Preliminary Rough Draft—Not for Distribution

Distributional Rules and the Bankruptcy Partition

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Bankruptcy's distributional rules are straightforward. Senior creditors must be paid in full before anyone junior.[1] And among creditors of the same class, distributions must be pro rata.[2] It is easy, however, to find cases that appear to depart from those rules.[3] Courts regularly approve debtors' requests to pay vendors, enter into financing agreements, assume contracts, and undertake new projects that dramatically alter the distributional landscape for all creditors.

In its recent bankruptcy case,[4] *Czyzewski v. Jevic Holding Corp.,* the Supreme Court appeared ready to confront the question of when departures from bankruptcy's distributional rules are permissible. The case was framed as a conflict between maximizing stakeholder value and strictly following the distributional rules. The only asset of any value to the creditors was a cause of action whose merits were not clear. The debtor lacked the resources to pursue the action on its own, and no one was willing to continue it on a contingent-fee basis. The defendant was willing to settle for a few million dollars, but only if

[1] See Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 116-17 (1939) (absolute priority the "'fixed principle' according to which . . . the character of reorganization plans [is] to be evaluated").

[2] See Locke v. Winning, 3 Mass. 325, 326 (1807) ("A principal object of the bankrupt law is that the property of the bankrupt . . . shall . . . be *equally* distributed among his creditors, in proportion to the sums respectively due to them.) (emphasis in original).

[3] See, e.g., David K. Skeel, The Empty Idea of "Equality Among Creditors" (ms. 2016) ("[I]f we look at current bankruptcy practice, creditor equality seems to be rapidly disappearing. Bankruptcy courts often bless arrangements that give one group of general creditors starkly different treatment than other groups."); Mark J. Roe & Frederick Tung, Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain, 99 Va. L. Rev. 1235 (2013); Stephen J. Lubben, The Overstated Absolute Priority Rule, available at https://ssrn.com/abstract=2581639.

[4] See Czyzewski v. Jevic Holding Corp., 580 U.S. • • • (2017).

none of the proceeds went to a certain creditor that was intent on suing that same defendant in a separate suit.[5]

Faced with the choice of leaving no creditor with anything or departing from bankruptcy's distributional rules (by excluding the one creditor), the bankruptcy judge took the latter course and approved the settlement. As part of the settlement, the court also entered an order dismissing the bankruptcy case. Bankruptcy practitioners refer to this coupling of settlement terms with an order of dismissal as a "structured dismissal." The district court and the court of appeals affirmed. The Supreme Court reversed.

In doing so, however, the Court said little about the extent to which the Bankruptcy Code permits departures from bankruptcy's distributional rules. Instead, it limited its holding to the narrowest version of the question that the bankruptcy judge faced—whether departures from bankruptcy's distributional rules were permitted *in the context of a structured dismissal*. It left the door open to "nonconsensual priority-violating distributions" in the presence of "significant Code-related objectives"—at least when they are not coupled with an order of dismissal. Nothing was said about why such departures would ever be desirable or even necessary in those other contexts and there was no discussion of how these commonly observed violations of distributional rules fit into the larger scheme of things.

That discussion is the focus of this paper. *Jevic* is not the rare distributional deviation case that some make it out to be. The problem it presents recurs throughout the bankruptcy process. And it is, in the end, not a problem of priority or distribution but rather a problem about the fundamental boundaries of the bankruptcy estate, what we call the bankruptcy partition. Bankruptcy law partitions off an estate from the rest of the world. This estate defines the interests that the parties and the court should seek to maximize. Those things outside of the estate are irrelevant to that maximization goal. Examining *Jevic* and similar cases with this partition in mind reveals that disputes framed as distributional issues are often, in fact, about which interests

[5] It seems odd that the private equity fund would be willing to settle for several million when the debtor lacked the resources to pursue the action. Perhaps the private equity fund faced costs (such as an inability to close out one of its funds) as long as some legal actions were outstanding, regardless of the likelihood those actions would actually be litigated. Getting rid of potential litigation might have value, even if, as a practical matter, no one would pursue the litigation on the merits.

the parties are allowed to take into account as part of the estate maximization process.

While one might be tempted, as the Court was, to view *Jevic* as a case about priority and distribution and whether the debtor's actions make no creditors worse off (are they Pareto superior?), these takes are not quite right. Strict adherence to priority and distribution cannot explain why the structured dismissal in *Jevic* is prohibited but other vendor and financing agreements are routinely approved even when they alter priority and distributional entitlements. Similarly, a focus on Pareto superiority fails to explain the lines between cases dealing with structured dismissals or vote designation (where courts prevent Pareto superior actions), and cases dealing with vendor orders, financing agreements, or general settlements (where courts allow actions that are value maximizing even when they might make some creditors worse off).

Another approach to these questions—suggested by the Supreme Court in *Jevic*—is to draw an arbitrary line between decisions made during the pendency of the case and decisions made at the end (during dismissal or plan confirmation). The Court hinted that during the case value maximization might be the prime directive but that in the final period distributional rules would control. This rule has little logic to commend it and at least three major flaws. First, it opens up an entirely new front of strategic behavior in which parties play a game of convincing the court that the case is or is not in its terminal stage. Second, it does not fit well with the practices of lower courts on questions like gifting. Finally, it provides no guidance on frontier questions like third-party stays and releases.

We suggest in this article that the bankruptcy partition provides a coherent principle to connect the questions raised by the apparent distributional cases and provide guidance on frontier questions. The central ambition of Chapter 11 is to vindicate the creditors' bargain.[6] By the common account, if the creditors could bargain among themselves, they would agree on a set of rules that would maximize value. As a group, they prefer more to less. There is, however, an important qualification to this idea that is deeply embedded in the Bankruptcy Code, but often overlookeed. Bankrupcy law has a narrower focus than maximizing the total wealth of creditors as a group. Instead, it creates a "bankruptcy estate," which partitions the

[6] See, e.g., Thomas H. Jackson, Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain, 91 Yale L.J. 857, 862 (1982).

stakes creditors hold in the debtor from everything else. The ambition of bankruptcy law is to maximize the value *of that estate*.[7] distributional policies.

This bankruptcy partition tells the court and the stakeholders which stakes they must try to maximize and which they must ignore. A debtor cannot take actions that favor one set of creditors over another *as creditors*. But if a creditor happens to be a competitor or a supplier, the debtor is free to deal with it *in that capacity*. The challenge is not one of deciding when distributional rules can be ignored, but rather ensuring that the debtor does not conflate the different capacities in which a creditor acts when it wears two hats.

This bifurcation of interests, however, can present challenges. It can disort distort the incentives of the creditors in ways that are not readily visible. Parties may seek to maximize values that are outside of the partitition. Courts and creditors constantly guard against this. For example, courts require that parties bargaining with each other in bankruptcy focus their action on the bankruptcy estate. This means that respecting the bankruptcy partition law allows a creditor to take selfish actions to maximize its stake in the estate, but prevents the same creditor from promoting its outside interests when it exercises its rights as a stakeholder. A stakeholder who wears two hats can use bankruptcy procedures to further its position as a stakeholder, but it loses those inside rights if it tries to use them to further its outside interests.

Similary, payments between stakeholders pose partition challenges that can be mistaken for distributional conflicts. As one should expect, there are often payments between parties to bankruptcy negotiations to resolve conflict. These can easily be recharacterized as payments from the bankruptcy estate and, as such, would violate bankruptcy's distributional rules. It is a mistake, however, to focus on the distributional consequences of these payments. Side-payments that distort the negotiation are bad regardless of whether the money is coming from the estate and regadless of whether the recipient is a prepetition creditor. The problem arises when the payment tilts the process toward maximizing interests that fall outside of the bankruptcy estate. What matters, as *Jevic* again illustrates, is how the

[7] See In re Innkeepers USA Trust, 442 Bankr. 227 (Bankr. S.D.N.Y. 2010) (declaring "it is 'Bankruptcy 101' that a debtor and its board of directors owe fiduciary duties to the debtor's creditors to maximize the value of the estate").

payment distorts bankruptcy law's purpose of maximizing the interests that lie within the partition.

Finally, the bankruptcy parititition has the counterintuitive effect of rejecting some Pareto superior transactions. Costs and benefits that are outside the estate are ignored, which means some approved actions will make creditors worse off and some prohibited ones would have made them better off. But there are reasons to embrace this outcome nonetheless once one understands the purposes behind the bankruptcy partition. Remote costs and benefits will be harder to verify and one's confidence in estimates of their value should be low. In addition, permitting transactions based on such remote factors may be beneficial to the estate after the fact, but they may permit costly maneuvering and introduce uncertainty that undermines the value of the estate before the fact. And it is important to remember that parties can always bargain around the bankruptcy partition's limitations through settlement.

The key question in all of this—and the one at issue in frontier cases like *Jevic* or third-party release cases—is figuring out precisely where to locate the partition, where to draw the line between what is inside and what is outside of the estate. This paper begins the task of answering that question.

