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THE FRAUDULENT CONVEYANCE ORIGINS OF CHAPTER 11: AN ESSAY ON THE UNWRITTEN LAW OF CORPORATE REORGANIZATIONS

Douglas G. Baird[*]

It might be possible to have a law of corporate reorganizations in which a judge or bureaucrat imposed a new capital structure by fiat, but our law of corporate reorganizations relies on creditors (and the professionals who work for them) to sit down at a conference table and forge a new capital structure themselves. The law's ambition is to make these negotiations possible. In large part for this reason, the way the Bankruptcy Code (Code) operates cannot be easily reconciled with conventional understandings of how statutes are supposed to work.

Negotiations are the lifeblood of bankruptcy practice, but the Code says little about how they are to be conducted. Instead, the bankruptcy judge enforces a set of largely unwritten rules.[1] Some logrolling and give-and-take are permissible, while other sorts of side deals are out of bounds. These are well-known to insiders, but largely invisible to those on the outside. This essay explores how reorganization's unwritten rules have evolved and tries to make sense of them.

Rather than a dispenser of Solomonic wisdom, the bankruptcy judge is like a referee. A good referee ensures that the rules of the game are followed. Some rules are set out with mechanical precision, but many others are not. Negotiations must be kept on track, and doing this requires enforcing principles that lie within the interstices of the Code. These unwritten rules have developed over time, and they grow out of a small handful of ideas that emerged in the early days of the republic.

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[*] Harry A. Bigelow Distinguished Service Professor, University of Chicago Law School. This essay sounds themes on the history of corporate reorganizations that echo those in a larger work that will appear soon. DOUGLAS G. BAIRD, THE UNWRITTEN LAW OF CORPORATE REORGANIZATIONS (forthcoming 2021). Many of the ideas presented here were first developed in work with Tony Casey, Ed Morrison, Randy Picker, and most especially Bob Rasmussen, and I am much indebted to them. I am also grateful to the Frank Greenberg Fund for research support.

[1] Experienced restructuring professionals might claim that many of the rules I characterize as "unwritten" can be derived from reported opinions. One can argue that, to this extent, they are not "unwritten." Fair enough. Even here, however, it is a mistake to think that the law is especially accessible to outsiders. For example, professionals commonly invoke *In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004), for the idea that debtors have the ability to pay critical vendors, and they point to Committee of Equity Security Holders v. Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983), for the idea that going-concern sales are permissible. This would come as a surprise to someone who was not part of the restructuring world, as the two opinions explicitly forbid the practices under the facts before them, and *Kmart* does not even allow that paying critical vendors is ever possible.

I. JUDICIAL OVERSIGHT AND THE STATUTE OF 13 ELIZ

The key question in the law of corporate reorganizations is one of construing the inherent power of the court to oversee the process. This equitable power derives from a general principle that was already deeply embedded in the law by the end of the eighteenth century: debtors cannot make transfers with the intent to "hinder, delay, or defraud" creditors.[2]

"Hinder, delay, or defraud" first appeared in a statute Parliament passed in 1571, the thirteenth reginal year of Queen Elizabeth.[3] This statute came to be cited in American courts as shorthand for the court's equitable power to review a distressed debtor's transfer of property. Eventually, these principles would be extended to crafting plans of reorganization in an equity receivership.[4] At the outset, however, the statute reached only the most obvious abuses.

In the first instance, the Statute of 13 Eliz. c. 5 was aimed at sham transactions.[5] A debtor attempts to thwart creditors by pretending to transfer assets to friends or relatives before absconding. The debtor plans to return and enjoy the assets once again once creditors lose interest. The statute was always understood to give the court the power to void such transfers, empowering creditors to seize the assets from the friend or relative just as if they were still in the hands of the debtor.[6]

The statute's reach, however, soon expanded beyond merely prohibiting out-and-out fraudulent transfers. The first inflection point came in *Twyne's Case* in 1602.[7] *Twyne's Case* held that, in addition to transactions involving actual fraud, the Statute of 13 Eliz. empowered the court to strike down any transactions that had "badges of fraud."[8] Badges of fraud came to be understood as indicia that a transaction was not an arm's-length deal in the marketplace.[9] A transaction was done secretly. There was no reasonably equivalent value. There was no physical transfer of assets. A transaction did not serve an economic purpose. Such

[2] *E.g.*, 11 U.S.C. § 548(a)(1)(A) (2019).

