2018

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ARTICLE

THE EMPTY IDEA OF "EQUALITY OF CREDITORS"

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INTRODUCTION

The equality of creditors norm is widely viewed as the single most important principle in American bankruptcy law, rivaled only by our commitment to a fresh start for honest but unfortunate debtors.[1] Equality of creditors teaches that similarly situated creditors should be treated similarly. Thus if one general creditor will be paid 25% of what it is owed, others also should receive 25%.

A glance at any bankruptcy casebook confirms the centrality of the principle. The leading casebook assures its readers that the trustee in a bankruptcy case "stands for the proposition that equity is equality."[2] "That maxim," the authors explain, "means that unless a creditor can clearly demonstrate that it deserves some priority in the bankruptcy payout, the trustee will assume all creditors are equal and try to maximize the pot for that collective."[3] "By treating all unsecured creditors the same," they say, in another of their numerous references to the principle, "that is, for all to collect a pro rata share of whatever is available for distribution . . . bankruptcy reinforces the goal of equality among these unsecured creditors."[4]

1 *See, e.g.*, Elizabeth Warren, *A Principled Approach to Consumer Bankruptcy*, 71 AM. BANKR. L.J. 483, 483 (1997) (describing "a 'fresh start' for debtors and equality of distribution for creditors" as "the two competing goals of consumer bankruptcy"). Back in her law professor days, Elizabeth Warren once said she knew that the students in her Bankruptcy class could identify equality of creditors as a central goal of bankruptcy in their sleep because she had quite literally heard them do it in the classes she taught at 8:30 in the morning. *Id.* at 483 n.1.

2 ELIZABETH WARREN ET AL., THE LAW OF DEBTORS AND CREDITORS 58 (7th ed. 2014).

3 *Id*.

4 *Id.* at 133. In our casebook, Dan Bussel and I also reference the equality of creditors principle with some regularity. *See, e.g.*, DANIEL J. BUSSEL & DAVID A. SKEEL, JR., BANKRUPTCY 89 (10th

Yet if we look at current bankruptcy practice, creditor equality seems to be rapidly disappearing. Bankruptcy courts often bless arrangements that give one group of general creditors starkly different treatment than other groups. In the Chrysler bankruptcy, Chrysler's retirees, trade creditors, tort creditors, and the unsecured portion of its senior bondholders' claims all had general unsecured claims. If the equality of creditors principle were vigorously pursued, we would expect each to receive roughly the same recovery. But they did not. The retirees and trade creditors were paid in full, or nearly so, while tort creditors and the bondholders' deficiency claims received almost nothing.[5] Parallel patterns can be seen in the ordinary run of cases as well. In many recent cases, debtors have used restructuring support agreements to secure the approval of creditors, sometimes offering side payments to creditors if they sign the agreement, but not to creditors that decline to sign.[6] As a result of these maneuvers, the recoveries of seemingly similar creditors are often widely divergent.

Ironically, equality's disappearance in bankruptcy occurred as equality ascended in other contexts, as reflected most recently in the success of the movement for same-sex marriage.[7] Equality sometimes seems to be the central principle in American life, but in bankruptcy it is rapidly losing purchase.

These developments have attracted surprisingly little attention in the scholarly literature thus far. Almost the only exception is a recent article by Mark Roe and Fred Tung.[8] Analyzing creditors' efforts to obtain special status through legislation or transactional innovation, Roe and Tung characterize the heightened protection as "priority jumps."[9] Their particular concern is the interest group dynamic that enables some creditors—especially large financial institutions—to secure priority for their claims in recent bankruptcy cases.[10]

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ed. 2015) (noting the view "that bankruptcy policies of fresh start for the debtor and equality of treatment for creditors, on balance, outweigh any nonbankruptcy policies that support specific performance of covenants not to compete").

5 Chrysler's $5.3 billion of trade creditors were promised payment in full by "New Chrysler." The retirees, who were owed $10 billion for their health benefits, received a $4.6 billion note and 55% of the New Chrysler stock. Other general creditors received little or nothing. *See* Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 733 (2010).

6 For an analysis of side agreements in bankruptcy and proposals for policing them, see generally Kenneth Ayotte et al., *Bankruptcy on the Side*, 112 NW. U. L. REV. 255 (2017).

7 Interestingly, much of the ascendency has taken place outside of the equal protection clause. *See* Kenji Yoshino, *The New Equal Protection*, 124 HARV. L. REV. 747, 748-49 (2011) (describing the Supreme Court's movement away from "group-based equality claims under the guarantees of the Fifth and Fourteenth Amendments to individual liberty claims under the due process guarantees of the [same a]mendments" (footnotes omitted)).

8 Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235 (2013).

9 *Id.* at 1238.

10 *Id.* Roe and Tung do not consider the influence in bankruptcy of other interest groups, including bankruptcy professionals. For more on that constituency, see Eric A. Posner, *The Political Economy of the Bankruptcy Reform of 1978*, 96 MICH. L. REV. 47, 82-84 (1997), which describes the influence of bankruptcy

My focus in this Article is somewhat different. My concern is with the shifting treatment of general creditors, and with the rhetorical power of bankruptcy's "equality of creditors" principle, which does not come into play in the "priority jump" analysis. I analyze the questions of priority that do arise in terms of their implications for (horizontal) relations among creditors with the same priority and ask what these and other developments mean for the "very policy and object of the bankrupt law,"[11] as one early court put it, or, as another court put it, the "cardinal purpose of the legislation [that] must never be overlooked."[12]

The erosion of creditor equality in recent practice raises two questions that lie at the heart of this Article: How difficult would it be to resuscitate equality of creditors? And just how beneficial would the project be? The good news is that reinvigorating equality would be surprisingly easy. Although several of the recent departures from equality would require legislative reform to correct, others would not. And in each case, the adjustments would be quite straightforward.[13]

The problem is that the equality norm itself contributes nothing to the analysis. As we begin to assess whether equal treatment would be beneficial in each of the doctrinal contexts, it quickly becomes clear that the key considerations lie elsewhere—with concerns such as curbing self-dealing or secret liens,[14] and maximizing the value of the debtor's estate. Although equality originally served as a rough proxy for some of these issues, this is no longer the case. In some contexts, the equality language is unnecessary but harmless. But in others, its historical pedigree and rhetorical resonance have been pernicious. If chicken soup can't hurt and may help a person who has a cold, the equality norm is the opposite: in current bankruptcy practice, it can't help—and it may (and does) hurt.

I begin (in Part I) by attempting to discover where the equality norm came from. The first place to look is the English predecessors to the earliest American bankruptcy laws. Hints of the equality principle can be found in the early English cases, and creditor equality was given a ringing endorsement in America in an influential 1807 case.[15] That case, like many of the cases that followed, involved preferences—payments or transfers made to a favored creditor shortly before bankruptcy—which were condemned as a violation of

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lawyers on the 1978 Code, and David A. Skeel, Jr., *The Genius of the 1898 Bankruptcy Act*, 15 BANKR. DEV. J. 321, 336-40 (1999), which describes the evolution of the bankruptcy bar in assuring the permanence of federal bankruptcy law.

11 Harrison v. McLaren, 11 F. Cas. 654, 657 (S.D. Miss. 1874) (No. 6139).

12 Linkman v. Wilcox, 15 F. Cas. 561, 562 (C.C.E.D. Mo. 1871) (No. 8374).

13 *See* discussion *infra* Section III.A.

14 A "secret lien" is a priority not reflected in a statute or the UCC filing system, and which may therefore come as a surprise to other creditors. For more, see Nathan B. Oman, *A Pragmatic Defense of Contract Law*, 98 GEO. L.J. 77, 106-09 (2009), which discusses the classic case of Benedict v. Ratner, 268 U.S. 353 (1925).

15 Locke v. Winning, 3 Mass. (1 Tyng.) 325, 326 (Mass. 1807) (opinion of Sedgwick, J.) ("A principal object of the bankrupt law is that the property of the bankrupt in all his estate . . . [is] to be *equally* distributed among his creditors, in proportion to the sums respectively due to them.").

the equality of creditors principle. Under the 1841, 1867, and 1898 Acts, preferences could be retrieved from creditors who received them, and a debtor that had made a preferential payment could be denied access to bankruptcy.[16]

Throughout the nineteenth century, the domain of the equality of creditors was limited to individual and small business bankruptcy cases. The principle played little role in reorganization cases involving substantial corporations, for reasons explored at the end of Part I. After Congress finally codified large-scale corporate reorganization in 1933 and 1934, however, the norm quickly spread to these cases as well. As with many central bankruptcy issues in the 1930s and 1940s, Justice William Douglas played a key role in the diffusion of the norm throughout all of American bankruptcy law.

After tracing the historical origins of creditor equality, I ask (in Part II) how debtors and favored creditors so often manage to circumvent the equality norm. It turns out that current bankruptcy law provides numerous devices for privileging one creditor or group of creditors over others. I briefly describe five of the most important. The strategies range from transferring value to the creditor prior to bankruptcy, to assuming the creditor's contract in bankruptcy, or to proposing to pay the creditor more than another class of unsecured creditors in connection with a plan of reorganization.[17]

If courts and lawmakers were committed to promoting equality, they could clamp down on each of these strategies for evasion. Briefly revisiting each, I consider (in Part III) how equality might be enhanced. In each context, courts or lawmakers could reinvigorate equality by making simple adjustments to existing doctrine. Lawmakers could remove the safe harbors that protect many preferences from avoidance, for instance, and courts could prohibit the special treatment of "critical vendors" and tighten the rules for classification of claims.

The question (the focus of Part IV) is whether reinvigorating the equality of creditors norm would improve bankruptcy law. I conclude that it would not. Equality does not appear to be the central concern with any of the doctrines I consider. In each context, the real issues, as noted above, are policing self-dealing, reducing the risk of "secret liens," or maximizing the value of the debtor's assets.[18] The case for retaining a vestige of the equality norm is slightly stronger in consumer cases and Chapter 7 liquidations, since these cases more

16 Under current bankruptcy law, payments within ninety days of bankruptcy may be deemed to be preferences retrievable by the trustee. *See* 11 U.S.C. § 547(b)(4)(A) (2012).

17 For simplicity, I will describe the debtor as the one who is evading equality, but in practice the departures from equality are often triggered by pressure from creditors.

18 For a critique of the equality (or "pari passu") principle in United Kingdom law on somewhat different grounds, see Rizwaan Jameel Mokal, Consistency of Principle in Corporate Insolvency 116-161 (Dec. 2001) (unpublished thesis, University College London), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=303722 [https://perma.cc/XN9K-JEGA], which emphasizes the plethora of special priorities and lack of payout for general creditors in most U.K. cases, and argues that preference law is unrelated to the pari passu principle.

closely resemble the context in which equality of creditors first emerged. But creditor equality does not play a meaningful role in practice even there.

In the final Part of the Article, I ask whether there are any other reasons for retaining the equality of creditors norm despite its apparent obsolescence. As I address this question, I consider the most compelling responses to the famous article referenced in my title,[19] as applied to the very different bankruptcy context. None provides a plausible basis for a renewed commitment to equality in bankruptcy. The equality principle should be abandoned.

I. THE HISTORICAL ORIGINS OF THE EQUALITY NORM

Like many features of American bankruptcy, the equality of creditors maxim came to these shores as a transplant from earlier English insolvency law but quickly took on a distinctly American coloration. Equality of creditors figured quite prominently in debates over traditional bankruptcy—that is, the bankruptcy of individuals and small businesses. It played much less of a role in large scale reorganizations, which took place outside of bankruptcy until the 1930s. During the twentieth century, however, the equality norm colonized that context too. The discussion that follows considers each of these developments in turn.

A. *Equality in Traditional Bankruptcy*

Modern American bankruptcy law traces its origins back to English bankruptcy laws enacted in 1543 and 1571, together with a 1704 law that gave debtors a permanent discharge from their obligations for the first time.[20] In the debates over bankruptcy and in the caselaw interpreting the early statutes, there are occasional hints of an equality of creditors principle. In a 1758 case called *Worsley v. DeMattos*, for instance, Lord Mansfield says that "[t]he policy of the bankrupt law . . . is to *level* all creditors, who have not actually recovered satisfaction, or got hold of a pledge which the bankrupt could not defeat."[21]

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19 Peter Westen, *The Empty Idea of Equality*, 95 HARV. L. REV. 537 (1982).

20 For a succinct history of the evolution of English and American bankruptcy legislation, see generally Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5 (1995).

21 97 Eng. Rep. 407, 416; 1 Burr. 467, 484 (emphasis added). Sir Edward Coke also had gestured at the equality objective in a much earlier opinion. In *The Case of Bankrupts* (1584) 76 Eng. Rep. 441, 473; 2 Co. Rep. 24b, 25a-26a, he wrote that "if, after the debtor becomes a bankrupt, he may prefer one (who peradventure hath least need), and defeat and defraud many other poor men of their true debts, it would be unequal and unconscionable, and a great defect in the law." For contemporary expressions of the equality principle in English law, see, e.g., ROY GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW 142 (2d ed. 1997), which describes the equal treatment rule as "all-pervasive," and Vanessa Finch, *Security, Insolvency and Risk: Who Pays the Price?*, 62 MOD. L. REV. 633, 634 (1999), which notes that "the normal rule in a corporate insolvency is that all creditors are treated on an equal footing."

In both England and America, the principal concern of the early bankruptcy laws was debtors' temptation to flee their creditors or, if they stayed, to secretly transfer assets to family members or favored creditors.[22] To discourage this temptation, the Bankruptcy Act of 1800, America's first federal bankruptcy law, permitted creditors to file a bankruptcy petition against a merchant or trader who, "with intent unlawfully to delay or defraud his or her creditors, depart[ed] from the state in which such person usually resides, or remain[ed] absent therefrom, or conceal[ed] him or herself therein."[23] Similarly, the Bankruptcy Act of 1841, the second federal bankruptcy law, authorized creditors to file a petition if a merchant or banker left his state "with intent to defraud his creditors," or "conceal[ed] himself to avoid being arrested," or concealed assets.[24]

Bankruptcy advocates envisioned that the assets of an insolvent debtor would be turned over to a trustee or assignee at or near the time the debtor committed an "act of bankruptcy."[25] The trustee or assignee would then sell the assets and distribute the proceeds to the debtor's creditors. In return for fully cooperating, the debtor would no longer be responsible for his prebankruptcy obligations; they would be discharged.[26]

The equality of creditors norm emerged as an increasingly important feature of this story. "A principal object of the bankrupt law," as an 1807 Massachusetts decision put it,

> is that the property of the bankrupt in all his estate, at the time of the act of bankruptcy, *by that act* shall cease; and at the same time, by relation, vest in the assignee; to be *equally* distributed among his creditors, in proportion to the sums respectively due to them.[27]

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22 In an influential 1697 tract defending bankruptcy relief for troubled debtors, the novelist Daniel Defoe acknowledged that debtors currently were tempted to abscond. D. DEFOE, AN ESSAY UPON PROJECTS 198 (1697) (noting that "no Statute can reach [a merchant debtor's] Effects beyond the Seas; so that he has nothing to secure but his Books, and away he goes into the *Friars*"); *see also* PETER J. COLEMAN, DEBTORS AND CREDITORS IN AMERICA 12-13 (1974) (describing the principal objectives of colonial bankruptcy laws as halting "races to the courthouse," policing fraud, ensuring an equitable division of assets, and providing relief to debtors).

