Bankruptcy's Trilemma: A Unifying Framework

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October 2, 2024

[EARLY-STAGE DRAFT: PLEASE DO NOT CITE WITHOUT PERMISSION]

Abstract

We propose a unified framework to explain the key problems underlying corporate bankruptcy law. Creditor rights take two primary forms: the right to take assets from the debtor and the right to block asset transfers from the debtor to third parties. Taking and blocking rights control *agency problems*, such as value-diverting transfers by management. But in financial distress, one creditor's rights can impose costs on the others. Multiple taking rights create the well-known *commons problem*: creditors can race to the debtor to collect, causing a valuable firm to be liquidated. Bankruptcy law can stay the creditor race, but a stay creates one of two alternative problems. Replacing taking rights with blocking rights creates an *anticommons problem* of holdout and costly delay. Holdout problems can be mitigated by removing blocking rights for some creditors. But creditors who can neither take nor block are vulnerable to the very agency problems their contracts try to prevent. We call these three problems—commons, anticommons, and agency—bankruptcy's *trilemma*: the law cannot solve all three at once. We show how most of bankruptcy law's features target at least one of the three problems. U.S. law's back-and-forth evolution over time reveals the inevitable tension between them.

[1] Thanks to Erwin Chemerinsky, Hanoch Dagan, Brook Gotberg, Alex Huang, Jared Mayer, Bruno Salama, Richard Squire, and seminar participants at the Harvard-Wharton Insolvency and Restructuring Conference for helpful comments.

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I. Introduction

In the Purdue Pharma case, the Supreme Court wrestled with one of its most difficult and most controversial bankruptcy law questions in decades. Could a bankruptcy judge give a release of liability to the Sackler family--who had not declared bankruptcy themselves—in exchange for their cash contribution to Purdue's bankruptcy estate? The court wrestled with the policy implications of the question. Justices Kavanaugh and Barrett wondered whether denying a release would cause uncoordinated litigation against the Sacklers that would deplete Purdue's assets. Justice Kagan expressed a different concern. Why should one "nut case holdout" be able to delay a settlement that would benefit the creditors as a whole? Justice Jackson took a different angle. She asked whether the real problem was not the holdout creditors, but the Sacklers. After all, they were the ones insisting on the release, which would allow them to keep money they diverted from Purdue while they managed it[2].

The Court in Purdue raised the three fundamental economic problems that define corporate bankruptcy law: *commons*, *anticommons*, and *agency*. The commons problem is sometimes called the "creditor run", or the "grab race": creditors acting individually to seize a debtor's assets can destroy value for the creditors collectively. The anticommons problem is the problem of holdout: creditors exercising rights to block a collective action can lead to costly delay. And the agency problem occurs when some creditors have neither the rights to seize, nor to block. This absence of creditor rights empowers controlling parties—who may be managers like the Sacklers, lawyers, trustees and other bankruptcy professionals--to take actions that benefit themselves at those creditors' expense.

Those three problems constitute what we call bankruptcy's *trilemma*: three undesirable alternatives that a firm in need of bankruptcy cannot eliminate simultaneously.

To see the trilemma in action, consider bankruptcy's automatic stay. The stay is a well-known solution to the commons problem of creditor runs. It creates time and breathing space for the debtor to restructure. And it creates liquidity by suspending payment obligations, conserving scarce cash for the debtor to operate. But more time and more liquidity are not always good for the creditor body; they could exacerbate agency problems, giving management time and money to further their own interests. One possible solution is to give creditors the power to block management's decisions. But if each creditor had a veto over all decisions, there would be too much risk of costly delay. Bankrupt firms are often analogized in the case law to melting ice cubes[3], or dying patients on an operating table.[4] Time-sensitive opportunities might be lost in the pursuit of creditor consent.

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[2] [JUSTICE JACKSON: "Only because the Sacklers have taken the money offshore, right? I mean, it's not like -- it's not like by operation of law it's necessary to do this. It is necessary to do this because the Sacklers have taken the money and are not willing to give it back unless they have this condition."]

[3] In Re Chrysler: "With its revenues sinking, its factories dark, and its massive debts growing, Chrysler fit the paradigm of the melting ice cube. Going concern value was being reduced each passing day that it produced no cars, yet was obliged to pay rents, overhead, and salaries."

[4] Cite to Judge Gerber in GM: "Neither the Code, nor the caselaw—especially the caselaw in the Second Circuit—requires waiting for the plan confirmation process to take its course when the inevitable consequence would be liquidation. Bankruptcy courts have the power to authorize sales of assets at a time when there still is value to

None of these problems is new individually. The literature emphasizes the fundamental importance of each of them.[5] But it tends to analyze them one or two at a time. Our primary contribution is to uncover the economic connections between them. We also argue that they are nearly comprehensive for explaining the law: bankruptcy's most important rules are designed to address at least one of the three problems.[6] Our framework thus simplifies a complex body of law, making it more approachable to outsiders. As such, it can serve as a teaching tool grounded in law and economics theory. It can also provide straightforward guidance to policymakers considering a policy change: by targeting one problem, policymakers must anticipate the risks associated with the other two.

To showcase some of the explanatory power of our framework, we provide a taxonomy of some of the key features of the U.S. Bankruptcy Code, and the problems they target. In some cases, like the stay above, the key trade-offs in the trilemma are immediately evident. But for others, the framework clarifies some of the strengths and weaknesses of existing law. We discuss, for example, how the law of preferences is incoherent because it has been used historically to target both agency and commons problems. As a result, preference law has a muddled character that solves neither.

Next, we reframe the history of U.S. bankruptcy law, drawing from existing historical narratives in the bankruptcy law scholarship. The law's evolution over time shows the trilemma's tension at play. Changes to U.S. bankruptcy law have targeted one or two of the legs in our three-legged stool, and in doing so have tended to create problems in another leg. This inevitable back-and-forth has animated the evolution of the law for more than a century.

Finally, we discuss developments in the modern bankruptcy case. We argue that the law has entered a new era, with agency costs being the most pressing problem with current law, from restructuring support agreements to Texas Two Steps to third party releases. One source of the trend is intensifying anticommons problems due to increasingly complex and secured credit-heavy capital structures. Another is the weakened checks on agency cost controls due to forum shopping into agent-friendly courts, and forum seeking by those courts. Though the agency problem mirrors concerns that drove

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preserve—to prevent the death of the patient on the operating table." See In Re GENERAL MOTORS CORP., et al., DECISION ON DEBTORS' MOTION FOR APPROVAL OF (1) SALE OF ASSETS TO VEHICLE ACQUISITION HOLDINGS LLC; (2) ASSUMPTION AND ASSIGNMENT OF RELATED EXECUTORY CONTRACTS; AND (3) ENTRY INTO UAW RETIREE SETTLEMENT AGREEMENT

[5] On anticommons, see Roe 1983 Bankruptcy and Debt, at 539: ["Stalemates occur. Even when all parties know that a particular proposed plan is better than the status quo, at least one party is often likely to reject the plan because yet another alternative is better for it."] and Vincent S.J. Buccola, *Bankruptcy's Cathedral: Property Rules, Liability Rules, and Distress*, 114 Nw. U. L. Rev. 705 (2019) ["But while supermajority rule solves the holdout problem, it also reintroduces the prospect of expropriation by corporate insiders or others with multiple (conflicting) investments in the debtor."] Baird and Rasmussen, Antibankruptcy, Yale L. Rev , Rolef de Weijs 2012, Harmonisation of European Insolvency Law and the Need to Tackle Two Common Problems: Common Pool and Anticommons, International Insolvency Review 2012. Anthony J. Casey, Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy, 120 Colum. L. Rev. 1709 (2020). On agency, see Triantis A Theory of the Regulation of Debtor-in-Possession Financing 46 Vand. L. Rev. 901 1993, Douglas G. Baird & Anthony Casey, "No Exit? Withdrawal Rights and the Law of Corporate Reorganizations," 113 Columbia Law Review 1 (2013). ["With these benefits to be gained, withdrawal rights make the most sense when there is the greatest need to discipline managers."].

[6] There are non-economic goals that our framework does not address; for example, issues of procedural justice, such as the rights of tort victims to be heard in court, and others, are not included here. See Foohey and Odinet, Silencing Litigation Through Bankruptcy, 109 Virginia Law Review 1261 (2024).

major reforms to the law during the Great Depression era, the pressure to fix agency problems today is currently quite weak. With bankruptcy costs rising, creditors are taking pre-emptive measures to avoid bankruptcy altogether.

II. Background

A. The Objective of Bankruptcy

What are the economic goals a bankruptcy procedure should try to achieve? We follow the law and economics literature in arguing that the primary goal is efficiency, in the Kaldor-Hicks sense: a bankruptcy procedure is more efficient when its rules create incentives to make the company's total asset value larger. The calculus should include not only what happens to company value within the bankruptcy (ex-post), but also the effects of bankruptcy rules on the firm's decisions prior to bankruptcy (ex-ante).[7]

Bankruptcy law contributes to these missions in two ways. The first is to maximize the value of the bankruptcy estate. This goal requires all parties to make efficient decisions: agents cannot shirk and creditors cannot force premature liquidation or delay the bankruptcy process.

The second objective is to defend priorities. This objective tends to serve ex-ante efficiency goals, because debtors choose their financing structure with some intention. If, for example, owners can extract value at the creditors' expense in bankruptcy, creditors will be less willing to provide financing up front. Enforcing the priority of secured creditors over unsecured creditors can economize on creditor monitoring costs by allowing secured creditors to focus monitoring efforts on their collateral. And respecting priorities in bankruptcy weakens incentive for controllers to seek out or avoid bankruptcy inefficiently to improve their payoffs.

The two objectives can sometimes be at odds, requiring that the law balance them. The firm might require new financing to maximize estate value, but the new lender requires seniority over the pre-petition creditors that those creditors could block. Management may require incentive pay to work hard for the estate, but this may require incentive pay from the estate that would otherwise go to the creditors.

[7] Even in the law and economics framework, the asset value maximization goal is contestable. The effects of a bankruptcy on non-creditor stakeholders can also matter. See Zachary Liscow, Counter-Cyclical Bankruptcy Law: An Efficiency Argument for Employment-Preserving Bankruptcy Rules, 116 Colum. L. Rev. 1461, 1462–66 (2016). Bankruptcy outcomes can also have spillover effects on other firms in the industry, and an optimal law may want to correct for this. See Antonio Bernardo, Alan Schwartz and Ivo Welch, Contracting Externalities and Mandatory Menus in the US Corporate Bankruptcy Code, 32 J. L. Econ. Org 395 (2016).

B. Creditor Protection as Rights to Take and Rights to Block

We now turn to some primitives regarding creditor rights, and the transfers of property rights from debtor to creditor that enable debt contracting. This will help us distinguish the nonbankruptcy rights of secured and unsecured creditors and how bankruptcy alters them.[8]

A debt contract is a debtor's promise to repay a debt in exchange for loanable funds. In an ideal world, debtors would always repay their debts. But in the real world, the law is necessary to protect creditors against agency costs. Of particular concern is that the debtor might transfer property rights to third parties—other creditors, buyers, managers, shareholders, etc.—at the original creditors' expense,[9] thereby making it hard to collect on the loan.