[3] Statute of Elizabeth, 13 Eliz., ch. 5 (1571).

[4] *See, e.g.*, Pepper v. Litton, 308 U.S. 295 (1939) ("The findings of the District Court, amply supported by the evidence, reveal a scheme to defraud creditors reminiscent of some of the evils with which 13 Eliz. c. 5 was designed to cope.").

[5] *See* Statute of Elizabeth, 13 Eliz., ch. 5 (1571).

[6] *See id.*

[7] For a brilliant analysis of the case and the circumstances out of which it arose, see Emily Kadens, *New Light on* Twyne's Case, 94 AM. BANKR. L.J. (forthcoming 2020).

[8] *See* GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §§61–61e (Baker, Voorhis & Co. rev. ed. 1940).

[9] *See id.*

transactions and many others possessed badges of fraud.[10] A transaction could "hinder, delay, or defraud" creditors even when there was no proof of the deceit that is essential to bringing an action for common law fraud.[11]

Over time, courts acquired the ability to review any transaction and decide whether it violated the rights of creditors.[12] It was already plain by the end of the eighteenth century that a transaction was not insulated from scrutiny merely because a third party acted with the debtor entirely in good faith. In the 1770s, Lord Mansfield, the greatest commercial law judge of his (or perhaps any) era, confronted a case that raised the question of whether creditors could challenge a transaction in which the only property that left the debtor's hands went to a third party who acted entirely honorably.[13]

The case involved a person who loaned a friend a large amount of money in order to help him sort out his business affairs.[14] Just a few days after he received the loan, however, the friend realized that he could no longer save his business.[15] The friend returned the money and then fled to France.[16] The creditors started a bankruptcy proceeding and sought to recover the repayment.[17] The loan had been made in good faith, and the lender's behavior was impeccable.[18] But Lord Mansfield held that this payment was void nevertheless.[19]

In the case before him, Lord Mansfield willingly conceded, the creditor was "very meritorious."[20] But this was of no moment. Allowing debtors to pick and choose among creditors when bankruptcy is imminent undermines the bankruptcy process, as bankruptcy is a regime in which assets are distributed pro rata. A transfer a debtor makes just before absconding therefore bears a badge of fraud. There is no actual fraud, but such a preferential payment nevertheless "hinders, delays, and defrauds" other creditors within the meaning of the Statute of 13 Eliz.

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10 As Justice Cardozo explained in Shapiro v. Wilgus, 287 U.S. 348, 354 (1932), "A conveyance is illegal if made with an intent to defraud the creditors of the grantor, but equally it is illegal if made with an intent to hinder and delay them."

11 *See id.*

12 Burd v. Smith, 4 Dall. 76 (1802).

13 *See* Harman v. Fishar, 98 Eng. Rep. 998 1 Cowp. 118, 122 (1774).

14 *Id.* at 998.

15 *Id.*

16 *Id.*

17 *Id.*

18 *Id.* at 1000.

19 *Id.* at 1001.

20 *Id.* at 1000.

Lord Mansfield's case, *Harman v. Fishar*, was connected with an impending bankruptcy, and it provided the wellspring for the power the trustee enjoys today to recover payments made to creditors on the eve of bankruptcy.[21] But the reasoning in the case was not limited to transfers made when bankruptcy is imminent. The case also established a more general principle. Financially distressed debtors had to cut square corners. A payment of a completely legitimate debt could violate the rights of creditors, even if no bankruptcy was in the offing.[22]

A case involving a financer whose fortunes collapsed in the 1790s shows the reach of this principle. Blair McClenachan transferred his land to several men to hold in trust for the benefit of his creditors.[23] On the face of it, McClenachan, far from evading creditors, was putting in place a mechanism to pay them. Moreover, the Court found that the facts "acquit Mr. McClenachan of any intentional, or mental, fraud."[24]