23 National Bankrupt Act, § 1 (1800) (repealed 1803); *see also* COLEMAN, *supra* note 22, at 19-20 (describing enactment and repeal of the 1800 Act).

24 Act of Aug. 19, 1841, ch. 9, § 1, 5 Stat. 440, 442 (1841) (repealed 1843).

25 In early bankruptcy law, acts of bankruptcy included fraudulent conveyances of property and other activities that suggested the debtor was evading payment of his obligations. But the category later expanded to include events suggesting the debtor might be insolvent, such as a creditor's obtaining a judicial lien. For discussion, see Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Peference*, 39 STAN. L. REV. 3, 34-39 (1986).

26 *See, e.g.*, EDWARD J. BALLEISEN, NAVIGATING FAILURE 70 (2001) (describing commercial moralists' view that troubled debtors should immediately disclose their financial distress and surrender their assets for sale and distribution to their creditors, and that creditors should then willingly discharge the obligations).

27 Locke v. Winning, 3 Mass. (1 Tyng.) 325, 326 (opinion of Sedgwick, J.).

In that case, the debtor had transferred "certain promissory notes" to one of his creditors as collateral the day before committing an act of bankruptcy. Because the transfer occurred in contemplation of bankruptcy, the court invalidated the transfer as "a fraud against the law, and therefore void."[28]

The early federal bankruptcy laws did not impose a blanket prohibition on prebankruptcy transfers. The Bankruptcy Act of 1841, the first bankruptcy law to permit voluntary bankruptcy filings, invalidated transfers made "for the purpose" of giving a preference within two months of a bankruptcy filing, thus limiting the prohibition to intentional preferences.[29] The restriction implied that fraud was the principal concern and equality was secondary with prebankruptcy transactions.[30] Under the 1867 Act, some district courts adopted a more single-minded focus on creditor equality, construing a similarly worded preference provision as giving the debtor an affirmative obligation to file for bankruptcy rather than permit a creditor to obtain a prebankruptcy lien that would give that creditor priority over the debtor's other creditors.[31] But the Supreme Court rejected these decisions, holding that the trustee or assignee needed to provide some evidence that the debtor intended to prefer the creditor.[32] Equality meant that the debtor could not play

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28 *Id.* at 326; *see also* Ogden v. Jackson, 1 Johns. 370, 372 (N.Y. 1806) ("It will not, however, be permitted that a person, insolvent at the time, and contemplating an act of bankruptcy, should parcel out his estate to such creditors as *he* may see fit to prefer; this is opposed to the very genius of the bankrupt laws, which proceed upon a principle of equality and a just distribution.").

29 § 2, 5 Stat. at 442. Justice Story was a key drafter of the 1841 Act. *See, e.g.*, BALLEISEN, *supra* note 26, at 114 (describing Story as "the most prominent judicial champion of the nation's bankrupts"); *see also* 2 JOSEPH STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES 385 (photo. reprint 1987) (1833) ("[T]he general object of all bankrupt and insolvent laws is, on the one hand, to secure to creditors an appropriation of the property of their debtors, *pro tanto* . . . ; and, on the other hand, to relieve unfortunate and honest debtors from perpetual bondage to their creditors . . . .").

30 In practice, some intentional preferences also seem to have been widely permitted. According to the leading historian of the 1841 Act,

> [a]s American business culture developed in the decades that followed independence, numerous participants in the credit system came to accept the proposition that all debts were not equal. Two kinds of debts stood apart as imposing special obligations—money that was borrowed without interest and debts that arose as a result of [guarantees of a debtor's obligation by a third party].

BALLEISEN, *supra* note 26, at 92. Because these creditors were "disinterested," debtors were permitted to pay them before other creditors. *Id.* at 93.

31 "It is said," as the Supreme Court summarized the argument,

> that the grand feature of th[e] law is to secure equality of distribution among creditors in all cases of insolvency; and that, to secure this, it is the legal duty of the insolvent, when sued by one creditor in an ordinary proceeding likely to end in judgment and seizure of property, to file himself a petition of voluntary bankruptcy.

Wilson v. City Bank, 84 U.S. (1 Wall.) 473, 484-85 (1873).

32 *Id.* at 487.

favorites among its creditors, and that each creditor should get a pro rata share of the assets available as of the time the debtor filed for bankruptcy.[33]

Although the equality norm figured prominently in the federal bankruptcy laws that were enacted,[34] the status of bankruptcy itself was hotly disputed throughout the nineteenth century, and federal bankruptcy laws were in place for a total of less than two decades.[35] Bankruptcy advocates, many of whom lived in the commercial states of the Northeast, viewed bankruptcy as essential to the development of commerce in America, and equality of creditors as a key feature of a properly functioning bankruptcy law.[36] Thomas Jefferson and other bankruptcy critics in the South and West, by contrast, questioned the need for a federal bankruptcy law; many critics insisted that it was perfectly appropriate for debtors to pay some of their general creditors rather than others.[37]

In defending the prohibition on preferences, a leading advocate of the legislation that eventually became the 1898 Act claimed that debtors themselves were the real beneficiaries. "It is the debtor whose interest it is to secure absolute equality in payment," he insisted, because creditors will be more willing to lend if they are confident that they will receive equal treatment.[38] If debtors "will pay their debts proportionately if they can not pay them in full, justly, man for man,

33 Weisberg suggests that the introduction of voluntary bankruptcy for the first time in 1841 played a key role in the evolution of the equality norm. This "divorced bankruptcy from the English model of the culpable act of the debtor," and shifted the moral focus of bankruptcy to "creditor[s'] collegial duty to uphold th[e] rather abstract collectivist spirit" reflected in the equality norm. ***See*** Weisberg, *supra* note 25, at 88.

34 Under the 1867 Act, which lasted considerably longer than the 1800 and 1841 Acts, courts regularly referred to equality of creditors as a key principle. *See, e.g.*, Harrison v. McLaren, 11 F. Cas. 654, 657 (S.D. Miss. 1874) (No. 6139) (characterizing "equality among creditors" as the "very policy and object of the bankrupt[cy] law"); *In re* Hunt, 12 F. Cas. 900, 902 (D.N.J. 1871) (No. 6882) (identifying "equality in the distribution of assets" as the "object of the law").

35 The 1800 Act lasted until 1803, the 1841 Act until 1843, and the 1867 Act until 1878. The 1898 Act was the first permanent federal bankruptcy law. *See* COLEMAN, *supra* note 22, at 18.

36 Alexander Hamilton and later Daniel Webster were the best known advocates. *See, e.g.*, DAVID A. SKEEL, JR., DEBT'S DOMINION 3, 26 (2001).

37 *Id.* at 3; *see also* BALLEISEN, *supra* note 26, at 14 (describing "two competing versions of commercial morality—one premised on special financial obligations to one's closest business associates, and another, formulated by apostles of an integrated, national economy, that mandated equal treatment to everyone in the marketplace"). In the absence of a federal bankruptcy law, many states permitted insolvent debtors to assign their assets to some creditors but not to others. *See, e.g.*, Grover v. Wakeman, 11 Wend. 187, 187 (N.Y. 1833) ("A debtor in failing circumstances may prefer one creditor or set of creditors by assigning his property for their benefit, in exclusion of his other creditors, provided that he devote the whole of the property assigned to the payment of his just debts; [and] that the assignment be absolute and unconditional . . . ."); Niolon v. Douglas, 10 S.C. Eq. (2 Hill Eq.) 443, 448 (1836) ("The insolvent laws of most of the States either allow the debtor to draw a distinction among his creditors, in the very act of surrendering under the law itself, or sustain it if already done.").

38 15 CONG. REC. 2963 (1884) (statement of Rep. Hoar).

without exception or discrimination," he predicted, "the pent-up accumulation of capital will run over this country like a Mississippi flood."[39]

Critics refused to concede that preferential payments are inherently problematic. Congressman Bailey of Texas, who had proposed an alternative to the bill that became the 1898 Act, criticized the assumption that "all debts shall stand upon exactly the same footing."[40] "As for my part," he countered, "I do not believe that it is true in morals, and I do not believe that it ought be made true in law, that all debts are of equal obligation."[41] Congressman Bailey then gave two illustrations: "If I owed $5000 to a man who possessed nothing else and I owed $25,000 to a man who was many times a millionaire," he said, but he could not pay both, he would not hesitate to pay the $5000 debt but not the $25,000.[42]

As finally enacted, the 1898 Act included a preference provision that took roughly the same form as the provisions in the 1841 and 1867 Acts. The trustee could retrieve any payments or other transfers made within four months of the bankruptcy, so long as the debtor was insolvent at the time of the transfer and the creditor "had reasonable cause to believe that [the transfer] was intended thereby to give a preference."[43] The provision was important both because it was a victory for advocates of creditor equality, and because the 1898 Act would prove to be the nation's first permanent bankruptcy law, escaping the early demise of its three predecessors. Within a few years, defenders of intentionally preferential payments would wane, and the equality norm would be embraced by nearly everyone.[44]

The 1913 Supreme Court case *Clarke v. Rogers*[45] is a good illustration of (and became the standard citation for) the vision of creditor equality that emerged. The debtor in *Clarke* was a trustee of numerous trusts who transferred assets to two trusts to which he owed money and then filed for bankruptcy shortly thereafter.[46] The question was whether these transfers amounted to preferences, enabling the

39 *Id.* "In order to do justice," another congressman insisted a few years later, "the law should compel an insolvent debtor, if he will not do it willingly, to distribute all his property—less his legal exemptions—among all his creditors pro rata . . . . Unless he does this he perpetrates a moral if not a legal fraud upon his creditors." 26 CONG. REC. 44 (1893) (statement of Rep. Layton).

40 26 CONG. REC. 103 (1893).

41 *Id.*

42 *Id.* Similarly, Bailey argued, if the friend of a businessman has lent him money to help the businessman through a period of financial distress, but the financial distress continues, the businessman "will under all circumstances protect the man who loan[ed] him the money, not for profit, but purely for the sake of helping him." *Id.* Other lawmakers, particularly Democrats from the South and West who opposed federal bankruptcy legislation, offered similar defenses of preferential payments. *See, e.g.*, 25 CONG. REC. 2874 (1893) (statement of Rep. Kyle).

43 Act of July 1, 1898, ch. 541, § 60(b), 30 Stat. 544, 562 (repealed 1978). The actual language of the 1898 Act was more complicated than the description in the text suggests, because the insolvency requirement was in one provision (60(a)) and the four month and "reasonable cause to believe" features in another (60(b)).

44 I consider the reasons for the shift in Section IV.A, *infra*.

45 228 U.S. 534.

46 *Id.* at 539-40.

two trusts and their beneficiaries to receive more than the debtor's other creditors.[47] The debtor raised several legalistic but technically plausible defenses. He argued that the trusts did not count as creditors for the purposes of the preference provision because there was no contract, and that the preference provision only covered transfers from the debtor to someone else, not the debtor to himself (as trustee of the trusts).[48] The lower courts had swept these arguments aside. "[W]hile giving attention to the technical elements of appellant's arguments," as the Supreme Court put it, the trial and appellate courts "cut through them to apply the fundamental purpose of the Bankruptcy Law, that is, equality between creditors."[49] The Supreme Court fully endorsed this approach. "Equality between creditors is necessarily the ultimate aim of the Bankrupt Law," the Court said, "and to obtain it we must regard the essential nature of transactions, not their forms or accidents."[50]

B. *The "Fair and Equitable" Requirement in Railroad Reorganizations*

During the same period that the equality principle took shape in traditional bankruptcy cases, Wall Street banks and law firms developed an approach for reorganizing large-scale corporations that became known as railroad or equity receivership.[51] "Equity" initially meant something quite different in this context than in ordinary bankruptcy.

The equity receivership arose as a result of the railroad failures of the middle and late nineteenth century. Many of the large railroads were cobbled together from mergers between smaller railroads as the system rapidly expanded in the nineteenth century.[52] When large railroads failed, everyone agreed they should be reorganized rather than liquidated. Even secured creditors, despite having the least to gain from reorganization, favored it because a railroad's capital structure often consisted of a jumble of different bonds with mortgages on different parts of the railroads' assets.[53] Bondholders who held a mortgage on,

47 *Id.* at 542 (quoting § 60(b), 30 Stat. at 562) ("A person shall be deemed to have given a preference, if, being insolvent, he has within four months before the filing of the petition, . . . made a transfer . . . to enable any one of his creditors to obtain a greater percentage of his debt than any other of such creditors of the same class." (first omission in original)).

48 *Id.* at 542-44. The debtor's argument was plausible because the Bankruptcy Act defined "creditor" narrowly, including only those who had "provable claims" against the debtor. *See id.*

49 *Id.* at 544.

50 *Id.* at 548.

51 The origins of the equity receivership are described much more fully in SKEEL, *supra* note 36, at 56-69.

52 The railroad story has been well told in a number of popular histories. For an entertaining account of the famous battle to take control of the key Erie Railway, see generally JOHN STEELE GORDON, THE SCARLET WOMAN OF WALL STREET (1988).

53 As the business historian Albro Martin put it, speaking of the 1884 Wabash receivership, "only a financial wizard, with plenty of time and money at his disposal, could have sorted out the property represented by the [railroad's] mortgages." Albro Martin, *Railroads and the Equity Receivership: An Essay on Institutional Change*, 34 J. ECON. HIST. 685, 699 (1974).

say, the Indiana tracks of a railroad that traversed Indiana and three other states would not recover much if the railroad were shut down.

Despite every constituency's support for reorganization and the perceived public interest in access to railroad transportation, it was far from clear that either Congress or the states could enact restructuring provisions for the railroads due to, among other things, perceived constitutional obstacles.[54] The railroad reorganizers and the judges before whom they appeared devised an ingenious solution: Creditors would ask the court to appoint a receiver to take charge of the railroad's property and to begin foreclosure proceedings, and while the foreclosure was pending, the Wall Street banks that had sold the railroad's bonds and stock would organize committees to represent the different classes of bonds and stock.[55] The committees would negotiate the terms of a reorganization with the railroad's managers.[56] When they had agreed on the reorganization, they would form a single committee—the reorganization committee—that would be the only bidder at the eventual foreclosure sale.[57] Its bid would consist of the old bonds and stock that had been deposited with the committee, together with cash to pay those who had declined to deposit their securities.[58] Until 1933, when it was finally codified by Congress,[59] railroad receivership took place entirely in the courts, outside of the bankruptcy process.