There are two main protective property rights the debtor grants creditors to limit agency costs: the right to *take* (or, equivalently, to *seize*) and the right to *block*. Seizures are involuntary transfers to the creditor of property rights from the debtor. Blocking rights, by contrast, leave the asset under the debtor's control, but prevent transfers to third parties. These are not the only possible rights a debtor can give creditors—they might also give a direct control right, such as a board seat, or an indirect control right, such as changing management to avoid a cutoff of credit[10]. But those rights are given more infrequently than taking and blocking rights; thus, we focus mostly on those.

1. Unsecured creditors: taking rights

Outside default, an unsecured creditor has neither the right to seize assets, nor the right to block their transfer. Only upon a default—i.e. a failure to comply with the loan contract's terms—is the unsecured creditor's taking right triggered. This means that timing is important to unsecured creditors. They will want to set maturity dates and events of default in the loan contract to limit the debtor's time and flexibility when their loan is most at risk.

Debt contract terms that take away time from the debtor can be efficiency-enhancing, because they control agency costs. If the debtor is wasting money on bad investments, or making collusive transfers that divert value, taking away the debtor's time can enlarge the economic pie. But when multiple creditors are involved, contract terms could inefficiently take away time. Cross-default clauses trigger a creditor's right to seize when the debtor defaults on any other creditor. These terms are intended to protect a creditor against the other creditors. But they can precipitate an inefficient "race to the courthouse" when creditors include them. Bilateral contracts between a debtor and a creditor might not internalize the

[8] When we say a property right, we follow a definition created by Henry Hansmann and Reinier Kraakman: a property right in an asset: 1) runs with the asset; and 2) binds subsequent transferees of other rights in that asset. Hansmann, Henry and Kraakman, R. (2002) "Property, Contract, and Verification: The *Numerus Clausus* Problem and the Divisibility of Rights," *Journal of Legal Studies*: Vol. 31: No. 4, Article 4.

[9] These concerns are strongly connected to a corporation's limited liability. In a world of unlimited liability, value-diverting transfers to owners would be less of a concern, because the creditors can collect their loans from the owners.

[10] David A. Skeel Jr. *Creditors' Ball: The New New Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917 (2003).

efficiency costs on the other creditors. As a result, we might see excessive taking rights in a world without bankruptcy[11].

2. Secured creditors: taking and blocking rights

A secured creditor also has seizure rights upon default, like an unsecured creditor has. But the secured creditor has additional protection that comes from taking a particular property right called a *lien*[12] on some of the debtor's assets, allowing those assets to serve as collateral. When liens are acquired by voluntary agreement, the Bankruptcy Code calls them *security interests*[13]*.* The security interest allows the secured creditor to block transfers of certain property rights in the collateral to third parties. These rights apply to the secured creditor even before a default—typically from the time the loan is made[14]—limiting both voluntary transfers and involuntary ones, like seizures by other creditors.

After granting a security interest to a creditor, a debtor cannot give a security interest to another creditor of equal or higher priority without the first creditor's consent. The debtor also cannot sell the collateral to a third party free and clear of the security interest. Since buyers rarely want to buy assets subject to liens, this means the secured creditor can effectively block sales of the collateral to third parties until the debt is paid in full. The secured creditor is also protected against involuntary transfers: if another unsecured creditor has the collateral seized and sold, the secured creditor is entitled to be paid first from the proceeds of the sale.

Thus, whereas an unsecured creditor must be concerned about earlier-arriving transferees of rights in the debtor's assets, such as creditors and third party buyers, the secured creditor can pursue the collateral in the hands of transferees even if they arrive after the transfer. This means that secured debt mitigates the commons problem, because secured creditors have less to gain from racing to the debtor.

But just like the unsecured creditor's right to take, bilateral contracts between a secured creditor and the debtor might create good and bad blocking rights. Blocking rights provide extra protection against value-diverting transfers. But they can also block value-creating ones. Suppose a secured creditor negotiates for a lien on key assets, such as the debtor's trademarks, that are complementary with the other assets in the company. If the debtor wants to sell the company as a going-concern, the secured creditor could prevent a sale of the trademarks and delay a deal that would benefit the general creditor body[15]. As with taking rights, the debtor and creditor may not fully internalize the anticommons costs that blocking rights impose on the debtor's other creditors when they contract.

[11] Unsecureds also have some blocking rights. They can block an exchange of their own claims and they can block any superior unsecured debt. Fraudulent transfer law allows unsecured creditors (or a bankruptcy trustee acting on their behalf) to unwind unfair transfers.

[12] 11 U.S.C. 101(37).

[13] 11 U.S.C. 101(51). In addition to security interests, liens can also be created by statute, or as part of the judicial collection process for unsecured creditors.

[14] More specifically, these rights transfer to the creditor when the security interest is perfected, which is typically when the loan is made. UCC 9-203.

[15] These allegations of value-destroying holdup by a trademark lender were made in the Toys R' Us bankruptcy; see Ayotte 2021.

III. The Trilemma Explained

The rights to take and block limit agency costs, but also impose costs on other creditors in the event of financial distress. With this insight in hand, we can now see the three problems of our trilemma. The three problems arise when there are multiple, uncoordinated creditors and financial distress is costly, in that the firm cannot meet its short-term obligations without sacrificing asset value. This means that the firm is illiquid: it cannot sell its assets for cash instantly and for full value.[16] The lack of creditor coordination is another essential element: it means that the creditors are unlikely to strike Coasean bargains that maximize their collective value.

Fundamentally, a reorganization or liquidation of a financially distressed firm requires transfers of rights to and from the debtor. If a debtor is to be liquidated, the debtor corporation must sell assets to another party, or the creditors must be permitted to take assets in exchange for their claims. If the firm is to remain in operation, old securities must be exchanged for new ones in a way that alleviates the company's financial distress. The firm might be sold to a financially healthy buyer for cash, which is paid to the claimants; or, the claimants might exchange their old debt claims for equity in the reorganized company[17].

In the absence of bankruptcy, the exercise of a taking right by one creditor can enable a transfer that would harm the creditor body. Conversely, the exercise of a blocking right can prevent a favorable transfer. Bankruptcy law can thus add value by relaxing individual taking and blocking rights. But relaxing them can re-introduce the same agency costs these creditor rights were intended to prevent. We now explain these potential problems one by one.

A. Commons: The Creditor Run

Commons problems occur generally when multiple actors have rights to use a resource and no one has the right to exclude. This leads to problems of inefficient overuse[18]. A classic example is the overfishing problem. A single fisherman can keep any the fish he catches. But he does not internalize that his catch reduces opportunities for fish to spawn, depleting the stock of fish in the lake for other fishermen.

In the bankruptcy context, the unsecured creditor run is the classic commons problem in action. As we noted above, the unsecured creditor has the right to seize assets upon default—an involuntary transfer—to satisfy his claim. The run happens when multiple creditors have rights to take, and no one has the power to block them. Like the fisherman, when the unsecured creditor seizes a complementary asset that affects the firm's going concern value, the other creditors can lose more in value than the

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[16] If it could, then a mandatory auction of the entire company for cash would solve the bankruptcy problem perfectly. Baird, Douglas G. (1986) "The Uneasy Case for Corporate Reorganizations," *Journal of Legal Studies*: Vol. 15: No. 1, Article 6.

[17] Involuntary transfers by creditors; voluntary transfers from debtor to creditor; voluntary transfers from debtor to third-party (non-creditor). All of these transfer types are necessary for an efficient reorganization of the debtor that maximizes value for the collective. Give examples.

[18] Garrett Hardin The Tragedy of the Commons, Science, New Series, Vol. 162, No. 3859 (Dec. 13, 1968), pp. 1243-1248.

seizing creditor takes away. The potential for insolvency gives creditors an incentive to race to the courthouse, because creditors are satisfied according to a first-in-time principle under state law. The run problem leads to too much seizure and excessive liquidation, i.e. too few reorganizations of viable firms.

Besides creditors, other counterparties of the debtor can create commons problems. Contract counterparties, such as licensors/licensees, suppliers, landlords, and others, typically have rights to terminate contracts upon events connected to the debtor's financial condition. Outside of bankruptcy, these rights are enforceable, but bankruptcy law will weaken them substantially.

The commons problem as a motivation for bankruptcy is well-known. Douglas Baird and Thomas Jackson developed this theory in the 1980s, and it remains the backbone of the law and economics theory of corporate bankruptcy. It explains why bankruptcy includes an automatic stay of creditor collection, which stops the run. But if this were the only problem, bankruptcy law could provide only a stay and stop there. To explain the many other features of the law, we need to look further.

B. Anticommons: The Holdout Problem

Anticommons problems are the reverse of commons problems. Stated generally, anticommons problems occur when too many parties have the right to exclude from a resource and no party has the effective power to use[19]. Bargaining problems in securing these permissions lead to underuse of the resource. Anticommons problems arise in many property law contexts where assembling permissions for many complementary assets is required for an undertaking, such as securing intellectual property rights for the development of a more advanced technology.

In the context of bankruptcy, we substitute the transfer-specific word "block" for the more general term "exclude". Anticommons in bankruptcy occurs when multiple creditors have the power to block the transfers that enable debt restructuring, and no one has the effective power to override the blocking. As noted above, secured creditors have blocking rights. If a debtor wants to sell assets subject to multiple liens, it must secure the consent of each lienholder. But other creditors have blocking rights outside of bankruptcy as well. Contract counterparties, such as landlords, usually have antiassignment clauses that prevent transfers of the debtor's contract rights to another party.

When a Chapter 11 bankruptcy is filed, both secured and unsecured creditors' rights to seize are suspended. But they are replaced by a new power to block transfers affecting the creditor collective. The blocking power is not absolute. The strength of the blocking right depends on the type of transfer, and the ability to block is usually contingent on whether other creditors and/or the bankruptcy judge agree. Creditors can object to transfers that affect the company's operations during the case, such as selling assets or borrowing new money. They can also block plans of reorganization by voting against them.

Anticommons problems occur when holdout creditors block transfers that would benefit creditors collectively. This usually occurs because the creditor is trying to extract more of the economic pie for themselves. The holdout problem leads to costly delay, and lost opportunities. A buyer might be interested in buying all the firm's assets free and clear of liens, but a lienholder of a complementary

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[19] See Michael A. Heller, The Tragedy of the Anticommons: Property in the Transition from Marx to Markets 111 Harv. L. Rev. 621 (1998).

asset to the firm might block the sale. Similarly, a creditor holding claims in a class might buy a "blocking position" in a class and hold up a reorganization hoping to achieve a greater payoff.[20]

C. Agency: Value Diversion and Shirking

The final problem is an agency problem. Agency relationships occur generally when an agent has the authority to act on a principal's behalf. Agents have superior information and skills that can benefit the principal. But agents also have private incentives that diverge from the principal's; thus, they can be expected to act in their self-interest. Incentive schemes, such as performance pay and the threat of dismissal for poor performance, help to align the agent with the principal.