Part I of the paper lays the groundwork. It reviews the facts and the ultimate decision in *Jevic* as well as how the basic rules of priority and distribution relate to a debtor's risk and operational choices. In Part II, the paper sets forth the idea of and justification for the bankruptcy partition. Everything inside the estate is viewed as a whole that should be maximized. Everything outside is beyond the court's power and consideration. The partition thus aligns (to some degree) the parties' interests in focusing on maximizing the value of the estate. At the same time, the partition removes some things from the calculus. Distributional consequences of various decisions that fall outside the bankruptcy partition are not taken into account. This creates tension that can be mistaken for conflict over distibutional and priority rules.

Part III expands the inquiry to look at how the bankruptcy partition interacts with bargaining between stakeholders. We show that these payments should be judged not on their distributional consequences but rather on how they effect the bankruptcy process. Understanding the bankruptcy partition, sheds light on which payments are likely to distort the process.

Part IV examines one more consequence of the bankruptcy partition—the extent to which the focus can remain single-mindedly on enhancing the value of the estate when the estate deals with suppliers who may also be prepetition creditors or turn to prepetition sources of credit for postpetition financing. As long as one is focused single-mindedly on enhancing the value of the estate, the effect of any deal on a third party is irrelevant, even if that party is also a prepetition creditor. Though this might leave some Pareto superior transactions unpursued, it can be explained and justificed by understanding the purposes behind the bankruptcy partition.

Part V concludes.

I. The *Jevic* Decision and the Tension between Risk, Value Maximization, and Distribution

Even though the Supreme Court resolved *Jevic* on the narrowest of grounds, its facts and minor variations on them illustrate virtually all of the apparent tensions between bankruptcy's distributional rules and its other policies. Several years after it went through a leveraged buyout, Jevic Transportation ceased operations without any advance notice to its workers. The absence of advance notice triggered liability under federal and state WARN acts.[8] As a result, the company was liable to the workers for sixty days of back pay and benefits. Shortly after it shut down, the company filed for bankruptcy. A large portion of the workers' claims for backpay was entitled to statutory priority. As is common, the debtor had many other general unsecured creditors.

By the time the parties reached the settlement in question, the debtor's only assets of any consequence were $1.7 million in cash and a fraudulent conveyance action against the private equity fund that had sponsored the buyout. The cash was subject to the liens of two secured creditors, one of which was the private equity investor. The only way the estate creditors could recover anything was to prevail in the fraudulent conveyance litigation against the secured creditors.

The creditors committee commenced that litigation, and its claims survived a motion to dismiss. On the face of it, however, there were no resources to bring the action. In the absence of outside financing, there would be nothing to distribute to the priority creditors or anyone else.

[8] Worker Adjustment and Retraining Notification Acts. See 29 U.S.C. § 2102; N.J. Stat. Ann. § 34:21-2.

A round of settlement negotiations ensued. For reasons that are not clear, the private equity fund was willing to contribute several million dollars in return for a settlement of the fraudulent conveyance action even though the debtor lacked the resources to bring it. But the private equity investor insisted that none of the money it contributed to the settlement go to the workers. It was concerned that the workers might bring an independent action against it for the WARN Act claims, and, as the fund's counsel explained in open court, "If the money goes to the WARN plaintiffs, then you're funding someone who is suing you who otherwise doesn't have funds."[9]

This sets up a complicated playing field. The debtor and the creditors committee have duties to maximize the value of the estate but they are also operating against the backdrop of bankruptcy's distributional rules. Ordinarily, a settlement that brought cash to the estate would be distributed through a plan according to those rules. But here, the only way for the debtor receive the cash was for it to promise to ignore those rules.

This puts the value maximization and distributional rules of bankruptcy in plain conflict. But that conflict is not unique to this case. Indeed, virtually every operational decision that a debtor makes has indirect distributional consequences. Just as the settlement offered to the debtor in *Jevic* was attractive to some but not all creditors, a debtor's decision to shut down a risky product line or liquidate a risky operational division will change the expected recoveries of its various creditors. Senior creditors will generally prefer converting risky projects to cash while junior creditors and equity will not. Similarly, a creditor who happens to also be a supplier to the product line or division will have a very different view from a creditor who happens to also be a competitor.

The question for the debtor and ultimately the bankruptcy judge in *Jevic* was whether the distributional distortion of the settlement was an acceptable price to pay for increasing the value of the estate. The only difference between that and common estate decisions – like roll-ups and critical vendor orders—was that the distributional distortion was explicit.

In the end, the settlement was agreed to and folded into a structured dismissal. This meant that the settlement money was distributed as agreed, the debtor's claims against the fund were

[9] See 787 F.3d 173, 186 (3d Cir. 2015) (Sirica, J., dissenting).

dismissed with prejudice, claims against the estate were extinguished, and the case was dismissed. The bankruptcy court (along with the district court and court of appeals) viewed this as an acceptable outcome, given that the alternative was for no one to recover anything. The Supreme Court reversed. It held that the distributional distortion was not an acceptable price to pay for estate maximization when it is coupled with dismissal. It did, however, suggest that such distortions would be acceptable in other value-maximizing contexts. The Court provided no principled explanation for drawing that line.

And so bankruptcy courts and litigants are left with little guidance on a debtor's decision to pursue or not pursue a risky project—such as running a product line or pursing an uncertain litigation—that benefits junior creditors and creditors who are also suppliers but hurts senior creditors and creditors who are also competitors.

This is a familiar problem in the context of junior and senior creditors. Risky projects tend to favor junior creditors. Imagine a firm that has $10 dollars in assets, one secured creditor with a claim of $10, several unsercured creditors, and a potential lawsuit it can pursue. Assume also that the lawsuit will cost $10 to pursue, will result in $100 recovery if successful, but has only a one-in-five chance of success. The lawsuit has a positive net present value but it is harmful to the secured creditor, who receives $10 if the suit is not pursued and receives an expected return of $2 if the suit is pursued (it gets $10 but only 20% of the time). The junior creditors get nothing if the law suit is dropped but an expected return of $18 ($90 return 20% of the time) if it is pursued.[10]

But the distributional consequences can also arise without priority creditors when one creditor has an outside interest in a project. That creditor may be a supplier, a competitor, or (as in *Jevic*) the litigant in a case that is indirectly affected by the actions of the debtor.

By the traditional account, the trustee (acting on behalf of the debtor estate) should ignore distributional consequences and simply maximize the value of the estate.[11] Bankruptcy law solves a collective

[10] There are ways to make this problem go away. Relative priority is one of them. A more robust use of adequare protection is another. See Douglas G. Baird, The Rights of Secured Creditors After *Rescap*, 2015 Il. L. Rev. 849. But these approaches have not been implemented and so the conflict remains.

[11] See In re Innkeepers USA Trust, 442 Bankr. 227 (Bankr. S.D.N.Y. 2010) (declaring "it is 'Bankruptcy 101' that a debtor and its board of

action problem among the creditors by allowing and requiring the trustee to take actions that are in that collective interest. At the very least, by that account the court should always bless debtor actions that are Pareto superior. But that account is hard to square with the decision in *Jevic*. Indeed, the briefs and the the oral argument in *Jevic* show that the Court considered but rejected the notion of blessing all Pareto superior decisions. And there are many cases that bless decisions that are not Pareto superior (because they harm some creditors) in other contexts.

One might instead think that the distinction lies in the importance of priority or distributional rules. But that is not the case either. Debtor-in-posession financing orders, critical vendor orders, and side payments regularly result in deviations from bankruptcy's priority and distribution rules. In the remainder of this paper, we will show that line between acceptable and unacceptable decisions that affect value and distributional dynamics has more to do with the bankruptcy partition and its interplay with procedural safeguards than with concerns about Pareto superiority or about the distribtional priority that creditors may or may not be entitled to.

II. The Bankruptcy Partition

There are fixed rules for distributing assets in a Chapter 7 liquidation or a Chapter 11 reorganization, but no explicit guidance in the Bankruptcy Code when a case is dismissed. In Jevic, the bankruptcy judge believed that he was therefore empowered to exercise his discretion. The private equity holder's lien might be vulnerable to a fraudulent conveyance attack in theory, but as a practical matter no one would bring it. The estate did not have the money. And no one would bring it on a contingent-fee basis. As the bankruptcy judge explained, "any lawyer or firm that signed up for that role should have his head examined."

Therefore, from the bankruptcy judge's perspective, there were two choices. If he refused to approve the settlement, no one would receive anything. On the other hand, if he approved the settlement, the workers would still receive nothing, but some creditors would receive something. By approving the settlement, no one was worse off and some were better off. The workers fared the same in either case, but the others fared better in the first instance.

directors owe fiduciary duties to the debtor's creditors to maximize the value of the estate").

