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# THREE AGES OF BANKRUPTCY

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# THREE AGES OF BANKRUPTCY

MARK J. ROE*

*During the past century, three decision-making systems have arisen to accomplish a bankruptcy restructuring—judicial administration, a deal among the firm's dominant players, and a sale of the firm's operations in their entirety. Each is embedded in the Bankruptcy Code today, with all having been in play for more than a century and with each having had its heyday, its dominant age. The shifts, rises, and falls among decision-making systems have previously been explained by successful evolution in bankruptcy thinking, by the happenstance of the interests and views of lawyers that designed bankruptcy changes, and by the interests of those who influenced decision-makers. Here I argue that these broad changes also stem from baseline market capacities, which shifted greatly over the past century; I build the case for shifts underlying market conditions being a major explanation for the shifts in decision-making modes. Keeping these three alternative decision-making types clearly in mind not only leads to better understanding of what bankruptcy can and cannot do, but also facilitates stronger policy decisions today here and in the world's differing bankruptcy systems, as some tasks are best left to the market, others are best handled by the courts, and still others can be left to the inside parties to resolve.*

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## Introduction

Embedded in the Bankruptcy Code are three decision-making methods—administration, a deal among existing creditors, and a sale of the firm intact. The code's text and intent privilege a deal among creditors and stakeholders, but it dispenses with the deal at times, empowering the judge to administratively determine the validity of a distribution. Elsewhere, the code dispenses with both administration and the deal and uses the market to sell the firm.[1]

If we stretch out the code over the past century, accordion-like, we see core provisions emerging in practice, dominating for a time, and then fading in importance. Each decision-making method has had its heyday. Each method's rise and fall usually fit with underlying market conditions and basic bankruptcy goals, sometimes mapped to political ideology currents, and often reflected the influence of powerful groups, such as well-organized creditors. Sometimes bankruptcy overshoots underlying market conditions, perhaps due to an ideological push or excessively influential interests, but often enough, there's a rough market fit. Interests often win, and they do better when their interests tie to market capabilities.

The rise and dominance of administration, deal, and sale make for three ages of bankruptcy. Administration flourished during and after the 1930s. The 1938 Bankruptcy Act put in place an administered system in which the judge, with an expert agency's advice, decided how and whether to restructure the firm; which creditors would survive the reorganization and which would not; and who would manage the firm—all indicative of top-down, market-skeptical, New Deal–style thinking.

The second age—that of the deal among the debtor firm's principal players—began its dominant era in 1978, when Congress displaced New Deal–style administration with business-deal-oriented rules for the most important bankruptcy decisions. Classes of creditors, grouped along common financial characteristics, and owners negotiate a deal among themselves on how to restructure the firm, with only loose judicial supervision. The 1978 statute, says its legislative history, "removes many of the supervisory functions of the judge . . . ."[2]

The deal-oriented statute respected the will and knowledge of private parties; it reflected doubt about the expertise of government agencies on

[1] Section 1129(a)(8) of the Bankruptcy Code, 11 U.S.C. § 1129(a)(8) (2012), and its associated provisions allow classes of creditors to vote on a deal, with two-thirds in dollar amount binding all creditors; judicial review of an approved deal is minimal. If no deal is reached, the judge values the firm and decides whether or not a proposed restructuring will go forward. *Id.* § 1129(b). Under § 363, the firm can be sold in its entirety, with neither a § 1129(a)(8) deal nor a § 1129(b) judicial determination. *Id.* § 363.

[2] H.R. Rep. No. 95-595, at 5966 (1977).

business deals. I call this age bankruptcy's business-judgment-rule phase. Corporate law academics would see the similarities: corporate courts deferred to unconflicted boards of directors in making corporate business decisions and unwilling to displace unconflicted business judgments with the judge's own view. No corporate law judge would second-guess the dutiful board and similarly no bankruptcy judge in this age of bankruptcy would second-guess the ordinary bankruptcy deal.

The third age of bankruptcy rose to prominence in the late 1990s, displacing the deal with the sale of the debtor firm's operations in their entirety to the highest bidder. Its rise occurred in a market economy in which mergers were common, professionals in law and finance had little difficulty engineering whole-firm sales, and markets often worked more quickly than courts or deals.

Not only had the merger market overall become deep and wide outside of bankruptcy by the time when this third age began, but bankruptcy deals became harder to strike in the 1990s than in the 1970s, when the deal-making code was first written. Better trading markets for claims on the bankrupt debtor by the 1990s meant that many creditors did not hold their claims long enough to readily negotiate a deal that restructured the right-hand side of the debtor's balance sheet. A sale could work even when claims traded because the operations would be sold and then the cash proceeds distributed to whomever happened to be the creditor at the time of the distribution. The rise of this third age coincided with an ideological era when market solutions were often seen as better than government driven or administered results.

The market-sale process arose although it was not the means of restructuring that the 1978 Bankruptcy Code favored or even anticipated. Even today, the sale derives its authority from two broad, open-ended sentences in the code that lack texture, standards, specifics, and instructions. Nevertheless, the market sale has become a prime system of industrial restructuring in the United States. Market conditions prevailed over statutory structure and, one can probably say, over congressional intent.

The market-oriented explanation I offer here for bankruptcy's three ages contrasts with prior explanations, which can be summarized as learning, lawyering, and rent-seeking. First, the learning explanation looks to incremental evolution and experiential learning to explain the shifts in decision-making modes; practical judges and lawyers sought to solve problems and, as they did, they came up with new and better means to reorganize firms.[3] In contrast to evolutionary improvement, the second theory explains shifts by the world views (and narrow interests) of the lawyers who wrote the bankruptcy laws.[4] Third, creditor rent-seeking has been brought forward to ex-

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[3] *See, e.g.*, Barry E. Adler, Vedran Kapkun, & Lawrence A. Weiss, *Value Destruction in the New Era of Chapter 11*, 20 J. L. Econ. & Org. 461, 462 (2013); David A. Skeel, *Creditors' Ball: The "New" Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917 (2003).

[4] *See, e.g.*, David Skeel, Debt's Dominion: A History of Bankruptcy in America 88–89 (2001).

plain important code and practice shifts.[5] The market-based explanation I offer here does not displace learning, lawyering, and rent-seeking as explanations but needs to be put on the same shelf as the preexisting three. I bring forward reasons why it fits well with the broad outline of the decision-making shifts during the past century.

Each system's emergence and dominance corresponded to underlying market-based phenomena. Moreover, by identifying these primary decision-making modes, one can analyze explicitly whether the decision-making mode selected for a bankruptcy task is suitable, accurate, and effective or whether another mode would do better. In other legal analyses, it is common to look for the relative advantage of the decision-maker in terms of factors such as information or lack of bias. Corporate law, for instance, regularly analyzes the relative propriety of decision-making by courts and boards of directors, with the business judgment rule as its most famous mechanism for doing so.

The three dominant decision-making systems are not stable, in the sense of having reached an end-point. Although a dominating fourth system is not yet in view, definitive fracture lines in the current system are forming: First, more creditors can immediately enforce their state-based rights without bankruptcy law impeding them. These creditors take no part in the collective bankruptcy proceeding to hold together the enterprise value. I analyze the market conditions—such as rapid, effective refinancing—that can make this structure fit market conditions. Second, industrial organization no longer depends as much on the integrity of the vertically integrated firm but often ties to contractual relationships that can more readily adjust: less of the firm must be centrally owned, financed, and kept intact through a bankruptcy because the business nodes can be pulled apart and then reassembled elsewhere. If these two trends continue, an attack on bankruptcy's core institution, the automatic stay,[6] is inevitable: the stay's raison d'être is to hold together a complex, interactive organization; as such organizations become fewer and plug and play structures become more common, the stay will become less valuable. These two trends in financing speed and industrial organization, thus suggest instability in the traditional longer bankruptcy stay.

* * *

In Part I, I outline the three bankruptcy ages that followed after the first-in-time race-to-the-courthouse: government administration of the failed firm, a deal among its creditors, and a market sale of the failed firm.

In Part II, I describe how each era typically corresponded to baseline market and institutional conditions, and why market capacity, perceived and real, seems to be at least as strong as the other forces that have been identi-

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[5] *See, e.g.*, Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 Va. L. Rev. 1235 (2013).

[6] The automatic stay stops all creditor action against the bankrupt during the pendency of what can be a long proceeding. Simply put, creditors cannot collect their debts or seize their security during the pendency of the bankruptcy. *See* 11 U.S.C. § 362 (2016).

fied in bankruptcy scholarship for explaining the shifts: evolutionary learning, lawyering, and rent-seeking.

It is no accident that the administrative system that persisted until the 1970s first emerged from the New Deal statutes when policymakers distrusted markets, which were often seen as corrupt and dysfunctional. Nor is it an accident that the deals among the market players came to the forefront when government action came to be distrusted during the deregulatory Carter presidency, on the eve of the Reagan magic-of-the-market era. Nor is it any accident that the sales rose to prominence during the 1980s and 1990s when the merger market for the firm's assets became deep and the market for the firm's liabilities became so liquid that they often could not stabilize long enough to sit in their lawyers' conference rooms to negotiate the deal that the 1978 Code had contemplated. Baseline economic conditions simultaneously made bankruptcy-by-sale more viable and creditor deal-making less viable.

In Part III, I ask whether this decision-making evolution is over. It is not. We can discern fissures in the current mechanisms that could lead to more fundamental change. In twenty-first-century financial markets, creditors can often rapidly realize their claims on the debtor without becoming subject to the debtor's bankruptcy, and firms can more readily be dismantled efficiently because the vertically-integrated firm, which vitally needs the bankruptcy stay on creditor collection to hold together its viable parts, is becoming less important in an increasing number of industries. The rationale for bankruptcy's core characteristic—again, the long bankruptcy stay on creditor action—is eroding. The fear of dismantling vital parts of a business enterprise is not as frightening if fewer firms are tightly put together. This development facilitates a partial return to what the original nineteenth century bankruptcy reaction to the race-to-the-courthouse sought to avoid: the dismantling of vital parts of the business enterprise. Once this was a cost; increasingly, it is becoming a strategy.

## I. Conceptualizing Three Ages of Bankruptcy: Administration, Insider Deal, and Market Sale

### A. *The Race-to-the-Courthouse*

Recall bankruptcy first principles: when a firm fails and defaults on its debts, creditors sue to be repaid. Under baseline state law, creditors would race to the courthouse to obtain a judgment authorizing the sheriff to sell the debtor's property for cash to go to the creditor.[7] Late creditors would seek to be repaid from a judgment-proof carcass, inevitably leaving empty-handed.