When a firm is financially healthy, the primary agency problem is between management and shareholders. The shareholders are the residual claimants: the parties who enjoy any upside and bear any downside to management's decisions. Pay tied to the firm's stock price, such as stock options and stock grants, are common ways to align management and shareholder interests.

But in financial distress, the nature of the agency problem changes. In an insolvent firm, creditors become the residual claimants. This poses a problem for incentive alignment. Agents continue to be aligned only with shareholders through their shareholdings. If creditors are not coordinated, they cannot create a new incentive alignment scheme from scratch in financial distress. And just like the problems of excess taking and blocking, we would not expect that a contract between a creditor and debtor will set up incentive schemes in distress that maximize value for all the creditors.

A second challenge is that managing financial distress requires distress-specific management expertise. Decisions become more time sensitive. We can think about restructuring professionals-- lawyers, investment bankers, and turnaround managers--as professional liquidity creators[21]. They must find financing, decide whom to pay and whom not to pay, provide information to new and existing investors, arrange asset sales, and negotiate debt adjustments on short timelines. They must be paid sufficiently to encourage their participation, and must have interests sufficiently aligned with the interests of the creditor body.

In a Chapter 11 case, management has powers to run the company during the case through the debtor's continuing role as a *debtor-in-possession (DIP)*. They can sell assets, borrow money, and decide which contracts to perform on or breach. They can hire professionals and guarantee them priority repayment rights. The debtor also has the initial agenda control, through exclusive rights to propose plans of reorganization in the early stage of a case. Centralizing control in pre-bankruptcy management has several potential advantages. Agents can take more informed actions regarding the firm's operations and the negotiating process with creditors. Agents with good incentives might also be encouraged to take actions in the interests of the creditor collective rather than that of a single constituency.

But in the absence of good incentives, and with creditor rights weakened, agents might try to divert value to themselves. The creditor body might have causes of action against management for their pre-bankruptcy behavior that management can settle on the cheap. Managers might collude with secured

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[20] Consider the hypo of a lift stay motion that leads to an efficient liquidation…

[21] A standard part of the turnaround manager's playbook is the 13-week cash flow budget, which ensures that the company has the liquidity necessary to survive.

creditors via a reorganization plan that squeezes out unsecured creditors but retains value for their shares. Professionals can extract excessive fees for their services.

Not all bankruptcy systems allow management to remain in control. The most common alternative controllers are trustees and large creditors. But neither of these strategies is a panacea for agency problems. Trustees are typically neutral third-parties appointed at the time of bankruptcy. While they may be freer of conflict than a manager, they typically have limited knowledge and limited economic interest in the firm. This makes trustees prone to shirking problems. They may fail to devote sufficient time and energy to seeking the best possible transactions for the creditor body. A large creditor, by contrast, will have a stronger economic interest in the firm. But this may produce a greater conflict of interest with the other creditors, exacerbating the value diversion problem. The large creditor can try to steer the recovery toward his claim at the expense of the others. Creditor preferences are often divergent due to the diverse nature of creditor claims. Senior creditors tend to prefer speed, for example, while junior creditors tend to prefer delay. In short, an agency problem will persist in any system that gives some actors control over transfers that affect the creditor collective.

D. Connecting the Three Forces: The Trilemma

With these concepts in hand, we can summarize the trilemma. Creditor property rights take two primary forms: the right to take and the right to block. A commons problem can arise when multiple creditors have an individual right to take assets from the debtor, and no one has the power to block it[22]. When multiple creditors have rights to block transfers, this gives rise to the anticommons problems of holdout and costly delay. Finally, when there are (non-controlling) creditors who lack the power to seize or to block, they are vulnerable to agency costs by controllers. Agents can make value-diverting or non value-maximizing transfers at their expense, often by colluding with creditor coalitions who do have blocking rights.

An example can illustrate the trilemma in action. Suppose the creditor body consists of one secured creditor (S) owed 100, and 10 unsecured junior-priority creditors (the Js) each owed 10, for a total of 100 in unsecured claims. A manager (M) owns all the shares of the debtor corporation (D), and controls its operations. All loans are in default, so all creditors have the right to seize assets from the debtor to satisfy their claims. By virtue of S's security interest, S has seniority over the J's: S would be entitled to the first 100 from any sale.

The company's assets could be worth 150 if the company keeps running and the debt is restructured. But suppose this requires M's judgment to achieve. To represent this simply, suppose that it may be better to restructure quickly or slowly, and only M knows which option is better. If the better timing is chosen, then the assets are worth 150, but they are worth only 125 under the worse timing. Alternatively, if D is liquidated piece-meal, the creditors collectively receive some amount L, where $100 < L < 150$.

We now illustrate how, depending on the law in place, each of the problems of the trilemma can arise.

State law only: Pure commons. Suppose that the creditors are left to their state law devices. The junior creditors know that creditors outside of bankruptcy are satisfied on a first-in-time is first-in-right

[22] Here, the commons problem can result from a single creditor having the right to seize if uncoordinated multiple creditors must try to prevent it.

principle. This causes them to try to collect immediately. S will be paid first from any asset sale, so S will receive 100, and the unsecured creditors will collectively receive L-100. M will receive nothing.

The advantage of the commons outcome is that it vindicates non-bankruptcy priorities, and eliminates any value diversion by the agent. Priority as between the junior creditors and M is preserved. But the downside is value destruction, since L is less than 150.

Automatic stay only: Pure agency. Next, suppose that collection is stayed, and the Js have no power to block a sale of the assets. This opens up value diversion by M. M and S could arrange the following bargain: M will sell the assets to S for a price of 100 (the sale price will go right back to S, since S has priority over the Js in the distribution of estate value).[23]After completing the purchase, S will agree to steer 50 of the company's future value back to M through shares in the new company, or through a compensation package. S keeps the remaining 100 in value.

The advantage of this approach is that it maximizes the value of the assets. Knowing that M will keep any value above 100, she has the incentive to choose the correct timing. But the disadvantage is the potential ex-ante problems from failing to respect the priorities of the Js over M. A system that fails to maximize creditor recovery is one where the Js may stop investing. This could increase the cost of capital for healthy firms, one of the ex-ante goals of bankruptcy law[24].

Unanimous creditor voting: Pure anticommons. Now, suppose that we try to remedy this problem by allowing M to sell the assets, but all Js must agree to the sale. This would successfully block the agency outcome above: no J would vote for a sale that pays them zero. Like the commons solution, the blocking right ensures greater protection for the Js. M will have to offer them something. But the requirement that all ten unsecured creditors must approve an offer creates a risk that any holdout creditor will withhold his consent. He might risk delay—which costs all the Js collectively--to try for a greater payoff for himself in a bargain. This will likely make a quick resolution more difficult to achieve, even when that option is the value-maximizing one.

Following the discussion above, our trilemma can be cast in terms of virtues rather than problems. There are three potential virtues of an efficient reorganization procedure; it is possible to have two of the three but impossible to have all three. One is *ex-post value-maximizing,* meaning that the pool of assets is put to its highest-valued use by the conclusion of the procedure. This virtue is lost when the commons problem occurs, because valuable going concerns can be liquidated. Another is *priority-respecting*, which means that non-bankruptcy relative priorities between creditors and agents are respected. This virtue is lost due to agency problems when some creditors lack the right to take or block. And a third is *fast*, which means avoiding lost opportunities caused by delay. This is caused by the anticommons problem when creditors use their blocking rights to hold out for a greater payoff.

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[23] If S pays cash, the purchase price will come from S's right pocket, but it will go back into S's left pocket: S's senior claim against D entitles it to the first 100 from any sale proceeds D receives. This is, of course, the rationale behind allowing creditors to credit bid; i.e. use their debt as currency in the auction.

[24] Of course, the value that spills down to equity would encourage shareholders to provide funding more cheaply, making the priority issue irrelevant; this is the fundamental capital structure irrelevance proposition in Modigliani and Miller. But in our example, M is a manager—he may have provided no funding to the firm at all. Any priority deviation toward him may be a windfall of sorts for which the firm cannot extract any benefits ex-ante.

These goals are often recognized as key goals of a procedure. In 1930, William O. Douglas, a key figure in U.S. bankruptcy history to whom we will return, put the goals of reorganization this way:

> "Reorganizers and investors will at times have different objects in reorganizations. Investors will be interested in an expeditious [fast][25], economical [value-maximizing][26], fair [priority-respecting][27], and honest[28] readjustment of their company's affairs."

E. Alternatives When Some Conditions are Missing

So far, we have assumed the presence of commons, anticommons and agency problems simultaneously. Under these conditions, a full bankruptcy proceeding may be warranted, and the trilemma reveals the inherent challenges in deciding on an optimal procedure.

When some but not all of these conditions are not present, then lighter-touch solutions are preferable.

No commons. Suppose the commons problem is negligible, but anticommons and agency problems are present. This might occur in a situation where the firm needs to engage in restructuring transactions that are subject to blocking rights, but there is no immediate threat of a value-destroying run. These conditions justify procedures that can be negotiated outside of court but allow for overrides of holdouts. Prepackaged bankruptcies are an example of this kind of procedure. In a prepack, the firm negotiates a restructuring without the benefit of a stay. Once a plan is proposed and votes are solicited, the company can confirm a plan that provides forced exchanges of holdout creditor claims. But avoiding the confines of a stay preserves the power of covenants and other contractual rights to keep agency costs in check. The preservation of these contractual rights obviates the need for court oversight over transactions that create anticommons problems inside Chapter 11.

No agency. Next, suppose the agency problem is weak, but commons and anticommons problems are present. This might occur because the best course of action to resolve distress requires little firm- or distress-specific knowledge or expertise. In these situations, standardized governance measures can protect asset value and limit agency costs. One example is when there is no going concern value to preserve, and the assets need only be liquidated in an orderly way. In this situation, a procedure like Chapter 7 liquidation is sensible. Chapter 7 is a liquidation conducted under bankruptcy protection by a third-party trustee. A stay will be required to stop a disorderly creditor run, and overrides of creditor blocking rights, such as free and clear sales, may be necessary to maximize liquidation value by keeping complementary assets together. A neutral trustee can supervise the orderly liquidation of the assets. To be sure, trustees also need incentives to maximize estate value. But as compared to managers of going-

[25] "They will be concerned with having the business restored to an efficient and trustworthy management as quickly as possible, so that they may the sooner have dividend or interest payments on their investments resumed."

[26] "They will be concerned with the cancellation of burdensome contracts and with the collection of all assets of the company, whether these assets be in the form of claims against their officers, directors, and bankers for mismanagement and the like, or otherwise."

[27] "They will want fair treatment accorded them by those whose claims are senior and junior to their own."