Strangers to bankruptcy might find the fund's explanation for insisting on excluding the workers from the distribution of the settlement proceeds decidedly odd. Rarely does a lawyer offer a desire to thwart meritorious litigation as a reason for approving a settlement. But, given the structure of the bankruptcy process, it is not so strange. A core feature of the bankruptcy process is that bankruptcy law focuses narrowly on rights against the estate. The estate is unaffected by—and the banktupcy judge ignores—the loss that the workers suffer from not being able to pursue the private equity fund in an independent action.

This sort of loss is unusual, but an analogous problem is one of the most contested issues of modern bankruptcy practice. The question is third-party releases—whether the court can, at the debtor's request, stay or release causes of action that some stakeholders have against third parties. Some judges have prohibited stays and releases outright. Some have required that they be consensual. Others have held that the bankruptcy judges have discretion over whether to approve such releases.

In general, courts are willing to take account of the negative effect of the stay on the third parties, but these courts do not include the value of the action against a third party as something that bankruptcy law affirmatively needs to care about. The question is whether the benefit to the bankruptcy estate was justified, given the loss to the third party. Any benefit that the third party would enjoy from the cause of action was not part of the calculus, regardless of whether the third party was a creditor of the estate and therefore part of the creditors' bargain.

Indeed, one court has gone so far as to suggest that bankruptcy judges should exercise their discretion without regard to how it affects specific parties. The Seventh Circuit reversed a bankruptcy judge for not exercising his discretion to enjoin a creditor from pursuing a claim against a third party when pursuing the claim could jeopardize a settlement that the debtor had reached with the same third party. From the point of view of Judge Posner, the question was simply "whether the injunction . . . is likely to enhance the prospects of a successful resolution" of the bankruptcy case.[12]

[12] See In re Caesars Entertainment Operating Company, Inc., 808 F.3d 1186, 1188 (7th Cir. 2015) (Posner, J.).

The narrow focus on the bankruptcy estate is one of the core features of bankruptcy law. The bankruptcy judge does not have a roving commission to do equity.[13] Instead, the bankruptcy judge is supposed to focus squarely on the bankruptcy estate and maximize its value. The bankruptcy estate is partitioned from the other rights that the various stakeholders have. The existence of this bankruptcy partition is central to resolving any tension between bankruptcy's distributional rules and other bankruptcy policies.

A. The Creditors' Bargain and the Bankruptcy Estate

Commentators commonly talk about bankruptcy as vindicating the creditors' bargain and the creditors' ambition to maximize their joint welfare,[14] but this misses an important qualification. The world of Chapter 11 is partitioned. The Bankruptcy Code creates a bankruptcy estate that is partitioned from the rest of the world.[15] The Bankruptcy Code directs the judge to look only at the estate itself and what maximizes its value. The consequences of a decision on other parties is not on the judge's radar screen. The judge can take into account how a decision affects the rights of the workers against the estate, but not how the decision affects the rights of the workers against a third party.

Asset-partitioning is central to the modern account of the firm.[16] Investors are better off when they can contribute capital to a discrete pool that is used for defined projects. The investor wants to limit her own liability if the project is unsuccessful, and, more importantly, wants to be able to monitor the fate of this project independent of all the other projects that fellow investors might have. The entrepreneur who runs a firm is charged with maximizing the value of the firm itself. The duties of directors run toward this firm alone. Those directors are not to take into account how actions they take at the firm benefit themselves or other parties in some other way. The effect of focusing narrowly on the firm itself risks losing some projects that might be in the collective interests of all the stakeholders, but these losses are more than offset by the way that the partition reduces monitoring costs.

[13] United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986).

[14] See Jackson, supra note

[15] §541(a).

[16] See Henry Hansmann & Reinier Kraakman, The Essential Role of Organizational Law, 110 Yale L.J. 387 (2000).

The bankruptcy estate works in the same way. In the hypothetical creditors' bargain, creditors recognize that it is not possible to reach a deal in which the benefits of every possible mutually beneficial deal among them is vindicated. Instead, they limit their focus to maximizing the value of the assets that are assembled in the bankruptcy process. To the extent they want to realize other benefits or pursue other rights, they must do so outside the bankruptcy process.[17]

Any other rule would create a world where bankruptcy unraveled the partition that exists in other states of the world. Investors would not be able to limit their monitoring to firm activities if the filing of a bankruptcy proceeding allowed those running the firm to use firm assets to maximize interests that are not related to the estate.[18]

Moreover, if parties could justify transactions based on indirect benefits running to any stakeholder in any capacity, the judicial inquiry becomes unmanageable. Imagine a debtor has to choose a new product line. One choice indirectly benefits a creditor who happens to sell a complementary product, and the other choice benefits another creditor who happens to sell another product, one that is also complementary. Courts are poorly equipped to measure such benefits. Things become even more complicated if we considered stakeholders who are also competitors or have investments that are equivalent to short positions in the debtor.

To avoid the mess of sorting through these scenarios, the Bankruptcy Code forces the judge to keep her focus narrow. We do not ask the bankruptcy judge to maximize wealth among all the parties to the creditors' bargain or account for the cost that a resolution imposes on third parties. We ask her to focus on the bankruptcy estate and maximize its value. Not only does this focus simplify the judge's task, but it also reduces the ability of creditors to behave strategically. To the extent that the debtor must consider the benefits of transactions beyond the estate, creditors have an incentive to ensure that these benefits exist. This might distort behavior before the bankruptcy in ways that are not in the interests of the parties.

The effect of bankruptcy partitioning is to take some possible benefits (and costs) off the table. The price of putting on these blinders,

[17] See Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972).

[18] One might argue that the outcome in the *General Growth Properties* bankruptcy did exactly this. And some feared that the result would be a shock to investment markets. For various reasons that shock did not result.

however, is easy to exaggerate. To the extent outside benefits exist, parties can still capture them if they can strike a deal among themselves. The bankruptcy partition means only that the judge cannot do it for them.

Consider the following case. The debtor wants to sell its assets as a going concern. One buyer bids $3 for the firm. It has an ongoing relationship with some of the prepetition suppliers that it does not want to jeopardize. For this reason, if it acquires the firm, it will pay an additional $2 to these prepetition suppliers so they are made whole. Another buyer has no such relationship and will not top off the prepetition suppliers. This second buyer offers to pay the estate $4. From the perspective of the creditors as a group, the first buyer is offering more (a total of $5 instead of $4), but the second buyer is giving more to the bankruptcy estate ($4 instead of $3).

Conventional wisdom in bankruptcy circles holds that the judge should accept the bid of the second buyer. She should focus only on what each bidder is offering the estate in return for its assets. The money that one buyer will later give one of the prepetition creditors is irrelevant. The proper focus should be entirely on what goes to creditors *on account of their claims against the estate*. There is nothing wrong with the first buyer paying prepetition trade creditors on its own, but it does not count as part of what the creditors as a group realize from the sale.

This outcome might seem counterintuitive. By assumption, the first buyer is willing to pay the creditors as a group more than the second buyer. It is the one who values the firm's assets the most highly. Once the bankruptcy partition is put in place, however, some of the benefits prepetition creditors receive are taken off the table.

The Bankruptcy Code is premised on the idea that the benefits of limiting the calculus in this fashion outweigh its costs. The costs, moreover, may be modest. To return to a theme that we have already mentioned, requiring the judge to award the firm to the second buyer does not necessarily mean that the firm will end up in the hands of the wrong buyer. The parties themselves are free to bargain in the shadow of this decision.

In this case, there is a deal to be cut between the suppliers who benefit from the sale to the new buyer and the creditors who do not. There is no guarantee, of course, that such a deal will happen, but, as is always the case with Coasean bargaining, the costs of reaching such a bargain put a cap on the loss that the parties face.

In short, the amount that the new buyer intends to pay to the old suppliers is not the question the bankruptcy judge faces. The only question is which buyer is offering the estate the most. Such partitioning is a core feature of bankruptcy law. Whether that is desirable is contestable. But bankruptcy's distributional rules need to be assessed against this backdrop.

The focus on what is best for the bankruptcy estate works in the other direction as well. Assume that the first buyer, in addition to paying the prepetition creditors $2 was willing to pay the estate $5, and the second buyer was still willing to pay only $4. In this case, the first buyer would prevail. Again, that some prepetition creditors would ultimately be paid in full is neither here nor there. It does not make the first buyer's bid higher, but it also does not implicate the pro rata sharing rule either. Some prepetition creditors might end up with more than others, but the bankruptcy's distributional rules are implicated only if they receive more *from the estate*. Assessments of priority rules and the pro-rata sharing norm take this bankruptcy partition into account.

The bankruptcy partition also affects obligations that creditors carry when they negotiate in bankruptcy. These are also implicated in *Jevic*. We turn to that in the next section.

B. Ulterior Motive and Rules of Engagement

Just as the bankruptcy partition keeps the bankruptcy judge from taking into account the interests of the workers in bringing an action against a third party, it also imposes a check on the way that the private equity fund acts in the bankruptcy. Those who participate in the formation of the plan can promote their interests as stakeholders, but they cannot advance outside interests.

