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# Taking Stock of Chapter 11

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## Introduction

The past generation will surely be seen as a golden era in American bankruptcy law. Prior to the enactment of the Code in 1978, bankruptcy practice was reputed to be a little sketchy.[1] There were frequent concerns about the influence of bankruptcy "rings" in the major cities—groups that treated bankruptcy cases as a source of patronage opportunities that they shared among themselves.[2] The once glamorous large scale corporate reorganization practice had fallen on hard times, dwindling in importance and prestige.[3] Law schools responded to these reputational issues by disguising the content of their bankruptcy classes with labels like Debtors' and Creditors' Rights or Commercial Credit I & II.[4]

This all changed after the 1978 Code was enacted. The Code took aim at concerns about bankruptcy rings by, among other things, sharply separating the administrative and judicial

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1 DAVID T. STANLEY & MARJORIE GIRTH, BANKRUPTCY: PROBLEMS, PROCESS, REFORM page (The Brookings Institution) (1971).

2 An influential study of bankruptcy practice in the 1960s (published in 1971) complained that "it is not difficult for creditors' attorneys to arrange elections among themselves," thus determining who would serve as trustee and hire a favored attorney as counsel. DAVID T. STANLEY & MARJORIE GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM (The Brookings Institution) (1971).

3 Page number needed

4 At the University of Pennsylvania, where I teach, the bankruptcy class was called Commercial Credit II until Fall 2010.

functions in a bankruptcy case, and limiting the judge to judicial responsibilities.[5] The Code also completely reworked the Code's corporate reorganization provisions, making it much more user friendly for businesses in financial distress.[6] Within a few years, bankruptcy had an entirely different vibe. Although Chapter 11, the principal focus of this Essay, was vigorously debated in the scholarly literature in the early 1990s,[7] those doubts, as important as they seemed to law professors, never troubled bankruptcy professionals in any serious way. And in time, even most law professors tended to conclude that Chapter 11 worked pretty well.[8] Lawmakers in other countries have been sufficiently impressed by Chapter 11 that many have incorporated features of Chapter 11 into their own insolvency laws.[9]

As his essay for this volume reflects, Sam Gerdano was in the middle of these developments almost from the very beginning.[10] After an initial exposure to bankruptcy issues in the New York attorney general's office, he worked for Senator Grassley, a key lawmaker on the Judiciary Committee, for a number of years before accepting a position as the executive director of the American Bankruptcy Institute in 1991.[11] Over nearly thirty years, he transformed the ABI from a small organization that didn't have a clear niche, to an essential

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5 D.J. Baker et.al., *Commission to Study the Reform of Chapter 11: 2012-2014 Final Report and Recommendations*, AMERICAN BANKRUPTCY INSTITUTE 10 (2014).

6 Baker et.al., *supra* note 5

7 Baker et.al., *supra* note 5 (citing several of the articles advocating alternatives to Chapter 11).

8 Baker et.al., *supra* note 5, at

9 Baker et.al., *supra* note 5, at 8 n.7

10 Samuel J. Gerdano, *An Oral History: Reflections on My 35 Years in Bankruptcy Policy*, SYRACUSE L. REV. (source and pincite need to be updated once Gerdano article is complete)

11 Gerdano, *supra* note 10

partner to the American bankruptcy system, and a key resource for insolvency professionals and others.[12]

To put the ABI in context, it is worth comparing it to the other two most important bankruptcy organizations. The oldest, the National Bankruptcy Conference, is an elite group of roughly sixty bankruptcy lawyers, judges and professors that serves as a nonprofit lobbying organization on behalf of its members' vision of bankruptcy law.[13] The American College of Bankruptcy—of which Sam is a member—is an honor society for the profession.[14]

The ABI is the organization for everyone in the bankruptcy profession, and a source of information for those outside the profession.[15] It remains carefully neutral, and provides information for lawmakers, sources for reporters, conferences and panel to discuss ideas, and much more.[16] One of the signature events in Sam's tenure was an extensive study of the bankruptcy system that produced by far the most important recent study of bankruptcy.[17] The ABI enlisted numerous bankruptcy professionals, and the report was overseen by a commission that limited its recommendations to those that received supermajority support.[18]

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12 Gerdano, *supra* note 10

13 *See About Us*, NATIONAL BANKRUPTCY CONFERENCE, http://nbconf.org/history/ (last visited Nov.22, 2020).The National Bankruptcy Conference has close ties to the Judiciary Committees in the House and Senate, which handle bankruptcy issues.

14 *See Directory,* AMERICAN BANKRUPTCY INSTITUTE, https://www.americancollegeofbankruptcy.com/ (last visited Nov.22,2020).

15 *See About Us*, AMERICAN BANKRUPTCY INSTITUTE (last accessed November 5, 2020) https://www.abi.org/about-us.

16 *See* Gerdano, *supra* note 10 (noting the neutrality policy).

17 *See generally* D.J. Baker et al., *Commission to Study the Reform of Chapter 11: 2012-2014 Final Report and Recommendations*, AMERICAN BANKRUPTCY INSTITUTE (2014) (hereinafter, ABI REPORT).

18 *Id.* at 17 (stating that a recommendation was not approved unless two-thirds of the commissioners voting supported it).

I first met Sam over two decades ago, and since then have come to expect to see his smiling face whenever bankruptcy issues are in the air—not just at ABI events but elsewhere as well. Fifteen years ago, he invited me to serve as scholar in residence for a semester at the ABI. It is hard to imagine a more pleasant way to spend a semester. I took the train down each week, spent a few days at ABI headquarters in Alexandria, and immersed myself in ABI activities. Suddenly newspaper reporters wanted to talk to me, and I had no trouble persuading bankruptcy luminaries to be interviewed for the ABI's oral history project. I also saw the enormous planning that goes into ABI events, and the efficiency and breadth of the organization.

Looking back over Sam's career, it is as if he took stock in the Bankruptcy Code back in the very beginning. But he didn't just watch American bankruptcy law flourish. To the contrary, he has done more than almost anyone else to make it flourish and ensure that it continues to flourish. During the current coronavirus crisis, which has led to a substantial increase in business bankruptcy filings, the resources and education that the ABI provides, thanks to Sam's leadership, are likely to be more important than ever.[19]

One of Sam's most remarkable qualities, in my view, is that he rarely seems to try to take credit for any of this. He didn't give long speeches at the beginning of ABI events or make sure his name was splashed all over the written materials. He quietly went about the business of doing what needed to be done.

Sam's retirement is an opportune time to assess where Chapter 11 stands after more than four decades with the same basic framework in place. Perhaps not surprisingly, the assessment I

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[19] While drafting an essay on the bankruptcy implications of the current crisis, I immediately thought of the ABI as the one private organization that could help expand the capacity of the bankruptcy system if needed. David Skeel, *Bankruptcy and the Coronavirus*, ECONOMIC STUDIES AT BROOKINGS, 11 (April 2020) ("Private organizations such as the American Bankruptcy Institute could assist by providing nationwide training for non-bankruptcy lawyers who are likely to be working on bankruptcy cases in the coming months").

offer in this Essay will quickly take a theoretical turn—I will focus not just on bankruptcy practice, but also on the current state of bankruptcy theory—since, as a law professor, that is what I do.

The standard theory of bankruptcy for the past generation has been the Creditors' Bargain Theory devised by Thomas Jackson, individually and in co-authored work with Douglas Baird.[20] The Creditors' Bargain Theory explains bankruptcy as a solution to coordination problems that might lead to the dismemberment of an otherwise viable firm if creditors were simply left to their own devices.[21] The role of bankruptcy, according to the theory, is to provide a collective forum for resolving these problems and to facilitate an efficient resolution of financial distress.