[28] The desire for "honesty", though not one of the three goals we mention above, reflected Douglas's concern with agency problems: "If their company has been a preserve for exploitation, they will want to be rid of the despoilers. They will want an extravagant, wasteful, inefficient, or faithless management ousted from control and a new one installed. In other words, before the new venture is started they will want a complete accounting of the old; they will consider that no reorganization is complete unless there is such an accounting.

concerns, lower-powered incentives and simpler rules constraining the trustee's activity can work well enough to limit value diversion and wasteful delay.

No anticommons. Next, suppose the anticommons problem is negligible, but agency and commons problems are large. Multiple creditors have taking rights and agent discretion is necessary to maximize value. But suppose blocking rights are weak, or overriding them is unnecessary: this could occur because delay is not costly, or because unblocking restructuring transactions are not necessary to preserve value. These conditions can arise in situations of temporary liquidity stresses, like those created by the COVID-19 lockdowns in 2020. Under these conditions, a debt moratorium may be sufficient. A stay can be imposed that is long enough to weather the crisis, but these need not be coupled with reorganization plan provisions that allow nonconsensual exchanges of debt. Many EU countries passed moratorium legislation in 2020, and in the U.S., some bankruptcy courts used their equitable powers to create moratoria for bankrupt debtors.[29]

F. Bankruptcy Reform Proposals and the Trilemma

The academic literature offers many bankruptcy-alternative reform proposals. Some scholars have proposed replacing Chapter 11 with a mandatory auction. Others have devised proposals that try to quickly concentrate control in a residual claimant. One way is to give some classes of creditors options to buy out other classes[30]. Another is to cancel out the old shareholders and make the most junior class of creditors into the new shareholders[31].

A common feature of these proposals is that they assume away the benefit of an agent-led collective procedure. As we noted above, a primary role of agents in bankruptcy is managing the firm's liquidity. Reform proposals tend to assume liquidity problems away, along with the benefits of agents to manage them[32]. Take the mandatory auction proposal as an example. If there is a deep market of informed asset buyers willing to provide immediate liquidity—that is, to pay the full value of the company's assets in cash--the best course of action is an immediate auction. But an immediate auction never happens in any real-world bankruptcy systems. Developing an auction process takes time, and this requires expertise and judgment about how to design the auction in light of the firm's circumstances. How should a bidding process work? Who has the right to inspect the debtor's books and records to gather information required to bid, and how much time should potential bidders receive? Can bidders bid with securities in lieu of cash? These kinds of decisions are the frequent source of litigation in bankruptcy, even when all parties have committed to an auction. And when agents have more discretion over them, they can use this power to enrich themselves.[33]

Whenever delay is required before a final resolution—whether it be a sale or a traditional reorganization that restructures the claims-- judgment will be required about how to manage the firm's assets in the

[29] Cite to Modells case?
[30] Bebchuk 1988, Casey 2011
[31] Adler, Bradley and Rosenzweig
[32] LoPucki Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig, Michigan Law Review 1993.
[33] Cite to Per Stromberg, who finds that Swedish auction bankruptcy often results in sale-backs to management that divert value from unsecured creditors. Conflicts of Interest and Market Illiquidity in Bankruptcy Auctions: Theory and Tests, *The Journal of Finance*, Vol. 55, No. 6 (Dec., 2000), pp. 2641-2692.

interim. How much borrowing should the debtor take on, and what priority should it have? Can "critical vendors" be paid immediately in cash? Which contracts should be assumed or rejected?

A second set of reform proposals are based in freedom of contract principles[34]. These proposals tend to assume away the potential for law to improve upon commons or anticommons problems. Debtors, they argue, can eliminate harmful commons or anticommons problems by structuring their credit relationships optimally ex-ante. If these problems do exist, they were created intentionally and serve to limit ex-ante agency costs or provide some other benefit to the parties. As such, they argue that the best bankruptcy law is a freedom of contract regime that eliminates any mandatory features of the law, such as the automatic stay.

These arguments add value to the debate because they highlight that debtors have incentive to balance these problems contractually. Mandatory rules can undermine these solutions. But no real world bankruptcy system relies on a pure freedom of contract regime. This is likely because real-world bankruptcy systems cannot rely on an assumption of optimal contracting. They must be robust to the possibility of inefficiencies when multiple contracts interact[35].

IV. Bankruptcy's Balancing Strategies

In this section, we will discuss how U.S. bankruptcy law alters non-bankruptcy rights in ways that address each of the three problems. For each problem, we will give the primary example of each intervention, and then some secondary examples. Because any intervention to combat one problem tends to exacerbate at least one of the others, the law will commonly provide limits to the intervention. These limits have a few common forms, and we will postpone discussion of these limits and their forms to the following section.

A. Commons: The Automatic Stay

These are policies that weaken the exercise of an individual right to take assets from the debtor, where that right would be exercisable outside of bankruptcy. These rules typically do not eliminate the taking right completely; instead, they temporarily suspend the exercise of the right. This suspension buys time for the debtor to make decisions that can help the creditor collective. But time-buying can exacerbate agency problems by giving controllers more freedom to use the asset to divert value to themselves. It can also exacerbate anticommons problems. The suspension enlarges the pool of assets over which the creditor body has blocking rights, and it subsidizes delay to the extent the rights holder is not fully compensated for it.

As discussed, the automatic stay is the most prominent example of a bankruptcy policy targeting the commons problem. The stay puts all collection activity to a stop. This includes collection by secured and unsecured creditors, and other third parties that might alter the pre-bankruptcy status quo. Parties affected by the stay can ask the judge to lift it, subject to conditions we will discuss in the next section. As we noted above, the stay has a liquidity-creating effect for the debtor. By suspending collection and

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[34] Barry E. Adler, *The Creditors' Bargain Revisited*, 166 U. Pa. L. Rev. 1853, 1854 (2018).

[35] For two case studies where complex contracts and capital structures lead to inefficient interactions, see Kenneth Ayotte and Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 Yale L.J. Forum 363 (2021).

payment obligations, the stay frees up cash and other assets the debtor can use to keep the company running, make urgent payments, and support new borrowing[36].

Two key corollary issues regarding the stay are the scope of assets subject to it, and the claims it reaches. As to the assets, the law addresses this issue by creating a bankruptcy estate. Broadly, the estate constitutes all valuable rights of the debtor as of the time of bankruptcy. Acts against estate property are automatically stayed. But sometimes the commons problem extends beyond the debtor's property. If the debtor is part of a corporate group, key complementary assets may be located in parent or subsidiary entities that are not bankrupt themselves. Judges sometimes extend stays to non-debtor entities' property on this basis[37].

A second set of policies concerns a debtor's contracts with parties other than creditors. In particular, executory contracts are bilateral contracts: those where material performance remains outstanding on both sides. Examples include leases, intellectual property licenses, supplier and employee contracts. With respect to these contracts, commons problems can arise when a counterparty of the debtor has the right to terminate the contract and withdraw future performance. Anti-ipso-facto provisions target these commons problems. These provisions prevent counterparties from using bankruptcy or financial condition to trigger termination of the contract. Another element is time-creating provisions for the debtor to make decisions regarding executory contracts. For most executory contracts, debtors can postpone decisions on which contracts to keep (i.e. "assume") or abandon ("reject"). Cures of missed pre-petition payments and other defaults can be postponed until the assumption decision is made.

B. Anticommons: Reorganization Plan Classes and Cramdown

Broadly, these are policies that allow for overriding a blocking right that the party could exercise outside of bankruptcy. The reorganization plan rules are the key bankruptcy rules targeting the anticommons. The key features of plans in this regard are the creation of creditor classes and the cross-class cramdown power.

Outside of bankruptcy, a creditor's claim cannot be exchanged for a new claim, or other alternative consideration, unless the creditor approves it. The ability to block exchanges of their claims creates a risk of holdout: they might hope for other creditors to take the pain associated with debt reduction, and then try to collect on their original claim in full. This incentive can make restructuring harder to achieve. By voting for a plan of reorganization, creditors have the power to force exchanges of other creditors' claims, powers they do not have outside of bankruptcy.

Inside bankruptcy, a plan proponent can group claims together into classes of claims that are substantially similar. Unsecured trade creditors and bondholders, for example, can be placed together in an unsecured class of claims. Claims within a class must receive equal treatment under the plan[38]. The claimants then vote, and supermajorities within a class can bind minorities. Creating "teams" of creditors in this way prevents individual holdout creditors within a class from delaying a restructuring while preserving the blocking right on a class-wide basis. Similarly, the cramdown power gives a plan

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[36] Also mention 552 which limits the perfection of liens based on prepetition security agreements; this frees up collateral for a DIP loan.

[37] Add cite

[38] 11 U.S.C. 1123(a)(4).

proponent the ability to exchange the claims of all creditors in that class for replacement consideration, even when that class votes against the plan.

A corollary power that enables a forced exchange of claims is the discharge power. Any claims against the debtor that arise before confirmation of a plan are automatically discharged by the plan[39]. The discharge power renders void any pre-confirmation claim—it cannot be asserted against the debtor after the reorganization, so the creditor's compensation through the reorganization plan is their only payment.

Outside of reorganization plan rules, some bankruptcy rules target anticommons during the pre-plan restructuring phase of a case. One is the debtor's ability to sell assets free and clear of liens[40]. This power eliminates a secured creditor's blocking rights stemming from its security interest in the collateral. This can limit anticommons by enabling a sale of the going concern that a creditor secured by a key asset could otherwise block. In a similar vein, debtors also have the power to override antiassignment clauses that would allow a contractual counterparty to block assignment of a debtor's contract rights to a third party.

Finally, there are several rules that serve as liquidity providers by overriding blocking rights over new financing. Inside bankruptcy, a debtor-in-possession lender can receive a lien with priority over the existing liens[41]. Similarly, unsecured creditors cannot be subordinated to other unsecured creditors without their consent outside of bankruptcy; but bankruptcy allows debtors to give priority unsecured claims to new lenders and administrative expenses incurred during the case.

C. Agency Problems: Court and Creditor Approval of Transactions

The Bankruptcy Code imposes limits to a debtor's ability to transact that do not exist outside of bankruptcy. These limits address agency problems by increasing creditor blocking rights inside bankruptcy. Most transactions during the case that the debtor could undertake unilaterally outside of bankruptcy must be approved by the bankruptcy judge. For transactions in the ordinary course of business, the debtor can transact without court approval, but outside the ordinary course, transactions require notice and a hearing[42]. This gives creditors the opportunity to block the non-ordinary course transaction by objecting to it. The ordinary/non-ordinary course distinction strikes a balance between agency and anticommons concerns. If a retailer required a hearing before it could sell its inventory or pay its employees, for example, a holdout objecting creditor could do substantial damage to the debtor's ongoing business by imposing even a small delay, and there is low risk of the value-diversion concerns that would justify the delay. But if the debtor wanted to sell the entire going concern to a buyer, the risk of value diversion is higher and the need for immediacy is lower, so creditor blocking rights are stronger.