The capital structure of a substantial railroad was like a messy layer cake. Rather than consisting primarily of general creditors, all of whom had the same priority, railroads had different classes of creditors with claims to different assets.[60] As a result, the controversies that arose tended to focus less on the treatment of similarly situated creditors—the classic equality of creditors concern—and more on how creditors and shareholders that occupied different layers of the priority hierarchy should be treated vis-à-vis one another. The disputes were vertical rather than horizontal. These cases were far removed from traditional bankruptcy, with its handful of creditors getting their pro rata share of a pot of assets.

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54 *See, e.g.*, SKEEL, *supra* note 36, at 52-56 (noting that it was not clear Congress's bankruptcy powers extended to corporations, that the Commerce Clause was narrowly construed during this period, and that states could not regulate beyond their borders).

55 For a detailed overview of the process by a leading early twentieth-century lawyer, see generally Paul D. Cravath, *The Reorganization of Corporations; Bondholders' and Stockholders Protective Committees; Reorganization Committees; and the Voluntary Recapitalization of Corporations*, *in* SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION, AND REGULATION 153 (1917).

56 *Id.*

57 *See id.* at 204-05 (describing one case where the reorganizers "spent a great many anxious hours preparing for the unexpected bidder," but that such bidders never appeared).

58 *Id.*

59 *See* Act of Mar. 3, 1933, Pub. L. No. 72-240, § 77, 47 Stat. 1467, 1474 (repealed 1938) (providing for statutory railroad reorganization process).

60 *See* Martin, *supra* note 53, at 699.

The key issue that emerged was whether a reorganization plan could permit shareholders to retain an interest in the reorganized company while excluding a creditor who was junior in priority to the bondholders but senior to shareholders. In 1913, the same year as its *Clarke* decision, the Supreme Court held in *Northern Pacific Railway Co. v. Boyd* that an ordinary creditor could not simply be excluded from a receivership that permitted shareholders to retain an ownership interest.[61] Equity in this context was a question of priority, not the treatment of two or more general creditors.

Courts had earlier addressed the question whether a debtor could pay some of its suppliers in full. Because all of the railroad's assets were usually subject to mortgages, this too was a question of priority rather than of equality among general creditors. In *Fosdick v. Schall*, the Supreme Court upheld payments to a train car supplier, despite the mortgagee's property interest in the railroad's assets.[62] According to the Court, "[e]very railroad mortgagee in accepting his security impliedly agrees that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim upon the income."[63]

When Congress finally codified large scale reorganization in the 1930s, the reorganization provisions continued to reflect this emphasis on vertical hierarchy. Under sections 77 and 77B, which codified railroad reorganization in 1933 and reorganization for other large corporations in 1934, Congress permitted confirmation of a reorganization plan only if it was "equitable" and "[did] not discriminate unfairly in favor of any class of creditors or stockholders."[64] In 1938, Congress completely revised the Bankruptcy Act, and enacted an entirely new framework for reorganizing large corporations. The new framework, known as Chapter X, adopted a simplified version of the earlier provision, requiring that reorganization plans be "fair and equitable, and feasible."[65]

The phrase "fair and equitable" does not immediately bring vertical hierarchy or layer cakes to mind (and certainly could be construed as implicating horizontal equality of creditors concerns), but the Supreme Court quickly decided that priority was its primary focus. In 1939, the Court held, in an opinion by Justice Douglas, that the "fair and equitable" standard required strict adherence to the absolute priority rule, which requires that higher priority creditors be paid in full before lower priority creditors or shareholders receive any recovery.[66] The equity

61 228 U.S. 482, 508.

62 99 U.S. 235, 255 (1878) (holding that the supplier could retain the payments it had received but that it was not entitled to additional payment from funds received in connection with the receivership).

63 *Id.* at 252.

64 § 77(g)(1), 204 Stat. at 1479.

65 Act of June 22, 1938, Pub. L. No. 75-696, § 221(2), 52 Stat. 840, 897 (repealed 1978).

66 Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 117 (1939).

receivership cases from which the standard emerged, he concluded, "dealt with the precedence to be accorded creditors over stockholders in reorganization plans."[67]

Although equity meant priority in large scale reorganization, not equality among similarly situated creditors, the equality of creditors principle seeped into corporate reorganization after 1938. There are at least two reasons for the expansion. First, before large scale corporate reorganization was added to the Bankruptcy Act, the provisions most closely associated with equality of creditors—such as the preference provision—did not apply to large scale corporate reorganization.[68] After codification, the preference provision and other bankruptcy provisions applied to large corporate debtors, just as they did with traditional bankruptcy debtors. The 1930s amendments grafted large scale corporate reorganization onto the structure that had given rise to the equality of creditors principle.

Second, a shift in the capital structure of large scale reorganizations may also have played a role. By the 1930s, the largest corporate debtors were increasingly likely to be nonrailroads rather than railroads.[69] Nonrailroads had fewer classes of debt, and more uncollateralized debt—they did not have the same messy layer cake structure as the railroads.[70] Over time, disputes among different unsecured creditors became more central than in the equity receivership.

The provision that most directly reflects this increasing horizontal focus is a requirement that Congress included in its 1933 and 1934 corporate bankruptcy legislation, but deleted in 1938: the requirement that a reorganization not "discriminate unfairly."[71] As originally enacted, the unfair discrimination requirement seems to have been primarily concerned with vertical fairness—that is, that a higher priority class not be mistreated as compared to a lower priority class, as in the *Boyd* case.[72] In 1938, Congress removed the unfair discrimination requirement from large scale corporate reorganization, apparently concluding that "unfair discrimination" concerns were subsumed in the "fair and equitable" requirement.[73] But the "unfair

67 *Id.* at 115-16.

68 *See supra* text accompanying note 59. Although a few states had preference provisions, most did not, and some of the provisions that did exist only applied when a state law insolvency regime was invoked. *See* David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 492-93 (1994).

69 *See* Herbert R. Northrup, *The Failure of the Teamsters' Union to Win Railroad-Type Labor Protection for Mergers or Deregulation*, 22 TRANSP. L.J. 365, 367 (1995).

70 *See generally* Efraim Benmelech et al., The Mysterious Decline of Secured Debt (2016) (unpublished manuscript) (on file with author) (documenting declining use of secured debt throughout the twentieth century).

71 *See supra* text accompanying note 64.

72 *Cf. supra* note 61 and accompanying text.

73 *See* S. REP. No. 75-1916, at 35-36 (1938) ("Implicit in ['fair and equitable'] is a prohibition against any unfair discrimination in the plan in favor of any creditors or stockholders and the express statement to that effect in Section 77B is therefore unnecessary.").

discrimination" requirement was never excised from the municipal bankruptcy chapter. In that context, it was soon construed in horizontal terms.

In two municipal bankruptcy cases in the 1940s, Justice Douglas explicitly linked the unfair discrimination requirement to equality of creditors, on each occasion citing *Clarke v. Rogers*.[74] In *American United Mutual Life Insurance Co. v. City of Avon Park*, the Court invalidated a Chapter IX plan that had been approved by a substantial majority of the town's creditors because of the plan's treatment of claims held by the town's fiscal agent.[75] Because the fiscal agent was given a commission, it received a "special favor or inducement" not available to other creditors, in violation of the "general rule of 'equality between creditors,'" which "has been embedded by Congress in Ch. IX by the express prohibition against unfair discrimination."[76] In *Mason v. Paradise Irrigation District*, the Court concluded that the equality between creditors principle was not violated when the Reconstruction Finance Corporation received more favorable treatment than other bondholders.[77] Justice Douglas pointed out that the Reconstruction Finance Corporation had financed the restructuring, and that "[i]t has long been recognized in reorganization law that those who put new money into the distressed enterprise may be given a participation in the reorganization plan reasonably equivalent to their contribution."[78]

When Congress enacted the current Bankruptcy Code in 1978, it reintroduced unfair discrimination into corporate reorganization.[79] In addition to permitting confirmation of reorganization plans that every class of creditors and shareholders votes to approve, Chapter 11 provides for cramdown of a plan over the objection of a dissenting class if the plan "does not discriminate unfairly" and is "fair and equitable" with respect to the dissenting class or classes.[80] The unfair discrimination requirement has been consistently construed as concerned primarily with the treatment of classes of creditors with the same priority—that is, with horizontal equity, and as reflecting the equality of creditors principle.[81]

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74 228 U.S. 534 (1913).

75 311 U.S. 138, 138 (1940).

76 *Id.* at 147 (citing *Clarke*, 228 U.S. at 548).

77 326 U.S. 536, 541 (1946) (citing *Clarke*, 228 U.S. at 548).

78 *Id.* at 541-42.

79 *See, e.g.*, Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 236-39 (1998).

80 11 U.S.C. § 1129(b) (2012).

81 *See, e.g.,* Markell, *supra* note 79, at 227-28 ("[U]nfair discrimination is best viewed as a horizontal limit on nonconsensual confirmation, in contrast to the vertical limit imposed by the requirement that a nonconsensual plan be 'fair and equitable.'").

By the middle of the twentieth century, the equality of creditors meme pervaded bankruptcy law. It was seen as reflected in the preference provision, in the general rule that unsecured creditors are entitled to a pro rata share of the debtor's assets, and in the prohibition on unfair discrimination. Courts that refuse to enforce a covenant not to compete in bankruptcy (and commentators who advocate this position) also have pointed to the equality of creditors norm, reasoning that the covenant would effectively pay its beneficiary in full, while other creditors would be getting far less.[82] As Justice Robert Jackson once said about the First Amendment, if there is one polestar in the bankruptcy firmament, it is the equality of creditors principle.[83] It is the principal constant of American bankruptcy law, the starting point and central theme of the bankruptcy process.

At least in theory. In practice, it can be, and is, easily evaded.

II. WAYS TO EVADE THE "EQUALITY OF CREDITORS" NORM

Paul Simon once wrote a song proclaiming that "there must be fifty ways to leave your lover."[84] ("You just slip out the back, Jack," and "make a new plan, Stan."[85]) The equality of creditors norm suffers from the same vulnerability as the unsuspecting lovers in Simon's song. In current practice, the most notable feature of the equality of creditors norm is how easily a debtor can evade it. Although there may not be fifty ways to sidestep the norm, the modes of escape are quite numerous.

This Part briefly chronicles five (or six) of the most common ways that the equal treatment norm is flouted in current practice. Each is widespread, and the use of all but the first appears to have sharply increased in recent years. Although I will speak of the debtor as the one who is evading the equality norm, debtors often do so under direct pressure from a creditor.

A. *Evading the Preference Provision*

Suppose that Firm owes $50,000 to Creditor A and also owes $50,000 to Creditor B; both are unsecured, but Firm would really like to favor Creditor A. If Firm repays Creditor A shortly before filing for bankruptcy (or gives

82 *See, e.g.*, Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 279 (1989) ("[I]t would be ironic if [the beneficiary of a covenant not to compete] got, in effect, full payment because its [equitable] claim could not be calculated, while those with clearly defined losses were left in the cold.").

83 *Cf.* W. Va. State Bd. of Educ. v. Barnette, 319 U.S. 624, 642 (1943) ("If there is any fixed star in our constitutional constellation, it is that no official, high or petty, can perscribe what shall be orthodox in politics, nationalism, religion, or other matters of opinion, or force citizens to confess by word or act their faith therein.").

84 PAUL SIMON, *50 Ways to Leave Your Lover*, *on* STILL CRAZY AFTER ALL THESE YEARS (Columbia Records 1975).

85 *Id.*

Creditor A a security interest), but doesn't repay Creditor B, there is of course a risk that the trustee will successfully challenge the payment as a preference.[86] In this case, Creditor A will be forced to disgorge the payment, putting Creditor A back on the same (unsecured) footing as Creditor B, and vindicating the equality of creditors norm. Our case would thus look a lot like *Clarke*.[87]

It is at least as likely, however, that the trustee will not recover the payment to Creditor A; that Creditor A will, in effect, slip out the back. This can occur in several different ways. If Firm holds off on filing for ninety-one days, its payment to Creditor A will be outside the preference period and thus immune from attack by the trustee.[88] Running out the clock is the cleanest escape for Creditor A, since it avoids any possibility of a preference action, except in the rare case where Creditor A might plausibly have been "in control" of Firm, which would extend the preference period to a full year.[89] Even if Firm does file for bankruptcy less than ninety days after its payment to Creditor A, Creditor A may be able to defend by arguing that the payment qualifies for one of the preference safe harbors.[90] The second of the safe harbors, which protects payments made in the ordinary course of business, is particularly promising, insulating many potential preferences from avoidance.[91] Firm may be able to supplement its defense by invoking one or more of the other eight safe harbors as well.[92]

The discussion thus far has assumed that Creditor A's claim arose from an ordinary loan or extension of credit. If Creditor A extended credit to Firm through a derivative contract or repurchase agreement, the $50,000 payment—or Firm's grant of a security interest to Creditor A—would be entirely outside of the preference system, regardless how close to bankruptcy Firm made the $50,000 payment. Current bankruptcy law exempts derivatives, repos, and other financial agreements from the preference provision altogether.[93] In the weeks before Lehman Brothers collapsed in 2008, J.P. Morgan Chase demanded and received a $5 billion payment from Lehman, an eve-of-bankruptcy grab that enjoyed blanket protection from the preference rules.[94]

From a historical perspective, these gaping holes in the trustee's ability to recover preferences are ironic. In 1978, Congress completely revised the

86 *See* 11 U.S.C. § 547(b) (2012) (authorizing the trustee to avoid payments and other transfers made within ninety days of bankruptcy).

87 *See supra* notes 45–50 and accompanying text.

88 *See* § 547(b).

89 *See id.* (establishing a one-year preference period for any "insider"); *see also* 11 U.S.C. § 101(31)(B)(iii) (2012) (defining "insider" to include "person in control" of the debtor-corporation).

90 *See* § 547(c).

91 *See id.* at (c)(2).

92 *See id.* at (c).

93 *See, e.g.*, 11 U.S.C. § 546(e)–(g) (2012).

94 *See* Darrell Duffie, *The Failure Mechanics of Dealer Banks*, 24 J. ECON. PERSP. 51, 67-68 (2010) (describing J.P. Morgan Chase's use of its "right of offset" to secure payment from Lehman).

preference rule in an effort to make it easier for the trustee to retrieve prebankruptcy transfers.[95] Yet in practice, nearly as many eve-of-bankruptcy transfers may be immune from attack as before.

If Creditor A receives a $50,000 payment prior to bankruptcy, the odds are quite high that Creditor A will be able to keep it, even if Creditor B stands to receive far less in bankruptcy. Neither the equality of creditors norm nor the preference rules that are the norm's principal instantiation in bankruptcy are likely to stand in Firm's and Creditor A's way.

B. *Using the Executory Contract Rules to Favor a Particular Creditor*

It might seem that, if Firm does not pay Creditor A before filing for bankruptcy, equal treatment of Creditor A and Creditor B is much more likely. But it isn't. Even in bankruptcy, Firm can easily ensure that Creditor A gets paid more than Creditor B if it so chooses.