When the Creditors' Bargain Theory was developed, shortly after the enactment of the Bankruptcy Code, the Code was thought to be a framework of mandatory rules.[22] Jackson characterized it, and bankruptcy law generally, as solving a bargaining failure by implementing—through a "hypothetical bargain"—rules the parties would have agreed to if negotiation were possible.[23]

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[20] Thomas H. Jackson introduced the Creditors' Bargain theory in *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 858 (1982). He and Douglas Baird subsequently developed the theory in other articles and a book. E.g., THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7 (Harvard Univ. Press 1986); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 100-01 (1984). Jackson recounts the origins of the Creditors' Bargain theory in a recent essay. Thomas H. Jackson, *A Retrospective Look at Bankruptcy's New Frontiers*, 166 U. PA. L. REV. 1867, 1867–68 (2018).

[21] David A. Skeel, Jr. & George Triantis, *Bankruptcy's Uneasy Shift to a Contract Paradigm*, 166 U. PA. L. REV. 1777, 1778 (2018).

[22] *Id.* at 1780.

[23] *See, e.g.*, JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, *supra* note 20 at 16-17.

The most distinctive feature of current Chapter 11 practice is the extent to which the parties now enter into actual contracts governing their rights and responsibilities.[24] Intercreditor agreements allocate authority between senior and junior lien creditors, restructuring support agreements commit the parties to the terms of an expected reorganization plan, and debtor-in-possession financing agreements dictate the course of many bankruptcy cases.[25] Building on a recent article with George Triantis, I call these developments the new contract paradigm.[26]

One question raised by the dramatic shift in bankruptcy practice is whether the Creditors' Bargain Theory is now largely irrelevant or even obsolete, as some scholars have suggested.[27] It is true, as Triantis and I and others have noted, that the particular coordination problem foregrounded by Baird and Jackson—the collective action problem faced by widely scattered unsecured creditors—no longer characterizes most Chapter 11 cases.[28] But this bargaining problem has been replaced by other bargaining failures— such as bilateral monopolies between the debtor and a key creditor, or between two creditors—to which the same logic applies.[29]

I do not mean to suggest the Creditors' Bargain Theory explains all of bankruptcy. It doesn't. The theory provides a much more complete picture of why bankruptcy is necessary, than of the optimal framework for resolving financial distress. This is not surprising, given that

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24 Skeel & Triantis, *supra* note 21, at 1779.

25 *Id.* at 1780.

26 *Id.*

27 *See, e.g.,* Vincent S.J. Buccola, *Bankruptcy's Cathedral: Property Rules, Liability Rules, and Distress*, 114 NORTHWESTERN U.L. REV. 705, 707 (2019); Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709 (2020). Buccola and Casey take their critiques in starkly different directions, with Buccola advocating a minimalist bankruptcy framework and Casey a maximalist one.

28 *See, e.g.* Skeel & Triantis, *supra* note [21], at 1779-80.

29 Vince Buccola is the scholar who has focused most directly on the bilateral monopoly issue. Buccola, *supra* note [27], at 724-25.

there does not appear to a single, optimal resolution strategy. In current practice, the key question is how to make sense of the contracts that now govern the Chapter 11 process. I argue that the principal objective should be to distinguish between ex ante and ex post agreements, and to seek to balance the costs and benefits of each. Perhaps because Chapter 11 is itself designed to facilitate an ex post agreement,[30] bankruptcy judges have been much more accommodating to ex post agreements than to ex ante agreements. This approach is, in my view, too hostile to ex ante contracts and does not provide sufficient scrutiny of ex post agreements.

In Part I of the Essay, I develop the theoretical analysis just described. Along the way, I comment on some of the important current bankruptcy contracts, including intercreditor agreements and restructuring support agreements. In Part II, I apply the insights of Part I to two types of ex post agreement that have become increasingly controversial, DIP financing agreements and managerial bonuses.

## I. THE NEW CONTRACT PARADIGM

The most remarkable bankruptcy development of the opening decades of the twenty-first century is the pervasiveness of contracts in Chapter 11—some entered into before financial distress and some entered into in anticipation of bankruptcy or during the case.[31] In this part, I identify and assess the contract paradigm that has emerged. To set the stage, I first consider whether these developments have rendered the reigning normative theory of bankruptcy—the Creditors' Bargain theory—obsolete. I then turn to the current contract paradigm itself.

### A) *Demise of the Creditors' Bargain Theory?*

[30] Skeel, & Triantis, *supra* note [21], at 1781.

[31] *Id*. at 1809.

For the past generation, the Creditors' Bargain Theory has been the preeminent normative theory of bankruptcy.[32] According to this theory, the principal role of corporate bankruptcy is to solve a coordination problem.[33] If a debtor's creditors are left to their own devices, it is individually rational for each to race to the courthouse, rushing to collect what it is owed, even though these collection efforts may lead to the dismemberment of otherwise viable firms, thus destroying social value.[34] Bankruptcy solves this bargaining failure by creating a collective forum for the resolution of financial distress.[35] Bankruptcy law should focus on this essential goal, according to the Creditors' Bargain Theory, but should not otherwise alter nonbankruptcy law, lest it invite costly squabbles between those that will be better off in bankruptcy and those who will do better if the debtor stays out of bankruptcy.[36] The deference to nonbankruptcy law is sometimes called the Butner Principle—a reference to the Supreme Court case it was inspired by.[37]

The Creditors' Bargain Theory was hotly contested from the beginning, most famously in a 1987 debate between Douglas Baird and Elizabeth Warren in the pages of the *University of*

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32 *See*, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, *supra* note 20 at 7.

33 *See*, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, *supra* note 20 at 18.

34 THE LOGIC AND LIMITS OF BANKRUPTCY LAW, *supra* note 20 at 190.

35 *See* THE LOGIC AND LIMITS OF BANKRUPTCY LAW, *supra* note 20 at 20.

36 *See, e.g.*, JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 21 (1986) ("[T]he establishment of new entitlements in bankruptcy . . . create[s] incentives for particular holders of rights in assets to resort to bankruptcy . . . to gain for themselves the advantages of those changes, even when a bankruptcy proceeding would not be in the collective interest of the investor group."). Jackson derived this principle from the Supreme Court decision in Butner v. United States: "Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'" 440 U.S. 48, 55 (1979) (quoting Lewis v. Mfrs. Nat'l Bank, 364 U.S. 603, 609 (1961)).

37 *See, e.g.,* Kenneth M. Ayotte & David A. Skeel, Jr., *Bankruptcy Law as a Liquidity* Provider, 80 U. CHI. L. REV. 1557, 1564–65 (2013) (using the term "Normative Butner Principle").

*Chicago Law Review*.[38] After the early 1990s, however, the Creditors Bargain Theory seemed to attract less commentary. This was perhaps due in part to the vagaries of scholarly attention, which turned in the 1990s to debates over whether Chapter 11 should be replaced by an alternative conception.[39] But it also seems to have reflected changes in the capital structure of Chapter 11 debtors. Even the largest frequently were fully encumbered when they entered Chapter 11, with little value likely to be available for unsecured claims.[40] The particular bargaining failure foregrounded by Jackson—the collective action problem faced by scattered unsecured creditors—is no longer as common as it once was.

One possible conclusion, given the sweeping changes in Chapter 11 practice, might be that the time has come to jettison the Creditors' Bargain Theory. Some scholars who share the law and economics lineage that spawned the Creditors' Bargain Theory have indeed questioned its continuing relevance.[41] According to the most aggressive recent critique, which questions

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38 *See* Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 777 (1987)(contending that the purpose of bankruptcy law is "to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors"); ,Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy,* 54 U. CHI. L. REV. 815, 822 (1987)(arguing that "[w]henever we must have a legal rule to distribute losses in bankruptcy, we must also have a legal rule that distributes the same loss outside of bankruptcy," and "that these two rules [should] be the same").