The global nature of a reorganization plan is also a response to agency concerns. Outside of bankruptcy, a debtor and a creditor can engage in a bilateral exchange of that creditor's debt. For example, the debtor might agree to settle a $100 debt due next year by paying the creditor $50 in cash today. But in bankruptcy, the exchange typically must take place in a plan of reorganization, giving the other creditors

[39] 11 U.S.C. 1141(d)(1)(A).
[40] 11 U.S.C. 363(f).
[41] 11 U.S.C. 364(d).
[42] 11 U.S.C. 363(b),(c)

the power to block this exchange by voting against the plan. Without this power, an agent might settle favorably with a preferred creditor and extract some value via the generous settlement.

A related agency cost-limiting tool is the ability of the trustee/debtor-in-possession to unwind fraudulent transfers that occurred prior to the filing. These transfers are ones that divert value from the creditor collective, or ones intended to "hinder, delay or defraud" them. The value of avoided transfers can be recovered by the bankruptcy estate for the benefit of the creditor body.

A second set of policies target payments to the agents and other service providers during the case. They place limits on the professionals that can be employed, limit their potential conflicts of interest, and place checks on the fees and other compensation they can receive from the debtor. Administrative expenses are limited to the "actual, necessary" costs of preserving the estate. Professionals serving in the case must be disinterested: they cannot hold securities or have some interest that is adverse to the estate.[43]Retention payments to executives are restricted, so executive pay must be performance-based[44].

D. Limits to Balancing Strategies

Each of the interventions above will necessarily increase at least one of the other problems in the trilemma. Thus, the Bankruptcy Code includes limits on these interventions. The limits can be put into three categories: valuation-based, ex-ante (or rule-based), and ex-post (or standards-based).

1. Valuation-Based Limits

The valuation-based limits give the non-debtor party the *value* of the non-bankruptcy right when the exercise of that right is taken away. In law-and-economics lingo, this limit protects the non-debtor party with a *liability rule* when bankruptcy law takes away an entitlement protected by a *property rule* (the right to take or block)[45]. These limits apply to both commons-focused interventions (like the stay) and anticommons-focused interventions (plan classes and cramdowns). For concreteness, we will discuss secured creditors as an example.

One example of a valuation-based limit on a commons intervention is the right to *adequate protection* for secured creditors. As noted above, the automatic stay limits a secured creditor's right to take its collateral to address commons problems. But the law requires that the debtor make adequate protection payments[46] to the secured creditor for any collateral value declines that occur as time passes in the case. If the debtor cannot make these payments, the judge must lift the stay[47]. Similarly, when a secured creditor's right to block a superior lien is taken away, the secured creditor is entitled to adequate protection to compensate for the impact of the superior lien. Adequate protection payments limit anticommons consequences of the stay, protecting the secured creditor against the cost of delay

[43] 11 U.S.C. 327.
[44] 11 U.S.C. 503(c).
[45] Cite to Calabresi and Melamed on property and liability rules; Buccola, Bankruptcy's Cathedral
[46] 11 U.S.C. 361.
[47] 11 U.S.C. 362(d)(1).

that holdout creditors might impose on it. It also protects against agency, limiting the ability of a controller to use delay to extract concessions or otherwise divert value[48] from that creditor.

There are also valuation-based limits to anticommons interventions. A plan proponent can cram down a reorganization plan over a secured creditor class who seeks to block it. But cramdown requires a determination that the creditor will receive the value of their security interest. This is usually done by assuring that the creditor receive a new secured note with present value equal to the value of their secured claim[49]. Similarly, if the debtor wants to sell collateral free and clear of the security interest, the judge must be satisfied that the sale proceeds gives the secured creditor the value of their lien[50].

2. Rules-Based Limits

The second kind of limit is a rules-based limit. These limits define certain conditions under which the law will lean more strongly in favor of the non-debtor. An example of a rules-based limit to a commons intervention is the single asset real estate (SARE) case. This status targets passive real estate investments, which tend to be financed by a single secured creditor. In these cases, the debtor must propose a reasonable reorganization plan or commence adequate protection payments quickly, or the stay will be lifted. The more creditor-protective SARE status is justifiable, because agency costs are higher and commons problems are lower for these kinds of debtors. Received wisdom is that bankruptcy filings in SARE cases are made for agency reasons, to stave off foreclosure and increase bargaining power against the foreclosing creditor. The risk of a value-destroying run is unlikely because SAREs tend to be financed with a dominant single creditor. And the passive nature of the debtor's investment means lower risk that an operating business will be torn apart by creditor collection[51].

3. Standards-Based Limits

A third type of limit is a standards-based limit. These limits create broad guidelines that courts must interpret ex-post. The key standards-based limitation to the commons intervention (i.e. the stay) is the power of the judge to dismiss the case "for cause". Dismissal vacates the stay and restores the status quo prior to the bankruptcy.

The Code instructs judges to consider the anticommons costs of delay: they may not dismiss when a plan will be confirmed "within a reasonable period of time"; on the flipside, cause for dismissal includes "continuing loss to or diminution of the estate." Courts have read into 1111(b) and the "for cause" requirement that a case must be filed in good faith. Broadly, these are situations where agency costs, and not a commons problem, are the primary motive for the filing. Courts have dismissed cases where they find an absence of financial distress, and where the debtor files the case only to achieve a tactical litigation advantage[52].

E. Interacting provisions and interacting goals: DIP financing and Preferences

[48] Unsecured creditors also receive valuation-based protections such as the best interests test and the absolute priority rule. Add that here?
[49] 11 U.S.C. 1129(b)(2)(A)(i).
[50] 11 U.S.C. 363(f)(3).
[51] Cite to Charles Jordan Tabb treatise, p 311.
[52] In re SGL Carbon, 3rd circuit 1999.

1. Debtor-in-Possession Financing

The previous section described bankruptcy policies in isolation that targeted one of the three problems in the trilemma. But in some cases, multiple provisions interact to balance the three goals. The Bankruptcy Code's financing provisions provide one example of this interaction. Bankruptcy, as we've discussed, plays a valuable role as a liquidity provider[53]. This happens through an interaction between the stay in Section 362, and the Code's DIP financing provisions in Section 364. The stay stops any ongoing creditor collection, which frees up cash for the debtor. In addition, the stay prevents parties from initiating any new litigation that would occur when debtors breach covenants in their debt contracts. Most credit agreements and bond indentures contain provisions that limit the ability of the debtor to incur new debt. If the debtor were to violate these provisions outside of bankruptcy, it would trigger the creditor's right to accelerate the debt, allowing the creditor to collect the full amount immediately. The default might also trigger acceleration by other creditors, because debt contracts commonly contain cross-default clauses. The stay stops these commons problems, and as such, allows the firm to take on new borrowing inside bankruptcy without any hindrance posed by contractual covenants. In this sense, the stay is a liquidity providing provision, even if it is not typically seen as such.

Of course, our trilemma framework suggests that the stay's liquidity providing role will exacerbate a different problem—in this case, the agency problem that these same debt covenants were set up to prevent. As a result, the Code's DIP financing provisions are mostly *limits* on the debtor's ability to borrow[54]. Section 364(c), the Code's most relevant section, allows the debtor to take on new borrowing secured by unencumbered assets, and by giving junior liens on encumbered assets. These provisions, by themselves, do not give the debtor any power they did not have outside of bankruptcy. The stay increases the debtor's power by taking the teeth out of covenants. Section 364(c), then, replaces the creditor protection of a taking right with a limited creditor blocking right. This addresses the agency concern that the bankrupt firm might over-borrow, or borrow too expensively. Creditors can object to the terms of DIP financing and force a hearing. Courts can deny the new financing when they believe it does not benefit the estate.

Anticommons concerns also animate DIP financing rules. Congress did not give creditors veto power over financing, as some countries do[55]. This is likely because the need for financing can be too urgent to submit it to a vote, and a holdout can do too much damage to firm value by holding up a financing. For similar reasons, new debt can also take priority over the general unsecured creditors as an administrative expense, and priority over lien creditors under limited circumstances. These priorities are not available outside of bankruptcy.

2. Preferences

One of the more vexing sections of the Bankruptcy Code is the section on voidable preferences. In simple terms, it gives the trustee/DIP the power to claw back transfers made to unsecured creditors in the wake of bankruptcy. This power is sometimes justified based on a norm of equality among the creditors. But

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[53] Cite to Ayotte and Skeel, Bankruptcy Law as a Liquidity Provider, U. Chi. L. Rev. 2013.

[54] This fundamental point is emphasized by George Triantis, A Theory of the Regulation of Debtor-in-Possession Financing, 46 Vand L. Rev 901 (1993).

[55] Some countries, such as Chile and India, do give creditors a veto. See Aurelio Gurrea Martinez DIP financing article.

scholars largely condemn this norm: David Skeel has called it an "empty idea"[56] that is not reflected in bankruptcy law as a whole. After all, debtors are free to elevate the priority of secured creditors over unsecured creditors by contract. And even in the law of preferences, there is a crucial safe harbor protecting creditors: those who receive a preferential payment in the "ordinary course of business" are entitled to keep their payment. If the law really wants creditor equality, it is doing a poor job of achieving it.

A different explanation for avoiding preferences is that it addresses the commons problem, discouraging a run that would begin before the filing[57]. But preference law does a poor job addressing that goal, too. Avoiding a preference requires costly litigation, and an unsuccessful defendant pays no penalty: he must only return the value received. So there is little harm in trying to collect. Moreover, transfers outside the 90-day window preceding bankruptcy are automatically safe; it is not hard for a diligent creditor to achieve safety with a bit of advance planning.

The history of preferences suggests that the doctrine has a confused and aimless quality because it has targeted different problems at different times. The English law origins of preferences were targeted more at agency problems than commons. As such, the concern behind preferences was similar to the agency problem-oriented goals underlying fraudulent transfers. A discredited bankrupt debtor, English courts reasoned, should not be able to decide which creditors should collect. The debtor might favor relatives, insiders, or other friendly parties, ultimately serving his own purposes[58]. Over time, Parliament developed an "ordinary course of trade" exception to protect innocent creditors who had no knowledge of the debtor's impending bankruptcy[59]. Early American law followed this pattern. Bankruptcy acts in the 1800s required that the trustee establish the debtor's intent to prefer the creditor.

V. Revisiting the History of U.S. Bankruptcy Law

The history of corporate reorganization in the U.S. reveals that the three forces in our trilemma. Over time, economic forces affecting the asset and liabilities sides of firms have shifted, affecting the severity of the three problems. As the severity of the three problems changes, policy responses move toward solving the most pressing ones. But inevitably, the changes worsen one of the others, leading to reform pressure in that direction as time passes. In this section, we draw heavily from excellent histories on the subject by Douglas Baird[60], Mark Roe[61], and David Skeel[62]. We add little to their historical evidence. But reframing the law through our trilemma framework simplifies and standardizes the narrative, showing the fundamental tension between the three forces. Each time a policy change targeted one of these forces, it created one of the others.

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[56] See David A. Skeel, The Empty Idea of Equality of Creditors

[57] See Jackson, Logic and Limits, p. 126: ["It is, in short, designed to deter individual opt-out behavior that would undermine the advantages to be gained from the collective proceeding."]