Most significantly, in distinct contrast to the case before Lord Mansfield, McClenachan was not trying to distort bankruptcy's rule of pro rata distribution as there was no bankruptcy law in place in the United States at the time.[25] In assessing McClenachan's behavior, the court recognized that, in the absence of a bankruptcy law, a preference, even when a debtor is distressed, was unobjectionable.[26]

Nevertheless, the Court found that the transfer of land was ineffective.[27] Various things McClenachan failed to do—such as call a meeting of his creditors or create a schedule of his assets or make some of the creditors trustees or explain to them how he would go about distributing the assets—suggested that McClenachan set up the trust as a way to defeat those who were about to secure judgments against him.[28] There were enough badges of fraud to require voiding the transaction. McClenachan could not purport to create a vehicle for paying off some creditors if he did it in order to undermine the rights of other creditors.[29]

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21 *See* 11 U.S.C. §547 (2019). For the canonical analysis of the evolution of preference law, *see* Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3 (1986).

22 *See Harman*, 98 Eng. Rep. at 1001.

23 Burd v. Smith, 4 Dall. 76 (1802).

24 *Id.* at 86.

25 The transfer took place in September 1797, and Congress did not pass its first bankruptcy statute until 1800. *See* Act of Apr. 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803).

26 *Burd*, 4 Dall. at 86–87.

27 *Id.* at 87–88.

28 *Id.* at 93.

29 *Id.* at 89.

As one of the justices explained:

> I cannot conceive [anything] more dangerous, than to sanction by a judicial determination, a deed of this description. It will be vesting the debtor with unlimited power at all times over his property, to baffle his creditors, under the specious pretext of paying them.[30]

This case is one of the earliest instantiations of the idea that assignments for the benefit of creditors are themselves subject to judicial scrutiny. The judge has a general mandate to assess the conduct of the parties engaged in such transactions and look for badges of fraud. The judge has the power to strike down transactions that are designed to undermine the rights of one or more of the creditors.

The Supreme Court applied this principle to an equity receivership—the most direct predecessor to modern chapter 11—in *Chicago, Rock Island & Pacific Railroad Co. v. Howard* in 1868.[31] The Mississippi & Missouri Railroad was hopelessly insolvent.[32] By all accounts, there was not enough value to pay its senior creditors in full.[33] The senior creditors wanted to foreclose on the railroad's assets and sell them to a third party, but those in control of the railroad could put numerous obstacles in their way.[34]

The senior creditors wanted to clear a smooth path to a sale so they reached a deal with those who controlled the debtor.[35] The senior creditors agreed to give some of the proceeds of the sale to those in control of the railroad in return for their promise of cooperation.[36] The buyer of the railroad would pay most of the consideration to the senior creditors, but some would go to the shareholders of the old corporation.[37] Meanwhile, the general creditors of the old corporation would be left with nothing.[38]

The Supreme Court had little difficulty finding that the general creditors of the Mississippi & Missouri were entitled to the proceeds that the buyer of the railroad was to give to the old shareholders.[39] The money the buyer promised to the shareholders was in the first instance an asset of the corporation, and, as

[30] *Id.* at 89.
[31] *See* R.R. Co. v. Howard, 74 U.S. 392 (1868).
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.* at 415–16.

between the shareholders and the general creditors, the general creditors were entitled to the corporation's assets first.[40] To be sure, the case would have been utterly different if the senior creditors had foreclosed without any help from the shareholders. The amount realized from the foreclosure sale would not have been enough to pay the senior creditors in full, and hence these senior creditors could have kept all of it. But matters changed when they brought the debtor into the picture. Any proceeds of the sale that did not go to the senior creditors had to go first to the creditors of the debtor.[41]

To understand the breadth of the principle at work, it is important to see that the same problem would arise if the transaction had been structured differently. Assume that, instead of the buyer agreeing to pay part of the consideration for the railroad to the old senior creditors and the other part to the old shareholders, the buyer had promised to give the entire consideration to the senior creditors, and the senior creditors then made a separate promise to the shareholders to share some of it with them.

