by a stakeholder to remain silent—to waive some procedural right they would otherwise have under the Bankruptcy Code—at potentially crucial points in the reorganization process.

Using simplified examples, we show that side agreements create benefits in some instances. But, in other cases, parties to a side agreement may attempt to extract value from nonparties to the agreement by contracting for specific performance or excessive stipulated damages that impose negative externalities on those nonparties. By using more extreme (and inefficient) remedies, the parties to the agreement can commit themselves to charging more to nonparties who—seeking to avoid the externalities—pay them to breach the agreement. While this can be profitable for the parties to the agreement, it can also lower the collective value of the estate for all stakeholders.

We develop a proposal that not only preserves the efficiency benefits of side agreements but also limits negative externalities and opportunities to extract value from nonparties. Where a nontrivial potential for value-destroying externalities exists, the court should enforce the agreements but limit the remedies for breach to expectation damages. Our proposal is superior to the current approach in the case law, which focuses on tougher contract interpretation standards instead of limitations on remedies.

We also use our model to determine whether intercreditor agreement disputes should be resolved by the bankruptcy court or by other courts. If the nonbreaching party asks for expectation damages, the bankruptcy court has no particular expertise and should defer to forum selection clauses. Where the nonbreaching party seeks specific performance or stipulated damages, by contrast, our model suggests that the dispute should be resolved exclusively in bankruptcy proceedings.

NORTHWESTERN UNIVERSITY LAW REVIEW

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INTRODUCTION

The Bankruptcy Code was designed to resolve coordination problems that arise when multiple creditors hold claims against a common debtor.¹ In broad terms, the Bankruptcy Code tries to strike a balance between respecting the individual rights held by creditors and limiting the negative impact of the exercise of those rights on the value of the company's assets as a whole.² Bankruptcy adds the most value when creditors and other stakeholders are dispersed and uncoordinated, making bargaining outside bankruptcy costly or impossible. To encourage coordination toward reaching a value-maximizing outcome in those cases, the law suspends creditors' individual collection efforts and creates a structured bargaining process.³

Resolving coordination problems while respecting individual rights is a challenging task, even in garden-variety cases. But recent developments in the financing structure of firms have added additional layers of complexity to the problem. In a spate of recent cases, bankruptcy judges have been asked to resolve disputes regarding side agreements between two or more stakeholders who form a subset of the overall stakeholder body.⁴ A common example of such a side agreement is an *intercreditor agreement*, whereby two creditor groups, and sometimes the debtor, agree on how to allocate cash flow and control rights between the parties to the agreement when a bankruptcy occurs.⁵ Outcomes in large corporate reorganization cases—not only the division of value but also what happens to the company itself—can turn on the judge's interpretation and enforcement of such a side agreement as well as on the secondary and tertiary deals arranged by one or more of the parties to work around that original side agreement. Disputes about the side agreement or the subsequent

¹ Even over a century ago, lawmakers recognized that if creditors were left to their state law collection remedies, they might “race to the courthouse,” potentially destroying the going concern value of an otherwise viable firm. Bankruptcy's role in solving this coordination problem is the focus of the principal normative theory of bankruptcy, the “creditors' bargain” model. See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 10–11 (1986).

² For example, although secured creditors are not permitted to foreclose on their collateral (because the collateral may be needed for a reorganization or other resolution of the debtor's financial distress), the Bankruptcy Code does require “adequate protection” of secured creditors' interests. 11 U.S.C. § 362(d)(1) (2012).

³ See 11 U.S.C. § 362(a) (2012) (imposing a stay on collection activities).

⁴ See, for example, the cases discussed *infra* Part V.

⁵ For a practitioner-oriented discussion of intercreditor agreements and the issues they raise in bankruptcy, see Jeffrey A. Marks, *Bankruptcy Issues in Intercreditor Agreements*, SQUIRE PATTON BOGGS (May 31, 2009), http://www.squirepattonboggs.com/~media/files/insights/publications/2009/05/bankruptcy-issues-in-intercreditor-agreements/files/intercreditor_agreements_2009/fileattachment/intercreditor_agreements_2009.pdf [https://perma.cc/A8N9-5UW2].

workaround arrangements—which we will call “defections”—have become one of the most important controversies in an increasing number of recent cases.⁶

A common theme in these disputes is the allegation that one of the parties to the side agreement breached a promise to be “silent” in some way, by asserting a right or taking an action that would otherwise be permissible under the Bankruptcy Code, but is prohibited by the agreement. Often, the dispute involves allegations by one of the parties to the side agreement (the promisee) that the other party (the promisor) has struck a new deal with another stakeholder to defect from the side agreement. Because the promisee alleges that this defection breaches the side agreement, the promisee then seeks to enjoin the defection. Thus, while the parties purportedly write these agreements to encourage coordination and limit unnecessary litigation, they are often invoked to shut down new coordination efforts.

The recent *Momentive* case provides an example of the kinds of side agreements and defections that can arise.⁷ Momentive Performance Materials (Momentive), a silicone and quartz manufacturer that had been acquired by a private equity fund in 2006, entered bankruptcy with a capital structure that included first- and second-lien secured debt, and other categories of unsecured debt.⁸ Prior to bankruptcy, the first- and second-lien creditors signed an intercreditor agreement that restricted the ability of the second-lien note creditors to enforce certain rights that would have been available to them as secured creditors.⁹ After Momentive filed for bankruptcy, the second-lien creditors reached a deal to defect with the debtors (called a *restructuring support agreement*) that would reorganize the company and give the stock of the reorganized Momentive to the

⁶ See, e.g., *In re Musicland Holding Corp.*, 386 B.R. 428, 438 (S.D.N.Y. 2008) (holding that the unambiguous language of the intercreditor agreement must be followed despite the subordinated creditors having a different understanding of its terms), *aff'd*, 318 F. App'x 36 (2d Cir. 2009); *In re TCI 2 Holdings, LLC*, 428 B.R. 117, 141 (Bankr. D.N.J. 2010) (holding, in a case involving competing plans of reorganization, that the court did not need to determine whether the second lien holders' plan violated the side agreement because, even with a violation, confirmation would not be impeded); *In re Hart Ski Mfg. Co.*, 5 B.R. 734, 736 (Bankr. D. Minn. 1980) (early case addressing the enforceability of intercreditor agreements under Bankruptcy Code § 510(a), holding that there is no indication that Congress intended to allow creditors to alter, through subordination agreements, bankruptcy provisions unrelated to asset distribution).

⁷ See *In re MPM Silicones, LLC*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014). We discuss the *Momentive* controversy in detail in Parts II.B and IV, *infra*.

⁸ *In re MPM Silicones, LLC*, 531 B.R. 321, 324–25 (S.D.N.Y. 2015), *aff'd in part, rev'd in part*, No. 15-1682, 2017 WL 4772248 (2d Cir. Oct. 20, 2017).

⁹ *MPM Silicones*, 518 B.R. at 751.

second-lien creditors.¹⁰ The second-lien creditors also supported actions the debtor took and arguments the debtor made to reduce the value that the first-lien creditors would receive.¹¹ The first-lien creditors sued the second-lien creditors in state court for violating the intercreditor agreement, but the litigation was removed to the bankruptcy court and decided after the plan was confirmed.¹² The court decided in favor of the second-lien creditors. In part, the judge reached this decision because he concluded that the ambiguous language of the intercreditor agreement should be read in favor of preserving second-lien creditors' bankruptcy rights.¹³ According to the judge, it was not "clear beyond peradventure" that the second-lien creditors had waived their rights in the agreement.¹⁴

In the *RadioShack* case,¹⁵ a bankruptcy judge took a notably different approach. The electronics retailer entered bankruptcy with two groups of secured creditors and an intercreditor agreement defining the rights of the two groups.¹⁶ Adding to the complexity, the creditors within each secured lender group divided themselves into classes via separate side agreements (called *agreements among lenders*, or AALs).¹⁷ In one of the AALs, the party in a junior priority position, the hedge fund Salus Capital Partners, was prohibited from objecting to any sale that the senior priority creditors, including the hedge fund Cerberus Capital Management, agreed to.¹⁸ When Salus raised an objection to a motion by RadioShack to sell its assets, Cerberus invoked the AAL to argue that Salus had no standing to object because Cerberus favored the sale.¹⁹ In this case, the judge specifically enforced the agreement to deny standing to Salus because the AAL prohibited the objection.²⁰

¹⁰ *Id.* at 746.

¹¹ *Id.* (describing the alleged breaches of the intercreditor agreement).

¹² See Order Denying Remand Motion, BOKF, N.A. v. JPMorgan Chase Bank, N.A., No. 14-08247 (Bankr. S.D.N.Y. Sept. 9, 2014).

¹³ See *MPM Silicones*, 518 B.R. at 750.

¹⁴ *Id.* (quoting *In re Boston Generating, LLC*, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010)).

¹⁵ *In re RadioShack Corp.*, 550 B.R. 700 (Bankr. D. Del. 2016).

¹⁶ See *id.* at 704–07; Transcript of Hearing at 19, *RadioShack Corp.*, 550 B.R. 700 (Bankr. D. Del. (No. 15-10197) (March 30, 2015); Sarah R. Borders et al., *Client Alert: Recent Unitranche Issues in the RadioShack Bankruptcy Case 1*, KING & SPALDING (June 1, 2015), <http://www.jdsupra.com/legalnews/recent-unitranche-issues-in-the-87848/> [https://perma.cc/J92M-KGF9].

¹⁷ See Transcript of Hearing, *supra* note 16, at 5; Borders et al., *supra* note 16, at 1.

¹⁸ See Transcript of Hearing, *supra* note 16, at 62–63; Borders et al., *supra* note 16, at 2.

¹⁹ See Transcript of Hearing, *supra* note 16, at 63; Borders et al., *supra* note 16, at 2.

²⁰ See Transcript of Hearing, *supra* note 16, at 63–64. Even in *RadioShack*, the court did not consistently enforce intercreditor agreements. The court did not resolve a related dispute under the other AAL, which had the effect of declining to enforce that agreement. *RadioShack* is discussed in more detail in Section I.C and Section IV.C., *infra*.

Disputes like these raise a host of questions that have not yet been consistently or coherently resolved. Should a side agreement be treated like any other contract? When a party agrees to waive a right it would otherwise have in bankruptcy, should the waiver be enforceable? Should courts interpret ambiguously drafted terms against the party seeking to get around the Bankruptcy Code? If the waiver of the right is enforceable, what remedies should be available—should the right be specifically enforceable, as in *RadioShack*, or enforceable with damages, as was sought in *Momentive*? And procedurally, should these disputes be adjudicated inside or outside the bankruptcy courts?

This Article provides a framework for thinking about these questions. Using simplified examples, we demonstrate the beneficial and harmful potential of side agreements. We will focus on intercreditor agreements involving a senior creditor and a junior creditor, but the basic principles are general enough to apply to side agreements involving other subsets of stakeholders as well. In a so-called “bad boy” agreement, for instance, a debtor agrees with a subset of creditors not to file for bankruptcy.²¹ Another example is special purpose securitization vehicles, whose organizational documents keep some creditors silent by restricting their ability to negotiate with the debtor.²²

On the benefit side, we show that side agreements can provide effective workarounds for some of the inefficient mandatory terms in the Bankruptcy Code, as well as solve problems caused by the inherent incompleteness of contracts. A side agreement can limit the ability of a party to use a bankruptcy right opportunistically against its counterparty, where the benefit to exercising a right for one party reduces value to the side agreement coalition as a whole. To give a concrete example, a second-lien creditor might agree not to raise any objections that—although allowed under the Bankruptcy Code—would stall a value-maximizing sale process.

On the cost side, however, we show that side agreements will not always maximize the value for all stakeholders. The parties to a side agreement will only maximize their joint value; they will not take into account the effect of their agreement on the company’s other stakeholders. And they may even use side agreements to impose negative effects on those outside stakeholders in an attempt to extract value from them. We

²¹ See, e.g., David Djaha et al., *Protect Yourself from the ‘Bad Boys’*, N.Y. L. J., (Aug. 13, 2012), <http://www.newyorklawjournal.com/id=1202566826929/Protect-Yourself-From-the-Bad-Boys> [<https://perma.cc/J9Q5-NSRC>] (discussing the use of bad boy agreements).

²² See, e.g., *In re Extended Stay Inc.*, 435 B.R. 139, 146 (S.D.N.Y. 2010) (discussing the plaintiffs’ argument that the defendants violated a side agreement prohibiting them from directly negotiating with creditors).

show that such extraction attempts can result in parties contracting for specific performance of a right, or excessive stipulated damages, when expectation damages would be preferred from an overall efficiency standpoint. These side agreements, though profitable for the parties to the agreement, can shut down opportunities in the bankruptcy proceeding for one or more parties to strike efficiency-enhancing deals to defect. This in turn lowers the expected value that can be recovered through the bankruptcy process and increases the *ex ante* cost of finance for debtors.²³

In light of the potential problems associated with enforcing side agreements as written, we develop a simple proposal that honors the intent of the parties to the side agreement and preserves the efficiency benefits they create, while limiting the negative consequences. We propose the following: if a side agreement is unlikely to cause value-destroying externalities,²⁴ a court should enforce the agreement according to its terms, including stipulated damage clauses or specific performance requirements. But if there is a nontrivial potential for value-destroying externalities, the court should limit a nonbreaching party's remedy to its expectation damages.

The above solution implies that, where there is a nontrivial possibility of externalities, a court should hear an objection or allow an action that would otherwise be permitted under the Bankruptcy Code, even if the parties' intercreditor agreement prohibits it. The court should not block defections that violate an intercreditor agreement unless they otherwise conflict with the Bankruptcy Code. Expectation damages for breach should be payable to the nonbreaching party, but the court can decide these damages independently from, and later than, the objection itself.

The efficiency benefits of expectation damages are well understood in the literature on contracts: when properly calculated, they force the promisor to internalize the costs imposed on the promisee.²⁵ Although our proposal to apply similar logic to intercreditor agreements in bankruptcy may seem novel—and it is quite different than the approach that appears to be emerging in the case law—bankruptcy law uses precisely the same strategy when dealing with other related issues. Outside of bankruptcy, for

²³ The general law-and-economics view of bankruptcy worries about the *ex ante* cost of finance. Bankruptcy rules that reduce the total *ex post* value of a bankruptcy estate create problems because they increase the cost of *ex ante* financing. See Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 579–80 (1998).

²⁴ Value-destroying externalities occur when enforcing the side agreement negatively affects the recovery of a stakeholder who is outside the side agreement.

²⁵ See, e.g., Daniel Markovits & Alan Schwartz, *The Myth of Efficient Breach: New Defenses of the Expectation Interest*, 97 VA. L. REV. 1939 (2011) (summarizing recent debate and defending the traditional view).

instance, a secured creditor has the right to seize its collateral when the debtor defaults.²⁶ Inside bankruptcy, the mandatory automatic stay prevents collateral seizure, and the secured creditor is promised “adequate protection” payments if the collateral begins to lose value.²⁷ This is justified on the ground that when bargaining among all creditors is not possible, the debtor and the secured creditor do not internalize the effects of seizure on the other creditors. Thus, the Bankruptcy Code replaces a specific performance right (the right to seize collateral) with damages (adequate protection payments), unless the risk that the seizure will affect the other creditors is negligible.²⁸ A side agreement usually does not threaten to remove a key *asset*, but it may remove a key *party* (the silent creditor) from negotiations, which can have similar negative effects on third-party stakeholders.

In the bankruptcy setting, we show that fully enforced expectation damages (ED) invite efficient, value-creating defections, provided that: (a) the promisor in the side agreement and the third party can negotiate efficiently—that is, they reach a deal to defect whenever it increases their joint payoff; and (b) the third party’s interests are aligned with the parties outside the side agreement. These conditions will not hold in all circumstances, so ED is not a panacea for all coordination problems in bankruptcy; but, importantly, we show that—given the specific dynamics of bankruptcy procedure—the costs of ED’s imperfections are likely to be lower than the costs of specific performance and stipulated damages.²⁹

Throughout the discussion, we consider the controversies over side agreements and defections that lie at the heart of a series of prominent recent cases. Although courts have not yet developed a settled approach to these issues, they are increasingly trying to regulate these arrangements by narrowly construing the contractual language and only enforcing language that is “clear beyond peradventure.”³⁰ Our model suggests that this

²⁶ See, e.g., U.C.C. §§ 9-609, 9-610 (AM. LAW INST. & UNIF. LAW COMM’N 2001) (setting forth state law remedies of foreclosure and sale of collateral under the Uniform Commercial Code).