[58] See Robert W. Weisberg, Commercial Morality, the Merchant Character, and the History of the Voidable Preference, 39 Stan. L. Rev 3, at 41.

[59] Weisberg, id, at 41.

[60] Baird, *The Unwritten Law of Corporate Reorganizations*

[61] Roe, The Three Ages of Bankruptcy *Harvard Business Law Review*, Vol. 7 (2017)

[62] Skeel, Debt's Dominion: A History of Bankruptcy Law in America.

A. Era 1: Railroads and the Equitable Receivership (1850s-1938).

The first major era in U.S. corporate reorganization history is the receivership era, spanning from the late 1800s through the early years of the Great Depression. During this era, the birth of the equity receivership procedure improved commons and anticommons problems, but increased agency problems.

The most important large corporations of this era were railroads. Railroads were capital-intensive and financed primarily with secured bonds. Bondholders were often overseas creditors, distant from the borrower, and dispersed. Moreover, railroads had complex legal entity structures due to mergers of railroad entities with their own separate debt structures. The rise of more dispersed and more complicated creditor structures increased commons and anticommons problems that complicated debt exchanges outside of court. The commons problem was the risk that creditors might exercise individual foreclosure remedies and seize the portions of the track that constituted their collateral. The anticommons problem was the difficulty of securing creditor consent to a capital structure adjustment that would reduce or restructure the debt.

The equitable receivership procedure used the devices of receivership and foreclosure to address the commons and anticommons problems, respectively. On the commons front, a court-appointed receiver would take control of the debtor's assets, creating a stay of creditor collection. Using federal rather than state courts to engineer the receivership was particularly useful in addressing the commons problem, because it expanded the scope of the stay to assets that crossed state lines.

The stay prevented the creditor run and bought time for restructuring negotiations. Next, investment banks would form protective committees to represent bondholders. By "depositing" their bonds with the committee, the bondholders would give advanced consent to the restructuring plan the investment banks formed. Management was typically appointed as the receiver, and would run the railroad in the interim while negotiations took place.

Once a deal was arranged, a debt exchange would be implemented through the formal device of a foreclosure sale of the railroad's assets. Typically, the only "bidder" in the foreclosure auction was the protective committee, using the deposited bonds as currency. Using the foreclosure sale as a restructuring tool was more than just formalism, though: it effectively addressed the anticommons problem of holdout creditors. The holdouts had to be paid in cash based on the sale price at the auction. But a large, distressed railroad is an illiquid asset that rarely drew bidders other than the committee of its existing creditors. Since the committee was the only bidder, they could bid a price well below the company's value, extinguishing the holdouts on the cheap.

Relative to the no-bankruptcy world that preceded it, the equity receivership greatly increased the powers of agents. Management remained in charge without the threat of creditor action. Lawyers and investment bankers received fees for managing the receivership procedure. Over time, agents added new features that cemented their control and limited competition. For an unhappy creditor, there was little they could do to drive the process: the protective committees could set the terms of the restructuring, and their own fees, unilaterally[63].

Two modifications to receivership procedures in this era addressed agency costs of collusion between controlling parties and creditors. One was the addition of upset prices by courts. These prices were minimum guarantees to minority creditors in a class of claims, protecting them against an unfair cash out price. In practice, however, courts typically set upset prices at low levels. Courts favored solving anticommons problems over agency problems: they were unlikely to risk a successful restructuring to protect holdout creditors.

A second agency-limiting modification was the Supreme Court's decision in *Northern Pacific Railway Co. v. Boyd*. This decision defended the interests of unsecured creditors against collusion by management with secured creditors. Typical terms of a restructuring would involve giving most of the company's value to the secured creditors. Shareholders could keep their shares by paying an assessment, set at a price low enough to ensure participation. General unsecured creditors typically received nothing. The Supreme Court held in *Boyd* that unsecured creditors were entitled to a "fair offer" before their claims could be eliminated. This protection increased anticommons problems, as now the unsecured creditor constituency had to be included in the reorganization bargain. Over time, though, lawyers devised reorganization plans that passed muster with courts and avoided significant holdout problems.

When the Great Depression struck, Congress codified corporate reorganization for the first time in Sections 77 (railroads) and 77B (non-railroad corporations). These codifications took stronger steps to address anticommons problems. Liquidity problems caused by the onset of the Depression made paying holdouts in cash more difficult. Sections 77 and 77B allowed for supermajority voting provisions in restructurings for the first time. This allowed reorganizers to force holdouts in a class to accept an exchange into other securities instead of cash.

In summary, the receivership era altered non-bankruptcy restructurings by targeting both commons and anticommons problems. These changes increased the power of agents to control outcomes and to affect their own compensation. The Chandler Act reforms in 1938 would squarely address these agency issues, changing corporate reorganizations drastically.

B. Era 2: The Chandler Act Era (1938-1978).

The early Depression-era responses further empowered agents and reduced anticommons problems. But the 1938 Chandler Act engineered a complete reversal from the pro-agent focus of the receivership era. The Chandler Act was spearheaded by former Yale Law professor William O. Douglas. Douglas's extensive SEC-sponsored study of protective committees emphasized the primacy of agency costs in receiverships. Bankers, lawyers and management, he believed, created a process that worked entirely in their own interests and at the creditors' expense. Professionals extracted excessive fees. Valuable

[63] Both Baird and Skeel suggest, however, that investment bank's reputational concerns kept agency problems in check. Investment banks were repeat players. They had incentives to generate fair recoveries for creditors in the receivership because their future underwriting business depended on it.

causes of action against management for their pre-bankruptcy misdeeds were buried. The main victims of this collusive behavior, Douglas argued, were small bondholders who were insufficiently active or informed enough to defend their claims.

The Chandler Act tried to remedy these agency problems toward a public administration model for large corporations. Under Chapter X of the Act, management was automatically replaced in favor of a neutral trustee. Interested parties with prior relationships, such as the debtor's bankers and lawyers, were wholly excluded from the process. The Securities and Exchange Commission took an active role in choosing trustees and weighing in on reorganization plans.

Another agency-limiting development at the time, also championed by Douglas, was the absolute priority rule. The APR was established in *Case v. Los Angeles Lumber Products*. Douglas had ascended to the Supreme Court by that time, and he authored the opinion. In the case, a small holdout bondholder dissented from a plan in which over 90% of the bondholder class approved. The plan reserved some equity in the reorganized debtor for the old stockholders due to the value they would add to the ongoing company. The *Case* opinion clarified the legal meaning of the phrase "fair and equitable": unsecured creditors were entitled to full payment before shareholders could retain value. Douglas saw the *Case* opinion as a complement to the Chandler Act reforms in "curb[ing] the reorganization racketeers", such as investment bankers, who controlled the process.

Baird notes the anticommons problems the *Case* decision enabled. The holdout bondholders in Los Angeles Lumber were the modern equivalent of distressed creditors; they acquired the debt at a substantial discount and used their blocking power to extract full payment on their claim. The need to satisfy these holdouts proved fatal to the company. It was not able to reach a deal with the holdouts for partial payment. Eventually, the parties reached an agreement that shut out the old equity holders, but taking them out of the picture led to the company's ultimate liquidation.

In retrospect, most commentators consider the Chandler Act era reforms a failure. They completely eliminated value-diverting agency problems by managers and controllers by eliminating bankers, lawyers, and pre-bankruptcy managers. But it created agency costs of a different type. Trustees and government regulators, with low-powered incentives and limited information, allowed cases to languish for years without resolution. The ability of individual creditors to insist on absolute priority made this problem worse. Patients in bankruptcy died on the operating table waiting for the SEC and courts to weigh in on plans[64]. And given the harsh treatment of management in bankruptcy, companies avoided triggering the procedure until it was too late.

The last major era is the Chapter 11 era. But it would be oversimplifying to lump large corporate reorganization practice over the past 45 years into a single theme. Instead, we describe the Chapter 11 era in three "acts" with unique themes and problems.

C. Era 3: The Chapter 11 Era (1978-present)

The 1978 reforms that became today's Bankruptcy Code evolved from a loophole. Though the trustee-led Chapter X was intended for large, public firms, the Chandler Act also created a separate procedure, Chapter XI, that allowed management to stay in control and did not require absolute priority in

[64] Roe, Three Ages, at 200-201: ["The common cliche was that the patient was dying on an operating table, while all waited for the doctor (the SEC and the courts) to arrive to recommend how to operate."]

distribution. Chapter XI was intended for small, private firms, but Congress did not explicitly restrict its access to those firms. Over time, companies of all sizes sought out Chapter XI to resolve their distress.

Today's Chapter 11 evolved from the Chapter XI procedure. By replacing the trustee-based system with a debtor-in-possession model, agency problems have shifted back from shirking toward value diversion. The absolute priority rule remains in the law, but the Bankruptcy Code makes APR a class-based right, rather than an individual right. This takes away an individual creditor's blocking right when a supermajority of his class favors the plan.

Though the Bankruptcy Code has changed only slightly, its use in practice has changed dramatically. Changes in capital structures and capital markets are the main cause. In particular, the rise of secured debt in large company capital structures reduced the power of agents to control cases, forcing management to collaborate with them. More recently, increasing dispersion of secured creditors has intensified potential anticommons problems. Agents have responded to these pressures strategically by squeezing reorganizations into pre-plan transactions, where creditor blocking rights in the Bankruptcy Code are weakest. Courts have largely responded to these tensions with permissive rulings that have enabled greater agency problems. One reason for this is the rise of forum shopping and forum seeking. We describe these developments below in our three acts.

1. Act I: Management in control (1978-2000)

Mark Roe characterizes the early years of Chapter 11 as a dealmaking, or business-judgment rule era. Largely freed from the oversight of public officials, managers and their creditors were free to craft reorganization plans that restructured debts and allowed more distressed firms to survive. Compared to the Chapter X/Chandler Act era, this represented a definite improvement. But a more pessimistic view of the era is that it served to increase agency costs. Lynn LoPucki characterized this era as "debtors in full control". By eliminating creditors' taking rights, management could operate for years in bankruptcy. The LTV Steel bankruptcy, for example, spent a full seven years in bankruptcy before completing its reorganization. An influential case study by Weiss and Wruck on the disastrous Eastern Airlines bankruptcy epitomized the problems of this era[65]. Eastern sat in Chapter 11 protection for two years, burning through half the company's value in losses before ultimately liquidating. Professors Bradley and Rosenzweig provocatively argued that Chapter 11 should be repealed entirely in favor of a more creditor-friendly, market-based system.

2. Act II: The 363-sale era (2000-2010)

The main reason that bankruptcy shifted so much control to agents in the early era was the unsecured-debt heavy capital structures of that age. Many of the prototypical large Chapter 11 cases in the early 1990s were failed leveraged buyouts financed with unsecured junk bonds. As we've discussed, the unsecured creditor's main power comes from the right to take, and the stay removes the taking right. For unsecured-heavy debt structures, then, a bankruptcy filing entails a large power shift toward agents.