If the firm has greater value as a going concern, then creditors' levies and sheriff's collateral sales will destroy organizational value. Worse, be-

[7] *Cf.* U.C.C. § 9-601 (Am. Law Inst. & Unif. Law Comm'n 2010) (describing secured creditors' commercially reasonable sale, with proceeds paying off their defaulted loan).

cause early creditors get paid in full and later creditors do not, the core state-law incentives can propel a destructive run on an otherwise viable enterprise. For a single creditor, it would be better to reach the courthouse first to be fully paid—even if doing so destroyed the debtor's organization—than for the creditor to wait and find itself with an unsatisfied claim on a hollowed-out debtor that had paid the quickly acting creditors first. Theorizing on justifications for a separate, overarching bankruptcy process has at its core the goal of replacing the race with a collective proceeding that maximizes creditors' joint value in the debtor by holding the firm's pieces together if they are worth more together than torn asunder.[8]

### *B. The Three Systems Conceptually*

After bankruptcy law froze the creditors' race-to-the-courthouse, vital questions still had to be decided: How should the business be redeployed? Should the business be kept intact or should it be shut down in an orderly way? Or should some factories be kept open and others closed? Which ones should be closed, and when? Since the bankrupt firm lacked enough value to pay all of its creditors, which claims would be cut down, and how would debts and ownership be reallocated?

Three decisional means for restructuring arose, with each reaching its apogee in a different decade during the past century—typically in ways and times fitting with baseline economic conditions. Each is still embedded in the Bankruptcy Code and on-the-ground practice. First, the government could decide what to shut down and what to continue operating. An administrative apparatus could decide through the judge how much the firm is worth, which creditors to eliminate, who would own the restructured firm, and how much other debt to write off.

Second, the creditors and the firm could decide among themselves what to do, operating under broad bankruptcy law rules and their state-law contracts. The creditors and the bankrupt firm's management could negotiate over which factories to shut down and which to keep going. The judge's role could be confined to handling contract disputes and bankruptcy particulars, such as fraudulent conveyances and preferences, but not core financial and operational restructuring decisions.

Third, the firm's operations could be sold intact for cash, with the cash thereafter applied to pay off creditors. The buyer would then resolve whether to shut down or reorganize the failed firm, as a matter of its business judg-

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[8] *See* Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 7–19 (1986). A persistent counterview is that for too many firms, an organized glide to shut it down is the best disposition. *See* Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. Chi. L. Rev. 575, 575–76 (1995). And with deft corporate structuring, the code's mandated collective continuation can be sidestepped. *See* Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 Colum. L. Rev. 1 (2013).

ment. Today, bankruptcy sales are common and lead to the bankrupt firm's operations going to the highest bidder.

And those are the alternatives to the race-to-the-courthouse. There's a limited menu of restructuring methodologies: administration, deal, and sale. Just three.[9]

## II. Three Ages of Bankruptcy: Historical Emergence, Market Conditions, and Ideological Coherence

Here, we review the major historical shifts in the structure of bankruptcy decision-making in light of underlying market conditions at the times the shifts occurred. For each shift, we see a supporting underlying market structure and sometimes a related dominant ideological perspective. First, we look at the conditions that had the equity receivership displace the race-to-the-courthouse. While this shift and its underlying market structure explanation is well known to bankruptcy analysts, subsequent shifts have not been systematically subjected to a market-oriented analysis.

### *A. The Baseline: Displacing the Race-to-the-Courthouse with the Equity Receivership*

*1. Historical Emergence*. The race-to-the-courthouse would not seriously degrade the simple firms lacking complex machinery, such as those dominating the early nineteenth century American economy. But the race-to-the-courthouse worked poorly for the complex railroads that crisscrossed the country in the last third of the nineteenth century, and then failed at that century's end. While the railroad failures came first, large-scale manufacturing at the end of the nineteenth century was constructed from interconnected large organizations that were typically vertically integrated. Interacting industrial parts inside a firm could not easily be removed and replaced.[10]

Although a railroad business operated as an integrated whole, the railroad's financing contracts were crude and slapdash.[11] One bondholder group had a security interest in the tracks and stations in one city and another group had a security interest in the tracks and stations in another city. If one bondholder group foreclosed on its security, the railroad could not operate

[9] Robert Clark saw the changing structure of stockholding over the twentieth century analogously, seeing a market-oriented evolution moving through several stages. His article's title is echoed in this Article's title. *See* Robert Charles Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 Harv. L. Rev. 561 (1981).

[10] Glenn Porter, The Rise of Big Business, 1860–1910, at 12–13 (1973).

[11] On the railroads as modern managerial corporations, see Alfred D. Chandler, Jr. & Herman Daems, Managerial Hierarchies: Comparative Perspective on the Rise of the Modern Industrial Enterprise 15–19 (1980); Alfred D. Chandler, Jr., The Visible Hand: The Managerial Revolution in American Business 81–121 (1977). On the decreasing relevance of Chandler's vertical hierarchies in and out of bankruptcy, see *infra* Part III.

between those two cities, as it would be missing a vital section of track and other physical assets.[12]

Once the tracks were laid down and the stations and rail yards built, the ongoing cost of operating the railroad was insubstantial, even though its corporate debt load was high. Compared to fixed costs, variable costs were low. "[T]here was usually a consensus that most railroads were worth more as [ongoing] entities than their liquidation value."[13] As a matter of efficiency, the railroad's business should not have been shattered by creditor grabs if the parties could re-negotiate well,[14] but the difficulty of negotiating and coordinating a solution among creditors was substantial. An alternative to the race-to-the-courthouse was needed.

The railroad also had a public utility quality that created a pervasive public policy problem for judges and legislators. Towns and people along the railroad's route depended on it to pick up their own goods for sale to distant markets and to deliver goods made elsewhere,[15] and the federal courts recognized as much.[16] "From the end of the Civil War until the beginning of the First World War, the railroad was a central, if not the major, element in the political, economic, and social development of the United States,"[17] with high saliency in multiple dimensions.[18] Politics pressed toward operational continuance. These public considerations affected the courts.[19]

Resolution came by adapting the common law receivership to keep the railroad running. In the equity receivership, a creditor would petition the court to appoint a receiver to gather the railroad's assets, receive its revenue, and operate its business, while the managers and the bondholders' bankers

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[12] Douglas G. Baird, *The Hidden Virtues of Chapter 11: An Overview of the Law and Economics of Financially Distressed Firms* 21 (U. Chi. L. & Econ Working Paper No. 43, 1997), www.law.uchicago.edu/files/files/43.Baird_.Chapter11.pdf.

[13] Peter Tufano, *Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century*, 71 Bus. Hist. Rev. 1, 6, 7 n.13 (1997).

[14] Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1960).

[15] *See* Richard White, Railroaded: The Transcontinentals and the Making of Modern America 155 (2011) ("[F]armlands with ready access to railroad stations, warehouses, and elevators had greater value than farmlands too far from a railroad for an easy haul. Towns competed so desperately for railroad connections . . . ."); James W. Ely, Jr., Railroads and American Law 80, 86 (2001).

[16] The classic statement for railroads came from the Supreme Court's Chief Justice in *Munn v. Illinois*, 94 U.S. 113 (1876):

> When . . . one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created.

*Id.* at 126.

[17] Gabriel Kolko, Railroads and Regulation, 1877–1916 1 (1965); *see* Barton v. Barbour, 104 U.S. 126, 135 (1881) ("[T]he cessation of business for [even a] day would be a public injury.").

[18] Ely, *supra* note 15, at 80–89; White, *supra* note 15, at 110; Kolko, *supra* note 17, at 1.

[19] *Cf.* Quincy, M. & P.R. Co. v. Humphreys, 145 U.S. 82, 95 (1892) ("[The] insolvent railroad . . . surrender[s] its property into the custody of the court, to be . . . *operated in the public interest*." (emphasis added)).

(often J.P. Morgan & Co. or Kuhn Loeb) reorganized the railroad's finances. In form, the railroad's assets would be sold to a new firm, which was owned by the participating creditors. That sale restructured the railroad's ownership, as the old owners took new securities with new terms in the buying entity.[20]

During the sale's pendency, the court enjoined creditor action against the railroad's property, thereby holding the going concern together via an injunction—the predecessor to today's automatic stay. Although the form of the receivership transaction was a sale, in reality it was a restructuring because the pre-transaction creditors were approximately the same as the post-transaction creditors, but with the terms of their ownership adjusted. There was no third-party buyer and typically no third-party bidder for the firm.

*2. Market conditions, ideological coherence.* While the receivership took the *form* of a marketplace sale, the market for selling large firms was then too weak to support a true arms-length sale. Too few strategic buyers wanted to add the bankrupt's business to their own, and financial markets were too primitive for competitive bidding syndicates to emerge. Thus, although the nineteenth century equity receivership was a sale in form, in substance it was a deal among the railroad's major creditors, with some judicial oversight. Judges were not particularly adept at running railroads, and markets lacked sufficient depth to support whole-firm sales. In such conditions, a deal—perhaps even one susceptible to some insider corruption—was better than the decision-making alternatives. The resulting system satisfactorily used the best institutional tools then available to handle a major national practical problem: how to keep the American railroad system running when panics and recessions gave too many creditors choke-point rights to shut the railroad down.[21]

The equity receivership was an amalgam of our three bankruptcy decision-making systems. In form, it was a sale, but in substance, it was a recapitalization,[22] one that amalgamated the deal with administration: the parties came up with the terms and the judiciary loosely checked the terms for conformity with priority rules.[23] This amalgam eventually gave way to three more distinct ages of bankruptcy. The first age was that of the administrative proceeding.

### *B. Bankruptcy's First Modern Age: New Deal Administration*

*1. Historical emergence.* By the 1930s, the equity receivership's deal qualities came to be seen as detrimental to sound reorganization policy. The

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[20] Skeel, *supra* note 4, at 56–58.

[21] *See generally* Albro Martin, *Railroads and the Equity Receivership: An Essay on Institutional Change*, 34 J. Econ. Hist. 685 (1974).

[22] *See* Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 Yale L.J. 1238, 1252–53 (1981).

[23] N. Pac. Ry. v. Boyd, 228 U.S. 482, 500–05 (1913). Continuing the firm's operations was quite likely efficient in the Coasean sense because of the railroad's low scrap value.

Depression-era Congress mandated a study of how reorganizations contributed to the Great Depression.[24] The report by New Deal luminaries like William O. Douglas and Abe Fortas, both future Supreme Court Justices, became the blueprint and justification for a new age of bankruptcy.[25]

Deals were made, yes, but the deals were corrupt, their report concluded, with controlling insiders eviscerating outsider creditors.[26] Information flow was poor, so markets could not work well. Businesses failed, it was thought, because corrupt creditor bargains impeded business stability and recovery. Eventually the Court decided that the judge was *not* to defer to the bankruptcy deal. "The [bankruptcy] court is not merely a ministerial register of the vote of . . . the [creditors]," Douglas wrote in the famous-in-bankruptcy *Los Angeles Lumber* decision.[27] "[T]he fact that the vast majority of the security holders have approved the plan is *not* the test of whether the plan is a fair and equitable one . . . . *Every* important determinant by the court in receivership proceedings calls for an informed independent [judicial or administrative] judgment."[28] "*[B]oth* . . . the required percentages of each class of security holders [must] approve the plan *and* . . . the plan [must] be found [by the court] to be 'fair and equitable.'"[29] He was not alone among prominent New Dealers.[30]

A judge, with an expert agency's advice, would decide how valuable the debtor firm was, how far that value could go to pay off creditors, how the firm's debts should be restructured, and whether the firm should be shut down or restructured. The strong-form of bankruptcy's absolute priority rule did the same by barring the financial players from deviating from formal

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[24] *See* Securities Exchange Act of 1934 § 211, 15 U.S.C. 78jj (repealed 1987).