Because the senior creditors were owed more than the value of the land, they were entitled to the entire consideration received from the sale. Once they had it, they were, it might seem, free to give any part of it to whomever they pleased. There would be no property *of the debtor* that flowed to the shareholders and skipped the creditors. But this should make no difference. As the case involving Blair McClenachan illustrated, courts had long established that even legal processes that were otherwise regularly conducted could be reviewed for badges of fraud.[42] It was enough that the debtor was involved in a process in which some creditors were paid and others were not.[43]

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[40] *Id.*

[41] The Supreme Court relied in *Howard* on Wood v. Dummer, 30 F. Cas. 435 (No. 17,944), 437–39 (C.C.D. Me. 1824). For an excellent account of this case, *see* Norwood P. Beveridge Jr., *Does a Corporation's Board of Directors Owe a Fiduciary Duty to Its Creditors?*, 25 ST. MARY'S L.J. 589, 595–600 (1994). In *Wood*, Justice Story held that the capital of a corporation that was liquidating was held by the corporation in trust for the benefit of the creditors. *Wood* is usually regarded as an evolutionary dead end. Its conception of invested capital as being held by the corporation in trust is out of step with modern thinking about corporate law. But the trust language in *Wood* is something of a red herring. The finding that there was a trust worked no special magic. To be sure, the business was solvent at the time of the distribution, but leakage of value to shareholders when a corporation is wrapping up is itself a badge of fraud. It requires no notions of trust law to find that distributions from a liquidating firm to its shareholders that put its ability to pay creditors at risk are problematic. Bruce Markell underscores this point in his masterful discussion of the evolution of the absolute priority rule. *See* Bruce A. Markell, *Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 74–77 (1991); *see also* Jerome N. Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 VA. L. REV. 541, 569 (1933).

[42] *See* Burd v. Smith, 4 Dall. 76 (1802).

[43] *Id.* at 88.

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It is the process as a whole that is subject to scrutiny. Courts had the power to review everything that went on. If square corners were cut, all was well and good. But if the entire process was in any way irregular, the court could strike it down. It was the assignment, the receivership, or any other procedure involving a debtor and its creditors as a whole, not any particular transfer to or from the debtor that was subject to oversight. But exactly what sort of oversight was appropriate in the specific context of a corporate reorganization took time to work out.

II. A SEAT AT THE TABLE

The equity receivership took the same form as an assignment for the benefit of creditors. In both cases, assets were put up for sale. The sale in an equity receivership, however, was largely a fiction. The holders of the senior securities would credit bid their claims. After the "sale," the senior protective committee owned all the assets of the railroad.[44] In theory, the senior committee could do with them whatever it pleased, but in virtually every case the senior committee promised in advance to give some shares in the reorganized railroad to junior stakeholders who participated in the reorganization.

The standard equity receivership is not so different from what happened in *Howard*. In both cases, there is a sale and the old shareholders ended up with a stake in the firm while some of the creditors were left out in the cold. It might seem that if *Howard* possessed badges of fraud, the typical equity receivership did as well. Many equity receiverships, however, proceeded without much thought given to distinguishing them from *Howard*.

The lawyers for investment bankers who orchestrated the receiverships dismissed the idea that they bore badges of fraud out of hand. Victor Morawetz, the preeminent reorganization lawyer at the predecessor firm to Cravath, addressed exactly this question in the treatise he wrote on corporate law.[45] In his treatise, Morawetz drew a sharp distinction between two sorts of transactions. If a corporate debtor transferred assets to a new entity in a manner that effected a fraud on the rights of the existing creditors, then the existing creditors could, of course, reach the assets in the new corporation.[46] On the other hand, if the assets were sold outright in good faith to a new entity, then the creditors of the old

[44] *See Howard*, 74 U.S. 392; *Burd*, 4 Dall. 76.

[45] *See* VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS (2d. ed. 1886).

[46] *See id.* at 779–921.