Suppose, for instance, the $50,000 that Firm owes Creditor A is an unpaid obligation under an ongoing contract between the two parties. Bankruptcy treats such a contract as "executory," and authorizes Firm to either assume or reject the contract.[96] If Firm assumes the contract, it is required to cure any defaults and pay any obligations in full;[97] by contrast, if Firm rejects the contract, any unpaid obligations under the contract give rise to an unsecured claim.[98] By assuming Creditor A's contract, while rejecting Creditor B's (if it too has an executory contract with Firm), Firm can thus arrange favorable treatment for Creditor A.

The recent municipal bankruptcy of Stockton, California illustrates the deviations from equality of creditors that can be achieved by assuming an executory contract. Stockton's restructuring plan proposed to pay some of its bondholders less than ten cents on the dollar. Stockton's large amount of unfunded pension liabilities were unsecured obligations, just like its bonds, and the bankruptcy judge strongly suggested that Stockton should restructure the obligations.[99] This might have assured a roughly comparable treatment of the two classes of unsecured claims. But the pension liabilities arose under an employment contract that was executory in nature. Rather than restructure the pensions, Stockton assumed the contract.[100] As

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95 *See infra* notes 163–66 and accompanying text.

96 11 U.S.C. § 365 (2012). According to the standard (though often criticized) definition, a contract is executory if the obligations still owed by both parties under the contract are significant enough that failure by either to perform would constitute a material breach of the contract. *See, e.g.*, Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

97 *See* § 365(b)(1).

98 *See* 11 U.S.C. § 502(g)(1) (2012).

99 *See* Mary Williams Walsh, *Judge Approves Bankruptcy Exit for Stockton, Calif.*, N.Y. TIMES (Oct. 30, 2014, 3:35 PM), https://dealbook.nytimes.com/2014/10/30/judge-approves-bankruptcy-exit-for-stockton-calif/?_r=0 [https://perma.cc/2B8A-55T3].

100 *In re* City of Stockton, Cal., 526 B.R. 35, 39 (Bankr. E.D. Cal. 2015).

a result, the City was able to pay its pension beneficiaries in full, while offering a radically smaller recovery to the bondholders.[101]

C. *Designating Favored Creditors as "Critical Vendors"*

If Firm and Creditor A did not have a contract, or if their contract was no longer executory by the time Firm filed for bankruptcy, the executory contract strategy obviously would not be available. Firm's trade creditors may provide goods or services on "open account," for instance, rather than under a longterm contract. Although Firm might need to be slightly more creative, there still are a variety of ways to give Creditor A more favorable treatment than Creditor B.[102]

The easiest strategy is for Firm to say that it desperately needs Creditor A's services and fears that Creditor A will stop providing them unless Firm pays the $50,000 of prebankruptcy obligations in full. In current practice, debtor can pay the unsecured claims of its "critical vendors" in full.[103] Critical vendor treatment traditionally was viewed as a limited exception to the equality of creditors norm,[104] but its use is now commonplace in large cases. Bankruptcy judges rarely require a debtor to present any meaningful evidence that a supplier truly is irreplaceable and would cease doing business with the debtor unless it is paid in full.

A few years ago, Judge Easterbrook put a scare into this strategy in the Kmart bankruptcy.[105] Kmart claimed that 2330 of its suppliers—with claims totaling $300 million—qualified as critical vendors. After pointing out that the bankruptcy laws do not explicitly authorize special treatment of critical vendors, Judge Easterbrook concluded that, even if it "allows critical-vendors orders in principle, preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors. This record does not, so the critical-vendors orders cannot stand."[106]

Although the *Kmart* decision caused a frenzy of excitement when it appeared, and perhaps has curbed some of the more extravagant claims about critical vendor status, debtors continue to make generous use of critical

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101 *Id.*

102 If Creditor A supplied goods within 20 days of bankruptcy, no ingenuity is required. In 2005, Congress added a provision giving priority treatment to these suppliers: 11 U.S.C. § 503(b)(9) (2012). This special protection has proven quite costly for Chapter 11 debtors in many cases.

103 *See, e.g.*, Mark A. McDermott, *Critical Vendor and Related Orders:* Kmart *and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 14 AM. BANKR. INST. L. REV. 409, 409 (2006) ("[T]here are several classes of prepetition creditors whose claims must be paid in the ordinary course, prior to confirmation of a plan, if the business is to have any realistic chance of successfully reorganizing.").

104 Critical vendor treatment is an outgrowth and expansion of the "doctrine of necessity," which dates back to the railroad receiverships of the late nineteenth century. *See* Fosdick v. Schall, 99 U.S. 235, 251-52 (1878) (upholding, with "no doubt," payment in full of key creditors).

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

106 *Id.* at 874.

vendor doctrine.[107] If Firm singled out Creditor A as a critical vendor and proposed to pay its $50,000 obligation in full, a bankruptcy judge would probably approve the critical vendor order.

D. *Incorporating Favored Treatment into a Sale*

The fourth strategy, which is available even if Creditor A cannot plausibly qualify as a critical vendor, is for Firm to arrange to sell its assets in a 363 sale to a buyer that is willing to assume Firm's obligations to Creditor A.

The most dramatic use of the sale strategy came in the Chrysler bailout in 2009. To rescue and restructure Chrysler, the government arranged for a sale of nearly all of Chrysler's assets to a newly created entity commonly known as New Chrysler.[108] In addition to the $2 billion purchase price, New Chrysler agreed to pay $5.3 billion of prebankruptcy trade claims in full, and also to give a $4.6 billion promissory note and 55% of New Chrysler's stock to Chrysler's retirees.[109] By including these commitments in the sales agreement, Chrysler and the government ensured that the trade and retiree claims were paid in full, even though Chrysler's senior lenders and tort creditors received almost no payment for their unsecured claims.

Even prior to *Chrysler*, purchasers often assumed some of a debtor's obligations in connection with a section 363 sale. *Chrysler* simply took the strategy to levels that no one had previously dared.[110]

E. *Subverting Equality in the Reorganization Plan Itself*

Finally, suppose that Firm doesn't want to sell its assets, and none of the other three strategies is available to it. The reorganization plan itself provides several additional opportunities to favor Creditor A over Creditor B.

If Firm can find an accommodating senior creditor, Firm may be able to arrange a "gifting" transaction as part of its reorganization plan. In a classic gifting arrangement, a senior creditor agrees to cede part of its recovery to a lower priority class of claims or interests. A bank that is owed $100,000 and claims to be fully secured might accept a $90,000 recovery, and donate the

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107 *See* Travis N. Turner, Note, Kmart *and Beyond: A "Critical" Look at Critical Vendor Orders and the Doctrine of Necessity*, 63 WASH. & LEE L. REV. 431, 434-36 (2006) ("Once a rare phenomenon, critical vendor orders have become increasingly standard operating procedure in large Chapter 11 cases.").

108 *See In re* Chrysler LLC, 405 B.R. 84, 87-92 (Bankr. S.D.N.Y. 2009) (describing and upholding the sale), *aff'd,* 576 F.3d 108 (2d Cir. 2009), *vacated*, 558 U.S. 1087 (2009).

109 *Id.* at 91-92.

110 For an analysis and comparison to the obligations assumed in other bankruptcy sales, see Mark J. Roe & Joo-Hee Chung, *How the* Chrysler *Reorganization Differed from Prior Practice*, 5 J. LEGAL ANALYSIS 399, 401 (2013) ("On multiple key financial characteristics, *Chrysler* was well outside the mainstream, in the company of only the most controversial of prior . . . sales.").

remaining $10,000 of its recovery to one class of general creditors. Gifting figured prominently in Detroit's bankruptcy case. The unlimited tax GO bondholders, who argued that their bonds were secured revenue bonds, agreed to a settlement that paid them 76 cents on the dollar, and required them to "gift" the other 24 cents on the dollar to Detroit's pension beneficiaries.[111]

Gifting has gotten somewhat tricky in the Second and Third Circuits, thanks to a pair of recent decisions invalidating gifting arrangements.[112] Both expressed concern that the ostensible gifts may in reality subvert bankruptcy's priority rules and equality of creditors norm. But bankruptcy practitioners have strongly defended gifting,[113] and it remains an option in many cases. The bankruptcy judge in the *Detroit* case approved the gifting features in Detroit's debt adjustment plan.[114] Nor has gifting disappeared altogether even in the Third Circuit. In the *World Health Alternatives* case, a Delaware bankruptcy judge distinguished the troublesome Third Circuit precedent and approved a reorganization plan that included significant gifting.[115]

Even if gifting isn't available, Firm may still be able to use the reorganization process to favor Creditor A. Firm and its managers have broad discretion on how to structure the proposed reorganization plan. Although both Creditor A and Creditor B are unsecured creditors, Firm can put them in separate classes, and can propose to give Creditor A's class a bigger payout than Creditor B's. This was precisely what Detroit did in its bankruptcy.[116] Detroit created a class for its pension beneficiaries, and gave them roughly 70 cents on the dollar, while offering a class of tort creditors much less—13 cents.[117] It was far from clear whether the differential treatment was permissible under current bankruptcy law. As discussed earlier, the "unfair discrimination" requirement has long been thought to require that classes of unsecured creditors receive roughly comparable treatment.[118] But the

111 The *Detroit* gifting is discussed more fully in David A Skeel, Jr., *From* Chrysler *and* General Motors *to* Detroit, 24 WIDENER L.J. 121, 145-46 (2015).

112 *See In re* DBSD, 634 F.3d 79, 97 (2d Cir. 2011) ("[Gifting] does not square with the text of the Bankruptcy Code."); *In re* Armstrong World Indus., 432 F.3d 507, 513 (3d Cir. 2005) ("[T]he plain language of the statute makes it clear that a plan cannot give property to junior claimants over the objection of a more senior class that is impaired . . . .").

113 *See, e.g.*, Harvey R. Miller & Ronit J. Berkovich, *The Implications of the Third Circuit's* Armstrong *Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?*, 55 AM. U. L. REV. 1345, 1349 (2006) (characterizing gifting as "creative structuring to achieve substantial consensus as to the distribution of value").

114 *See In re* City of Detroit, 524 B.R. 147, 171, 189 (Bankr. E.D. Mich. 2014).

115 *See In re* World Health Alts., Inc., 344 B.R. 291, 297 (Bankr. D. Del. 2006).

116 524 B.R. at 255-59. In the consumer bankruptcy context, courts have sometimes allowed debtors to provide a much higher payout for a class of nondischargeable obligations such as student loans than for other unsecured creditors. For discussion and critique of the cases, see Richard M. Hynes & Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy Law*, 33 REV. BANKING & FIN. L. 609, 635 (2014).

117 524 B.R. at 253.

118 *See, e.g.*, *supra* note 81 and accompanying text.

bankruptcy judge in the *Detroit* case concluded that the test for whether discrimination is acceptable is the bankruptcy judge's conscience,[119] thus suggesting that the judge is under no obligation to honor the equality of creditors norm.

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Together, these developments enable the debtor to favor a particular creditor or group of general creditors prior to filing for bankruptcy and at nearly any point in the bankruptcy case.[120] Absent major adjustments to current bankruptcy doctrine, the equality of creditors norm seems to be on the verge of disappearing altogether.

What, if anything, should be done? The three most plausible answers to this question are to do nothing, to reinvigorate the equality of creditors norm, or to abandon it. Having shown what doing nothing looks like in this Part, I consider the other alternatives in the next two.

III. Reinvigorating the Equality of Creditors Norm

The equality of creditors norm has long been central to American bankruptcy law, as we have seen. We should therefore begin by considering what a more robust pursuit of equality would look like, and whether this might be an improvement on existing law. As this Part illustrates, a few simple reforms could restore much of the vanishing equality if this were a desirable objective. Whether reinvigorating equality really is the right objective will turn out to be a very different question.

A. *What Might Reform Look Like?*

1. Preferences

We start with preference law, the doctrine most closely associated with the equality of creditors norm. Much of the leakage in current preference law can be traced to the expansiveness of the safe harbor for payments made in the ordinary course of business.[121] Once limited to payments made within forty-five days of the

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119 524 B.R. at 256.

120 Yet another strategy that may protect a favored creditor is a roll-up of a prebankruptcy loan. By subsuming an old loan into a new loan that adds to the prebankruptcy collateral, a debtor assures fully secured status, and thus full payment, for a loan that might otherwise have been partially unsecured. *See, e.g.*, Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 707-09 (2009) ("Postpetition lenders seek to condition the debtor's access to credit on [, *inter alia*,] roll-ups . . . .").

121 *See* 11 U.S.C. § 547(c)(2) (2012). In 2005, Congress amended § 547(c)(2) to make the requirement disjunctive. Prior to 2005, the creditor was required to show that the transfer was in the ordinary course both from the perspective of the industry and in terms of the two parties dealings with one another. *See* Bankruptcy Abuse Prevention & Consumer Protection Act of 2005, Pub. L. No. 109-8, § 409, 119 Stat. 23, 106.

extension of credit, it now has unlimited scope.[122] In addition to the absence of any temporal limitation, a creditor need only show that the payment it received was in the ordinary course of either the industry or the two parties.[123] The simplest way to restore the equality of creditors norm in the preference context would be to sharply restrict the ordinary course safe harbor, or perhaps excise it altogether. If Creditor A could not invoke this safe harbor, it would be considerably more difficult for Firm to favor Creditor A by repaying it on the eve of bankruptcy.

The other glaring intrusion on equality of creditors is the special treatment of derivatives and other financial contracts.[124] If Firm and Creditor A have structured their transaction as a derivative, payments to Creditor A are entirely exempt from the preference rules. Reversing this special treatment would further reinvigorate the equality of creditors norm.

These two adjustments would restore much of the lost equality in the preference context. Bankruptcy courts could play a small role in restoring creditor equality by construing each of the intrusions narrowly.[125] But the preference inequality has a statutory basis. A more complete restoration of creditor equality would therefore require amendments to the Bankruptcy Code.

2. Executory Contracts

As with preferences, Firm's ability to favor Creditor A by assuming the parties' executory contract comes from the bankruptcy statute itself, and therefore would require a statutory fix. But the fix is remarkably simple: all Congress would need to do is amend the executory contract provision to require that any unpaid prebankruptcy obligations be treated as unsecured obligations in all cases—regardless of whether Firm assumes the executory contract.[126] If Firm assumed Creditor A's contract, Firm would commit to fulfill any future obligations under the contract, but the $50,000 of prebankruptcy obligations would be treated as a general unsecured claim, just as with Creditor B. This simple fix would not put Creditor A and Creditor B in precisely the same place. Their postpetition status would be different, since Firm's postpetition obligations

122 Under the 1978 Code as first enacted, transfers made in the ordinary course of business were only protected if the transfer occurred within forty-five days of the time the creditor extended credit. The forty-five day restriction was removed in 1984. The Supreme Court discusses these developments in its most important preference case under the 1978 Code, *Union Bank v. Wolas*, 502 U.S. 151, 156-59 (1991).

123 *See supra* note 121.

124 *See supra* text accompanying notes 93–94.

125 A few courts have gestured in this direction. *See, e.g.*, *In re* Nat'l Gas Distribs., 346 B.R. 394, 402-03 (Bankr. E.D.N.C. 2006).