[25] SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1936–40).

[26] *Id.* at PT. II—COMMITTEES AND CONFLICTS OF INTEREST 162–63 (1937) [hereinafter SEC BANKRUPTCY COMMITTEE CONFLICTS REPORT]; *id.* at PT. VII—MANAGEMENT PLANS WITHOUT AID OF COMMITTEES 438–61 (1938); *cf.* William O. Douglas, *Protective Committees in Railroad Reorganizations,* 47 HARV. L. REV. 565, 567 (1934) ("So often [protective] committees have been constituted by the inside groups, those affiliated with . . . management.").

[27] Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 114–15 (1939).

[28] *Id.* (internal quotation marks omitted) (emphasis added).

[29] *Id.* at 114 (emphasis added); *see also* William O. Douglas, *The Need for Reform in Corporate Reorganizations*, *in* DEMOCRACY AND FINANCE 189–90 (J. Allen ed. 1940); William O. Douglas, *Protective Committees in Railroad Reorganizations*, 47 HARV. L. REV. 565, 567 (1934).

[30] Jerome Frank, Douglas's protégé and successor as chair of the SEC, sought to bar the judge from considering creditors' consent when determining if the plan complied with bankruptcy standards:

> *[N]o probative value whatever* shall be given to the number of stockholder or creditors . . . who have assented to the plan. But the judge and the [administrative] Commission shall determine such questions on their merits and shall thoroughly investigate . . . all facts bearing on the equitableness of the plan and on such values.

Jerome Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization* (pt. 2), 19 VA. L. REV. 698, 714 (1933) (emphasis added).

priority even if a class of creditors voted in favor of making a deal to get the company more quickly through the proceeding.[31]

This administrative system that emerged from policymakers' theory as embedded in chapter X of the 1938 Bankruptcy Act[32] became the means to reorganize public firms for the next four decades. Upon the debtor filing for bankruptcy, incumbent senior management was replaced by a court-appointed trustee—no deference here to market processes or to the sanctity of private management. Then, the court determined the firm's value, with the advice of public experts from the Securities and Exchange Commission—no marketplace valuation here. The plan of reorganization "had to be submitted to the SEC for comment prior to confirmation. The SEC vigorously fulfilled its watchdog role, participating in meetings, challenging the appointment of trustees and trustees' administrations, opposing plans of reorganization, and criticizing compensation arrangements."[33] Once the court determined the firm's value, the "logical problem [for the judge] in determining the [proper] participation of various classes of security holders [was] comparatively simple"[34]—the judge, with a valuation number in hand, could mechanically figure out how far down the firm's creditor hierarchy to go until value was fully allocated.

True, the structure here was "administrative-light:" the Bankruptcy Act of 1938 did not establish a governmental agency that took over the bankrupt firm, such as the "administrative-heavy" mechanisms by which the Interstate Commerce Commission dealt with failed railroads,[35] bank regulators handled failed banks,[36] and the SEC restructured public utilities.[37] Stronger administrative structures for industrial bankruptcies were contemplated in

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[31] *See L.A. Lumber*, 308 U.S. at 114–15. Absolute priority requires that a higher-ranking creditor be fully paid before lower ranking creditors. *See id.* Today's deal-making code allows creditors at differing priorities to make a deal to take less; the 1938 Act, as interpreted, did not.

[32] Chandler Act of 1938, Pub. L. No. 75-696, 52 Stat. 840 (repealed 1978).

[33] Daniel J Bussel, *A Third Way: Examiners as Inquisitors*, 90 AM. BANKR. L.J. 59 (2016); Jonathan C. Lipson & Christopher Fiore Marotta, *Examining Success*, 90 AM. BANKR. L.J. 1, 13–14 (2016); *see also* Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 65 (1997).

[34] Abe Fortas, Ass't Director of the Public Utilities Division, Sec. and Exch. Comm'n, Speech before a Legal Seminar: Corporate Reorganizations and the Holding Company Act, at 9 (July 14, 1938).

[35] *See* Max Lowenthal, *The Railroad Reorganization Act*, 47 HARV. L. REV. 18, 18–19 (1933); *see also* Paul Stephen Dempsey, *The Rise and Fall of the Interstate Commerce Commission: The Tortuous Path From Regulation to Deregulation of America's Infrastructure*, 95 MARQUETTE L. REV. 1151, 1165 (2012).

[36] *See* Charles W. Calomiris, *The Political Lessons of Depression-Era Banking Reform*, 26 OXFORD REV. POL. ECON. POL'Y 540, 550–51 (2010).

[37] Roberta S. Karmel, *Is the Public Utility Holding Company Act a Model for Breaking Up the Banks That Are Too-Big-to-Fail?*, 62 HASTINGS L.J. 821, 827–28, 852 (2011).

the 1930s and championed by William O. Douglas,[38] and built or expanded for restructuring key businesses of the era, namely railroads and utilities.[39]

This bankruptcy era, starting in the New Deal, was the age of bankruptcy-by-administration: an outside, court-appointed trustee took over and ran the business; deal-making consent was suppressed; and the judge was central to plan confirmation. The era lasted for four decades. This was not simply an evolution in decision-making or a success for narrow interests, but a change that reflected the perceived weaknesses of market conditions and bankruptcy deal-making, and the perceived strengths of having a central, administrative decision-maker. I document and analyze this contrast next.

*2. Market conditions, ideological coherence.* The depression had discredited both markets in general and bankruptcy deal-making in particular.[40] Leading business law academics of the 1930s hailed the 1938 Act's turning of reorganization from the deal-oriented equity receivership into an administered system.[41] While deference to the business judgment of the relevant players is today commonplace in corporate settings if the players are not afflicted with egregious conflicts of interest,[42] bankruptcy would accord no such deference in the 1930s, when the players were viewed as hopelessly conflicted and corrupt. This concept for bankruptcy was consistent with a more general worldview that those with policymaking influence in that era held—that is, that marketplace competition had declined greatly, and since competitive checks were few, regulation of the corporation and not deference to it was needed.[43]

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[38] Skeel, *supra* note 4, at 118 (noting however that the bankruptcy bar impeded Douglas from a full-scale administrative agency takeover of all of bankruptcy, which would have made bankruptcy lawyers and judges superfluous).

[39] Public Utility Company Holding Act of 1935 § 11, 15 U.S.C. 79k (2016) (administrative restructuring of the then-large public utility industry by the SEC, which starts in the 1930s); Lowenthal, *supra* note 35, at 18–19; Karmel, *supra* note 37; Skeel, *supra* note 4, at 118 (Douglas held back in negotiating the provisions of chapter X in 1938 from "insisting on sweeping authority of the sort the Interstate Commerce Commission enjoyed in railroad reorganizations").

[40] *Cf.* A.C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices*, 95 Va. L. Rev. 841, 844, 913 (2009) ("The New Deal Justices . . . blamed the excesses of private ordering for the Great Depression." And, "the New Deal Court[ ] defer[red, with the tacit approval of President Roosevelt] to the SEC as it asserted governmental control over finance, displacing broad areas of private ordering that had previously dominated the field.").

[41] *See* Jerome Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U. L.Q. Rev. 317, 350–51 (1941) (stating that a restructuring in bankruptcy "is only in its superficial aspects litigation [that results in a settlement among the] parti[e]s and [is instead] fundamentally . . . an administrative problem of business and finance").

[42] *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vand. L. Rev. 83, 96–97 (2003); *see also* E. Norman Veasey, *Musings on the Dynamics of Corporate Governance Issues, Director Liability Concerns, Corporate Control Transactions, Ethics and Federalism*, 152 U. Pa. L. Rev. 1007, 1009 (2003) ("The keystone of state-based corporation law is the business judgment rule.").

[43] Walter E. Volkomer, The Passionate Liberal: The Political and Legal Ideas of Jerome Frank 159, 180 (1970).

The SEC's 1930s study of reorganization—Douglas's document, which facilitated his rise to fame and authority—pointed to corrupt insider dealings that he wanted replaced.[44] Abe Fortas, Douglas's principal assistant in the 1930s reorganization study and another future Supreme Court Justice, said when rejecting the deal as a model for reorganization and advocating for more administrative control:

> I need not relate how corporate reorganization was . . . a state of nature in the Hobbesian sense: where substantive rules of law were virtually suspended; where . . . contract rights might be freely violated; and where diplomacy was devious, covenants secret and the rights of thousands of ordinary citizens disposed of by and for their ruling minorities. These were the actualities in hundreds of cases . . . .[45]

While Fortas is today the more well-known figure, Jerome Frank wrote the 1933 New Deal analysis of reorganization that then became iconic. Frank, a Douglas protégé who would succeed Douglas as chair of the SEC, excoriated a modern whole-firm, § 363-style sale, considering such an effort to be a sham (as he put it) because merger markets in 1933 were so decrepit that no bidder other than prior controlling creditors would even consider making a bid.[46] The judicial sale in bankruptcy is "meaningless mumbo-jumbo"[47] that insiders controlled and that too often failed to benefit the debtor or its other creditors.[48] There was no competitive bidding, because it was "almost impossible . . . to induce any banking group to compete with [the insiders] in charge of the reorganization."[49] "The bulk of the security holders are inevitably uninformed and usually concur in . . . the reorganizers[' plans] because of lack of information and lack of any practical alternatives."[50] It often kept scurrilous management in place.[51] Go straight to

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[44] *See* Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 114–15 (1939).

[45] Fortas, *supra* note 34, at 5. While Fortas was speaking specifically of utility restructurings, the speech makes clear that he saw the issues and advantages as applying to bankruptcy restructurings as well.

[46] Jerome Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization* (pt. 1), 19 VA. L. REV. 541, 554–55 (1933) (using words "farce," "mockery," and "sham" to characterize whole-firm, § 363-style sales).

[47] *Id.* at 568.

[48] *See id.* at 565.

[49] *Id.* at 554 (arguing that a modern analytic would see information asymmetries between insiders and outsiders as potentially stymieing outsider bids).

[50] *Id.* at 568; *see also* SEC BANKRUPTCY COMMITTEE CONFLICTS REPORT, *supra* note 26, at 1, 162–63; Douglas, *supra* note 26, at 197–99. Bar association studies of creditor indifference and disorganization recommended not deferring to creditors and preferred judicial administration. Grenville Clark, *Reform in Bankruptcy Administration*, 43 HARV. L. REV. 1201, 1201 (1930) ("[E]ven if the creditors are willing to neglect bankruptcy proceedings, the public . . . [is] not in the same position . . .").