The problem arises most concretely in a case like *Jevic* when the private equity fund, in order to prevent the workers from bringing an action against it resolved to vote against any plan that paid the workers' claim in cash.[19] In such a case, the private equity fund's vote could be "designated."[20] Its negative vote would be found to be cast in

[19] Such a strategy on the part of the private equity fund might well not work. Such a plan could not be imposed on the workers unless they accepted the plan because of §1129(a)(9), but they might agree to such a plan if the private equity fund was sufficiently intransigent.

[20] §1126(e).

bad faith and it would be deemed to have voted in favor of the relevant plan.

While there is debate about how creditors should be treated when they wear multiple hats, there is no debate about the basic principle that third parties who act with ulterior motives cannot exploit the levers of the reorganization process to advance their own agendas. The challenge ultimately comes in drawing the line between an ulterior agenda and permissible behavior. Some cases are easy. For example, disgruntled former employees who have started a competing firm cannot acquire claims and cast their votes to inflict misery on their former employer.[21] A developer who recaptures rights if a debtor goes through foreclosure instead of reorganization cannot buy claims for the purpose of defeating the reorganization.[22]

There are, of course, cases where matters are uncertain, especially when an outsider buys claims with a view to acquiring the firm as a whole. Like any other creditor, such a purchaser is entitled to advance its own interests as a creditor. As long as it is voting for a plan that it believes will maximize the value of its stake in the firm, it is free to do so. But it is one thing to try to maximize the value of a claim and quite another to use the vote to force the debtor to choose a path for the firm that suits its other interests. A third party cannot buy claims merely to control the reorganization process and persuade the debtor to sell key assets to it. As the Second Circuit explained: "In effect, [the claims buyer] purchased the claims as votes it could use as levers to bend the bankruptcy process toward its own strategic objective of acquiring [the debtor's assets], not towards protecting its claim."[23]

These principles suggest a court would have little difficulty constraining the private equity fund if it voted to thwart the workers' independent action against it. The private equity fund does not owe fiduciary duties and is free to advance its own interests as a stakeholder, but it is not free to promote other interests it might have. Actions that promote its position in third-party litigation have nothing to do with advancing the private equity fund's stake in the debtor.

The facts of *Jevic* itself, of course, were somewhat different. The relevant question is whether the bankruptcy partition does anything to check the private equity fund when it is negotiating with the debtor

[21] *See* In re MacLeod Co., 63 Bankr. 654 (Bankr. S.D. Ohio 1986).

[22] *See* In re Dune Deck Owners Corp., 175 Bankr. 839 (Bankr. S.D.N.Y. 1995).

[23] *DBSD*, 634 F.3d at 104.

over the settlement of a fraudulent conveyance action. The private equity fund can argue that, with respect to the settlement of the cause of action, it stands as a third party. There is a difference between its participation in the shape of the plan of reorganization and it being the defendant in litigation the debtor is bringing against it. In the former capacity, it must conform to bankruptcy's rules of engagement, but, in the later capacity, it enjoys the same freedom to deal with the debtor at arm's length. When the debtor is bringing litigation against the private equity fund, it is, precisely because of the bankruptcy partition, entitled it to treat the debtor as a stranger. In this capacity, it is free to demand the same settlement terms that it could demand in any other litigation.

The private equity fund is not entirely a stranger, however. It is dictating the distribution of the debtor's estate and participating in a comprehensive settlement of all the outstanding issues among all the parties. The more the settlement and dismissal substitutes as a plan of reorganization, the more problematic the private equity fund's behavior becomes. But the solution to that problem does not come through policing the fund's behavior. The key is to ensure that those negotiating with estate representatives as outsiders are being treated as such, that the negotations are arm's length. And that is accomplished by ensuring that the estate representatives are not, themselves, acting with ulterior motives.

In *Jevic*, the creditors' committee was negotiating with the private equity fund on behalf of the estate. The court had given it control of the cause of action, and with this control came obligations. When parties bargain in bankruptcy, the bargaining itself must be above-board. Bribes and side deals are not acceptable because they benefit the estate representative on the side outside of the bankruptcy partition. We turn to these, and how it might be implicated in a case like *Jevic*, in the next Part.

III. Bankruptcy's Anti-Bribery Principle

A payment aimed at bending the bankruptcy process in the favor of one of the creditors is illegitimate. Just as a competitor might misuse bankruptcy procedure to enhance its outside interest, a stakeholder who is bribed will use its power in the case not to promote its own interest as a stakeholder, but rather to advance the interests of the person making the bribe.

The complication is that sometimes parties are paid to waive procedural rights not to further some outside interest but rather to enhance the value of the estate. For example, one creditor may have the right to bring a procedural objection that brings little or no value to the estate as a whole. Other stakeholders may be willing to give that creditor a tip to make the nuisance go away.

When a senior creditor who manifestly is owed more than the firm is worth wants to bring the bankruptcy process to a speedy conclusion, a payment of money to someone not to invoke unnecessary procedures make be entirely sensible. The senior creditor should be able to use what is in effect its own money to bring the case to a swift conclusion when elaborate procedures are unnecessary.

Of course, in theory junior parties should not be able to invoke procedures that are wasteful and unnecessary. Indeed, a junior creditor's vote can be designated when it is merely asserting procedures in order to be extract value rather than to protect its own rights.[24] But there is a substantial domain where procedures are unnecessary but asserting them is not abusive. Making payments to junior creditors and to professionals who have done work for the debtor, the creditors' committee, and other constituents is a sensible way to ease frictions. The amount of money tends to be small in the grand scheme of things. Nor is it troubling that the secured creditor is paying for professionals who work for others. The process is being run for the benefit of the secured creditor, it is entirely sensible that it should pay for it.

Distinguishing such tips from problematic bribes can be hard, but the bankruptcy partition provides some guidance. When a creditor is paying to cut short an inquiry, it is not trying to maximize the value of the estate. When a creditor pays to eliminate unnecessary and costly procedures, the value of the firm (and, of course, the creditor's own stake in the firm) increases. Bribes have the opposite effect.

[24] In the words of William O. Douglas when he was the head of the SEC and testifying to Congress on what would become the Chandler Act, it is not legitimate for a creditor to engage in hold-up behavior and tell another stakeholder, "For a price, you may have my vote." See Revision of the Bankruptcy Act: Hearing on H.R. 6439 Before the House Comm. on the Judici-ary, 75th Cong. 182 (1937) (statement of William O. Douglas).

(a) Bribes as a form of ulterior motive

Jevic might be viewed as a case in which the debtor has an asset (a cause of action against a third party) and must decide what to do with it. The creditors' committee was charged with vindicating the interests of the estate. When the bankruptcy judge reviews the deal between the private equity fund and the creditors' committee, she is supposed to ensure that the choice that is made is the one that brings the most value to the estate, independent of distributional consequences. But before she looks at the substance of the deal, the bankruptcy judge looks to the process that led up to it.

On its face, the settlement is a deal between the private equity fund and the estate. The structure of the deal, however, invites a recharacterization. Instead of a payment to the estate that is distributed according to a particular scheme, it is rather a payment from the private equity fund to the creditors' committee for which in return the creditors' committee agrees to drop the litigation.

The creditors' committee might not have the resources to litigate the action to the end, but they might have enough to do some digging and this might be enough to change the dynamics of the case. For example, there might be a bad email among the private equity investors at the time of the buyout that suggested that the deal left the debtor with unreasonably small capital.[25] In order to ensure that the email never comes to light, the private equity firm offers $2 million to the committee and its professionals. This settlement is enough to sate their curiosity. The private equity firm did not have to pay the workers anything because the workers did not have the resources to pursue the action on its own.

The problem under these facts is not that property of the estate is distributed contrary to bankruptcy's distributional rules. Instead, there has been a side payment from the senior creditor to the creditors' committee that has corrupted the process. We can no longer be confident that the committee is in fact acting in a way that maximizes the value of the estate. The committee is no longer acting in a way that maximizes the value of the estate. As with any bribery scheme, the

[25] This would be enough to satisfy the elements of a fraudulent conveyance action. For an example of a case in which there was such an email, see In re TOUSA, Inc., 422 Bankr. 783, 794 (Bankr. S.D. Fla. 2009) (CFO characterizing the condition of the debtor after the transaction using a compound noun, the first half of which was "cluster").

problem is that the committee is selling something that does not belong to it.

The bankruptcy judge might strike down the transaction, not because of the way the proceeds of the settlement are distributed, but rather because of the risk that those directing the process act with an ulterior motive—that is to say, a motive that is outside the bankruptcy partition. The possibility of that motive makes the settlement untrustworthy. The bankruptcy judge can strike down such transactions without knowing whether there is anything wrong with the substance of the actual bargain.