39 *See, e.g., Barry E. Adler, Financial and Political Theories of American Corporate Bankruptcy,* 45 STAN. L. REV. 311, 323 (1993) (advocating use of "chameleon equity"); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Reorganization*, 71 TEX. L. REV. 51, 68 (1992) (menu approach). Thomas Jackson also had exited the scene, serving at law dean and provost at the University of Virginia, then president at the University of Rochester. *Our History: Former Faculty: Jackson, Thomas H. (1988-1994)*, UNIV. OF VA. (October, 22, 2020, 5:43 PM), https://libguides.law.virginia.edu/faculty/jackson.

40 Even if the firm does have significant unsecured debt, unsecured creditors are less likely to be fragmented and dispersed than in the past. *See, e.g.,* Buccola, *supra* note [27], at 716-17.

41 *See* Buccola, *supra* note [27](arguing that key features of Chapter 11 such as the automatic stay are no longer needed due to changes in credit markets); Casey, *supra* note [27] (rejecting the Creditors' Bargain Theory and advocating a focus on ex post holdup issues). Scholars from the progressive tradition exemplified by Elizabeth Warren never embraced the Creditors' Bargain theory. *See* Elizabeth Warren and Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: and Empirical Intervention*, 118 Harv. L. Rev. 1197, 1203 (2005). The recent criticism by law and economics scholars is thus more striking. *See* Casey, *supra* note 40 at 4.

whether the theory was ever compelling and aims to kill the giant, "the model of an ex ante agreement among creditors [to provide a collective forum for resolving financial distress] proves both unnecessary and unhelpful in defining the substance and scope" of bankruptcy.[42] Similarly, the admonition to honor nonbankruptcy rules unless necessary to achieve a bankruptcy objective, as called for by the Butner Principle, "is both circular and wrong.[43] It is circular—or at least self-contradicting—because it relies on nonbankruptcy entitlements to tell us when the law should interfere with nonbankruptcy entitlements."[44] Another scholar does not explicitly reject the Creditors' Bargain theory but suggests its relevance has receded.[45] He frames his inquiry as asking what features of Chapter 11 remain necessary.[46]

The Creditor's Bargain Theory unquestionably is an incomplete account of bankruptcy. I will say more about this in a moment. But first let me explain why the new round of critiques is not likely to slay the giant. One limitation of the recent challenges is that they are often unfair to the theory itself.[47] It is not altogether accurate, for instance, to say that the Creditors Bargain Theory is circular, because "it relies on nonbankruptcy entitlements to tell us when the law should interfere with nonbankruptcy entitlements."[48] The Creditors Bargain theory justifies

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42 Casey, *supra* note [27] at 1725.

43 Casey, *supra* note [27], at 1728.

44 *Id.*. Juliet Moringiello seems to have been the first recent scholar to point out the ambiguity in the Butner Principle. Juliet Moringiello, *When Does Some Federal Interest Require a Different Result?: An Essay on the Use and Misuse of* Butner v. United States, 2015 U. ILL. L. REV. 657, 658 (2015). Versions of this critique also were directed at the Creditors' Bargain Model during the earlier debate. *See, e.g.,* David Carlson, *Philosophy in Bankruptcy* 85 MICH. L. REV. 1341 (1987) (reviewing JACKSON, *supra* note [20]) (contending that the details of nonbankruptcy law are indeterminate in many respects).

45 Buccola, *supra* note [27], at 715.

46 Id. at 720-21.

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48 Casey, *supra* note [27], at 1728.

bankruptcy as providing a collective forum for resolving financial distress, and thus starts with the claim that the provisions needed to achieve this objective—such as the automatic stay, a preference provision and the rules for executory contracts[49]—should override any inconsistent nonbankruptcy law.[50] The Butner Principle is an implication of the theory's contention that bankruptcy should not do more than this—it should not be used to address nonbankruptcy problems.

Second, the core insight of the Creditors' Bargain Theory—that a collective forum is needed to address the bargaining failures will otherwise occur in the event of financial distress—is as compelling a justification for bankruptcy as it was forty years ago. In current cases, coordination problems among scattered unsecured creditors often are not a serious problem, but other bargaining failures threaten to prevent an efficient resolution of the debtor's financial distress. Today's bargaining failures often are created or exacerbated by the parties' contracts. The complex combination of intercreditor and agreement among lenders provisions in the *RadioShack* case is a vivid illustration.[51] The sophisticated parties in that case created what was, in effect, a synthetic collective action problem. In other cases the potential bargaining failures are simpler, but also could not be effectively resolved without a bankruptcy forum.[52]

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[49] 11 U.S.C. § 362(a) (2020) (automatic stay); § 547(b) (2020) (preferences); § 365(a) (2020) (executory contracts).

[50] Buccola, *supra* note [27], at 706, 711, 712, 721.

[51] Salus Capital Partners, LLC v. Std. Wireless Inc. (*In re* RadioShack Corp.), 550 B.R. 700, 703 (Bankr. D. Del. 2016). RadioShack had two major groups of secured lenders, with an agreement between the two groups and separate agreements within each group. For an overview of the case, see Kenneth Ayotte, Anthony J. Casey, & David A. Skeel, Jr., *Bankruptcy on the Side*, 112 *Northwestern U.L. Rev.* 255, 269-72 (2017).

[52] *See, e.g.,* Buccola, *supra* note [27], at 724-25 (describing bilateral monopolies that can interfere with efficient resolution of financial distress and characterizing bankruptcy as "toggling" from property rights to liability rules to resolve these potential bargaining failures).

It also is telling that features of the Creditors' Bargain Theory frequently slip back into the accounts of its critics. The vigorous critique cited earlier dismisses the importance of the bargaining failures described by the Creditors' Bargain Theory, yet later states that: "The automatic stay is one of bankruptcy's central provisions.[53] It directly addresses the classic 'collective action problem.'"[54] The critique also implicitly acknowledges bankruptcy is needed to assure that these and other bargaining failures do not destroy a distressed firm's going concern value.[55] After describing the Butner Principle as "both circular and wrong," the critique later concludes that "a soft version of Butner" should be applied,[56] and that "bankruptcy is limited in scope and should [only] address bankruptcy matters."[57]

Perhaps a bankruptcy equivalent of quantum theory will come along and reorient everyone's thinking. But it strikes me as more likely that the Creditors' Bargain theory will endure.

*B) The Limits of the Theory*

I do not mean to suggest that the Creditors' Bargain Theory is a complete theory of bankruptcy. It isn't. The theory provides a compelling explanation of why business bankruptcy is needed and of the importance of protecting non-bankruptcy entitlements except where deviation is needed for the purposes of providing a collective forum for resolving financial distress. The theory has much less to say about the details of the resolution process..

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53 Casey, *supra* note [27], at 1755.

54 *Id*.

55 *Id.* at 1734 fn. 108 (focusing on the need to protect "relationship-specific investments" but defining them in terms of going concern value).

56 *Id.* at 1751.

57 *Id.* at 1747.

One missing piece is liquidity. The debtor's operations need to be funded during the bankruptcy process, but a distressed firm is likely to face serious obstacles to borrowing, even if it has profitable business opportunities, due to debt overhang and asymmetric information problems.[58] Chapter 11 counteracts this problem, and generates liquidity, in a variety of ways. The most obvious is its provision for debtor in possession financing.[59] Other sources of liquidity include the automatic stay, the treatment of proceeds of collateral, and the provision that permits bankruptcy sales.[60]

The theory also provides only limited insight into governance and resolution.[61] Any bankruptcy framework needs to make choices about how the business will be governed during bankruptcy and how its distress is to be resolved. According to the Creditors Bargain Theory, the distress should be resolved the way it would be resolved if there were a single owner of the business.[62] The single owner perspective is helpful but provides only limited insight how to get there.[63]

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58 *See* Ayotte & Skeel, *supra* note [37]. Buccola suggests that the Ayotte & Skeel analysis "expanded" the Creditors' Bargain Theory. Buccola, *supra* note [27], at 712.