[51] This feature was long noticed, *see* D.H. Chamberlain, *New-Fashioned Receiverships*, 10 HARV. L. REV. 139, 146 (1896), but tolerated until the 1930s.

the judicial determinations, said Frank.[52] "[T]he judge [should] look [for the court's] function from the beginning of the receivership to [be to] . . . supervis[e] . . . the formulation of a reorganization plan."[53]

Creditor consent should not be dispositive, Frank stated:

> Each individual investor will receive elaborate printed documents which he will have difficulty in understanding . . . . Solicited by a more or less self-constituted committee to give his consent, he will not know to whom else to turn for guidance. Inertia and a feeling of helplessness will lead him to accept a plan offered by such a committee. Past experience goes to show that the great bulk of the creditors or stockholders take what is offered to them with a feeling of resignation.[54]

Frank then rejected proposals from the "deans of the reorganization bar, such as Messrs. Cutcheon and Swaine, . . . that the courts should not concern themselves with the formulation of the plan. . . ,"[55] and he pushed courts to actively shape the plan of reorganization.[56] More conservative voices, such as that of Harvard Law School's Dean Roscoe Pound, criticized Douglas's and Frank's bankruptcy administration.[57] But they lost out to the New Deal thinking: an administrative apparatus of experts was needed to handle the problem,[58] not a deal and not a marketplace sale.

### *C. The Second Age: Post–World War II Deal-making, Bankruptcy's Business Judgment Era*

*1. Historical emergence.* The administered system did not wear well after World War II. It was seen as a death-knell for companies that could have rebuilt themselves. The common cliché was that the patient was dying

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[52] Frank, *supra* note 46, at 561–62.

[53] *Id.* at 569.

[54] Frank, *supra* note 30, at 711 (emphasis removed). However, if the bond market had already been institutionalized by then, Frank's analysis would need to be re-thought.

[55] Frank, *supra* note 46, at 568.

[56] *Id.* at 568–69.

[57] American Bar Ass'n, Reports to Be Presented for Action at the Sixty-First Annual Meeting, Cleveland, Ohio, July 25–29, 1938, at 134, 147–48 (comments of Roscoe Pound). The ABA report was referenced by Frank, *supra* note 41:

> How far American legislation is tending to go in the direction of *administrative absolutism* is illustrated by the [1938 Bankruptcy Act] as to reorganization proceedings. . . . In *effect the tendency is to subject the management of all individual property and enterprise to an unchecked administrative control.*

*Id.* at 321 (emphasis added). Frank rejected Pound's view, seeing Pound's "snarl[ing]" use of "administrative absolutism" as "symptom[atic] of [a] disturbance . . . in the speaker." *Id.* at 324.

[58] *See* Pritchard & Thompson, *supra* note 40.

on an operating table, while all waited for the doctor (the SEC and the courts) to arrive to recommend how to operate.[59]

> The negative results under [the post-1938 bankruptcy system] have resulted from the stilted procedures, under which management is always ousted and replaced by an independent trustee, the courts and the Securities and Exchange Commission examine the plan of reorganization in great detail, no matter how long that takes, and the court values the business, a time consuming and inherently uncertain procedure.[60]

A deal between and among the debtor and its creditors was to be preferred, said the 1978 Code's legislative history:

> [Alternative processes could] allow[ ] a debtor to negotiate a plan outside of court and, having reached a settlement with a majority in number and amount of each class of creditors, permit[ ] the debtor to [achieve an] arrangement. . . .[61]

The postwar environment became less anti-market, and less suspicious of private deal-making than had been the case in the Depression environment. Public opinion trusted markets more and regulation less.[62]

The age of the bankruptcy deal crystalized in 1978, when Congress passed a new Bankruptcy Code that enshrined the deal and displaced administration. (And even before 1978, parties sought to move public firm bankruptcies from chapter X's administrative structure to chapter XI, which was intended for privately-held firms but was more deal-friendly.[63]) The 1978

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[59] *See* H.R. Rep. No. 95-595, at 5965 (1977); Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, at 256 (1973).

[60] H.R. Rep. No. 95-595, at 6536 (1977); *see also* 124 Cong. Rec. S34004 (Oct. 5, 1978) (statement by the Hon. Dennis DeConcini, Chairman of the Subcomm. on Improvements in Judicial Machinery, Upon Introducing the Senate Amendment to the House Amendment to H.R. 8200).

[61] H.R. Rep. No. 95-595, at 6538 (1977).

[62] *Compare* Gallup Brain, *The Gallup Poll #238*, https://institution.gallup.com/documents/questionnaire.aspx?STUDY=AIPO0238&p=1 (last visited Apr. 25, 2017) (question qn12b: only 44% of those polled opposed greater regulation in 1941), *with* Gallup, *Big Business*, http://www.gallup.com/poll/5248/big-business.aspx (last visited Apr. 25, 2017) (when Congress passed the 1978 Code, only 19% of those polled considered big business the biggest threat to the country, while as many feared big labor, and 47% feared big government), *and* Frank Newport, *Americans More Likely to Say Government Doing Too Much*, Gallup Politics, Sept. 21, 2009, http://www.gallup.com/poll/123101/americans-likely-say-government-doing-too-much.aspx (in 1981, when Reagan was president, 54% thought there was too much government regulation). One could attribute this trust and distrust of business and government institutions to some cycling, to changing economic conditions, and to the possibility that the New Deal reforms cleaned up the financial marketplace sufficiently for the market's best features to shine. (The polling comparison is not conclusive, because the questions are not identical.)

[63] *See* Benjamin Weintraub & Harris Levin, *A Sequel to Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation*, 26 Fordham L. Rev. 292, 292 (1957); *cf.* General Stores Corp. v. Shlensky, 350 U.S. 462 (1956).

Code announced that, from thenceforward "[t]he parties are left to their own to negotiate a fair settlement. . . ."[64]

In the New Deal's 1938 chapter X, the court decided on the distribution of value in the restructuring, without deferring to the parties' deal. But in the 1978 Code, the creditors voted by class on a proposed deal.[65] If a majority of each class of similar creditors approved a plan, the decision-making structure called for no judicial finding on the plan's fairness, the value of the debtor, or whether the plan respected priority. Administration after 1978 was weak. Only if deal-making failed would the court value the firm and decide on the fairness of the distribution.[66] Nor would the court involve itself deeply in business operations. As one prominent bankruptcy player said, "the court's only function [now] with respect to the operation of the business should be to change the composition of the creditors' committee if it is not representative. The bankruptcy judge should not worry about 'how's the business doing?' "[67]

*2. Market conditions, ideological coherence.* One again can see the shift as stemming from changes in underlying market conditions and stemming not just from interests or simple learning from experience. Congress enacted the deal-oriented 1978 Code during a business-friendly time when dealmakers were, if not respected, at least deferred to, and market-mimicking mechanisms seemed appropriate. One president was elected in 1976 extolling the virtues of small government, deregulation, and zero-based government budgeting.[68] Another would be elected in 1980 extolling the "magic of the market."[69] The 1978 Code reflected this pro-market tenor in political discourse.

Similarly, the major bankruptcy theoretical innovation just after the 1978 Code appeared was the concept of a (hypothetical) *creditors' bargain*—that is, a deal, with the creditors' bargain concept justifying (most of) the 1978 Code's main features as reflecting the deal that creditors would have made beforehand (had transaction costs been low enough for creditors to specify the terms that would govern if a firm failed).[70]

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[64] H.R. Rep. No. 95-595, at 6183 (1977).

[65] 11 U.S.C. §§ 1126, 1129(a)(8) (2012).

[66] *Id.* § 1129(b).

[67] J. Ronald Trost, *Business Reorganizations Under Chapter 11 of the New Bankruptcy Code*, 34 Bus. Law. 1309, 1216 (1979); *cf.* Melissa B. Jacoby, *What Should Judges Do in Chapter 11?*, 2015 U. Ill L. Rev. 571, 576–79. The on-the-ground dynamic has, however, been more mixed. If the parties cannot conclude a deal, the court can cram one down. 11 U.S.C. § 1129(b) (2012). The players surely have had one eye on the court even when making a deal.

[68] *See* Zero-Base Budgeting in the Executive Branch, 1 Pub. Papers 728 (Apr. 27, 1977).

[69] *See* Barbara Slavin & Milt Freudenheim, *Magic of the Market Place*, N.Y. Times (Oct. 4, 1981), http://www.nytimes.com/1981/10/04/weekinreview/the-world-in-summary-magic-of-the-market-place.html.

[70] *Cf.* Robert A. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U. Chi. L. Rev. 690 (1986). *See generally* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate*

When Congress enacted the 1978 Code four decades after the New Deal, the business judgment of the parties was thought to be good enough,[71] government was again sufficiently disrespected, and, with the impending Reagan election, dominant political players would disrespect it even more ("government is the problem, not the solution"). Hence, policymakers comparing government and market expertise for the task at hand—repositioning a business firm—were then more likely to defer to the market and see the government as error-prone. In corporate law, deference to management in decision-making was high.[72]

Moreover, another market change had occurred: the make-up of the firms needing to be restructured. Although this overall industrial change is generally well known,[73] its specific impact on bankruptcy structure has not, as far as I know, been considered. During the century before the passage of the 1978 Code, the bulk of the firms requiring reorganization in bankruptcy had shifted from railroads and public utilities to industrial firms. Railroads were suffused with a public interest and a strong bias for continuation; for industrial firms, however, judicial policymaking could weigh the costs of insider deal-making more heavily than with the railroads because there was less outside public impact if an industrial firm closed down than if a railroad had stopped running. The long evolution of the market here—in the form of the types of firms that comprised the bulk of bankruptcy reorganization proceedings—helps to explain the shift in reorganization thinking and mechanics. For the railroads, deals that would liquidate trunk lines and stop service were too politically unpalatable to be considered. By 1978, the population of firms needing reorganization was dense with industrial firms, retailers, and ordinary businesses—and while an unnecessary shut-down was to be avoided, none of these had the same heavy positive externalities from continuance.

The inside player deal-making structure was in place for only a few years before it was criticized for three distinct deal-oriented weaknesses: First, it was attacked as entrenching public firm managers[74]—a distortion

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*Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97 (1984); Jackson, *supra* note 8, at 7–19.

[71] *See, e.g.*, Lawrence P. King, *Chapter 11 of the 1978 Bankruptcy Code*, 53 Am. Bankr. L.J. 107–09 (1979) (commenting on general satisfaction with private parties' deal-making and dissatisfaction with judicial supervision); Douglas G. Baird, *The New Face of Chapter 11*, 12 Am. Bankr. Inst. L. Rev. 69, 95 n.93 (2004).

[72] *See* Lyman Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 Del. J. Corp. L. 405, 411 (2013) (strong business judgment rule formulated in 1984 in *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). *See generally* Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule,* 19 Del. J. Corp. L. 971, 980, 996–97 (1994); Krishnan Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 Del. J. Corp. L. 505 (1985).