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corporation could look only to the proceeds of the sale that the old corporation received.[47] Equity receiverships are transactions of the second sort.[48]

Morawetz's position in his treatise was not on its face different from that of Lord Mansfield or even the court reviewing McClenachan's maneuvering once one concluded that equity receivership was a transaction done without badges of fraud. But this merely states the conclusion. Morawetz argued that that badges of fraud were absent because an equity receivership was completely above board.[49] A reorganization in which the stakeholders formed committees and negotiated with each other and agreed on a plan was completely transparent.[50] As long as the sale was done under the auspices of a court and the debtor had not engaged in mischief, it was entirely unobjectionable.[51] Indeed, because the receivership put the business back on a sound footing and the value of everyone's stake remained the same, this process, far from bearing badges of fraud, was entirely salutary.[52]

In the typical railroad receivership, the only ones given a seat at the bargaining table were those stakeholders who were to be part of the business going forward. If the reorganized railroad was not going to use a spur line that was owned by a wholly owned subsidiary, the creditors of that subsidiary could be left out, even if the parent corporation had guaranteed the loans. To be sure, the guarantees did make the subsidiary's bondholders junior creditors of the parent. But the senior bondholders who bought the railroad at the foreclosure sale with a credit bid had no legal obligation to share the proceeds with those junior to them, and their norms required them to share only with those who had invested in the assets of the railroad that were to stay with the business.

The bondholders of these subsidiaries who were frozen out sometimes complained. When they did, they invoked the same fraudulent conveyance principles that the creditors of Blair McClenachan and the Mississippi & Missouri invoked. These creditors lost in the lower courts. Courts deferred to the investment bankers and other professionals in deciding whether a particular creditor was entitled to participate in the reorganization. There was nothing objectionable about a reorganization plan "unless it can be said that it was a scheme to defraud creditors."[53] There were no badges of fraud when

[47] *See id.*
[48] *See id.*
[49] *See id.*
[50] *See id.*
[51] *See id.*
[52] *See id.*
[53] Paton v. N. Pac. R. Co., 85 F. 838, 842 (C.C.E.D. Wis. 1896).

professionals were negotiating with investors who were part of the railroad's future and leaving out those who were not. The transaction was designed to restore the railroad to sound financial health. In doing this, the investment bankers and professionals exercised their best judgment about the sensible boundaries of the firm going forward.

Judges supervise the reorganization, but judges do not dictate the outcome of the bargaining. The creditors craft a plan according to whatever norms constrain them. The court does not intervene as long as there is nothing underhanded about the way the plan is forged. Among other things, the court is simply not competent to craft details of a plan of reorganization. In an equity receivership, investment bankers and other professionals did the heavy lifting, and they had the incentive to do right by the stakeholders as a group.

That the bondholders of the subsidiary had formal legal rights against the railroad before the receivership began was neither here nor there. As a technical matter, they were junior to the senior bondholders who bid at the foreclosure sale. In the absence of any topping bid, they had no legal right to receive anything. Hence, they had nothing to complain about when they received only what the norms of the investment bankers allowed. And as far as the norms of the investment bankers were concerned, the subsidiary was not part of the firm on a going-forward basis, so its bondholders were not entitled to share in the value of the reorganized firm.

At the end of the nineteenth century, however, the Supreme Court muddied the waters. Before it came the receivership of the Louisville, New Albany & Chicago Railway Company, commonly known as the *Monon*.[54] The railway had guaranteed bonds of a subsidiary.[55] The bondholders of the subsidiary sought to hold the parent to the guarantee, but before they could vindicate their rights in court, the railway persuaded a general creditor to put it into receivership.[56] There was a foreclosure sale, and the claims of the bondholders on their guarantee were wiped out.[57]

The Supreme Court refused to uphold the sale.[58] It remanded to the lower court to see if the receivership was a scheme to defeat the rights of general

[54] *See* Louisville Tr. Co. v. Louisville, N.A. & C. R. Co., 174 U.S. 674 (1899).
[55] *Id.*
[56] *Id.* at 682.
[57] *Id.* at 683–84.
[58] *Id.* at 688–89.

creditors.[59] If it was, the sale could not stand.[60] The Court found that the lower court had not given the railway's reorganization plan the kind of scrutiny that was required.[61] Once judges are called upon to oversee a receivership, they cannot be idle spectators. They have to ensure that the receivership is not part of a scheme to hinder, delay, or defraud creditors. In its view, a judge should "never rightfully become the mere silent registrar of the agreements . . . ."[62]