²⁷ 11 U.S.C. § 362(d)(1) (2012). As another example, plans of reorganization can be “crammed down” even when classes of creditors dissent, replacing the right to veto a plan with judicially valued compensation in the form of new securities. See 11 U.S.C. § 1129(b) (2012).

²⁸ For discussion of the liquidity-enhancing benefits of these rules, see Kenneth Ayotte & David A. Skeel Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557 (2013); George G. Triantis, *Financial Slack Policy and the Laws of Secured Transactions*, 29 J. LEGAL STUD. 35 (2000). Section 362(d)(2) requires that the judge lift the stay if the debtor: (a) has no equity in the collateral; and (b) the collateral is not necessary to an effective reorganization. 11 U.S.C. § 362(d)(2). When both of these conditions hold, the effect of collateral seizure on third party creditors is small, and hence, the specific performance right of the secured creditor is honored.

²⁹ See *infra* Section III.A.

³⁰ *In re Boston Generating, LLC*, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010).

approach is a mistake and that it could have serious unintended consequences. The parties, desiring an enforceable but narrow side agreement, may be compelled to draft something broader or all-encompassing to get courts to specifically enforce the agreement. This could result in the paradoxical outcome that courts do not enforce narrowly tailored efficient side agreements but fully enforce (with specific performance) broad side agreements that create serious externalities. Our model suggests that courts should focus primarily on the remedy, rather than on the scope of the contractual language.

Our model also provides a simple framework for resolving the increasingly vexing questions of whether intercreditor agreement disputes should be resolved by the bankruptcy court or outside bankruptcy, and whether forum selection clauses should be enforced. If the nonbreaching party asks for expectation damages, the bankruptcy court has no particular expertise and should defer to forum clauses that call for a different forum. Where specific performance or stipulated damages are at issue, by contrast, our model suggests that the dispute should be resolved exclusively in bankruptcy proceedings.

We are not the first to consider the issues surrounding intercreditor agreements and propose recommendations. In a recent paper, Edward Morrison argues, as we do, that enforcement of intercreditor agreements should turn on the presence or absence of externalities.³¹ He identifies rules of thumb judges can use to guide decisions on enforcement and potential actions (such as vote assignment), in which externalities are more or less likely to be present.³² Our analysis adds to this understanding of side agreements in three ways. First, our theory analyzes the potential for deals that defect from side agreements, an important phenomenon in many recent, prominent Chapter 11 cases. Second, we analyze the incentives of parties to side agreements at the drafting stage—including incentives to extract value from nonparties—in order to better understand why externalities might exist in the first place. Third, we generate several new proposals that can guide judicial enforcement of side agreements and defections from those agreements and address the complicated jurisdictional questions that have arisen.

The Article will proceed as follows. In Part I, we summarize some of the recent prominent cases involving intercreditor agreements and note the common themes in these cases. In Part II, we present our theoretical

³¹ Edward R. Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015 U. ILL. L. REV. 721.

³² See *id.* at 730–33 (describing courts' ability to delay making a decision on an intercreditor agreement as a key rule of thumb); *id.* at 732 (discussing the risk of externalities with vote assignment provisions).

framework, which uses a series of simple numerical examples to generate intuitions about the costs and benefits of enforcing intercreditor agreements. In Part III, we discuss normative implications of the theory and, in Part IV, we apply the theory to recent cases including those discussed in Part I. Part V provides additional analysis of expectation damages before briefly concluding.

I. THE CURRENT STATE OF THE LAW

Subordination agreements, which subordinate the claims of one creditor to those of another, have been a familiar feature of bankruptcy for decades. The Bankruptcy Code explicitly endorses these arrangements, stating that a subordination agreement “is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.”³³ Because many intercreditor agreements do more than simply subordinate second-lien creditors, however, courts cannot point to the Bankruptcy Code’s prosubordination agreement policy as resolving the senior and junior creditors’ disputes over the intercreditor agreement. They must determine whether the agreement covers the dispute in question, and if it does, whether the term in question is permissible.

Bankruptcy courts’ handling of these disputes has been quite inconsistent. On one extreme, some courts have flat-out refused to enforce provisions that seem to interfere with the Chapter 11 negotiating and voting process. In *In re 203 North LaSalle Street Partnership*,³⁴ for instance, the court invalidated a provision that transferred a junior creditor’s voting rights to the senior creditor.³⁵ On the other extreme, some courts have fully enforced these provisions.³⁶ In the middle are cases where the courts have been less straightforward, paying lip service to enforcement while nonetheless finding ways to conclude that an enforcing senior creditor (the promisee) is not entitled to relief.³⁷ Finally, we suspect that some courts are

³³ 11 U.S.C. § 510(a) (2012).

³⁴ 246 B.R. 325 (Bankr. N.D. Ill. 2000).

³⁵ See also *In re SW Hotel Venture, LLC* 460 B.R. 4 (Bankr. D. Mass. 2011), *aff’d in part, rev’d in part, sub nom. In re SW Boston Hotel Venture, LLC*, 479 B.R. 210 (B.A.P. 1st Cir. 2012) (also refusing to enforce a vote assignment provision), *vacated*, 748 F.3d 393 (1st Cir. 2014).

³⁶ See, e.g., *In re Aerosol Packaging, LLC*, 362 B.R. 43 (Bankr. N.D. Ga. 2006) (enforcing vote assignment).

³⁷ Morrison divides the intercreditor agreement cases into three categories: those that refuse to enforce the agreements because they are inequitable or otherwise interfere with the bankruptcy process, those that enforce the agreements, and those that “take[] the middle road.” Morrison, *supra* note 31, at 725. In the middle-road cases, courts purport to enforce provisions that require the promisor to stay silent in the case but nevertheless consider the merits of the promisor’s motion or objection. *Id.* at 723–25 (citing, among others, *In re Erickson Ret. Cmtys., LLC*, 425 B.R. 309, 316–17 (Bankr. N.D. Tex.

just reaching pragmatic outcomes regardless of the provisions in the side agreements.³⁸

In the discussion that follows, we try to make sense of three leading recent cases: *In re Boston Generating, LLC (Boston Generating)*,³⁹ *In re MPM Silicones, LLC (Momentive)*,⁴⁰ and *In re RadioShack Corp (RadioShack)*.⁴¹ Although the cases continue to reach divergent outcomes, several recurring themes seem to be emerging.

A. *The Boston Generating Approach: “Clear Beyond Peradventure”*

The decision in *Boston Generating* has set the tone for courts’ recent handling of disputes over the implications of intercreditor agreements. *Boston Generating* was a wholesale electricity provider in Boston and its environs, with the third largest generation operations in New England.⁴² For eighteen months before its August 18, 2010 bankruptcy filing, the debtors sought to find a buyer for most or all of their assets.⁴³ After initially contacting 199 potential buyers, *Boston Generating* winnowed the potential bidders down to 6, actively negotiated with 2, and selected Constellation Holdings.⁴⁴ Under the parties’ agreement, Constellation would pay \$1.1 billion for the assets of *Boston Generating*, and *Boston Generating* would file for bankruptcy and seek prompt bankruptcy court approval of the sale under section 363 of the Bankruptcy Code.⁴⁵

As of the bankruptcy filing, *Boston Generating* had \$2 billion of debt, including \$1.13 billion of first-lien debt under a First Lien Credit Agreement, \$350 million of second-lien debt, and \$422 million of unsecured debt.⁴⁶ Under the proposed sale, the first-lien creditors would be paid nearly in full, while second-lien creditors and unsecured creditors would receive little or nothing.⁴⁷ Not surprisingly, the second-lien creditors were much less enthusiastic about the proposed sale than the first-lien creditors. When the debtors asked the bankruptcy court to approve the sale to Constellation after an auction process that produced one other bid, the

2010), which held that the subordinated creditors were precluded by their intercreditor agreement from seeking an examiner but nevertheless considered the merits of the examiner request).

³⁸ See *infra* Section I.C.

³⁹ 440 B.R. 302 (Bankr. S.D.N.Y. 2010).

⁴⁰ *In re MPM Silicones, LLC*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014).

⁴¹ 550 B.R. 700 (Bankr. D. Del. 2016).

⁴² *Boston Generating*, 440 B.R. at 308.

⁴³ *Id.* at 310.

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.* at 308–09.

⁴⁷ *Id.* at 310.

agent for the second-lien creditors and several of the second-lien creditors objected.⁴⁸ The agent for the first-lien creditors pointed to the parties' intercreditor agreement as precluding the objection because the agreement gave the first-lien creditors the exclusive right to "enforce rights, exercise remedies . . . and make determinations" regarding the parties' collateral.⁴⁹ The agent for the second-lien creditors countered that its objection was not interfering with the first-lien creditors' exclusive enforcement rights and that it was simply making an objection that ordinary unsecured creditors make, as permitted by the agreement.⁵⁰

The bankruptcy court made two determinations, each of which has important implications for the treatment of intercreditor agreements. The court first ruled that the second-lien creditors could press their objection, despite the first-lien creditors' exclusive right to exercise remedies.⁵¹ The court based this conclusion in part on a puzzling decision by the first-lien agent to stipulate that the first-lien creditors' consent to (and other involvement in) the sale of assets did not constitute an "exercise of remedies" under the intercreditor agreement.⁵² But the court also emphasized the lack of clarity in the parties' agreement. "If a secured lender seeks to waive its rights to object to a 363 sale," the bankruptcy judge wrote, "it must be clear beyond peradventure that it has done so."⁵³ The court contrasted the parties' agreement with the American Bar Association's (ABA) model intercreditor agreement in this regard. Unlike the ABA model agreement, which explicitly states that the second-lien agent is deemed to consent to a section 363 sale that the first-lien agent approves, the "language in the Intercreditor Agreement [in this case] falls short of such clarity."⁵⁴

The court's second ruling pointed in the opposite direction. Although the judge permitted the second-lien creditors to object, she nevertheless allowed the sale to go through. The judge gave the second-lien creditors their day in court but did not let the objections derail the asset sale that Boston Generating had spent nearly two years arranging.⁵⁵

The ultimate outcome of the hearing makes the contrast between *Boston Generating* and two earlier cases that had enforced the literal terms

⁴⁸ *Id.* at 306.

⁴⁹ *Id.* at 319.

⁵⁰ *Id.*

⁵¹ *Id.* at 320.

⁵² *Id.* at 317–18.

⁵³ *Id.* at 319.

⁵⁴ *Id.*

⁵⁵ *Id.* at 335–36.

of intercreditor agreements less stark than it initially appears. In *In re Erickson Retirement Communities, LLC*⁵⁶ and *In re Ion Media Networks, Inc.*,⁵⁷ several bankruptcy courts relied on the explicit language of the intercreditor agreement to deny standing to second-lien creditors. Distinguishing the two cases, the *Boston Generating* court pointed out that the intercreditor agreements in the earlier cases were much clearer. But the courts in the two earlier cases also seem to have been mindful of the effect their rulings would have on the outcome of each case. In both *Erickson* and *Ion Media Networks*, the second-lien creditors' actions threatened to bog down a case that was otherwise close to resolution. By denying standing in *Erickson*, the court avoided statutory language that suggests an examiner must be appointed if a creditor requests one.⁵⁸ Similarly, in *Ion Media*, denying standing silenced a second-lien creditor that was far out of the money and appeared to be objecting in the hope of being bought off.⁵⁹ By contrast, in *Boston Generating*, the court allowed the objection but did not permit it to derail the debtor's proposed sale.

Boston Generating places a premium on careful drafting of intercreditor agreements and also suggests that bankruptcy courts may be keeping one eye on the pragmatic implications of permitting second-lien creditors to take action in the face of contractual language that appears to require their silence. In this case and the related *Erickson* and *Ion Media Networks* cases, the courts focused primarily on the scope and validity of the agreements, without carefully considering the choice of remedy that courts would provide if they concluded that the agreements were enforceable.⁶⁰

⁵⁶ 425 B.R. 309 (Bankr. N.D. Tex. 2010).

⁵⁷ 419 B.R. 585 (Bankr. S.D.N.Y. 2009).

⁵⁸ See 11 U.S.C. § 1104(c) (2012). For evidence that courts often decline to appoint examiners even when ostensibly required to appoint them, see Jonathan C. Lipson, *Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies*, 84 AM. BANKR. L.J. 1 (2010).

⁵⁹ See, e.g., *Ion Media*, 419 B.R. at 597–98 (noting, as it considered the language of the agreement, that even the first-lien creditors were likely to receive only a fraction of what the \$850 million they were owed because the debtor was not worth more than \$310–\$455 million).

⁶⁰ *Boston Generating* and the two prior cases also raise the question of just what specific performance means. In *Ion Media*, the effect of specific performance was not clear given that the court was fully informed about the objection it declined to hear and essentially addressed the objections. See *id.* at 598 (stating that “[d]espite the determination that Cyrus lacks standing to object to the Plan, the Court recognizes that it has an independent obligation to review the Plan to make sure that it satisfies the standards for plan confirmation”). In *Erickson*, specific performance may have made a more tangible difference because it removed a demand for an examiner. But here too, the court essentially considered the requested action before concluding that the request was precluded by the parties' intercreditor agreement. See 425 B.R. at 316–17 (declining to appoint examiner). We will attempt to sort out these issues later in this Article. See *infra* Section III.B (providing framework for determining the parties' rights).

B. The Intercreditor Dispute in Momentive

The Momentive bankruptcy was hotly contested from the outset, and it produced important decisions on difficult issues that might have been avoided if the parties had managed to settle, as the bankruptcy judge strongly hinted they should do. Momentive, a silicone and quartz manufacturer that had been acquired in 2006 by Apollo Global Management, the well-known private equity fund, proposed a “deathtrap” reorganization plan. The “deathtrap” reorganization plan gave its senior creditors a choice between either accepting the plan, which promised payment in cash in full but required the creditors to waive a \$200 million make-whole claim,⁶¹ or rejecting the plan, asserting their make-whole claim, and receiving replacement notes plus the cramdown rate of interest.⁶² Although the senior creditors rejected the plan, the bankruptcy court held that they were not entitled to a make-whole payment and confirmed the proposed plan under the cramdown provision.⁶³ The senior creditors then brought a state court damages action against the junior creditors under the parties’ intercreditor agreement. The senior creditors argued that the junior creditors’ support for the reorganization plan violated the agreement and that any distributions to the junior creditors needed to be turned over to the senior creditors because the agreement required that the senior creditors be paid in full before the junior creditors received any distribution. The junior creditors responded by removing the litigation to federal court and having it referred to the bankruptcy court.⁶⁴

⁶¹ A “make-whole” provision requires a breaching promisor to pay a fee designed to compensate the promisee for profits lost as a result of the breach. In a loan contract, the lost profits often consist largely of not-yet accrued interest payments. Some courts have enforced make-whole payments, *see, e.g., In re Energy Future Holdings Corp.*, 842 F.3d 247, 261 (3d Cir. 2016) (holding that the make-whole provision must be honored); *In re Sch. Specialty, Inc.*, No. 13-10125 (KJC), 2013 WL 1838513, at *17–19 (Bankr. D. Del. Apr. 22, 2013) (concluding that a make-whole provision was a legitimate liquidated damages provision, not unmaturing interest, which would be precluded by section 502(b)(2)), while other courts have rejected them, *see, e.g., In re MPM Silicones LLC*, 531 B.R. 321, 336 (S.D.N.Y. 2015) (holding that a make-whole provision was not enforceable because it did not “clearly and unambiguously call for the payment of the make-whole premium in the event of an acceleration of debt”), *aff’d* No. 15-1682, 2017 WL 4772248 (2d Cir. Oct. 20, 2017).

⁶² *MPM Silicones*, 531 B.R. at 326; *see also* *Till v. SCS Credit Corp.*, 541 U.S. 465, 479 (2004) (holding that the cramdown rate of interest can be determined by using the formula approach, which starts with the prime rate and adjusts based on risk of nonpayment).

⁶³ *MPM Silicones*, 531 B.R. at 332.

