BARGAINING BANKRUPT: A RELATIONAL THEORY OF CONTRACT IN BANKRUPTCY

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This Article studies the growing use of contract in bankruptcy. Sophisticated "distress" investors (for example, hedge funds and private equity funds) increasingly enter into contracts amongst themselves and corporate debtors during bankruptcy in order to evade "mandatory" rules on the priority of distributions, thus preferring themselves at the expense of other stakeholders (for example, employees of the corporate debtor). Bankruptcy courts that supervise these cases struggle with these priority-shifting contracts. They are asked to approve them, but have little theoretical or doctrinal guidance on how to assess them.

This Article develops a "relational" framework to explore this shift toward contract in bankruptcy. Relationalism seeks to understand power dynamics, and preferences for formal and informal promissory mechanisms in private ordering. Distress investors, bankruptcy professionals (lawyers), and judges in large cases form a classic relationalist environment. They are a community of repeat players with their own norms and preferences for formal and informal promissory exchange. Their contracting practices can affect the hundreds (sometimes thousands) of stakeholders in a large corporate debtor.

At the same time, there are growing calls to amend the Bankruptcy Code. Congress, however, has botched recent efforts to do so. Contract may be a better vehicle for institutional adjustment than Congress—if it is perceived as legitimate. A relationalist framework would help sort legitimate from illegitimate contracts in bankruptcy, thus improving our understanding of the system and its operation.

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Introduction

> *"Although . . . negotiations are the lifeblood of . . . bankruptcy practice, the rules that should govern these negotiations are largely unexplored in the academic literature."*[1]

> "*Any theory about the role of contract law must include the functions of bankruptcy or it will be seriously incomplete . . . .*"[2]

One of the most difficult and enduring questions in corporate bankruptcy involves the role of contract: to what extent should private ordering override mandatory rules imposed by chapter 11 of the Bankruptcy Code?[3]

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[1] Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. Chi. L. Rev. 738, 741 (1988) [hereinafter Baird & Jackson, *Bargaining After the Fall*].

[2] Stewart Macaulay, *The Real Deal and the Paper Deal: Empirical Pictures of Relationships, Complexity and the Urge for Transparent Simple Rules*, 66 Mod. L. Rev. 44, 77 (2003).

[3] "Chapter 11" usually governs corporate reorganization, and generally refers to 11 U.S.C. §§ 1101–1174 (West 2015), as well as other provisions of the Bankruptcy Code and Judicial Code. The current version of the Bankruptcy Code was originally enacted in 1978, Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, and has been amended several times, most recently in 2005, Bankruptcy Abuse Prevention and Consumer Protection

The question is difficult because most observers tacitly accept two contradictory assumptions about the process. On one hand, chapter 11 depends heavily on bargaining and negotiation, the historic goal of the process being a "plan of reorganization" agreed to by most stakeholders.[4] On the other hand, most agree that Congress can and should enact mandatory bankruptcy laws, even if they may disagree about the principles that should animate those laws.[5] The problem is enduring because it is often conceptualized as one of finding balance between permissive and mandatory rules—drawing lines between contract and command.

Yet, the core of this "contract bankruptcy debate" is hollow, because no one has asked or answered a prior question: what do we mean by "contract" here? "Contractualist" scholars advocate greater private ordering in bankruptcy.[6] Yet, they offer neither doctrinal nor theoretical accounts of the instrument and institution they laud. This absence is disappointing, because the problems of contract outside of bankruptcy—for example, fraud, duress, and good faith—matter in deciding whether (or to what extent) to recognize contract in bankruptcy.[7] Moreover, there are different theories of contract.[8]

Act (BAPCPA) of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11, 18, 28 U.S.C.).

[4] *See, e.g.*, Theodore Eisenberg, *Commentary on 'On the Nature of Bankruptcy': Bankruptcy and Bargaining*, 75 VA. L. REV. 205, 207 (1989) (discussing "the emphasis on bargaining in bankruptcy"); *see also* 11 U.S.C. §§ 1126, 1129 (setting forth plan confirmation requirements).

[5] *See* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 599 (1998) (reasoning that debates over the role of contract in bankruptcy "'must ultimately dissolve into a study of aesthetics and morals.'" (quoting R.H. Coase, *The Problem of Social Cost,* 3 J.L. & ECON. 1, 43 (1960)).

[6] The contractualist position is rooted in the work of Thomas Jackson. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 32–33 (1986) [hereinafter, JACKSON, LOGIC AND LIMITS] (developing "creditor's bargain" theory). *See also* Anthony T. Kronman & Thomas H. Jackson, *Secured Financings and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Thomas H. Jackson, *Bankruptcy, Non-bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 860 (1982) [hereinafter Jackson, *Bankruptcy, Non-Bankruptcy*]; Baird & Jackson, *Bargaining After the Fall*, *supra* note 1, at 738; Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984); Robert E. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U. CHI. L. REV. 690, 692 (1986) (reviewing DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY (1985)) (describing Baird and Jackson's creditors' bargain heuristic as "set[ting] the terms of the scholarly debate for the next decade"). Alan Schwartz has perhaps developed the strongest version of this view. "Viewing bankruptcy through the lens of contract theory," he argued in a provocative 1998 paper, "reveals bankruptcy's anachronistic character: Bankruptcy is a government enterprise. The state runs the postal system and the bankruptcy system, and restricts competition with both by law. This Essay's central claim is captured in a variation on a trendy slogan: Privatize bankruptcy." Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1850–51 (1998).

[7] These are discussed in Part II, below.

[8] These include deontological (e.g. Kantian) and utilitarian (e.g. economic) theories. *See, e.g.*, Curtis Bridgeman & John C.P. Goldberg, *Do Promises Distinguish Contract from Tort?*, 45 SUFFOLK U. L. REV. 873, 890–91 (2012) (stating that Kantian contract centers around the idea that "one ought to perform the promises one makes—that they should not be broken out of mere regret, because it has become inconvenient to perform, or because a better opportunity

One's theory of contract should influence one's view of doctrine. Both should, in turn, influence one's understanding of the role of contract in bankruptcy.

But they do not. Contractualism tends to rely on what Robert Ellickson would call a "cardboard" Coasean theory of contract.[9] This hypothetical model starts from the assumption that contracting involves bilateral monopoly (two parties), and low transaction and information costs.[10] To be sure, the diplomacy of law-and-economics requires contractualists to relax these assumptions to varying degrees.[11] Yet, they are the starting point of analysis—and they are conditions that almost never obtain in bankruptcy, collective proceedings that can involve hundreds, if not thousands, of stakeholders.[12]

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has come along"); Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829, 832 (2003) (explaining that the "[t]he standard approach [of economic theory] assumes that the parties enter a contract in order to secure investment in a jointly beneficial project").

[9] Robert C. Ellickson, *The Case for Coase and Against "Coaseanism"*, 99 YALE L.J. 611, 612 (1989). An acute example of the omission appears in Schwartz, *supra* note 6, whose title, "*A Contract Theory*," promises just that: theory. Yet, as LoPucki notes, in his reply to Schwartz's second attempt at stating a "contract theory" of bankruptcy, Schwartz's basic premises ("implicit assumptions") about contract theory were, in fact, unsupported by contract theory. Lynn M. LoPucki, *Bankruptcy Contracting Revised: A Reply to Alan Schwartz's New Model*, 109 YALE L.J. 365, 366 (1999). Schwartz argued that "[c]ontract-theory models assume that parties will not engage in fraud." Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343, 349 (1999). This was wrong. As LoPucki explains:

> Schwartz cites two articles in which the authors expressly assumed that the contracting parties would be truthful, but it is equally easy to cite articles in which the authors expressly assumed the contracting parties in their models could lie. More to the point, the authors Schwartz cites do not make the no-lying assumption merely because it is a convention of contract theory; they make it because it is plausible given the other assumptions of their model. By contrast, Schwartz's original model assumes that the private information (the private benefits) is "unverifiable," making an assumption of truthful disclosure implausible.

Lynn M. LoPucki, *supra*, at 367 (citations omitted).

[10] Coasean contracting seeks to minimize transaction costs incurred by parties bargaining around these default terms in favor of explicit terms. *See* Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990); Jason Scott Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291, 293–94 (1992). *See generally* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

[11] As Barry Adler explains, if we did reside in a world of bilateral monopoly, low-information costs, and easy access to information, then "corporate bankruptcy law itself would be largely unnecessary." Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219, 230 (2004) [hereinafter Adler, *Bankruptcy Primitives*] (recognizing that bankruptcy creates "a conflict-ridden, uncertain environment"). Yet, the Coasean bargain retains a deep allure for contractualists. *See, e.g.*, Barry E. Adler, *Game-Theoretic Bankruptcy Valuation*, 41 J. LEGAL STUD. 209, 215–16 (2012) (arguing that Coasean bargains may occur but "they can be expensive and are not inevitable"). I am indebted to my colleague, Craig Green, for the phrase "diplomacy of law-and-economics."

[12] *See, e.g.*, Merton H. Miller, *Leverage*, 46 J. FIN. 479, 484 (1991) (observing that bankruptcy costs are high and can entirely consume assets of smaller firms). *See also* Adler, *Bankruptcy Primitives*, *supra* note 11. Key legal reasons the conditions do not exist in bankruptcy include the facts that commencement of a case creates an "estate" composed of all property of the debtor, 11 U.S.C. § 541 (West 2015), and successful confirmation of a plan of reorganiza-

Contractualism has been deeply controversial. Anti-contractualist scholars object that it lacks empirical support,[13] normative force,[14] or basis in law.[15] Yet, they too offer no theory of contract, perhaps worried that any effort to develop a direct response would give contractualism greater dignity than it deserves.

Until recently, this omission was a forgivable oversight, a luxury problem for academics. Today, however, it matters for two reasons. First, distress investors, who often influence large chapter 11 cases,[16] increasingly use contract, or contract-like mechanisms such as settlement agreements, to evade bankruptcy's most important mandatory feature, its priority rules and norms. In simple terms, these rules and norms are embodied in the priority structure of the Bankruptcy Code, in particular the absolute priority rule (APR), which provides that junior stakeholders (for example, shareholders) may receive nothing unless senior claimants (for example, secured creditors) are paid in full or otherwise agree.[17] Distress investors defy these norms through priority-skipping contracts[18] such as roll-ups, which confer super priority on their pre-bankruptcy claims, and structured dismissals which, in at least one con-

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tion will likely result in a discharge of claims against the debtor, 11 U.S.C. § 1141(d) (West 2015).

[13] *See, e.g.*, Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy*: *An Empirical Intervention*, 118 HARV. L. REV. 1197 (2005) [hereinafter Warren & Westbrook, *Contracting Out of Bankruptcy*]; Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Corporations*, 141 U. PA. L. REV. 669 (1993); Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 AM. BANKR L.J. 499 (1999) [hereinafter Warren & Westbrook, *Financial Characteristics*].

[14] *See, e.g.*, Donald R. Korobkin, *The Role of Normative Theory in Bankruptcy Debates*, 82 IOWA L. REV. 75 (1996); Susan Block-Leib, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503 (2001).

[15] *See, e.g.*, Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777 (1987) (arguing that bankruptcy law in fact reflects "competing—and sometimes conflicting—values").

[16] *See* Jonathan C. Lipson & Christopher diVirgilio, *Controlling the Market for Information in Reorganization,* 18 AM. BANKR. INST. L.J. 647 (2010); Jonathan C. Lipson, *Governance in the Breach: Controlling Creditor Opportunism*, 84 S. CAL. L. REV. 1035 (2011) [hereinafter Lipson, *Governance in the Breach*] (discussing creditor pre-bankruptcy efforts to obtain control); Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. L. REV. 281, 282 (2009) ("What distinguishes hedge funds from other investors is that hedge funds tend to pursue active and aggressive investment strategies. Thus, hedge funds use leverage, sell short, and invest in derivatives. They trade much more frequently than other investors."). *See, e.g.*, Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703 (2008) (describing the activities of distressed debt investors); Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1640 (2009) [hereinafter Lipson, *Shadow Bankruptcy*] (discussing problem of creditor control in bankruptcy committees).

[17] The absolute priority rule (APR) is reflected in, among others, the "fair and equitable" standard of Bankruptcy Code section 1129(b). 11 U.S.C. § 1129(b) (West 2015). I elaborate on the background of the APR in Part I, below. As discussed, section 507 creates a distinct, but related, priority scheme among unsecured creditors. *See* 11 U.S.C. § 507(a) (West 2015).

[18] *See* Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235, 1237–40 (2013) (discussing "priority jumping" efforts by distress investors).

troversial case, distributed property in defiance of these norms.[19] Bankruptcy courts struggle with these contracts because they have little doctrinal or theoretical guidance with which to assess them, yet they are not enforceable without court approval.

Second, there is growing pressure to amend the Bankruptcy Code,[20] which will soon be forty years old.[21] One might think Congress is the logical institutional choice to make these changes. Yet, Congress's 2005 amendments are widely viewed as a disaster.[22] This failure leaves contract as the main vehicle for institutional adjustment in bankruptcy. The ascendency of contract is in fact what has happened, as evidenced by the rise of roll-ups, structured dismissals, and other forms of contracting in bankruptcy. Thus, the important question is not *whether* we should permit contracting in bankruptcy, but by what standards we should assess—and thus permit or deny—those contracts. Attempts to draw lines between contract and command are of little use because the analysis to this point offers no underlying theory of contract.

This Article provides an underlying theory of contract. Contracting in bankruptcy should be informed by "relational contract theory."[23] Relationalism focuses on "the commitment that [parties] have made to one another,

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[19] Examples of these types of contracts are presented in detailed case studies of the *Colt* and *Jevic* bankruptcies, in Part I, below.

[20] *Chapter 11 Commission 2012-2014 Final Report*, American Bankruptcy Institute, https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h (visited Aug. 5, 2015); *Rethinking Chapter 11*, National Bankruptcy Conference, https://drive.google.com/a/temple.edu/file/d/0BzGxkXL_Y_oATkYtaUM1MnhrNXM/view (visited Aug. 5, 2015).

[21] Superstition among practitioners holds that no bankruptcy law can last longer than forty years because the two prior bankruptcy laws—the Bankruptcy Act of 1898 and the Chandler Act of 1938—were each in force for about forty years (1898–1938 and 1938–1978, respectively). Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, amended by Chandler Act, ch. 575, 52 Stat. 840 (1938), repealed by Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101–1330 (2000 & Supp. V 2005)). Before that, the United States only sporadically had in force a federal bankruptcy law. Jonathan C. Lipson, *Debt and Democracy: Towards a Constitutional Theory of Bankruptcy*, 83 Notre Dame L. Rev. 605, 625-30 (2008) [hereinafter Lipson, *Debt and Democracy*] (discussing the origins of bankruptcy law in America). The current law will turn forty in 2018.

[22] *See, e.g.*, Jean Braucher, *A Fresh Start for Personal Bankruptcy Reform: The Need for Simplification and a Single Portal*, 55 Am. U. L. Rev. 1295, 1296 (2006) ("'The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005' commits two counts of intentional fraud in its name alone. The law, which will be referred to hereafter simply and neutrally as 'the 2005 Act,' does not do a good job of preventing abuse and also does not protect consumers but rather puts new burdens on all filers, even the worst-off, who are clearly not abusers.") (citations omitted) (footnotes omitted).

[23] *See, e.g.*, Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*, 94 Nw. U. L. Rev. 877 (2000); Ian R. Macneil, *Contracts: Adjustments of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 Nw. U. L. Rev. 854, 895 (1978) [hereinafter Macneil, *Adjustments*]; Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 Nw. U. L. Rev. 847, 852 (2000) [hereinafter Scott, *Formalism*]; Ian R. Macneil, *The Many Futures of Contracts*, 47 So. Cal. L. Rev. 691, 693 (1974) [hereinafter Macneil, *Many Futures*] (discussing "the real life of contractual behavior"); Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 Am. Soc. Rev. 55 (1963) [hereinafter Macaulay, *Non-Contractual*]; Oliver E. Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting (1985).

and the conventions that the trading community establishes for such commitments . . . ."[24] It thus rejects the view that a contract is no more or less than "the paradigm transaction of traditional contract law, [the] discrete transaction."[25] Rather, finding roots in Stewart Macaulay's path-breaking study of business contracting practices,[26] relationalists recognize that "a unitary contract law appropriate to all [contracting] environments is a hopeless fiction."[27] Yet, contractualist theory rests on just such a fiction—the Coasean model.

Although it has largely escaped scholarly notice,[28] relational contract theory offers a rich approach to contracting in bankruptcy for two reasons. First, large chapter 11 cases now create what Robert Scott, a leading relational theorist, would call a "contracting environment."[29] In large chapter 11 cases, the most important participants—for example, distress investors, lawyers, and judges—often form a tightly knit community of repeat players because they are largely located in or around one of two courts (New York or Delaware) and tend to appear in many of the same cases. The relational characteristics of this community—its preferences for formal or informal mechanisms, promises of future play or retribution, and so on—will deter-

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[24] Robert W. Gordon, *Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law*, 1985 WIS. L. REV. 565, 578 (1985). Goetz and Scott provide the following:

> A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance . . . . [L]ong-term contracts are more likely than short-term agreements to fit this conceptualization, but temporal extension per se is not the defining characteristic.

Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts,* 67 VA. L. REV. 1089, 1091 (1981).

[25] *See* Victor P. Goldberg, *Relational Contract*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 289, 292 [hereinafter Goldberg, *Relational Contract*] (defining "relational contract"); Jay M. Feinman, *Relational Contract Theory in Context*, 94 NW. U. L. REV. 737, 741 (2000) ("Relational contract simultaneously dramatically broadens and dramatically fragments the scope of contract law as compared to neoclassical law.").

[26] Macaulay, *Non-Contractual*, *supra* note 23.

[27] Robert E. Scott, *The Promise and the Peril of Relational Contract Theory*, *in* REVISITING THE CONTRACTS SCHOLARSHIP OF STEWART MACAULAY 105, 108 (Braucher et al. eds., 2013) [hereinafter Scott, *Promise*].

[28] About twenty years ago, Professors Tung and Block-Lieb anticipated the possibility of the relational analysis presented in this Article. *See* Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small*, 57 BROOK. L. REV. 803, 862 n.221 (1991) (discussing relationalism in involuntary bankruptcies); Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1754 n.177 (1996) ("Chapter 11 in essence replaces the debtor's multiple bilateral prebankruptcy obligations with a sort of multilateral relational contract.") (citing Macneil, *Adjustment*, *supra* note 23). While helpful, their observations preceded the rise of modern distress investing, and the relationships among those investors. Therefore, the observations would not have developed the relational analysis in this Article.

[29] Scott, *Promise*, *supra* note 27. Marc Galanter has similarly described "bargaining arenas." Marc Galanter, *Worlds of Deals: Using Negotiation to Teach About Legal Process*, 34 J. LEGAL EDUC. 268, 272–73 (1984).

mine the kinds of contracts that it produces. The relationalist project is deeply invested in studying these environments, although it has not yet focused on chapter 11 reorganizations.

Second, relationalism often centers on the power dynamics of ongoing relationships. Does the party with more leverage behave opportunistically or appropriately in bargaining with the weaker party? How are third parties affected by the bargain? In any case, what should courts do about any of this? These questions are especially important in chapter 11, because priority-skipping contracts such as roll-ups and certain structured dismissals often take the form of a bargain between distress investors and debtors, sometimes at the expense of weaker creditors. Relationalism would ask courts to focus on these effects of contracting and would provide tools to address them.

The Article makes two claims: (1) relational contract theory provides a better framework for assessing contracting in bankruptcy than other theories used to date (or none at all); and (2) judges have a special duty in this contracting environment because they should not approve contracts in bankruptcy unless they are confident that the contracts are the products of reasonably fair and efficient bargaining processes. In particular, judges should assure that third parties affected by priority-skipping contracts had a meaningful opportunity to participate in the bargaining that produced the contracts in question. To make this assessment, judges should be sensitive to well-established contract doctrines with a relationalist thrust, such as fraud, duress, and good faith.