59 11 U.S.C. § 364 (2020). George Triantis was the first to recognize the importance of this provision as a solution to debt overhang. George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 Vand L Rev 901, 919–20, 925 (1993).

60 *See* Ayotte & Skeel, *supra* note [37] at 1565, 1623; George G. Triantis, *Financial Slack Policy and the Laws of Secured Transactions*, 29 J. LEG. STUD. 35, 66 (2000).

61 I say "limited" rather than "no" insight because Baird and Jackson had more to say about governance and resolution than about liquidity. *See, e.g.,* Baird & Jackson, *supra* note 20 at 100.

62 Casey, *supra* note [27], at 1731.

63 As Professor Casey points out, correctly in my view. *Id.*.

In my view, there are multiple ways that a bankruptcy system can encourage efficient governance and resolution by, among other things, reducing potential agency costs.[64] The approach taken in Chapter 11 begins with the drafters' decisions to permit the managers of a debtor to continue running the business after it files for bankruptcy as debtor in possession,[65] and to give the managers an "exclusivity period" during which they are the only ones who can file a reorganization plan.[66] These provisions are in many respects the "secret sauce" of Chapter 11, the provisions that distinguished it from any other country's insolvency rules for many years.[67] Because the debtor's managers are not immediately displaced at the outset of a bankruptcy case, they are less likely to delay filing for bankruptcy.[68] The managers are not given free reign in bankruptcy, however. They are subject to extensive oversight, and any actions outside the ordinary court of business must be approved by the court after full disclosure and an opportunity for other parties to object.[69] The other key feature of Chapter 11 is its waivable absolute priority

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64 I discuss two very different strategies for achieving these objectives—the more reorganization-oriented U.S. approach and an approach that tends toward liquidation if insolvency proceedings are initiated-- at length in earlier work. *See generally* John Armour, Brian R. Cheffins & David A. Skeel, Jr., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699 (2002); David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325 (1998).

65 11 U.S.C. § 1107(a) (2018).

66 11 U.S.C. § 1121(b) (2018).

67 For a helpful discussion of the recent adoption of Chapter 11-like bankruptcy rules in many countries, see James H.M. Sprayregen, *International Insolvency: From Punitive Regimes Toward Rescue Culture*, 36 EMORY BANKR. DEV. J. 7 (2020).

68 *See id*.

69 11 U.S.C. § 363(b) (2018).

rule.[70] The overall framework is designed to facilitate the reorganization of a debtor's obligations (and to nudge them in this direction).[71]

One can imagine courts fully protecting these governance choices by prohibiting contractual efforts to alter them. A court might invalidate contracts that have the effect of diminishing the debtor's managers' flexibility in proposing a reorganization plan. But that is not what bankruptcy judges have done. For the past several decades, lenders have used debtor-in-possession financing agreements to, among other things, require that debtors conduct a sale of their assets or propose a reorganization plan within a restricted period of time.[72] Contractual arrangements have also been used to reshape many of the other features of bankruptcy.[73]

The ubiquity of contract in current Chapter 11 raises the questions I will focus on for much of the remainder of this Essay: how are the contracts being regulated, and how should they be regulated?

C) *The Contours of the New Contract Paradigm*

Contract theory suggests that the best starting point for thinking about the role of contract in bankruptcy is to distinguish between ex ante contracts—contracts entered into before the onset

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70 The absolute priority rule, which prohibits lower priority creditors or shareholders from receiving a recovery unless higher priority creditors will be paid in full, only applies to classes that object to a proposed reorganization plan. 11 U.S.C. § 1129(b) (2018).

71 It also is designed to shift decision-making authority from shareholders to the residual class of creditors. David A. Skeel, Jr., *Corporate Anatomy Lessons*, 113 YALE L.J. 1519, 1557 (2004).

72 Early articles exploring this development include Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 75 (2002); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003).

73 *See, e.g.,* David A. Skeel, Jr., *Distorted Choice in Corporate Bankruptcy*, 130 YALE L.J. 366, 371-73 (2020)(describing how restructuring support agreements and deathtrap provisions alter Chapter 11's disclosure and voting rules). .

of financial distress—and agreements that parties reach ex post.[74] Each has important costs and benefits. A signal benefit of an ex ante agreement is that, because it allocates risks between the parties, it invites each to invest in the relationship.[75] If the parties know the contract may later be subject to renegotiation, the allocation of risk and their incentive to invest in the relationship may be undermined.[76] Given the importance of these benefits, the parties sometimes take steps to make the contract more difficult to renegotiate.[77] The classic scholarly account posits that a borrower may wish to borrow from multiple creditors if it wishes to minimize its incentive to default and renegotiate the contract.[78]

An important downside of ex ante contracts is that the parties have limited information when they enter into the contract, and they are unlikely to be able to fully anticipate all of the issues that may arise in the future.[79] The parties can hedge to some extent by including flexible standards in their agreement, but vague provisions can reduce the benefits of the contract by increasing uncertainty and the risk of subsequent litigation.[80] Ex post contracts are not subject to

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[74] The discussion in this section draws on and extends the analysis in Skeel & Triantis, *supra* note 21, at 1779.

[75] Skeel & Triantis, *supra* note 21, at 1778; *see* Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RES. L. REV. 187, 192–94 (2005) (discussing the tension between ex ante and ex post contracting, and the related tension between commitment and flexibility).

[76] Skeel & Triantis, *supra* note 21, at 1782.

[77] *Id*. at 1783.

[78] Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1, 14 (1996).

[79] Another important downside is that possibility an ex ante contract can be used to expropriate value from third parties. For discussion of this risk with intercreditor agreements, and a possible response, see Ayotte et al., *supra* note [58], at 263.

[80] *Id.* at 263 (*see BOKF, N.A. v. JPMorgan Chase Bank, N.A. (*In re MPM Silicones, LLC*),* 518 B.R. 740, 751 (Bankr. S.D.N.Y. 2014)).

these constraints. Because the future state of the world has already materialized when the parties negotiate the terms of an ex post contract, ex post contracting takes place in information rich environment. The parties have much more information than with an ex ante contract.

It is tempting to imagine a contract that achieves the benefits of both ex ante and ex post contracting. The parties might negotiate a detailed, fully specified contract ex ante, with the expectation that they will later renegotiate the contract to keep it up to date. But such a contract has the downsides of an ex post contract: the prospect of renegotiation would destabilize the parties' allocation of risks and chill the incentive to invest in the relationship. The tradeoff between ex ante and ex post contracts is unavoidable, and needs to be taken into account in courts' handling of contracts in bankruptcy.

There is an odd asymmetry in bankruptcy courts' current scrutiny of ex ante and ex post contracts. Courts seem to be much more sympathetic to the latter than the former.[81] The most striking illustration is the emerging doctrine with respect to two of the most important contracts in many current cases, intercreditor agreements and restructuring support agreements.[82] Bankruptcy judges have subjected intercreditor agreements, which allocate the rights of senior and junior secured lenders ex ante, to intense scrutiny.[83] Unless a term that a senior lender wishes to enforce is "clear beyond peradventure," courts often refuse to honor it.[84] With restructuring support agreements, by contrast, courts have been far more welcoming.

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[81] *See* Skeel & Triantis, *supra* note 21, at 1780.

[82] *Id.* at 1806 *(citing* In Re Bos. Generating, LLC, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010))*; see also* David Skeel, *Unwritten Rules and the New Contract Paradigm*, 36 Emory BANKR. DEV. J. 739, 743, 747 (2020).

[83] *See* Skeel & Triantis, *supra* note 21, at 1810.

[84] *Id*. at 1806. The "clear beyond peradventure" language was coined in In re Boston Generating, LLC, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010)).