126 Lawmakers could achieve the change through a simple amendment of 11 U.S.C. § 365(b) making clear that the debtor's obligation to cure any defaults and to provide adequate assurance of future performance does not apply to compensating the nondebtor for prebankruptcy obligations. These would be treated as general claims, just as they are under current law when the debtor rejects a contract. *Cf.* 11 U.S.C. § 502(g)(1) (2012).

to Creditor A would be treated as administrative expenses and given priority status.[127] But it would eliminate much of the disparity in their treatment.[128]

3. The Other Departures from Equality

Each of the other intrusions on creditor equality could be remedied without formally amending the bankruptcy laws. Courts gaveth critical vendor doctrine, and courts could taketh it away.[129] Judge Easterbrook's *Kmart* decision laid the groundwork for just such a retrenchment.[130] The debtor would not be required to cease dealing with its key suppliers, and it could pay them in full for postpetition deliveries, but the court would require unpaid prebankruptcy obligations be given the same treatment as other general unsecured claims.

Protecting the equality of creditors principle in the context of a sale would be slightly more complicated, given the presence of a third party that theoretically is making an independent judgement whether to repay some of the debtor's prebankruptcy obligations. If a third party that purchases Firm's assets also decides to repay Creditor A entirely outside the bankruptcy process, this is arguably not a concern of bankruptcy.[131] Creditor equality requires only that Creditor A and Creditor B receive comparable treatment *in* bankruptcy. The problem comes when the asset purchase and payment of Creditor A appear to be connected, and are in effect an ad hoc reorganization plan.[132] This concern is especially acute if the cost of paying Creditor A's claim is treated as part of buyer's purchase price. But the special treatment of a favored creditor may be an implicit part of the bid, even if it is not included in the formal purchase price.

Two adjustments might strengthen creditor equality. The first is to consider only the cash (or credit bid) portion of a buyer's bid in determining the amount of the bid.[133] If Firm receives two bids for its assets, the higher cash bid would

127 *See* 11 U.S.C. § 503(b)(1)(A) (2012).

128 Strictly speaking, this adjustment would not be based on the original equality of creditors norm. Under the historical norm, creditors whose claims arose because their executory contracts were not assumed would be general creditors, but creditors whose contracts were assumed would not. For more on the historical evolution of bankruptcy's treatment of executory contracts, see, e.g., Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection"*, 59 U. COLO. L. REV. 845, 849-50 (1988). For a critique of the contemporary relevance of this history, see Westbrook, *supra* note 82, at 325.

129 One qualification: to fully assure equality of creditors, Congress would need to undo the special treatment of sellers of goods by removing § 503(b)(9).

130 *See supra* text accompanying notes 105-06.

131 For a defense of the GM and Chrysler cases on these grounds, see Stephen Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J. 531, 538 (2009).

132 In the Chrysler case, the sale agreement arranged by the U.S. government explicitly required New Chrysler, the purchaser, to pay Chrysler's trade claims and retiree benefits. *See* Motion of Debtors & Debtors in Possession, Pursuant to Sections 105, 363 and 365 of the Bankr. Code and Bankr. Rules 2002, 6004 & 6006 at 25-31, *In re* Chrysler, LLC, No. 09-5002, 2009 WL 1227661 (Bankr. S.D.N.Y. May 4, 2009).

133 For a proposal along these lines, see generally Richard Squire, Debt Bidding (May 2014) (unpublished manuscript) (on file with author).

prevail, even if an alternative bid might be higher if debt assumption were treated as part of the bid. The second is to ensure a robust market check by minimizing the obstacles to making a bid.[134] Neither would directly assure equal treatment, but both would reduce the likelihood of deviations.

The final intrusion on creditor equality—differential treatment of different classes of unsecured creditors—can also be prevented without amending the Bankruptcy Code. Courts could simply interpret the "unfair discrimination" requirement stringently, casting a skeptical eye on classification schemes that call for divergent treatment of otherwise similar classes of creditors.[135]

B. *The Implications of Greater (or Lesser) Equality*

The discussion to this point has shown that if courts and Congress were motivated to do so, they could easily reinvigorate the equality of creditors norm. Debtors and other parties probably would still manage to evade the equality norm on occasion, but the changes described in the last section would ensure much more robust adherence to the norm. Is this the way forward? Is greater creditor equality preferable to the landscape that characterizes current bankruptcy practice?

I'm not so sure.

The first thing to note is that there's nothing inherently problematic about giving one creditor more favorable treatment than another in bankruptcy if the special treatment is fully disclosed in advance. As long as creditors know where they stand and can adjust the terms of the credit they extend, a disfavored creditor will simply take its expected bankruptcy treatment into account when it makes its initial loan to the debtor.[136] From an ex ante perspective, the disfavored creditor is no worse off than the favored creditor. In some contexts, it may be more problematic *not* to provide differential treatment.[137] Nor are deviations from equal treatment ethically charged, as they are in other contexts. The deviations are not used to discriminate on the basis of race or gender, for instance. To the contrary, they sometimes favor more vulnerable creditors, such as pension beneficiaries. We cannot simply assume that failures to honor creditor equality are pernicious.

134 Courts could significantly limit any termination fees or qualified bid requirements, and could require that the auction be kept open long enough for potential bidders to emerge. *See, e.g.*, Roe & Skeel, *supra* note 5, at 766.

135 For an argument that this is required under current law, see Richard M. Hynes & Steven D. Walt, *Fair and Unfair Discrimination in Municipal Bankruptcy*, 37 CAMPBELL L. REV. 25, 69 (2015); *see also* Markell, *supra* note 79, at 228.

136 For the classic analysis of creditors who cannot realistically adjust, see Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 865 (1996), which notes "the ability to use security interests to divert value from nonadjusting creditors tends to distort the borrower's choice of contractual arrangements with its creditors, giving rise to certain efficiency costs."

137 *See* Chem. Bank N.Y. Tr. Co. v. Kheel, 369 F.2d 845, 848 (2d Cir. 1966) (Friendly, J., concurring) ("Equality among creditors who have lawfully bargained for different treatment is not equity but its opposite . . . .").

Second, while some of the equality-enhancing strategies might improve current bankruptcy law, others would not. As discussed in the next Part, tighter restrictions on sales might be beneficial. The implications of the other reforms are more mixed, however, and with preference law—the doctrine with which creditor equality is most closely associated and from which it emerged—a shift to true creditor equality would make bankruptcy law worse, not better. In bankruptcy, equality is not everything it's imagined to be.

IV. RETHINKING THE EQUALITY OF CREDITORS NORM

The absence of an obvious benefit from increasing equality, and the normatively mixed results of moving in this direction, suggest that we cannot simply assume that the equality norm is desirable. As we consider the equality-enhancing strategies more closely, we will find that it is not.

A. *Equality's Original Home: The Preference Provision*

Start with the prohibition on preferences, the context where the equality norm first arose. As noted in the last Part, the best way to realign preference law with the equality of creditors norm would be simply to remove the ordinary course safe harbor.[138] Other safe harbors can be reconciled with equality of creditors; ordinary course, much less so. If a company falls into financial distress after previously having paid all of its creditors in a timely fashion, and decides to stop paying all but one of its creditors, the favored creditor's treatment clearly violates the equality of creditor norm, but the creditor is likely to come squarely within the ordinary course safe harbor.[139]

In addition to moving preference law much closer to the equality of creditors norm, removing the ordinary course safe harbor would reduce the litigation costs of preference avoidance actions. Creditors that have received prebankruptcy transfers regularly invoke the ordinary course safe harbor in their defense.[140] The defense often succeeds, and the need to show that a payment was *not* given in the ordinary course imposes significant costs even when the trustee eventually prevails.[141] The sharp reduction in the cost of avoiding preferential transfers would be a major benefit of promoting equality of creditors by removing the ordinary course safe harbor.

138 *See supra* subsection III.A.1.

139 *See* 11 U.S.C. § 547(c)(2) (2012).

140 *See, e.g.*, Bryan Kotliar, Note, *A New Reading of the Ordinary Course of Business Exception in Section 547(c)(2)*, 21 AM. BANKR. INST. L. REV. 211, 215 (2013) (concluding that the ordinary course of business safe harbor is overly broad and needs to be narrowed).

141 *See, e.g.*, Daniel J. Bussel, *The Problem with Preferences*, 100 IOWA L. REV. BULL. 11, 12-13 (2014) (noting the cost of preference litigation and proposing that the dollar amount in the de minimis exception to the preference provision in § 547(c)(9) be significantly increased).

Removing the most frequently invoked safe harbor is not the only way to reduce the costs of preference litigation, however. The same benefit could be achieved in precisely the opposite way, by curtailing the preference provision or even deleting it altogether. Is an expanded preference provision superior to no provision at all?

In the nineteenth century, the answer to this question might well have been yes. In the absence of preference law, out-of-state creditors faced a significant risk that the debtor would favor some creditors—often family members, relatives, or other local creditors—over others if it fell into financial distress.[142] By the time the disfavored creditor realized that a once-viable business was in swift decline, it might have been too late. This, at least, was the risk that creditors and their advocates repeatedly pointed to when they argued for a robust preference law.[143] This suggests that preference law might have diminished creditors' need to take costly precautions.

Over the course of the late nineteenth and early twentieth century, a series of developments significantly reduced a potentially disfavored creditor's risk, and thus the need for the preference law. The first was that improvements in information technology made it less likely that creditors would be taken by surprise by a debtor's financial distress. In the last quarter of the nineteenth century, the leading credit reporting agency incorporated formal financial statements into its data collection process[144] and began using typewriters and carbon paper to replicate its reports, "thus permitting a rapid and simultaneous distribution of credit information throughout the firm."[145] These innovations dramatically expanded its scope and effectiveness. In 1870, the agency had 7000 subscribers; by 1900, it had over a million.[146]

Second, and most important, the distinction between local and out-of-state creditors diminished in significance. Bankruptcy itself contributed to this shift. Because bankruptcy courts had nationwide jurisdiction, a financially distressed debtor could no longer pay local creditors and then flee.[147] Gone

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142 *See also supra* notes 38–42 and accompanying text (discussing nineteenth century debates over preferences).

143 *See supra* notes 38–39 and accompanying text.

144 *See* James H. Madison, *The Evolution of Commercial Credit Reporting Agencies in Nineteenth-Century America*, 48 BUS. HIST. REV. 164, 172 (1974).

145 *See* JAMES D. NORRIS, R.G. DUN & CO. 1841–1900, at 138 (1978); *see also* Madison, *supra* note 144, at 176.

146 *See* Rowena Olegario, *Credit-Reporting Agencies: A Historical Perspective*, *in* CREDIT REPORTING SYSTEMS AND THE INTERNATIONAL ECONOMY 115, 122-23 (Margaret J. Miller ed., 2003).

147 Debtors may have been less likely to obtain financing from family and friends, though these sources of financing remained relevant for many small businesses.

were the days when local courthouse clerks stamped G.T.T.—"Gone to Texas"—on pleadings filed by creditors whose debtors had left the state.[148]

Finally, the expansion and systemization of the law of secured credit made it easier to create and perfect a security interest. In the nineteenth century, a creditor often could not take a security interest unless it took possession of the collateral, and some kinds of assets such as accounts receivable were difficult to secure.[149] Requiring a debtor to provide collateral thus became a genuine option for a broader range of creditors who might otherwise have been vulnerable in the event of financial distress.

I do not mean to suggest that financially distressed debtors no longer pay favored creditors, thus leaving fewer assets available for disfavored creditors. The laws of human nature have not been repealed. Business owners sometimes are tempted to repay loans from family members, or repay themselves, shortly before their business fails. But this problem could be addressed by a targeted rule prohibiting self-dealing, much as the duty of loyalty does in corporate law,[150] rather than a broad preference provision that purports to promote equality of creditors.[151]

If preference law served another function, in addition to policing self-dealing, a broader prohibition on preferences might be justified. The traditional explanation for preference law does indeed have a second theme: preserving the value of a troubled debtor's assets by discouraging a race to the courthouse.[152] Because payments made to, or liens obtained by, a creditor shortly before bankruptcy can be retrieved by the trustee, the reasoning goes, creditors will be less likely to grab assets, thus making it more likely that the parties can reach a collective, value-preserving solution to the debtor's financial distress.

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148 *See, e.g.*, BALLEISEN, *supra* note 26, at 170 (describing the G.T.T. phenomenon, as well as the "Shirkshire Road" label given to debtors who fled from Massachusetts to upstate New York by way of the Berkshire Mountains).

149 For an overview of the history of secured credit, see generally 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY (1965).

150 *See, e.g.*, DEL CODE ANN. tit. 8, § 144 (2017). Retaining the trustee's power to avoid security interests and other liens acquired on the eve of bankruptcy also would make sense, since these liens do not serve any beneficial function.

151 A self-dealing oriented provision could simply permit the trustee to avoid payments made to insiders on the eve of bankruptcy, relying on the existing (or perhaps an expanded) bankruptcy definition of insider. *See supra* note 89 and accompanying text. The Uniform Fraudulent Transfer Act, which has been adopted by many states and is available to the trustee in bankruptcy under 11 U.S.C. § 544(b) (2012), already includes such a provision. UNIF. FRAUDULENT TRANSFER ACT § 5(b), 7A U.L.A. 129 (2006) ("A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.").

152 *See, e.g.*, Brook E. Gotberg, *Conflicting Preferences in Business Bankruptcy: The Need for Different Rules in Different Chapters*, 100 IOWA L. REV. 51, 64 (2014) (describing the "race to the courthouse" or "grab race" concern and differing views as to whether this is a more or less important objective of preference law than the equality of creditors objective).

The first thing to note about the "grab race" justification for preference law is that it has very little to do with the equality norm.[153] The argument contends that the preference prohibition discourages creditors from destroying the going concern value of a debtor's assets in their rush to collect what they are owed. According to this rationale, the virtue of preference law is that it maximizes the value of the debtor's assets. Equality, which is concerned with how the assets are distributed, is at most an accidental byproduct.

If the "grab race" rationale for preference law were compelling, the equality norm would be irrelevant (rather than counterproductive) in this context. But the "grab race" rationale is deeply flawed. With the earliest bankruptcy laws, the preference prohibition did play at least a limited role in discouraging a race to the courthouse. The early laws did not explicitly impose an automatic stay on creditor collection efforts at the time a bankruptcy petition was filed.[154] A creditor theoretically could ignore the bankruptcy proceeding, and continue to try to collect what it was owed. In *Ex parte Foster*, Justice Story, sitting as a circuit court judge, ruled that the preference provision in the 1841 Act voided the prejudgment attachment obtained by a creditor that continued to pursue its state law action after the bankruptcy filing.[155] In this context, preference law served as a substitute for a stay on enforcement.