These claims will be controversial. The first suggests that academics should reframe their studies of the reorganization system to account for the relational aspects of contracting in bankruptcy. Historically, bankruptcy scholarship has largely been about ex ante entitlements (the contractualist position) or ex post outcomes (the anti-contractualist position), with line-drawing as the compromise (or stalemate) position. To study relational contracting in bankruptcy is to shift the focus from its outcomes to its underlying processes. Understanding promissory relationships is never easy, and there is no reason to think that chapter 11 will be any different; yet, it is imperative if we wish to understand the development of this system. The second asks judges to level the playing field. Yet, they are likely to believe they have limited power to do so, especially because distress investors may resist, preferring the advantages conferred on those who are familiar with the process. Nevertheless, if contracting in bankruptcy is its future, then getting it right—developing a framework for deciding which contracts to approve or not—is vital to the legitimacy and sustainability of the system.

This Article has five parts. Part I briefly summarizes two examples of priority-skipping contracts used by distress investors in chapter 11 cases; roll-ups that confer super priority on pre-bankruptcy debt and structured dismissals that deviate from statutory priorities, and some of their relational implications. Part II reviews the contract bankruptcy debate, and explains how it fails to account for the contracting we now see in bankruptcy. Part III develops an alternative, relational framework for contracting in chapter 11. Part IV applies the framework, sketching major aspects of the chapter 11 contracting environment. Part V anticipates and addresses potential objections, and suggests an agenda for further study.

I. Bankruptcy Contracting for Priority

What are contracts in bankruptcy for? For our purposes, the most important and controversial seek to contract around the Bankruptcy Code's priority structure. This part summarizes priority rules and norms in bankruptcy and discusses two recent examples of contracting in bankruptcy around them: roll-ups that confer super priority on pre-bankruptcy debt and a structured dismissal that skips statutory priority.

A. Priority Norms in Bankruptcy

Priority in bankruptcy derives from two related sets of rules. First, and most important, the absolute priority rule (APR) holds that junior stakeholders cannot receive or retain property of the debtor unless senior stakeholders (for example, secured creditors) either (i) are paid in full, or (ii) agree to a different treatment.[30] It applies when a plan of reorganization is confirmed and (perhaps) when other settlements are approved.[31] This long-standing priority norm was succinctly expressed by the Supreme Court in 1898:

> [T]he stockholder's interest in the [debtor's] property is subordinate to the rights of creditors. First, of secured, and then of unsecured, creditors. And any arrangement of the parties by which the subordinate rights and interests of the stockholders are at-

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[30] The APR is codified, in part, in 11 U.S.C. § 1129(b)'s requirement that a reorganization plan be "fair and equitable, with respect to each class of claims or interests." 11 U.S.C. § 1129(b) (West 2015). *See* N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 502 (1913) ("[A] transfer by stockholders from themselves to themselves cannot defeat the claim of a non-assenting creditor."); Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 116 (1939); Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988); Bank of Am. Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 441 (1999). Although the rule is controversial for various reasons, scholars have long acknowledged its force. *See, e.g.*, Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganization*, 41 U. Chi. L. Rev. 651, 654 (1974) ("[B]efore a class of investors can participate in a reorganization, all more senior classes must be compensated in full for their claims, measured on the basis of their priorities upon involuntary liquidation . . . ."); Baird & Jackson, *Bargaining After the Fall*, *supra* note 1, at 744; Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 130 U. Pa. L. Rev. 125, 130 (1990) ("The condition that a plan be fair and equitable requires that senior classes receive absolute priority over junior classes; this condition is thus known as the 'absolute priority rule.'"); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 Stan. L. Rev. 69, 74–84 (1991) (describing the absolute priority rule as foundational).

[31] As discussed below, the *Jevic* case is evidence of contractual deviation from priority norms in bankruptcy. *See* discussion *infra* Part I.

> tempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.[32]

Second, Congress created special priorities for unsecured creditors, set forth in section 507 of the Bankruptcy Code. To the extent the debtor has unencumbered assets, for example, first priority in a chapter 11 case will usually include expenses of lawyers and other professionals appointed to represent the debtor in possession and official committees of stakeholders (for example, creditors).[33] Unpaid wages of the debtor's employees are entitled to a fourth priority, capped at a statutory amount.[34] A plan of reorganization cannot be confirmed unless priority claims are paid in full or these priority creditors agree otherwise.[35] These priorities also apply if a debtor liquidates under chapter 7.[36]

Take a simple example. Debtor (*D*) has a secured creditor (*A*), who has a perfected lien on all of *D*'s assets. The assets are worth $100; *D* owes *A* $75. *D* thus has equity in its assets of $25 (that is, net of *A*'s $75 secured claim). *D* owes priority unsecured claims of $10 to employees (*B*) and non-priority, general unsecured claims of $30 to *C*. Thus, *D* is insolvent; it has assets of $100 against claims of $115. If *D* is a corporation, its stock is worthless. The question is: who among *A*, *B* and *C* gets what—and in what order?

Many distributional schemes are conceivable. All could share ratably, for example, for a distribution of about $0.87 on the dollar. Or the distribution could be made by political determinations about the "value" of the underlying claims (for example, wage claims are paid first). Instead, we use a complex mix of contract, property, statutory law and priority norms incorporated in the APR to make these decisions. Thus, traditionally, *A* would receive $75, or 100% of its claim, due to its secured claim against *D* and its property. If we accept the priority scheme of the Bankruptcy Code, *B* would get the next $10 (also 100%), leaving $15 in assets to pay the $30 claim of general unsecured creditors (*C*), who would therefore take a loss of 50%.

Scholars often claim that the APR is central to the chapter 11 process. Anthony Casey, for example, argues that "[c]orporate reorganization under chapter 11 of the Bankruptcy Code is built on the foundation of the [APR], which requires that senior creditors be paid in full before any value can be

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[32] Louisville Trust Co. v. Louisville New Albany & Chi. Ry. Co., 174 U.S. 674, 684 (1899). Nor would side agreements between seniors and juniors (shareholders) be tolerated. *See Case*, 308 U.S. at 116. ("[A]ny arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.").

[33] *See* 11 U.S.C. § 507(a)(2) (West 2015). Technically, first priority goes to "domestic support obligations" arising in connection with divorce, child support, and the like. 11 U.S.C. § 507(a)(1) (2015). However, these are likely not important in corporate reorganization.

[34] 11 U.S.C. § 507(a)(4) (West 2015).

[35] 11 U.S.C. § 1129(a)(9) (West 2015).

[36] 11 U.S.C. § 726(a) (West 2015).

distributed to junior creditors."[37] Mark Roe and Fred Tung observe that "[a]bsolute priority is central to the structure of business reorganization and is, quite appropriately, bankruptcy's most important and famous rule."[38]

The APR performs at least three functions. First, it may promote the efficient allocation of resources. As explained in Part II, below, contractualist scholars sometimes view the APR as producing wealth-maximizing results. Deviations from the APR can be wealth-destroying. While priority-skipping may sometimes be efficient, Roe and Tung worry that it leads to rent-seeking by creditors in a position to exact a higher priority status for their claims than they may otherwise be entitled to receive.[39] The inefficiencies may result from either or both of the transaction costs of priority-jumping strategies (new transaction forms, litigation, or legislation) or Pareto losses suffered by weaker, less sophisticated creditors unable to compete with the priority strategies of stronger, more sophisticated creditors.[40]

Second, the APR may advance norms of good faith and fair dealing. The modern conception of priority reflected in the APR can be seen as a response to perceived abuses in the railroad reorganizations that occurred through much of the nineteenth and first half of the twentieth centuries.[41]

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[37] Anthony Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. Chi. L. Rev 759, 759, 763 (2011) ("[The APR is] viewed by many as the foundational principle for corporate reorganization.").

[38] Roe & Tung, *supra* note 18, at 1236. As Douglas Baird succinctly observes: priority matters. *See* Douglas G. Baird, *Priority Matters*, 165 U. Penn. L. Rev. (forthcoming 2017); *see also* Walter Blum, *The Law and Language of Corporate Reorganization*, 17 U. Chi. L. Rev. 565 (1950).

[39] *Id.* at 1242 ("Many, perhaps most, priority jumps in recent years show strong indicia of having been inefficient overall, even if some were locally efficient in one deal or another. Too many resemble the classic rent-seeking story applied to the costs of monopolization: if monopoly profits are high enough, social resources will be over-spent as parties pay for a chance of obtaining those monopoly profits.").

[40] As Roe & Tung explain:

> On the inefficiency side of the ledger, creditors may seek a priority jump, not because of its ultimate transactional efficiency, but because they can react quickly and shift losses to less nimble creditors or because they enjoy a comparative advantage in obtaining priority in one decisional forum or another. The less nimble may suffer from institutional or cognitive scleroses that impede them from reacting rapidly and effectively. The overall costs of priority-seeking may therefore not be trivial. Especially when the process becomes competitive, the total cost spent pursuing and contesting priority jumps may swamp any efficiency gains from streamlined credit provisions.

Id.

[41] These reorganizations were, until 1933, governed not by the Bankruptcy Code, but rather were federal equity receiverships. In 1933, Congress enacted Section 77 of the Bankruptcy Act in order to address the "sudden evaporation of railroad earning power" that "was plunging thousands of miles of lines into insolvency." Reorganization of Railroads Engaged in Interstate Commerce, Pub. L. No. 72-420, § 77, 47 Stat. 1474 (1933), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978). *See also* Report of the Commission on the Bankruptcy Laws of the United States 284 (1973) ("[S]ection 77 was originally added to the Bankruptcy Act in 1933 and completely rewritten in 1935 for purposes of rearrangement, simplification, and clarification."). A large body of literature was generated during this period contemplating the merits of the system as it developed at the time.

These reorganizations occurred not through bankruptcy as we currently understand it, but through the equity receivership, a process that was thought often to violate absolute priority by permitting senior claimants to skip over general unsecured creditors and make distributions to junior stakeholders, such as managers and shareholders.[42]

William O. Douglas, the Chairman of the Securities and Exchange Commission (SEC) (1937–1939), argued that these reorganizations were controlled by insiders who profited at the expense of the railroads' various constituents, in particular, widely dispersed unsecured (or undersecured) creditors.[43] Frequently, these insiders were professionals—investment bankers and lawyers—who may not have had shares in the debtor, but who nevertheless profited in the form of generous fees.[44] By permitting (junior) shareholders to maintain an interest in the railroad even though certain (rela-

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See, e.g., Paul D. Cravath, *The Reorganization of Corporations*, *in* Some Legal Phases of Corporate Financing, Reorganization and Regulation (1917); Arthur H. Dean, *Corporate Reorganization,* 26 Cornell L. Rev. 537 (1941).

[42] As Dean explained:

> The pattern, generally speaking, following the appointment of the receiver or receivers was for one or more of the various mortgage trustees to petition the receivership court for leave to foreclose the mortgage. The foreclosure action or actions [were] consolidated with the original general creditor's bill, and the receivers for the latter were then usually appointed receivers for the mortgage bondholders . . . Following the formulation of a plan by the committee, the court on motion fixed an upset price for the sale of the mortgaged properties. Generally, the creditors or the reorganization managers bid in the properties, using the [bondholders'] deposited mortgage securities as part payment for the foreclosure price, and borrowed or raised enough cash to pay non-assenting or dissenting creditors. An agreement was then entered into with a new corporation created for the purpose, whereby, in consideration for the transfer to it of (1) the properties foreclosed at the foreclosure sale and (2) cash or securities to the extent provided in the plan, the new corporation would issue its securities in accordance with the reorganization plan."

Dean, *supra* note 41, at 538–39.

[43] As Justice Cardozo explained:

> There is little doubt that many of these receiverships were legitimate and helpful. None the less there resided in the practice a capacity for abuses which will be found reflected in the decisions of this and other courts. At times the receivership was used as an instrument of fraud or covin. . . . At times it had a tendency to [entrench] delinquency in power, and to stifle inquiry into acts of waste or spoliation.

Duparquet, Huot & Moneuse v. Evans, 297 U.S. 216, 218 (1936); *see also* Dean, *supra* note 41, at 540 ("[M]any features of the equity receivership were criticized; the allegedly collusive nature of its inception; the delays; the disproportionate rate of expenses to debts when applied to small or medium sized corporations; the great opportunity for political patronage in the appointment of receivers and their counsel by judges . . . ."); E. Merrick Dodd, *Reorganization Through Bankruptcy: A Remedy for What?*, 48 Harv. L. Rev. 1100, 1100–01 (1935) (claiming that a "tacit understanding among members of the banking fraternity" meant that the reorganization would be managed by "those particular investment bankers through whom the corporation had been accustomed to conduct its long-term financing").

[44] *See* David A. Skeel, Jr., *Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship*, 113 Harv. L. Rev. 1075, 1089 (2000) ("[T]he Wall Street professionals who organized protective committees in order to negotiate the reorganization seemed to focus more on obtaining generous fees for themselves than on striking a good bargain on behalf of the scattered investors whom they purported to represent.").

tively senior) creditors would take little or nothing, these proceedings permitted a kind of opportunism that tainted the process in the eyes of many observers.[45] The APR performs, in other words, an "expressive function," telling us something about who the legal system thinks should win and lose in a fight over limited assets, and how those disputes should be resolved.[46]

A third, and perhaps underappreciated, role of the APR is that it provides a bargaining framework.[47] I have argued elsewhere that the APR is, in fact, "none of those three things (absolute, about priority, or a rule)."[48] Instead, it is—like other entitlements in private ordering—a basis for arguments for and against positions, here vis-à-vis the debtor's assets and future value.[49] Nor is bargaining around it new. Through the so-called new value exception (or corollary), old stakeholders (for example, shareholders) of the debtor can provide "new value" in order to retain their junior position (shares) that should otherwise be wiped out under the APR.[50]

Yet, this bargaining has historically occurred in connection with a plan of reorganization, which is subject to fairly robust procedural protections for all stakeholders, including class voting and the assurance of minimal distributions.[51] Contracting in bankruptcy outside the plan context has no such protections—except as provided by judges or the contracting environment itself. How, then, are judges to assess such contracts? Before considering answers to this question, this Article describes two recent and controversial examples of this kind of contracting in bankruptcy.

B. Contracting in Bankruptcy around Priority Norms

Studies of two very recent cases—*Colt* and *Jevic*—show how distress investors can use contract to improve their priority positions. In the process, these case studies reveal important problems that this contracting environment chapter 11 creates. Parts III and IV discuss how relationalist theory can help address the problems created by such contracts.

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[45] Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420, 1445 (2004) ("One of the most controversial features of receiverships was the frequency with which existing shareholders were able to maintain their position in the reorganized railroad, despite the failure to pay creditors in full."); *see also* Dean, *supra* note 41, at 541. The classic discussion of this, and the collusion it implied, appears in N. Pac. Ry. v. Boyd, 228 U.S. 482 (1912). For a critical discussion of *Boyd,* see Douglas G. Baird & Robert K. Rasmussen, Boyd's *Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393 (1999).

[46] *See* Jonathan C. Lipson, *The Expressive Function of Directors' Duties to Creditors*, 12 STAN. J.L. BUS. & FIN. 224, 287–88 (2007).

[47] Roe & Tung, *supra* note 18, at 1271 ("Creditors begin by bargaining inside a priority framework.").

[48] Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1229 (2003).

[49] *See id.*

[50] *See* Case v Los Angeles Lumber Prods. Co., 308 U.S. 106, 116 (1939); Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).

[51] *See* 11 U.S.C.A. § 1126, 1129(a)(7), 1129(a)(8), 1129(b) (West 2015).

1. *Roll-ups of Prepetition Debt*—Colt *Case Study*

In many large chapter 11 cases, a debtor requires post-petition debtor-in-possession (DIP) financing to fund its operations throughout the bankruptcy.[52] As one practitioner explains, "Section 364 of the Bankruptcy Code authorizes a debtor to obtain post-petition financing. If a debtor cannot obtain post-petition financing on an unsecured or administrative priority basis, section 364(c) permits a debtor to provide a claim with a "'super-priority.'"[53] This super-priority provides the claimant priority ahead of all other priority claims.[54]

In some cases, a prepetition lender will provide DIP financing, and will ask that its prepetition claim be "rolled up" into the DIP loan. The lender will infuse new capital into the firm in exchange for a promise that the previous loan will be given priority over other pre-bankruptcy debts that normally would have been repaid first.[55] This action has the practical effect of "converting the DIP lender's (likely) undersecured pre-bankruptcy loan into a fully secured postpetition claim."[56] Thus a priority skip occurs where the original, pre-bankruptcy loan would not have been paid (in full) under the APR.[57] As with all problems of priority, the important questions are about distributional processes and outcomes: who wins and who loses from a roll-up, and how should bankruptcy judges approach contracts that create them?

Take the case of gun-maker Colt. On June 15, 2015, the day after Colt Holdings and affiliates went into bankruptcy, the debtors filed a motion to obtain post-petition financing.[58] Colt initially asked the Court to approve a loan of up to $20 million secured by liens on Colt's assets and granted super-priority status.[59] Colt said it needed the loan to finance operations until it could be sold, which the debtors hoped would occur quickly.[60] Colt owed

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[52] Nicole Stephansen, *Roll-Up Financing Gains Prominence,* Restructuring Review 10 (June 2010) http://documents.lexology.com/2f2d4fb8-6839-49fd-a592-c8710bfab9a3.pdf.

[53] *Id.; see also* 11 U.S.C.A. § 364(c) (West 2015).

[54] *See* Stephansen, *supra* note 52, at 10.

[55] Roe & Tung, *supra* note 18, at 1251.

[56] *Id.*

[57] *Id.* at 1252.

[58] Debtors' Motion (I) Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364, and 507 Authorizing the Debtors to (A) Obtain Post-Petition Financing, (B) Grant Senior Liens and Superpriority Administrative Expense Status, and (C) Utilize Cash Collateral of Pre-Petition Secured Parties; (II) Granting Adequate Protection to Pre-Petition Secured Parties Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364; (III) Scheduling a Final Hearing; and (III) Granting Related Relief, *In re* Colt Holding Co., No. 15-11296 (Bankr. D. Del. June 15, 2015) [hereinafter DIP Motion].

[59] *Id.* at 1–3. "The obligations under the DIP [f]acilities will constitute allowed superpriority administrative expense claims in the [c]hapter 11 [c]ases having priority over all administrative expense claims and unsecured claims against the [d]ebtors now existing or hereafter arising." *Id.* at 9.

[60] *Id.* at 5. Though the debtors tried to negotiate with senior noteholders regarding reorganization, the debtors could not obtain their consent, and so decided that "moving forward on an expedited basis with the orderly sale of [the] business as a going concern is the most value-maximizing strategic alternative for the benefit of all of the [d]ebtors' stakeholders." *Id.* In

money to the proposed DIP lenders,[61] but, the debtors noted, "the [p]repetition [s]ecured [o]bligations . . . are not being rolled-up with the proceeds of the DIP Facilities."[62]

The next day, an ad hoc consortium of senior noteholders objected to Colt's DIP financing motion[63] and proposed an alternative financing of $55 million, funded by the consortium (the Alternative DIP).[64] This alternative would, the consortium claimed, "provide new money loans in the aggregate original principal amount of up to $55,000,000" to Colt.[65] In addition, a certain amount of the proceeds of this Alternative DIP would be used "to repay up to approximately $35,000,000 on account of principal, accrued interest and all other amounts outstanding . . . under the [p]repetition [senior] [l]oans,"[66] thereby introducing a roll-up of prepetition debt that would skip the priority to which it would ordinarily be entitled.