As time passed, the capital structures of bankrupt firms became more secured debt-heavy. Since the blocking rights of secured creditors are mostly preserved in bankruptcy, the increase in agent power

[65] Weiss and Wruck, Information problems, conflicts of interest, and asset stripping: Chapter 11's failure in the case of Eastern Airlines. 48 J. Fin. Econ. 55,1998.

caused by a bankruptcy filing is much smaller. Secured creditors can almost always block priming DIP loans, and they can block sales that do not pay them the full value of their liens.

Though there are many reasons for the rise of secured financing, one was a change to Article 9 of the Uniform Commercial Code in 2000 that facilitated liens on bank accounts[66]. These changes increased secured creditor control over the debtor's cash, allowing them greater informal control over case outcomes. Other significant changes included the rise of activist investors in bankruptcy. This facilitated the concentration of debt positions, and increased liquidity for asset sales.

All of these developments contributed to the representative case in this era: the secured creditor-driven quick sale through Section 363. Scholars differ on the efficiency consequences of this era. Some characterize it similarly to the agency problems in the railroad receivership era—one where management and professionals are forced to collude with secured creditors against unsecureds, but are able to divert value nonetheless. Lynn LoPucki and Joseph Doherty describe the Polaroid 363 sale as one example. One Equity Partners, a private equity buyer, acquired Polaroid at a fire sale price, and rehired old management with a generous equity grant. Melissa Jacoby and Edward Janger suggested an "ice cube bonds" proposal to cure the fire sale agency problem: some proceeds of a quick sale should be held in escrow to cover unsecured creditor claims about value and priority that the quick sale would otherwise wash away.

Other scholars saw this era in a more positive light. Through the lens of our trilemma, secured creditors replaced management as the controlling agents. Secured creditors as agents have interests that diverge from unsecured creditors, but secured creditors as agents generate smaller costs than the manager-driven agency costs of prior eras. Sophisticated parties design contracts that allocate control to parties well-placed to exercise it. Secured creditors may prefer quick sales, but well-developed capital markets can absorb them.[67]The main benefit of bankruptcy in this world is to overcome the holdout problems that non-bankruptcy law imposes on the parties.

3. Act III: Today's Chapter 11

Over the last decade, more profound shifts in capital structures have occurred in large Chapter 11 practice. Like the early 1990s, private equity-sponsored leveraged buyout cases have shaped restructuring trends in the post-financial crisis era. Agency costs take a different and more intense form in these cases than in the 363-sale era that preceded it. Much like the equity receivership era, professionals play a prominent role as both engineers and beneficiaries of value diversion strategies.

Capital structures continue to trend away from unsecured credit and toward secured credit. Newer variants of secured debt in capital structures include second lien debt as a junior priority security. In addition, the collateralized loan obligation (CLO) has replaced unsecured bonds as a way for passive investors to hold pools of diversified positions in corporate debt. Collateralized loan obligations (CLO) vehicles hold a majority of syndicated secured loans. A term loan facility can frequently have hundreds

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[66] Adler, B., V. Capkun, and L. Weiss, 2013, Value Destruction in the New Era of Chapter 11, Journal of Law, Economics, and Organization 29, 461-483.

[67] "We are not troubled by such a shift in bankruptcy practice. As a comparative matter, the senior lender who will not be paid in full will more likely exercise control in a sensible fashion than will managers whose net worth depends on continuation or a bank-

of CLO holders[68]. These trends have made it more common for the fulcrum security in a restructuring to be an uncoordinated pool of secured creditors, rather than unsecured.

For agents, this means that value diversion is no longer as simple as conducting a 363 sale. It requires devising complex transactional maneuvers, clever contract interpretations, and aggressive bankruptcy strategies to get around secured creditor blocking rights. This new era, described as "bankruptcy hardball"[69], has been a boon for professionals because of the sophistication it requires. Fees in large cases have risen precipitously in recent years[70], increasing pressure on creditors to devise strategies that avoid bankruptcy altogether.

a) Post-crisis leveraged buyouts

In the post-financial crisis era, private equity-sponsored leveraged buyouts have been trend-setters. These cases are usually deeply insolvent, so there is no serious argument that shareholders are entitled to any value. Nor are there serious disputes about whether the company should survive or liquidate. Instead, the main interest of management is minimizing liability on litigation connected to the pre-bankruptcy LBO transaction and subsequent out-of-court restructurings.

These litigation rights are assets of the bankruptcy estate, and their settlement value drives creditor recoveries. In the Caesars bankruptcy[71], for example, the main conflict in the case involved fraudulent transfer and fiduciary duty litigation against the private equity owner, Apollo, and its principals. Sponsors like Apollo and the LBO secured lenders are commonly defendants in LBO litigation. But these parties exert control over the plaintiff debtor: sponsors through their management of debtors-in-possession, and secured lenders as the source of DIP financing.

When litigation rights are involved, reorganization plans provide a more favorable path than 363 sales; a confirmed reorganization plan can more easily provide for releases of liability. This may be one reason why the pendulum has shifted away from 363 sales and back toward traditional reorganizations.[72] Agency costs are clearly large in these reorganizations: management and the lenders have both the incentive and the power to minimize the value of litigation against themselves.

Debtor-side professionals have created new transactional devices and strategies to assist agents and favored creditors in collusive strategies. One is the restructuring support agreement (RSA). The RSA is an agreement between the debtor and a subset of creditors, arranged near the beginning of a bankruptcy case. The RSA specifies a timeline for how the case will proceed, and outlines payoffs in the eventual reorganization plan. The RSA functions as a de-facto transfer of bankruptcy process control from the debtor to the lender signatories; management is bound by the agreement to pursue the plan outlined in the RSA. The RSA is typically tied to the DIP loan, so that the debtor loses access to bankruptcy financing if they try to pursue an alternative plan[73]. In return for selling control of the case, management bargains

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[68] Berlin, Nini and Yu find an average of 155 CLO lenders in their institutional term loan data. Concentration of Control Rights in Leveraged Loan Syndicates, Mitchell Berlin, Greg Nini, and Edison G. Yu, J. Fin. Econ 2019.
[69] Jared A. Ellias and Robert J. Stark, *Bankruptcy Hardball*, 108 *Cal. L. Rev.* 3 (2020).
[70] https://creditorcoalition.org/data/
[71] For an in-depth narrative, see Max Frumes and Sujeet Indap. The Caesars Palace Coup.
[72] Add cite
[73] Ayotte and Ellias, Bankruptcy Process for Sale, Yale J. Reg 2022.

for releases from liability and payment through management incentive plans. Any left-out creditors face an uphill battle to preserve value when the RSA-driven plan is to their disadvantage.

b) Creditor-on-Creditor Violence and Forum Shopping

RSAs shift bankruptcy decision-making to the early stages of a case. This serves strategic goals for the agents. Management receives more deference—i.e. weaker creditor blocking rights--regarding operational decisions, such as DIP financing, than they do on plans of reorganization. From the perspective of our trilemma, this policy makes sense. The operational decisions that implicate asset values are more time-sensitive and place firm value at greater risk, so anticommons problems are plausibly more severe. And operational decisions require more managerial expertise than decisions regarding the payoffs in a reorganization plan, so greater deference to agents is warranted.

But areas of the Code that are targeted more at fighting anticommons problems also create greater agency problems. Weaker creditor blocking rights over operating transactions gives agents incentive to bundle reorganization plan payoffs into these pre-plan transactions. Priorities can be undermined through these transactions in ways that reorganization plan rules are set up to prevent. In this new environment, restructuring professionals have taken a more assertive role by using the anticommons threat strategically.

The J.C. Penney bankruptcy illustrates how a pre-plan bundling strategy can undermine the equal treatment of same-priority creditors[74]. In a reorganization plan, an individual creditor can block any plan that does not provide the same treatment to all members of his class[75]. In the J.C. Penney case, a majority coalition of first lien lenders navigated around this constraint by channeling their superior recovery into a DIP loan rather than a plan. They arranged the DIP loan to have seniority over the first lien group, and the loan included expensive fees and interest. They eliminated competition from a minority group's loan proposal by convincing the judge that the exigent circumstances did not permit a hearing on it. The loan terms also gave the majority group control over the case process. This enabled the majority group to engineer a sale to entities they controlled on a tight timeline. The rushed sale enabled the majority to buy the assets at a discount, generating a recovery well above 100% on their DIP loan principal. If the fees and extra return on principal are expressed as interest on the DIP loan, the interest rate would be over 565%.

As in earlier eras, there are two ways to see these developments. The justification offered by the companies is that these are necessary responses to more severe anticommons problems. As the J.C. Penney case illustrates, in modern capital structures, secured creditors can be the fulcrum security, with the fulcrum class held by numerous, uncoordinated creditors. The company filed for Chapter 11 during the COVID lockdowns, when the survival of the company was clearly at risk. Under these circumstances, time may not permit full consideration of the rights of a holdout group of creditors[76].

The less sanguine perspective is that outcomes like these followed from a rise in unchecked agency costs. Intensification of forum shopping may be one driver of this change. The bankruptcy venue rules

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[74] See Kenneth Ayotte and Alex Zhicheng Huang, Standardizing and Unbundling the Sub Rosa DIP Loan, Emory Bankr. Dev. J.

[75] 11 U.S.C. 1123(a)(4).

[76] A different, sanguine view is that respecting priority as between sophisticated parties is less important than protecting the rights of the unsophisticated. See Baird's recent article.

give debtors and their agents substantial flexibility about where to file their case. In the 1990s, large cases filed primarily in Delaware and the Southern District of New York. Academics, including one of us, debated whether these developments were helpful or harmful[77]. Critics noted a higher refailure rate of Chapter 11 reorganizations filed in Delaware; supporters noted Delaware's greater speed and experience.

But forum shopping today is like 1990s forum shopping on steroids: it may be better characterized as judge shopping rather than forum shopping. The J.C. Penney case was filed in the Southern District of Texas and heard by Judge David Jones. After becoming the chief judge in the district in 2015, Jones collaborated with lawyers from Kirkland and Ellis, the largest debtor-side law firm, to create complex case procedures for large companies that would make filings attractive. These procedures guaranteed that either Jones, or his colleague Judge Marvin Isgur, would hear any large cases filed there. The strategy was successful: in 2023, the Southern District of Texas heard nearly half of all large bankruptcy cases[78]. In addition to the J.C. Penney case, Jones made rulings in other high-profile cases, such as Neiman Marcus and Serta[79], that paved the way for debtor-favorable exits from bankruptcy.