Indeed, she might strike down such transaction even if she thought that this particular settlement did maximize value. There are only a handful of bankruptcy judges who hear large cases, and there are comparatively few lawyers who litigate before them. The local rules and the practices of individual judges fix the structure of the bargaining that takes place outside the courtroom. She might want to keep parties before her from contemplating such side deals. The bankruptcy judge may want to limit her own discretion going forward. She wants to establish rules of engagement that encourage parties to focus on benefits to the estate and not on securing and enhancing side payments. Having in place clear rules about what sorts of transactions she will and will not approve establishes the environment in which creditors in the case bargain.

Seen from this perspective, *Jevic* presents much the same problem as another case, *ICL Holdings*, that came to the Third Circuit at the same time.[26] In that case, the debtor proposed to auction the company, and the secured creditor planned to bid. If the secured creditor were able to credit bid at the auction and that bid was the high bid, the secured creditor would end up as the owner of the firm. Negotiations over the rules governing the auction ensued. In return for an agreed-upon sales process, the senior creditors agreed to pay the professionals of the committee and provide several million dollars to the creditors' committee. If, as happened, the secured creditor proved the high bidder, the government's tax claim would be unpaid and the general creditors would receive nothing.

This could be characterized as a bribe that corrupts the process. The secured creditors may have feared that their liens were not sound or that more shopping the firm would bring out additional buyers. The

[26] See In re ICL Holding Co., Inc., 802 F.3d 547 (3d Cir. 2015).

side payment to the creditors' committee may have the effect of preventing the sort of process that a well-run bankruptcy process requires, just as the side-payment in *Jevic* might have had that effect. The procedures of the bankruptcy process permit all interested parties to raise objections, but they are not all equally well positioned to raise them. The government's tax lawyers are not privy to the particulars of the business. By contrast, the creditors' committee has access to information about the debtor and the debtor's business. It is much better able to assess whether the secured creditor's proposed auction will yield top dollar.

On the other hand, ICL Holding might be an illustration of a tip. The senior creditors were not trying to prevent an auction that secured top dollar, but rather was striking a bargain that avoided unnecessary and costly procedures. The bankruptcy judge permitted the payment.

The Third Circuit ultimately upheld this bargain. It gave weight to the fact the payment was not a distribution of property of the estate under a plan, but rather was deal between the secured party and the creditors' committee in the context of an auction. But it is a mistake to think that anything goes when the money being exchanged is not property of the estate. The rules when the firm is being sold rather than reorganized are less rigid and the bankruptcy judge enjoys more discretion. In *ICL Holding*, Third Circuit is ultimately assessing whether, in this environment, the bankruptcy court abused its discretion in finding that the payment was a tip rather than a bribe and found that it was not.

If the payments were effectively a bribe to disrupt the bankruptcy process to maximize outside interests, the bankruptcy judge must step in, regardless of where the money comes from. They are many ways she can do this. Among other things, she can refuse to approve the auction on the terms that the debtor proposes, and she is obliged to exercise her discretion to ensure that the auction process works effectively to maximize the estate as defined by the bankruptcy partition.

The Third Circuit was willing to accept the possibility that the side payment reflected a settlement in which the senior creditor was paying the creditors' committee in return for not invoking procedures that everyone knew were not necessary for maximizing the stakes that are inside the bankruptcy partition. The payment did not take anything from the estate because the court had concluded that the procedures that were being waived would not benefit the estate. To a large extent,

parties can sell their nuisance value on the side – that is outside the bankruptcy partition – but they cannot sell procedural rights that might benefit others in the estate – those are inside the partition.

The proper way to compare this version of *Jevic* (one in which it is paying the creditors' committee to look the other way) and *ICL Holding*, then, is not to ask whether some creditors received more of the estate than they were entitled, but rather whether the overall negotiations were conducted in a fashion could be trusted to maximize the stakes within the bankruptcy estate. Regulation of the partitioned bargaining environment rather than distribution rules are what matters most.

(b) Bribery, the Partition, and Priority

Recognizing the importance of the bankruptcy partition in the governing process can also go a long way to explain the nuanced ways that courts enforce priority rules. Reorganization law has long put constraints on bargaining in bankruptcy.[27] Exactly how bankruptcy regulates the process, however, turns on context. In the case of confirming a plan of reorganization, there are elaborate and hard-edged rules. Absolute priority must be enforced unless two-thirds of a class in amount and one-half in number consent.[28] A plan can be confirmed only if at least one impaired class accepts.[29] Administrative expenses must be paid in cash.[30]

Even in this context, however, there is play in the joints. The bankruptcy judge, in addition to determining that the plan corresponds with absolute priority must also find, when a class votes against the plan, that the plan is "fair and equitable" and does not "discriminate unfairly." The phrases have become terms of art over the course of more than a century of Supreme Court learning.[31] These phrases are often asserted to embody a substantive commitment to a particular

[27] See, e.g., Louisville Trust Co. v. Louisville, New Albany & Chicago Railway, 174 U.S. 674, 688 (1899).

[28] §1129(b)(2).

[29] §1129(a)(10).

[30] §1129(a)(9)(A).

[31] Among other things, the "fair and equitable" requirement prohibits "gifts," plans in which senior creditors divert value to a junior class, skipping over a class. DISH Network Corp. v DBSD North America, Inc., 634 F.3d 79 (2d Cir. 2011).

way of distributing the assets (the absolute priority rule). In operation, however, these rules focus on the integrity of the negotiations.

Consider a case in which a substantial shareholder of a business is also its CEO. The debtor proposes a plan in which the equity of the reorganized firm will go entirely to the old secured creditor. The secured creditor agrees to keep the CEO on as a consultant after the reorganization and will pay her with stock options. The general creditors receive nothing under the plan and oppose it. The debtor puts on witnesses showing that the business is not worth enough to pay the senior creditor in full. Can the bankruptcy judge approve this plan?

There are two different ways of characterizing the award of stock options to the former owner-manager. The bankruptcy partition can tell us how to choose between them. It could be a "gift" that impermissibly skips over a class of creditors. As such, the plan is not "fair and equitable." The stock options are side-payments that ensure that the CEO induces the debtor to put forward a plan that is to the secured creditor's liking. The CEO is less inclined to reveal information that shows that the firm is worth enough to put the general creditors in the money.

But the judge might uphold the award of the options. If the firm is not worth enough to pay the senior creditor, the belongs to that creditor. The creditor is entitled to retain whomever it wants as a consultant. If the judge finds that the transaction is offered to the CEO in her capacity as a provider of future services, the bankruptcy judge should not strike it down.

The "fair and equitable" language of the Bankruptcy Code addresses the situations in which the senior creditor makes transfers to other stakeholders in the context of a plan. As the cases that developed the doctrine make plain, the focus is not on distributions themselves, but rather on the process that led to the plan of reorganization.[32] Is the CEO selling an inside asset (the process rights) on the side? Is she an insider maximizing an outside interest in her bribe payment or is she an outsider selling future services in an arm's length transaction?

The bankruptcy partition, thus, in addition to drawing a line between what interests are to be maximized and what are not, also directs the court to assess whether a stakeholder is acting in her

[32] See, e.g., Northern Pacific Railway Company v. Boyd, 228 U.S. 482 (1913).

capacity as a stakeholder or in her capacity as an outsider in any given transction. That assessment—and not some notion of priority or distributional equality—determines the propriety of the transaction.

Context has a large effect on the way in which the Bankruptcy Code directs the judge to make these distinctions. When the bankruptcy judge is confirming a plan, there is a hair-trigger. There is a strong presumption against any payment that flows from a senior creditor to a junior one that skips over an intervening, nonconsenting class. This "anti-gifting rule" operates even when there is strong evidence that the senior creditor is owed more than the firm is worth.

The rules serves a prophylactic purpose. It nips bribery in the bud. It aims at ensuring that the plan-formation process is squeaky clean. As the Second Circuit put it, "if the parties here were less scrupulous or the bankruptcy court less vigilant, a weakened absolute priority rule could allow for serious mischief between senior creditors and existing shareholders."[33] In the course of bargaining with the debtor in advance of bankruptcy, creditors can negotiate with those who control the reorganization process, but they cannot bribe them. To protect other parties, the bankruptcy judge can insist that square corners be cut.[34]

The bankruptcy judge's ability to ensure the integrity of the plan process extends beyond transfers from one stakeholder to another. Assume, for example, that the CEO is not a shareholder at all. The senior creditor offers her a lucrative consulting contract even though it is clear that her services are no longer needed. (She has, for example, retired and moved out of state.) The bankruptcy judge can refuse to confirm such a plan on the ground that it was not proposed in good faith.[35] Again, the driving factor is that the CEO is getting an outside payment for selling an inside interest.

Outside the plan confirmation process, the bankruptcy judge enjoys more discretion, but it remains her obligation to ensure the integrity of the bankruptcy process. Imagine a senior creditor desires a speedy auction in which it might well prove to be the only bidder. The secured creditor suggests that the debtor propose such an auction. At

[33] *DBSD,* 634 F.3d at 100.