[73] By the second half of the twentieth century fewer than 8% of business bankruptcies were in the transportation, communications, and utilities industries. Sudheer Chava & Robert A. Jarrow, *Bankruptcy Prediction with Industry Effects*, 8 Rev. Fin. 537, 542 (2004).

[74] *See generally* Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 Yale L.J. 1043, 1075, 1088 (1992); Julian R. Franks & Walter N. Torous, *An*

that prolonged the life of zombie firms that had failed operationally. While director and managerial turnover was substantial, in the view of many it was not enough. Second, it was criticized as misapplying a respect for deal-making because parties who are stuck with one another will not strike deals as effectively as parties who are not already embedded in the firm[75]—that kind of embedded bankruptcy deal-making was costly, slow, and susceptible to deadlocking.[76] Third, it was disapproved of for wrongly replicating what financial markets do every day, and do much better (that is, value and reposition firms via mergers and sales).[77] Some of this 1980s criticism of the bankruptcy deal ironically echoed the 1930s criticism, in ways that have been unremarked upon. The 1980s critique was that the 1978 Code deferred to a deal that allowed strategically-placed players—inside management—to extract excessive value in the bargaining process at the expense of creditors and the best repositioning of the firm.[78]

These criticisms left bankruptcy unsettled in the 1980s and 1990s, with critics thinking bankruptcy restructurings could be and needed to be done better. Part of the problem was the chapter X process had stunted the development of public firm bankruptcies; the new, 1978 chapter 11 made them possible, but institutional learning was indeed needed to make the deal work well. But even as the deal evolved and improved, new thinking arose as to whether the deal was needed at all. The age of the bankruptcy deal was reaching its apogee and critics saw it as needing adjustment and potentially replacement.[79] Many thought it was a failure.[80]

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*Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747 (1989). *But see* Stuart Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, J. FIN. ECON. 355, 370 (1990) (stating that more than half of the directors of the sampled firms are gone by the time a bankruptcy or restructuring is completed during the years 1979–85).

[75] *See* Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 540–45 (1983) (analyzing how deals among those already inside the firm would be lengthy and inefficient, and could readily disrespect baseline bankruptcy priorities); *cf.* Franks & Torous, *supra* note 74, at 753–54 (arguing that actual deal results violate absolute priority and involve lengthy bargaining); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1850 (1998) ("Viewing bankruptcy through the lens of contract theory reveals bankruptcy's anachronistic character: Bankruptcy is a government enterprise. The state runs the postal system and the bankruptcy system, and restricts competition with both by law.").

[76] Roe, *supra* note 75, at 536–45.

[77] *Id.* at 563; *cf.* Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 779–80 (1988).

[78] While 1980s entrenchment is the generally accepted view, *see, e.g.*, Bradley & Rosenzweig, *supra* note 74, it is plausible that people were projecting the general corporate, 1980s view of power residing too firmly in the hands of executives instead of investors onto the bankrupt public firm. The most targeted evidence is inconsistent with extreme entrenchment: managerial turnover in bankruptcy was substantial, even in the 1980s. *See* Stuart Gilson, Edith Hotchkiss, & Matthew Osborn, Cashing Out: The Rise of M&A in Bankruptcy (Jan. 2016) (unpublished manuscript), https://papers.ssrn.com/abstract=2547168.

[79] *See* sources cited *supra* notes 74–75.

[80] *See, e.g.*, Bradley & Rosenzweig, *supra* note 74.

### *D. The Third Age: End-of-Twentieth Century Merger Markets*

And today? Today we sell firms in bankruptcy to the highest bidder. The successful buyer decides how to restructure the failed firm's operations; the cash from the sale is then distributed to the debtor's creditors. One descriptive:

> Chapter 11 has healed itself. According to some of its leading critics, chapter 11 is no longer the long, expensive process that it was in the 1980s, when storied companies . . . wasted away their remaining value in vainglorious attempts to survive in a changed marketplace. Today's chapter 11 is a swift, market-driven process that quickly moves troubled companies into more capable hands.[81]

*1. Emergence.* By the late 1990s, this third decision-making mechanism—the whole-firm sale—rapidly rose to stand alongside the prior two.[82] Firms filed for bankruptcy and soon thereafter put themselves up for bids, with the highest bidder buying the firm's operations and the proceeds of the sale going to the firm's pre-bankruptcy creditors. Sometimes a buyer was ready at the time of the bankruptcy filing, with an auction testing the bona fides of the consideration offered.[83]

As late as the 1970s, courts were casting aspersions on market value. The standards for market valuation, such as "existing market prices . . . and comparable sales[,] *need not be significant factors in determining reorganization value*," said the court in a major bankruptcy of the 1970s.[84] Reorganizational value was for courts, not markets, to find.

Early appellate decisions in the 1980s did not support the whole-firm sale.[85] The code was deal-oriented, not sales oriented. While the deal provisions were extensive, the code's mechanism for the sale was barebones and undeveloped, embedded in a single sentence.[86] On its face, even that sentence was not sales friendly, in that it required that the debtor formally propose the sale—there was no direct authority for the *creditor* to move the

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[81] Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 Ky. L.J. 839, 840 (2005). Lubben summarizes the conventional wisdom of supporters of bankruptcy sales, but he is skeptical that the market-driven approach is good, primarily because the sale has control rights migrating to a single lender, who manages the process for the lender's benefit in ways that need not maximize the firm's and its stakeholders' overall value. *Id.*

[82] *See* Am. Bankr. Inst., Commission to Study the Reform of Chapter 11: Final Report and Recommendations 2012–2014 (2014); *see also* Gilson, Hotchkiss, & Osborn, *supra* note 78.

[83] Gilson, Hotchkiss, & Osborn, *supra* note 78, at 8.

[84] *In re* Equity Funding Corp., 391 F. Supp. 768, 772–73 (C.D. Cal. 1975) (emphasis added). Equity Funding was a huge firm that went bankrupt after the largest financial fraud in American history (up to that time). Raymond L. Dirks & Leonard Gross, The Great Wall Street Scandal (1974).

[85] *See, e.g.*, *In re* Lionel Corp., 722 F.2d 1063 (2d Cir. 1983); *In re* Braniff Airways, Inc., 700 F.2d 935 (5th Cir. 1983); *In re* Continental Air Lines, Inc., 780 F.2d 1223 (5th Cir. 1986).

[86] 11 U.S.C. § 363(b)(1) (2016) ("The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . . .").

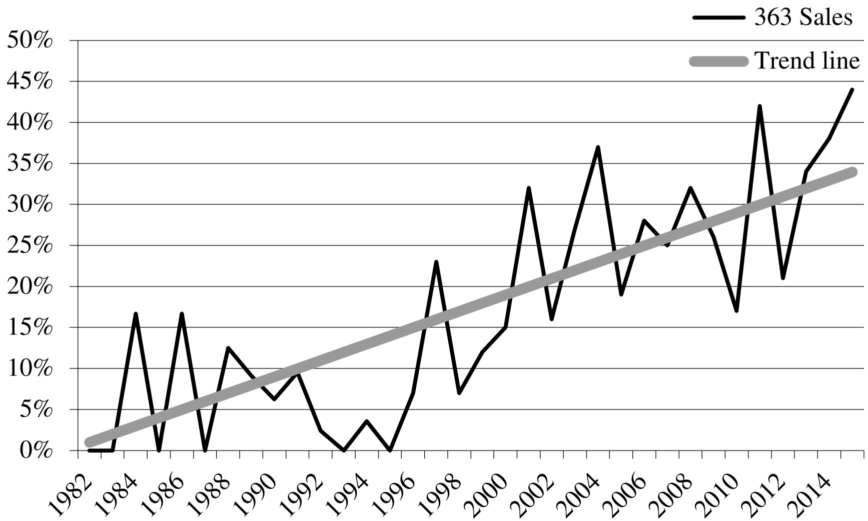
court to force a sale. But despite early appellate decisions that impeded the sale, the practice became common during the mid to late 1990s and it is now a major mechanism for reorganization,[87] as Figure 1 shows. There were no reported § 363 sales of public companies in 1989; by 2007, 35% of the reorganized public companies were sold via § 363 sales. The import of the sale for bankruptcy decision-making goes further, as divisions and subsidiaries are individually sold and the potential for a sale influences administrative determinations, such as the assigned value of the firm, which formerly was disconnected from market value.[88] Even in reorganizations that seem structurally to be deals or administered decisions, the market determines key aspects of the deal or administered result, because the baseline value of the firm becomes its third-party sale value, from which deviation needs to be justified.

[87] *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 Stan. L. Rev. 673 (2004); Edward I. Altman, *The Role of Distressed-Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations*, 22 Am. Bankr. Inst. L. Rev. 75, 92–93 (2014); Jared A. Wilkerson, *Defending the Current State of Section 363 Sales*, 86 Am. Bankr. L. J. 591, 601 (2012).

Baird and Rasmussen divide old-style from new-style chapter 11's along a boundary different from that in this paper. They see the new chapter 11 as the sum of sales and proceedings with a deal already in place when the bankruptcy petition is filed (so-called "pre-packaged bankruptcies"), as opposed to a deal that is developed in bankruptcy. Baird & Rasmussen, *supra*, at 674 ("84% of all large Chapter 11s from 2002 [had] the investors enter[ ] bankruptcy with a deal in hand or used it to sell the assets of the business"). Here, I see and categorize pre-packaged bankruptcies as faster forms of 1978-Code-inspired deal-making and see the § 363 sale as a new and different decision-making mechanism.

[88] On the limited connection to market value, see Roe, *supra* note 75, at 547–48, 563; Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. Chi. L. Rev. 565, 569, 571 (1950). Without a clear marker for value, priority is indeterminate, because the potential deal-making parties do not how far down the capital structure pecking order the distribution of value can go.

FIGURE 1. INCREASING NUMBER OF WHOLE-FIRM § 363 SALES IN QUARTER-CENTURY AFTER 1989




The graphic shows the 30-year trend-line of § 363 sales, which go from zero in 1983 to 44% of public firm bankruptcies in 2015. The data underlying the chart comes from the UCLA-LoPucki Bankruptcy Research Database.[89]

*2. Market conditions, ideological coherence.* Criticisms of managerial control of the bankrupt and the code-supported deals of the 1980s[90] fit snugly with a corporate worldview of that era, namely that the core problem in the large public firm was that of managerial agency costs, with managers running too many public firms poorly. The hostile takeover could, in this view, cure the problem.[91] Bankruptcy should imitate the takeover, not the deal; bankruptcy should oust managers and put new owners in place.

In a market-friendly era, a statute that had as its backup a judge—a government figure—valuing a business firm seemed peculiar to market-driven players because the marketplace was valuing firms and securities every day.[92] Underlying market conditions drove the emergence of the § 363 sale even more strongly than it drove prior shifts; it lacks strong statutory authority but nevertheless prevailed.