In 2023, Jones was forced to resign his judgeship due to allegations of judicial misconduct. Jones's romantic partner and former clerk, Elizabeth Freeman, served as an attorney for the law firm Jackson Walker in cases in which Jones presided and awarded fees. Jones did not disclose this relationship, as required by federal law rules of judicial conduct. Kirkland and Ellis knew of the relationship, and reportedly hired Jackson Walker as co-counsel to create a back channel to the Houston judges[80]. The Jones scandal demonstrates the corruption of the bankruptcy system that can result when courts collude with lawyers to create a friendly forum[81].

c) *Mass Torts Cases: Injunctions, Releases, and Texas Two-Steps*

A mass torts case is a bankruptcy case brought about by harms caused by the debtor's pre-bankruptcy activity that affect many potential claimants. These cases also create trilemma problems of commons, anticommons, and agency. There are risks of asset value-destroying runs, holdout problems, and risks that agents will divert value or shirk. But in a mass torts case, there are additional considerations, due to the special nature of the liabilities, that intensify each of these problems.

Start with commons. Tort claims are involuntary claims: the claimants did not choose to contract with the debtor. Without a bankruptcy, the grab race of individual litigation against an insolvent debtor can mean that early plaintiffs may recover in full while late arriving plaintiffs are shut out. This effect is true for any firm facing financial distress. But in a mass torts case, plaintiff claims can be large relative to their wealth, and claimants cannot diversify their exposure to the firm as easily as a contract claimant can. Unlike contractual claims, there is no chance that private contracting would have addressed the

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[77] Ayotte and Skeel An Efficiency-Based Explanation for Current Corporate Reorganization Practice, Chicago Law Review. Lynn M. LoPucki, Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts.
[78] See Sujeet Indap, The downfall of the judge who dominated bankruptcy in America, Financial Times November 21, 2023.
[79]Sujeet Indap and Eric Platt, Big debt investors dealt blow in mattress maker bankruptcy ruling, Financial Times Mar 28, 2023.
[80] Indap downfall article
[81] Wall Street Journal Article, Nancy Rapoport article.

problem in advance. These differences mean that ensuring equality of distribution among tort claims is more important than it is among ordinary contract claims. A bankruptcy grab race would undermine this insurance motive.

Next, consider anticommons. These problems can be larger in a mass torts case as well. In a mass torts case, claims from the debtor's harm may take years to manifest, and years to reduce the known claims to judgment. Under these circumstances, waiting for all claimants to be known so that they can negotiate exchanges with the debtor could take years, or even decades. At the same time, the cost of delaying payment to tort victims can be larger than delay of contract claims. Victims may be manifesting immediate medical costs or other liquidity needs caused by the debtor's harmful conduct.

Finally, agency problems can be harder to control in a mass torts case. Unsecured contract creditors have devices to control agency costs that tort claims do not. Bonds have covenants that limit value-diverting activity. Trade creditors have a threat to cut off future relationship with the debtor. Sophisticated parties, like hedge funds, can buy contract claims and fight for greater recoveries. Lacking all of these forms of leverage, tort claims are much weaker by comparison. Controlling agents can also be stronger: they may be large parent corporations, with greater resources and abilities to arrange value-diverting transfers.

We can now analyze a few of the controversial questions in mass tort bankruptcies using our trilemma framework.

d) Third Party Releases

A particularly controversial part of the mass torts case concerns the liability of affiliated third parties who are connected to the debtor, but who are not debtors in bankruptcy themselves[82]. These parties are connected in some way to the harmful conduct that precipitated the debtor's bankruptcy. But some claimants have direct claims against these affiliated parties, rather than (or in addition to) claims against the debtor. The debtor may also have claims against the affiliates, and the affiliates may be willing to contribute money to a fund to settle all the claims against it. As a condition to providing the money, they ask bankruptcy courts for releases (i.e. discharges) of their liability to claimants as part of the reorganization plan.

In the Purdue Pharma case, the affiliated parties were members of the Sackler family who owned and controlled the opioid manufacturer prior to its bankruptcy. The Sacklers diverted over $11 billion from the company prior to its bankruptcy in the form of dividends and other distributions. These diverted funds made the Sacklers defendants in potential fraudulent transfer actions by the Purdue estate. As such, Purdue is a creditor of the Sacklers. At the same time, the Sacklers are creditors of Purdue, via agreements by Purdue to indemnify the Sacklers for some claims against them connected to their management of the company.

In 2024, the Supreme Court's opinion in Harrington v. Purdue Pharma, L.P. ruled that non-debtor releases are impermissible. This upended a settlement in which the Sackler family contributed $6 billion to the Purdue estate to settle numerous claims connected to opioids.

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[82] Lindsey Simon, Bankruptcy Grifters

The Purdue case involved a challenging statutory interpretation question about a courts residual authority in reorganization plans. The majority, following a long-term trend in Supreme Court jurisprudence, interpreted this provision narrowly to limit the bankruptcy judge's powers.

The dissent, written by Justice Kavanaugh, focused heavily on the foundational principles we discuss here. It argued that a race to the courthouse problem would result when a debtor must indemnify a third party:

> A separate collective-action problem can arise when the insolvent company's officers and directors are indemnified by the company for liability arising out of their job duties. In such cases, "a suit against the non-debtor is, in essence, a suit against the debtor." In re Purdue Pharma L. P., 69 F. 4th 45, 78 (CA2 2023) (quotation marks omitted). If not barred from doing so, the creditors could race to the courthouse against the indemnified officers and directors for basically the same claims that they hold against the debtor company. If successful, such suits would deplete the company's assets because a judgment against the indemnified officers and directors would likely come out of the debtor company's assets.

This commons argument in favor of a nondebtor release is unconvincing. As discussed, the Bankruptcy Code's solution to the commons problem is a stay, not a discharge. Once there is a stay, the bankruptcy process can preserve asset values and provide for fair treatment through a plan of reorganization. The stay in the debtor's case should be sufficient to protect the debtor's asset value and ensure priority of distribution[83]. If, for some reason, it would not be, then a third-party stay would be the right approach to the problem, not a discharge/release. Justice Kavanaugh may have tried to shoehorn the principles-based argument into the commons problem because the Creditors Bargain Theory focuses exclusively on that one.

A better way to think about Purdue is that it reflects a difficult agency vs. anticommons trade-off. In the Purdue case, the $6 billion money contribution offered by the Sacklers to settle its Purdue-related claims was the backbone of the reorganization plan. Seen this way, the parties holding claims against the Sacklers personally look like holdout creditors that escape the holdout-binding provisions of the Bankruptcy Code. At the same time, allowing the Sacklers to pay their creditors less than in full allows the Sacklers to get off easier.

The Court's decision in *Purdue* mirrors other decisions in which courts have emphasized the role of defending priorities to reduce agency costs. As Purdue illustrates, common fact pattern is that one party offers to contribute assets to the debtor's estate, but demands the subordination of other creditors priority rights against it as a condition. In the *Jevic* case[84], the Supreme Court held that end-of-case deals like this must respect priorities. In doing so, they placed greater weight on the agency cost of insider collusion that would occur under flexible priority, and downweighted the difficulty of reaching bargains in the presence of a priority creditor's blocking right. But the Court also left room for courts to override

[83] The issue of a race to the assets of the Sacklers is one that personal bankruptcy law addresses.

[84] In the *Jevic* case, a bank offered to settle the estate's fraudulent transfer litigation against it by contributing money to the estate. But the bank required that the money would skip over the priority claims of truck drivers to pay general unsecured creditors. The priority-skipping was to ensure that the truck drivers would lack funding to pursue their own litigation against the bank. The Court decided that a "structured dismissal"—an end-of-case alternative to a reorganization plan--could not circumvent the absolute priority rule in this way.

blocking rights in pre-plan transactions, such as priority payment to "critical vendors". Implicitly, the Court recognized that anticommons problems can be more severe when time-sensitive decisions regarding the going-concern's asset value are at issue.

e) *The Texas Two-Step*

In several high-profile mass torts cases, a new entity was created immediately before the bankruptcy to separate the liabilities from the assets of the going-concern. The most famous of these is the Johnson and Johnson/LTL case. A consumer products subsidiary of J&J was liable for numerous mesothelioma and ovarian cancer claims connected to the talc in its baby powder and its other consumer products. To manage this liability, J&J split their consumer products subsidiary, JJCI, into two parts using a device called a divisional merger. After splitting in two, the operating assets were placed in one legal entity and the tort liabilities in another (LTL, short for "Legacy Talc Liabilities"). The company then filed the liabilities entity for bankruptcy, leaving the assets entity to operate outside of it. Because the technique is available under Texas corporate law, and involves a divisional merger followed by a bankruptcy, commentators gave it the colloquial name "Texas Two-Step". As part of the operation, the company promised to provide for the talc claims through a funding agreement that promised up to the full value of the subsidiary's assets (roughly $61 billion) to pay tort claims.

The main policy argument for conducting the Two-Step, rather than simply filing the original JJCI entity for bankruptcy, is an avoidance of anticommons argument. The proponents argue that the need to seek court approval for all major actions within the bankruptcy generates unnecessary cost and interference with operations. By providing a funding agreement to cover tort claims, the company could make the tort claimants as well off as they would be otherwise, yet still operate the consumer products business freely outside of bankruptcy[85].

On the other side, of course, is an agency argument. As we've noted, when a stay is imposed on creditors, it opens up the possibility of value diverting transfers that creditor taking rights could stop. Court supervision of transactions, which give the creditors an opportunity to object and to block, substitutes for creditor taking rights when the stay is imposed. Suppose Johnson and Johnson did not conduct the divisional merger, and instead filed the entire JJCI subsidiary for bankruptcy. Under this strategy, JJCI would have needed court approval under Section 363 to transfer the operating assets to another entity in exchange for a funding agreement. Creditors could have objected to the transaction based on the absence of a good business reason for the sale, as case law requires[86]. Critics of the Two-Step thus called the maneuver *bankruptcy a-la-carte*:[87] Johnson and Johnson tried to buy the anticommons benefits of bankruptcy it wanted, while avoiding its agency cost controls.

Subsequent events in the bankruptcy demonstrated the validity of the agency cost concerns of Texas Two-Steps. A New Jersey bankruptcy judge initially ruled that LTL's filing was in good faith. The decision was appealed to the Third Circuit, who dismissed the case, ruling that the LTL entity did not exhibit the

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[85] See Michael Francus, Designing Designer Bankruptcy, 102 Texas L. Rev. 1206 (2024)["Further, by maintaining the productive assets of the business outside of bankruptcy, the Two-Step promises AssetCo a smoother set of business operations and saves bankruptcy costs, all of which accrues to the benefit of the tort victims in the form of more value to be distributed to them."]

[86] Cite to Lionel case.

[87] Cite to Melissa Jacoby, Unbundling Business Bankruptcy Law 101 N.C. L. REV. 1703 (2023), discussing bankruptcy a la carte strategies.

financial distress necessary to be a debtor in bankruptcy. Following this ruling, Johnson and Johnson transferred the $61 billion consumer products business to an upstream entity. Then, they re-filed for bankruptcy with a new funding agreement backed by a promise of less than $9 billion in assets, rather than the $61 billion backing they originally promised. Had the assets been part of a bankruptcy case all along, creditor blocking rights would have come into play. They could have objected to the sale, and the transfer would not have been possible without a judge's approval.

VI. Conclusion

To come.