The ex post bias is in many respects understandable. Chapter 11 itself has a substantial ex post bias. Its voting rules enable the parties to restructure obligations that would be more difficult to renegotiate outside of bankruptcy, and the threat of cramdown or liquidation nudges the parties toward a consensual restructuring.[85] In addition, ex post contracts tend to facilitate a restructuring or other resolution of the debtor's financial distress, whereas ex ante contracts often do not; and ex post contracts are negotiated by bankruptcy insiders.[86] The bias comes with significant costs, however: courts may not fully police the potential problems with ex post contracts, and they may undermine the benefits of the parties' ex post contracts.

This does not mean that ex ante contracts always should be enforced as written. Intercreditor agreements between senior and junior lenders are a good illustration both of the excessive hostility to ex ante agreements and the need for scrutiny. Bankruptcy courts' insistence that the terms of an intercreditor agreement by "clear beyond peradventure" seems problematic.[87] But intercreditor agreements can create externalities that harm other creditors and undermine the efficiency of the bankruptcy process.[88] It is altogether appropriate to police these externalities by, for instance, limiting senior creditors to their expectation damages in the event of a breach.[89]

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85 *See* Skeel & Triantis*, supra* note 21, at 1799–1800.

86 *Id.* at 1809–10; *see* Ayotte et al., *supra* note [58], at 260 (describing the downsides of intercreditor agreements, such as stalling a value-maximizing sale).

87 *See, e.g.,* Ayotte et al., *supra* note [58], at 262–63 (arguing that courts' narrow reading may prompt the parties to adopt overly broad provisions); *see* In re Boston Generating*, LLC*, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010).

88 *See, e.g.,* Ayotte et al., *supra* note [58], at 260–61.

89 *Id.* at 261.

The much-discussed bankruptcy of General Growth Properties is a much closer call.[90] General Growth Properties, a large network of shopping centers, set up many of the shopping centers in bankruptcy remote entities.[91] Despite their bankruptcy remote status, GGP filed bankruptcy petitions for many of them.[92] The bankruptcy court upheld the filings and permitted GGP to use the entities to fund the bankruptcy case.[93] It is possible that the extraordinary market conditions of the 2008-2009 financial crisis justified undoing of the parties' ex ante commitments, but this seems debatable at best.[94] The ruling has the potential to undermine the benefits of ex ante planning.[95]

Just as my analysis is not a call to wave off scrutiny of ex ante contracts altogether, I also do not mean to suggest ex post contracts are invariably problematic. Restructuring Support Agreements (RSA) (or Plan Support Agreements, when they are entered into post-petition) are a good illustration.[96] An RSA commits its signatories to a reorganization plan that has the features specified in the contract, and often includes a signing fee for those who sign.[97] In my view,

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90 In re Gen. Growth Props., Inc., 409 B.R. 43, 43 (Bankr. S.D.N.Y. 2009).

91 *Id.* at 47–48.

92 *Id.* at 54–55.

93 *Id.* at 69.

94 Professor Ayotte has offered another possible concern with ex ante arrangements of this sort, suggesting that they sometimes may reflect inefficiencies arising from the parties' different views about valuation. Kenneth Ayotte, *Disagreement and Capital Structure Complexity*, 49 J. LEG. STUD. 1, 14 (2020).

95 For a similar view, see Douglas G. Baird & Anthony J. Casey, NO EXIT? WITHDRAWAL RIGHTS AND THE LAW OF CORPORATE REORGANIZATIONS, 113 COLUM. L. REV. 1, 29 (2013). For a more robust defense of the court's ex post intervention, see Casey, *supra* note [27], at 1760.

96 For an extensive analysis of restructuring support agreements and proposed rules of thumb for scrutinizing them, see Skeel, *supra* note [81] (manuscript at passim) (on file with authors).

97 *Id*. at 381.

these fees, like other features of RSAs, should be scrutinized, but they are not invariably pernicious. A signing fees may help counteract strategic holdout behavior, for instance. Although bankruptcy courts have sometimes approved problematic RSAs, as in the recent *Ad Hoc Comm. of Non-Consenting Creditors v. Peabody Energy Corp.* case,[98] in my view, they have properly upheld RSAs with signing fees in others.[99]

Responding to this perspective, several scholars have recently contended that my framework for analyzing RSAs is far too permissive.[100] "While he ably examines the tension between the 'legal' aspects of the disclosure and voting process contemplated by the statute and the practicalities of bargaining in the current world of financial players and financial instruments," they write in a careful critique, "he fails to appreciate fully the importance of these "legal" aspects and is therefore too quick to acquiesce [to provisions that alter them]."[101] These scholars appear to call for a strong presumption against contractual provisions that can be seen as altering the traditional disclosure and voting process in any way, and to contend that RSAs with signing fees should be prohibited altogether,[102] "even if this puts

98 933 F.3d 918, 923–24 (8th Cir. 2019).

99 In re Indianapolis Downs, LLC, 486 B.R. 286, 32 (Bankr. D. Del. 2013).

100 Edward J. Janger & Adam J. Levitin, *The Proceduralist Inversion—A Response to Skeel*, YALE L.J. FORUM 335 (Nov. 24, 2020)[hereinafter, *Proceduralist Inversion*]. *See also* Edward J. Janger & Adam J. Levitin, *Badges of Opportunism: Principles for Policing Restructuring Support Agreements*, 13 BROOK. J. CORP. FIN. & COM. L. 169, 172–73 (2018) [hereinafter, *Badges of Opportunism*](arguing for intense scrutiny of RSAs).

101 Janger & Levitin, *Proceduralist Inversion*, *supra* note [100], at 338. One minor quibble with Janger's and Levitin's characterization of my work in their response: I have never used the term "proceduralist" to describe my work, preferring the standard term "law-and-economics." I also have called Elizabeth Warren and other critics of this perspective "progressives," not "traditionalists." *See* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA __ (2001).

102 Janger & Levitin, *Proceduralist Inversion, supra* note [108], at 346 (noting that "[i]n an earlier article we took the position that entitlement-distorting RSAs ought to be proscribed," and subsequently stating that this response is intended "not only to defend our position, but to flesh it out"); Janger & Levitin, *Badges of Opportunism*, *supra* note [108], at 186 (calling payments to signatories a "badge of opportunism").

ultimate confirmation at risk."[103] If the authors are as hostile to contractual provisions that shape the Chapter 11 voting and confirmation process as their call for a pristine process seems to suggest, their approach would bar a wide range of potentially beneficial contracts—not just many RSAs, but also intercreditor agreements (which often limit second lien creditors' ability to object to a proposed reorganization plan) and other contracts. In my view, a more nuanced approach is far preferable.

Although they would severely restrict RSAs, these scholars do acknowledge that the risk of holdouts is particularly serious in current practice.[104] Rather than permitting signing bonuses where they serve to discipline potentially problematic holdouts, these scholars would limit the voting rights of creditors who buy claims to the amount they paid for the claim, and would also limit a creditor's voting rights to the creditor's true economic interest in the claims they are voting.[105] Although their proposals are intriguing, in my view they are a poor fit for the holdout problems that signing fees often address. Creditors who acquire their claims after the onset of financial distress are not always the creditors that strategically hold out, for instance.[106] The reforms also would significantly complicate the voting process,[107] undermine the liquidity of the

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103 *Id.* at 344.

104 *See, e.g.,* Janger & Levitin, *Proceduralist Inversion, supra* note [108], at 346 (stating that the "injunction to look at the structure of the business and the liquidity of the claims trading market [to assess the likelihood of holdout behavior] is perhaps Skeel's most useful insight").

105 *Id.* at 351. Professors Janger and Levitin first advocated these proposals in an earlier article, Edward J. Janger & Adam J. Levitin, ONE DOLLAR, ONE VOTE: MARK-TO-MARKET GOVERNANCE IN BANKRUPTCY, 104 IOWA L. REV. 1857, 1861 (2019).