Two market conditions made the § 363 sale especially propitious when it arose at the twentieth century's end; one is well-recognized and the other is

[89] UCLA-LoPucki Bankruptcy Research Database, http://lopucki.law.ucla.edu/trend_tracking.htm (last accessed Apr. 3, 2017); *see also* AM. BANKR. INST., *supra* note 82, at 203.

[90] *See* Bradley & Rosenzweig, *supra* note 74.

[91] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Ronald Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

[92] Roe, *supra* note 75, at 559–62, 574.

not. First, the merger market boomed in the 1980s, with the merger rate double that of even prior booms.[93] Hostile takeovers were common during the 1980s, with nearly one-third of the largest industrial firms being targeted by a takeover bid.[94] Against that 1980s-market backdrop, it was natural to ask why a failed firm in bankruptcy should not just be sold to a better-managed firm. The merger market by the 1990s was deep and broad, with a strong infrastructure of supporting bankers, lawyers, and other professionals—all of whom could easily turn from their bread-and-butter merger practice to handle bankruptcy-based mergers, which they did.[95]

A second market change supports the § 363 sale's rise. Debt claims trade more often than they did in earlier decades in the run-up to, and during, the bankruptcy.[96] But the deal-centered framework of the 1978 Code needs *stable* creditors with knowledge of the firm and its management. These stable creditors would negotiate a deal among themselves and with the firm's executives, and would give input on the best direction for the business. However, these deals cannot be concluded if the claims have dispersed to multiple investor portfolios, with the owners ready to trade and often actually trading.[97] Such creditors have less reason and reduced capacity to negotiate a deal. Particularly when they have a small economic interest, they have little incentive to invest in understanding the debtor, and their smallness weakens them as negotiators.

Trading claims do often coalesce nowadays in hedge fund or investment portfolios—so-called vulture funds—when the fund buys up the bulk of a class of distressed claims that it thinks is undervalued.[98] These investors often study the target company carefully before buying and know its business; they may not know the executives personally and well, but they will bring fresh knowledge of the business to the negotiating table. But even this

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[93] *See* David J. Ravenscraft, *The 1980s Merger Wave: An Industrial Organization Perspective*, *in* THE MERGER BOOM 17, 19 (Lynn E. Browne & Eric S. Rosengren eds., 1987); Linda Brewster Stearns & Kenneth D. Allan, *Economic Behavior in Institutional Environments: The Corporate Merger Wave of the 1980s*, 61 AM. SOC. REV. 699, 700 (1996).

[94] *See* Gerald F. Davis & Suzanne K. Stout, *Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Targets, 1980–1990*, 37 ADMIN. SCI. Q. 605, 605 (1992).

[95] Michael C. Jensen, *Corporate Control and the Politics of Finance*, 4 J. APP. CORP. FIN. 13, 31–32 (1991) ("One way to solve the . . . [bankruptcy] problem would be to allow any party . . . to make an all-cash bid for the control rights to the company. At the close of the auction, the highest bidder would immediately assume control of the company and its operations." (emphasis removed)).

[96] *See* Victoria Ivashina, Benjamin Iverson, & David C. Smith, *The Ownership and Trading of Debt Claims in Chapter 11 Restructurings*, 119 J. FIN. ECON. 316 (2016).

[97] *See* Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 651, 655 (2010); Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 AM. BANKR. INST. L. REV. 69, 83, 93 (2008); Robert K. Rasmussen & David A. Skeel Jr., *Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 101 (1995); Ivashina, Iverson, & Smith, *supra* note 96.

[98] *See* Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distress Firms*, 43 J. FIN. ECON. 401, 401–05, 430–31 (1997); Ivashina, Iverson, & Smith, *supra* note 96.

block coalescence need not lead to a cohesive group that negotiates a deal effectively. The hedge fund often wants to be able to trade in and out of its position when it assesses the market price as being too low or too high. But participation in the deal negotiations, particularly if the trading creditor is part of an official creditors' committee, would usually sterilize that creditor's ability to trade legally, as it will be privy to much inside information.[99]

This new market condition—fragmentation and instability due to claims trading—has been noticed before as debilitating the code's preference for a deal.[100] But not yet explained, as far as I know, is that fragmentation and instability do *not* concomitantly weaken bankruptcy's capacity to auction the whole firm via § 363. Market conditions have strengthened bankruptcy institutions' relative capacity to use the left-hand side of the debtor's balance sheet (where the assets are), and ignore the right-hand side (where the debts are), by selling the debtor's operations while leaving the debts behind. These two market developments (of merger market depth and claims trading liquidity) largely explain the apogee of the age of the sale.[101]

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Here we can see this paper's market-driving thesis at work, cycling through the twentieth century. When the merger market was rudimentary at

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[99] *See In re* Wash. Mut., Inc., 461 B.R. 200, 254, 263 (Bankr. D. Del. 2011), *vacated in part*, No. 08-12229, 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012); James M. Peck, *Settlement Talks in Chapter 11 After "WaMu": A Plan Mediator's Perspective*, 22 AM. BANKR. INST. L. REV. 65, 66–68 (2014) ("Many distressed hedge funds [fear] negotiations that might expose them to . . . insider trading claims. . . . What funds are most reluctant to do is to restrict their ability to trade for extended periods of time . . . ."); Daniel B. Kamensky, *Furthering the Goals of Chapter 11: Considering the Positive Role of Hedge Funds in the Reorganization Process*, 22 AM. BANKR. INST. L. REV. 235, 243–44 (2014); HILARY ROSENBERG, THE VULTURE INVESTORS 107, 322–24 (1992); Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 3, 8, 37, 46 (1990); *cf. In re* Allegheny Int'l, Inc., 118 B.R. 282, 289–90 (Bankr. W.D. Pa. 1990), *amended on reconsideration*, 1990 BKRTCY LEXIS 1759 (1990).

[100] *See* Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 68, 71–76 (2009); Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U.L. REV. 1684, 1686, 1715–26 (1996). Creditor concentration, when it exists, makes a prearranged filing more likely to succeed, shortens the debtor's time in bankruptcy, and increases the probability of the debtor emerging intact at the end of the proceeding. *See* Ivashina, Iverson, & Smith, *supra* note 96.

[101] Analysis shows that § 363 sales are not always arms-length sales to third parties but sales to a dominant creditor who has purchased the so-called fulcrum security or become the post-filing dominant lender. *See* Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians at the Gate?*, 89 WASH. U. L. REV. 155, 161–69 (2011); *cf.* Sarah Paterson, *Rethinking Corporate Bankruptcy Theory in the Twenty-First Century*, 36 OXFORD J. LEGAL STUD. 697, 711, 714, 723 (2015). This observation adds texture to the core thesis of bankruptcy decision-making reflecting market conditions. The outside bidding can begin before the § 363 sale, starting when an outsider acquires control of the fulcrum security or an insider cements its dominant relationship by becoming the post-petition lender to the bankrupt (the so-called "DIP lender"). Hence, decision-mode lines blur: these latter hybrids are quasi-restructurings, but mediated and tested by the market via an eventual § 363 sale, which the fulcrum creditor or the inside DIP lender wins. An outsider can buy the company away from the owner of the fulcrum security or the DIP lender if the insiders have set too low a price, thereby, hybriding a restructuring and a sale. Such modern restructurings are thereby made subject more to a market test than to judicial review and valuation.

the end of the nineteenth century, a deal had comparative advantages over the two other decision-making systems. When the policymaking atmospheric was that courts lacked sound business judgment compared to the firm's players, then courts deferred to parties (in the nineteenth century receivership and a century later in the post-1978 restructurings). When corrupt, insider dealing seemed a bigger risk than administrative and judicial error—as it seemed to be in the 1930s—then judicial administration seemed better suited to handle the vivid problem of the time; yes, courts' business judgment was imperfect, but judges would be better than the parties at rooting out insider deals—or so it was thought. The administrative system rose to prominence during the Great Depression, when markets generally did not command respect.

## III. Modern Fissures?

Consequences of the above analysis: as markets evolve, so will bankruptcy. Moreover, many nations around the world look at chapter 11's success and seek to emulate it, but since its success depends on underlying market conditions, they may err.

Moreover, perceptions of market quality need not tie tightly to actual market quality. While U.S. decision-makers still broadly favor market solutions, these sentiments could shift. The recession following the 2008–2009 financial crisis did not deepen and extend pro-market opinion. The 2016 presidential election, and the broad hostility in the polity to the Trans-Pacific, market-oriented trade agreement, show reservations to, or a generalized turn against, market solutions, which, if it persists and strengthens, may in time influence the structure of bankruptcy decision-making.

And two new bankruptcy and market features make the collective proceeding less central than it has been: First, in recent decades more financial instruments and structures have become exempt from bankruptcy's core provisions (like the automatic stay), creating a decision-making system for these instruments that differs from those prevailing during the last century. Second, changes in industrial organization could be rendering bankruptcy's collective proceeding less important than it once was. More specifically, when industrial organizations were typically built around big, vertically integrated firms, collective restructuring was absolutely critical. But with fewer firms fully vertically integrated today, the need to hold the whole enterprise together in bankruptcy is less vital than it once was. The function of the § 363 sale could shift; no longer would it hold a coherent organization together, but it could become the means to break it up—similar to how the hostile takeover of the 1980s broke up the unwieldy conglomerates.

Whether these forces will be just an important undertow or will become strong enough to bring about a fourth age of bankruptcy remains to be seen. We look at each in more detail.

### A. The New Finance

*1. The new finance: what is it?* A derivative transaction is a risk-transferring transaction—for example, one party agrees to pay the other, for a fee, if a foreign currency rises above a specified level. Operating firms use derivatives to shield themselves from risks that are not core to their business: an American manufacturer selling to European customers, with the contract payment to come in euros, often wants to avoid the risk of currency fluctuation. So it makes a derivatives contract to sell euros for dollars, with the foreign exchange contract to be performed when the manufacturer expects to deliver the product and be paid in euros. These derivatives transactions are increasingly common.[102] While many are between financial institutions, many involve operating firms that want to buy their way out of bearing a particular risk. When such a derivatives-using firm goes bankrupt, its derivatives debts are exempt from the firm's bankruptcy and typically are immediately liquidated.

Wide classes of repurchase agreements (repos) are exempt from bankruptcy as well. A repo is functionally a secured loan, with the "purchased" security the collateral. The securities that qualify for exemption from bankruptcy include secured loans with U.S. Treasury securities as collateral, as well as secured loans with mortgage-backed securities as collateral.[103]

*2. Exit from bankruptcy.* The exempt instruments are neither part of a bankruptcy deal, nor subject to bankruptcy administration, nor sold as part of a bankruptcy sale of the debtor's operations. Instead the bankrupt's counterparties are not stopped by the bankruptcy proceeding from collecting on their contracts immediately; unlike other creditors, they can sell their collateral and keep the proceeds.[104] Under these conditions, none of the three core decision-making methods come into play.

The safe harbors played an important role in the 2008–2009 financial crisis, exacerbating financial instability according to several economists and legal academics.[105] There was a run on safe-harbored repos, particularly repos on mortgage-backed securities,[106] similar to that of an old-style bank run. That run led to financial institutions reducing lending, freezing transactions,

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[102] *See* Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 543–44 (2011).