Preference law is highly unlikely to discourage grabs more generally, however. Because the worst that can happen to a creditor who receives a potentially preferential payment is being asked to give it back, creditors have very little incentive to refrain from collecting.[156] A creditor who pursues a prebankruptcy payment will not be able to recover its litigation and other collection expenses if the payment is later avoided as a preference.[157] But this is the only significant cost. And if the debtor does not file for bankruptcy for more than ninety days or the creditor can invoke a safe harbor, the creditor will be able to keep the full payment, rather than waiting for its pro rata share of a subsequent bankruptcy distribution.[158]

153 *See id.*

154 Congress did not implement an explicit automatic stay for the first time until 1933. *See* Frank R. Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. MICH. J.L. REFORM 177, 179-80 (1978).

155 9 Fed. Cas. 507 (C.C.D. Me. 1842) (No. 4954).

156 *See also* John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 264 (1981) (noting that creditors have "much to gain and little to lose" by engaging in a potentially preferential transaction since "there is a good chance that one who receives a preference will be able to keep it"—"[b]ankruptcy may never be filed," or at least not "within ninety days of the transfer," or "the trustee may find it inexpedient to initiate recapture proceedings"). The futility of preference law may explain why Justice Stevens seems to have gotten confused about the logic in his opinion in a key preference case. *See* Union Bank v. Wolas, 502 U.S. 151, 161 (1991) (suggesting that an exception from, rather than application of, the preference provision "may benefit all creditors by deterring the 'race to the courthouse' and enabling the struggling debtor to continue operating its business").

157 *See* McCoid, *supra* note 156, at 265.

158 For an argument that the incentive to collect well before bankruptcy actually is a benefit of existing law, since it rewards early monitoring, see George G. Triantis & Ronald J. Daniels, *The Role*

To be sure, it would not be hard to give the preference provision real teeth. Lawmakers need only include a stiff penalty on top of the requirement that a favored creditor disgorge the preference.[159] But this option has never been seriously considered—probably because creditors have a legal and moral entitlement to be repaid, and in that sense are not doing anything wrong when they attempt to collect on the eve of bankruptcy.[160]

If preference avoidance should be limited to self-dealing transactions, as I have argued, the equality norm appears to have played a pernicious role in the twentieth century evolution of preference law. The early preference provisions functioned very much like a ban on self-dealing. Under the original version of the 1898 provision, the trustee could avoid preferential transfers that occurred less than four months before bankruptcy, but only if the trustee could show that the beneficiary "had reasonable cause to believe that it was intended thereby to give a preference."[161] This requirement was amended in 1938 to require only that the trustee show that the beneficiary had "reasonable cause to believe that the debtor is insolvent."[162] Even under the more relaxed standard that emerged, the trustee would fare better in preference actions against insiders than with outside creditors, because it was much easier for the trustee to show insiders knew the debtor was insolvent.

In the debates that led to the 1978 Code, these earlier provisions were condemned as failing to live up to the equal treatment objective. A House subcommittee report was particularly pointed in its condemnation. A "creditor's state of mind has nothing whatsoever to do with the policy of equality of distribution," the report's drafters wrote, "and whether or not he knows of the debtor's insolvency does little to comfort other creditors similarly situated who will receive that much less from the debtor's estate as a result of the prebankruptcy transfer to the preferred creditor."[163] Whatever arguments might be marshalled in support of the existing provision were trumped, the drafters believed, by these equality concerns. "To argue that the creditor's state of mind is an important element of a preference and that creditors should not be required to disgorge what they took in supposed innocence," they insisted, "is to ignore the strong bankruptcy policy of equality among creditors."[164] Other proponents

of Debt in Interactive Corporate Governance, 82 CALIF. L. REV. 1073, 1094-95 (1995). In my view, any additional monitoring benefits are not sufficient to justify the costs of the current preference rules.

159 *See* McCoid, *supra* note 156, at 269-70.

160 *See also id.* (arguing that sanctions for preferential transfers would punish innocent and guilty creditors alike).

161 Act of July 1, 1898, ch. 541, § 60(b), 30 Stat. 544, 562 (repealed 1978).

162 Act of June 27, 1938, ch. 6, § 60(b), Pub. L. No. 75-696, 52 Stat. 840, 870 (repealed 1978).

163 H.R. REP. NO. 95-595, at 178 (1977).

164 *Id.*

of a broader preference provision made similar arguments.[165] As a result, Congress adopted the current presumption that every eve-of-bankruptcy transfer to an unsecured creditor should be avoidable as a preference.[166]

Notice the perverse effect of the equality norm in this context. Equality of creditors was the inspiration for the current, deeply flawed preference provision. If the equality of creditors principle were not so entrenched in bankruptcy mythology, the preference provision might be limited to its proper domain—policing self-dealing. But the equality of creditors norm continues to prop up a doctrine long after its significance has withered away.[167]

B. *Moving Beyond Equality: Sales and Other Issues*

Although preference law was the original home of the equality of creditors norm, the prohibition on preferences had a shifting and idiosyncratic history in America. Perhaps, one might think, the "equality is equity" principle plays a more central and necessary role in the other doctrinal contexts where it is proclaimed. In this Section, I more briefly revisit each of these other contexts we have considered. In none of them is the equality norm necessary, or even helpful.

1. Tweaking the Treatment of Executory Contracts

After preferences, executory contracts are the context where the equality norm seems most likely to play an essential role. Commentators frequently point to equality of creditors as the principle on which the current rule is based.[168] If the debtor rejects an executory contract, the Bankruptcy Code characterizes the nondebtor's damages claim as a general unsecured obligation, thus giving it the same status as unsecured claims that arose prior

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165 *See, e.g.*, *The Bankruptcy Reform Act: Hearings on S. 235 and S. 236 Before the S. Subcomm. on Improvements in Judicial Mach. of the S. Comm. on the Judiciary*, 94th Cong. 101 (1975) (statement of the Hon. Conrad K. Cyr, National Conference of Bankruptcy Judges).

166 A contemporaneous article by a leading drafter of the 1978 Code suggests that the equality norm figured prominently in the decision to broaden the preference provision. *See* Richard B. Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANKR. L.J. 173, 183-84 (1979).

167 An interesting recent article by Brook Gotberg proposes to reinvigorate the equality of creditors feature of preference law in Chapter 7 liquidations, while eliminating preference law in Chapter 11 reorganization cases. *See generally* Gotberg, *supra* note 152. This would remove some of the counterproductive features of current preference law and would restore the preference rule to something like its original domain. But equality is not the real objective even in that context, as the plethora of priorities in Chapter 7 make clear. It would make more sense to have a more limited, self dealing–oriented preference rule that applied in all contexts.

168 *See, e.g.*, Westbrook, *supra* note 82, at 252.

to the bankruptcy filing.[169] This treatment is often described as promoting—and dictated by—the equality of creditors objective.[170]

The problem identified earlier—debtors thwarting the equality norm by assuming the contract of a favored creditor—complicates but does not by itself undermine the conventional understanding of executory contracts. Although bankruptcy's treatment of rejection accords with equality of creditors, the reasoning might go, its handling of assumption does not. By treating the prepetition obligations of a contract that the debtor assumes as unsecured rather than priority claims,[171] lawmakers could curb debtors' use of assumption to give better treatment to favored creditors, and more fully align the executory contract provision with the equality of creditors norm.[172]

Yet even here, equality of creditors is a loose and potentially misleading description of the concern. Promising a higher payout to pension beneficiaries than to bondholders, as several municipal debtors have done, is not inherently problematic. Their claims are somewhat different, and one can easily imagine rationales for favoring the pension beneficiaries.[173] The real problem was that the debtor's ability to assume its contract to the pensioners functioned as a hidden priority—a "secret lien"—confounding the bondholders' expectations.[174]

Three decades ago, Alan Schwartz pointed out that secret liens are not always as serious a problem as critics assume.[175] If a creditor can determine through ordinary diligence whether other creditors with superior priority exist, he argued, the fact that the superior creditor has not filed notice of its interest is not problematic.[176] The secret lien problem with executory contracts is much more intractable than the secret liens Schwartz has in mind. Under Schwartz's proposed scheme, first-in-time creditors would take priority over subsequent creditors, even if the earlier creditor were unsecured and had not filed a public financing statement.[177] Schwartz envisioned that subsequent creditors could discover any existing creditors by reviewing the debtor's audited financial statements or tax

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169 *See* 11 U.S.C. § 365(g) (2012).

170 *See, e.g.*, Andrew, *supra* note 128, at 924 ("[T]he entire purpose of rejection is to preclude . . . discriminatory elevation of the nondebtor party to priority over other creditors.").

171 Recall that the debtor is required to cure any defaults and provide assurance of performance when it assumes a contract. *See* 11 U.S.C. § 365(b)(1)(A) (2012). These obligations are treated as administrative expenses that must be paid in full. *Id.*

172 As noted earlier, this adjustment would depart from the historical contours of equality of creditors in this context. *See supra* notes 126–28.

173 This is especially true in the municipal bankruptcy context, since cuts in pension beneficiaries' entitlements could lead to greater social costs in the future if the lower pension benefits are not sufficient to live on.

174 For discussion of secret lien problems, see generally Douglas G. Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL. STUD. 53 (1983), and *supra* note 14.

175 *See* Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEG. STUD. 209, 219-22 (1989).

176 *Id.* at 220.

177 *Id.* at 219.

records.[178] With executory contracts, by contrast, it is impossible to know whether a particular creditor will be favored, because the creditor's status is not determined ex ante. The debtor makes its assumption or rejection decision *after* it files for bankruptcy. This is a far more pernicious secret lien issue.

A true secret lien imposes several potentially serious costs. The most obvious is the cost of uncertainty. A creditor that does not know what its status will be in the event of bankruptcy will need to assume that its recovery may be subordinated to that of other creditors.[179] Creditors may also take costly measures that will make them seem more essential to the debtor, and thus more likely to receive favored treatment in bankruptcy. In each instance, creditors may adjust the terms of the credit they extend, passing the costs on to debtors and increasing the debtor's cost of credit.[180]

The relationship between equality and these concerns is accidental at best. Changing the treatment of the prepetition obligations of an executory contract is one possible solution, but one could also solve the problem by giving explicit priority status to particular claims (such as pensions) that are thought to warrant special protection, as Congress has done with a variety of obligations.[181] This solution would not accord with the equality of creditors norm, but it would address the real underlying problem—the distorting effect of secret liens.

With another executory contract issue, the equality norm is even more problematic. Several commentators have pointed out that treating the nondebtor's damages claim as an unsecured obligation when the debtor rejects an executory contract can give the debtor *too* great an incentive to reject.[182] The estate only bears a portion of the cost of rejection, since it invariably will pay unsecured creditors less than the full amount of their claims. The more deeply insolvent the debtor is, the greater its incentive to reject will be, even if rejection imposes substantial costs on the nondebtor. George Triantis proposed that the damages claim be treated as an administrative expense when the debtor rejects a contract, to assure that the debtor fully internalized the cost of rejection.[183] Jesse

178 *Id.* at 220-21.

179 For a similar argument, see Roe & Tung, *supra* note 8, at 1273. Henry Hansmann and Reinier Kraakman have argued that removing the somewhat analogous uncertainty faced by creditors of a business was one of the key benefits provided by the creation of the corporate form. *See generally* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 402 (2000).

180 Secret liens also introduce potential distortions with respect to "nonadjusting" creditors. *See* Bebchuk & Fried, *supra* note 136, at 882.

181 Pensions are one of the obligations that are given special priority, but only to a limited extent. *See* 11 U.S.C. § 507(a)(5) (2012) (limiting priority for contributions to employee benefit plan arising from services rendered within 180 days of bankruptcy).

182 *See, e.g.*, Jesse M. Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, 46 DUKE L.J. 517, 532 (1996); George G. Triantis, *The Effects of Insolvency and Bankruptcy on Contract Performance and Adjustment*, 43 U. TORONTO L.J. 679, 710 (1993).

183 *See* Triantis, *supra* note 182, at 697.

Fried offered a series of other possible correctives, including adjustments to the contract purchase price and a variation on the administrative expense proposal.[184]

Both Triantis and Fried noted that equality of creditors is considered to be a central principle in the treatment of executory contracts.[185] But both left it behind as they analyzed the distortions created by the current rule and potential responses to the distortion.[186] They were right to set equality of creditors to the side. Clinging to the equality norm would further entrench the distortion—and in fact, may well have already done this under current law.[187] The real problem is that the current rule has a socially inefficient spillover effect. The benefits to the debtor of rejecting a contract may be less than the costs to the nondebtor of the rejection, but the current rule does not give the debtor an incentive to take the costs into account.[188]

With executory contracts, an issue where the equality norm has seemed most important, it is anything but. The equality norm provides a distorted picture of the purpose of the provision, and it distracts attention from the real issues raised by the current rule.

2. Clarifying Critical Vendor Doctrine

As with executory contracts, the central concern with critical vendor doctrine is that it functions as a hidden priority or secret lien. Nothing in the Bankruptcy Code identifies some creditors as deserving critical vendor treatment; the decision of which creditors to designate as critical is made by the debtor after filing for bankruptcy. The lien is not entirely hidden. In many large cases, other creditors could make an educated guess as to some of the critical vendors. In a carmaker bankruptcy, suppliers of parts are obvious candidates, given that many have

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184 *See* Fried, *supra* note 182, at 550-66.

185 *See, e.g.*, *id.* at 522; Triantis, *supra* note 182, at 691.

186 Yeon-Koo Che and Alan Schwartz have offered still another approach that does not rely on the equality of creditors principle. Focusing on the possibility that the debtor may have an incentive to assume a socially inefficient contract, Che and Schwartz question the invalidation of ipso facto clauses and the mandatory nature of § 365. *See* Yeon-Koo Che & Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 J.L. ECON. & ORG. 441, 444 (1999). In his classic functional account of executory contracts, by contrast, Jay Westbrook treated the equality principle as creating a strong presumption against any deviation from the existing rule that the nondebtor receives only an unsecured claim if the debtor rejects a contract. *See, e.g.*, Westbrook, *supra* note 82, at 256 (concluding that permitting a nondebtor to receive specific performance "would seriously violate the equality principle").

187 Courts have occasionally denied debtors' requests to reject contracts where rejection appears to be socially problematic, but these cases are uncommon. For discussion, see Fried, *supra* note 182, at 540-44.

188 In my own view, the simplest solution to the distortions discussed in this Section might be to treat the prepetition obligations of an assumed contract as an unsecured claim (thus addressing the secret lien problem) and to make greater use of the "balancing test" used by some courts to determine whether the debtor should be permitted to reject a contract (thus counteracting the spillover problem). The principal downside is that the debtor could avoid the risk of being forced to assume a contract by breaching prior to bankruptcy. *See id.* at 544. The most important point for present purposes is that the equality norm adds nothing to the analysis.

developed in tandem with the carmaker.[189] But others will not be so easy to predict: some debtors define critical vendor very broadly, others more narrowly.[190]

It is possible that critical vendor doctrine is justifiable, at least with some vendors, despite the secret lien problem. If some vendors truly would refuse service if they were not paid in full, and if these vendors cannot realistically be replaced, courts perhaps should permit payments to critical vendors.[191] If the threats to cut off service are not credible, by contrast, courts should not permit the payments.[192] Either way, the equality norm is once again irrelevant to the analysis.