106 Skeel, *supra* note 96, at 10 n.34.

107 *See* Janger & Levitin, *supra* note [113], at 1877 (discussing the voting process). The court would need to determine the amounts paid by every claim who acquired her claim after distress, and incorporate this into the voting calculations. *Id.*

claims trading markets,[108] and unfairly punish those who acquired the claims. To the extent the prohibition on RSAs with signing fees and other distortive techniques made it more difficult to negotiate and confirm a reorganization plan, their hostility to these techniques also could have the ironic effect of leading to more section 363 sales, which lack many of the protections provided by the Chapter 11 voting process.

Another scholar has recently critiqued Triantis's and my analysis of the new contract paradigm from a different perspective, arguing that it gives too much deference to ex ante contracts.[109] The critique is part of a more general argument that the purpose of bankruptcy is to minimize the holdup behavior that might otherwise undermine the ex post renegotiation of a debtor's obligations in the event of financial distress.[110] Ex post contracting is given priority under this perspective, which advocates "cramdown for everything."[111]

Although the analysis is fascinating and compelling at times, it has two crucial limitations, in my view.[112] First, privileging ex post contracts, and treating existing obligations

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[108] *See* Janger & Levitin, *supra* note [113], at 1886. Professors Janger and Levitin would only limit claims traders' voting rights, not their economic rights to a payout. *Id.* As a result, the chilling effect on claims trading would be less dramatic then it would be if all of their rights were limited, as Janger and Levitin note in their earlier article. *Id*. But the chilling effect would not disappear.

[109] Casey, *supra* note [27], at 1751 n. 220 (criticizing our approach as "plac[ing] more trust in ex ante contracting than Chapter 11 does.")

[110] Casey, *supra* note [27] at 1715. Professor Casey conceptualizes bankruptcy as a response to the inevitable incompleteness of contracts made while the debtor is financially healthy. *Id.* He suggests that a risk of hold-up arises in the event of financial distress as a result of the parties' relationship specific investments, as conceptualized in the contracts literature. *Id.* (citing, among other sources, Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMITRICA 755, 757 (1988)). But Professor Casey goes on to deploy the term "holdup" far more broadly than this, using it as a catch-all that seems to encompass any behavior by a party that deviates from the efficient result. *Id*. at 1717 (stating that "the potential for hold-up arises when parties have made investments that involve or link in some way to the going-concern value of the debtor").

[111] *Id.* at 1753.

[112] I also quibble with several of the applications of the analysis, such as its defense of the current treatment of executory contracts, despite the well-known distortions caused by section 365, *id.* at 1757 & note 255 (citing and disagreeing with Skeel, *The Empty Idea of Equality of Creditors*, at 721-22), and its defense of the controversial *Qualitech* case, *id.* at 1764-65.

as expendable, undermines the benefits of ex ante contracting discussed earlier.[113] It raises uncertainty whether allocations of risk will be honored, and diminishes the parties' incentives to make relationship specific investments.[114] It also could increase overall transaction costs, since contractual arrangements that would otherwise be settled are reopened for possible negotiation.[115]

Second, this bias for ex post renegotiation—"cramdown for everything"—magnifies the need for bankruptcy judges to exercise judicial discretion.[116] For many years, bankruptcy practitioners avoided the use of the cramdown provision for precisely this reason—that it required a determination of the value of the firm and as a result put significant discretion in the hands of the bankruptcy judge.[117] The more contexts in which a cramdown style approach is implemented, the more judicial discretion is required. Chapter 11 works best when judicial discretion is cabined rather than magnified, in my view.[118]

Rather than privileging ex post renegotiation, the better approach in my view is to balance the costs and benefits of ex ante and ex post contracts.

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113 Skeel & Triantis, *supra* note [21], at 1794. The Chapter 11 confirmation rules themselves provide the framework for an ex post contract, as Professor Triantis and I pointed out in the earlier article. *Id*. at 1784–85. But courts' hostility to ex ante contracting goes well beyond the Code itself. *Id.* at 1785.

114 *Id.* at 1801. Professor Casey's approach, which focuses on holdup in relational contexts, could thus undermine relational investment. Casey, *supra* note [27], at 1.

115 Skeel & Triantis, *supra* note [21], at 1816.

116 *See In re* LMR, LLC, 496 B.R. 410, 428 (Bankr. W.D. Tex. 2013) (discussing the discretion given to judges in determining the cramdown interest methodology).

117 Charles D. Booth, *The Cramdown on Secured Creditors: An Impetus Toward Settlement*, 60 AM. BANKR. L.J. 69, 94 (1986).

118 Professor Casey appears to acknowledge this problem, noting that the need for the court "to value the relevant assets, claims and outcomes . . . may be the Achilles heel" of this approach. Casey, *supra* note [27], at 1769.

## II. Two Trouble Spots

In the process of identifying and offering a normative defense of the new contract paradigm, I briefly considered its implications for a variety of key bankruptcy-related contracts, including intercreditor agreements, RSAs, and bankruptcy remote entities. In this part, I focus in somewhat more detail on two additional contractual issues that have provoked increasing controversy, the treatment of DIP financers and other senior lenders and managerial bonuses arranged shortly before or during bankruptcy. Each is one of the first contracts that were used to shape Chapter 11 cases roughly twenty-five years ago when the contract paradigm first began to emerge.[119] I consider them in turn.

### *A) DIP Financers and Other Senior Lenders*

The debtor-in-possession financing provision is an extremely generous grant of authority to the bankruptcy judge to approve loans to the debtor.[120] Debtors generally arrange the financing prior to filing for bankruptcy, and ask the bankruptcy judge to approve it immediately after the filing, as part of the debtor's "first day orders."[121] Seventy-five percent of the time, the new lender is the same as the debtor's old lender.[122] The DIP financing agreement generally

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119 *See* Skeel, *supra* note [80], at 923-26 (DIP financing); 926-30 (bonuses and compensation). .

120 *See generally* 11 U.S.C. § 364(d) (2012) (discussing when the court may authorize obtaining credit or incurring debt). As discussed below, the most dramatic power, in section 364(d), is the court's authority to grant a "priming lien" given the DIP financing priority even over earlier liens. *Id.*

121 *The U.S. Trustee's Role in Chapter 11 Bankruptcy Cases*, UNITED STATES DEPARTMENT OF JUSTICE, https://www.justice.gov/ust/bankruptcy-fact-sheets/us-trustees-role-chapter-11-bankruptcy-cases (last updated Nov. 2, 2020).

122 Frederick Tung, *Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis*, 37 YALE J. REG. 651, 655 n.13 (2020).

includes "milestones" that the debtor is required to meet.[123] The milestones may contemplate a sale of the debtor's assets or significantly limit the time for filing a reorganization plan.[124] The DIP financing agreement, together with the lender's lien on most or all of the debtor's assets, often gives the DIP financer control of the case.[125]

The dominance of secured creditors—especially DIP financers-- has been quite controversial for some time.[126] Although the complaints often blur together, there are two, conceptually different critiques of senior lenders in bankruptcy. The first is a critique of the treatment of senior lenders' prebankruptcy claims, and applies to all senior lenders, whether are not they also are DIP financers. According to this criticism, the prebankruptcy lender should not be entitled to all of the proceeds of a sale or other disposition of the debtor's assets, even if the lender purports to have a "blanket" lien. These scholars contend that the lender's ex ante lien does not[127] or should not encumber all of the value of the debtor.[128] The ABI Report adopted a

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123 *See, e.g.,* Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale* 15 (May 26, 2020) (unpublished manuscript) (finding that 86% of DIP financing agreements in 2015-18 sample had milestones).

124 The DIP financing agreement often is coupled with an RSA. *See, e.g., id.* at 2 (describing DIP financing and RSA).

125 Julian S.H. Chung & Gary L. Kaplan, *An Overview of Debtor in Possession Financing*, THE INT'L COMPAR. LEGAL GUIDE TO: LENDING & SECURED FIN. 2020, 120, 121 (July 4, 2020).