In its opinion, the Court held that judges must draw a distinction between the right of the senior bondholder "who has acquired absolute title by foreclosure to mortgaged property to thereafter give of his interest to others"[63] and an illegitimate attempt on the part of the senior bondholder "to destroy the interest of all unsecured creditors, to secure a waiver of all objections on the part of the stockholder, and consummate speedily the foreclosure . . . ."[64]

This case left professionals like Morawetz uneasy, but they believed Monon distinguishable from the typical equity receivership. The Monon went through the receivership only because the parent corporation was trying to thwart the bondholders of a subsidiary who held guarantees. A transfer, even to a completely legitimate creditor, can be struck down if the purpose of the transaction is to thwart the rights of other creditors. The court held this in *Burd v. Smith*, and Morawetz said as much in his treatise.[65] Morawetz pointed to the motive behind the actions of the debtor in *Monon* to set it apart from the standard reorganization.[66] *Monon* involved a deliberate effort to thwart a creditor group. The typical equity receivership did not. *Monon* might require courts to give greater scrutiny to reorganization plans, but this did not work a sea change. It was one thing to insist on giving the reorganization process greater scrutiny to ensure that it was not a scheme to deprive creditors of their rights and quite another to intrude into responsible decision-making by investment bankers and other professionals.

The standard equity receiverships were not begun in order to freeze anyone out. The railroads that entered into receiverships would do so whether or not there were subsidiary bondholders with guarantees against the parent. If there were such bondholders, the treatment they received would be a consequence of

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[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *See* Burd v. Smith, 4 Dall. 76 (1802); MORAWETZ, *supra* note 44; *Louisville T.R. Co.*, 174 U.S. 674.
[66] MORAWETZ, *supra* note 44; *see Louisville T.R. Co.*, 174 U.S. 674.

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charting the best course for the railroad going forward. If the subsidiary was to be part of the railroad going forward, these bondholders would be part of the negotiations. But if those in control of the reorganization decided that, as a sound business matter, a particular stretch of track did not belong inside the firm, then the investors in that line were out of luck. This was as it should be. If the business no longer included the assets in which the bondholders invested, they were not part of its future. Hence, they were not entitled to a seat at the bargaining table.

It was against this background that the Supreme Court's most important equity receivership case, *Northern Pacific Railway Co. v. Boyd*, must be read. The creditor who complained was not an investor at all, but rather the assignee of an unpaid supplier.[67] He took more than a decade to establish his claim against a spur line.[68] More to the point, he had not been harmed by the reorganization.[69] The receivership had been regularly conducted, and the assets were found to be insufficient to pay the senior creditors in full.[70] None of the value that the secured creditors chose to give to the old shareholders was tainted with any badge of fraud.[71]

The *Boyd* Court did not deny that the senior creditors could do with their share in the railroad what they pleased, but this argument was not a showstopper.[72] The foreclosure sale, as everyone knew, was just a legal device to allow bargaining to take place under a judicial umbrella. As long as the shareholders were participating, the courts had to ensure that the process rights of every creditor were respected. As soon as the senior creditors started bargaining with the shareholders, they lost the ability to ignore general creditors. It is not enough merely to examine the intent of those participating in the reorganization process. It is irrelevant that the purpose of the reorganization was not to freeze out creditors like Boyd. Those in charge had no right to pick and choose who to include in the negotiations. Everyone had a right to a seat at the table.

The equitable principle that the court invoked against McClenachan had evolved by the time of *Boyd*. The courts no longer looked merely at whether the debtor was trying to thwart creditors. It did not matter whether the motive behind the transaction was bad. In order for a reorganization to alter the rights of

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[67] *See* N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913).
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.* at 510.

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creditors, the affected creditors had to be given a chance to come to the bargaining table and participate in the reorganization process. Referees must ensure all the players can enter onto the field.