⁶⁴ An obvious question raised by this sequence of events is why the senior creditors brought a damages action rather than seeking to prevent Momentive from confirming a reorganization plan that would give distributions to the junior creditors. One possible explanation for the senior creditors’ approach is that courts generally have not required that a reorganization plan comply with an intercreditor agreement so long as the promisee’s rights under the agreement are preserved. *See* 11 U.S.C. § 1129(b) (2012) (requiring a court to confirm a nonconsensual plan notwithstanding the enforceability of subordination agreements); *see also, e.g., In re Croatan Surf Club, LLC*, No. 11-

The senior creditors' alternative strategy failed. Explicitly endorsing the *Boston Generating* standard that the waivers of junior creditors' rights must be "clear beyond peradventure," the bankruptcy court rejected each of the senior creditors' arguments.⁶⁵ Much as the agreement in *Boston Generating* failed to specify that junior creditors could not object to a section 363 sale that senior creditors approved, the agreement here focused on the parties' collateral and liens, rather than on their right to payment. "[T]he ICA is very clearly an intercreditor agreement pertaining to the parties' rights in respect of shared collateral," the court concluded.⁶⁶ "That is the overall context of the Agreement, and it is in that context that the complaints' claims should be evaluated."⁶⁷ Because the junior creditors' support for Momentive's plan did not interfere with the senior creditors' liens or collateral in any way, the junior creditors' actions were not barred by the intercreditor agreement.⁶⁸ The court also ruled that the junior creditors were entitled to contest the amount of the senior creditors' claims because the agreement lacked the explicit "silent seconds" lien provisions often included in intercreditor agreements.⁶⁹

C. *The Intercreditor Dispute in RadioShack*

In *RadioShack*, the creditor coalitions were more complex than in any of the cases discussed thus far.⁷⁰ RadioShack had two main groups of secured lenders: the ABL lender group, which held a first lien on RadioShack's liquid assets and a second lien on its intellectual property securing a \$585 million obligation, and SCP, which held a second lien on the liquid assets and a first lien on the intellectual property securing a \$250 million loan.⁷¹ Each of the loans was divided into multiple tranches. The

00194-8-SWH, 2011 WL 5909199, at *2 (Bankr. E.D.N.C. Oct. 25, 2011) ("[A] court can confirm a plan which disrupts bargained for priority, and thus is inconsistent with the terms of a subordination agreement, as long as it is fair and equitable and does not discriminate unfairly."); *In re TCI 2 Holdings, LLC*, 428 B.R. 117, 140-41 (Bankr. D. N.J. 2010) (noting that section 1129(b) provides for confirmation of plans even when parties have violated intercreditor agreements on supporting the plan); see also *In re Tribune Co.*, 472 B.R. 223, 241 (Bankr. D. Del. 2012) (citing *TCI 2 Holdings*, 428 B.R. at 141), *aff'd in part, vacated in part*, 12-CV-1072 GMS, 2014 WL 2797042 (D. Del. June 18, 2014), *aff'd in part, rev'd in part sub nom.*, *In re Tribune Media Co.*, 799 F.3d 272 (3d Cir. 2015).

⁶⁵ *MPM Silicones*, 518 B.R. at 750 (citing *In re Boston Generating, LLC*, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010)).

⁶⁶ *Id.* at 746.

⁶⁷ *Id.*

⁶⁸ *Id.* at 750-52.

⁶⁹ *Id.* at 752 (contrasting the agreement here to the much more restrictive provisions in the agreement in *In re Erickson Ret. Cmty., LLC*, 425 B.R. 309, 313 (Bankr. N.D. Tex. 2010)).

⁷⁰ For an overview of the loans and the dispute discussed in the text that follows, see Borders et al., *supra* note 16.

⁷¹ *In re RadioShack Corp.*, 550 B.R. 700, 703 (Bankr. D. Del. 2016).

relationship between the ABL and SCP loans was coordinated by an intercreditor agreement, and relations within each lender group by AALs.⁷²

The ABL lender group was divided into two groups, referred to as the first-out and second-out lenders.⁷³ The lightning rod for the dispute was a proposal by Standard General, which held a “second out” position in the ABL lien to buy a large number of RadioShack’s stores in partnership with Sprint. Under the proposal, Standard General would be permitted to credit bid its claim.⁷⁴ Although it was clear to everyone that RadioShack’s assets needed to be sold, Salus, one of the lenders in the SCP lender group (and the agent for the group’s loans), asked the bankruptcy court to prohibit Standard General from credit bidding. Salus argued that Standard General’s credit bid violated the priority terms of the intercreditor agreement between the ABL and SCP group.⁷⁵ To further complicate matters, the first-out lenders in the ABL group sided with Salus in opposing the bid by Standard General. They argued that a credit bid by Standard General violated their AAL with Standard General.⁷⁶

⁷² *Id.* at 704–05.

⁷³ *See id.* at 705.

⁷⁴ A “credit bid” is a bid that consists of a lien creditor’s promise to release some or all of its lien—the amount to be released is the amount of the credit bid—if the bid is accepted, rather than a promise of new consideration. *See generally* RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. 639 (2012) (holding that secured lenders must be permitted to credit bid a debtor proposes to sell assets in connection with a Chapter 11 plan).

⁷⁵ The basis for this objection was hotly contested. The ABL lenders had converted some of their revolving loans into term loans. Salus argued that under the intercreditor agreement, the term loans were junior in priority to the SCP loans. At the time of bankruptcy, \$129 million of the term loans had been repaid and \$103 million remained outstanding. Salus argued that it was entitled to the \$129 million that had been paid to the ABL lenders and that the \$103 million outstanding debt was junior to the SCP loan and therefore could not be credit bid. *See generally* Debtors’ Combined Motion for Entry of Orders: (I) Establishing Bidding and Sale Procedures; (II) Approving the Sale of Assets; and (III) Granting Related Relief, *RadioShack Corp.*, 550 B.R. 700 (No. 15-10197); Objection of Salus Capital Partners, LLC to Debtors’ Sale Motion, *RadioShack Corp.*, 550 B.R. 700 (Bankr. D. Del. 2016) (No. 15-10197); Statement of Cerberus Lenders in Support of Sale to General Wireless, Inc., *RadioShack Corp.*, 550 B.R. 700 (Bankr. D. Del. 2016) (No. 15-10197); Debtors’ Consolidated Reply to Objections to Going Concern Sale, *RadioShack Corp.*, 550 B.R. 700 (Bankr. D. Del. 2016) (No. 15-10197); *see also* Transcript of Hearing, *supra* note 16; Transcript of Hearing, *RadioShack Corp.*, 550 B.R. 700 (No. 15-10197) (March 31, 2015).

⁷⁶ The details of the interplay of the indemnity and the credit bid are complex. At its most simple, the term loan priority litigation between Salus on the one side and the ABL group on the other could result in the ABL group owing \$129 million to Salus after the sale. The first-out lenders were concerned that if the sale went through before that litigation was resolved, they would be on the hook for some or all of that \$129 million. They claimed that the possibility that they would be liable without protection violated their AAL with Standard General, which provided that Standard General could not recover anything (and thus, they argued, could not credit bid) until the first-out lenders were paid in full. They read “paid in full” to include reassurance that they would not have to disgorge any payments they had already received. Thus, the first-out lenders argued that Standard General had to resolve the \$129 million litigation or provide reliable indemnity protection before the credit bid could go through. *See*

Things were equally complicated on the SCP side. Another SCP group lender, Cerberus, took Standard General's side in the dispute. Cerberus argued that the SCP group's agreement among lenders prohibited Salus from objecting to any sale that Cerberus had agreed to.⁷⁷ While Cerberus had initially consented to Salus's objection, it changed its position shortly before the sale hearings.⁷⁸ Salus argued that the initial consent barred Cerberus from interfering with its objection.⁷⁹

The court resolved some of these disputes but not others. On the first-out lender's objection to Standard General's credit bid, the court merely urged settlement and signaled that it was unlikely to grant the first-out lenders' full request to use the AAL to block the credit bid.⁸⁰ The bankruptcy court did, however, allow Cerberus to use its AAL to block Salus's objections to the sale. The court rejected Salus's argument that Cerberus was precluded from revoking its consent. "The plain language of Section 14(c) [of the agreement among lenders] does not restrict Cerberus from settling or otherwise changing its position or its mind," the court said; "and, indeed, to construe the document otherwise would be demonstrably contrary to Cerberus's presumed contractual expectations"⁸¹ Cerberus then had the right to agree to a sale, and that agreement blocked Salus from asserting the SCP group's rights to object to a sale. As a result, the sale went forward.

The agreements in *RadioShack* arguably were clearer than the agreement in *Momentive*, and Salus's objection was more obviously

generally Debtors' Combined Motion for Entry of Orders, *supra* note 75; Objection of the First Out ABL Lenders to the Debtors' Combined Motion for Entry of Orders: (I) Establishing Bidding and Sale Procedures, (II) Approving the Sale of Assets and (III) Granting Related Relief, *RadioShack Corp.*, 550 B.R. 700 (Bankr. D. Del. 2016) (No. 15-10197); Supplemental Brief in Support of the First Out Lenders' Objection to the Debtors' Combined Motion for Entry of Orders: (I) Establishing Bidding and Sale Procedures, (II) Approving the Sale of Assets and (III) Granting Related Relief, *RadioShack Corp.*, 550 B.R. 700 (Bankr. D. Del. 2016) (No. 15-10197); Response of Standard General L.P. to the Objection of the First Out ABL Lenders to the Debtors' Combined Motion for Entry of Orders: (I) Establishing Bidding and Sale Procedures, (II) Approving the Sale of Assets and (III) Granting Related Relief *RadioShack Corp.*, 550 B.R. 700 (Bankr. D. Del. 2016) (No. 15-10197); Debtors' Consolidated Reply to Objections to Going Concern Sale, *supra* note 75; *see also* Transcript of Hearing, *supra* note 16; Transcript of Hearing, *supra* note 75.

⁷⁷ Statement of Cerberus Lenders in Support of Sale to General Wireless, Inc., *supra* note 75, at 2–3; *see also* Transcript of Hearing, *supra* note 16, at 22–25, 29–30.

⁷⁸ *See* Statement of Cerberus Lenders in Support of Sale to General Wireless, Inc., *supra* note 75, at 2–3 (filed five days before the sale hearings).

⁷⁹ *Id.* at 34–37.

⁸⁰ *Id.* at 72 (referring to requested relief as "silly"); *id.* at 87 (referring to demands as "screwy" and noting a lack of enthusiasm for granting them); *id.* at 97 (noting "no possibility" of the request reserve being posted); *id.* at 100 (noting "the fix I am in" with regard to granting the requested relief if the sale of RadioShack is going to happen).

⁸¹ *Id.* at 63.

precluded by the AAL terms. Perhaps these facts fully explain the court's ruling. But it does not seem coincidental that the ruling, together with the court's failure to rule on the first-out lenders' objection to Salus's credit bid, also had the effect of removing potential obstacles to the best deal available for selling RadioShack's assets.

D. Implications

One obvious effect of these recent intercreditor disputes is to raise significant questions about the assumption that intercreditor agreements reduce transaction costs by keeping some parties silent.⁸² Perhaps intercreditor agreements will serve this function as they evolve, and as courts interpret them in more consistent fashion. But the agreements have prompted extensive litigation, as parties who agreed to be silent have raised objections and entered into deals to defect that may have violated their side agreements. They appear to have magnified transaction costs, rather than reduced them.

In their handling of intercreditor agreement disputes, courts seem to focus primarily on the scope of the agreement—that is, the question whether the promisor has violated the agreement—and much less on the question of what remedy is appropriate in the event of a breach. A common theme in the cases is that courts read the terms of an intercreditor agreement against the party who seeks to contract around the Bankruptcy Code, unless it is “clear beyond peradventure.”⁸³ This approach may reflect the courts' belief that enforcement of intercreditor agreements can have deleterious effects on the bankruptcy process as a whole.

To increase the likelihood of enforcement, lenders can be expected to make their future agreements broader. This in fact is precisely what bankruptcy professionals have begun to advise. “In the future,” a prominent law firm wrote after summarizing the *RadioShack* dispute, “senior creditors would be well advised to demand specific and far-reaching protections that cover more than pure collateral enforcement.”⁸⁴ In response to the *Momentive* court's narrow reading of the lien subordination in the parties' intercreditor agreement, another prominent law firm recommended that senior creditors consider asking for, among other things, a broader provision requiring “[t]urnover of distributions received in respect of the

⁸² See generally Morrison, *supra* note 31, at 726 (noting that cost savings are an important benefit of intercreditor agreements, but also pointing out the potential for exploitation).

⁸³ See, e.g., *In re Boston Generating, LLC*, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010).

⁸⁴ Michael A. Rosenthal & Josh Weisser, *Silence is Golden: Second Lien Creditor Rights Post-Momentive* 3, GIBSON DUNN (Nov. 12, 2014), <http://www.gibsondunn.com/publications/documents/Silence-Is-Golden--Second-Lien-Creditor-Rights-Post-Momentive.pdf> [<https://perma.cc/95FZ-LQUM>].

junior lien creditor's secured claim, regardless of source or form, as opposed to only distributions of collateral or proceeds thereof."⁸⁵

It is not clear, however, that broader agreements will result in better outcomes than the parties' current agreements when all stakeholders are taken into account. What is needed is a better understanding of the costs and benefits of side agreements, and a theory as to whether and to what extent the agreements should be enforced. In the next Part, we attempt to provide such a theory. Our analysis suggests that courts should focus less on the scope of the agreements and more on the appropriate remedy.

II. A SIMPLE THEORETICAL MODEL OF SIDE AGREEMENTS AND DEFECTIONS

In this Part, we provide a simple theoretical framework that helps to identify the costs and benefits of enforcing side agreements in the presence of deals to defect. The theory, in turn, helps us understand the reasons parties write these agreements and the sources of externalities that bankruptcy law may help solve.

A. Background Principles

Underlying our analysis is the foundational normative theory of bankruptcy known as the Creditors' Bargain theory.⁸⁶ The Creditors' Bargain theory says that an ideal bankruptcy outcome is one that maximizes the expected value of the firm *ex ante*.⁸⁷ This translates to the outcome that would be chosen by a sole owner—a hypothetical individual who owns all of the firm's assets on the bankruptcy petition date.⁸⁸ The sole owner would choose to dispose of the company's assets—deciding whether to reorganize, liquidate, or sell the assets as a going concern, and determining the timing of this decision—in a way that maximizes the company's value. If the firm's creditors could collectively agree to an

⁸⁵ Damian S. Schaible & Kenneth J. Steinberg, *Momentive: Intercreditor Agreement Issues* 8, DAVIS POLK, <http://www.davispolk.com/sites/default/files/Momentive.Intercreditor.Agreement.Issues.pdf> [https://perma.cc/AM39-GWQW].

⁸⁶ JACKSON, *supra* note 1; Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984) (exploring the rights of secured creditors in bankruptcy); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982) (developing the "Creditors' Bargain theory").

⁸⁷ More precisely, the optimal bankruptcy framework will maximize the expected value of the firm *across all states* of its existence. A bankruptcy rule that increased the value of the bankruptcy estate but reduced the non-bankruptcy value (by distorting non-bankruptcy incentives) would violate the Creditors' Bargain theory if the reduction outweighed the increase.

⁸⁸ *See, e.g.*, Baird & Jackson, *supra* note 86, at 104–09 (describing how the decisionmaking of a group of diverse owners should follow that of a sole owner).

outcome once bankruptcy occurs, they would choose to act as a sole owner would act because this would maximize the total recovery for all the creditors. Thus, when we refer to an outcome as *efficient* or *inefficient*, the sole owner's decision will be our efficiency benchmark.

Corporate bankruptcy law is built on the premise that a debtor's contracts with its creditors will not necessarily lead to an efficient outcome in bankruptcy because the creditors are not coordinated either *ex ante*, when they lend to the debtor, or *ex post*, when bankruptcy occurs.⁸⁹ Bankruptcy's automatic stay, which prevents creditors from seizing the debtor's assets upon bankruptcy, is one of bankruptcy law's mandatory (nonwaivable) terms.⁹⁰ It is based on the premise that a debtor and a creditor would not be expected to contract for a stay on their own, even if the collective creditor body would benefit from it. Nor will a creditor voluntarily postpone collection at bankruptcy. She may instead have the incentive to "race to the courthouse" to get a bigger share of the bankruptcy estate for herself. Though this negatively affects the other creditors, the debtor and the particular creditor will not, in general, be expected to internalize any impact their contract has on the other stakeholders.⁹¹

The Creditors' Bargain theory argues that when the sole owner principle is at risk, the law is justified in altering the creditor's rights. Of particular importance for our analysis, the specific enforcement remedy the creditor would be entitled to pursue outside bankruptcy is often replaced with compensation that approximates the value of that remedy. A secured creditor upon bankruptcy can no longer seize collateral, as it could do outside bankruptcy, but the Bankruptcy Code gives the secured creditor the right to receive *adequate protection* payments in lieu of the repossession right.⁹²

⁸⁹ See JACKSON, *supra* note 1. For skepticism about this traditional rationale, see, e.g., Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 669–70 (1992) (arguing that security interests could be used to address collective action problems); Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199, 1200 (2005) (questioning the need for an expansive, state-supplied bankruptcy framework).