[34] See, e.g., In re Innkeepers USA Trust, 442 Bankr. 227 (Bankr. S.D.N.Y. 2010) (rejecting an agreement as outside debtors' business judgment where the adversely affected parties "deserve more of a process that what has been provided thus far").

[35] §1129(a)(3). For a variation on these facts, see In re Bush Industries, Inc., 315 Bankr. 292 (Bankr. W.D.N.Y. 2004).

the same time, the secured creditor offers the CEO a consulting contract that requires little actual work. Here too the judge can refuse to approve the sale.[36] The senior creditor's promise of money to the CEO is likely enough to make most judges suspect that the speedy auction being proposed is not one designed to maximize value.

Whenever these payments become large enough, the bankruptcy judge is likely to find that what are characterized as "tips" are nothing of the sort. They are just the price that the secured creditor is willing to pay to insulate its plan from close scrutiny. The Bankruptcy Code is designed to ensure that parties who participate in the process act on behalf of everyone in their class. Again, the bankruptcy partition is key to policing ulterior motives. Stakeholders cannot strike deals in which they agree to drop objections in return for payoffs that go only to them.[37] But neither should they be allowed to use those objections to hold up the process in favor of their individual interests.

Resolving exactly which type of side payments is appropriate is beyond the scope of this paper. Our point, however, is that whether these payments should be permitted depends on the bankruptcy partition and how the payments affect the bankruptcy process. The question has nothing to do with the bankruptcy judge's discretion to depart from bankruptcy's distributional rules. The payments may be either appropriate "tips" or impermissible bribes, but they are not "distributions." This is illustrated by our example in which the secured creditor pays its own money to a CEO that owns no stock. There is not a use of property of the estate and the recipient is not a stakeholder, but the transaction raises the same issues as when an old shareholder receives something under a plan while the general creditors receive nothing. Bankruptcy rules must ensure that side payments do not compromise the process, regardless of where they come from.

[36] One might think that bankruptcy law need not play a role here. The CEO who accepts payment for a consulting contract when her advice is emphatically not wanted (but whose cooperation is essential) is probably violating her fiduciary duties to the corporation. The implicit quid pro quo is that she will look the other way and not attend to maximizing the value of the assets for the benefit of all the stakeholders. But those contours of those duties can be hard to delineate, and the bankruptcy judge has a responsibility to ensure that there is a process that leads to the assets being put to their highest and best use, independent of whether there are violations of nonbankruptcy duties.

[37] Young v. Higbee Co., 324 U.S. 204 (1945).

As the Supreme Court put it long ago, the court should "never rightfully become the mere silent registrar of the agreements."[38] This is true not because the agreements involve distributions that violate pro-rata sharing rules, but because they have the potential to undermine the integrity of the bankruptcy process and the goal of maximizing the value of the estate as defined by the bankruptcy partition.

IV. Bargaining with Third Parties

It is possible that *Jevic* not about corruption of the bankruptcy process at all. It is possible that everyone's cards were on the table. There was no infirmity in the private equity investor's security interest. No lawyer would take up an avoidance action against it because the costs of litigation vastly exceeded the expected value of the action. But the private equity fund is still willing to pay something to have this action disappear once and for all. It knows that the creditors' committee lacks the resources to litigate the matter to the hilt, but the continuing existence of the cause of action even after the bankruptcy case is dismissed is an irritant. It may not, for example, be able to close out some of its funds as long as the cause of action lingers.

For this, or some other reason, the private equity fund is willing to pay something to make the action go away. It benefits if it can close out its unhappy adventure into the trucking business. But it is exactly for this reason that the private equity firm has no interest in any settlement that includes the workers. It is not willing to buy peace, if it comes at the cost of triggering litigation from another quarter. The opportunity to settle with the private equity fund is simply a chance to enter into a transaction that makes some creditors better off and leaves none worse off. In this part, we explore the question of how we think about these transactions.

A. Deals with Nonstrategic Prepetition Actors

The Bankruptcy Code expressly allows deals with prepetition creditors where there is an executory contract between the creditor and the debtor.[39] If the debtor chooses to assume an executory contract,

[38] Louisville Trust Co. v. Louisville, New Albany & Chicago Railway, 174 U.S. 674, 688, 19 S. Ct. 827, 832, 43 L. Ed. 1130 (1899).

[39] A prepetition contract is "executory" when, at the time of the petition, there are meaningful obligations owing on both sides. For the classical

payments will be made to the nondebtor party to the contract. Depending on how much it will cost the other party to complete the contract, it may be better off if the contract is assumed. But whether the third party is benefited is irrelevant.[40] Even though the party to the executory contract will be paid in full while other creditors are not, blessing the assumption of many of these contracts is an entirely uncontroversial application of §365.[41]

The focus of the judge in reviewing the decision to assume an executory contract is again on the bankruptcy estate. The only question is whether the decision to assume the estate's payout to the other creditors brings them more cents on the dollar. The party to the executory contract is receiving the money only because of rights she established outside of bankruptcy long before it began. She is in no way gaining the money because she is engaging in hold-out behavior or otherwise undermining the bankruptcy process.

discussion, see Vern Countryman, Executory Contracts in Bankruptcy (Part I), 57 Minn. L. Rev. 439 (1973).

[40] There is a qualification to this point. If the transaction is manifestly beneficial to the nondebtor party to the executory contract, the debtor might reject the contract (or threaten to reject the contract) and renegotiate the deal on better terms. One could argue that this ability to renegotiate is something that the debtor should take into account in deciding whether to assume or reject. Similarly, the bankruptcy judge should take into account the ability to renegotiate in deciding whether to bless this decision. For our purposes, however, what matters is that the provision governing executory contracts explicitly empowers the debtor to pay off someone who is a prepetition creditor, using as her benchmark whether it makes the other creditors better off.

[41] To take a concrete example, assume that the debtor has a contract with *A* in which the debtor promises to pay *A* $10 in a week's time for a specialized part. And assume that the transaction will, *after the $10 is paid*, make the debtor's business worth $25 instead of $20. Assume further that, if the debtor fails to go through with the deal, *A* will have to scrap the part and will have lost $10. In this event, *A* will have an unsecured claim against the estate for $10. Other creditors are owed $50. If the debtor in possession asks the court for permission to assume this contract, the court should grant it.

Rejecting the executory contract leads to $60 in claims ($50 from other creditors and the additional $10 claim from *A*) chasing $20 in claims. By contrast, if the trustee assumes the contract, the creditors (a group that no longer includes *A*) receive 50 cents on the dollar ($50 in claims chasing $25 in assets).

The executory contract is only one of many types of deals that a debtor can enter that enhances the value of the estate. Courts have generally accepted the idea that bankruptcy judges can deal with prepetition creditors beyond the context of executory contracts, provided that the estate is better off as a result.[42] There are problems of proof in many cases, but clear examples are easy to find.

In *Marvel Entertainment*, for example, the debtor proposed, and the court approved, continuing shipment of product for which customers had already paid.[43] The cost to the debtor to continue shipments was not great, and the production costs were largely sunk. More to the point, a failure to ship would sow unhappiness in the customer base. The products in question were comic books, and the prepaying buyers were subscribers.

Apart from the sheer silliness of serving tens of thousands of twelve-year-olds with proper notice and inviting them to be heard as creditors in the case, demanding they pay a second time for *Spiderman* and the *Fantastic Four* would undermine the future of the business. It would save relatively little money and would do considerable reputational damage. All the other stakeholders would be worse off if subscribers were treated like ordinary creditors.

A similar issue arises with respect to frequent-flier miles in an airline bankruptcy. The obligation of an airline to provide additional services (in the form of free travel and upgrades) generates a “claim” within the meaning of the Bankruptcy Code. Because the obligation arose before the filing of the petition, it is again a prepetition claim that ordinarily would be cashed out at cents on the dollar just like any other. But few doubt that the bankruptcy judge can approve honoring them. It is just good business.

The relevant question is not whether some creditors receive more than others, but rather again whether the estate is better off. That a transaction also brings higher relative benefits to the favored party is hardly a reason for not doing it. Arm’s length transactions, by their nature, make both parties better off. This is as true with deals with

[42] In re Kmart, 359 F.3d 866 (7th Cir. 2004).

[43] The buyers had already paid for the comic books. Because they had no obligations to the publisher, there was no executory contract to assume. Hence, they were simply, as a matter of bankruptcy law, unsecured creditors. Analytically, of course, it makes no difference whether they had obligations to the debtor. What mattered was whether continuing to do business with them made Marvel worth more.

prepetition creditors as with everyone else. The critical question is whether the estate benefits from making the payment.

To illustrate the challenges at play here, consider the following.[44] A firm manufactures an IUD birth-control device that proves defective. Facing massive tort liability, it files for bankruptcy. The bankruptcy judge appoints an examiner to assess the tort claims and propose a course of action. The examiner is a well-seasoned professional.