Boyd is sometimes singled out as a harbinger of the absolute priority rule, but this fundamentally misunderstands what it was about. The Court did not mandate that Boyd receive any particular substantive entitlement. Boyd, like everyone else, would receive whatever emerged from the bargaining process. As the Court explained, "If [a general creditor] declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it."[73]

Boyd is not about priority rights or the distribution of property from the estate. Instead, it continues a long line of cases that focus on the sort of oversight that a judge must give to a reorganization. Before *Boyd*, a consensus among professionals had emerged that the judge's job was merely to ensure that those engaged in the plan formation process were not intentionally trying to undermine other creditors. In *Boyd*, the Court made it clear that this was not enough. A judge supervising a reorganization had an affirmative obligation to ensure that everyone had a chance to participate in the bargaining process on fair terms.[74] A failure to do this would give excluded creditors the ability to invoke fraudulent conveyance principles.

The Supreme Court in *Boyd*, however, left open the question of what it means to participate in the bargaining process and how the judge should go about policing the behavior of the parties to the negotiations. The principles of fraudulent conveyance law that mandated the scrutiny were still evolving, and they went through tectonic changes with the arrival of the New Deal.

III. THE EMERGENCE OF THE MODERN BANKRUPTCY JUDGE

Two reorganization scholars from the Yale Law School came to Washington to help implement the New Deal, and they brought with them their own distinct conception of the law. William O. Douglas and Jerome Frank were young Turks who set themselves apart of the white shoe crowd on Wall Street. They did not trust investment bankers and their lawyers to do right by investors. Central to their conception of reorganizations was the steady hand that the judge was to

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[73] *Id.* at 508.
[74] *See id.* at 482.

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hold on the tiller. Frank himself identified *Howard* as the seminal case that captured the way that fraudulent conveyance principles animated the law.[75]

The lawyers who succeeded Morawetz continued to believe that judges should only ensure that there was no deceit or underhanded dealings by the debtor.[76] By their account, *Boyd* did not fundamentally change the landscape. It merely ensured that everyone had a seat at the table. William O. Douglas and his fellow New Dealers disagreed. They believed that judges should do more. They should hold the reins and direct the process. Those who negotiated with one another in a corporate reorganization could not be trusted to bargain in such a way that everyone's interest was protected. In the case of the reorganization of large firms, one had to be especially wary of the risk that, left to their own devices, insiders systematically harmed small public investors. The judge had to apply the principles of the Statute of 13 Eliz. c. 5 more aggressively, insist on full disclosure, and be quick to act if the potential for advantage-taking arose.

Douglas and Frank believed that the judge had broad powers, an idea Douglas articulated after he was appointed to the Supreme Court in *Pepper v. Litton.*[77] The judge's powers had to be "invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." Hence, "[i]n the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate."[78]

Douglas and Frank both believed that bankruptcy judges should be broadly empowered—whether by designating votes, subordinating claims, disallowing claims, or otherwise sanctioning the parties—to do what was necessary to ensure that parties bargained in good faith. The judge had to protect the integrity of the process. To do this, judges had to know what was going on. Hence, disclosure was the first obligation of participants in the reorganization process, but only the first.

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75 *See* Frank, supra note 40, at 541–43.

76 Morawetz left his firm to become general counsel of the Atchison, Topeka and Santa Fe Railway. To continue the firm's reorganization practice, his partners turned to a young associate to fill the void. His name was Paul Cravath.

77 Pepper v. Litton, 308 U.S. 295 (1939). *Pepper* was a case that involved only prepetition misconduct by a creditor, but Douglas used the case as a vehicle to announce a principle that extended to actions undertaken in the reorganization itself.

78 *Id.* at 307–08.

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> We have emphasized that full disclosure is the minimum requirement in order not to imply that it is the limit of the power and duty of the bankruptcy court in these situations.[79]

There are a number of provisions of the Code and the Bankruptcy Rules that mandate disclosure, but the unwritten rules ensure that they do not end there. Parties who fail to disclose a matter to the court do so at their peril, whether there is a provision of the Code that requires such disclosure or not.

The bankruptcy judge, like any referee, must remain in control. Because they must make decisions on the basis of imperfect information, the judge can also impose limits on what parties can do, not because a particular behavior is necessarily bad, but because it reduces the risk of bad behavior that the judge cannot see or perhaps not understand. One of the most conspicuous signals that mischief might be afoot arises when one investor receives better treatment than others who seem similarly situated. Bankruptcy judges do not have to allow play to continue merely because they cannot point to any specific provision of the Code that has been violated.