⁹⁰ 11 U.S.C. § 362(a) (2012).

⁹¹ There are contractual devices to mitigate these externalities. An early creditor might include covenants that limit the rights a borrower can grant subsequent lenders so as to minimize these externalities. But these contractual devices are imperfect for both legal and practical reasons. See, e.g., Barry E. Adler & Marcel Kahan, *The Technology of Creditor Protection*, 161 U. PA. L. REV. 1773 (2013) (analyzing the limits of covenants under existing law and advocating that they be given binding effect).

⁹² 11 U.S.C. § 362(d)(1) (2012). This is not to say that U.S. law always provides the amount of compensation that the Creditors' Bargain theorist would advocate. Most notably, the Bankruptcy Code does not give an undercollateralized secured creditor compensation for the lost time value of money. See *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 382 (1988).

B. Side Agreements and Defections

The background principles above are well known, and the use of bankruptcy law to replace a specific performance remedy with damages when the contract is between the debtor and a creditor is well accepted. But what, if anything, changes when the contract is between two creditors? It is less obvious that a side agreement between creditors implicates the same issues. Because creditors compete in bankruptcy for the common pool of debtor assets, it is clear that a contract with the debtor that provides better treatment to one creditor can be to the detriment of the other creditors. But the effect that a side agreement between creditors has on the nonparty stakeholders is not as evident. If a side agreement merely reshuffles the value that these parties are entitled to receive from the debtor, it is hardly an issue for bankruptcy law to interfere with.

Moreover, these side agreements might be expected to help the nonparty stakeholders. Side agreements should create incentives for the parties to the agreement to deal with other parties in ways that maximize the joint value of their collective claims. To be sure, the side agreements will not be written in the interests of all creditors. But the agreements might be expected to consolidate the side agreement parties to the equivalent of a single party who owns all the claims of the coalition.

For example, suppose a senior creditor (*S*) and a junior creditor (*J*) each make \$100 loans secured by the same \$200 asset, and they write an intercreditor agreement that governs their relationship in bankruptcy. We might expect that if bankruptcy occurs, the intercreditor agreement will be written so that the *S* and *J* coalition will take the same actions that a single secured creditor with a \$200 loan against the asset would take. If the intercreditor agreement transforms *S* and *J* into a single, unified actor, the agreement could reduce fragmentation and increase the scope for value-creating bargains with the debtor's other creditors that bankruptcy law tries to create. In such cases, the side agreements increase the *ex ante* value of the debtor and are consistent with the Creditors' Bargain theory.

The numerical examples below demonstrate, however, that this intuition is only true in some, but not all, cases. When bargaining frictions between the parties to a side agreement exist, the side agreement can create negative externalities. Bargaining frictions might occur because the senior loan position is held by a group of lenders in a syndicate, and the terms of the syndicated loan agreement require a high degree of consensus among

the lenders to restructure any key terms.⁹³ When bargaining is imperfect, the side agreement may steer the parties toward outcomes that favor the side agreement parties at the expense of the other nonparty stakeholders of the debtor. The side agreement parties may even use the threat of negative externalities to attempt to extract value from these stakeholders. This can reduce overall value of the debtor's estate in the bankruptcy process (and thus increase *ex ante* cost of finance) when the parties' attempts to keep more of the surplus for themselves make it less likely that a value-creating defection will occur through bargaining. In short, the side agreement parties do not take into account the benefits that other stakeholders receive from defections; hence, side agreements foreclose defections too often.

1. *Setup and Assumptions*

Suppose that parties *S* and *J* write a side agreement before bankruptcy. The concrete example we have in mind is two creditors who agree to take a senior (*S*) and a junior (*J*) lien on the same collateral, but the example can apply to any two parties who are stakeholders in a company. *S* and *J* will be expected to choose the terms that maximize the expected value of their combined claims.

Party *C* is also a stakeholder in the company, but *C* is not a party to the *ex ante* side agreement between *S* and *J*. This could occur because *C* comes along after the agreement is signed, or because *C* became a creditor before the transaction but was not actively monitoring the debtor and is thus uninvolved with the negotiation of the side agreement when it occurs.⁹⁴ *C* can be thought of as an unsecured creditor, whose interests are often more aligned with *J* than with *S*.⁹⁵

In order for our problem to be interesting and realistic, there must be some impediment to bargaining over outcomes in bankruptcy. The Coase Theorem tells us that if all interested stakeholders bargain perfectly, the sole owner principle will always hold and the efficient outcome will always occur under any bankruptcy rules.⁹⁶ But bargaining frictions in bankruptcy

⁹³ See, e.g., Amir Sufi, *Information Asymmetry and Financing Arrangements: Evidence from Syndicated Loans*, 62 J. FIN. 629, 633 (2007) (discussing renegotiation rights of lenders in syndicated loans).

⁹⁴ To keep the discussion simple, we do not explicitly involve the debtor in the negotiation of the side agreement, but we suspect that this would not affect our analysis significantly. The debtor will want to borrow at the lowest possible interest rate from *S* and *J*, so a side agreement between *S* and *J* that maximizes the joint payoff of *S* and *J* in bankruptcy would be preferred by the debtor as well.

⁹⁵ Junior lienholders in bankruptcy are also unsecured creditors to the extent that their collateral value is less than what they are owed. 11 U.S.C. § 506(a)(1) (2012). Thus, an unsecured creditor is more likely to prefer the junior lienholder's preferred action than the senior creditor's preferred action when they disagree.

⁹⁶ See R. H. Coase, *The Problem of Social Cost*, 3 J.L. ECON. 1, 2–8 (1960).

are common and can occur for many reasons. One reason is coordination problems caused by the fragmentation of claims. Large corporate loans are often broken into pieces and held by many holders; in such cases, coordinating these diverse holders can take time. We represent these frictions in our theory in a simple fashion by assuming that one of the parties is unable to bargain.

For the first part of our discussion, we consider examples in which *S* will not be able to bargain, but *C* will be able to negotiate with *J* to agree to a defection if a mutually beneficial deal is available. These assumptions will not be true in all cases, and we relax them in subsequent examples, but they track a common pattern in the cases where junior lien holders align themselves with unsecured creditors after the debtor files for bankruptcy.⁹⁷ When analyzing the incentives of *S* and *J* to write the side agreement, we will assume that *S* and *J* fully anticipate the parties that will be available to bargain and the likely payoffs.

Some uncertainty will, however, remain over payoffs at bankruptcy. We represent this through two possible “states of the world” that may occur at bankruptcy, each with equal probability. The states can be analogized to the future prospects of the company when the bankruptcy occurs, which may be more or less favorable depending on conditions that are hard to forecast in advance (at the time when the debtor borrows). We will suppose that these conditions are known and observable to everyone on the bankruptcy date, but they are sufficiently hard to describe in advance such that *S* and *J* cannot write a contract that is conditioned on the state of the world.⁹⁸

Whatever the state of the world, there will be two possible actions, action *R* and action *L*, that can be chosen. For concreteness, one can think of “*R*” as an action that makes a more prolonged reorganization process more likely, while “*L*” is an action that might lead to a quicker sale or liquidation. But, more generally, the model applies to any two possible strategies that party *J* would be free to pursue absent a side agreement, which are payoff-relevant and may affect what happens to the bankrupt company’s assets. For example, suppose that the debtor, at the behest of the senior creditor, makes a motion to liquidate the company and *J* has the

⁹⁷ The *Momentive* and *Boston Generating* cases are examples in which a second-lien creditor took actions that opposed a first-lien creditor and potentially stood to benefit the unsecured creditors. See *supra* Sections II.A., II.B.

⁹⁸ For example, the sale versus reorganization decision might depend on whether key employees decide to stay with the company or go elsewhere. These key employees might be easily observable at the time of bankruptcy but hard to identify in advance of bankruptcy when the intercreditor agreement is written.

option to be silent or exercise its legal right to raise an objection to the liquidation. Alternatively, *J* might express an interest in providing a debtor-in-possession loan that facilitates a reorganization plan proposed by *C*.⁹⁹

We make one final assumption concerning the bargaining process. Whenever a deal to defect between *J* and *C* is possible, they will reach an agreement that makes *J* and *C* collectively better off, and any surplus as a result of the deal will be split evenly between *J* and *C*. The 50/50 split of surplus is not essential to our results, but our results do rely importantly on the idea that *C* captures at least some of the surplus in bargaining with *J*.

2. *Examples*

Example 1: Side agreements align with efficiency

	Good State (p=.5)		Bad State (1-p=.5)	
	R	L	R	L
<i>S</i>	120	200	120	200
<i>J</i>	20	0	20	0
<i>C</i>	70	0	10	0
<i>S+J</i>	140	200	140	200
<i>S+J+C</i>	210	200	150	200

We start with Example 1, which demonstrates the potential benefit of side agreements. The table shows the direct payoffs—the payoffs that would result absent any side agreements or defections—to parties *S*, *J*, and *C*, which depend upon the state of the world and the chosen action. In this example, *S* and *J* have divergent interests in both states: *S* prefers action L and *J* prefers action R. Collectively, though, *S* and *J*'s total direct payoffs favor action L in both states, as their collective payoff is 200 under action L and 140 under action R. The good and bad states differ only in *C*'s payoff. *C*'s direct payoff favors action R, and thus *C*'s preferences align with *J*'s.

To make an analogy between the example and the real world, party *S* might favor a fast sale of the company in bankruptcy (action L), rather than

⁹⁹ The setup here is based on the framework of incomplete financial contracts from Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 475–79 (1992). To suit the issue at hand, we make important modifications to their setup, including the existence of the side party and the assumption that *S* cannot bargain. Because the bargaining parties are usually creditors, we do not assume that one of the two parties has no wealth, which is the key source of bargaining frictions in the Aghion and Bolton model. *See id.* at 475.

a long and protracted reorganization process (action R). *J*, the junior creditor, may be “out of the money” and would not stand to receive any payoff if the company is immediately sold. This might cause *J* to raise objections or employ delay tactics to slow the process down. This might benefit *C*, who represents unsecured or other lower priority creditors, who also favor delay. But, importantly, *J*’s preferred action will hurt *S* more than it helps *J*; thus, *S* and *J* have an incentive to strike a side agreement that induces *J* to consider *S*’s payoff when it chooses an action.

a. Status quo actions

Under the status quo (no side agreements or defections), *J* would choose action R in both states, to get 20 instead of 0. The *S+J* coalition would receive a total payoff of 140 in both states.

This choice would be efficient in the good state because the total payoffs of all parties (*S+J+C*) are 210 under action R and 200 under action L. But it would be inefficient in the bad state, as action L generates a larger payoff for all parties (200) than action R (150). Because the good state and bad state occur with equal probability, the status quo would produce a total expected payoff to all parties of 180.¹⁰⁰

Now, let’s suppose that *S* and *J* can write a side agreement that maximizes the expected payoff of the *S* and *J* coalition. We will first analyze the best agreement *S* and *J* could write, assuming that the parties provide that the agreement will be enforced via specific performance. We will then do the same analysis assuming the parties contract for stipulated damages, and we will compare the two possibilities to see which remedy *S* and *J* will choose. We will then examine whether the choice leads to an efficient outcome.

b. Side agreement enforced by specific performance (SP)

First, let’s consider the side agreement *S* and *J* would write, supposing for the moment that any side agreement can be enforced specifically by *S*. SP implies that *S* can require that *J* choose action L. Because the parties anticipate *S*’s inability to negotiate, a decision to require action L will always lead to action L being chosen, even if *C* were willing to pay any amount to have the decision changed to R.

Under SP, *S* and *J* will write an agreement that requires that *J* choose action L. *S+J* will prefer this outcome to the status quo with no side agreement. *J* will agree to choose action L, and the *S+J* coalition will receive 200 in both states. This is preferred to the status quo, where the *S+J*

¹⁰⁰ The expected value is calculated by multiplying the probability of each state times the payoff of all the parties (*S+J+C*) in that state and adding it up. In this case, we have $.5 \times 210 + .5 \times 150 = 180$.

coalition would receive only 140 in both states. But it leads to an inefficient outcome in the good state because the $S+J$ coalition does not take C 's value into account.

If the choice were between the status quo and a SP contract, the SP contract is preferred from an efficiency perspective. The total expected value under SP is 200, which is greater than the expected 180 payoff under the status quo. It is not always true, however, that a SP contract is preferred to the status quo from an efficiency standpoint whenever the parties choose it. If, for example, we increase C 's payoff by more than 20 in both states when action R is chosen, then the status quo payoff will be larger than 200. Generally, SP contracts may increase or decrease efficiency relative to the status quo because the parties do not internalize the effects of their contract on C .

c. Side agreement enforced by stipulated damages (SD)

Using the numbers in Example 1, S and J can improve upon SP by enforcing their side agreement through damages. Let "d" denote the SD payment in the side agreement between S and J . When the agreement is enforced through damages, J can choose to breach the side agreement and choose action R if it is willing to pay d. This opens the door for C to make a deal to defect with J to encourage the breach. Because S and J seek to maximize their joint payoff, they will take any anticipated payment from C to J into account when they decide on the right level of damages.

Here, S and J will write a contract that requires J to choose action L and pay $d = 90$ to S if it chooses action R. They will choose damages of 90 because it elicits the maximum possible side payment from C to encourage the breach in the good state. Their logic is as follows: In the good state, the $J+C$ coalition prefers action R to action L by 90: J prefers action R by 20, and C prefers R by 70. Hence, C can only convince J to breach and choose action R if C pays J the entire 70 it would gain from action R. If C offers any payment lower than 70, J will perform under the side agreement and choose action L. In the good state, then, J will breach the contract and choose action R. C will make a side payment of 70 to J , and J will pay 90 in damages to S . In the good state, taking side payments into account, the $S+J$ coalition will get a total payoff of 210.

In the bad state, J will choose action L. In the bad state, $C+J$'s direct payoffs would only increase by 30 if they chose action R, so it will not be in their joint interest to pay 90 in damages to S . Hence, in the bad state, the $S+J$ coalition will get a total payoff of 200.

d. Side agreement enforced by expectation damages (ED)

We just showed that when parties choose a SD contract, they will choose to set damages at 90. This level of damages is higher than ED—the damages that would give *S* the same payoff under breach that *S* would receive when the contract is performed. Breach of a promise by *J* to choose action L would reduce *S*'s payoff by only 80 in this example (200 – 120). As is well known, ED gives *J* the incentive to breach efficiently. In this example, *J* will choose to breach and choose action R in the good state, and perform in the bad state. Though the parties choose damages that are higher than ED, there are no efficiency consequences to that choice in this example.

e. Takeaways from Example 1

There are several useful takeaways from our analysis in Example 1. First, a side agreement with a SP remedy improves upon the status quo for the *S+J* coalition, but it can be inefficient. This happens because the defection creates negative externalities on the outside creditor (*C*) by inducing action L in the good state. In this case, however, the optimal *S+J* side contract will not include SP. *S+J* will prefer a contract SD that results in action R being chosen in the good state and action L in the bad state, which is consistent with efficiency.

Second, the *S+J* coalition chooses damages that are larger than ED. *S* loses only 80 when action R is chosen, but *S+J* contract for $d = 90$ to divert more value from *C*. In this case, there are no efficiency consequences to this redistribution of value, so our normative theory is unconcerned with the difference between SD and ED.¹⁰¹ But as we will show in Example 2, the difference can also matter for efficiency.

¹⁰¹ As a doctrinal matter, courts distinguish between appropriate liquidated damages provisions, which are enforceable, and penalties, which are not. See RESTATEMENT (SECOND) OF CONTRACTS § 356 (AM. LAW INST. 1981). In theory, they might therefore refuse to enforce a provision that provided for more than ED. But in practice, the lines are much fuzzier. See, e.g., *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1290 (7th Cir. 1985) (describing “[t]he distinction between a penalty and liquidated damages [as] not an easy one to draw in practice”). In addition, a substantial body of theoretical work concludes that SD that promise more than the promisee’s expected loss can be efficient. See, e.g., Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977); Samuel A. Rea, Jr., *Efficiency Implications of Penalties and Liquidated Damages*, 13 J. LEG. STUD. 147 (1984). We reach a similar conclusion in this Article, although our model will often call for the promisee’s remedy to be limited to ED.