Prior to the hearing on the Alternative DIP, certain members of the consortium purchased claims of other prepetition creditors, as distress investors sometimes do.[67] They then negotiated an alternative financing plan (the Second Interim DIP) with Colt. Among other things, this would increase the "roll up" of pre-bankruptcy debt from $35 million in the Alternative DIP to $55 million in the Second Interim DIP, a substantial portion of the prepetition debt that was now held by consortium members.[68]

At a June 24, 2015 hearing, the Second Interim DIP was discussed and approved by Bankruptcy Judge Silverstein.[69] During the hearing, attorneys

fact, substantially all of the debtors' assets under Bankruptcy Code section 363 were to be sold within 65 days of the petition date. *Id.* at 8, 13.

[61] The debtors owed prepetition senior lenders ($35,000,000), prepetition term lenders ($72,900,000), and senior noteholders ($250,000,000). *Id.* at 14.

[62] *Id.* at 9.

[63] *See* Objection to the DIP Motion and Response to the Debtors' Allegations Regarding the Ad Hoc Consortium at 1, *In re* Colt Holding Co., No. 15-11296 (Bankr. D. Del. June 16, 2015) [hereinafter Objection to DIP Motion].

[64] Declaration of Steven B. Levine in Regard[ ] to Alternative Debtor in Possession Financing Proposal at 5, *In re* Colt Holding Co., No. 15-11296 (Bankr. D. Del. June 16, 2015) [hereinafter Levine Declaration].

[65] *Id.* at Exhibit A, page 1.

[66] *Id.*

[67] *Id.* at 3.

[68] The new roll-ups would now cover 100% of the debt held under the prepetition senior loan and a little over a quarter of the debt held under the prepetition term loan. *Id.* at 5. The claims associated with this financing (pre-bankruptcy and new loans) would also constitute "allowed superpriority administrative expense claims in the [c]hapter 11 [c]ases having priority over all administrative expense claims and unsecured claims against the [d]ebtors now existing or hereafter arising." *Id.* at 69.

[69] *See* Transcript: Motion to Approve Second Interim DIP Financing Order Before the Honorable Laurie Selber Silverstein, United States Bankruptcy Judge, *In re* Colt Holding Co., No. 15-11296 (Bankr. D. Del. June 24, 2014) [hereinafter Second Order Hearing]; *see also* Second Interim Order (I) Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364, and 507 Authorizing the Debtors to (A) Obtain Post-Petition Financing, (B) Grant Senior Liens and Superpriority Administrative Expense Status, (C) Use Cash Collateral of PrePetition Secured Parties, and (D) Grant Adequate Protection to PrePetition Secured Parties; (III) Scheduling a Final hearing; and (III) Granting Related Relief, *In re* Colt Holding Co., No. 15-11296 (Bankr. D. Del. June 24, 2015).

for Colt argued that, as compared to the original DIP motion, the Second Interim DIP would result in a lower interest rate for the debtors; a total roll-up of $55,000,000 for the DIP loans; a conversion from "sale" milestones to "plan" milestones; and an agreement to pay DIP lenders' prepetition fees and expenses as part of the DIP obligation.[70]

Colt's controlling shareholder, Sciens Capital Management (Sciens)[71] objected that "while it is not a today issue, [the] roll-up tilts the playing field in favor of another group that wants to buy this company and control it; namely, the bondholders."[72] Sciens criticized the roll-up because it would allow the consortium to be "immune from a plan of reorganization cram down on account of the [p]repetition [s]enior [l]oan,"[73] and to have super-priority administrative expense claims covering "100% of the . . . [c]onsortium [l]enders' prepetition secured claims."[74] The consortium responded to Sciens' objection,[75] noting that various stakeholders, including lenders, Colt's creditors' committee[76] and Colt, had reached "an agreement in principle with respect to all of the issues informally raised by the [c]reditors' [c]ommittee," which had been formed around that day.[77] They further argued that the roll-up was warranted because it was both a "material inducement to the DIP [l]enders"[78] and "simply the substitution of old secured debt for new secured debt."[79]

At the same time, Colt filed a statement[80] in support of the Second Interim DIP asserting that, despite Sciens objection, the proposed roll-up had become "a non-negotiable condition to the DIP [l]enders extending additional financing, and is an integral part of a deal that provided material covenant relief and flexibility to the [d]ebtors."[81] Although Sciens, Colt's main

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[70] Second Order Hearing, *supra* note 69, at 6:15–8:11.

[71] "Affiliates of Sciens Management LLC own approximately 87% of the equity interests in Colt Holding Company LLC." Keith A. Maib's Declaration in Support of the Debtors' Chapter 11 Petitions and First Day Pleadings, at 20, *In re* Colt Holding Co., No. 15-11296 (Bankr. D. Del. June 15, 2015) [hereinafter Maib Declaration].

[72] Second Order Hearing, *supra* note 71, at 18:1–4.

[73] Limited Objections of Sciens Capital management LLC to Debtors' Proposed Alternative DIP Financing at 4, *In re* Colt Holding Co., No. 15-11296 (Bankr. D. Del July 2, 2015).

[74] *Id.* at 5.

[75] Reply of Ad Hoc Committee of Holders of Senior Notes Due 2017 in Support of Entry of Order Approving DIP Facilities, *In re* Colt Holding Co., No. 15-11296 (Bankr. D. Del. July 8, 2015) [hereinafter Ad Hoc Reply].

[76] On June 25, 2015, the official committee of unsecured creditors of Colt Holding LLC was formed. *See* Debtors' Statement in Further Support of Debtor's Motion (I) Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364, and 507 Authorizing the Debtors to (A) Obtain Post-Petition Financing, (B) Grant Senior Liens and Superpriority Administrative Expense Status, and (C) Utilize Cash Collateral of Pre-Petition Secured Parties; (II) Granting Adequate Protection to Pre-Petition Secured Parties Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364; (III) Scheduling a Final Hearing; and (IV) Granting Related Relief at 3, *In re* Colt Holding Co., No. 15-11296 (Bankr. D. Del. July 8, 2015) [hereinafter Debtors' Statement].

[77] Ad Hoc Reply, *supra* note 75, at 4.

[78] *Id.* at 7.

[79] *Id.* at 8.

[80] Debtors' Statement, *supra* note 76.

[81] *Id.* at 4.

shareholder, remained unhappy,[82] the court gave final approval to the Second Interim DIP on July 10, 2015,[83] subject to protections to challenge "rolled up" debt.[84] According to Judge Silverstein "the overall financing terms are appropriate and the roll-up provisions had been softened as a result of concessions negotiated earlier this week by the official committee of unsecured creditors."[85]

The *Colt* result exposes difficult questions raised by contracting around priority in bankruptcy. Some are doctrinal. Was the ultimate financing the product of economic duress or bad faith? The roll-up was, by Colt's admission, "non-negotiable."[86] How plausible was it to think that the creditors' committee could meaningfully bargain on behalf of all of Colt's other creditors if it had only about two weeks—including the July 4th holiday weekend—to digest and negotiate changes to the deal? Effective bargaining requires time and information. What effect would this change in priority have on the future of the case? Altering priority with the roll-up gave the consortium greater leverage than it had before. As the Sciens shareholders worried, the roll-up might enable those lenders to obtain Colt's assets for little more than the money they had already lent—even if the fair market value of Colt exceeded the value of the loans.[87] This would then enable the consortium to capture Colt's future value at the expense of its other stakeholders. Yet, without the roll-up, Colt may have had inadequate financing to proceed further, perhaps resulting in a fire sale of the company's assets. These are hard questions for any judge, and as explained in Part II, current theory about bankruptcy provides little guidance.

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[82] An attorney for Sciens was quoted as saying that the final DIP should be rejected in order "to prevent [a] small group of creditor[s] from gaining plan leverage." Jamie Santo, *Bankrupt Colt Earns Nod for $75M DIP Package*, LAW360, July 10, 2015, http://www.law360.com/articles/677881/bankrupt-colt-earns-nod-for-75m-dip-package (alteration in original).

[83] Final Order: (I) Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364, and 507 Authorizing the Debtors to (A) Obtain PostPetition Financing, (B) Grant Senior Liens and Superpriority Administrative Expense Status, (C) Use Cash Collateral of PrePetition Secured Parties, and (D) Grant Adequate Protection to PrePetition Secured Parties; and (II) Granting Related Relief, *In re* Colt Holding Co., No. 15-11296 (Bankr. D. Del. July 10, 2015) [hereinafter Final Order].

[84] *Id.* at 42 ("[N]othing herein shall prevent the Bankruptcy Court, after notice and hearing, from issuing an order to unwind such [r]oll-[u]p [l]oans, or a portion thereof, solely in the event that there is a timely successful [c]hallenge pursuant to and subject to the limitations contained in . . . this [f]inal [o]rder.").

[85] *Id.*

[86] Ad Hoc Reply, *supra* note 75, at 4.

[87] Sciens objected on the ground that the net effect of the DIP roll-up would be to "compel a quick Section 363 sale; ensure no competitive bidding; and then reclaim the company by bidding a peppercorn above the secured debt." Supplemental Objections of Ad Hoc Consortium of Holders of Senior Notes to Debtors' DIP Motion at 2, *In re* Colt Holding Co., No. 15-11296 (Bankr. D. Del. June 19, 2015).

2. *Structured Dismissals*—Jevic *Case Study*

A second, and perhaps more controversial, example of a priority-skipping contract involves structured dismissals. A structured dismissal is the combination of a dismissal under section 1112 of the Bankruptcy Code[88] with something akin to a consent decree among the parties.[89] Deviating from the approach of courts of appeal for the Second and Fifth Circuits, the U.S. Court of Appeals for the Third Circuit held in the recent *Jevic* case that these consent decrees—essentially, contracts—may skip over the special statutory priority of employees, despite their objections.[90]

Jevic, a trucking company headquartered in New Jersey, was acquired by hedge fund Sun Capital in a leveraged buyout (LBO) that was financed by CIT.[91] When Jevic went into bankruptcy, its drivers sued it and Sun Capital for violating state and federal Worker Adjustment, Retraining and Notification (WARN) Acts.[92] Its creditors' committee sued the LBO participants, claiming that the transaction was a fraudulent transfer.[93]

After three years, the Bankruptcy Court for the District of Delaware (Judge Shannon) granted in part and denied in part CIT's motion to dismiss the fraudulent transfer suit, holding that the committee had adequately pleaded claims under Bankruptcy Code section 548 and was permitted to replead claims under section 544.[94]

Thereafter, the major parties met to discuss settlement of the fraudulent transfer suit. They agreed, in pertinent part, that (1) the committee, Jevic, CIT, and Sun Capital would release one another, and (2) CIT would fund a distribution of about 4% to general unsecured creditors, after paying the committee's legal fees and other administrative expenses.[95] The parties thus

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[88] Section 1112(b)(1) of the Bankruptcy Code authorizes the bankruptcy court to dismiss a chapter 11 case for "cause." 11 U.S.C. § 1112(b)(1) (West 2015).

[89] *See generally* Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable And Growing Alternative After Asset Sales*, 29 Am. Bankr. Inst. J. 1 (June 2010); Nan Roberts Eitel, T. Patrick Tinker & Lisa L. Lambert, *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?*, 30 Am. Bankr. Inst. J. 20 (Mar. 2011); Robert P. Simons, *Structured Dismissal Strategy: A Viable Alternative to Chapter 7 Liquidation From Chapter 11 Reorganization?*, Chapter 7 Commercial Bankruptcy Strategies (2014); Aaron M. Kaufman & Paul R. Hage, *Benchnotes*, Am. Bankr. Inst. J. 6 (January 2015) ("In recent years, structured dismissals of chapter 11 cases following a sale of substantially all of the debtor's assets have become increasingly common, albeit somewhat controversial."). In *In re* Buffet Partners LP, 2014 WL 3735804 (Bankr. N.D. Tex. 2014), the U.S. Bankruptcy Court for the Northern District of Texas ruled that §§ 105(a) and 1112(b) of the Bankruptcy Code provide authority for the structured dismissal of a bankruptcy case, noting that the remedy "is clearly within the sphere of authority [that] Congress intended to grant to bankruptcy courts in the context of dismissing chapter 11 cases." *Id.* at 4.

[90] *In re* Jevic Holding Corp., 787 F.3d 173, 180 (3d Cir. 2015), *cert. granted*, 136 S. Ct. 1242 (2016).

[91] *Id.* at 176.

[92] 29 U.S.C.A. § 2102 (West 2015); N.J. Stat. Ann. § 34:21-2 (West 2015).

[93] *In re Jevic Holding Corp.*, 787 F.3d at 176.

[94] *Id.* (citing *In re* Jevic Holding Corp., 2011 WL 434204, at *10 (Bankr. D. Del. 2011)).

[95] *Id.* at 177; *Id.* at 177 n.1.

"contemplated a structured dismissal."[96] There remained, however, "just one problem with the settlement: it left out the [d]rivers, even though they had an uncontested WARN Act claim against Jevic," which they estimated to be worth $12.4 million, and of which $8.3 million would have been entitled to priority over general unsecured claims as unpaid wages.[97]

The drivers and the trustee objected to the proposed settlement, "mainly because it distributed property of the estate to creditors of lower priority than the [d]rivers under [section] 507 of the Bankruptcy Code."[98] Although the bankruptcy court recognized that no explicit provision of the Bankruptcy Code authorized the structured dismissal, "the dire circumstances that are present in this case warrant the relief requested by the Debtor, the Committee and the secured lenders."[99] These "dire circumstances" included the fact that there was " 'no realistic prospect' of a meaningful distribution to anyone but the secured creditors unless the settlement was approved because the traditional routes out of chapter 11 bankruptcy were impracticable."[100] Over the objection that the settlement violated the Bankruptcy Code's priority structure, the bankruptcy court approved the dismissal as a settlement governed by Federal Rule of Bankruptcy Procedure 9019 and *In re Martin*.[101]

On appeal to the Third Circuit,[102] the main issue was whether the structured dismissal could permit this deviation from absolute priority. Judge Hardiman, writing for himself and Judge Barry, concluded that while it was "a close call,"[103] the deviation was permissible under the circumstances.

The court compared the two leading opinions on the priority of distributions in structured settlements, *In re AWECO, Inc.*,[104] and *In re Iridium Operating LLC*.[105] In *AWECO,* the Court of Appeals for the Fifth Circuit rejected a settlement of a lawsuit against a chapter 11 debtor that would have transferred $5.3 million in estate assets to an unsecured creditor despite outstanding senior claims.[106] The Fifth Circuit held that the "fair and equitable"

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[96] *Id.*

[97] *Id.* (citing *In re* Powermate Holding Corp., 394 B.R. 765, 773 (Bankr. D. Del. 2008) ("Courts have consistently held that WARN Act damages are within 'the nature of wages' for which § 507(a)(4) provides").

[98] *Id.* at 178.

[99] *Id.* (quoting App. 31).

[100] *Id.* (quoting App. 32).

[101] *Id.* at 178–79 (citing *In re* Martin, 91 F.3d 389 (3d. Cir. 1996)).

[102] The bankruptcy court's decision was affirmed by the United States District Court for the District of Delaware. *Id.* at 179 (citing *In re* Jevic Holding Corp., 2014 WL 268613 (D. Del. Jan. 24, 2014)). The drivers appealed to the U.S. Court of Appeals for the Third Circuit, supported by the Office of the United States Trustee as amicus curiae. *Id.*

[103] *In re Jevic Holding Corp.*, 787 F.3d at 184.

[104] 725 F.2d 293 (1984).

[105] 478 F.3d 452 (2007).

[106] *In re AWECO, Inc.,* 725 F.2d at 295–96.

standard applies to settlements, and "'fair and equitable' means compliant with the priority system."[107]

In *Iridium*, the Second Circuit also refused to approve a priority-skipping settlement, but announced a different test than the one used in *AWECO*. In *Iridium*, the unsecured creditors' committee sought to settle a suit it had brought against a group of secured lenders on behalf of the estate. The suit would have split the estate's cash between the lenders and a litigation trust set up to fund a suit against Motorola, a priority administrative creditor and the debtor's former corporate parent.[108] Motorola objected to the settlement, arguing that the distribution violated priority by skipping Motorola and distributing funds to lower-priority creditors.[109]

Rejecting the approach taken by the Fifth Circuit in *AWECO* as "too rigid," the Second Circuit held in *Iridium* that the APR "is not necessarily implicated" when "a settlement is presented for court approval apart from a reorganization plan."[110] The Second Circuit Court of Appeals instead held that "whether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and equitable' under Rule 9019," but a noncompliant settlement could be approved when "the remaining factors weigh heavily in favor of approving a settlement."[111] Although the deviation from priority was problematic, the Second Circuit remanded the settlement to the bankruptcy court for further determinations.[112]

In *Jevic*, Judge Hardiman ostensibly agreed with the Second Circuit's approach in *Iridium* because, "[a]s in other areas of the law, settlements are favored in bankruptcy."[113] The majority acknowledged that "compliance with the Code's priorities will usually be dispositive of whether a settlement is fair and equitable" because "[s]ettlements that skip objecting creditors in distributing estate assets raise justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals."[114] Although the court concluded that the APR "do[es] not extend to . . . settlements in bankruptcy, we think that the policy underlying the rule—ensuring the even-handed and predictable treatment of creditors—applies in the settlement context."[115]

Judge Scirica concurred in part and dissented in part. He construed the facts of the case differently than the majority, questioning whether "this appeal presents an extraordinary case where departure from the general rule

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[107] *Id.* at 298.
[108] *In re Iridium Operating LLC*, 478 F.3d at 456, 459–60.
[109] *Id.* at 456.
[110] *Id.* at 463–64.
[111] *Id.* at 464.
[112] *See id.* at 456.
[113] *In re Jevic Holding Corp.*, 787 F.3d at 184.
[114] *Id.* (citing *Iridium*, 478 F.3d at 464).
[115] *Id.*

[of the APR] is warranted."[116] In his view, the settlement failed to advance one of the Bankruptcy Code's "core goals[:] to maximize the value of the bankruptcy estate."[117] He observed,

> [h]ere, it is difficult to see how the settlement is directed at estate-value maximization. Rather, the settlement deviates from the Code's priority scheme so as to maximize the recovery that certain creditors receive, some of whom (the unsecured creditors) would not have been entitled to recover anything in advance of [the drivers].[118]

The *Jevic* majority opinion presents an important advance in priority-skipping contracts for two reasons. First, unlike *Colt,* which involved a contract around arguably default rules, *Jevic* involved contracting in defiance of mandatory rules. The Bankruptcy Code contemplates a limited number of ways to distribute property of the estate. The presumption in chapter 11 is that this will occur under a reorganization plan, which involves a number of checks and balances designed to produce a broad electoral (in some sense contractual) consensus about the plan's distributional effect. If a debtor is instead liquidated under chapter 7, the priority rules of section 507 apply, which include the fourth priority to which the truckers' claims in *Jevic* would otherwise have been entitled.[119]

Historically, altering priorities under the guise of a settlement was not permitted. Yet, the *Jevic* majority reasoned that the APR "do[es] not extend to . . . settlements in bankruptcy."[120] This contention, of course, may be literally true in the sense that Federal Rule of Bankruptcy Procedure (FRBP) 9019, which governs settlements, says nothing about priority at all,[121] and the "absolute priority rule" applies under the Code to reorganization plans—not dismissals.[122] Yet, Rule 9019 traces its roots back to the 1968 Supreme Court opinion in *TMT Ferry*, which explicitly held that settlements in bankruptcy had to be "fair and equitable."[123] Because "fair and equitable" is synony-

[116] *Id.* at 186 (Scirica, J., concurring in part and dissenting in part).
[117] *Id.* (citing Toibb v. Radloff, 501 U.S. 157, 163 (1991)).
[118] *Id.* at 187.
[119] *Id.* at 177.
[120] *Id.* at 184.
[121] FED. R. BANKR. P. 9019(a). ("On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement. Notice shall be given to creditors, the United States trustee, the debtor, and indenture trustees as provided in Rule 2002 and to any other entity as the court may direct.")
[122] 11 U.S.C.A. § 1129(b) (West 2015).
[123] Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 441 (1968). The court in *In re* Iridium Operating, LLC summed up *TMT Trailer Ferry*'s relation to Federal Rule of Bankruptcy Procedure 9019, articulating that "Rule 9019, unique in that it does not have a parallel section in the Code, has a 'clear purpose . . . to prevent the making of concealed agreements which are unknown to the creditors and unevaluated by the court.'" *In re* Iridium Operating, LLC, 478 F.3d 452, 461 (2d Cir. 2007) (quoting *In re* Masters, Inc., 141 B.R. 13, 16 (Bankr. E.D.N.Y. 1992)) (footnote omitted). The court further detailed that "courts in this Circuit have set forth factors for approval of settlements

mous with "absolute priority,"—the term is the heart of the APR in chapter 11[124]— this common law of priority should have applied to the *Jevic* settlement. Moreover, the *Jevic* majority itself acknowledged that section 507's priority scheme (analogous to the APR for these purposes) did apply.[125] Thus, priority-skipping was permitted under a settlement to which the skipped party objected. Since a basic principle of law (contract and otherwise) is that "parties who choose to resolve litigation through settlement may not dispose of the claims of a third party, and a fortiori may not impose duties or obligations on a third party, without that party's agreement,"[126] it is simply not clear how the court could approve this settlement—unless contract can defy priority rules and norms.