[103] For a precise history of the exemptions, see Steven L. Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis*, 71 WASH. & LEE L. REV. 1715 (2014).

[104] 11 U.S.C. § 362(b)(6)–(7) (2012).

[105] *See* Edward R. Morrison, Mark J. Roe, & Christopher Sontchi, *Rolling Back the Repo Safe Harbors*, 69 BUS. LAW. 1015 (2014); Enrico Perotti, *Systemic Liquidity Risk and Bankruptcy Safe Harbour Privileges*, 4 J. INT'L BANKING & FIN. L. 187 (2011); David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152, 201 (2012).

[106] *See* Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo*, 104 J. FIN. ECON. 421, 448 (2012); Antoine Martin, David Skeie, & Ernst-Ludwig von Thadden, *Repo Runs*, 27 REV. FIN. STUD. 957, 958 (2014).

and cutting back their key economic activities.[107] The economy fell into a recession.

### *B. New Market Conditions: Financing Speed, Decentralized Industrial Organization*

Market conditions could justify these changes and, hence, could support a fourth age of bankruptcy, one that is more liquidation-oriented than the last century's. Two of the most important market conditions are the increasing speed of finance and potentially changing modes of modern industrial organization.

The rapidity by which assets can be refinanced has not been seen as a variable, but should be; extremely rapid refinancing capacity, if nearly instantaneous, could justify the rise of bankruptcy-exempt instruments, such as repos and derivatives.[108]

*1. The speed of finance.* As far as I know, the financial market conditions that would fully justify the exemption from bankruptcy have not been specified—the critical underlying financial market condition being the speed with which firm-specific assets can be refinanced. We are closer in 2017 to the justifying conditions than ever. But like traveling along an asymptote, we will never arrive there. Hence, there is good reason to conclude that the widening full exemption from bankruptcy overshoots what the market can support: narrowing, yes; exemption, no.

If the debtor with a sound ongoing business could instantaneously replace a defaulted loan with financing from another lender, then the rationale for the traditional bankruptcy stay wanes. The debtor files for bankruptcy and the bankruptcy-exempt creditors immediately have themselves repaid by helping themselves to any collateral they have obtained.

Even if the specific assets are critically necessary for to the debtor's operations, bankruptcy exemption will not destroy the debtor's value *if* the debtor can rapidly replace the financing. The debtor could cash out the bankruptcy-exempt creditor and, having been paid, the creditor would have to leave the collateral with the debtor, who would own it outright. As long as the debtor can immediately obtain sufficient post-filing debtor-in-possession financing, then the debtor can use that funding to pay off its bankruptcy-exempt debt and thereby keep the underlying assets. If the collateral is less

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[107] *See* Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007–2008*, 23 J. ECON. PERSP. 77 (2009); Roe, *supra* note 102, at 567–69.

[108] Other increasingly-used structures are similarly bankruptcy-exempt. The special purpose entity (SPE) structure has a company place assets into a business entity that normally will not be pulled into the bankruptcy of the originating company. Gary B. Gorton & Nicholas S. Souleles, *Special Purpose Vehicles and Securitization*, *in* THE RISKS OF FINANCIAL INSTITUTIONS 549 (Mark Carey & Rene M. Stulz eds., 2006) (stating that SPEs "exist in large part to reduce bankruptcy costs"). Creditors of the SPE, then, are able to collect as if the structure were bankruptcy-exempt. Such SPEs should be grouped with bankruptcy-exempt derivatives and repos for the text's analysis.

valuable than the loan, the largest available loan (at typical secured terms) on the collateral would in a fully competitive market be an indicator, albeit a noisy one, of the value of the underlying collateral. If financial markets have achieved that level of perfection, there is less reason for full-scale traditional bankruptcy decision-making, vis-à-vis secured creditors, whether by administration, deal, or sale.[109] That instantaneous possibility is of course unavailable, but we are closer to it now than before. A shorter stay of days or weeks might come to be more appropriate than the "forever" stay now embedded in the code.

Posit that the firm has a steel mill, which secures $1 billion in (hypothetically) bankruptcy-exempt debt. (Such debt is not bankruptcy-exempt today.) Even if that debt were bankruptcy-exempt, then, *if* the debtor could immediately obtain $1 billion in a new loan when the firm is operationally viable, the debtor could pay off the old creditor and retain the steel mill. The firm would not, in such circumstances, need the bankruptcy stay in order to survive. Properly understood, the longstanding justification for the bankruptcy stay (that without it the firm would be ripped apart) is correct, but incomplete. It's not just that the debtor has a firm-specific use for the asset, a point that is correct and has been well made.[110] It's more a mutually dependent combination that justifies the stay: the debtor has a firm-specific asset *and* it cannot obtain financing for that asset rapidly enough on ordinary market terms to retain the asset if its business warrants retaining it.

That is, firm-specificity in itself does not justify the stay if instantaneous and appropriately priced refinancing for the over-secured loan is available. Firm-specificity is necessary but insufficient. With instantaneous refinancing, the debtor could retain the firm-specific asset for its reorganization. While formerly it was implausible to expect quick refinancing, rapid debtor-in-possession financing and even out-of-court refinancing is how common enough that one core justification for an extended bankruptcy with an endless stay is diminishing.

Hence, even the firm-specific quality of the asset would not justify it being subject to bankruptcy and the stay, if financial markets were so effective that they could immediately refinance the mill without noticeable bargaining or other transaction costs. (Or, stated more properly, without bargaining and other transaction costs greater than those of a regular bankruptcy. Again, I do not mean to short-change other problems that need to be

[109] To be clear, the text is not arguing that debt overhang justifications disappear. *See* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 149, 154–55 (1977). And some firms simply are not worth continuing. Rather, if a fully senior, secured loan can be rapidly refinanced, one major justification for bankruptcy and the automatic stay disappears.

[110] *See* Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. REG. 92, 94, 108–11 (2005); *see also* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 768–72 (2002).

overcome for under-secured creditors,[111] just that previously-thought show-stoppers will become, and are becoming, less relevant.)

For the financial contracts that bankruptcy does exempt, posit that, like the firm-specific steel mill, a financial debtor needs the exempt financial asset because that derivative interest rate swap is part of a well-constructed portfolio that has more value sold intact than in pieces.[112] Even if the asset has firm-specific value, if the debtor firm could instantaneously refinance the over-secured debt financing of that asset at acceptable cost, it could keep the asset for its own operations or portfolio sale. Market conditions would support allowing the asset to be bankruptcy-exempt. If refinancing could be obtained in, say, a week, then market conditions would justify a stay and a bankruptcy of a week, but not longer.

To be sure, this speed-of-financing dynamic cannot displace all, or perhaps even a majority, of bankruptcy decision-making. The firm-specific asset's value must be high enough to pay off the relevant debt. The stay could remain important, however, when the debt is greater than the value of the firm-specific asset, such that the refinancing cannot fully pay off the creditor. Even for this scenario, not at all uncommon, hybridization is possible: quick refinancing, if available, can provide cash to pay off the secured creditor to the extent of the security, with the deficiency dropping down to be an unsecured claim, which is stayed until, say, the firm can be sold under § 363.[113]

*2. A new industrial organization?* Another market change reduces industrial firms' need for a collective proceeding that holds the organization intact. The collective bankruptcy proceeding is needed for an industry comprised of big, vertically integrated firms that cannot readily be separated into stand-alone businesses.

But more and more, modern industry is not organized as deeply as before in large, vertically integrated enterprises, but rather in contracting entities.[114] The older organization—celebrated and analyzed in Alfred Chandler's famous prize-winning books—is no longer front and center for Ameri-

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[111] *See supra* note 109.

[112] *See* Mark J. Roe & Stephen Adams, *Restructuring Financial Firms in Bankruptcy: Selling Lehman's Derivatives Portfolio*, 32 Yale J. on Reg. 363, 365 (2015).

[113] *Cf.* Paterson, *supra* note 101, at 710–11 (pointing out that concentrated creditors in the distressed debt market will tend to redeploy the firm in a rational manner, making the automatic stay less valuable than it once was, if creditors coalesce). Changed market refinancing circumstances could also incentivize firms and creditors to be sure that the debt is fully collateralized such that there would be no reasonable challenge to the collateral's adequacy, making the near-instantaneous refinancing scenario realistic.

[114] *See* Gillian K. Hadfield, *Legal Infrastructure and the New Economy*, 8 I/S: J.L. & Pol'y for Info. Soc'y 1, 12–18 (2012) (arguing that globalization and the internet have transformed the organization of production and distribution such that firms are no longer vertically-integrated boxes, but rather networks of suppliers, consumers, regulators, investors, and researchers); Larry A. DiMatteo, *Strategic Contracting: Contract Law as a Source of Competitive Advantage*, 47 Am. Bus. L.J. 727, 772–79 (2010) (identifying hybrid, disintegrated organizations as increasingly common).

can and indeed worldwide industrial organization.[115] For today, think first of Uber and the gig economy, in which firms rent easily-sold goods or services to customers, or connect end-users with providers, but own neither.[116] This structure lacks the deep synergies from keeping together the physical, dedicated assets of a railroad or an integrated steel mill. The use of such decentralized organizational structures diminishes the value of a collective bankruptcy proceeding. Ronald Gilson, Charles Sabel, and Robert Scott have analyzed how and why this decentralized structure is particularly important and increasingly widespread in industries dependent on constant innovation.[117]

The emerging organization of the drug industry illustrates: Big Pharma pushes new drugs through the regulatory process, and then manufactures, markets, and distributes them. But decentralized biotech firms develop the new products and then sell either the product or the small successful company itself to the Big Pharma enterprise, which takes over regulatory relations, manufacturing, and marketing.[118] A bankruptcy of the Big Pharma company poses less need to keep the debtor together because a vital part of the business consists of the separately operating biotech firms that can continue despite the big firm's demise. The separately-operating firms then just sell their product (or the firm itself) to another Big Pharma operation.[119]

Moreover, big pieces of the debtor can be removed from its interior and pushed elsewhere in the economy; the debtor is no longer an integrated whole, whose divisions must move in tandem in the way they had to move together previously. Yes, bankruptcy disrupts elements of the larger interconnections—the biotech feeder firms must scramble—but they adjust more

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[115] *See* Chandler, *supra* note 11; Chandler & Daems, *supra* note 11. For analysis of the breakdown of the Chandlerian hierarchy outside bankruptcy, see Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 Colum. L. Rev. 431, 433–34 (2009).

[116] *See* Daniel E. Rauch & David Schleicher, *Like Uber, But for Local Government Law: The Future of Local Regulation of the Sharing Economy*, 76 Ohio St. L.J. 901, 903 (2015). Douglas Baird makes this point well for the service industry. *See* Baird, *supra* note 71, at 82 ("[T]he going-concern surplus is less evident now than in the time of the great railroads. Few businesses today center around specialized long-lived assets. In a service-oriented economy, the assets walk out the door at 5:00 pm."). Here, I make a related point for more core, vertically-integrated firms.