In the course of crafting the plan of reorganization, this examiner discovers that any delay in implementing a plan of reorganization adversely affects a number of the tort victims and, crucial from her perspective, the size of their claim against the estate. The use of the IUD rendered them infertile. If they have tubal ligation surgery immediately, they might be able to have children. If they receive the surgery now and it is successful, their claim is likely little more than the cost of the surgery. But if they are not paid immediately, the surgery might come too late. If the victims cannot conceive, they would receive damages *both* for the costs of the surgery and the damages from being rendered infertile, an amount at least an order of magnitude larger than the cost of the surgery. The examiner concludes that paying these prepetition creditors increases the value of the estate available to the other stakeholders. Others have a full opportunity to voice objections. Only a few do.

Deciding to approve such payments to prepetition creditors in such an environment is easy. Given a recommendation from an unbiased, highly competent decisionmaker with access to all the relevant information and the acceptance of her recommendation by the vast majority of other stakeholders, those whose money was on the line, there is little work for the bankruptcy judge to do.

The atmospherics in this case are somewhat different than in the typical critical-vendor case. The purpose of paying the magazine subscribers and the frequent flyers is to enhance the value of the estate. The purpose of making an early payment to the tort victims is to reduce the total claims against the estate by an amount that is much larger than the payout to the tort victims. In both instances,

[44] This hypothetical is closely based on the facts of Official Committee of Equity Security Holders v. Mabey, 832 F.2d 299, 299–302 (4th Cir. 1987). In that case, the court found that the court lacked the power to make the payment, but no other circuits have followed its league and, even in its own circuit, the case is read extremely narrowly.

however, the payouts to the remaining creditors go up, and this is what matters.

When a payment to a prepetition creditor is proposed and someone does object, the bankruptcy judge, in addition to assessing the evidence that it is value enhancing, will focus as much on the process that led to the proposal. The judge is ultimately assessing the merits of the decision. From this perspective, the question is not whether the payment violates some distributional rule, but rather whether the process itself was one that allows the judge to infer that the deal being presented is a good one. In looking toward the level of creditor consent, the bankruptcy judge is mimicking the more formal plan confirmation process, in which there is formal voting and where a supermajority of a class can waive the absolute priority rule.

B. Bargaining with Strategic Actors

All of the examples examined so far involve payments to entirely passive prepetition creditors. The passive role makes it easier for the bankruptcy judge to conclude that those controlling the estate were paying them because it is good business and not to secure something on the side. Paying them had no effect on the dynamics of the case itself. But this is not always the case. Consider *Chrysler*.

When Chrysler filed for Chapter 11 and proposed selling its assets, the prospective buyer of Chrysler offered the estate $2 billion, far less than Chrysler's secured creditors were owed. The buyer also agreed to pay substantial retirement benefits to Chrysler's workers. These benefits were unsecured prepetition claims against Chrysler. But paying the retirement benefits did not make Chrysler's other creditors worse off as long as no one else would pay more than $2 billion for the assets.

Hence, the focus in the first instance should be on why these prepetition creditors are being paid. The buyer—in effect the federal government—may have simply wanted to bestow largess upon the workers, but one might say the same thing about its decision to rescue the carmaker in the first place. Chrysler's senior creditors were beneficiaries of a government bailout. As such, they were hardly in a position to complain that someone else was also receiving government largess.[45]

[45] What does matter, however, is whether in the course of providing such largess, the government chilled other bidders. In other words, the senior

More likely, the buyer chose to pay the benefits because the workers would have refused to work if it did not pay them and the business could not operate without them. From the perspective of any buyer who planned on continuing the business, the money they demanded was merely another cost.

Let us assume that Chrysler would be worth $5 billion but only if the workers continue to work and they will work only if the retirees are paid $3 billion. How much is Chrysler worth as a going concern? In a world in which the workers' threat to shut down the firm is credible, Chrysler is worth only $2 billion. The need to pay the retirees $3 billion is a cost of doing business—no different from the money needed to pay what might seem high prices for zoning variances, concrete, or garbage collection. Of course, few of us like paying these high prices, and no one likes to be shaken down. But every buyer takes these into account in making a bid.

If an outside vendor threatened not to do business with a debtor, courts would simply ask whether the threat was credible. The question here is whether it should make any difference that the person who possesses the credible threat happens to be a prepetition creditor.

Of course, bankruptcy puts in place rules like the automatic stay that constrain the efforts of prepetition creditors to be paid. These rules are a sensible part of the creditors' bargain. Such behavior and fighting against such behavior both consumes resources and threatens to put assets to less productive uses. Ensuring that bankruptcy has procedural rules that prevent such hold-up behavior is part of maximizing the value of the estate. It is the hold-up behavior itself that is objectionable. It has nothing to do with bankruptcy's distributional rules, but rather with the need to create a bankruptcy process in which competing creditors cannot engage in hold-up behavior.

Another type of transaction with prepetition creditors who have negotiating power arises when the debtor seeks postpetition financing. Before the petition was filed, the debtor might have had a relationship with a certain bank that provided it credit. At the time of filing the

creditors can object to a process in which the assets are being sold for less than their true value. In particular, the auction process was set up in such a way as to make it exceedingly unlikely that a rival buyer would appear whose plan was to liquidate the assets, even if such a course would yield more than $2 billion.

debtor owes that bank a sizeable amount. To keep doing business as usual, the debtor needs new credit to fund its operations. The bank that provided the financing prepetition agrees to provide postpetition financing, but it insists that the a portion of the new loan be used to pay off its old loans.

The effect of such a "roll-up" is to pay off prepetition debt. The bank ceases to be a prepetition creditor and instead becomes an extender of postpetition credit and enjoys the stronger rights associated with that status. Roll-ups, by their nature, lead to prepetition debt being paid off—and paid off with first priority.

The bank, of course, is exploiting its leverage. Other prospective postpetition financers do not know as much about the debtor as it does and it has this knowledge as a result of its prepetition relationship with the debtor. But again the question is the degree to which rules can be crafted to keep creditors from exploiting such leverage. One might, of course, ban roll-ups entirely and sharply limit critical vendor orders at least when the suppliers were active in the case.

Preventing hold-up behavior by prepetition creditors is a tricky business, however. The question should always turn on the effects various approaches have on the estate and the pro-rata share the other creditors enjoy. It might seem that a flat rule that prohibits hold-up behavior makes sense. If a person is disabled from paying ransom, she will be subject to fewer ransom demands in the first instance. Tying the judge's hands, like a strategy of never negotiating with terrorists, may keep people from bringing threats just to extract hold up value. The estate is better off as a result.

Implementing such a ban is not easy, however. Under the variation of *Jevic* in which the private investors demand a particular distribution because they have no interest in replacing one lawsuit with another, a ban on the settlement will simply block a value-enhancing deal.[46] A third party will make demands whenever (at the time she makes the demand) it is in her interest to carry out the threatened course of action. A rule that prevented a deal with the private equity fund under these facts would merely leave the estate worse off.

[46] Einer Elhauge explores these issues in a variety of contexts. See Einer Elhauge, Contrived Threats Versus Uncontrived Warnings, 83 U. Chi. L. Rev. (2016).

As a matter of statutory construction, it is possible to distinguish this version of *Jevic* from other cases in which prepetition creditors were paid. Unlike critical vendor payments, the settlement and the agreement about distributing it does not arise from the operation of the business. Section 363(b) allows the trustee to "use" assets during the bankruptcy case. It is pointed to as the source of the power to make critical vendor orders and settle claims against the estate. One can argue that this section does not apply at the very end of the case when the "use" of the asset is merely a distribution to a creditor. The Bankruptcy Code, for whatever reason, does not empower the judge to bless a transfer to prepetition creditors, regardless of whether it is Pareto superior, if the transfer is simply a naked distribution to a creditor.[47] The rules governing the distribution of assets apply to the exclusion of §363 when the case is being dismissed.

It is hard, however, to articulate a bankruptcy policy that justifies distinguishing between a critical vendor order that benefits the estate and a settlement that brings an equal benefit. The motives of the private equity investor are considerably less benign than those of the comic-book subscribers, but again it is not obvious why the motives of the private equity investors should be relevant.

Part of the answer may lie not so much in the reach of §363, but in the unusual posture of the case. In addition to accounting for strategic behavior, the bankruptcy judge must also take account of the difficulties in determining whether the transaction is in fact above board and wealth enhancing. Payments to insiders are always troublesome. The more ties the estate has with a party, the more likely it is that the deal is not what appears to be. And the more exotic the transaction—the more it deals in interests outside the bankruptcy partition—the more likely it is that the bankruptcy judge cannot completely understand what is going on and should be on this account reluctant to bless it. To use a hypothetical that Justice Breyer introduced at oral argument, what would happen if a pirate possessed the debtor's gold and was willing to part with it only under the condition that it be given to a creditor that happened to be the pirate's cousin? It is much easier to judge a transaction that simply transfers assets between the debtor and a counter party than to judge a transaction where an outsider pays the debtor to take actions that

[47] Justice Kagan focused on exactly this issue in oral argument, couching the problem in exactly these terms, specifically discussing the notion of Pareto superiority.

either hurt or help a third party, who may in turn be a creditor of the estate.