126 An early cri de coeur is Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession,* 22-7 A.B.I.J. 12, 12 (2003).

127 Ted Janger has been the strongest proponent of the view that the scope of secured creditors' lien is limited even under existing law. *See* Edward J. Janger, *The Logic and Limits of Liens, 2015 U. ILL. L. REV.* 589.

128 Anthony Casey argues that secured creditors should only be entitled to the liquidation value of their collateral in the first instance, and that unsecured creditors should retain the option value of their claims even after a debtor files for bankruptcy. Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 765 (2011). Melissa Jacoby and Ted Janger propose that funds be set aside to compensate unsecured claims in the event a bankruptcy sale later appeared to have garnered too low a price. Melissa B. Jacoby and Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L. REV. 862, 862 (2014).

version of these proposals, calling for unsecured creditors to receive the option value of their claims in either an asset sale or a traditional reorganization.[129]

The second criticism, by contrast, is a concern about ex post contracts—the DIP financing agreements a debtor enters into after having fallen into financial distress. Evidence has recently emerged that DIP financers earn supra-competitive profits from DIP loans.[130] One study measured the profits directly, and concluded that DIP lenders' supra-competitive profits have not declined through time.[131] The second found that the pricing of DIP loans is comparable to junk bonds, despite the much lower default rate on DIP loans.[132] The most likely explanation for persistently supra-competitive profits is the advantage a debtor's existing lenders have over other potential sources of funding.[133] The debtor's prebankruptcy lenders have much more information about the debtor than other lenders, and are often well positioned to quickly provide the operating funds the debtor needs.[134] As noted earlier, 75% of debtors that obtain DIP financing get the financing from inside lenders.[135] In response to this evidence, some scholars have suggested that courts or lawmakers should intervene in the DIP financing market.

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129 *See* ABI REPORT, *supra* note 17, at 207–11.

130 *See* B. Espo Eckbo et al., *Rent extraction by super-priority lenders* 1 (Mar 13, 2020) (unpublished manuscript) (on file with the Tuck School of Business); *see also* Tung, *supra* note 120, at 653.

131 Eckbo et al, *supra* note 127, at 11, 37.

132 Tung, *supra* note 120, at 686–87.

133 Eckbo, *supra* note 127, at 3–4.

134 *Id.* at 27.

135 *Id*. at 4; Tung, *supra* note 120, at 658.

The analysis of ex ante and ex post incentives in the last part suggests that the policy recommendations emanating from the first critique—the calls to limit senior creditors' liens—would be a mistake. If senior lenders have a lien on all of the debtor's assets, the should be treated as having priority with respect to all of the value.[136] Artificially limiting the scope of a lender's security interest would undermine the ex ante benefits of collateralized lending..[137]

The second critique—which focuses on ex post contracts-- is more serious. The persistence of supra-competitive profits suggests the market for DIP financing may not be working efficiently. A variety of harms may flow from this. The most obvious is that debtors will be forced to pay more for DIP financing than they would in a competitive market.[138] DIP lenders also may use their leverage to insist on benefits that improve their position at the expense of other creditors.[139] Finally, the DIP lender could use its leverage to dictate an outcome that benefits the DIP lender but diminishes the overall value of the firm.[140] Rather than allow the debtor to pursue a traditional reorganization, for instance, the DIP lender may condition its loan on a prompt sale of the debtor's assets, even if reorganization would be more efficient.[141]

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[136] For a similar conclusion, see Douglas G. Baird, *The Rights of Secured Creditors After* Res Cap, 2015 U. ILL. L. REV. 849, 857-58 ("As long as a creditor has a senior security interest in everything at the moment the petition was filed, any increase in value during the bankruptcy belongs to this creditor.").

[137] For a similar argument, see Barry E. Adler & George Triantis, *Debt Priority and Options in Bankruptcy: A Policy Intervention*, 91 AM. BANKR. L.J. 563, 591 (2017)(criticizing the ABI proposal).

[138] Tung, *supra* note 120, at 687.

[139] *Id*. at 654. One common strategy—known as a "roll-up"—is to insist that the debtor pay off the earlier loan with proceeds of the DIP loan, which ensures that the earlier loan is paid in full even if it was not actually fully collateralized. The DIP financer may also ask the debtor to waive causes of action the debtor may have against the DIP financer. *Id.* at 667–68.

[140] Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 514 (2009).

[141] *Id*. at 529–30.

It is important to recognize that DIP lender control can also be beneficial. Before lenders began using DIP financing agreements as a governance lever, the debtor's managers often had too much flexibility, and cases sometimes dragged on for considerable periods of time.[142] Neither problem is nearly as prevalent today.[143]

Bankruptcy judges face a difficult predicament when they scrutinize proposed DIP lending agreements. The debtor and the inside lender often warn that, unless the court approves the loan, the business will collapse in short order.[144] In theory, bankruptcy judges could scrutinize the terms of the loan contract, and forbid those that seem problematic. To some extent, they already do this by requiring clear identification of potentially problematic DIP loan provisions.[145] But it is unrealistic to expect judges to micromanage the contracts.

One strategy that might help is to signal a willingness to grant a priming lien to a non-insider that offers to make a loan.[146] Courts have been very reluctant to authorize a priming lien for a non-insider lender unless the earlier lender consents.[147] Yet the Code explicitly authorizes courts to approve priming liens so long as the prior lender's loan is adequately protected.[148]

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[142] Fotenini Teloni, *Chapter 11 Duration, Pre-Planned Cases, and Refiling Rates: An Empirical Analysis in the Post-BAPCPA Era,* 23 AM. BANKR. INST. L. REV. 571, 580–81 (2015).

[143] *Id.* at 593 (finding that the mean duration for traditional Chapter 11 cases dropped from 634 to 430 days after 2005, and the mean for all cases (including prepackaged bankruptcies) fell from 480 to 261 days).

[144] Tung, *supra* note 120 at 665.

[145] The bankruptcy judges in the Southern District of New York have guidelines requiring proponents of debtor-in-possession loans to explicitly flag, among other things, any provision using new collateral to collateralize pre-petition obligations. *See* S.D.N.Y. USBC. LAB. Rule 4001–2(a)(6) (2017).

[146] Professors Ayotte and Ellias advocate a more aggressive approach, advocating that courts provide a two-three month period for a priming loan at the beginning of the case. Ayotte & Ellias, *supra* note [132]..

[147] Tung, *supra* note 120 at 658 n. 25. *See* 11 U.S.C. § 364 (d)(1)(B) (2018).

[148] *See* 11 U.S.C. § 364(c)-(d) (2018).

Notice that adopting a more flexible stance toward priming liens would not require any legislative reform. If bankruptcy judges simply signaled a willingness to grant priming liens, and did in fact grant them in appropriate cases, the market might quickly become more competitive. In another work, a co-author and I advocate that banking regulators facilitate DIP lending by ordinary banks to medium-sized firms, which currently have little access to DIP loans.[149] These steps seem more promising than a more dramatic intrusion into the market.

*B) Managerial Bonuses*

The other early ex post contractual strategy for shaping managers' behavior was the use of performance bonuses.[150] These bonuses might promise the managers a bigger payout if a reorganization plan was confirmed within a specified period of time, or the payout might be linked to the value of the debtor's assets at confirmation. More recently, companies have increasingly begun paying bonuses to their executives before filing for bankruptcy rather than after, a trend that is quite controversial.[151] "Such bonuses have long spurred objections," as one story put it, "that companies are enriching executives while cutting jobs, stiffing creditors and wiping out stock investors."[152]

Ironically, the rush to award bonuses prior to bankruptcy seems to have been prompted by changes made to the Bankruptcy Code in 2005, after scandals involving Enron, WorldCom

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149 *See* Peter Conti-Brown & David Skeel, *Using the Federal Reserve's Discount Window for Debtor-in-Possession Financing During the COVID-19 Bankruptcy Crisis*, THE BROOKINGS INSTITUTION (July 2020) at 2.