Second, and more important, are the relational implications of the decision. One might think there are none, since the structured dismissal terminated the case, and thus the relationships of the parties here. The trucking company would be dissolved, its relationships at an end. And yet, the participants in the process—in particular the hedge fund (Sun Capital), counsel (Kirkland & Ellis) and the bankruptcy judge (Judge Shannon) are all repeat players in the sense that they are part of the contracting environment created by large chapter 11 cases. It seems entirely plausible that law firms that practice in this area will start to advertise their expertise in obtaining structured dismissals as alternatives to plan confirmations, and that distress investors will seek them accordingly.

Indeed, *Jevic* has gained attention because it suggests that the traditional reorganization plan, with its stakeholder protections of class voting and minimum distributions,[127] may no longer be necessary. If debtors sell their assets, then all that will remain will be a pot of proceeds for distribution. One could argue that *Jevic* stands for the proposition that *A, C* and *D* can settle a dispute in a chapter 11 case pursuant to an agreement that skips *B*, despite *B*'s statutory (and perhaps common law) priority over *C.* Such assets can be distributed in some consensual order of priority entirely outside a plan or the Code's priority structure. If there are objections, courts will then need to develop some criteria by which to assess them, but the APR is apparently not the only standard they will use. Contract may then displace mandatory distributional rules, leaving the difficult question: how should courts approach such contracts?

based on the original framework announced in *TMT Trailer Ferry*," which are used to determine whether such a 9019 settlement is "fair and equitable." Id. at 462. (citing *TMT Trailer Ferry*, 390 U.S. at 424–25).

[124] *See* 11 U.S.C.A. § 1129(b) (West 2015) (reciting "fair and equitable" tests).

[125] *In re Jevic Holding Corp.,* 787 F.3d at 184.

[126] Local No. 93, Int'l Ass'n of Firefighters, AFLCIO C.L.C. v. City of Cleveland, 478 U.S. 501, 529 (1986).

[127] *See* 11 U.S.C.A. §§ 1129(a), 1126 (West 2015) (setting forth voting rules for reorganization plans and "best interests of creditors" test, which requires that the chapter 11 reorganization plan pay at least as much as would be paid in a liquidation under chapter 7).

This question matters not only to businesses, investors, and the lawyers that advise them, but also to the United States Supreme Court, which granted *certiorari* in *Jevic* in June 2016 to address the split among the circuit courts on whether bankruptcy courts may approve settlements that violate the APR.[128] Advocating for the *AWECO* (Fifth Circuit) approach in its recommendation for review, the Solicitor General said, "bankruptcy is not a free-for-all in which parties or bankruptcy courts may dispose of claims and distribute assets as they see fit."[129] However, as noted above in the analysis of *Iridium* and *Jevic*, the Second and Third Circuit rationales for permitting priority-skipping are not without merit. Argument in the Supreme Court is planned for December 2016, with an opinion to be issued in 2017.[130] The outcome will have significant practical and relational implications.

While the legal world waits for the Supreme Court to rule, this Article shifts focus from the bankruptcy judges to bankruptcy scholars. Part II describes how scholars have thought about contract thus far in the context of priority-skipping, and why that literature has been unable to help courts approach such contracts. Thereafter, this Article provides a more robust relational framework that courts and observers can use to make sense of priority-skipping contracts, such as those approved in *Colt* and *Jevic*.

II. Contract Bankruptcy Theory and Its Limits

To say that chapter 11 would benefit from a richer understanding of contract is not to say that bankruptcy scholarship lacks writing about contract. To the contrary, contract has been a major preoccupation of bankruptcy scholars.[131] While the contractualist project has been criticized for many reasons, no alternative vision of contract in bankruptcy has emerged. In order to frame relational contracting as an alternative vision, it is first useful to summarize briefly the "contract bankruptcy" debate.

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[128] *See* Czyzewski v. Jevic Holding Corp., 136 S. Ct. 1242, 1242 (2016) (inviting the Solicitor General to file a brief expressing the views of the United States); *Supreme Court Will Review Jevic to Rule on Structured Dismissals and Gift Plans*, Am. Bankr. Inst., Rochelle's Daily Wire (June 28, 2016), http://www.abi.org/newsroom/daily-wire/supreme-court-will-review-jevic-to-rule-on-structured-dismissals-and-gift-plans [hereinafter *Supreme Court Will Review Jevic*]; *Czyzewski v. Jevic Holding Corporation*, SCOTUSBlog (June 28, 2016), http://www.scotusblog.com/case-files/cases/czyzewski-v-jevic-holding-corporation/. In the interests of full disclosure, I am counsel of record to amici law professors in support of petitioners in *Jevic*.

[129] *Supreme Court Will Review Jevic*, *supra* note 128 (quoting the Solicitor General).

[130] *Id.*

[131] *See, e.g.*, Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 Colum. L. Rev. 1, 1 (2013) ("Bankruptcy scholarship is largely a debate about the comparative merits of a mandatory regime on one hand and bankruptcy by free design on the other."); Roe & Tung, *supra* note 18, at 1239 ("[B]ankruptcy's standard positive and normative conceptualization is contractarian."). Some scholars are now beginning to explore contract in bankruptcy. *See* Kenneth Ayotte, Anthony J. Casey & David A. Skeel, Jr., *Bankruptcy on the Side*, working paper, *available at* http://ssrn.com/abstract=283947.

A. The Contractualist Project

The debate begins with Thomas Jackson's "creditors' bargain."[132] He argued over thirty years ago that the optimal system of reorganization should maximize private ordering, and be "designed to mirror the agreement one would expect the creditors to form among themselves were they to negotiate such an agreement from an *ex ante* position."[133] Bankruptcy should, on this view, minimize interference with state-created rights at contract, property, and other similar areas.[134] Except to the extent that collective action problems prohibit contracting, bankruptcy should be largely procedural. "Bankruptcy," Jackson observed, "provides a way to make . . . diverse [creditors] act as one, by imposing a *collective* and *compulsory* proceeding on them."[135]

To the extent that collective action does impair contracting—and of course, bankruptcy is a response to collective failure—courts should impose the hypothetical bargain that creditors would have chosen for themselves *ex ante* had they anticipated the debtor's bankruptcy. Jackson, with Scott, later explained:

> The cornerstone of the creditors' bargain is the normative claim that prebankruptcy entitlements should be impaired in bankruptcy only when necessary to maximize net asset distributions to the creditors as a group and never to accomplish purely distributional goals.[136]

While this would tend to privilege financial creditors at the expense of employees and other smaller creditors, Jackson was largely unconcerned, confident either that their interests were unimportant[137] or that contractualism would still produce greater aggregate wealth in the long run.[138]

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[132] *See* Jackson, Logic and Limits, *supra* note 6; Jackson, *Bankruptcy, Non-bankruptcy*, *supra* note 6.

[133] Jackson, *Bankruptcy, Non-Bankruptcy*, *supra* note 6, at 860.

[134] See Jackson, Logic and Limits, *supra* note 6, at 22 ("[I]n its role as a collective debt-collection device, bankruptcy law should not create rights. Instead, it should act to ensure that the rights that exist are vindicated to the extent possible.").

[135] *Id.* at 12–13.

[136] Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 Va. L. Rev. 155, 155–56 (1989).

[137] Jackson, Logic and Limits, *supra* note 6, at 32–33 (postulating that managers and employees "have no rights that need to be accounted for in [bankruptcy].").

[138] In choosing reorganization over liquidation, for example, the important question is "which path provides the greatest aggregate dollar-equivalent return from the assets . . . ." *Id.* at 212–13.

The theory has gained traction among academics. Professors Barry Adler,[139] Yair Listokin,[140] Rasmussen,[141] Scott Schwartz[142] and Anthony Casey[143] have all offered creative variations on Jackson's basic theme. This development may be because the core question contractualists pose—under what conditions is private ordering superior to public (or mandatory) ordering?—has special salience to a process such as bankruptcy, which I have elsewhere observed is a hybrid of public and private processes.[144] It is a question the answer to which is difficult, if and essential to developing a plausible understanding of the system.

B. Limits

Yet, the theory has also been problematic for several reasons. First, as noted in the Introduction, anticontractualists challenged the normative and empirical foundations of the creditors' bargain. David Carlson, an early critic, argued that Jackson's theory made implausible assumptions about human behavior.[145] To claim that "[p]rofit maximization . . . displaces all

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[139] *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323, 332–33 (1993). Under this proposal, a firm would include a "chameleon equity" scheme in the corporate charter at the time of formation or upon mutual agreement with a debtor when receiving financing. Essentially if a firm with equity, unsecured debt, and secured debt that used chameleon equity became insolvent, the equity interest (junior claimants) would be extinguished and the unsecured debt (or next in priority) would become the residual claimants against the firm's assets. Participating creditors would automatically be replaced with holders of chameleon equity claims.

[140] *See generally* Yair Listokin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with Debt*, 155 U. PA. L. REV. 777 (2007).

[141] *See* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 53–54 (1992) ("Congress should create a menu bankruptcy system. Under this system, a firm upon formation would be required to select one of the alternatives from the menu, thereby specifying the firm's available bankruptcy option. Such a commitment mechanism would assure all potential lenders that their rights would be governed by the same bankruptcy regime as the rights of all the firm's other creditors.").

[142] *See* Schwartz, *supra* note 6, at 1811.

[143] *See* Casey, *supra* note 37, at 764. The use of options in this context is not entirely new. Earlier similar proposals appear in Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988). *See also* Lucian A. Bebchuk, *Using Options to Divide Value in Corporate Bankruptcy*, 44 EUR. ECON. REV. 829 (2000). Casey's proposal "requires that a senior creditor buy out the option value of junior creditors before taking control of the [c]hapter 11 process." Casey, *supra* note 37, at 770–71. Under this mechanism, bankruptcy would respect priority as follows: "(1) the senior creditor's nonbankruptcy liquidation value of the collateral; (2) the junior creditor's option value; and (3) the senior creditor's right to the residual value – after the junior option has been paid out – up to the face value of the senior debt." *Id.* at 765.

[144] *See* Jonathan C. Lipson & Jennifer L. Vandermeuse, Stern*, Seriously: The Article I Judicial Power, Fraudulent Transfers, and Leveraged Buyouts*, 2013 WIS. L. REV. 1161, 1167 (2013) ("the reality of the bankruptcy process. . . seems best understood as a hybrid of public and private rights."); Lipson, *Debt and Democracy, supra* note 21, at 678 ("bankruptcy presents a highly complex mix of public and private rights.").

[145] David Gray Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341, 1342 (1987) ("The controversial aspect of [Jackson's] contractarian rhetoric is whether the theorist has introduced a plausible account of personality.").

other forms of ideology . . . is the product of extremely unrealistic assumptions about human nature."[146] No one really behaves in the ways imagined by Jackson's model, so the important question was really about the normative virtues of its simplifying assumptions: could the system produce better outcomes if we merely pretended that they were true? Carlson believed that only empirical study would answer this question.[147] While scores of empirical studies have followed in the wake of the *Creditors' Bargain*, none has "proved" or "disproved" its core claims.[148]

Second, given Jackson's faith in contract, one might think that he would have explored the nuances of contract doctrine as it pertains to the contracts that interest him, those involving pre-bankruptcy lending.[149] For example, doctrines such as fraud, economic duress,[150] and good faith[151] may all be at issue in connection with pre-bankruptcy loan agreements because they are often renegotiated prior to bankruptcy under difficult conditions.[152] While Jackson recognized that bankruptcy might involve problematic contracts, he appeared largely indifferent to the possibility that answers to contract questions are often unclear.[153] Nor did he appear interested in theoretical debates

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[146] *Id.* at 1352.

[147] *Id.* at 1349 (arguing that "[w]hether there's a [creditor's] bargain to made here is entirely an empirical proposition.").

[148] Empirical studies of chapter 11 are too numerous to meaningfully cite in full here. *See, e.g.*, LoPucki & Whitford, *supra* note 13; Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 25–27 (2007); Warren & Westbrook, *Financial Characteristics*, *supra* note 13; Warren & Westbrook, *Contracting Out of Bankruptcy*, *supra* note 13; Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 VAND. L. REV. 749, 758–60 n.46–59 (2011); Jonathan C. Lipson, *Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies*, 84 AM. BANKR. L.J. 1 (2010).

[149] The index to LOGIC AND LIMITS contains no entry for "contract." JACKSON, LOGIC AND LIMITS, *supra* note 6, at 284.

[150] *See* Domenico v. Alaska Packers' Ass'n, 112 F. 554 (N.D. Cal. 1901). The court found that a boat owner did not have to pay fishermen who demanded a higher-than-bargained-for wage while at sea because the owner was under "duress" when he had to agree to the higher payments. *See also* Richard A. Posner, *Let Us Never Blame a Contract Breaker*, 107 MICH. L. REV. 1349, 1358–59 (2009) (discussing the practical effects of the *Alaska Packers* ruling); Selmer Co. v. Blakeslee-Midwest Co., 704 F.2d 924, 927-29 (7th Cir. 1983) ("*Alaska Packers' Ass'n* shows that because the legal remedies for breach of contract are not always adequate, a refusal to honor a contract may force the other party to the contract to surrender his rights-in *Alaska Packers' Ass'n,* the appellant's right to the libelants' labor at the agreed wage."). Some question whether the owner was, in fact, under duress. *See* Debora L. Threedy, *A Fish Story:* Alaska Packers' Association v. Domenico, 2000 UTAH L. REV. 185 (2000) (analyzing *Alaska Packers*).

[151] Lipson, *Governance in the Breach*, *supra* note 16 (discussing the development of the doctrine of good faith in bankruptcy).

[152] *Id.* ("Historically, financial distress rarely resulted immediately in bankruptcy. Instead, it usually resulted in talk—between a troubled borrower and its lenders. This talk was known colloquially as the 'workout.'").

[153] *But see* Macaulay, *supra* note 3, at 40 ("Often careful study would reveal that contract law featured a rule opposed by a counter rule with no principled way of knowing when one or the other would apply. American law, for example, tells us that it is not duress to threaten to do what you have a legal right to do. Yet a wrongful although not illegal threat can be duress.") (citations omitted).

about the nature and function of contract.[154] Rather, his commitment to a particular vision of efficiency required him to view contract doctrine as determinate, and without complexity or contradiction. This view probably reflects the Coasean predicates of the creditors' bargain, which require, among other simplifying assumptions, bilateral monopoly and low transaction and information costs.[155] Yet, transaction and information costs cannot be low if contract law is unstable. Doctrinal indeterminacy results in analytic and litigation costs which clutter the creditors' bargain model.

Indeed, Jackson made questionable statements of law in the service of efficiency. In explaining that bankruptcy should not be concerned with preserving jobs, for example, Jackson claimed that business "owners are free to close the business without considering the interests of the workers if doing so brings the owners more money."[156] This is problematic because larger employers are now subject to "WARN Act" notification obligations, which give workers priority claims, such as those in *Jevic*.[157] It is also at best arguable as a matter of contract law, as criticisms of famous employee-reliance cases such as *Youngstown Steel* show.[158]

Nevertheless, the assumption of a "simple" contract doctrine has persisted in contractualist literature. In explaining his "menu" proposal, for example, Dean Rasmussen argued that "[t]he mandatory nature of bankruptcy is itself anomalous when viewed in the larger context of general contract

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[154] See, for example, Jackson's discussion of the doctrine of specific performance as it might play out in bankruptcy. Jackson, *Bankruptcy, Non-bankruptcy*, *supra* note 6, at 65–67, 110–13. The cases that Jackson cites on such matters as executory contracts and collective bargaining agreements are bankruptcy (or equity receivership) cases, not cases involving the propriety of recognizing (or not recognizing) specific performance as an appropriate remedy in the first place. This is hardly to be assumed. Alan Schwartz, for one, has argued that "the remedy of specific performance should be as routinely available as the damages remedy." Alan Schwartz, *The Case for Specific Performance*, 89 Yale L.J. 271, 271 (1979). *See generally supra* sources accompanying note 8.

[155] *See supra* sources accompanying note 10.

[156] Jackson, Logic and Limits, *supra* note 6, at 25.

[157] Admittedly, when Jackson first made these claims, the WARN Act was not in effect. The WARN Act was enacted on August 4, 1988, and became effective on February 4, 1989. 29 U.S.C.A. §§ 2101 et seq.

[158] In Local 1330 v. U.S. Steel Corp., 631 F.2d 1264, 1270 (6th Cir. 1980), steel workers for U.S. Steel became worried about rumors that two factories in Youngstown, Ohio were to be closed. U.S. Steel made a series of representations to its employees to reassure them, in particular that the plant was profitable and that the company would not close its plant as long as it stayed that way. *See id.* (describing message from company to employees that there were "no immediate plans to permanently shut down" either factory, and that the mills' "continued operation" was "absolutely dependent on their being profit-makers."). This reassurance lasted several years, until the company closed the plant. Critics have noted that the employees may have had claims sounding in promissory estoppel or fraud. Daniel A. Farber & John H. Matheson, *Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake,"* 52 U. Chi. L. Rev. 903, 938-42 (1985) (arguing that plaintiff in Local 1330 established claim of promissory estoppel); Kent Greenfield, *The Unjustified Absence of Federal Fraud Protection in the Labor Market*, 107 Yale L.J. 715, 717-22 (1997) (arguing that employees could have established fraud claim against company).

law."[159] Rasmussen did not explain what "general contract law" was, or what made it "general."

Third, while contractualist models may have been elegant, their particular proposals seem not to have appealed to the institution contractualists extolled—the market, where they remain largely unused.[160] In fairness, their absence from practice may have been due, in part, to the aspirational qualities of the models. In some cases, implementing the models would have required major legislative reform that was never forthcoming.[161] In other cases, there were practical problems that the proposals could not surmount.[162] Nevertheless, these scholars were selling proposals for which there were no apparent buyers.[163]

This is not, however, to say that contractualism had no impact on chapter 11 practice. Although it would be difficult to plot a precise connection, it seems more than mere coincidence that chapter 11 has become an increasingly contractualized process. As described in the case studies in Part I, bankruptcy-specific contracts are among the most important and challenging distributional mechanisms in reorganization. Whether contractualist writing created an environment in which practitioners felt free to introduce their own variations of private ordering, or other forces were at work, is difficult to say. But it would appear that contract is more important to reorganization than ever before. In this sense, contractualism was at least a qualified success.