Here and elsewhere, it is tempting to try to resuscitate the equality norm by saying that lawmakers and courts should promote equality of creditors unless the benefits of equality are outweighed by another important bankruptcy objective, and by narrowly defining equality's scope. With critical vendor doctrine, if we conclude that a vendor's threat is credible, we could justify this in equality terms by arguing that the threat is unrelated to the vendor's prepetition claim—it is a precondition for future service—and thus does not implicate equality of creditors.[193] Allowing the payment under these circumstances would maximize the value of the debtor's assets. But if we conclude that the threat is not credible, the reasoning might go, we would revert to the equality of creditors baseline. The problem with this reasoning is that equality of creditors is not doing any work. It is unnecessary to the analysis, which turns entirely on the question whether allowing critical vendor status will maximize the value of the debtor's estate.

3. Policing Unusual 363 Sales

A sale by the debtor of most or all of its assets also can create a secret lien (or hidden priority) in much the same fashion as with critical vendor doctrine. Suppose the debtor proposes to sell nearly all of its assets to a buyer for $2 billion, and the buyer signals its intention to pay two classes of junior creditors in full, as

189 For analysis of supply chain links among other manufacturers, see generally Lisa Bernstein, *Beyond Relational Contracts: Social Capital and Network Governance in Procurement Contracts*, 7 J. LEGAL ANALYSIS 561 (2015).

190 *See also* McDermott, *supra* note 103, at 415-16 (reviewing the different standards courts use when analyzing critical vendor classification).

191 Because the cost of the goods supplied to the debtor prior to bankruptcy is a sunk cost, a rational vendor should not take it into account in deciding whether to continue providing goods after the debtor files for bankruptcy. *See generally* JOHN SUTTON, SUNK COSTS AND MARKET STRUCTURE 7-12 (1991) (explaining the basic economic theory of sunk costs). But many people do take already incurred costs into account—a phenomenon known as the "sunk cost fallacy." For a sample of the large behavioral economics literature exploring the sunk cost fallacy, see, e.g., Hal R. Arkes & Catherine Blumer, *The Psychology of Sunk Costs*, 35 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESS 124 (1985).

192 In his *Kmart* decision, Judge Easterbrook suggested that courts should attempt to distinguish between these two possibilities. *See In re* Kmart Corp., 359 F.3d 866, 873 (7th Cir. 2004) (suggesting that it be "necessary to show . . . that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid").

193 Thanks to Douglas Baird for identifying this issue and pressing me to clarify the discussion.

in the Chrysler bankruptcy. If a class of senior creditors will receive the $2 billion as payment on its $6.9 billion of debt, but will not receive anything else, the seniors may object that they have been displaced by a secret lien. Classes of junior creditors whom the buyer does not offer to pay may raise similar objections.

Based on these facts alone, we cannot immediately determine whether the disfavored creditors' objections are legitimate. The introduction of an additional party—the buyer—adds a new complexity. So long as the buyer purchases the assets legitimately, nothing precludes it from paying some of the debts owed to former creditors. In the *Chrysler* example, if the assets were worth $2 billion or less, the senior creditors got what they were entitled to.[194] If the assets were worth more than $2 billion, by contrast, the disfavored creditors had a real grievance. A portion of the purchase price may actually have consisted of value the seniors should have received, but which went to the favored creditors instead.

The strategies described earlier would help distinguish between these two possibilities. Courts could limit the use of buyer protections that discourage other potential bids, and they could consider only the amount of a buyer's cash bid (or credit bid) when selecting a winning bid.[195] Once again, the equality of creditors principle does not add anything to this analysis. The principal concern is disguised priorities and the inefficiencies they can cause.

4. Unfair Discrimination

The final set of strategies for favoring one group of creditors over others—gifting transactions and disproportionate payouts under a plan—is in some respects the most subtle. The other strategies often pay a favored creditor in full, while leaving other creditors with little or nothing. Gifting and discriminatory payouts rarely distinguish so sharply. They usually give favored creditors somewhat more and disfavored creditors somewhat less. Pension creditors received at least 60-70% of their claims in the Detroit bankruptcy, for example, whereas other creditors were given far less.[196]

Notice that classification—the debtor's or plan proponent's authority to place creditors with equal priority in different classes[197]—is itself in a sense a rejection of the equality of creditors principle. If equality of creditors were the principal objective, all unsecured claims would be put in the same class,

194 The bankruptcy judge heavily emphasized this point in the *Chrysler* decision. *See In re* Chrysler LLC, 405 B.R. 84, 97 (Bankr. S.D.N.Y.), *aff'd*, 576 F.3d 10 (2d Cir.), *vacated sub nom.* Ind. State Police Pension Tr. v. Chrysler LLC, 558 U.S. 1087 (2009).

195 *See supra* notes 133–34 and accompanying text. They also could refuse to approve sales that really are disguised reorganizations. *See, e.g.*, Roe & Skeel, *supra* note 5, at 755-56 (advocating a presumption that courts invalidate a proposed sale if more than half of the value of the assets would continue to belong to old shareholders or creditors after the sale).

196 *See supra* notes 116–17 and accompanying text.

197 *See* 11 U.S.C. § 1122(a) (2012).

as was done under the early American bankruptcy laws. Differential payouts arise only *because* the debtor or other proponent of a reorganization plan is permitted to place general unsecured claims in different classes.

Rather than equality, the real concern once again is the risk of secret liens. A reorganization plan that offers one class of general creditors considerably more than another gives a partial priority or partial lien to one group of creditors. Partial priorities are a familiar feature of the Bankruptcy Code.[198] The key difference is that the partial priorities in the Code are explicit, whereas the implicit lien created by differential payouts is a secret lien whose contours are not known when the debtor or other plan proponent proposes a reorganization plan.

The secret lien problem could be addressed in either of two ways. The first is to interpret the unfair discrimination requirement strictly, and to forbid any significant deviations in the payouts of two classes of general creditors.[199] Under this approach, a debtor might be permitted to offer a different kind of payment to different classes of creditors—cash and debt to one, for instance, and stock to another. But the value of the expected payout would need to be very similar.[200] Otherwise, the favored class would benefit from a hidden priority or secret lien. Under the second approach, courts would look more favorably on differential payouts, but they would uphold the proposed treatment only if the debtor could show that the favored class could expect favored treatment outside of bankruptcy.[201] The priority is not hidden, according to this logic, because the parties would have reason to expect that pension claims would receive a higher payout than bonds.[202] Neither approach is perfect, but both would counteract the secret lien problem.[203]

In theory, the equality norm could be used as a supplemental principle, guiding the inquiry. The stricter approach could be viewed as a rules-based

198 Employees are given a partial priority for prebankruptcy wages, for example, and a related priority for contributions to an employee benefit plan. 11 U.S.C. § 507(a)(4)–(5) (2012) (authorizing priority for up to $12,850 of wage claims).

199 Richard Hynes and Steven Walt have argued that existing doctrine, properly understood, imposes significant constraints on differential treatment. *See* Hynes & Walt, *supra* note 116, at 616 (arguing that "courts have been applying an unduly narrow construction" and identifying "good reasons to limit judicial discretion" in regards to the unfair discrimination requirement).

200 A deviation of, say, 10-15% might be acceptable in an appropriate case, for instance, but wider gulfs would not. *See, e.g.*, David Skeel, Opinion, *Fixing Puerto Rico's Debt Mess*, WALL ST. J. (Jan. 6, 2016), https://www.wsj.com/articles/fixing-puerto-ricos-debt-mess-1452040144 [https://perma.cc/TT2A-S8D8] (arguing for an explicit cap of 10-15% on deviations in the context of the Puerto Rico bankruptcy).

201 *See also* Markell, *supra* note 79, at 262 (including this factor as part of a proposed standard for addressing unfair discrimination issues).

202 The bankruptcy judge employed a version of this second approach in the Detroit bankruptcy. Because pensions are protected by Michigan's state constitution, he concluded, Detroit's pensioners had an expectation of preferred treatment in bankruptcy. The Michigan constitutional provision did not fully protect the pension claims, but it justified a partial priority. *In re* City of Detroit, 524 B.R. 147, 257 (Bankr. E.D. Mich. 2014).

203 Strict scrutiny of deviations might make it difficult to confirm a reorganization plan in a complex case; the partial priority approach would require a judge to make judgments about implicit priorities.

equality perspective, for instance, and the more flexible approach as allowing deviations where the creditors are not truly similarly situated. But equality language is an awkward fit. Equality language is most compelling when it draws attention to discrimination against a vulnerable and disfavored class, as with the classic Equal Protection Clause cases. With unfair discrimination, as with the preference context in which the equality norm first emerged, the creditors crying out for help are powerful creditors (such as bondholders, in the Detroit bankruptcy) rather than weak ones. Although equality language certainly can be used by the comparatively well-off,[204] this is not its natural habitat.

Equality language also does not lend itself well to the kinds of comparative judgments courts make with unfair discrimination, especially in the bankruptcy context. Equality tends to be either/or: the court determines whether two creditors are similarly situated, and if they are, it insists that they be given the same treatment.[205] Unfair discrimination is more incremental. It does not call for absolutely equivalent treatment, just treatment that does not unduly favor or disfavor a particular class of creditors vis-à-vis other creditors with the same priority. The terms "fairness" and "unfair discrimination" nicely capture the relevant concerns. Equality of creditors does not.

C. *Equality of Creditors in Consumer Bankruptcy or Liquidation*

My focus in this Part has been on the role of the equality norm in Chapter 11 cases. We cannot fully dismiss the equality of creditors norm without briefly considering its implications for two contexts that more closely fit the original habitat of the equality norm: consumer bankruptcy and Chapter 7 liquidation. If equality of creditors figured more prominently in either of these contexts, its function would be far more limited than conventional wisdom implies, but still vital.

1. Equality in Consumer Bankruptcy

From a historical perspective, the possibility that equality might matter more in consumer bankruptcy than in corporate cases is not farfetched. Although the

204 As with the reverse discrimination cases in the Supreme Court's affirmative action jurisprudence. *See, e.g.*, Regents of the Univ. of Cal. v. Bakke, 438 U.S. 265, 277-78 (1978) (opinion of Powell, J.) (describing a white male's invocation of the Equal Protection Clause to challenge a public medical school's racial preferences in admissions).

205 To be sure, equality is a protean concept, and some conceptions of equality do contemplate more incremental comparisons. But equality in the bankruptcy context has always been based on the formal equality principle that equals should be treated equally, as construed in pro rata terms. The formal equality principle is usually traced to Aristotle. *See generally* ARISTOTLE, *Nicomachean Ethics* (J.O. Urmson ed., W.D. Ross trans.), *in* 2 THE COMPLETE WORKS OF ARISTOTLE 1785 (Jonathan Barnes ed., Princeton Univ. Press 1984) (c. 349 B.C.E.) (noting that equality requires that if persons "are not equal, they will not have what is equal" and that disorder emerges "when either equals have and are awarded unequal shares, or unequals equal shares").

earliest bankruptcy laws were restricted to merchants and traders, these debtors were usually individuals and partnerships. Starting in 1841, consumer debtors could file for bankruptcy even if they were not merchants or traders.[206] Like the early consumer bankruptcy cases, the two-thirds of today's consumer cases filed under Chapter 7 fit the pattern from which the equality norm arose: the debtor turns any assets over to the court so that the assets can be sold and the proceeds distributed to creditors, and the debtor is then given a discharge.

In theory, most consumer cases thus hew closely to the equality of creditors norm, with general creditors each receiving a portion of the payout. The problem is that the payout is zero. Because most consumer debtors do not have any nonexempt, unencumbered assets, general creditors often do not receive a recovery.[207] Equality of creditors has little meaning when creditors are not receiving any recovery at all.

Moreover, and at least as important, equality of creditors is entirely unhelpful when issues do arise. Perhaps the best illustration is the treatment of covenants not to compete—a debtor's contractual promise not to engage in business activities that compete with her employer after their contract is terminated—since this issue is often characterized as raising equality of creditors concerns. Courts have wrestled with the question whether a debtor must comply with a covenant not to compete that would be enforceable under state law, or whether the debtor's obligations should be treated as a claim that can be discharged.[208] The equality norm is sometimes viewed as suggesting that the debtor should not (or should rarely) be bound by a covenant not to compete.[209] The nondebtor should be treated like other general creditors, the reasoning goes, and given an unsecured claim rather than specific enforcement of the covenant.

In reality, however, the equality norm is irrelevant to the analysis. From a policy perspective, covenants not to compete lie at the intersection between two key bankruptcy principles that do matter: the fresh start[210] and the commitment to honoring state law entitlements wherever possible.[211] Declining to specifically enforce a covenant not to compete strengthens the fresh start by removing constraints on the debtor's ability to earn a living in

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206 *See supra* text accompanying note 29.

207 *See, e.g.*, ROBERT E. GINSBERG ET AL., GINSBERG & MARTIN ON BANKRUPTCY § 15.03 (2017).

208 The Bankruptcy Code defines "claim" to include a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment." 11 U.S.C. § 101(5)(B) (2012). The difficulty arises because it is not clear just when a covenant not to compete "gives rise to a right to payment" and thus can be treated as a dischargeable claim.

209 *See, e.g.*, Westbrook, *supra* note 82, at 245.

210 *See* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) ("One of the primary purposes of the bankruptcy act is to 'relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh . . . .'" (quoting Williams v. U.S. Fid. & Guar. Co., 236 U.S. 549, 556-55 (1915)).

211 *See* Butner v. United States, 440 U.S. 48, 55 (1979) (holding state entitlements should be honored in bankruptcy unless the law clearly indicated otherwise).

the future, whereas specific enforcement more closely replicates the parties' respective rights outside of bankruptcy.[212] Even here, the equality norm is unhelpful and unnecessary to the analysis.[213]

2. Equality in Chapter 7 Liquidation

Like consumer bankruptcy, Chapter 7 liquidation cases much more closely resemble the conception of bankruptcy that gave rise to the equality of creditors norm than most Chapter 11 cases do. When a debtor files for Chapter 7, a trustee is appointed.[214] The trustee sells the debtor's assets and distributes the assets to creditors.[215]

If there were a place where equality might continue to thrive, Chapter 7 appears to be the most likely candidate. Several of the principal deviations from equality, such as critical vendor doctrine and sales that favor some creditors over others, play much less of a role when a business is being liquidated by a third party such as a trustee. And general creditors do sometimes receive at least a limited recovery in business cases resolved under Chapter 7. It is not hard to imagine a process where the debtor's assets are sold and the proceeds distributed in accordance with the equality norm.