Example 2: Side agreements lead to inefficiency; ED corrects the inefficiency

	Good State ($p=.5$)		Bad State ($1-p=.5$)	
	R	L	R	L
<i>S</i>	120	200	120	200
<i>J</i>	20	0	20	0
<i>C</i>	100	0	70	0
<i>S+J</i>	140	200	140	200
<i>S+J+C</i>	240	200	210	200

Example 2 is similar to Example 1. *S*'s and *J*'s payoffs have not changed, but *C* has a stronger preference for action R in both states. In fact, *C*'s preference is so strong that action R is now the efficient action in both the good and bad states.

Because *S*'s and *J*'s payoffs have not changed, the status quo, SP, and ED calculations are the same as under Example 1. But SD analysis is different in an important way: the side agreement may set the damages too high, leading to inefficient outcomes.

a. Stipulated damages

Under SD, the *S+J* coalition will face a trade-off when they set the terms of the side agreement. If they want to divert the most surplus from *C* in the good state, they will choose $d = 120$, so that (following Example 1) *C* will pay *J* its entire surplus of 100 in order to induce a breach. But if they do this, the damages will be so high that in the bad state, *J* will prefer not to breach and will choose action L. *S+J* will receive a total of 240 in the good state, and 200 in the bad state. Because the probability of each state is 50%, the *S+J* coalition would get an expected payoff of 220.

Alternatively, *S* and *J* could set $d = 90$. This damage payment will induce *C* to pay its full surplus of 70 in the bad state. In the good state, however, *C* will keep some of its surplus. When *C* and *J* bargain to a deal to defect in the good state, they will bargain to a 50/50 split of any surplus that arises in moving from action L to action R. A quick calculation will verify that *C* will pay a side payment of 85 to *J*, in order to induce *J* to breach.¹⁰²

¹⁰² Under action R, *J+C* together would get a direct payoff of 120, but pay damages of 90 to *S*. Under action L, they would get 0 and pay no damages. Thus, *J+C* would get a surplus of $120 - 90 = 30$ from choosing action R. Under a 50/50 split, *C* would keep a surplus of 15. Since *C*'s direct payoff is

Taking the side payments from *C* into account, if *S+J* choose $d = 90$, they would get $120 + 20 + 85 = 225$ in the good state and 210 in the bad state. This has an expected value of 217.5. Because 217.5 less than 220, *S+J* will set the damages high ($d = 120$). This leads to an inefficient choice of action L in the bad state.

Example 2 illustrates that SD can lead to inefficient outcomes. In an attempt to divert more of the surplus from *C*, *S+J* set the SD so high that *C* chooses not to bargain with *J* in the bad state. As a result, action L is chosen in the bad state instead of the efficient action R.¹⁰³

As in Example 1, if *J* were required to pay ED to *S*, it would pay only $200 - 120 = 80$ to *S* upon breach. As with Example 1, ED again yields an efficient outcome, as *J* will breach in both states and choose action R. In fact, ED will always lead to efficiency whenever the outside party (*C*) can freely bargain with *J*. To see this, note that *C+J* will strike a deal to defect to induce *J* to breach whenever the net gains to *C* and *J* exceed the damages. But the damages, because they are calculated using ED, are the net losses to *S*. Hence, *C* and *J* will internalize the costs of their action on *S*, making it the socially efficient choice.

b. Takeaways from Example 2

There are several new takeaways from Example 2. First, we saw in Example 1 that SP contracts can be detrimental to efficiency because they may inhibit a value-increasing bargain. In that example, the *S+J* coalition would prefer the more efficient SD contract. Example 2, by contrast, shows that a SD contract can lead to the same inefficiencies as SP. Again, the reason for inefficient side agreements is externalities: *S* and *J* do not have any incentive to consider the lost surplus that outside parties (*C*) sacrifice when the opportunity for a value-creating defection is lost due to excessively high damages. ED always lead to an efficient outcome, provided that the parties outside the side agreement can bargain with *J*. But the parties to the side agreement do not always have the incentive to write an agreement that leads to efficient outcomes, even if such an agreement is possible.

Before moving on to applications of the theory, we should note a few caveats. In the two examples above, we have shown that SP contracts can

100 in the good state, this means that *C* must pay $100 - 15 = 85$ to *J*. Notice that *J*'s total payoff is the direct payoff plus the side payment minus the damages: $20 + 85 - 90 = 15$.

¹⁰³ This result is an application of a classic result in the antitrust literature, which shows that exclusive dealing contracts between a buyer and a seller can have anticompetitive effects by blocking a lower cost seller from entering a market. See Philippe Aghion & Patrick Bolton, *Contracts as a Barrier to Entry*, 77 AM. ECON. REV. 388, 388–89 (1987). To our knowledge, the application of this idea to bankruptcy law is novel.

be inefficient because they prevent efficient breaches too often. But we haven't yet shown why the parties would choose a SP contract, notwithstanding its inefficiency. There are several reasons this could happen. For example, the parties might think—correctly or incorrectly—that courts will underestimate ED payable upon breach. SP can also be part of an optimal contract when it is the promisee (*S*) and not the promisor (*J*) who has the ability to bargain with an outsider to defect. We provide examples of these possibilities in the Appendix. In these cases, it will often be efficient to replace the parties' chosen remedy with ED. It is important to note, however, that replacing the parties' choice of remedies with ED is not a panacea for all efficiency problems and can lead to worse outcomes if externalities are low.

Our theory points out the costs and benefits of side agreements, but it notes that no alternative will provide a perfect solution for all sources of inefficiency that might arise. In the next section, we argue that while ED is not a perfect remedy, the Bankruptcy Code is better placed to handle the costs of ED than it is to handle the costs that arise from SP and SD.

III. NORMATIVE IMPLICATIONS

We can apply the results of the above analysis to develop a new framework for how courts should approach intercreditor disputes. To show how this framework plays out, we will revisit the disputes that faced courts in several recent high-profile bankruptcy cases¹⁰⁴ and then conclude by considering a final key case that was not treated as an intercreditor dispute but raises the same issues. We maintain our assumptions that bankruptcy law has a primary goal of maximizing the value of the estate. We also assume that there are, in some cases, limitations on the ability of parties to bargain around certain outcomes. The key, then, is for judges to enforce intercreditor agreements in the way most consistent with the model we have laid out above.

A. *Basic Principles*

We briefly state some of the lessons from the model before delving into the cases.

First, intercreditor agreements can reduce coordination problems between the parties to an agreement, and can thus maximize the joint value of their claims. This suggests that bankruptcy law need not interfere when the intercreditor agreement presents no risk of externalities. We define externalities as the potential to reduce the value of the estate for creditors

¹⁰⁴ See *supra* Part I.

who are not party to the intercreditor agreement (these creditors are the Cs in our examples above).

Second, side agreements, written to maximize the bankruptcy payoff of the parties to the agreement, can lead to inefficient outcomes when the party with the right to enforce (the promisee, or *S*) cannot bargain costlessly with other creditors in bankruptcy. Inefficiency can occur whether the parties contract for SP or SD. The inefficiency arises because the agreement between promisor (*J*) and promisee (*S*) does not take into account the benefits that nonparties would realize if a beneficial deal to defect were struck. Thus, the promisee and promisor may *ex ante* choose a remedy that puts a potentially efficient defection at risk in order to capture more of the surplus for themselves. Replacing SD or SD rights with ED eliminates this problem and leads to efficient outcomes when nonparties and the promisor can bargain, as long as the courts calculate ED properly.

Finally, ED do not solve all bargaining problems or eliminate all externalities. ED do not always lead to efficiency when it is the promisor, and not the promisee, which cannot bargain with outside parties. Moreover, if damages are calculated in a biased way by courts, they will not give proper incentives to the promisor to internalize the effects of her actions on the promisee.

While our theory so far helps us understand the costs and benefits of side agreements and various remedies in a qualitative way, it does not tell us which costs and benefits are quantitatively more important. To answer this question, we need to take a closer look at the costs associated with each remedy in the bankruptcy context.

In bankruptcy proceedings, the errors introduced by SP and excessive SD and the errors introduced by ED are different in kind. SP and excessive SD force the promisor to *under-assert* its interests and rights. In some cases, the agreement forces the promisor to go along with the promisee even when it is in the promisor's interest (either directly or because of a potential deal to defect) to do otherwise. If SP is fully enforced, the court is never exposed to information about the promisor's interests in the estate.¹⁰⁵ More importantly, the bankruptcy process relies crucially on self-interested parties taking affirmative steps—such as providing new financing or collaborating on a plan of reorganization—that can benefit the other stakeholders. If some parties are silenced by a side agreement, there is little a court can do to compensate other stakeholders for that silence.

¹⁰⁵ If the court considers a junior creditor's objection before ruling that it is precluded by an intercreditor agreement, the information loss will be more limited. But even in this context, the court will have less information than it would if the issue were fully argued.

Another way to frame this idea, then, is to say that SP of an intercreditor agreement removes a key party from the bankruptcy process. This should be as concerning as actions that remove essential assets from the estate. The Bankruptcy Code is designed around the concept of coordinated behavior of stakeholders. At key junctures, the Bankruptcy Code depends on the actions of one creditor providing benefits to the estate as a whole.¹⁰⁶ Most obviously, section 1129(a)(10) works this way: A plan of reorganization cannot be confirmed unless at least one class of impaired creditors votes in favor of it.¹⁰⁷ This provides a compromise between requiring unanimous (or majority) approval and allowing confirmation of any plan. The Bankruptcy Code assumes that if an adversely affected class of creditors votes in favor of a plan, that plan must be doing more than merely shifting value to the debtor or to a senior class of creditors. But intercreditor agreements could render this protection meaningless. If a class of creditors is bound by an agreement to support a plan, their vote will not provide any information about the propriety of the plan. And agreements that silence other objections will have a similar effect.¹⁰⁸

Limiting the promisee to ED, on the other hand, allows the promisor to *over-assert* its interests and rights. Sometimes the promisor will assert its interests even when they cut against the overall interest of the estate. For instance, the promisor may object to a sale or vote in favor of a plan even when doing so destroys value.¹⁰⁹ Given this possibility, the court will have to weigh the asserted interests of the promisor against the asserted interests of the promisee and the nonparty stakeholders. The difference, then, is essentially one of false negatives (from the standpoint of efficiency, the promisor is not asserting its rights enough) and false positives (from the standpoint of efficiency, the promisor is asserting its rights too often).

These costs are different in kind because the false negatives destroy value-enhancing agreements or deprive the court and the parties of the information necessary to assess the impact of decisions on the value of the estate. A side agreement might prohibit a junior lien creditor from

¹⁰⁶ See generally Douglas G. Baird, *Bankruptcy's Quiet Revolution* (Univ. Chi. Coase-Sandor Inst. for Law & Econ. Research, Paper No. 755, 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2767057 [<https://perma.cc/MKU8-MTCC>] (discussing the bargaining process and concessions between parties that ultimately lead to the emergence of a middle ground).

¹⁰⁷ 11 U.S.C. § 1129(a)(10) (2012).

¹⁰⁸ Similarly, agreements that prohibit a creditor from providing debtor-in-possession (DIP) financing would remove a viable lender from the process. Ultimately, any agreement that takes away a party's role in assessing the worth of the estate or a plan is an agreement that can harm the estate as a whole.

¹⁰⁹ The second-lien creditor's numerous objections that threatened to hold up the reorganization of ION Media are an example of over-assertion of rights to obtain a more preferable settlement. See *supra* Section I.A.

providing debtor-in-possession (DIP) financing.¹¹⁰ If the prohibition is specifically enforced, the value of the potential financing is never tested by the market or the bankruptcy court. And that value may have been such that it would have run to all stakeholders in the estate. Or a side agreement may prevent a junior lien creditor from objecting to a sale or voting in favor of a plan. Again, SP deprives the court of the information that would have been contained in the objection or the favorable vote. That lack of information may be detrimental to other dispersed and disorganized creditors who cannot bring objections (or support) on their own behalf.

The false-positive costs from the over-assertion of rights are much more readily mitigated by the Bankruptcy Code. The main cost is merely that the court has to sift through extra information, which may impose a delay. But that is not a major cost. Indeed, weighing the merits of self-interested arguments of stakeholders is precisely what bankruptcy courts and the Bankruptcy Code are set up to do. It is their primary function. Moreover, the entire Bankruptcy Code envisions a process whereby the court and stakeholders together resolve conflicting self-interests through a process of structured negotiation and litigation.¹¹¹

Thus, the costs of false positives imposed by ED are relatively small. When ED are inefficient, they merely require the court or the parties to do a little more information filtering. But SP and excessive SD deprive the court of valuable information and opportunities that could meaningfully enhance the value of the estate.

B. The Proposed Framework

The practical implication of our analysis is that courts should award ED rather than SP if there is a nontrivial likelihood of externalities. To be clear, courts should always enforce agreements for *at least* ED. Courts that have declined to give the promisee any remedy at all based on an unusually stringent interpretation of the scope of a side agreement have done so without justification. But SP or SD should only be available in the case

¹¹⁰ COMM'N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., 2012–2014 FINAL REPORT AND RECOMMENDATIONS 75 (2014), <http://abiworld.app.box.com/s/vvircv5xv83aav14dp4h> [<https://perma.cc/YG6L-VKKS>]; Mark N. Berman & David Lee, *The Enforceability in Bankruptcy Proceedings of Waiver and Assignment of Rights Clauses Within Intercreditor or Subordination Agreements*, 20 NORTON J. BANKR. L. & PRAC. ART. 1 (2011).

¹¹¹ A secondary cost is litigation costs. But if litigation costs are included as part of the expected damages reward, this cost is born by the party who is over-asserting their rights and will deter over-assertion. So, the real cost remains the court's effort in deciding the matter. Moreover, for large corporate bankruptcies, at least in relative terms, litigations costs are low. *How Much does Corporate Bankruptcy Cost?*, NOVA L. GRP. (Nov. 5, 2009), <http://novalawgroup.com/blog/?cat=28> [<https://perma.cc/95VW-FHSZ>].

where it is plain that there is no externality on the estate—that the dispute truly is contained in its impact to the creditors who were parties to the agreement.

A court should, thus, first determine whether an intercreditor agreement creates externalities. Because our analysis suggests that the costs of limiting SP are small (essentially just marginal decision costs on the court) relative to the costs of allowing it (depriving the court of information and estate enhancing opportunities), we do suggest that courts should err on the side of assuming there is an externality and limiting SP. SP should only be allowable where the risk of externality is *de minimis*. When that is true, the agreement should be enforced as written.

When, on the other hand, externalities are plausible, and a party seeks SP, we should first consider how our proposal would work in an ideal environment. If it were feasible, a perfect court would first assess whether there are bargaining hurdles between nonparties and either the promisee or the promisor. If bargaining hurdles exist only between the nonparties and the promisee, then ED is always preferable (assuming ED can be calculated). If there are bargaining hurdles between nonparties and the promisor, then the right remedy is ambiguous and the court would have to assess the actual level of externalities and only enforce agreements where doing so minimized externalities.¹¹²

This ideal-world prescription is unlikely to work in practice. It would require a court to: (1) identify the relative bargaining hurdles and determine which parties can effectively enter into deals to defect and (2) identify the magnitude of externalities that would arise from enforcing a side agreement and those that would arise from not enforcing it. It may be easy enough for a court to assess whether externalities are likely to exist. But to ask a court to dig into the precise nature and magnitude of bargaining hurdles as well as externalities is essentially to ask the court to litigate out the value of the estate. Once the court has determined which parties can bargain with each other and the full effects that those bargains will have on all other stakeholders in the estate, the court will have essentially determined which paths are best for the estate and which are worst. It is meaningless at that point to talk about specifically enforcing an agreement not to allow a junior creditor to assert a right. If the right is beneficial to the estate, the court will say that the prohibition has externalities. If it is costly to the estate, the court will say it has no externalities. The right will have been asserted and fully adjudicated. Moreover, such an inquiry, to the extent it looks at

¹¹² Bargaining hurdles on all sides would, of course, preclude deals to defect altogether and suggest that all bankruptcy decisions should be reviewed with an eye toward identifying externalities.

bargaining hurdles, may incentivize parties to create those hurdles where they do not otherwise exist.