The problem remains, however, that "contract" as contractualists understood it was *a priori*. It assumed pre-existing entitlements that were stable and transparent. It did not, therefore, have room for complexity or nuance in general, much less the collective and fractious environment created once a debtor generally defaults and commences a chapter 11 case. It did not, in other words, focus on a world of contracting *in* bankruptcy, for it

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[159] Rasmussen, *supra* note 141, at 53 ("Most rules governing the consensual relationship among various parties are default rules. In other words, they apply only if the parties do not provide otherwise.").

[160] A potential exception might involve so-called "coco" bonds—convertible contingent capital securities. Charles W. Calomiris & Richard J. Herring, *How to Design a Contingent Convertible Debt Requirement that Helps Solve Our Too-Big-To-Fail Problem* , 25 J. Applied Corp. Fin. 21 (2013). While coco bonds remain rare in the United States, their use in Europe may be on the rise. These bonds are discussed largely in the context of large, troubled financial services firms, which exhibit many unusual features. *See* David A. Skeel, *The New Synthesis of Bank Regulation and Bankruptcy in the Dodd-Frank Era*, *in* Research Handbook on Corporate Bankruptcy Law (Barry Adler ed., Elgar Press, 2015/2016, Forthcoming), *available at* http://ssrn.com/abstract=2628694. *But see* Jonathan C. Lipson, *Against Regulatory Displacement: An Institutional Analysis of Financial Crises*, 17.3 Penn. J. Bus. L. 673 (2015) (discussing characteristics of large financial services firms).

[161] Rasmussen's proposal, for example, would have required amendments to the Bankruptcy Code.

[162] There were, for example, concerns that "time may render a company's charter solution outmoded, and corporate charters are inconvenient to amend." Schwartz, *supra* note 6, at 1811.

[163] Jonathan C. Lipson, *Where's the Beef? A Few Words About Paying for Performance in Bankruptcy*, 156 U. Pa. L. Rev. PENNumbra 64 (2007).

largely assumed that important contractual questions would have been answered before bankruptcy. Given the rise of distress investing and the contracting environment that it creates, this assumption no longer holds. We must therefore look to some alternative theory of contract in bankruptcy to help us understand the work that contract can and cannot do in resolving corporate financial distress. Relationalism offers one promising alternative.

III. Relational Contracting

The relationalist project began with Stewart Macaulay's 1963 paper, *Non-Contractual Relations in Business*.[164] Macaulay's empirical study of business contracting practices yielded important observations about the limited relevance of formal contract terms and the limited use of formal (judicial) enforcement mechanisms. These, in turn, led to important questions about the work of contract with which we continue to grapple. For example, under what conditions will sophisticated businesses use[165] or eschew formal contracts?[166] The answers to these questions matter because they help to define the logic and limits of the formal legal system. Given the transformation of the chapter 11 process, they would seem to matter just as much in bankruptcy as elsewhere.

Relationalism has generated an enormous body of literature, which can be divided into roughly two camps that share certain common goals. On one hand, "economic relationalists," such as Victor Goldberg,[167] Oliver Williamson,[168] Lisa Bernstein,[169] and Robert Scott,[170] focus on the problem of hold-ups and the role that formal contract could play in minimizing it ex ante. On the other hand, "sociological relationalists," such as Ian Macneil,[171] William

[164] Stewart Macaulay, *Non-Contractual*, *supra* note 23; Scott, *Promise, supra* note 27, at 105 (characterizing *Non-Contractual Relations* as "the foundation of what is now known as relational contract theory.").

[165] *Id.* at 62 ("Why are relatively non-contractual practices so common?").

[166] *Id.* ("Why does business ever use contract in light of its success without it?").

[167] *See, e.g.*, Victor Goldberg, *Regulation and Administered Contracts,* 7 Bell J. Econ. 426, 439 (1976) (developing "hold up" problem observed by Macaulay).

[168] *See, e.g.*, Oliver Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J.L. & Econ. 223 (1978) (studying use of firm structures to address "hold up" problem).

[169] *See, e.g.*, Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. Pa. L. Rev. 1765 (1996); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms and Institutions*, 99 Mich. L. Rev. 1724 (2001) [hereinafter Bernstein, *Cooperation*].

[170] *See, e.g.*, Goetz & Scott, *supra* note 24; Robert E. Scott, *A Relational Theory of Secured Financing*, 86 Colum. L. Rev. 901, 926 (1986).

[171] *See, e.g.*, Macneil, *Many Futures*, *supra* note 23, at 693.

Whitford,[172] Richard Speidel,[173] and Robert Hillman,[174] focus on power disparities in ongoing exchange relationships that they find normatively troubling. This group was led by Macneil, who believed that exchange relations could be understood only in terms of the social, cultural, and political context in which exchange behavior was found.[175]

Despite these differences, relationalists share the view that contract law is neither simple nor concerned solely with the "discrete transaction."[176] Rather, as Scott explained, the divergence between the economically and sociologically-minded relationalists reflects different methodological commitments and prior assumptions about the world and participants in exchange relationships.[177] Yet, he observes, "[r]elationalists of all stripes believe that the institution of contract can only be understood by observing the law 'in action', and, in particular, by exploring the interaction between the threat of legal coercion and the array of informal norms that also regulate the relationship in important ways."[178]

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[172] *See, e.g.*, William C. Whitford, *The Appropriate Role of Security Interests in Consumer Transactions*, 7 Cardozo L. Rev. 959, 998 (1986) (noting "the lack of information that is so endemic to consumer transactions.").

[173] *See, e.g.*, Richard E. Speidel, *An Essay on the Reported Death and Continued Vitality of Contract*, 27 Stan. L. Rev. 1161, 1173 (1975) ("These perceived excesses included the wasteful utilization and inefficient allocation by private parties of increasingly scarce resources, the accumulation and frequent abuse of strategic market power, and a growing disparity in wealth, capacity, and opportunity among those who used or, in some cases, were used by contract.").

[174] *See, e.g.*, Robert W. Hillman, *Business Partners as Fiduciaries: Reflections on the Limits of Doctrine*, 22 Cardozo L. Rev. 51, 54–55 (2000) ("The moral mandate approach promotes virtuous conduct in business relationships . . . . Support for the view is found in the potential for inequity when bargaining power is unequal.").

[175] *See* Macneil, *Many Futures*, *supra* note 23, at 693.

[176] *See* Victor P. Goldberg, *Relational Contract*, *supra* note 25, at 292; Feinman, *supra* note 25, at 741 ("Relational contract simultaneously dramatically broadens and dramatically fragments the scope of contract law as compared to neoclassical law.").

[177] The success of either view, he has argued, ultimately turns on whether formal and informal enforcement mechanisms "are viewed as *complements*, and therefore a mixed strategy is feasible, or are *substitutes,* such that recourse to formal enforcement when the informal norms have failed 'crowds out' the operation of informal contracting in future transactions." Scott, *Promise*, *supra* note 27, at 122.

[178] *Id.* at 107. *See also* Victor P. Goldberg, *Relational Contract*, *supra* note 25, at 292. Of course, not all observers believe that those with different methodological commitments can be lumped together as relationalists. An example is Richard Craswell's observation that relational scholars and law-and-economics scholars tend to be interested in different questions. "Economic analysts sometimes use the phrase relational contract as little more than a synonym for a contract which is incomplete in some important sense." Richard Craswell, *The Relational Move: Some Questions from Law and Economics*, 3 S. Cal. Interdisc. L.J. 91, 91 (1993). Richard Speidel asserts that scholars such as Scott's reliance on "social rather than legal norms" in their conception of relationalism is "questionable." Richard E. Speidel, *Article 2 and Relational Sales Contracts*, 26 Loy. L.A. L. Rev. 789, 807 (1993). I set this question to one side for the time being.

A. Contracting Environments

Relationalists have followed Macaulay's lead and studied contracting in discrete environments or contexts. While there is no precise definition of "contracting environment,"[179] leading scholars have observed the relational incidents of promissory exchange in auto-franchising,[180] the diamond industry,[181] cotton markets,[182] technology-startups,[183] and the motion-picture industry.[184] Within these environments, relationalists want to study interpersonal relations across many dimensions, including bargaining leverage, the effect of contracting on third parties, and the efficacy of formal versus informal legal mechanisms.

If bargaining leverage is an important question, a good way to understand its relational qualities is by studying contract renegotiations.[185] Renegotiation also happens to be an especially apt analogy because contracting in bankruptcy over priority is often a renegotiation of the distributional priorities that existed before bankruptcy. If, for example, *A* and *B* are in a long-term, incomplete contract outside bankruptcy, what should formal law do in the event that conditions for *A* change, leading *A* to seek new terms from *B*? *B*, recognizing it has a good deal, does not want to change. It has leverage over *A*. It may therefore "hold up" *A*, extracting supracompetitive rents as the price of modification. Most relationalists would agree that this is a problem.[186] Courts struggle to address these questions through doctrines of "eco-

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[179] Scott uses the term "contracting environment." *See, e.g.*, Robert E. Scott, *Text and Context: Contract Interpretation as Contract Design*, 100 CORNELL L. REV. 23, 29 (2014). Gordon uses the term "semi-autonomous contracting cultures." Gordon, *supra* note 24, at 575. Galanter uses the term "bargaining arena." *See* Galanter, *supra* note 29, at 272–73.

[180] *See, e.g.*, Stewart Macaulay, *"The More Things Change. . .": Business Litigation and Governance in the American Automobile Industry*, 21 LAW & SOC. INQUIRY 631 (1996); William C. Whitford, *A History of the Automobile Lender Provisions of BAPCPA*, 2007 U. ILL. L. REV. 143 (2007).

[181] Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992).

[182] *See* Bernstein, *Cooperation*, *supra* note 169, at 62.

[183] *See generally* Ronald J. Gilson, *Locating Innovation: The Endogeneity of Technology, Organizational Structure, and Financial Contracting*, 110 COLUM. L. REV. 885 (2010); Lisa Bernstein, *The Silicon Valley Lawyer as Transaction Cost Engineer?*, 74 OR. L. REV. 239 (1995).

[184] *See generally* Victor P. Goldberg, *The Net Profits Puzzle*, 97 COLUM. L. REV. 524 (1997); Victor P. Goldberg, *Bloomer Girl Revisited or How to Frame and Unmade Picture*, 1998 WIS. L. REV. 1051 (1998); Jonathan Barnett, *Hollywood Deals: Soft Contracts for Hard Markets*, 64 DUKE L.J. 605 (2015).

[185] Macneil, *Adjustments*, *supra* note 23, at 898 (suggesting that the neoclassical approach to contract law be replaced by relational contract law in which "recognition is easily accorded to the creation of such [contractual] interests arising naturally from any behavior patterns within the relation.").

[186] *See, e.g.*, Ronald J. Gilson, Charles F. Sabel, & Robert E. Scott, *Contracting For Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 451 ("How do the parties deal with the problems of opportunism and the risk of hold-up that seem endemic in such interactive collaborative relationships?"); Goldberg, *supra* note 167, at 439.

nomic duress" and "good faith," among others.[187] We can expect this struggle to surface in bankruptcy as contract becomes an increasingly important decisional mechanism.

Relationalists also want to understand the effects of contracting choices on the larger community—that is, on third parties. If *B*'s demands of *A* hurt not only *A*, but cause *A* to breach other agreements, do we have a problem—and if so, is it a contract problem? Economically oriented relationalists would worry here about the externalities that contracting might create.[188] Scott and Schwartz, for example, seem to recognize that interpretive techniques should adjust depending on the presence of third-party effects, such as by expressing a preference for formalism when externalities are possible.[189] Alternatively, sociologically-oriented relationalists would focus on the communitarian effects of such a situation.[190] This problem—the third-party effect of renegotiation—is perhaps the most acute relational problem the chapter 11 system now faces. One might therefore expect relationalist insights from contract theory to inform our understanding of contracting in bankruptcy.

At the same time, relationalists also want to understand the mix of formal and informal mechanisms involved in contracting, whether ex ante or in renegotiation. Economic-relationalists prefer textualism, "the traditional Willistonian approach to interpretation," an approach that Scott and Schwartz claim "a large majority of common law courts . . . continue to follow."[191] Socio-relationalists, by contrast, prefer "contextualist" adjudication. They gravitate toward courts such as those in California, which "favor

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[187] *See supra* sources and text accompanying notes 150 and 151.

[188] Michael J. Trebilcock, The Limits of Freedom of Contract 20 (1993) (discussing the difficulty of "[d]etermining which [externalities] are to count in constraining the ability of parties to contract with each other."); Manuel A. Utset, *Towards A Bargaining Theory of the Firm*, 80 Cornell L. Rev. 540, 557, n.70 (1995) ("Of course, one can still conceive of implicit contracts that are enforced by third parties (e.g., relational contracts).") *But see* Gunther Teubner, *Expertise as Social Institution: Internalizing Third Parties into the Contract*, *in* Implicit Dimensions of Contract, 333, 343–46 (recognizing that relational contract theory risks contractualizing social life and arguing that would be bad). Indeed, there is a view among some that the very presence of third parties drives the relational analysis. *See, e.g.*, Margaret F. Brinig, *Are All Contracts Alike?*, 43 Wake Forest L. Rev. 533, 534 (2008) ("The presence of minor children (who economists would call third party externalities and who may or may not be third party beneficiaries in the legal sense) is what requires the majority of separation agreements to be long-term relational contracts, and therefore makes them similar to the telecom agreements.").

[189] *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 Yale L.J. 541, 568–69 (2003).

[190] *See, e.g.*, Gordon, *supra* note 24, at 569 (describing relationalism as concerned with "participants in continuing relations, members of interactive communities whose projects themselves, as well as expectations about how they will be carried out, are partially created by the community.").

[191] Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 Yale L.J. 926, 932 (2010).

a soft parol evidence rule" and treat merger clauses as raising only a rebuttable presumption of integration.[192]

Most relationalists—and certain important contract-related laws, such as Article 2 of the Uniform Commercial Code (UCC)—assume that repeat players want the informal ("immanent") norms that govern off-contract exchange to inform formal adjudication of contract disputes.[193] Lisa Bernstein has, however, shown that preferences for formal versus informal mechanisms within contracting communities may vary both across such communities, and even within them, depending on the nature of the relationships and disputes in question.[194] Among other contracting environments, Bernstein studied the National Grain and Feed Association and found that, contrary to the assertions of many relationalists, this group of repeat players did not want their informal norms to be used in formal adjudications of their disputes.[195] Rather, she found a distinction between "relationship preserving norms" (RPNs) and end-game norms (EGNs).[196] At least in this context, merchants may want courts to use RPNs in assessing performance-related disputes where the parties expect continued dealing. But, where they believe they are at the end of their relationship, they do not want their off-contract exchange norms to be used against them. Instead, they want the formal deal to be enforced as written.

Bernstein's insights about preferences for formal versus informal dispute resolution have important implications for contracting in bankruptcy. The premise of chapter 11 reorganization is that, even though bankruptcy almost always involves a breach of contract, it renders hope in the future plausible. As enacted, chapter 11 reflected a legislated preference for RPNs, which appears to have been made manifest through the immanent norms of chapter 11 practice. As distress investors increasingly dominate the contracting environment in chapter 11, however, their strategies increasingly

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[192] *Id.* at 960–61.

[193] *See, e.g.*, ALAN SCHWARTZ & ROBERT E. SCOTT, COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES 8-9 (2d ed. 1991) ("Article II of the Code can profitably be viewed as adapting the philosophy of 'immanent law' to a specific context. . . . [It] frequently speaks as though courts should discover the law merchant from a careful, disinterested examination of custom and fact situations."); Robert D. Cooter, *Structural Adjudication and the New Law Merchant: A Model of Decentralized Law*, 14 INT'L REV. L. & ECON. 215, 226 (1994) ("The role of the state in a decentralized legal system is to elevate appropriate social norms to the level of law[,] . . . lawmakers should identify the actual norms that have arisen in business communities[,] . . . identify the incentive structures that produced the norms[,] . . . [and enforce] [t]hose business norms that arise from an efficient incentive structure.").

[194] *See* Bernstein, *supra* note 169, at 1820.

[195] *See id.* at 1770 ("[T]ransactors do not necessarily want the relationship-preserving norms they follow in performing contracts and cooperatively resolving disputes among themselves to be used by third-party neutrals to decide cases when they are in an end-game situation.").

[196] *Id.* at 1796 ("Even when these RPNs are clear and well-developed, they may be quite different from the terms of transactors' written contracts, which contain the norms that transactors would want a third-party neutral to apply in a situation where they were unable to cooperatively resolve a dispute and viewed their relationship as being at an end-game stage ('end-game norms,' or 'EGNs').").

demand EGNs, even as those may conflict with the RPNs of particular debtors and their other stakeholders. If, for example, distress investors wish to cash out sooner rather than later, there is a good chance that they cannot invest time and resources to preserve whatever relationships might have constituted the corporate debtor's contracting environment. Instead, the norms and preferences of the distress investors' contracting environment will displace those of the debtor. While this may conflict with Congress' policy choices in enacting chapter 11, there is little to stop it—other than more thoughtful approaches to contracting in bankruptcy.

B. Contract Renegotiation: the Westinghouse *Example*

Relationalist insights about leverage, third-party effects and formality in the context of renegotiations are demonstrated by an important line of cases involving energy supply contracts from the 1970s and 1980s.[197] In the *Westinghouse* nuclear power cases, for example, Westinghouse promised electric utilities buying its nuclear reactors that it would guarantee the price of fuel.[198] A cartel of uranium suppliers then created a classic "hold up" problem by raising the price of uranium far beyond the price Westinghouse had guaranteed. This maneuver made it very costly to Westinghouse to perform.

Westinghouse attempted to extricate itself from these contracts through the contract doctrine of "commercial impracticability" under Article 2 of the UCC.[199] A key question was whether Westinghouse or its counterparts would be liable for future costs of disposing of spent fuel to the extent that it had already been purchased under these contracts. Westinghouse asserted, as part of its impracticability defense, that its counterparties should bear this cost. After an elaborate discussion of the doctrine of impracticability and the politics of nuclear power, the U.S. Court of Appeals for the Fourth Circuit turned to what it considered the "equitable" component of the problem: any decision's effect on third parties, in this case ratepayers who would have to absorb the cost of disposal if Westinghouse did not do so. In concluding that ratepayers should absorb the cost, the court observed:

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[197] *See generally*, Aluminum Co. of Am. v. Essex Grp., Inc., 499 F.Supp. 53 (W.D. Pa. 1980); Mo. Pub. Serv. Co. v. Peabody Coal Co., 583 S.W.2d 721 (Mo. Ct. App. 1979), *cert. denied* 444 U.S. 865 (1979); Fl. Power & Light Co. v. Westinghouse Elec. Corp., 517 F. Supp. 440 (E.D. Va. 1981), 597 F. Supp. 1456 (E.D. Va. 1984), *aff'd in part and rev'd in part*, 826 F.2d 239 (4th Cir. 1987).

[198] *See*, *e.g.*, James B. Stewart, The Partners: Inside America's Most Powerful Law Firms, 152–200 (1983); William Eagan, *The Westinghouse Uranium Contracts: Commercial Impracticability and Related Matters*, 18 Am. Bus. L.J. 281, 283 (1980); Paul L. Joskow, *Commercial Impossibility, the Uranium Market and the Westinghouse Case*, 6 J. Legal Stud. 119, 119 (1977); Anthony J. Parisi, *The Great Uranium Flap*, N.Y. Times, July 9, 1978, at F1.

[199] U.C.C. § 2-615(a) provides an excuse "if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made. . . ." (Am. Law Inst. & Unif. Law Comm'n. 1977).

> Over the expected life of the [power] plants, the ratepayers would realize a saving in their electric costs of some eight billion dollars, and for the period for which Westinghouse was obligated to dispose of the spent fuel, a saving of just under two billion dollars. It seemed fair to assess the relatively insubstantial costs of storage against these tremendous savings rather than upon Westinghouse, which was the victim of the Government's failure to carry out its "implied commitment."[200]

While scholars may debate the wisdom of judicial decisions to save large corporations from their loss-making contracts, it appears that at least part of the "relational" analysis undertaken by the Fourth Circuit involved consideration of the effect of any decision about the parties to the contract on third parties, *ex contractu*. By inference, an important part of any relationalist analysis of bankruptcy bargaining would require consideration of the relationships of both the parties to the contract as well as the larger body of stakeholders affected by the contract.