Even here, however, the equality norm is obsolete. One problem with retaining the equality norm in Chapter 7 is that distinctions between Chapter 7 and Chapter 11 would create serious frictions. If an equality-based preference rule were retained in Chapter 7, for instance, but not in Chapter 11, some creditors might do better and others worse in Chapter 7, which would invite unproductive fights over converting from Chapter 11 to Chapter 7, particularly in cases that result in a liquidation of the debtor's assets in Chapter 11.[216]

In addition, today's Chapter 7 cases look very different from the nineteenth century vision of creditor equality, which imagined that most or all of a debtor's creditors would be general creditors—all with the same priority—and each would receive a pro rata share of the proceeds of the debtor's assets. To the extent there are unencumbered assets in a modern

212 *Compare In re* Ward, 194 B.R. 703, 712 (Bankr. D. Mass. 1996) (treating a covenant not to compete as a dischargeable claim), *with In re* Udell, 18 F.3d 403, 404-05 (7th Cir. 1994) (enforcing a covenant not to compete).

213 It also is a particularly bad fit, given that the real parties in interest are the debtor and the creditor whose contract includes a covenant not to compete, not the general creditors vis-à-vis one another. If there are no nonexempt assets, the other creditors have no stake in the dispute. If there are assets, the "equality" result would give the existing creditors a *lower* payout if the case is filed under Chapter 7, as most are, since the claim of the creditor with a covenant not to compete would increase the amount of claims without altering the available assets.

214 *See* 11 U.S.C. § 701(a) (2012).

215 *See* 11 U.S.C. § 704(a) (2012).

216 In my view, this is the principal difficulty with Brook Gotberg's very intriguing proposal to enforce preference law in Chapter 7 but not Chapter 11. *See generally* Gotberg, *supra* note 152.

Chapter 7 case, the assets are rarely distributed equally. The largest creditor is often the Internal Revenue Service, which enjoys a priority over other general creditors.[217] Other creditors may also claim a priority. The actual distribution deviates quite markedly from the equality of creditors vision. If lawmakers were committed to equality of creditors in Chapter 7, they would need to significantly alter its structure. But there is no good reason to do so.

D. *Pari Passu Treatment: The Last Redoubt of Equality of Creditors?*

As we have seen, the equality norm is either perverse or unnecessary in every context where it is thought to hold sway. Equality of creditors does seem to have one last redoubt, however: the requirement that each creditor *within* a particular class of claims or interests be given the same ("pari passu") treatment.[218] Surely, one might assume, equality of creditors is still essential within classes of creditors.

Before we address the question directly, it is worth noting how tiny this plot of ground is. The Bankruptcy Code itself removes numerous general creditors from the pool by giving them special priority,[219] thus largely abandoning the old assumption that all of a debtor's general creditors would receive the same pro rata payment. As we have seen, the debtor itself can remove still more claims by assuming the creditors' contracts or putting them in a separate class and giving that class a more favorable payout.[220] Only the claims that are left are subject to the equal treatment rule.[221]

Even within a class of claims, the Bankruptcy Code does not require that the creditors be given identical treatment. The Code's pari passu requirement explicitly allows for differential treatment, so long as the holder of a claim accepts this treatment.[222] Chapter 11 debtors frequently take advantage of this flexibility, offering creditors in a particular class of claims two or more options, such as a choice between a cash payout and a different debt payout. Nor are the options simply two different forms of the same payout. Often the value of the options is discernibly different. Equal treatment does not hold sway at all.

217 *See* 11 U.S.C. § 507(a)(8) (2012).

218 *See* 11 U.S.C. § 1123(a)(4) (2012).

219 § 507(a).

220 11 U.S.C. § 1122(a) (2012).

221 The pari passu rule applies within each special priority and separate class, of course, but it would be odd to suggest this is an illustration of equal treatment, given that these are *exceptions* to equal treatment. For a similar argument, see Mokal, *supra* note 18, at 119, which notes the confusing phenomenon of "commentators who regard the distribution to preferential creditors *inter se* to be governed by the *pari passu* principle, [but] still accept that the existence of preferential claims itself constitutes an exception to that principle."

222 § 1123(a)(4).

In recent cases, debtors have taken this disparate treatment even further through the use of restructuring support agreements.[223] In a restructuring support agreement, a creditor or group of creditors agrees to support a debtor's reorganization plan in return for specified concessions. These concessions may be given to some members of a class of creditors but not others. In the Caesars bankruptcy, for instance, the nondebtor parent corporation of the debtor agreed to pay a fee to creditors that signed the restructuring support agreement. Creditors who declined to sign the agreement would not be given the fee and thus would receive a markedly lower payout than creditors who signed.[224]

There are reasons for concern about the rising use of restructuring support agreements, but the equality of creditors norm is completely unhelpful in identifying and addressing them. The real issues are self-dealing and the risk that silencing a group of potentially active creditors will undermine the reorganization process, leading to inefficient reorganization outcomes.[225] The equality norm is a poor proxy for these concerns.

Even apart from these visible departures from equality, the pari passu treatment within a class of general unsecured claims masks important differences among the creditors.[226] A creditor whose contract calls for 10% interest is treated no differently than a creditor that has been promised 4%, for instance, and both are in the same position as a creditor whose contract did not provide for interest.[227] This is yet another sign that the key principles lie elsewhere. Rather than equality, more useful yardsticks are whether the treatment is fair, and whether it is likely to maximize the efficiency of the bankruptcy process.[228]

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223 The first and best treatment of restructuring support agreements in the scholarly literature is Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593 (2017).

224 *Id.* at 609-10.

225 *Id*. The concern is analogous in important respects to vote buying in corporate law, which is viewed with suspicion but permitted if, among other things, other shareholders approve. *See, e.g.*, Schreiber v. Carney, 447 A.2d 17, 26 (Del. Ch. 1982).

226 Thomas Jackson's defense of the pari passu rule in his classic creditors' bargain theory of bankruptcy is instructive in this regard. Jackson defends the rule only as a second best—because of the difficulty of determining which creditor would have won a race to the courthouse outside of bankruptcy. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 29-33 (1986). The absence of pressure to adopt a more refined rule may reflect the facts that general creditors receive little or no payout in many cases and that creditors can protect themselves by taking a security interest—rather than any particular virtue in the rule itself.

227 *See* 11 U.S.C. § 506(b) (2012) (authorizing interest payments only for oversecured creditors).

228 Not only is equality language outmoded and potentially counterproductive in the class treatment context, but it may even have perverse implications for the initial issuance of bonds and other debt. When debtors issue a class of bonds, they traditionally have promised pro rata treatment of each bond in the issuance. In the past, it might have been too complicated to deviate from this norm in any significant way. But this is no longer true. A debtor could easily issue a class of bonds that provided for different payouts, depending on the subsequent performance of the company. Risk-averse investors might choose a low variance payout, while risk-preferring investors could opt for a payout with higher upsides and downsides. These tailored payouts could significantly increase the attractiveness of the bonds and thus reduce the debtor's overall cost of credit. The pari passu presumptions of the equality principle may have impeded these developments.

V. IS ANYTHING LEFT FOR EQUALITY?

Although most critics of the Peter Westen article referenced in my title acknowledged the force of some of his arguments, they insisted that equality nevertheless plays an essential role in American law.[229] Perhaps the same is true here. Might equality serve a desirable function that I have not yet considered, as seems to be the case in other contexts? I will answer that question in two steps: first by briefly surveying some of the proposed benefits of equality arguments; and then by considering whether they apply in the bankruptcy context.

A. *The Role of an Equality Concept*

While recognizing that equality relies on other principles for its content, Westen's critics insisted that the equality language nevertheless makes at least three crucial contributions that would be lost if the norm were jettisoned.[230] First, equality has a moral dimension that is distinct from other concepts, such as justice or rights. The concept of equality "tells us that different treatment of people does matter," and it "forces us to consider how society treats people in relationship to one another."[231]

Second, the equality norm creates a beneficial presumption against differential treatment. By introducing an expectation that people should be treated in roughly the same way, equality "puts the burden of proof on those who wish to impose differences in treatment,"[232] thus assuring that equality prevails unless there are good reasons for deviation. The principal beneficiaries of the equality presumption are the powerless. "A presumption of like rather than unlike treatment," as one advocate put it, "requires the dominant group to live by its own rules. No other principle so systematically and comprehensively restrains the abuse of political power."[233]

The third contribution is rhetorical. Equality language has an emotional resonance that can shape our response to particular issues. Although it was

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229 *See, e.g.*, Erwin Chemerinsky, *In Defense of Equality: A Reply to Professor Westen*, 81 MICH. L. REV. 575, 582 (1983). Even Westen himself later came around to this view to some extent. *See* PETER WESTEN, SPEAKING OF EQUALITY, at xix-xx (Marshall Cohen ed., 1990) (acknowledging some potential benefits of equality analysis).

230 In addition to the contributions discussed in the text that follows, Kent Greenawalt argued that equality can provide a separate basis for disallowing differential treatment in contexts where another principle applies. *See* Kent Greenawalt, *How Empty is the Idea of Equality?*, 83 COLUM. L. REV. 1167, 1171-73 (1983). Westen responds to this argument, persuasively in my view, in his book, *supra* note 229, at 195-204.

231 Chemerinsky, *supra* note 229, at 585. This argument draws on Ronald Dworkin's conception of equality as a right to equal respect. *See* RONALD DWORKIN, TAKING RIGHTS SERIOUSLY 180 (1977) (describing "a right to equality" as "a right to equal concern and respect in the design and administration of the political institutions that govern them").

232 Chemerinsky, *supra* note 229, at 588.

233 *Id.* at 589.

only one of many contributing factors, the language of "marriage equality" seems to have played an important role in the startlingly rapid shift in American culture from rejecting to embracing same sex marriage. Equality arguments have a rhetorical power and cultural resonance that cannot easily be replicated by appeals to other values.

B. *The Bankruptcy Contrast*

Outside of bankruptcy, many find these and other arguments in favor of the equality principle persuasive. Yet whatever purchase these considerations have elsewhere, the benefits completely disappear in the bankruptcy context. In bankruptcy, the equality norm has all of the downsides that equality has in other contexts, with none of its ostensible virtues.

Start with equality's moral injunction that "different treatment of people does matter."[234] This lesson quickly becomes muddled if we try to apply it in bankruptcy. One problem is that the boundaries between those who are favored and those who are not are far less stable in bankruptcy than elsewhere. With race, sex, or sexual orientation discrimination, the categories are fairly clear. The pursuit of equality is designed to ensure that individuals are treated on their own merits, rather than being favored or disfavored because of their race or other characteristics. In the late nineteenth century, it might have been possible to speak in vaguely similar terms about the implications of equality in bankruptcy. Debtors often favored, or were thought to favor, family members and other local creditors at the expense of out-of-state creditors. Equal treatment might ensure that debtors could not systemically favor local creditors over distant ones. Over a century later, these categories no longer exist. We cannot generalize in any meaningful way the categories of people or institutions who will be favored or disfavored in the absence of an equality norm. Many of us are debtors in one context, for instance, and creditors in another.

The boundaries are unstable in another way as well. A creditor can exit or avoid the class of general creditors by requiring that the debtor provide collateral for the obligation or by obtaining priority in another way, such as contracting with a subsidiary with a clean balance sheet.[235] So long as the creditor does not obtain priority under the cloak of darkness, there is nothing wrong with contracting for special treatment. Indeed, numerous courts and commentators have pointed out that insisting on equality would be deeply unfair under these circumstances. As Judge Friendly once wrote, "Equality among creditors who have lawfully bargained

234 Chemerinsky, *supra* note 229, at 585.

235 *See* Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1, 12 (2013).

for different treatment is not equity but its opposite."[236] Deviations from equality simply are not inherently problematic in the same way as they are in other contexts.

Equality's second function—allocating the burden of proof—is even more unhelpful in bankruptcy. With an issue like employment or voting discrimination, equality language may strengthen the cause of the powerless by "requir[ing] the dominant group to live by its own rules."[237] In bankruptcy, the lines are far less clear, as we have seen. Historically, the principal advocates of equality were often strong, out-of-state creditors, not the weak and vulnerable. More recently, bondholders have bemoaned departures that favored pension beneficiaries. Like the out-of-state creditors of the nineteenth century, today's bondholders are strong creditors, not weak ones. Equality language provides little of the prophylactic effect its advocates extol in other contexts.[238]

Not only is the presumption misplaced, by protecting creditors who do not seem to need extra help, it also can have pernicious consequences. The starkest examples are preference law and executory contracts.[239] Equality language seems to have played a central role in justifying the current preference rules, for instance, with their sweeping invalidation of prebankruptcy payments. But the current rules are costly, ineffective, and difficult to defend. Removing the equality presumption might make it easier to adopt a more sensible approach to policing problematic prebankruptcy behavior.

Finally, equality rhetoric no longer provides expressive benefits in bankruptcy. Two centuries ago, equality language may have had real rhetorical value. Although equality's dictates seem to have been widely ignored in practice, appeals to equality called debtors and creditors to transparency and evenhandedness. Today, these concerns can addressed more directly, especially outside the individual and small business context where the equality norm first emerged. As a result, equality has much less resonance in bankruptcy than elsewhere.[240] It does not have the same rhetorical power, and other principles are adequate to counteract potential abuses.

A consideration of equality's special virtues in other contexts does not rehabilitate it in bankruptcy. To the contrary, it underscores the emptiness of bankruptcy's equality norm.

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236 Chem. Bank N.Y. Tr. Co. v. Kheel, 369 F.2d 845, 848 (2d Cir. 1966) (Friendly, J., concurring).

237 Chemerinsky, *supra* note 229, at 589.

238 For a somewhat similar point, see WESTEN, *supra* note 229, at 257-81, which argues that equality language does benefit from the sometimes-problematic presumption that the equality position is desirable.

239 *See supra* text accompanying notes 161–67 (noting that "the equality norm appears to have played a pernicious role in the twentieth century evolution of preference law"), and 185–88 (noting the "current rule" related to executory contracts "has a socially inefficient spillover effect").

240 Except, of course, where traditional equality issues are at stake, such as discrimination against debtors based on race. For an overview of these problems, see generally A. Mechele Dickerson, *Race Matters in Bankruptcy*, 61 WASH. & LEE L. REV. 1725 (2004), and David A. Skeel, Jr., *Racial Dimensions of Credit and Bankruptcy*, 61 WASH. & LEE L. REV. 1695 (2004).

CONCLUSION

The equality of creditors norm dates back to bankruptcy's earliest days in America. It emerged most fully as a justification for retrieving prebankruptcy transfers as preferences, and as an admonition about distributions in individual and small business bankruptcy cases, but in the twentieth century it spread throughout bankruptcy law more generally. It is often viewed as the central principle of bankruptcy.

A century ago, the equality norm served as a plausible (though much debated) proxy for concerns about discriminatory treatment of different groups of creditors. The equality norm no longer plays anything like this role. In each of the contexts in which it figures most prominently, the real normative issues are preventing self-dealing or secret liens, or addressing other concerns, not equality. If the rhetoric of equality served other purposes in bankruptcy, such as "telling us that different treatment of people does matter," the equality of creditors language might still play a valuable role, despite the distortions it produces. But it doesn't. In bankruptcy, the equality norm has become a costly distraction. Bankruptcy judges, professionals, and scholars would do well to foreswear the language of equality, and direct their attention to the principles that still matter.