Thus, the first best world of judicial inquiry into the precise bargaining hurdles and externalities involved with every side agreement is not possible. Instead, we suggest, as a second-best solution, a blanket rule favoring ED in the plausible presence of externalities. This solution dominates the other alternatives (all SP, all SD, or some combination) because, as noted above, the costs introduced by SP (and SD)—namely a reduction in information about the estate and other valuable opportunities that may arise from asserted rights—are of a kind that the Bankruptcy Code and the courts are not equipped to deal with. The errors introduced by ED, on the other hand, are mitigated by the core provisions of the Bankruptcy Code and the core expertise of the bankruptcy court. As a result, the costs of an all-ED rule are much lower than the costs of an all-SP or all-SD rule. SP and excessive SD can lead to inefficient outcomes in a large subset of cases, whereas ED merely requires the court to entertain self-interested arguments that run against the interest of the estate.

Again, assessing the merits of such arguments is one of the core functions of a bankruptcy court. Indeed, modern bankruptcy procedure is modeled on our civil adversary system and assumes the constant flow of information (good and bad) to the judge.¹¹³ Judges are well equipped to deal with overzealous parties and we should expect courts to deny motions and objections that destroy value. That likelihood of denial provides at least an imperfect deterrent against such motions and objections.¹¹⁴ Because the party knows that a court will deny a motion that destroys total value, it will account for the destruction of value to others when deciding whether to bring the motion. This effectively causes the party to internalize the value destruction. Moreover, ED that include the cost of litigation provide further incentives against motions and objections that parties expect the court to deny.

We cannot reach a parallel conclusion about value-creating motions or objections or financing arrangements that are never raised. If a party is forced to be silent and no one asserts a position, the adversary system does not do a good job of identifying and correcting that efficiency loss. An

¹¹³ See, e.g., Baird, *supra* note 106, at 35 (arguing that reorganization plans are unfair if they keep “bankruptcy judge[s] in the dark”); Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 981 (2004) (discussing the similarities of modern bankruptcy procedure and civil procedure).

¹¹⁴ An increased likelihood of denial reduces the possible return a party realizes from bringing a motion. If the party knows with certainty that a motion will be denied, the only value that can be realized from bringing the motion is from the possibility of getting a nuisance settlement (payment by the other party to avoid litigation costs).

efficient DIP financing arrangement that is never proposed cannot be created by the court, but an inefficient DIP financing arrangement that is proposed can be rejected by the court. The same is true of plan support or opposition. The asymmetry in how a judge deals with a bad objection (or assertion of a right) and a bad non-objection (or non-assertion of a right) creates the difference in kind between the costs of ED and the costs of SP that forms the foundation for our proposed framework.

It is worth pausing here to contrast our proposal to the 2014 proposal from the ABI reform commission.¹¹⁵ As part of a global proposal for reforming Chapter 11, the ABI commission specifically considered the impact of agreements that prevent junior creditors from providing DIP financing¹¹⁶ and the impact of agreements that provide for the assignment of junior creditor voting rights.¹¹⁷ In both instances, the commission concluded that these specific provisions could negatively affect the value of the estate and should, therefore, be unenforceable.

The first thing to note is that because the ABI commission proposal considers only DIP-financing and voting-rights provisions in intercreditor agreements, it does not cover the many other types of provisions that could create potential inefficiencies. The proposal is, in this sense, underinclusive.

With the two provisions the proposal does address, the commission's proposal is far too blunt. It would completely deny enforcement of DIP-financing and voting-rights assignment provisions even if there were no externalities present. Our model suggests that the provisions should be enforced in this context. And even where externalities are present, the model suggests that intercreditor agreements can often be enforced under an ED regime in a manner that increases rather than decreases the value of the estate.

C. *Forum and Venue*

In the discussion so far, we have focused on the questions of when and to what extent intercreditor agreements should be enforced. In an increasing number of recent cases, courts have faced an additional issue. If one party seeks to pursue its rights in bankruptcy and the other argues for a nonbankruptcy forum, which court should make the determination? Our model provides guidance here as well.

¹¹⁵ COMM'N TO STUDY THE REFORM OF CHAPTER 11, *supra* note 110.

¹¹⁶ *Id.* at 79.

¹¹⁷ *Id.* at 261.

There are two relevant groups of cases: (1) cases where the plaintiff only asks for ED; and (2) cases where the plaintiff asks for SP or SD.

1. ED-Only Contracts

There is no theoretical reason to think that a bankruptcy court has any special knowledge in determining ED or that ED must be determined before a plan is confirmed.

Rather, our analysis simply suggests that ED works better when a court gets the calculation right. In the absence of evidence that bankruptcy courts are better at measuring damages, there is no reason to favor a bankruptcy court over any other court and we should defer to the parties' contractual choices about forum.¹¹⁸

The takeaway, then, is that for ED only cases, courts should enforce forum selection clauses as written. If the contract does not contain a forum selection clause, courts should turn to the default rule that the plaintiff chooses the forum.¹¹⁹ There is really no bankruptcy reason to ignore these defaults and drag the case into the bankruptcy court.

In doctrinal language: If the promisee seeks ED, the parties' intercreditor agreement dispute is not "core" because the key issues are sufficiently independent of the issues in the reorganization.¹²⁰ The intercreditor agreement does not affect the total claims on the estate. It only affects the *ex post* redistribution of payouts among subgroups of creditors. The bankruptcy court can ignore the intercreditor agreement, award payments to the group of creditors as if the intercreditor agreement did not exist, and allow them to litigate the distribution later.¹²¹

One might argue that the intercreditor agreement claims are non-core claims that are nonetheless related to the bankruptcy and should be brought into the proceedings.¹²² But that position has no strong logic behind it. As a starting point, non-core claims cannot be resolved with finality by the

¹¹⁸ This is consistent with the general treatment of forum selection provisions in non-bankruptcy contexts. *See* *Atl. Marine Const. Co. v. U.S. Dist. Court for W. Dist. of Tex.*, 134 S. Ct. 568, 581 (2013) (noting that when a forum-selection clause is valid, "a district court should ordinarily transfer the case to the forum specified in that clause").

¹¹⁹ *See id.* at 574 (noting the default rule that the plaintiff selects the forum and the parties' ability to contract out of that default rule).

¹²⁰ *See, e.g., In re Best Prods. Co.*, 168 B.R. 35, 66–68 (Bankr. S.D.N.Y. 1994) (concluding that the court could not rule on objections to confirmation because the intercreditor dispute is not core under 28 U.S.C. § 157).

¹²¹ *See* Anthony J. Casey & Aziz Z. Huq, *The Article III Problem in Bankruptcy*, 82 U. CHI. L. REV. 1155, 1218–23 (2014).

¹²² *See* 28 U.S.C. § 1334(b) (2012) ("[T]he district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11.").

bankruptcy court.¹²³ So the bankruptcy court's power to coordinate is weak. And more importantly, these ED claims are state law claims between nondebtors with little impact on the claims against the estate. The only issue is the amount of damages and that has nothing to do with the size of the estate. All of these factors weigh in favor of honoring the forum selection clause if a side agreement includes one, and permitting the plaintiff to choose the forum if it does not.¹²⁴

2. *SP and SD Cases*

Considerations are much different for SP and SD cases. Our model shows that in many cases, the enforcement of SP (or SD) will impose direct externalities on the bankruptcy estate. The promisor may fail to assert rights whose benefits run to other creditors. Bankruptcy is a collective process that assumes that parties rely on the arguments and actions of other parties. Its very premise is to prevent behavior that will benefit some stakeholders at the expense of the collective estate.

Our model therefore has suggested that courts should refrain from enforcing SP and SD when there is a chance of externalities. Those externalities are directly related to the reorganization because an inefficient plan of reorganization or sale might be chosen if the promisor is silenced. For example, as we have shown, when J is specifically prohibited from objecting, C may be adversely affected because the value of the estate will be reduced.¹²⁵

A bankruptcy court overseeing the reorganization process has a unique expertise in determining whether SP (or SD) of a particular agreement will have externalities within that reorganization. This particular bankruptcy court should therefore decide the initial question of whether there are potential externalities. Once the court has undertaken to make that initial determination, it should continue with the case.

In doctrinal terms, any time that a plaintiff in one of these cases seeks to get SP (or SD), the case becomes core because it is integrally linked to the reorganization. This easily fits within both the statutory definition of core under 28 U.S.C. § 157 and under the constitutional definition in the *Stern v. Marshall* line of cases.¹²⁶

¹²³ See *Stern v. Marshall*, 564 U.S. 462, 471 (2011) (discussing how bankruptcy courts may enter final judgments in core proceedings, but in non-core proceedings, the bankruptcy courts submit proposed findings to the district court for review and final judgment).

¹²⁴ See *Gulf Oil Corp. v. Gilbert*, 330 U.S. 501, 508 (1947) (“[T]he plaintiff’s choice of forum should rarely be disturbed.”).

¹²⁵ See *supra* Section II.B.2.

¹²⁶ 564 U.S. 462. For bankruptcy courts to have adjudicatory power over a dispute, the dispute must be fall under the statutory definition of “core” set out in 28 U.S.C. § 157 and it must also meet the

This approach does allow the plaintiff (*S* in our model) some freedom to choose which court has power over the case. If *S* never asks for SP (or SD), then the case never becomes core. This is consistent with the general pattern in U.S. litigation of allowing the plaintiff as master of the complaint to craft a case consistent with its desired forum.¹²⁷

IV. APPLYING OUR THEORY TO CASES

In Part II, we described how bankruptcy courts have handled intercreditor agreement issues in the most important recent cases. Having developed our model and its implications, we now revisit the cases and explain how they would be resolved under our approach. In addition to the cases discussed earlier, this Part analyzes the *In re Extended Stay, Inc.* (*Extended Stay*) bankruptcy, which raises particularly subtle intercreditor agreement issues.

A. Boston Generating

The *Boston Generating*¹²⁸ bankruptcy involved an intercreditor agreement that set the priority of the parties to the agreement. It also included provisions preventing the second-lien creditors from bringing any objections or asserting certain rights. During the case these provisions raised the question of whether the second-lien creditors had standing to object to a sale. Despite terms providing that the second-lien creditors had no rights other than holding the lien, voting on a plan, and asserting the interests of unsecured creditors, the court allowed them standing to object to bid procedures.¹²⁹

To get there, the court introduced and applied the “beyond peradventure” standard.¹³⁰ The court appeared to say that provisions of an intercreditor agreement that limit the ability of a party to assert bankruptcy rights should be held to a higher standard of interpretation and enforced

constitutional definition of “core” laid out in *Stern*. Thus the court in *Stern* held that a bankruptcy court could not adjudicate a tort counter claim because it was statutorily core but not constitutionally core. *Id.* at 502–03.

¹²⁷ *Atl. Marine Const. Co. v. U.S. Dist. Ct. for W. Dist. of Texas*, 134 S. Ct. 568, 581 (2013) (“Because plaintiffs are ordinarily allowed to select whatever forum they consider most advantageous (consistent with jurisdictional and venue limitations), we have termed their selection the ‘plaintiff’s venue privilege.’” (quoting *Van Dusen v. Barrack*, 376 U.S. 612, 635 (1964))).

¹²⁸ Interim Order (I) Authorizing Debtors to Utilize Cash Collateral Pursuant To 11 U.S.C. § 363; (II) Granting Adequate Protection to Prepetition Secured Parties Pursuant to 11 U.S.C. §§ 361, 362 and 363; and (III) Scheduling a Final Hearing Pursuant to Bankruptcy Rule 4001(B), *In re Boston Generating, LLC*, 440 B.R. 302 (Bankr. S.D.N.Y. 2010) (No. 10-14419).

¹²⁹ See *Boston Generating*, 440 B.R. at 319.

¹³⁰ *Id.*

only if they lack any ambiguity. This is a strange mode of contract interpretation and suggests the courts may be playing fast and loose with the canons of contract law to get to a pragmatically desirable outcome.¹³¹ It also suggests that courts that adhere to the same approach will find themselves in a tough spot when the parties have drafted an ironclad agreement that nonetheless destroys value.

To be sure, the primary outcome in *Boston Generating*—denying specific enforcement of the agreement—is exactly what our proposal calls for, provided that the objection could impose externalities on nonparties to the agreement.¹³² The posture of the case was such that the externalities were *potentially* high, and the court would not have known the exact level until after it considered the objection. The sale, if it was not optimal, could have drained value from the remaining unsecured creditors (an externality). And until the court heard the objection from the second-lien creditors, it would not have known whether the sale was optimal or not. And if there had not been an organized and powerful creditor group to bring the objection, then the issue would have gone unreviewed. The potential externality from leaving important issues unreviewed is the precise problem that requires the denial of SP.

The path by which the court got to that outcome, however, is problematic. The “beyond peradventure” standard makes it less likely that a promisor would be required to pay damages when a side agreement is breached. To be sure, the damages in *Boston Generating* would have been small. The objection that the second-lien creditors brought was ultimately denied, and the sale went through.¹³³ The damages running to the first-lien creditors should, therefore, have been no more than the costs of responding to the objection. But if the objection had succeeded and value for the firsts had been lost, the damages might have been more significant.

Generally, the “beyond peradventure” standard invites promisors to opportunistically breach intercreditor agreements that involve some ambiguity. Imagine that the second-lien creditors’ objection could have

¹³¹ This is consistent with a common observation that bankruptcy courts often take some doctrinal license when working toward the right pragmatic outcome. *See, e.g.*, Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1, 24 (2013) (explaining that “judges are tempted to overlook the niceties of corporate form”).

¹³² A court might reasonably decide that the other creditors are so far out of the money that the outcome of the hearing would only affect the payoffs of the first- and second-lien creditors. SP would be justifiable under those circumstances.

¹³³ *Boston Generating*, 440 B.R. at 320–21 (acknowledging that “this is a somewhat hollow victory for the Second Lien Lenders, inasmuch as I have determined, after giving full consideration to the arguments and evidence presented by the Second Lien Agent and the objecting Second Lien Lenders, to approve the Sale Transaction”).

disrupted things just enough to stop the sale, and the first-lien creditors would have borne a large loss as a result. If the second-lien creditors do not bear any costs for that disruption, then they may bring the objection even when it destroys estate value. The only way to correct this is through ED, which causes them to bear the costs of the failed sale (and to balance them against the benefits of bringing the objection). But those damages are not awarded under the “beyond peradventure” standard that the court used.

Another potential unintended consequence of the “beyond peradventure” approach is that parties will skew the substance of future agreements so as to delineate the promisee’s rights more broadly. This may lead to promisors waiving more bankruptcy rights and create greater negative externalities. One common ambiguity in intercreditor agreements comes from promisors waiving only the rights that accrue to secured creditors while preserving their rights to object as unsecured creditors.¹³⁴ If second-lien creditors waive these additional rights, the waiver may become “clear beyond peradventure,” but it will also become much broader and actions that have the potential to benefit unsecured creditors will become less likely.

Boston Generating highlights the risks of both SP on one hand and a “beyond peradventure” standard (in which damages are not available) on the other hand. Our proposal suggests that it is better to alter the contractual remedies for breach (from SP or SD to ED) rather than the interpretive standard for determining breach. Enforcing broad contracts but not narrow contracts is over and underinclusive in perverse ways. Broad contracts that prohibit all defection will be specifically enforced without regard to the harm to the estate while narrow provisions that are targeted at specific holdout behavior will be unenforceable even for damages. An alternative approach—faithfully interpreting the language of the contract but only allowing for ED—ensures that the parties to the side agreement can tailor the agreement to prevent holdout behavior when it is most likely to occur without prohibiting other potentially beneficial defection behavior. If courts focus on the remedy, they can limit negative externalities of side agreements without interfering with this tailoring ability.

B. Momentive

Momentive was ultimately a damages case. Though the intercreditor agreement specifically gave the senior lien creditors the option to ask for a

¹³⁴ A junior secured lender will usually be both a secured creditor and an unsecured creditor because the value of its collateral will be less than the full amount of its claim, leaving the junior creditor with a secured claim up to the value of the collateral and an unsecured claim for the deficiency. See 11 U.S.C. § 506(a) (2012) (bifurcating claims of undersecured creditors).