This view has important implications for contracting in bankruptcy. Commencement of a bankruptcy case creates an "estate" against which all prebankruptcy stakeholders have claims.[201] Any important prebankruptcy contract between select stakeholders that affects priority in the debtor's assets will potentially affect all stakeholders. That is, for example, the economic premise of secured credit. Although creditors who are not parties to contracts made in bankruptcy may gain or lose from the contracts, there is little question that the material, priority-skipping contracts discussed in Part I have effects on all or most stakeholders against the debtor and its estate. Whether or to what extent participants in the bankruptcy bargaining process account for these interests is, as noted, a difficult question underlying debates about priority.

The *Westinghouse* case also offers insight into the complex role that judges can play in a contracting environment. Here, Westinghouse was able to settle in part because of the intercession of United States District Court Judge Merhige, who used a mix of formal and informal mechanisms to bring the parties together. Macaulay explains:

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[200] *Fl. Power & Light Co.*, 826 F.2d at 279. Another court more explicitly recognized the "community" interest in determining the boundaries of the impracticability doctrine:

> The [impracticability] doctrine ultimately represents the ever-shifting line, drawn by courts hopefully responsive to commercial practices and mores, at which the community's interest in having contracts enforced according to their terms is outweighed by the commercial senselessness of requiring performance. When the issue is raised, the court is asked to construct a condition of performance based on the changed circumstances . . . .

Transatlantic Fin. Corp. v. United States, 363 F.2d 312, 315 (D.C. Cir. 1966) (footnotes omitted).

[201] *See* 11 U.S.C.A. § 541(a) (West 2015).

> In the *Westinghouse Electric Corp. Uranium Contracts Litigation*, Judge Merhige read the contract very literally so that Westinghouse could not escape liability for its promise to remove spent uranium rods from a nuclear power plant. However, he then attempted to coerce the parties into a settlement. As part of the process, he required the parties to appoint a panel of nuclear engineers to assist in finding a resolution. This panel found a technical solution. The cooling ponds could be reworked so that all of the rods produced during the life of the plant could be stored there while awaiting a governmental solution to the problem of nuclear waste. Merhige was famous, or infamous, as a judge who settle[s] big cases rather than tries them. It was said that he gathered the CEO's of utilities and Westinghouse on his sun porch and fed them mint juleps. He forced executives to confer without their lawyers and appointed the dean of a law school to act as a mediator so that executives of one utility could be sure that they were not settling for less than what another utility gained.[202]

As Bernstein might predict, a mix of end-game and repeat-play norms were used to put these difficult disputes to rest. In the end, it may be that this settlement averted a bankruptcy of Westinghouse.[203]

C. Private Governments in Contract

Relationalists recognize that neither formal law (contracts, doctrine) nor informal mechanisms (jawboning), in themselves, paint a full picture of ongoing relationships in contract. Yet, this merely exposes deeper, potentially more difficult questions about the incentives and dynamics in these environments. Macaulay, for example, views parties in contracting communities as "private governments," akin to political interest groups, whose members jockey for position using whatever means are available.[204] Those means may be informal social sanctions (gossip) or formal, instrumental applications of doctrine or, more plausibly, a combination of the two. As Robert Gordon has observed, long-term promissory relationships can be good, or bad, or some of both.

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[202] Mark P. Gergen, et al., *Transcript of Panel Discussion-Transactional Economics: Victor Goldberg's Framing Contract Law*, 49 S. Tex. L. Rev. 469, 483 (2007) (remarks of Stewart Macaulay) (footnotes omitted).

[203] *See* Stewart Macaulay, *An Empirical View of Contract*, 1985 Wis. L. Rev. 465, 472 (1985) ("After elaborate rituals before the courts, the cases were settled. Westinghouse injured its reputation, but the alternative might have been the destruction of a major multinational corporation.").

[204] *See generally* Stewart Macaulay, Law and the Balance of Powers: The Automobile Manufacturers and their Dealers (1966); Stewart Macaulay, *Private Government*, *in* Law and the Social Sciences 445 (Leon Lipson & Stanton Wheeler eds., 1986).

> In the messy and open-ended world of continuing contract relations, where the contours of obligations are constantly shifting, the effects of power imbalances are not limited to the concessions that parties can extort in the original bargain. Such imbalances tended to generate hierarchies that can gradually extend to govern every aspect of the relation in performance. This is the potential dark side of continuing contract relations, as organic solidarity is the bright side: what starts out as a mere inequity in market power can be deepened into persistent domination on one side and dependence on the other.[205]

This observation speaks directly to problems created by contract in bankruptcy that may harm estate stakeholders. Will the "powerful" in chapter 11—presumptively distress investors (but perhaps sometimes unions, or the U.S. government, as some allege happened in the auto-maker cases[206])—exploit leverage that judges cannot detect? If so, how are judges to correct such imbalances? One can imagine that Judge Merhige's example might appeal to some but not others, especially those who believe that judges should be little more than "umpires" in disputes between the parties. And, by parity of reasoning, if major stakeholders present a settlement to a court, who is the judge to second guess their agreement? If, on the other hand, the judge is worried, is she willing to risk reversal for defying well-accepted doctrine?

In short, relationalism teaches that to understand contract we must understand the bargaining environment that produces promissory exchange. To understand the bargaining environment, we must assess the incentives and effects of contracting amongst the parties and other stakeholders in that environment, as well as the formal and informal mechanisms at the parties' disposal. The process of renegotiation is a point of special importance in relationalist thinking because it recognizes the interactive qualities of contracting in this context. All have implications for contracting in bankruptcy.

IV. Contracting in Bankruptcy

There is little question that contract has come to dominate the chapter 11 process. Contract operationalizes the important examples of priority skipping described in Part I (debt roll-ups and certain structured dismissals). As discussed in Part V, there are many other aspects of contracting in bankruptcy to explore. And in each case, the contracts are the products of a complex bargaining environment with its own norms, customs and dynamics. Thus, to understand these contracts and the chapter 11 process of which they are a part, we should understand something about the contracting environment created by chapter 11.

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[205] Gordon, *supra* note 24, at 570.

[206] *See* Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 Mich. L. Rev. 727, 769 (2010).

A. *Who Participates in the Bankruptcy Relational Environment?*

To say that chapter 11 creates a contracting environment begs an obvious question: who is part of this environment? The dominant participants will be distress investors, professionals (in particular, lawyers and advisors, such as "chief restructuring officers"), and bankruptcy judges.[207]

1. *Distress Investors*

When Congress developed chapter 11 in 1978, it sought to preserve certain relationships, chiefly those between seemingly viable companies and their employees.[208] While this goal was long controversial—many wondered why financial interests would not be more important—it nevertheless described at least the relational logic of the reorganization process for its first fifteen years or so. This logic had important implications for chapter 11's bargaining environment. A corporate debtor and its stakeholders had a fairly good idea who called the shots: management of the debtor in possession.[209] The composition of the debtor's stakeholders—that is, creditors and shareholders—was likely to remain stable during bankruptcy because, as one lawyer has said to the author, "the parties were chained to the negotiating table." Official committees and management probably did the bulk of negotiating.

Because neither debtors nor creditors made a habit of being in bankruptcy, the stakeholders involved were probably not repeat players in the

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[207] There are, of course, others who play important roles in this process whose participation will have to wait further analysis. I am thinking in particular of the Office of the United States Trustee, a regulator that plays an increasingly important watchdog role in chapter 11 bankruptcy. *See* H.R. REP. NO. 95-595, at 4 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 5966 ("Some of the supervisory functions removed from the judge will be transferred to a new system of United States Trustees who will act as bankruptcy watchdogs.").

[208] The legislative history explains:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. . . . It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.

H.R. REP. NO. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179. *See also* N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) ("The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.").

[209] *See generally* Christopher W. Frost, *Running the Asylum: Governance Problems in Bankruptcy Reorganizations*, 34 ARIZ. L. REV. 89 (1992); Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?* (pt. 2), 57 AM. BANKR. L. J. 247 (1983); Lynn M. LoPucki, *The Debtor in Full Control - Systems Failure Under Chapter 11 of the Bankruptcy Code?* (pt. 1), 57 AM. BANKR. L. J. 99 (1983); Jerome R. Kerkman, *The Debtor in Full Control: A Case for Adoption of the Trustee System*, 70 MARQ. L. REV. 159, 183 (1987).

process.[210] This meant that chapter 11 did not really create a contracting environment as relationalists would understand it.[211] Beginning in the early 1990s, however, the system began to change, the changes reflected in the relationships of those involved in the reorganization process. In particular, large and medium-sized chapter 11 cases came to be dominated or influenced by "distress investors," hedge funds, private equity funds, and investment banks that invest in or purchase claims against troubled companies with a view towards making a profit on the investment. Chapter 11 thus became a process in which distress investors produce returns while (possibly) salvaging distressed companies.

Observers estimate that more than 200 financial institutions have invested $400 to $500 billion in the distressed debt market in the United States.[212] Distressed debt is corporate debt that is in default, sold by the initial holder (creditor) to distress investors. Demand for distressed debt reflects the potential return on investment.[213] Distressed investing was the strategy of 14 hedge funds on Bloomberg's 100 Top-Performing Large Hedge Funds, which appeared in their February 2013 issue of Bloomberg Markets, making it the third most popular investment strategy on the list, behind multi-strategy and long/short.[214] Cerberus Capital Management (Cerberus) was ranked eighteenth on the list, with a 19.0% year to date return on investment.[215] According to Cerberus's website, through investments in distressed debt and equity, they "provide liquidity to parties seeking to exit troubled situations," and their company "brings flexibility and innovation to the restructuring process, working closely with sellers, management, teams, and business owners to craft solutions that deliver success."[216] Other major

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[210] This contention sets aside the fact that many larger banks may have had "work out" departments in which bank employees were experienced in negotiating with distressed debtors. While those individuals were "repeat" players in the process, the "work out" department was not in the bank's larger business, which would most likely have been traditional lending.

[211] Unless one views the lawyers who ran the process as the important repeat players. *See* Lynn LoPucki, Teacher's Manual for the Debtor Creditor Game 71 (West 1984), called *The Debtor's Lawyer as Trojan Horse*, *as reprinted in* Elizabeth Warren & Jay Lawrence Westbrook, The Law of Debtors and Creditors: Text, Cases, and Problems 780 (3d ed. 1996). The role of lawyers in chapter 11 is important, even as its relationalist aspects remain largely under-developed.

[212] *See* Edward L. Altman, *The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations*, 22 Am. Bankr. Inst. L. Rev. 75, 76 (2014).

[213] *See* Allison Collins, *Early Warning Signs*, Mergers & Acquisitions, 26, 41–42 (Jan. 2015); *Distressed Debt Fundraising*, 2015 Preqin Glob. Priv. Debt Rep., https://www.preqin.com/item/2015-preqin-global-private-debt-report/9/11053; *see also* Keith Sharfman & G. Ray Warner, *Hedge Funds in Bankruptcy*, 22 Am. Bankr. Inst. L. Rev. 61, 61 (2014) ("Hedge funds and other professional and institutional investors are playing an increasingly important role in bankruptcy cases.").

[214] *The 100 Top-Performing Large Hedge Funds*, Bloomberg.com (Jan. 4, 2013), http://media.bloomberg.com/bb/avfile/rMz9ZuocMhKo.

[215] *Id.*

[216] *Investment Strategies: Distressed Securities and Assets*, Cerberuscapital.com, http://www.cerberuscapital.com/investment-strategies/distressed-securities-and-assets.

distress investors include Aurelius Capital Management, Oaktree Capital Management, and Fortress Investment Group.

It is difficult to overstate the impact distress investors have had on the chapter 11 process. Their sophistication, aggressiveness, and creativity have been among the most important advances in the system in the past twenty years. They are important elements of chapter 11's contracting environment because their business model expects them to be repeat players in it. While they may sometimes collaborate, and sometimes fight, with one another, they should understand that their relationships are not an end game, even if their collective decision-making in a given case liquidates (terminates) the debtor. A relational approach to contracting in bankruptcy would explore the underlying dynamics and effects of these relationships. It would consider whether they advance or impede Congress' policy goals in chapter 11, and whether their participation has other important social consequences.

2. *Bankruptcy Professionals*

Distress investors do not act alone. A variety of professionals significantly influence the process, either as counsel to distress investors or others, or "turnaround managers" who may be appointed to run the corporate debtor in chapter 11.

A number of law firms appear to be recurrent players in this environment, in particular Weil, Gotshal & Manges, Kirkland & Ellis, and Skadden, Arps, Slate, Meagher & Flom. While the relationship between lawyer and client in this context is, itself, quite interesting, it is sufficient to note that both lawyers and clients in large- and medium-sized chapter 11 cases are frequently familiar to one another, either because of dealings in prior cases, or by reputation, or both.

Another important professional will be the so-called "turnaround manager," often denominated a "chief restructuring officer" (CRO). "[T]he goal of a CRO is to restructure a distressed company's balance sheet and make the difficult determination of defining the company's business within a compressed timeframe."[217] According to one observer, "Today, most large

[217] Kevin M. Baum, *The Basics for Retaining a CRO*, *in* AM. BANKR. INST. J. 50, 50 (Oct. 2011) (quoting Shai Y. Waisman & John W. Lucas, *The Role and Retention of the Chief Restructuring Officer*, *in* AM. RESTRUCTURING & INSOLVENCY GUIDE 200 (2008/2009)). As Baird and Rasmussen explain:

> The arrival of a CRO alters the terrain of corporate governance. The CRO is not a typical member of the management team. Unlike other officers of the corporation, she does not report to the CEO. Rather, she reports directly to the board. Whereas the CEO tends to choose other members of her management team, the CEO has little role in the selection of the CRO. The CRO is often tasked with passing judgment on which members of the management team add value and which ones need to be replaced. Indeed, the [c]hapter 11 filing may take place only after the CRO has had a chance to resolve the operational problems and the business has settled on a plan to restructure its finances. The CRO may be compensated by the company, but her interests are aligned with the lenders.

companies will employ a CRO, and his or her turnaround-management firm, before filing for bankruptcy."[218] CROs present a number of technical issues for bankruptcy courts,[219] many of which have been addressed by the so-called "Jay Alix Protocols,"[220] named after one of the nation's leading turnaround management firms (and a repeat player, itself).[221] These protocols require some level of independence on the part of the CRO, including that he or she be approved by an independent board of the debtor(s). Nevertheless, "the CRO is not required to disclose its connections with the debtor, creditors and other parties in interest, as a professional seeking to be employed pursuant to § 327(a) would be."[222]

Mechele Dickerson explains some of the concerns with CROs:

> CROs and other privatized trustees now routinely serve as the debtor's representative during the bankruptcy case, oversee the development of financial projections, disseminate information to parties in interest, oversee the sale of assets, and prepare and negotiate the reorganization plan with creditor, bondholder, and equity committees. Though they at times appear to serve as surrogates for a court-appointed trustee or examiner, they are predisposed to favor only one entity involved in the debtor's [c]hapter 11 reorganization: the creditor who was responsible for getting them hired. Indeed, in most instances, the privatized trustee reports directly to the firm's board of directors, not to the CEO or other managers.[223]

One of the most important questions all professionals face in bankruptcy is how they are going to be paid. There are essentially two classes of

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See Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*," 154 U. PENN. L. REV. 1209, 1234 (2006).

[218] *Id.* (citing Mark Lewis, *CRO is Newest Acronym in Corporate Lexicon*, FORBES (Feb. 2, 2002), www.forbes.com/2002/02/19/0219cro.html).

[219] There is, for example, a question as to whether a CRO is a "professional person" under the Bankruptcy Code, although courts seem to think that they are. *See, e.g.*, *In re* Bartley Lindsay Co., 120 B.R. 507 (Bankr. D. Minn. 1990); *In re* Dola Int'l Corp., 88 B.R. 950 (Bankr. D. Minn. 1988).

[220] *See* The United States Department of Justice, *Protocol for Engagement of Jay Alix & Associates and Affiliates*, Region 2: Chapter 11, https://www.justice.gov/ust-regions-r02/region-2-chapter-11-3. These protocols have become "*de facto* requirements for CRO retention . . . in the Southern District of New York and the District of Delaware." Timothy W. Brink & James R. Irving, *Emerging Trends and Lingering Criticisms: A CRO Retention Update*, 32 AM. BANKR. INST. J., 18, 88 (2013).

[221] Jay Alix & Associates currently operates as AlixPartners. *See Jay Alix, Founder*, AlixPartners, http://www.alixpartners.com/en/About/Founder.aspx.

[222] Brink & Irving, *supra* note 220, at 88. Nevertheless, in some cases they will make such disclosures voluntarily. *See, e.g.*, *In re* Ctr. European Distrib. Corp., No. 13-10738 (Bankr. D. Del. 2013); *In re* WP Steel Venture LLC, No. 12-11661 (Bankr. D.Del 2012); *In re* Dippin' Dots Inc., No. 11-51077 (Bankr. W.D. Ky. 2011); *In re* BI-LO LLC, No. 09-02140 (Bankr. D.S.C. 2009).

[223] A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875, 918–19 (2009) (footnotes omitted).

professionals in chapter 11 for this purpose: those who are formally retained by the estate and those who are not. Those retained by the estate must be "disinterested" and not hold interests "adverse" to the estate.[224] If formally retained by the estate, professionals must file "fee applications" under sections 330 and 331 of the Bankruptcy Code. While CROs do not always file such applications, courts "will often require the CRO to file monthly 'staffing reports' disclosing the time that the CRO and his or her firm's employees have spent on various aspects of the debtor's engagement."[225]

Professionals not retained by the estate will be paid by their clients, subject to an important caveat: if the client holds a secured claim, and the collateral is worth more than the claim, then an attorney may be paid from the proceeds of the collateral if "reasonable."[226] This caveat can be an incidental benefit of entering into a priority-skipping contract, if it is a roll-up that creates an equity cushion in a debtor's assets. In that case, the secured creditor will have a much greater chance of having its legal fees paid from the debtor's assets, rather than its own.

The role of professionals in chapter 11 is an important relationalist touchstone that is largely unexplored. While they, too, may be repeat players, they may also be subject to codes of conduct associated with their professional calling (e.g., membership in a bar association). These codes of conduct may place them in tension with their clients or other participants in the process. Economic pressures associated with these professions may exacerbate these tensions. All of these tensions should inform a relationalist approach to contracting in bankruptcy.

3. *Bankruptcy Judges*

Consider also the judges, who present relational questions about both identity and role. Identity is, in large part, determined by venue, long a controversial subject in chapter 11. The distress investing environment has coalesced around two principal bankruptcy courts, those in the Southern District of New York (SDNY) and the District of Delaware (DE). These are where the largest cases are usually filed. The choices are possible because of fairly loose venue rules: a corporate debtor can file in virtually any venue in which it has an actual or entity (corporate) presence.[227] This has led to a heated debate about the ostensible "race to the bottom" (or "top") that has resulted

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[224] The debtor in possession and official committees "may employ one or more attorneys, accountants, appraisers, auctioneers or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title." 11 U.S.C.A. § 327(a) (West 2015).

[225] Brink & Irving, *supra* note 220, at 88. Preparing these reports "is significantly less burdensome than preparing a typical fee application that complies with sections 330 and 331 and satisfies other requirements that may be imposed by the U.S. Trustee and bankruptcy courts in various jurisdictions." *Id.*

[226] 11 U.S.C.A. § 506(b) (West 2015).