It is often hard to establish under the facts of a particular case whether the payment to the prepetition creditor is a tainted preference or an estate-maximizing use of assets. Moreover, as we have noted before, a judge's refusal to bless a transaction is not the end of the matter. It merely forces the creditor with a credible threat to strike a deal with the creditor body as a whole. If the transaction leaves the remaining creditors better off, there is a deal to be struck with them. The bankruptcy judge can bless a greater payout to one creditor if the other creditors consent to it. An outright ban leaves everyone worse off only if the parties cannot reach a consensual agreement among themselves. Of course, in the end, if a deal is reached the assets will still not be distributed pro rata.

C. Strategic Behavior, Bankruptcy, and Coasean Bargaining

Bankruptcy, of course, posits the existence of a collective action problem that prevents the parties from reaching an agreement with each other, but part of the way bankruptcy solves the collective action problem is by making it easier for parties to bargain with each other. Various rules allow a class as a whole to bind the minority. To be sure, these rules operate principally when a plan of reorganization is in the offing. But the possibility that parties will be able to reach a bargain with each other in bankruptcy reduces the risk that creditors will end up in a place that is contrary to their collective interests. This may be especially important when the only issue on the table is, as in *Jevic*, a question of distributing assets and does not involve operational decisions, decisions that creditors as a group may have difficulty assessing.

Consider *Jevic* again. The judge in *Jevic* found that, in the absence of approving the settlement, none of the creditors would receive anything. But it is possible that if he had refused to approve the settlement, some new bargain would have emerged. One can imagine a deal that overcame the private equity fund's resistance to funding litigation against it that would still distribute value to the workers.

The parties, for example, could set up a "litigation escrow." A fund could be created in which a third party held on to the funds until after the statute of limitations for the workers' independent action against the private equity fund expired. To prevent the workers from borrowing against it, the escrow agreement might also provide that the

workers would enjoy none of the money if they used the funds as collateral for a loan. If the existence of the litigation escrow would itself make financing of the lawsuit possible, a settlement might require that its existence be kept secret.

We are not suggesting such litigation escrows are a good idea. Rather, we are noting only that when a judge refrains from blessing transactions that are Pareto-improving, there is a social loss only when bargaining among the parties does not happen. The parties in *Jevic* might still have reached a settlement even if the judge refused to enforce the deal presented and insisted that the parties continue negotiating.

Of course, it is possible that no deal would have been reached. Cooler heads do not always prevail. But one of the functions of bankruptcy is to create an environment in which forging an agreement among the parties is possible. Assessing how the bankruptcy judge should exercise her discretion to approve transactions with prepetition creditors is linked to the bargaining environment in which the parties find themselves. This bargaining environment is in turn shaped by the rules of engagement that the Bankruptcy Code puts in place.

This returns to an observation we have already made. The Bankruptcy Code generally does not require unanimity among stakeholders, but the courts do in fact look to consensus as important evidence when deciding how to exercise their discretion. In deciding to go forward with debtor-in-posession financing orders, critical-vendor orders, and the like, bankruptcy judges commonly look to whether there is consensus among the various constituencies. In other words, in practice there is not a binary choice between asking the judge to approve a transaction that favors a particular creditor or forcing the parties to bargain with each other. The willingness of the court to approve a transaction turns critically on the extent to which the other creditors consent to it.

V. Conclusion

The dynamics at play in *Jevic* were not as unusual as the courts suggested. Structured dismissals in which value passes to a creditors' committee or some other player are common. In those cases, however, the question is usually whether there is an impermissible side payment or an innocuous "tip." What seemed unusual in *Jevic* is that one of the players affirmatively cared not only about what it received, but also about what others received. But variations of that theme can

be found in cases about critical vendor orders and the like where one group of stakeholders favors a project that lowers the recovery of another. All of these variations turn not on distributional rules but rather on the location of the bankruptcy partition.

One can, of course, come up with unusual hypotheticals versions of *Jevic* where one stakeholder will gain from and pay to affirmatively hurt another stakeholder. Imagine if the fund was willing to pay $20 to the estate if it would impose costs of $10 on the drivers.[48]

This example is different from our previous variations on *Jevic*. This deal leaves the drivers unequivocally worse off, but the estate as a whole better off. There is a straight-out conflict between bankruptcy's distributional rule and the goal of maximizing the value of the estate. The fund is not masking its motivations. Under these assumptions, there is no side deal that is keeping the judge in the dark. Nor is there any mystery about why the settlement is being made. There is simply a choice to be made between one estate that is divided according to bankruptcy's traditional rules, and a more valuable estate that is not.

This is not the case that the bankruptcy judge in *Jevic* thought was before him. Indeed, such a case is most unusual. Most of the players in bankruptcy care only about how much they receive, not how much

[48] For example, assume that the debtor begins with both $10 in cash and a fraudulent conveyance action. Assume further that the workers enjoy no special priority. The fraudulent conveyance action will bring $200 with a 10 percent probability, and it will cost $10. By bringing the cause of action, the expected value of the debtor's estate increases by $10.

Assume that the target of the action faces litigation costs of $10. From the target's perspective, the expected cost from litigating the fraudulent conveyance action is $30. There is a mutually beneficial settlement possible. If a settlement can be reached for $20, there will be $30 to distribute to creditors, rather than $10 if nothing is done or a judgment with an expected value of $20 if the litigation is pursued.

The target offers to settle the case for $20, but conditions the settlement on none of the assets going to a particular creditor. From the perspective of the target, in the absence of settlement, if it has to litigate the fraudulent conveyance action against the creditors' committee, it will spend $10 on fees, and face an expected judgment of $20. Everything else equal, it would be willing to settle for $20 and save $10 in fees. But if the settlement will expose it to litigation from the creditor that will cost more than $10 in expectation, it has no interest in settling. It gains nothing from settling one lawsuit, if the effect of settling it is merely to finance another.

others receive. Someone in the position of the private equity fund would insist simply on the settlement most favorable to it.

The only other recent case that comes to mind is the bankruptcy of the City of Detroit. The city owned the art museum and the creditors pressed for a sale of its treasures. The mediator in the case organized a "grand bargain" in which a group of foundations and the state of Michigan contributed $800 million to put the museum into private hands permanently, but they were willing to contribute this money only if it were used to pay benefits to workers, not if it went to institutional lenders, even though, as a legal matter, they shared the same priority.

Here the bankruptcy court was in fact faced with a choice of approving a transaction in which the transaction itself could take place only if the proceeds of the transaction were divided among creditors in a particular fashion. Insisting on Pareto superiority would have prevented the grand bargain for Detroit. It was a case in which a third party wanted workers to be favored, rather than disfavored.

Detroit, however, may be an exception that proves the rule. A distinctive characteristic of municipal bankruptcies that distinguishes them from others is that no estate is created. There is no partition with hard boundaries directing the parties to act with a narrow focus.

One can argue that in unusual cases like the variation on *Jevic* that we are considering, there is no reason, as a matter of first principle, to allow the estate maximization principle to give way to bankruptcy's distributional rule, at least in cases in which a creditor (unlike the workers in *Jevic*) are not singled out for priority. But there may be many prudential reasons to insist on adherence to the distributional rules. Strictly enforcing distributional rules limits costly rent-seeking. A creditor who cannot receive more than its pro-rata share is disabled from bargaining for more. The estate, in most cases, is better off with fixed distributional rules.

In the case of *Jevic*, it may matter little whether the bankruptcy judge refuses to enforce settlements because they violate distributional rules or because they do not serve to maximize the value of the estate or because they were coupled with dismisals. But there is a large domain of cases in which the distinction does matter.

A debtor might agree to pay one group of creditors before plan confirmation to reduce friction in the negotiation process.[49] Or it might agree to take actions that protect one creditor from a preference challenge in exchange for that creditor's support of a smooth plan process.[50] These sorts of actions shift value, usually from one set of institutional investors to another. Should the shift of value itself be something that troubles the judge, independent of any other bankruptcy policies that are implicated?

The answer to those questions is often reached through unspoken enforcement of bankruptcy partition. The courts can and do assess the substance of decisions based on their utility in maximizing the interests that lie within the partition and can assess the process based on whether those participating in it were seeking to maximize their stakes in the estate or some outside interest. There are costs to enforcing this partition but they are capped by the ability of the stakeholders to collectively bargain themselves, bargaining that bankruptcy law itself facilitates.

[49] See In re Energy Future Holdings Corp., 648 Fed. Appx. 277 (3d Cir. 2016).

[50] This issue came up in the dispute over the filing date in the *Caesars* bankruptcy.