[117] Gilson, Sabel, & Scott, *supra* note 115, at 433–34 (contrary to the older, conventional industrial organization theory, rapidly innovating industries today are moving away from vertical integration and toward contract).

[118] *See* Walter W. Powell, Kenneth W. Koput, & Laurel Smith-Doerr, *Interorganizational Collaboration and the Locus of Innovation: Networks of Learning in Biotechnology*, 41 Admin. Sci. Q. 116, 122–24 (1996); Weijan Shan, Gordon Walker, & Bruce Kogut, *Interfirm Cooperation and Startup Innovation in the Biotechnology Industry*, 15 Strategic Mgmt. J. 387, 387–88 (1994) (more major collaboration between large, established pharmaceutical companies and small biotech start-ups to successful biotech product development); Gilson, Sabel, & Scott, *supra* note 115, at 439–40.

[119] *See generally* Lisa Beilfuss, *MannKind, Sanofi End Licensing Pact of Diabetes Medicine Afrezza*, Wall St. J. (Jan. 5, 2016), https://www.wsj.com/articles/mannkind-sanofi-end-licensing-pact-for-diabetes-medicine-afrezza-1452008402.

readily than if they had been, as they once often were, embedded inside a vertically integrated firm. They can find ways to deal with other nonbankrupt firms and survive without crippling costs.

Contracting entities depend less on a centralized collective reorganization than nineteenth century railroads and twentieth century vertically-integrated manufacturing firms did. Whereas the race-to-the-courthouse would have dismantled vital parts of such enterprises, the new industrial organization literature sees interconnections more often than before being made outside the traditional firm via contracts and relationships. Bankruptcy thus could come to be a transitional means from the old vertically-integrated structures to new more decentralized ones. If this new decentralization becomes a dominant form of new industrial organization, then we may well see a fourth age because the change would render the administered system, the deal, and the sale less vital than they once were.

Bankruptcy could become a mechanism to break up vertically-integrated firms that it once needed to keep intact via the long stay; picking the right decision-making mode to keep the vertically-integrated firm *intact* would subside, replaced by the goal of picking the right mode *to break apart* the vertically-integrated firm. Decision-making modes would experience a functional shift. For example, the § 363-sale could persist, but be repurposed, with § 363-buyers not reconditioning the vertically-integrated firm for continuance but instead sharply breaking up what once seemed necessary interlocks among divisions.[120]

These changes do not stand alongside the deal and the sale as a complete decision-making means for restructuring a failed firm. And in truth, any new system with these new characteristics will never completely displace the prior systems. It will erode, but not replace them. First, the formal new exemptions from bankruptcy are big but not all-encompassing for industrial, retail, and other operating firms' liabilities. Although operating firms sometimes seek to build themselves around bankruptcy-exempt entities,[121] it is hard to build an entire economy that way. Finally, while more businesses can today be run in a decentralized manner, others cannot; even those that can be decentralized into separate corporate units, cannot be decentralized for every business task.

Hence, for now, we speak of fissures and not a new bankruptcy era comparable to the prior three ages. The fissures are not yet a fourth age for bankruptcy, but they are now reducing, and could in the future sharply reduce, the strength of prior ages.

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[120] *Cf.* Leslie Picker & Liz Moyer, *Xerox Said to Be Ready to Divide Into 2 Units*, N.Y. Times, Jan. 29, 2016, at B1 ("Xerox . . . will be joining other big American corporations that have split apart . . . in recent years . . . .").

[121] *See, e.g.*, *In re* Gen'l Growth Props., Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009) (the General Growth real estate empire put each real estate entity into an ostensibly bankruptcy-remote entity, with mixed success in resisting bankruptcy impact).

### C. Foreign Lessons: Can Chapter 11 Travel?

Another lesson can be learned from this Article's analysis. Nations around the world see an American-style chapter 11 as a model to emulate.[122] "Many European jurisdictions have sought . . . to emulate the perceived success of Chapter 11 by establishing similar regimes,"[123] a leading American law firm reports. Additionally, "[t]he centerpiece of the [new French] act is . . . inspired by the US bankruptcy system's Chapter 11 process."[124] But emulation is mistaken if the underlying market conditions are a bad fit. Reformers may prefer the deal-oriented structure of a traditional chapter 11, but its efficacy depends on the quality of market transparency, the nation's financial system's ability to develop bankruptcy refinancing, and the capacity of managerial markets to replace old management. If any of these underlying market conditions is missing, chapter 11 will not work well.[125]

More concretely, many thought chapter 11 was a failure[126] in its first decade and, hence, emulating 1980s-style chapter 11 could well be mistaken. In this paper's view, chapter 11 eventually triumphed because of underlying market conditions and the rise of § 363-sale, which both took many firms out from the deal and made market values more legitimate and vivid. This thereby reduced the likelihood and debilities of deadlocked deals because deadlocks could be broken via a sale. But § 363-sales depend critically on the viability of merger markets; another nation's economy lacking them may be unable to make chapter 11 work well and could be buying into the bargaining deadlocks, incumbent entrenchment, and delays that afflicted chapter 11's first decade.[127]

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[122] Bob Wessels & Rolef J. de Weijs, International Contributions to the Reform of Chapter 11 U.S. Bankruptcy Code 3 (2015); Alexandra Rhim, *Reorganization Schemes Under U.K. Insolvency Act of 1986: Chapter 11 as a Springboard for Discussion*, 16 Loyola L.A. Int'l Comp. L.J. 985, 986, 1019 (1994).

[123] James H.M. Sprayregen, Erin N. Brady, & Graham R. Lane, *Two Systems Divided By a Common Language*, Kirkland & Ellis 9 (Sept. 20, 2013), www.kirkland.com/siteFiles/kirkexp/publications/2318/Document1/Final%20Submission%20for%2023%20September%20ABI%20Conference.pdf; *see* Deborah Ball, *Europe Builds Own Chapter 11*, Wall St. J., Apr. 5, 2013, at B1; Jim Brunsden, *Brussels Considers Chapter 11–Style Bankruptcy Regime*, Fin. Times (Nov. 22, 2016), www.ft.com/content/e67870c0-b0ae-11e6-a37c-f4a01f1b0fa1.

[124] Eric Cafriz & James Gillespie, *French Bankruptcy Law Reform Assessed*, 24 Int'l Fin. L. Rev. 41, 41 (Dec. 2005).

[125] Such missing pieces are sufficient to undermine a chapter 11 transplant, but they are not the only impediments. If bankrupt firms are too closely associated with malfeasance and moral failure, rehabilitation will be hard even if legal structures are supportive. Legal structures may not blend well with market sales and deal-making in some nations, even if their markets support sales and deals. And it takes time for lawyers and bankers to figure out how to make restructurings work.

[126] *See supra* note 74; Wessels & de Weijs, *supra* note 122, at 23–25. But to conclude, as some do, that chapter 11 "failed" requires a baseline. Chapter 11 may have worked imperfectly in its first decade, but even if suboptimal, if it nevertheless worked better than 1938 administration, it succeeded.

[127] *Cf.* Cem Demiroglu, Julian Franks, & Ryan Lewis, Do Market Prices Improve the Accuracy of Court Valuations in Chapter 11? (Sept. 22, 2016) (unpublished manuscript),

Furthermore, even if the country importing chapter 11 has compatible market conditions, the internal attitudes concerning the operation of the market may not fit. If its citizens are hostile or uncomfortable with markets and market-based solutions, a polity with the necessary baseline market capabilities to be able to mimic chapter 11's operation should think twice before instituting reform.

## Conclusion

Bankruptcy law imposes a collective proceeding on a debtor's creditors, who, absent bankruptcy's constraints, would have strong incentives to race to the courthouse, to sue, to obtain a judgment, and then to levy on the debtor's property, disassembling the debtor's business.

Three decision-making systems have arisen to accomplish this restructuring—administration, a deal, and a sale. Each is embedded in the Bankruptcy Code today and each has been in play for more than a century. But each has had its heyday, rising, dominating, and then, for the first two, falling from prominence over the twentieth century. Those shifts, rises, and falls give the code a palimpsest quality, as elements of each survive their decline.

Previous explanations for bankruptcy shifts have relied on bankruptcy institutions' learning, on lawyers and their influence, and on rent-seeking from powerful creditors. But shifts in bankruptcy's decisionmaking structure over time cannot be evaluated or even understood without considering surrounding market conditions. Underlying market conditions can explain the broad outlines of the shifts over the twentieth century, with ideology and political pressures from dominant groups explaining why some shifts went further than underlying market conditions could justify. The first age flourished for four decades after the New Deal's 1938 Bankruptcy Act established an administered system in which the judge, with an expert agency's advice, decided whether and how to restructure the firm. It reflected top-down, New Deal thinking. The second age began its dominant era in 1978, when the current Bankruptcy Code re-established a deal-oriented system in which classes of creditors and owners negotiate a deal with only loose judicial supervision. The deal-oriented statute reflected a mindset in which the will and knowledge of private parties were respected, while the expertise of government agencies and administrators on business deals was doubted.

In the late 1990s, the third system rose to prominence—the sale of the firm in its entirety to the highest bidder. Its rise grew out of a market economy in which mergers were common, professionals in law and finance had little difficulty engineering whole-firm sales, and markets were respected enough and operated more quickly than courts and bargaining creditors. The whole-firm sale has become prominent for industrial restructuring in the

https://papers.ssrn.com/abstract=2693056 (showing that the availability of good market prices for bonds greatly reduces misvaluation).

United States. Market conditions prevailed over an unfriendly statutory structure, skeptical appellate decisions, and an absence of supportive congressional intent.

Is the current age of bankruptcy the culmination? Cracks have appeared. The financial safe harbors, special purpose vehicles, and decentralized industrial organization instead of the single, large vertically-integrated firm of prior decades all are major market changes that could change bankruptcy. Bankruptcy-exempt creditors can now enforce their state-based based contract rights despite the debtor's bankruptcy. They take no part in that collective bankruptcy proceeding to hold together the enterprise value. Their exemption can be justified—or at least a substantial exemption via a very short bankruptcy stay against creditor collection could be justified—if financial markets are now so good and so fast that valuable assets can readily be refinanced quickly. Second, because connected pieces of industry—think biotech firms with relationships to a bankrupt Big Pharma firm, but not owned by the debtor Pharma firm—can readjust more easily, the stand-alone bankruptcy of a vertically-integrated firm is less important than it once was. The long bankruptcy stay, to keep the firm together, intact, may no longer be vital for many debtors. Lastly, foreign efforts to emulate chapter 11 should be considered more carefully; chapter 11 in the United States works relatively well, but it does so because it is well-adapted to American market conditions.

Over the past century-long arc for bankruptcy, one can see three ages for bankruptcy decision-making—administration, the deal, and the market sale—with each resting on underlying market conditions.