[227] 28 U.S.C.A. § 1408 (West 2015) provides, in relevant part, that:

from these venue rules. Scholars such as Lynn LoPucki argue that these venue rules have produced a "corrupt" system.[228] Others reject this claim, viewing venue choice as simply one of many options that corporate stewards could make in deciding where to resolve the company's troubles.[229]

While lax venue rules may have contributed to the formation of the distress investing community, they are unlikely to be important to its persistence, because distress investors could go wherever the action is. They can communicate electronically, remote from one another (and sometimes from the courts themselves[230]). As with all social relations, physical space—the frame of reference for venue—has become only one of many factors that determine networks and connections. Consequently, changing the venue

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> [A] case under title 11 may be commenced in the district court for the district (1) in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement, or for a longer portion of such one-hundred-and-eighty-day period than the domicile, residence, or principal place of business, in the United States, or principal assets in the United States, of such person were located in any other district; or (2) in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership.

Courts generally respect the statute and management's venue choices. *See In re* Patriot Coal Corp., 482 B.R. 718, 739 (Bankr. S.D.N.Y. 2012) (noting that "[a] debtor's choice of forum is entitled to great weight if venue is proper" and that a party seeking transfer of a bankruptcy case must carry its burden of proof by a preponderance of the evidence); *House Holds Hearing on Proposed Chapter 11 Venue Reform Legislation*, 30 AM. BANKR. INST. J., 89, 93 (2011) (noting that judges give deference to the venue choice of bankruptcy debtors).

228 *Cf.* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (2006). A recent paper argues:

> [F]orum shopping has divorced modern bankruptcy practice from traditional historical principles underlying the bankruptcy system and venue itself. Large bankruptcies now cater almost exclusively to the wishes of power players, to the detriment of smaller stakeholders who would have a better chance of getting their views heard if the bankruptcy proceedings happened close to home. Further, many stakeholders in these bankruptcy cases are effectively deprived of notice and an opportunity to participate, in contravention of fundamental due process and fairness principles.

Laura Napoli Coordes, *The Geography of Bankruptcy*, 68 VAND. L. REV. 381, 386–87 (2015).

229 *See generally* Kenneth Ayotte & David A. Skeel, *An Efficiency-Based Explanation for Current Corporate Reorganization Practice,* 73 U CHI. L. REV. 425 (2006) (reviewing LOPUCKI, *supra* note 228); David A. Skeel, Jr., *What's So Bad About Delaware?*, 54 VAND. L. REV. 309 (2001). *See also* Marcus Cole, *Delaware is not a State*, 55 VAND. L. REV. 1845 (2002); Robert K. Rasmussen & Randall S. Thomas, *Whither the Race? A Comment on the Effects of the Delawarization of Corporate Reorganizations*, 54 VAND. L. REV. 283 (2001).

230 In some cases, judges permit parties to participate in hearings via teleconference. *See* Melissa B. Jacoby, *The Detroit Bankruptcy, Pre-Eligibility*, 41 FORDHAM URB. L.J. 849, 858 (2014) ("Detroit's Emergency Manager objected to a limited number of questions in a deposition, which led the court to set guidelines for future depositions and to offer to resolve disputes in real time on the phone if necessary."); Gerald G. Ashdown & Michael A. Menzel, *The Convenience of the Guillotine?: Video Proceedings in Federal Prosecutions*, 80 DENV. U. L. REV. 63, 65 (2002) ("Video teleconferencing has been used in many types of federal court proceedings, including . . . bankruptcy hearings.").

rules, as some have proposed,[231] would likely change little, except, perhaps, to add costs for transportation and local counsel.

However, venue does not merely determine geography. It also determines identity, in that it assures participants of a reasonably stable pool of judges who are recruited to approve bankruptcy bargains. While distress investors do not "choose" the judges who preside over the chapter 11 cases in question, the potential universe of judges who participate in this contracting process is smaller (and thus more predictable) than the universe of judges who might preside over traditional litigations involving a relational contract dispute.

The distress investing community appears to prefer the judges of the SDNY and DE. This preference may be outcome driven or reflect a preference for judges whose reputations are well known to the investing and professional community. Or, this preference may derive from these judges having developed expertise and sophistication sufficient to keep pace with the investors. A relationalist agenda in chapter 11 would explore which of these answers was more plausible—and whether the plausible answer was problematic.

This leads to the second, and more difficult, question about judges: what, exactly, should judges do in this environment?[232] This is not a new question, but viewing chapter 11 as a relational contracting environment adds nuance to it. Nearly thirty years ago, Jack Ayer noted:

> One of the most important problems in the material on bankruptcy procedure is the issue of the independent responsibility of the bankruptcy judge. How far should the judge be permitted to act "on his own?" To what extent, if at all, should the bankruptcy judge have the power or the duty to do something that no party wants him to do? On this important issue, the drafters gave little, if any, guidance. Such a failure reflects more than a mere drafting

[231] *See* Lynn M. LoPucki, *Courting Failure: Book Summary*, 54 BUFF. L. REV. 325, 340 (2015) ("Congress could adopt venue rules similar to those proposed by the National Bankruptcy Review Commission in 1997. The new rules should delete the debtor's place of incorporation from the list of proper venues and provide for the mandatory transfer of misfiled cases to the proper venue."); Coordes, *supra* note 228, at 384 ("The procedural venue rules adopted in bankruptcy directly influence the substance of a bankruptcy case. By modifying venue rules and procedures, we can create more transparency in the bankruptcy process and begin restoring the principles that forum shopping has shattered.").

[232] To be sure, bankruptcy judges hardly have limitless power. The Supreme Court reminded bankruptcy judges in 2011 that, being Congressional creations, these judges may not usurp the Article III judicial power. *See* Stern v. Marshall, 131 S. Ct. 2594 (2011); Lipson & Vandermeuse, *supra* note 144, at 1179 (discussing the ramifications of the Supreme Court's ruling in *Stern*); *see also* Wellness Int'l. Ltd. Network v. Sharif, 135 S.Ct. 1932 (2015) (reversing prior ruling that bankruptcy courts may not adjudicate *Stern* claims). This Article sets aside these constitutional questions for the time being. The priority-skipping contracts of concern here are unlikely to offend the boundaries of a bankruptcy judge's constitutional authority.

> error. It indicates that the drafters did not wish to commit themselves"[233]

To raise these questions is to invoke difficult questions about whether (or to what extent) judges should be managerial. A managerial judge will assume an active role in cases, both on and off the bench, similar to how Judge Merhige performed in the *Westinghouse* case.[234] This approach is problematic for those who believe that a judge's highest duties are neutrality and procedural regularity.[235] Judges should not manage cases, some worry, but instead act as "umpires," deciding disputes based on "neutral" principles of law.[236]

Today, bankruptcy judges appear to be significantly managerial. They frequently encourage settlements and to greater and lesser degrees scrutinize the merits of the requests made of them. An entire chapter of the Bankruptcy Code (chapter 3) is devoted to case "administration," which contemplates varying degrees of judicial management. Of course, Melissa Jacoby reminds us that "judges vary in their enthusiasm for [managerial] techniques."[237] Jacoby adds:

> [T]he nonadversarial methods judges might use to oversee cases go beyond case management and sometimes are in tension with the goals of case management. For example, bankruptcy judges face conflicting messages on whether to conduct an independent evaluation of some issues even in the absence of party objection.[238]

Ultimately, Jacoby observes, our theory of judging in chapter 11 "is too often underdeveloped, unrealistic, or pointing in conflicting directions."[239]

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[233] John D. Ayer, *The Forms of Action in Bankruptcy Practice: An Exposition and a Critique*, *in* 1985 ANN. SURV. BANKR. L. 307, 329 (William L. Norton ed., 1985).

[234] *See, e.g.*, Judith Resnik, *Managerial Judges*, 96 HARV. L. REV. 374, 414–26 (1982) (providing foundational critique of movement favoring case management); Lipson, *Debt and Democracy*, *supra* note 21, at 657–58 (characterizing bankruptcy judges as "exemplars" of managerial judging).

[235] Perhaps ironically, this focus on neutrality and procedural regularity is how bankruptcy judges were at least initially expected to act. *See, e.g.*, J. Ronald Trost, *Business Reorganizations Under Chapter 11 of the New Bankruptcy Code*, 34 BUS. LAW. 1309, 1316 (1979) ("Until an appropriate pleading is filed the court's only function with respect to the operation of the [debtor] should be to change the composition of the creditors' committee if it is not representative. The bankruptcy judge should not worry about 'how's the business doing?' ").

[236] *See Confirmation Hearing on the Nomination of John G. Roberts, Jr. To Be Chief Justice of the United States: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. 55 (2005) (statement of John Roberts, Nominee for Chief Justice, U.S. Supreme Court) (Roberts stated that "Judges and justices are servants of the law, not the other way around. Judges are like umpires. Umpires don't make the rules, they apply them. The role of the umpire and a judge is critical. They make sure everyone plays by the rules, but it is a limited role. Nobody ever went to a ball game to see the umpire.").

[237] Melissa B. Jacoby, *What Should Judges Do in Chapter 11?*, 2015 U. ILL. L. REV. 571, 581 (2015).

[238] *Id.*

[239] *Id.* at 572.

To the list of items we do not know about the role of bankruptcy judges we must add "relational contracting participant." While judges asked to approve bankruptcy bargains are not parties to the contracts, the insights of relationalism surely apply to them: they are repeat players; they have bargaining leverage in their capacity to scrutinize or reject requests to approve such contracts; they have reputations that affect how the parties themselves are likely to view the judge and how appeals of the judge's decisions may be received. Judges are important relational actors in chapter 11. A relational theory of contract in bankruptcy would account for their role.

B. The Bargaining Environment

A second class of relational questions involves the nature of the bankruptcy bargaining environment. What are its dynamics? What are the participants' preferences for formal versus informal mechanisms? To what extent will reputation or expectations of repeat play influence current behavior? While it is not yet possible to answer these questions definitively, it is possible to sketch some of the contours of this bargaining environment.

1. Information

Bargaining dynamics depend heavily on the flow of information. This dependency can be problematic in chapter 11 for a variety of reasons. Distress investors may trade in and out of positions rapidly.[240] They may hold multiple positions (e.g., debt and equity).[241] These phenomena can make it difficult to predict incentives because those incentives may be subject to quick change. Distress investors may also form alliances with one another, such as the consortium of lenders in the *Colt* case study, in Part I.

Recent amendments to bankruptcy rules of procedure may help by forcing distress investors to reveal their "disclosable economic interests."[242] The disclosures "shall be filed by every group or committee that consists of or represents, and every entity that represents, multiple creditors or equity security holders that are (A) acting in concert to advance their common interests, and (B) not composed entirely of affiliates or insiders of one

[240] As one lawyer has told me, "'Today, I don't know who's sitting across the table from me. When somebody is in district court, I know what they want. But now, in bankruptcy, I may not know all the right players and, even if I do, I may not know their real incentives.'" Lipson, *Shadow Bankruptcy*, *supra* note 16, at 1644–45 (quoting Telephone Interview with Lawyer No. 3 (Feb. 6, 2009)).

[241] I reported in a prior paper that an attorney told me that it can at times be difficult to know other parties' incentives. "The assumption was that [it] was a simpler capital structure at the time." Lipson, *Shadow Bankruptcy*, *supra* note 16, at 1654 (quoting Telephone Interview with Lawyer No. 3 (Feb. 6, 2009)).

[242] A "'disclosable economic interest' means any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right granting the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest." FED. R. BANKR. P. 2019(a)(1).

another."[243] This will go some way toward addressing the "shadow bankruptcy" problem I have described elsewhere.[244] But, it may be too little, too late to create the "cooperative" environment required for efficient bargaining. Game-theoretically-oriented observers of chapter 11 worry that the "core" of bankruptcy negotiation may be "empty."[245] While this seems unlikely—chapter 11 negotiations occur every day—opacity impairs patterns of trust, and thus bargaining dynamics. The insights of relational contracting would help judges and other system participants understand the implications of their choices about information flow.

2. *Sophistication and Participation*

Distress investors are sophisticated. They are funds likely to be managed by professionals with experience in chapter 11 and the restructuring process, whether as bankers, lawyers, or advisers. This sophistication means that they have the capacity to make complex decisions under difficult conditions. This ability gives them a bargaining advantage to identify potentially lucrative distress investments. Yet, a chapter 11 case will affect all of a debtor's stakeholders, including those who may not be sophisticated. A large corporate debtor could have many unsecured creditors with claims arising from many different transactions or occurrences. Some may be trade creditors; others employees or tort creditors. Some (large creditors or unionized employees) may be well-organized. But they are unlikely to have had repeat experience in chapter 11, and, thus, unlikely to have developed the sophistication of distress investors. Consequently, these less sophisticated creditors may not participate in the bargaining process effectively, or at all.

There are a limited number of ways that the Bankruptcy Code "levels the playing field" to protect the bargaining positions of unsophisticated creditors. One is through statutory (mandatory) priority, such as the rules in section 507. Cases such as *Jevic* may mean that contract can overcome these rules. Another is the official committee of unsecured creditors appointed to represent these widely dispersed creditors. But, the rise of distress investing has impaired committees' effectiveness. Distress investors often do not participate on official committees, as that would restrain trading activity and impose fiduciary duties to all stakeholders inconsistent with their investing strategies. Distress investors' sophistication can therefore give them a bargaining advantage over widely dispersed, one-off stakeholders or the official committees that would represent them.

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[243] FED. R. BANKR. P. 2019(b)(1).

[244] *See generally* Lipson, *Shadow Bankruptcy*, *supra* note 16.

[245] Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 652 (2010) ("The current environment is one in which there are no natural leaders (or followers) among the creditors to perform the shuttle diplomacy required to build a consensus. Without familiar benchmarks, there is no shared understanding of what form a plan should take. Coalition formation is harder. Worse yet, in some cases there may be no stable equilibrium at all. To use the language of cooperative game theory, the core may be empty.") (footnotes omitted).

This dynamic places pressure on judges who seek assurance that the contracts they are asked to approve are the product of a reasonably fair and efficient contracting environment. It returns to the question of judicial management. To what extent should bankruptcy judges assure that all creditors participate in a meaningful way in chapter 11 negotiations over distributional priority, and how can they do so? In cases where judges approve settlements of limited fund class actions, they are said to be "fiduciaries" for all class members.[246] Is that how we should think of bankruptcy judges participating in the negotiation and approval of priority-skipping bankruptcy bargains? Bankruptcy judges may not be enthusiastic about such status, and it is not how bankruptcy judging is understood today. Appellate review of these agreements is subject to a fairly deferential standard, generally "abuse of discretion."[247] Will appellate courts rethink this standard if they become concerned about contracting in bankruptcy?

3. *Formality*

As discussed above, a critical contribution of relationalism has been to focus on the mix between formal and informal mechanisms used in different contracting environments. By "formal," this Article means both written instruments and judicial decisions about those instruments. By "informal," this Article means exchange-related behavior that occurs outside a writing and/or which deviates from contract doctrine. Gauging this blend is the doctrinal problem of contract interpretation, which, Scott notes, is "the largest single source of commercial contract litigation."[248]

Bankruptcy bargaining presents complex examples of the interaction between formal and informal mechanisms. On one hand, no bankruptcy bargaining that adjusts priorities in a material way can be approved without documentation and judicial approval. These aspects of bankruptcy bargain-

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[246] *See, e.g.*, Reynolds v. Beneficial Nat'l Bank, 288 F.3d 277, 279–80 (7th Cir. 2002) ("We and other courts have gone so far as to term the district judge in the settlement phase of a class action suit a fiduciary of the class, who is subject therefore to the high duty of care that the law requires of fiduciaries."); Grunin v. Int'l House of Pancakes, 513 F.2d 114, 123 (8th Cir. 1975).

[247] *See, e.g.*, *In re* Adelphia Comm. Co., 368 B.R. 140, 283 (Bankr. S.D.N.Y. 2007) ("The ACC Bondholder Group's principal complaint is its objection to the settlement, but an issue of that character is reviewed on an abuse of discretion basis, and the appellant must show that the settlement falls below the lowest range of reasonableness."); *In re* Olde Prairie Block Owner, LLC, 460 B.R. 500, 510–11 (Bankr. N.D. Ill. 2011) ("'The [bankruptcy] court is in the best position to interpret its own orders' and we will reverse its interpretation only if 'the record clearly shows an abuse of discretion.'") (quoting *In re* Chi., Rock Island & Pac. R.R. Co., 865 F.2d 807, 810 (7th Cir. 1988)); *In re* WebSci Technologies, Inc., 234 F. App'x 26, 29 (3d Cir. 2007) ("We review the Bankruptcy Court's approval of a [9019] settlement for abuse of discretion."); Ad Hoc Comm. of Kenton Cty. Bondholders v. Delta Air Lines, Inc., 309 F. App'x 455, 457 (2d Cir. 2009) ("Approvals of Bankruptcy Rule 9019 settlements are also reviewed for abuse of discretion.") (citing *In re* Iridium Operating, LLC, 478 F.3d 452, 461 n.13 (2d Cir. 2007)).

[248] Scott, *Promise, supra* note 27, at 119 (citations omitted).

ing are about as formal as one can get. On the other hand, chapter 11 creates what Marc Galanter might call a "litigotiation"—a process of "contesting claims in the vicinity of courts, where recourse to the full process of adjudication is an infrequent occurrence but at every stage an important option and threat."[249] Most of the important decisions about chapter 11 are negotiated privately, through processes that are largely informal. These negotiations will have many of the characteristics found in contracting environments generally: repeat players will have different incentives than one-shot participants. Some participants prefer more aggressive tactics; others more conciliatory ones.

As relationalists would predict, preferences for formality adjust inversely to levels of trust. This seems especially true when the loss of trust becomes outright hostility. The *Fibermark* bankruptcy offers an example of relationships gone awry.

> Silver Point L.P., a hedge fund that traded in distressed debt, was invited to join the official creditors' committee after it acquired a large position in FiberMark's public notes. The committee was, according to the report of examiner Harvey R. Miller, dominated by another creditor, AIG Global Investment Corp., and its workout specialist, Mark Musante. Conflicts between Silver Point and AIG resulted in significant and costly disruptions, including allegations (unsubstantiated) that Silver Point engaged in illegal trading in FiberMark claims. According to Miller, committee members "resort[ed] to strategic litigation based upon doubtful claims . . . [which] further inflamed an already counterproductive environment to the detriment and prejudice of the reorganization process and the interest of creditors other than AIG . . . and Silver Point." The FiberMark examiner estimated that the delay caused by these fights reduced the value of distributions to creditors by almost sixty million dollars.[250]

The mix of formal and informal mechanisms used in chapter 11 contracting will reflect and refract the bargaining goals of the parties. What starts as a negotiation may rapidly become a litigation. Litigations are generally more costly than negotiations. Yet, litigations have procedural virtues of

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[249] Marc Galanter, *The Regulatory Function of the Civil Jury*, *in* VERDICT: ASSESSING THE CIVIL JURY SYSTEM 61, 69 (1993) ("litigotiation" is the "strategic pursuit of a settlement through mobilizing the court process."); Marc Galanter, *Worlds of Deals: Using Negotiation to Teach About Legal Process*, 34 J. LEGAL EDUC. 268, 268 (1984). *See also* Marc Galanter & Mia Cahill, *"Most Cases Settle": Judicial Promotion and Regulation of Settlements,* 46 STAN. L. REV. 1339, 1340–42 (1994) (arguing that bargaining in the shadow of the law, or "litigotiation," is what actually occurs in civil cases). Surprisingly, I find only one bankruptcy paper mentioning the term, despite its obvious descriptive (and euphonious) merits. Andrea Coles-Bjerre, *Bankruptcy Theory and the Acceptance of Ambiguity*, 80 AM. BANKR. L.J. 327, 344 n.49 (2006).