SP remedy, senior lien creditors did not press arguments to enjoin the junior lien creditors from asserting their rights. Such a move would have been problematic, due to the dynamics of the Chapter 11 reorganization process. The Bankruptcy Code authorizes the debtor to propose a resolution of the bankruptcy.¹³⁵ In that process, the debtor can choose the particulars of the plan. In practice, this is achieved through complicated negotiations with various stakeholders, which result in a plan that favors some and disfavors others. The Bankruptcy Code then provides baseline protections such as absolute priority and the best interests test to ensure that alliances do not overly favor or disfavor certain groups of creditors.¹³⁶ There is still, however, a wide range of discretion in which the debtor may operate. Lots of deals to defect and other agreements are negotiated to ensure the debtor has the necessary support for a plan. Within the limits of the absolute priority rule and the best interests test, value moves from one group of stakeholders to another in an attempt to lock in a feasible plan that creates value for the estate as a whole. In *Momentive*, these deals took the form, as they increasingly do in large bankruptcies, of a restructuring support agreement (RSA).¹³⁷ The RSA locked in the defection and provided the details of the plan that would result.¹³⁸

If the senior lien holders in *Momentive* had forced the junior lien holders to vote against a plan, the court might have lost information about the value of the estate and the claims.¹³⁹ As noted above, only when parties assert their interests by voting and arguing in favor of a plan does the court receive information about: (1) whether the proposed plan complies with Bankruptcy Code requirements, such as the absolute priority rule and the best interests test; (2) whether the plan provides value to the estate; and (3) whether the deals to defect are problematic. Imagine a reorganization with three classes of creditors where side agreements silence the class in the middle. Now imagine there are two possible plans that could be confirmed. The best plan maximizes value and benefits the junior two classes. The other plan shifts value from the middle class to the senior creditors and

¹³⁵ See 11 U.S.C. § 1121(c) (2012) (giving the debtor an exclusive right to propose a plan initially); *id.* § 1121(d) (authorizing court to extend the debtor's exclusivity period).

¹³⁶ The absolute priority rule prohibits confirmation of a reorganization plan that would give any recovery to a lower priority class unless the objecting class is paid in full. See 11 U.S.C. § 1129(b) (2012). The best interests test requires that each creditor or equity holder be given at least as much as it would receive in a Chapter 7 liquidation. See 11 U.S.C. § 1129(a)(7) (2012).

¹³⁷ Baird, *supra* note 106, at 19.

¹³⁸ See Declaration of William H. Carter, Chief Financial Officer of Momentive Performance Materials Inc., In Support of Chapter 11 Petitions and First Day Pleadings at 66, *In re MPM Silicones, LLC*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014) (No. 14-22503).

¹³⁹ This might include information about the risk of the business, the value of its assets, or the cost and availability of alternative capital sources.

leaves the third class completely out of the money. Without hearing from the middle class, the court is faced simply with a two-party disagreement about the value of the two plans. Now imagine, quite realistically, that the third class is a fractured and dispersed group of unsecured creditors. If we let the middle class vote and assert their interest, we are likely to get a plan that maximizes the estate and benefits the two junior classes.¹⁴⁰ Much information can thus be gained by allowing the middle class to assert its interest and express its independent view of the options.

As noted above, the junior lien holders in *Momentive* were allowed to assert their interests. In that sense, the outcome of the case is consistent with our model. The standard was a rough doctrinal tool to get a pragmatic outcome. Yet, the court—applying the “beyond peradventure” standard—found no breach of the agreement and therefore awarded no damages for the senior lien creditors. Applying the “beyond peradventure” standard to damages cases in that way is not consistent with our model. This application introduces unnecessary costs on independent contracting, and thus makes it harder to design an agreement that is targeted at preventing holdout behavior.

Once SP was off the table and the junior lien creditors were allowed to assert their interests, there was no longer a bankruptcy purpose to justify not awarding damages on the contract. Instead, the court simply failed to enforce an intercreditor agreement and reduced the ability of the nondebtors to privately order their respective payments from the bankruptcy estate. Our model suggests instead that *Momentive* should have been an ED case—and one that never belonged in the bankruptcy court in the first place.¹⁴¹

C. RadioShack

As noted earlier, the disputes in *RadioShack* were quite complicated.¹⁴² Standard General wanted to credit bid the amounts owed to it under the ABL.¹⁴³ Salus was trying to assert the rights of the SCP lender group under an intercreditor agreement to stop Standard General from doing that.¹⁴⁴

¹⁴⁰ See generally David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992) (arguing that the Bankruptcy Code is designed to focus voting authority on the affected class or classes).

¹⁴¹ We discuss the appropriate damages calculation in Part V, *infra*.

¹⁴² See *supra* Section I.C.

¹⁴³ See Transcript of Hearing, *supra* note 16, at 38.; Borders et al., *supra* note 16, at 2. On the definition of credit bidding, see, e.g., *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 320 (3d Cir. 2010) (defining credit bid as “allow[ing] a secured lender to bid the debt owed it in lieu of other currency at a sale of its collateral”).

¹⁴⁴ See Transcript of Hearing, *supra* note 16, at 23, 29–30, 34, 63.

Cerberus was trying to assert its rights under an AAL to prohibit Salus from asserting its rights to block the credit bid.¹⁴⁵ Finally, the first-out lenders of the ABL were trying to assert their rights under an AAL to stop Standard General from moving forward with the sale and credit bid.¹⁴⁶

In the end, the court formally held that Cerberus could stop Salus from asserting its rights.¹⁴⁷ At the same time, the first-out lenders were pressured by the court to settle and give up their objections to the sale.¹⁴⁸ As a result, the sale went forward.¹⁴⁹

From a realist perspective of the whole case, the court was fully aware of (and likely considered) all the various parties' reasoning and arguments and let the sale go forward. The realist might view the court's actions as refusing to allow anyone to assert rights that would prohibit the sale. The court, then, heard all the arguments, decided the sale was the appropriate outcome, and ruled on the various agreements in a way that allowed the sale to go through. In that sense, the denial of Salus's ability to object did not deprive the court of the necessary information to rule on the sale.

From a more formalistic viewpoint, it declined to specifically enforce the first-out lenders' asserted right to prohibit Standard General from bidding. It then specifically enforced Cerberus's right to stop Salus from specifically enforcing its right to prohibit the bidding.

Our model suggests that the court got to the right outcome but that the formalistic path was not quite right. Salus's attempt to stop the sale under the intercreditor agreement was fraught with the risk of imposing externalities on the estate (the unsecured creditors in particular). The court should have denied Salus the right to invoke the intercreditor agreement outright, rather than denying it indirectly by granting Cerberus's SP request. Finally, damages suits should have been the remedy allowed for each of the various parties.

D. Extended Stay

The *Extended Stay* bankruptcy involved two separate disputes that implicate our model.¹⁵⁰

The Extended Stay hotel chain had been acquired by an investor consortium led by David Lichtenstein in 2007.¹⁵¹ The funds were raised

¹⁴⁵ *Id.* at 63.

¹⁴⁶ *Id.* at 67.

¹⁴⁷ See Transcript of Hearing, *supra* note 75, at 64–65.

¹⁴⁸ See *id.* at 65–67.

¹⁴⁹ See *id.* at 60–67.

¹⁵⁰ See *In re Extended Stay Inc.*, 418 B.R. 49 (Bankr. S.D.N.Y. 2009), *aff'd in part*, 435 B.R. 139 (S.D.N.Y. 2010).

through a mortgage loan and ten layers of mezzanine loans.¹⁵² The mortgage loan was sold to a trust and certificates in the trust were then sold off into eighteen different priority classes.¹⁵³ Some of the mezzanine loans were also securitized and interests in them were resold.¹⁵⁴ The result was a constellation of dozens of creditor classes who were vying for power when the chain filed for bankruptcy in 2009.¹⁵⁵

The first dispute that concerns us was among the holders of the trust certificates for the mortgage loan. The trust agreements provided for a Servicer and Special Servicer who would be the sole representatives of the certificate holders.¹⁵⁶ The certificate holders agreed that they would have no individual rights to institute any action or proceeding in bankruptcy.¹⁵⁷ They also agreed that no certificate holder could take any action that would prejudice the rights of any other certificate holder.¹⁵⁸

Based on these agreements, Five Mile Capital, one of the certificate holders, brought an action against other junior certificate holders to enjoin them from engaging in any negotiations and agreements with a debtor.¹⁵⁹ Consistent with our venue analysis, which characterizes an attempt to specifically enforce a side agreement as core, the bankruptcy court held that an attempt to enjoin negotiations with a debtor was plainly core and affected the bankruptcy proceedings.¹⁶⁰

This dispute falls at the heart of our model. Five Mile Capital's attempt to prevent any negotiation of deals to defect was likely to create externalities that could reduce the overall value of the estate. The appropriate remedy for the breach of the trust agreements under our analysis is to deny the injunction and allow an action for damages.

The second dispute related to a “bad boy” guarantee agreement. Bad boy guarantees are terms by which a borrower and its guarantors agree to be liable to lenders for certain “bad acts.”¹⁶¹ The bad acts often include the

¹⁵¹ *Id.* at 54.

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 56.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.* at 57.

¹⁶⁰ *Id.* This ruling was affirmed on appeal by the district court. *Extended Stay*, 435 B.R. at 146 (“Five Mile’s efforts to prevent the Debtors from pursuing ongoing post-filing negotiations in their reorganization proceeding clearly implicate the core bankruptcy function of estate administration, particularly plan formulation.”).

¹⁶¹ See Djaha et al., *supra* note 21.

filing of bankruptcy. The effect is a provision that converts a non-recourse mortgage into a loan with recourse against the debtor and its principals when a debtor files for bankruptcy. In *Extended Stay*, Lichtenstein and his equity fund had personally guaranteed the mezzanine debt up to \$100 million in the event that the debtor filed a bankruptcy petition.¹⁶² The bankruptcy court held that these claims were neither core nor related to the bankruptcy and found that it did not have jurisdiction over them.¹⁶³ Our model suggests this was the wrong decision.

These guarantees may not appear on their face to be intercreditor agreements of the type we have been considering. Instead, they are agreements between the debtor and its principals on one side and a creditor on the other. But the liability of the principals can have the exact same effect as the intercreditor agreements in our model. If a principal is required by the guarantee to take or not take certain actions, this can change the decisionmaking process in bankruptcy. Just as a creditor may be forced to refrain from negotiations or from voting on a plan, a controlling shareholder may be forced to refrain from filing a bankruptcy and proposing a plan. This can prevent deals to defect between other creditors and the controlling shareholder.

For example, a net positive value bankruptcy filing may benefit the estate as a whole but be prohibited under a bad boy guarantee. If the creditor chooses to enforce that guarantee specifically or by SD, the estate will be worse off. And, it turns out, these agreements in operation often have the flavor of excessive SD.

This was true in *Extended Stay*. Bank of America argued that its claim had nothing to do with the bankruptcy estate because the money came out of the equity holders' pockets, not the estate. The agreements even prohibited any indemnification claims from guarantors against the estate.¹⁶⁴ But, if enforced, the agreements—which required payment of up to \$100 million—functioned as a SD provision that would discourage the filing of a bankruptcy even when that filing was value-enhancing for the estate.

To see why, compare the payouts to Bank of America outside bankruptcy to those in bankruptcy. Outside bankruptcy, Bank of America had a non-recourse claim on the collateral. Inside bankruptcy, Bank of America had that same claim. Thus, the expected damages for the bad act—filing for bankruptcy—would be the difference in the value of that

¹⁶² See *Extended Stay*, 418 B.R. at 54.

¹⁶³ *Id.* at 57–59. On appeal, the district court agreed that the matters were not core but found that they were related to the bankruptcy. *Extended Stay*, 435 B.R. at 150. It nonetheless affirmed the holding because it found that abstention of jurisdiction was appropriate in that case. *Id.*

¹⁶⁴ *Extended Stay*, 418 B.R. at 58.

recourse claim in bankruptcy and the value of the same claim out of bankruptcy.¹⁶⁵ But the guarantee provides damages equal to the total deficiency claim (the difference between the total debt and the value of the recourse claim). The guarantee value, then, can greatly exceed the ED.¹⁶⁶ This transforms the guarantee into a SD clause that imposes the exact externalities we discuss in our model. These claims are therefore core to the bankruptcy proceeding,¹⁶⁷ and if the externalities do exist, only ED should be allowed and awarded.

V. CALCULATING EXPECTATION DAMAGES

Now that we have discussed the leading cases, we can address with examples a concern that our proposal might raise—namely that a court might not calculate ED properly. If the parties do not have faith in the courts to calculate the damages for breaches of intercreditor agreements, the superiority of ED over the side agreement parties' choice of remedies is not guaranteed.¹⁶⁸ Damage awards that are too high have the same effects as SD. Damage awards that are too low may have no useful impact and encourage too many breaches. In those cases, ED will be flawed.

This problem is not unique to intercreditor agreements. Rather, the inability to calculate accurate damages is common to all areas of contract law.¹⁶⁹ But there are at least three reasons to think that the scope of the problem will be limited in relation to intercreditor agreements.

First, courts calculate complicated damages claims all the time. Indeed, every large bankruptcy is really one large series of claim and asset

¹⁶⁵ The difference might arise from the Bankruptcy Code's suspension of rights that the creditor might exercise or be based on economic effects from the filing. Unsecured creditors are not entitled to interest or opportunity cost payments during the bankruptcy case.

¹⁶⁶ For example, a creditor may have a lien of 100 on an asset worth 50. Assume the debtor has no other assets. Outside bankruptcy, that claim is worth 50 (assuming no cost of foreclosure). Inside bankruptcy, that claim might be worth 45 (assuming 5 in process costs of bankruptcy). The ED are 5. A bad boy guarantee provides recourse against the principal for any shortfall below 100. Assuming the guarantor is solvent, the bankruptcy filing provides recovery of 100.

¹⁶⁷ If damages were set high enough, the bad boy guarantee could become the equivalent of an absolute agreement that prevents a party from filing bankruptcy altogether. Such an agreement goes to the very heart of bankruptcy and is generally not enforceable. *See, e.g., In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 263 (Bankr. D. Del. 2016) ("It is a well settled principle that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy." (internal quotation marks and citation omitted)). Again our framework suggests that such a policy is wise as it applies to SP and SD but not as it applies to ED.

¹⁶⁸ *See* Example 3 in the Appendix, which shows that ED can be inferior to the parties' choice of SP when externalities are low.

¹⁶⁹ *See, e.g., Metallurgical Indus., Inc. v. Fourtek, Inc.*, 790 F.2d 1195, 1208 (5th Cir. 1986) ("If too few facts exist to permit the trier of fact to calculate proper damages, then a reasonable remedy in law is unavailable.").

valuations. Courts will not be perfect at valuing the damages for these claims, but they should be relatively good at it. Nevertheless, damages could be too speculative to calculate.

This is a practical and a doctrinal problem. Courts generally will not award damages when the claims are unduly speculative. This rule varies by jurisdiction, but the general rule is that the parties have to be able to show the presence of damages with some certainty.¹⁷⁰ Notably, this doctrine does not require absolute certainty and allows for sophisticated financial evidence to provide a reasonable estimate of the losses caused by a breach.¹⁷¹

That said, courts are more skeptical of some types of claims than others. For instance, lost-profits claims tend to garner the closest scrutiny under the uncertainty doctrine.¹⁷² That suggests that our proposal will face the largest obstacle when damages claims are brought based on the speculative future business performance under counterfactual plans of reorganization that *might have* been confirmed but for the breach of the side agreement. But damages based on the value of actual differences in asset distributions, in concrete financing proposals, in interest rates, in costs of procedures, and in the price paid for assets should fit easily within the courts' traditional valuation toolkit. If the party seeking damages can show the likelihood that the breach foreclosed a concrete alternative, the court will be able to arrive at a reasonable estimate of the damages associated with that breach.

Most damages claims for breach of a side agreement will meet this standard. For example, the primary claims in *Momentive* were that the junior creditor breached the side agreement by (1) supporting a plan with a low cramdown interest rate for the senior creditor; (2) supporting a plan that did not provide make-whole payments to the senior creditors; (3) opposing the senior creditors' request for adequate protection payments; (4) receiving distributions that violated the priority set forth in the agreement; and (5) supporting DIP financing that provided the new lender with priming liens on the senior creditors' collateral.

The damages on the first and second claims would be easy to calculate. The interest rate differential and the make-whole differential are set, so finding those numbers requires simple subtraction. The only open

¹⁷⁰ See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 352 (AM. LAW INST. 1981).