150 *See* Skeel , *supra* note [80], at 926-30.

151 Mike Spector & Jessica DiNapoli, *On eve of bankruptcy, U.S. firms shower execs with bonuses*, REUTERS (July 17, 2020, 7:05 A.M.) https://www.reuters.com/article/us-health-coronavirus-bankruptcy-bonuses/on-eve-of-bankruptcy-u-s-firms-shower-execs-with-bonuses-idUSKCN24I1EE.

152 *Id*.

and other companies prompted amendments designed to discourage bonuses in bankruptcy.[153] The 2005 amendments essentially ban post petition pay-to-stay bonuses, forbidding them unless, among other things, the executive has a bona fide offer from another employer at the same or greater compensation.[154] Because the prohibition only applies to stay bonuses, debtors can evade it by making sure the bonuses have performance-based features. But the changes seem to have prompted frequent challenges to the bonus plans.[155]

The new prebankruptcy bonuses are not immune from attack altogether. They can be challenged as fraudulent conveyances—based on the argument that the company received insufficient consideration in return for the payout.[156] But the debtor is not likely to challenge the bonuses, since its managers or directors are the ones who authorized the bonuses in the first place; thus, the creditors' committee would need to obtain court approval to challenge the bonus.[157] In many cases, the bonuses are never formally challenged, and in the end any claims against the executives are released as part of the Chapter 11 reorganization plan.[158]

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153 *See* Baker et al, *supra* note 17, at 313..

154 11 U.S.C. § 503(c) (2018).

155 In an extensive empirical study of bankruptcy bonuses, Professor Jared Ellias finds that section 503(c) is easily evaded, but the bonuses are often contested and seem to be used somewhat less frequently than before BAPCA. Jared Ellias, *Regulating Bankruptcy Bonuses*, 92 S. CAL. L. REV. 654, 664–65 (2019).

156 *See id.* at 660 (citing James Sprayregen et al., *Recent Lessons on Management Compensations at Various Stages of the Chapter 11 Process*, Financier Worldwide (Mar. 2013), https://www.financierworldwide.com/recent-lessons-on-mangement-compensation-at-various-stages-of-the-chapter-11-process/#.XEZb6S3Myu4).

157 *Id.* at 667; *see* M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low*, 101 NW. U. L. REV. 1543, 1581 (2007).

158 *See* Henderson, *supra* note 155, at 1575.

A proposal to ban all post-petition bonuses was recently introduced in Congress.[159] The proposed legislation would prohibit a debtor from paying bonuses to any employee making more than $250,000 a year, and covers bonuses of all kinds, defining "bonus" to include any compensation that "can be construed as a form of retention, incentive, or reward related to the services provided to the debtor."[160]

Awarding bonuses to managers after a company has fallen into financial distress is analogous to resetting executives' stock options after a decline in the firm's stock price. From an efficiency perspective, the problem with an option reset is that it undermines executives' ex ante incentives—suggesting they will be given another opportunity to benefit even if the firm performs poorly.[161] But the reset also can improve the executives' ex post incentives by, for instance, linking the bonus to performance milestones.[162] The challenge, as always, is to approximate the optimal balance between ex ante and ex post incentives.[163]

The same logic suggests that a complete ban on bonuses would be a mistake, given the possibility they will improve managers' incentives in bankruptcy. To be sure, this by itself does not mean proposals to preclude post-petition bonuses are problematic. If bonuses are best arranged prior to bankruptcy rather than during the bankruptcy case, perhaps such a ban could be justified. But precisely the opposite is true.[164] The risk of self-dealing is much more severe if the bonus is given prior to bankruptcy. Arranging bonuses post-petition ensures more

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159 No Bonuses in Bankruptcy Act of 2019, H.R. 1557, 116th Cong. (2019)

160 *Id.* at section 2 (proposed for codification at section 503(d)(2)(B)).

161 *See, e.g.* Viral V. Acharya et al., *On the Optimality of Resetting Stock Options*, 57 J. FIN. ECON. 63 (2000).

162 *Id.*

163 *Id.*

164 Even if pre-bankruptcy bonus awards were preferable, the proposed legislation would effectively bar performance-based bonuses entered into before bankruptcy, since the performance would occur during the bankruptcy case and the legislation bars any bonus payment during the case. Only pre-bankruptcy stay bonuses that were paid prior to filing would escape the ban.

transparency, given the requirement of notice and a hearing as a prerequisite for approval.[165] Moreover, prebankruptcy bonuses can be used to help cement the control of inside lenders. Pre-bankruptcy bonuses should therefore be viewed with more skepticism than post-petition bonuses, not less.

These considerations not only weigh against adopting a ban on bankruptcy bonuses; they also suggest that the current restrictions on post-petition bonuses should be rolled back, given the evidence that the existing restrictions on post-petition stay bonuses have spurred more challenges to performance-based bonuses. Either approach—the current rule or a rule that removed the 2005 restriction on stay bonuses—requires a bankruptcy judge to police the bargain with imperfect information, as with other ex post contracts.[166] This may counsel in favor of adopting rules of thumb, such as a presumption against ever permitting pre-bankruptcy bonuses and closer scrutiny of stay bonuses than true performance bonuses that are proposed after the debtor files for bankruptcy. Courts employ a similar strategy in corporate law. In determining whether to enforce lockup or breakup fee provisions that promise compensation to a bidder if the bidder's acquisition of a target company is not successful, for instance, courts have developed rough guidelines for permissible provisions, while striking down lockups that are clearly excessive.[167]

## Conclusion

Although the statutory framework of Chapter 11 has not changed dramatically for more than forty years now—the interval at which major reforms had previously arrived over the past

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165 11 U.S.C. 363(b)(requiring court approval of transactions out of the ordinary course of business).

166 For a similar point, see Barry Adler & George G. Triantis, *The Aftermath of* North LaSalle Street, 70 U. CINN. L. REV. 1225, 1237 (2002)(concluding that judges are not well-positioned to balance the ex ante and ex post incentives).

167 *Brazen v. Bell Atlantic Corp*, 695 A.2d 43, 49–50 (Del. 1997) is the leading case on breakup fees, suggesting that fees up to 3-4% of the value of a deal will generally be permitted. In both *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 185 (Del. 1986) and *Paramount Commc'ns Inc. v. QVC Network, Inc.*, 637 A.2d 34, 51 (Del. 1994), the Delaware Supreme Court struck down lockups as excessive.

century[168]—bankruptcy practice has. I have referred to the regime that has emerged as bankruptcy's new contract paradigm. I have argued that the key focus of oversight should be trading off the benefits and costs of ex ante and ex post contracts, and have advocated that bankruptcy judges give a little less deference to ex post contracts, and a little more to ex ante arrangements.

Just as bankruptcy practice is dynamic, judicial oversight of bankruptcy-relevant contracts also needs to be dynamic. Twenty-five years ago, some of the contracts that are most central to current Chapter 11 practice, such as intercreditor agreements and RSAs, were uncommon. Other contracts, such as DIP financing agreements have evolved in ways that are more problematic than they were in earlier periods.

The Bankruptcy Code has had a splendid run, and it has proven more adaptable than anyone imagined four decades ago. Sam Gerdano has been there pretty much from the beginning, and his fingerprints are everywhere present in American bankruptcy law, in ways both visible and invisible. It has been a privilege to watch him in action, and it is a privilege to call him a friend.

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[168] Congress enacted pervasive bankruptcy reform in 1898, 1938 and 1978. *See* Bankruptcy Act of 1898 (Nelson Act), Pub. L. No. 55-541, 30 Stat. 544; Bankruptcy Act of 1938 (Chandler Act), Pub. L. 75-696, 52 Stat. 840; Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2549 (codified at 11 U.S.C.)