[250] Lipson, *Shadow Bankruptcy*, *supra* note 16, at 1649–50 (citations omitted).

transparency and reasoned decision-making that may be absent from negotiation. Neither is a perfect mechanism, and so, like Judge Merhige in the *Westinghouse* case, we find both at work in chapter 11 contracting.

C. Timing

A final, critical aspect of the contracting environment will reflect temporal preferences. As noted, some view bankruptcy largely as an end-game. But this will be true only when stakeholders are cashed out with cash, which may occur under a post-sale chapter 11 plan. But it is equally plausible that the distributional "pot" will contain cash as well as securities of the purchaser of the debtor. To the extent those securities are distributed to prebankruptcy stakeholders, they will retain an ongoing-relationship with the company.

Participants who anticipate some ongoing relationship with respect to a particular debtor are therefore likely to think about the informal consequences of their formal actions. The plan may, for example, provide higher and better treatment (and thus, effectively higher priority) for companies with which the debtor must continue to do business. The reorganization plan can classify these claimants in a way that permits this, and courts seem largely tolerant of it, on relationalist grounds.[251]

Perhaps the most serious temporal problem from a relationalist perspective is the demand for speed. There is little doubt that pacing affects bargaining, and the pace of chapter 11 has increased in two ways. First, through claims trading, distress investors are often not a debtor's original lenders, but instead purchase defaulted claims against the debtor.[252] Although the Bankruptcy Code has some rules regarding claims trading,[253] I have elsewhere argued that this has created an unregulated secondary securities market.[254] It appears that claims against debtors trade at a pace that is difficult to determine because the trades are not public. There is some reason to believe that trading can occur quite quickly, however, so that stakeholders dissatisfied

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[251] *See, e.g.*, *In re* Johnston, 21 F.3d 323, 328 (9th Cir. 1994) ("Steelcase's separate classification under the Johnston plan does not violate § 1122(a)."); *In re* Jersey City Med. Ctr., 817 F.2d 1055, 1060–61 (3d Cir. 1987) ("The express language of this statute explicitly forbids a plan from placing dissimilar claims in the same class; it does not, though, address the presence of similar claims in different classes. Although the legislative history behind § 1122 is inconclusive regarding the significance (if any) of this omission, it remains clear that Congress intended to afford bankruptcy judges broad discretion to decide the propriety of plans in light of the facts of each case."); *In re* Texas Star Refreshments, LLC, 494 B.R. 684, 696 (Bankr. N.D. Tex. 2013) ("TSR's trade vendors, in addition, have an interest in continuing to sell their products to TSR, just as TSR has a business need to continue purchasing their products. The separate classification of trade vendors from CFG is reasonable and proper.").

[252] Lipson, *Shadow Bankruptcy, supra* note 16, at 1638–1648.

[253] *See* FED. R. BANKR. P. 2019.

[254] Lipson, *Shadow Bankruptcy, supra* note 16, at 1645 ("Problems of identity are significantly magnified by the development of a robust secondary market for claims against, and interests in, distressed firms. This market exists to a significant extent as an unregulated securities market.").

with the pace or direction of a restructuring can likely find a buyer for their position.[255]

Second, distress investors appear to want chapter 11 cases to resolve quickly. This preference is evident in the rise of "prepackaged" plans of reorganization, which can be confirmed quickly because they are usually negotiated before case commencement,[256] as well as the rise of quick sales of assets in chapter 11. Jacoby and Janger have warned that the "need for speed" in reorganization is one of the system's greatest challenges.[257] Distress investors are the ones usually seeking to resolve cases quickly, so understanding their bargaining around case timing is important.

The need for speed is often driven by the need for cash. Distress investors are often organized as limited partnerships, meaning they are pass-through entities investing others' money. Investors in the distress funds may make liquidity demands (e.g., through redemption rights).[258] If, for example, Cerberus needs to cash out one of its investors, it may seek liquidity from its distress investments sooner than it may otherwise prefer.[259] Or, it might work the other way around: distress investors may claim to be subject to such pressure when they are not. Either way, liquidity demands will affect timing in ways that may be hard to predict. Relationalism would encourage system observers to understand the temporal constraints on participants.

V. Objections and Further Inquiry

There is little question that relationalism is an essential, if not dominant, tool in the contract analyst's kit. "We are all relationalists now," Robert Scott has observed.[260] Part IV sketched some of the features of chapter 11 contracting that affect the process, including the identities and characteristics

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[255] As noted in Part I above, this ability to find a buyer appears to have applied to the DIP financing in the *Colt* bankruptcy.

[256] As with all pre-bankruptcy negotiations, relationalism may help to explain the dynamics of prepackaged reorganizations. This Article reserves analysis of relationalism in prepackaged bankruptcies, and other aspects of prebankruptcy negotiations, for later consideration.

[257] Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 Yale L.J. 862, 926 (2013) ("[W]hen a sale of substantially all assets takes place under § 363 and outside the purview of the [c]hapter 11 plan process, the bankruptcy court should require the sale proponent(s) to post a bond or reserve a portion of the sale price to cover any damages suffered by the estate. We call this reserved fund the 'Ice Cube Bond.'").

[258] I have been told that "'Creditors want cash, so the market is affecting going concern values.'" Lipson, *Shadow Bankruptcy*, *supra* note 16, at 1662. Another lawyer put it more bluntly: "In the old days, people wanted to see two things: to get paid and to see the company survive. Today, people only want one thing: to get paid." *Id.* (quoting Telephone Interview with Private Investor No. 3 (July 14, 2009)).

[259] *Id.* at 1618 ("Today's private investors, however, may feel far greater pressure to cash out sooner, even if this destroys long-term value. To that end, they may acquire control (through claims trading) before bankruptcy and use that control to strip—and then flip—assets, rendering an otherwise viable firm incapable of reorganizing.").

[260] Scott, *Formalism, supra* note 23, at 852.

of the participants, and the bargaining environment in which they operate. Yet, like any theoretical framework, relationalism has both limits and opportunities. Part V briefly discusses both.

A. *Objections*

There are at least two important classes of objections to a relationalist analysis of contracting in chapter 11. The first is simply that relationalism is, to some, not a "theory" in a conventional sense because it offers no testable hypotheses.[261] "Theory," these scholars may argue, "requires a rigorous formulation of hypotheses based on formal modes of analysis that can be tested through equally rigorous empirical observations."[262] While it may be a collection of important insights into human behavior, it lacks the elegance and intellectual "hardness" of a theory such as Coase's predictions about bargaining entitlements (i.e., that parties would trade to the highest valuing user). For all its limitations, Coasean theory has had an enormous impact on legal theory in part because it appears to offer a testable hypothesis.

The response is simple: it depends on one's goals for a theory. More pure (e.g., economic) theories seek to predict future behavior based on intuitions about human behavior, not to explain the current state of the world. Relationalism seeks the opposite, to explain the world first in order to enable better decision-making about it in the future. It is less concerned with mechanisms that predict how such decisions will be made. Relationalists make granular observations that are unlikely to be captured in a single theory. "Economic" relationalists often subsume Coasean predicates in their analyses, but it would be difficult to claim that there is a single "relationalist theory" of contract. Rather, there are many theories built into this framework,[263] having to do not only with neoclassical economics, but also behavioral economics, institutional choice, and more pragmatic sociological approaches to legal environments that defy easy categorization. Relationalism is broader and more complex than traditional conceptions of legal theory. But, its capacity to capture and identify important features of a complex bargaining environment make it a more apt tool (or set of tools) than other available approaches.

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[261] *See, e.g.,* Scott, *Promise*, *supra* note 27, at 106 ("Fundamentalist economic relationalists scoff at the notion that any of those who have worked in the law and society tradition, including Macneil—who coined the term relational contract theory—deserve to be called 'theorists.'").

[262] *Id.* (citing Alan Schwartz, *Law and Economics Next?*, 105 Ill. L. Rev. 1531, 1537 (2011)).

[263] Elinor Ostrom explains that "[f]rameworks organize diagnostic and prescriptive inquiry. They provide the most general list of variables that should be used to analyze all types of institutional arrangements. Frameworks provide a meta-theoretical language that can be used to compare theories." Elinor Ostrom, Institutional Analysis and Development: Elements of the Framework in Historical Perspective, http://www.eolss.net/Sample-Chapters/C04/E6-99A-34.pdf.

Second, some may claim that chapter 11 does not create a "contracting" environment. The environments discussed above all arose more or less "organically," through the ordinary operation of the "market." Companies in chapter 11 were likely participants in their own, pre-bankruptcy contracting environments. Chapter 11, by contrast, is essentially a legal, not a market, construct. While certain forms of contracting appear to be increasingly important in chapter 11, it is fundamentally different from the bargaining arenas described by other relationalists.

The answer is: yes, but so what? Chapter 11 is different from other contracting environments for many reasons (among others, its contracts require judicial approval *ex ante*). But that does not mean it is not a contracting environment. Relationalists have not rigorously defined a "contracting environment," but it seems to refer not simply to the institutional features of the context (e.g., market versus judicial) but to the characteristics of the parties. If they are repeat players in a fairly contained environment who use varying mixtures of formal and informal mechanisms to develop and operationalize their promissory relations, they are in a contracting environment. In other words, the definition of contracting environment used in this Article looks not to its institutional source (limited only to markets), but instead to the characteristics of the participants in it. Indeed, relational contracting helps to explain chapter 11 precisely because the rise of distress investment now creates a relational environment that differs in important respects from other relational environments.

B. Opportunities—Further Inquiry

To view chapter 11 as creating a relational contracting environment creates opportunities for further study. This part briefly suggests some elements of such an agenda.

1. Methodology

A key challenge for relationalists has long involved choices of methodology. Because socio-relationalists eschew neoclassical economic modeling as an end in itself, they tend to prefer "thick" qualitative descriptions of particular cases or contexts. This preference often requires them to interview participants in cases, to obtain and interpret pleadings in cases, to look to media and industry publications about the case or context, and so on. By definition, the results of such anthropological investigations are not "reproducible" in a scientific fashion, as Epstein and King might require in traditional social science research.[264]

[264] *See* Epstein & Gary King, *The Rules of Inference*, 69 U. Chi. L. Rev. 1, 3 (2002). *See generally* Lee Epstein & Andrew D. Martin, An Introduction to Empirical Legal Research (2014).

Methodological choice presents special problems and opportunities in chapter 11. Much of what occurs in this context—especially priority-skipping contracts—requires judicial approval. Judicial proceedings are presumptively public. There is thus much rich material available to the analyst willing and able to review and code pleadings, transcripts, and so on.[265] Formality will often produce documentation that can be observed, catalogued, quantified, and analyzed with relatively little concern about selection bias.[266] That said, much of what really happens in this context—in particular, negotiations that lead to priority-skipping contracts—is informal and private. Thus, for example, if we want to know whether a deal among key investors in Case 1 was made based on an implicit agreement about a potential outcome in Case 2, we would be unlikely to learn that from pleadings. Repeat play in a judicial shadow will only sometimes reveal what is in the shadows. A relational theory of contract in bankruptcy will likely require a mix of methods to get at what is actually happening in the system.

2. *Assessing Outcomes*

An important debate in chapter 11 is about outcomes: does chapter 11 produce "good" or "bad" results?[267] Obviously, how one answers the question depends on one's definition of good and bad. I have tried to avoid making normative claims about the outcome effects of contracting in bankruptcy because I do think we yet know enough about it to make such judgments. That is, this Article is concerned with understanding and improving the bargaining environment in chapter 11, without a particular view about what results that environment should produce. A better bargaining environment may favor distress investors in some cases and other stakeholders in other cases. It is a process-based analysis, not one that focuses on outcomes. That said, certain bargaining characteristics will likely correspond with certain kinds of outcomes. If, for example, some parties do not participate in negotiations, there is no reason to think a contract resulting from those negotiations will account for the interests of the absent parties.

3. *Prebankruptcy Contracting*

Students of the chapter 11 system may wonder why this Article has not discussed relational aspects of "workouts" that almost certainly occur in

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[265] An example in a non-relationalist study is Lipson, *supra* note 148, at 1.

[266] "Selection bias" is "[a] systematic tendency on the part of the sampling procedure to exclude one kind of person or another from the sample." Christina L. Boyd, *In Defense of Empirical Legal Studies*, 63 Buff. L. Rev. 363, 367 (2015) (quoting David Freedman, Robert Pisani & Roger Purves, Statistics 335 (4th ed. 2007)). *See also* David M. Trubek, *Where the Action Is: Critical Legal Studies and Empiricism,* 36 Stan. L. Rev. 575, 580 (1984) (discussing problems of selection bias in empirical legal studies).

[267] *See, e.g.,* Lynn M. LoPucki, *Changes in Chapter 11 Success Levels Since 1980*, 87 Temp. L. Rev. 989, 989–92 (2015).

most cases prior to (or in lieu of) bankruptcy. As I have explained elsewhere, these are common and important events in the run up to a chapter 11 case.[268] Because distress investors are important repeat players in chapter 11, it is likely that they are important repeat players prior to bankruptcy. These investors may well agree among themselves, and with the debtor, about the debtor's reorganization in such a way that the chapter 11 process is a *fait accompli*. Prepackaged reorganization plans are perhaps the most overt example of this pre-bankruptcy contracting.

The response is: yes, that is correct. Prebankruptcy contracting should be studied for its relational aspects. This Article does not do so for three reasons. First, the commencement of a chapter 11 case does change legal conditions for a debtor and its stakeholders. Those conditions have an important effect on the mix of formal and informal elements of contracting in bankruptcy.

Second, I have argued elsewhere that chapter 11 cases impose on all participants in the process a kind of "institutional good faith."[269] This imposition requires participants in the process to behave differently toward the tribunal and one another than they would outside bankruptcy (of course, prior to bankruptcy, there may be no tribunal in the absence of a collection or similar lawsuit).[270] Through special ethical obligations imposed on professionals under the Bankruptcy Code, special oversight of the process by courts and special rules created by the Bankruptcy Code, the chapter 11 environment is likely to be different from the pre-bankruptcy environment. Both can have relational attributes, and both should be studied.

Third, and perhaps most pragmatically, I have chosen to defer consideration of relationalism in prebankruptcy workouts in order to keep this Article a manageable length. As I have noted elsewhere, pre-bankruptcy workouts have their own dynamics, and to discuss them here would overweight this Article, or shortchange their analysis, or both.

4. *Reorganization Plans*

Similarly, some may wonder why this Article does not discuss chapter 11 plans of reorganization. After all, they are the principal expression of the absolute priority rule, and deviations from priority often occur under them, in particular through so-called "gift plans."[271] These are plans of reorganization in which a senior class (e.g., secured creditors) "purchases" the sup-

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[268] *See generally* Lipson, *Governance in the Breach, supra* note 16.

[269] *See id.* at 1080–84

[270] *See id.* at 1082 ("Bankruptcy courts . . . use "good faith" as a way to preserve their integrity, and the integrity of the bankruptcy process. Viewed this way, good faith is really a way that courts (or, for that matter, other institutions) can channel behavior to conform to established policy goals.") (footnotes omitted).

[271] *Compare In re* SPM Mfg. Corp., 984 F.2d 1305, 1313 (1st Cir. 1993) (approving "gift" plan) *with In re* DBSD N. Am., Inc., 634 F.3d 79 (2d Cir. 2011) (declining to approve such a plan because it violated APR).

port of a junior class (e.g., unsecured creditors) for a plan by contributing some of the seniors' entitlement to the juniors. Courts are divided on whether, or to what extent, such plans are permissible.

Reorganization plans are often viewed as "contracts," and there is no reason to think that relationalist insights would be inapplicable to them. Yet, as with pre-bankruptcy workouts, a full-blown relational analysis of reorganization plans could fill an entire paper. In part, this is due to the complex rules that govern both the process and substance of reorganization plans. Reorganization plans are, for example, subject to somewhat complex rules (and practices) regarding disclosure about the plan,[272] voting on it,[273] and the actions the plan can (and cannot) take.[274] Each element introduces features that may affect the contracting behavior of parties in the process. These, in turn, will have important relational implications. Their complexity both suggests that they are, in some important (formal) ways, different from conventional contracts and that they are likely to warrant somewhat different analysis.

Moreover, and perhaps more disturbing, is the possibility that phenomenon such as the roll-up and the structured dismissal, discussed at length in Part I, will render reorganization relatively unimportant. The real effect of those types of contracts may be that distress investors will contract out of the procedural protections of chapter 11 plans, to the detriment of stakeholders who do not participate in the bargaining process (participation that would be somewhat more likely under a plan).

5. *Relational Contracting and the Future of Chapter 11*

There are growing calls to amend chapter 11 of the Bankruptcy Code.[275] In some cases, proposed amendments would address the kinds of bankruptcy contracting discussed here, roll-ups and structured dismissals. While it seems plausible that Congress could amend the Bankruptcy Code in ways that "level the playing field," that seems unlikely. Similarly, one could imagine that the Supreme Court, as the ultimate judicial authority overseeing bankruptcy courts, could produce change, including in response to concerns about contracting in bankruptcy.

The problem is that neither Congress nor the Court has shown great understanding or appreciation of the chapter 11 system, or bankruptcy in general. Rather, it is highly likely that any effort to amend the Bankruptcy Code today would be as fraught with cronyism as were the 2005 amendments to the Bankruptcy Code that have been decried for their ineptitude and

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[272] *See* 11 U.S.C. § 1125 (on "disclosure statements" that accompany proposed plans).

[273] *See* 11 U.S.C. §§ 1122, 1126 (on rules governing the classification of claims and interests, and voting by such classes on a plan).

[274] *See* 11 U.S.C. §§ 1123, 1124, 1129 (setting forth mandatory and permissive elements of reorganization plans).

[275] See *supra* sources and text accompanying note 20.

bias.[276] Similarly, controversial opinions about the scope of bankruptcy court power such as that in *Stern v. Marshall* have left some observers wondering whether the Court takes bankruptcy seriously.[277]

If we can trust neither Congress nor the Court to make appropriate changes to chapter 11, that leaves contract. A comparative institutional analysis of this hypothesis—that contracting is a better governance mechanism than Congressional or judicial interventions—is beyond the scope of this Article. Yet, if contracting in bankruptcy is the trend it appears to be, then getting that right may be the best we can do given other "imperfect alternatives," in the words of Neil Komesar.[278]

6. *Relationship to Relational Contracting Theory*

A subsidiary theme in this Article has been that chapter 11 creates a contracting environment that differs from other contracting environments by virtue of the relatively high salience of formal law created by the process. This, in turn, should have implications for the study of contracting elsewhere. If we want better insight into preferences for formality, contracting in bankruptcy is a good context to study because it provides special opportunities (and demands) for formality not present in other contracting environments. Thus, "contracting" in the context of marriage or divorce, "deferred prosecution agreements" for corporate wrongdoers, and consent decrees in public law litigations may all have relational aspects in common with chapter 11 that enrich our understanding of the agreements produced by those processes. That is, contract in bankruptcy is not only about bankruptcy, but is and should also be about contract.

Conclusion

To understand the chapter 11 reorganization process in relational contracting terms is to see it in a different way than scholars or system participants currently view it. Yet, its relational aspects—the repeat play among a small group of sophisticated actors with varying preferences for mixtures of formal and informal promissory mechanisms—are undeniable. Thus, the important question for future study is: how best do we explore these relationships, and what normative judgments will we make as we learn more? This Article has begun to sketch a relational framework for chapter 11, focusing on the incidence and implications of such contracts for judges who must decide whether to approve them. Yet, it would appear that there is the potential for a fruitful relationship between a relational theory of contract and our

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276 Lipson, *Debt and Democracy*, *supra* note 21, at 624–37.

277 *See generally* Lipson & Vandermeuse, *supra* note 144.

278 Neil K. Komesar, Imperfect Alternatives 5 (1994) ("The choice is always a choice among highly imperfect alternatives.").

understanding of the chapter 11 system. Studying contract *in* bankruptcy, in other words, can help us better understand contract *and* bankruptcy.