¹⁷¹ See *Ashland Mgmt. Inc. v. Janien*, 624 N.E.2d 1007, 1010–11 (N.Y. 1993); *Tanner v. Exxon Corp.*, No. 79C-JA-5, 1981 WL 191389, at *1 (Del. Super. Ct. July 23, 1981); RESTATEMENT (SECOND) OF CONTRACTS § 352; 24 SAMUEL WILLISTON & RICHARD A. LORD., A TREATISE ON THE LAW OF CONTRACTS § 64:8 (4th ed. 2002).

¹⁷² See Example 3 in the Appendix.

question is whether or not the plan would have been approved but for the support of the breaching party. That is a mechanical application of Bankruptcy Code's voting requirements for cramdown.

Damages for the third claim turn on the amount of the adequate protection payments and the likelihood that they would have been granted in the absence of the opposition by the breaching creditors. The only speculation required to calculate those damages is speculation on the outcomes of judicial process, a topic on which judges have sufficient expertise. The damages on the fourth claim are straightforward, as courts regularly resolve priority and subordination questions. The fifth claim poses perhaps the most uncertainty. To prove damages, the senior creditors would have to show a concrete alternative financing proposal that would have been adopted if the breaching creditors had not supported the one they did. Once that showing is made, calculating damages is just a matter of comparing the protections the senior creditors would receive under two proposals.

The *RadioShack* and *Boston Generating* cases dealt with objections to bankruptcy sales. In *Boston Generating*, the damages would have been merely the litigation costs. The breaching party brought its objection to the sale, the objection was denied, and the sale went through. Had the sale been blocked, the court would have had to compare the actual outcome with the terms of the proposed sale. That is not a speculative calculation. In *RadioShack*, the parties on both sides of the sale objections invoked side agreements. Salus and the first-out lenders wanted to invoke side agreements to block the sale, and Cerberus wanted to invoke a side agreement to push the sale through (to block objections to the sale). Cerberus's damages claims would be no different than the damages claims in *Boston Generating*. If the sale was blocked, the court would just need to compare the sale that was blocked with the actual outcome.

Salus's damage claim, on the other hand, might have been deemed unduly speculative. There was little evidence that any alternative buyers were actually available to buy the assets. Nothing was known about competing prices or terms. Any claim based on a breach that leads to a sale is speculative if the alternative to a sale was simply waiting and hoping for a better deal to come along. That suggests that without concrete evidence of an alternative, the damages for a breach that leads to a sale will be zero (or at least no more than the cost of litigating the issue).

Five Mile Capital's claims in *Extended Stay* would be, perhaps, the most speculative. The allegation was that the breaching party was negotiating with the debtor "over the contours of a potential plan of

reorganization” in violation of the side agreement.¹⁷³ Measuring the damages in that situation requires a prediction of what the “contours” of a confirmable plan would have looked like in the absence of the negotiation. Without deeper information about the specific provisions at issue,¹⁷⁴ that is a difficult counterfactual to prove. Thus, we recognize that in a small population of cases ED might undercompensate because they are speculative. But the realm of cases where damages are truly speculative is small enough to give us confidence that ED are preferable as a general rule.¹⁷⁵

Second, the relevant comparison in measuring how well damages are calculated is between the courts’ accuracy in setting damages *ex post* and the accuracy of the parties in estimating damages *ex ante*. For expectation damages to function as we describe in our model, they only need to be as good as or better than the *ex ante* estimates that parties use when writing these agreements. There is good reason to think the courts will be more accurate: A court adjudicating these claims after the fact has more information about the damages claim than the parties have when setting SD or providing for SP long before distress arises. The court also has the benefit of expert testimony and could even bring in unbiased court-appointed experts.

The *ex post* nature of the damages inquiry also gives the court the time for reflection and gathering of evidence. In deciding a SP question that determines whether a court will allow objections to a sale or a confirmation hearing, the court is under considerable time pressure. Parties often argue that a quick sale is imperative to avoid the classic “melting ice cube” problem of bankruptcy. In those contexts, decisions on SP, and general decisions about whether certain debtor actions are acceptable, have to be made with limited information. An intercreditor damages claim, on the other hand, need not be decided on such a short time frame. If a junior

¹⁷³ *In re Extended Stay Inc.*, 435 B.R. 139, 146 (S.D.N.Y. 2010).

¹⁷⁴ Because the case was injunctive in nature, Five Mile Capital was attempting to prevent all potential negotiations and thus framed its legal argument broadly. Had the case been in a damages stage, Five Mile Capital likely would have pointed to concrete provisions that harmed it, and that evidence might have demonstrated damages more specifically.

¹⁷⁵ Many of the damages calculations we have discussed deal with bankruptcy-specific processes. That might lead some to disagree with our earlier conclusions on forum and venue and call for these disputes to be litigated exclusively before a bankruptcy court. But none of these processes are conceptually inaccessible to a generalist judge who is experienced in hearing evidence on and measuring damages in all sorts of fields. And the ability of bankruptcy experts to testify as to the costs of these processes makes the damages calculation here no different than the calculations in the medical malpractice, environmental, or financial cases that courts routinely adjudicate. Additionally, the parties always have the ability to include forum selection or arbitration clauses that require the cases to be heard by someone with expertise.

creditor wants to support an emergency bankruptcy sale in violation of an intercreditor agreement, the court can allow the sale to go through under standard bankruptcy principles and then adjudicate later whether the junior creditor's support harmed the senior creditor. Evidence that comes to light after the sale (such as proof that another firm bidder would have come to light if the sale had been delayed) cannot be used to undo the sale, but it can be used to support a damages claim under the intercreditor agreement.

Third, the problem only exists if the expected value of a claim is skewed in one direction. If courts are imprecise in an unbiased manner, the model still holds.¹⁷⁶ When considering whether to breach a side agreement and valuing the potential damages for that breach, the parties will compare the benefit of breaching against the expected value of the damages claim. If errors are unbiased, that expected value does not change. Of course, if there are some claims where the courts are known to systematically err in one direction, the framework could be modified to allow for SP where we expect courts to get things systematically wrong. The judicially mandated interest rates used in cramdown¹⁷⁷—which do not match actual market rates—might be an example of this sort of systematic bias.

CONCLUSION

In this Article, we analyzed intercreditor and other side agreements, and what bankruptcy law should do about them. The courts' current approaches to the topic vary. They recognize potential problems with fully enforcing these agreements, but their response to that recognition tends to be a decision to read the contract language narrowly so as to preserve the rights the Bankruptcy Code provides. This approach, as we show, may cause parties to simply draft these side agreements using broader language, thus exacerbating the underlying problem. We argue that a more systematic approach that addresses remedies is warranted.

We model the costs and benefits of enforcing side agreements and show that side agreements can create externalities that bankruptcy law is justified in limiting. We propose that side agreements should be enforceable but only for damages and not specific performance. The equitable remedy of specific performance for a breach of a side agreement should be replaced with expectation damages if there is a potential for

¹⁷⁶ See Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORG., 279, 293 (1986); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399, 406 (1973); Kenton K. Yee, *Control Premiums, Minority Discounts, and Optimal Judicial Valuation*, 48 J.L. & ECON. 517, 536–37 (2005) (noting the irrelevance of unbiased errors for risk neutral litigants).

¹⁷⁷ See *Till v. SCS Credit Corp.*, 541 U.S. 465, 479 (2004).

value-destroying externalities. Though our proposal is not a panacea for all problems that might arise in bankruptcy, on balance, it honors the purpose of the side agreement while preserving open space for value-increasing actions that can benefit outside stakeholders.

APPENDIX

In this Appendix, we give two additional examples to show that parties may choose SP inefficiently and that ED can improve upon SP. But ED is not a panacea, and when externalities are low, enforcing the parties' agreed-upon bargain is socially preferred.

Example 3: Undercompensatory ED

	Good State ($p=.5$)		Bad State ($1-p=.5$)	
	R	L	R	L
<i>S</i>	130	200	100	250
<i>J</i>	20	0	20	0
<i>C</i>	70	0	120	0
<i>S+J</i>	150	200	120	250
<i>S+J+C</i>	220	200	240	250

In Example 3, we consider the possibility that courts will underestimate expectation damages, which leads the parties to choose SP instead. But ED would be efficient notwithstanding its undercompensation of the promisee. The undercompensation allows *C* to capture more of the gains from defection, which *S+J* do not internalize when they strike their side deal.

a. Status quo

As in Examples 1 and 2, *J* would choose action R to improve her payoff by 20. This is efficient in the good state (it produces a total payoff of 220 versus 200) but inefficient in the bad state (a total payoff of 240 instead of 250).

b. Side agreement with SP

If the parties choose SP, *J* will agree to choose action L, which generates a higher payoff for the *S+J* coalition in both states (200 versus 150 in the good state and 250 versus 120 in the bad state). The *S+J* coalition will get an expected payoff of 225 under SP.

c. Side agreement with SD

In Example 3, action R is costly for *S*, but it is particularly costly for *S* in the bad state. If the parties choose a SD contract, they have two choices: they can try to set damages high enough to prevent action R in the bad state, or they can set damages lower in order to elicit action R and a side

payment from *C* in the good state. They cannot do both. If they set damages above 90, then *J+C* would find it too expensive to defect in the good state. But if they set damages below 140, *J+C* would defect and choose action R in the bad state.

In Example 3, the optimal SD contract for the *S+J* coalition is $d = 140$ or higher, which elicits action L in both states. Thus, the optimal SD contract is equivalent to a SP contract. If they were to choose $d = 90$ instead, action R would be chosen in both states. In the good state, this elicits a side payment of 70 from *C* to *J*, and in the bad state, *C* pays 95 to *J*.¹⁷⁸ The *S+J* coalition anticipates these side payments, and thus they expect a total payout of 220 in the good state and 215 in the bad state for an expected payoff of only $217.5 < 225$.

d. Undercompensatory ED

Now, let's assume that courts will attempt to estimate ED upon a breach, but they will underestimate the damages by 50%, and all parties are aware of the undercompensation. In the good state, *S* loses 70, so the true damages will be estimated at 35. In the bad state, the true damages of 150 will be estimated at only 75. Given the undercompensatory damages, *J* will choose to defect in both states and choose action R. When *C* and *J* bargain, *C* will make a side payment of 42.5 in the good state and 87.5 in the bad state to induce action R.¹⁷⁹ Thus, the *S+J* coalition expects 192.5 in the good state (direct payoff of 150 plus the 42.5 side payment) and 207.5 in the bad state (120 plus 87.5). This produces an expected payoff of 200, which is less than their expected payoff from the SP contract (225). Though SP is preferred by the *S+J* coalition, undercompensatory ED produces a higher total payoff for all parties. Undercompensatory ED results in action R in both states, and the total expected payoff to all parties is 230. The SP contract results in action L in both states, which produces a total expected payoff of only 225.

Two points about undercompensatory ED are worth emphasizing. First, undercompensatory ED beats the *S+J* coalition's SP contract from a social perspective because externalities are sufficiently high. To see this, suppose *C*'s payoff from action R falls by 40 in both states (to 30 in the good state and 80 in the bad state). Because damages are low, *C* and *J* would bargain to breach and choose action R in both states, but the social

¹⁷⁸ A side payment of 95 splits the surplus from defection between *J* and *C* in the bad state. Collectively, *J* and *C* gain 50 from defecting (their direct payoff increases by 140, less 90 in damages). *C* gets half of that surplus in bargaining, so it will pay 95 to *J* and keep $120 - 95 = 25$.

¹⁷⁹ In the good state, *C* and *J* would get a surplus equal to the improvement in their payoff from choosing action R less the damages they pay to *S*. This is $90 - 35 = 55$. *C* gets half of that surplus, or 27.5, so *C* pays a side payment of $70 - 27.5 = 42.5$ to *J*. The bad state calculation follows similarly.

payoff would be inferior to choosing action L in both states. Significant externalities are necessary to justify replacing SP with ED.

Second, undercompensatory ED is not as efficient as fully compensatory ED would be. If ED were estimated properly, *J* would breach and choose action R in the good state and L in the bad state. This would be the most efficient option, and if it were available, *S* and *J* would choose it. But because it is not available, they choose a SP contract that is inferior socially to the undercompensatory ED that is available.

e. Takeaways from Example 3

Example 3 illustrates that parties may rationally avoid ED because they do not expect courts to fully estimate the damages from breach. When damages are undercompensatory, breach occurs more often than is socially efficient. Undercompensatory ED also results in a greater surplus being retained by parties outside the side agreement. This causes the side contracting parties *S+J* to steer away from ED and choose an alternative (SP) that allows the coalition to keep more of the surplus that is available, even though this choice may be socially inferior. When externalities are higher, the incentives of parties become more skewed toward SP and away from undercompensatory ED.

Example 4: Bargaining with *S* to enforce the side agreement

	Good State ($p=.5$)		Bad State ($1-p=.5$)	
	R	L	R	L
<i>CI</i>	0	50	0	50
<i>S</i>	210	200	120	200
<i>J</i>	20	0	20	0
<i>C2</i>	50	0	50	0
<i>S+J</i>	230	200	140	200
<i>CI+S+J+C2</i>	280	250	190	250

In Example 4, we consider the possibility that the bargaining environment may change. In this case we suppose that *S* is able to strike a deal to defect but *J* is not. What effects will this have on the incentives of the *S+J* coalition with respect to the side agreement they write, and how will this impact the efficiency of ED as an alternative?

To make the case interesting, we introduce two outside parties (*CI* and *C2*). *CI*'s interests are more aligned with *S* than with *J*, while *C2*'s

interests are more aligned with *J*. We suppose that *CI* has the ability to bargain with *S*, but *C2* and *J* cannot bargain.

f. Status quo

The status quo outcome is similar to Examples 1 and 2. *J* will choose action R to improve her payoff by 20. This will be consistent with efficiency in the good state (a total payoff of 280 versus 250) but inefficient in the bad state (190 versus 250).

g. Specific performance and stipulated damages

Notice that in this example, *S*'s and *J*'s direct payoffs are aligned in the good state: they both prefer action R. This makes the analysis of SP contracts different from the earlier examples. If *S+J* can write a side deal that includes SP as a remedy, *S* will require that *J* choose action L. This will result in *J* choosing action L in the bad state. In the good state, however, *S* also prefers action R. Thus, *S* can choose not to enforce the side agreement, allowing *J* to choose action R. Knowing this, *CI* will offer a side deal to *S* to induce *S* to enforce the contract against *J*.¹⁸⁰

Because *CI* strongly prefers action L, *CI* will be willing to pay *S* to invoke its right against *J*. Because *CI* and *S* will split their total surplus of $250 - 210 = 40$ in half, *CI* will pay 30 to *S* to induce *S* to invoke *J*'s choice of action L.¹⁸¹ This is inefficient in the good state because *C2*'s payoff is not taken into account.

If *S* and *J* chose to write a contract with SD, the outcome would be equivalent to the SP outcome. *S* and *J* would set damages high enough that *J* will prefer not to breach the contract if *S* chooses to enforce it. *J* will choose action R in both states, and in the good state, *CI* will make the same side payment to induce *S* to enforce the contract against *J*.

h. Expectation damages

Under ED, the outcome differs from the outcome that would occur under the *S+J* coalition's preferred contract. In Example 4, ED again results in a more efficient outcome. In the bad state, *J* will perform under the contract and choose action L. In the good state, *J* will breach and choose action R. *J* will not need to pay any damages for breach because *S*'s direct payoff also favors action R. This outcome is consistent with efficiency.

¹⁸⁰ Note that this does not require a bargain with *J*, which we have assumed is not possible here. *S* could simply communicate to *J* whether it intended to enforce its contract against *J* or not, and *J* will act accordingly.

¹⁸¹ The payment of 30 consists of 10 to compensate *S* for its lower payout under L (200, vs. 210 under R), plus one half of the parties' joint surplus of 40.

It is crucial to emphasize, however, that the efficiency consequences can be reversed, depending on *C2*'s payoff. To see this most simply, consider Example 4 if *C2*'s payoff in both states falls from 50 to below 20 under action R. None of the contracts or outcomes would change, but the efficiency consequences would be reversed and the SP contract the parties prefer would yield an efficient outcome, while ED would not.

i. Takeaways from Example 4

Example 4 highlights another potential source of inefficiency that can result from side contracting, but it also illustrates that replacing the parties' choice of remedies with ED is not a panacea for all efficiency problems. The inefficiency of the side agreement follows because the parties to the side agreement will take into account only themselves and the parties with whom they expect to be able to strike bargains. In the earlier examples, we showed the virtues of ED, which flow from the ability of *J* to strike deals to defect. But when *J* cannot bargain, a SP contract (or a SD contract with damages high enough to prevent breach) can be preferred.