The policing power that William O. Douglas introduced into the law of corporate reorganizations emerges out of the old idea that creditors cannot manipulate legal processes to their own advantage. The spirit behind introducing this broad equitable power into reorganization law, however, is quite different from what came before. The equitable powers of the bankruptcy judge exist to ensure that the bargaining is done in a fashion that respects the rights of all.

Exercising equitable powers to ensure that there is disclosure and that the players bargain in a way that comports with the unwritten rules is not the same as exercising equitable powers in a way that undermines the substantive rights of the parties. The modern bankruptcy judge has no power to do this. As one court has put it, the Code "does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity."[80] Moreover, the unwritten rules do not allow for the bankruptcy judge to participate in the bargaining. The judges are referees, not players. They are in the arena, but they are not combatants.

The drafters of the Code sought to create an environment in which it was easy for sophisticated professionals to bargain with one another and chart a course for the business that made sense. The managers of the old firm proposed

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[79] Am. United Mut. Life Ins. Co. v. Avon Park, 311 U.S. 138, 145 (1940).
[80] United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986).

a plan, and the senior creditors pushed back. Once they settled on a future for the business, the question was how to divide the pie. The senior creditors were willing to give ground because they wanted to resolve matters quickly and cheaply; the old shareholders and general creditors were willing to give ground because, in the end, the senior creditors as a class had the right to freeze them out. It was in the interests of all to find a middle ground.

The law of corporate reorganizations needs to put in place a framework that made bargaining possible. In such bargaining, cooler heads will likely prevail, and as long as they do, economically viable firms will be able to reorganize successfully and their cash flows can be allocated as the dynamics of the bargaining dictated. As long as they employ able champions, a deal of some kind will be reached. To be sure, clients with the good fortune to retain a forceful lawyer might do better than others, but the exact terms of the deal are not as important as ensuring that some deal is made.

Policing by the bankruptcy judge ensures that participants in the bargaining cannot use their position to further their outside interests. Nor can parties make side payments with a view to tilting the bankruptcy process in their favor. Nevertheless, in asserting their rights to the assets of the estate, creditors can choose the course that maximizes the value of their own stake in the firm. They are not fiduciaries of the estate.

Determining exactly what actions are permissible, of course, is not always easy. Someone involved in negotiating a plan may make a transfer to another player during the course of bargaining and such a transfer might be permissible. In a perfect reorganization regime, the rules should prevent junior parties from invoking procedures that are wasteful and unnecessary, but it is likely impossible to create rules that work perfectly. As a result, a junior creditor may have the right to bring a procedural objection that is costly to defend against, but that adds little or no value to the estate as a whole. When a senior creditor who manifestly is owed more than the firm is worth wants to bring the reorganization process to a speedy conclusion, that creditor's decision to pay money to someone junior to truncate unnecessary procedures may be appropriate.

The amount of money tends to be small in the grand scheme of things. And it might not be troubling that the senior creditor is paying for professionals who work for others. The process is being run for the benefit of the senior creditor when it is owed more than the business is worth, so it is entirely sensible that the senior creditor pays for it. The senior creditor should be able to use what is, in effect, its own money to bring the case to a swift conclusion when the relevant

issues are plain for all to see. Such payments are analogous to settlements routinely made when civil litigation is settled.

But it is an entirely different matter when creditors make side payments to tilt the playing field in its direction. When they do this in the course of trying to confirm a plan that is to their liking, courts prevent them by invoking the statutory mandate that a plan be "fair and equitable." Finding an "anti-gifting" component in the terms "fair and equitable" can be securely linked to *Boyd* and other receivership cases. Courts invoke this power even when there is strong evidence that the senior creditor is owed more than the firm is worth. It nips mischievous side payments in the bud and helps ensure that the plan formation process is squeaky clean.[81] It is a mistake, however, to limit the bankruptcy judge's ability to police transactions to the narrow question of whether a plan is "fair and equitable" within the meaning of § 1129(b) of the Code.

Imagine that a debtor has a senior lender, substantial priority tax claims, and a pool of general creditors. The debtor plans to auction the company. It soon appears that the senior creditor plans to credit-bid. No other buyers are on the horizon. Unless the creditors' committee works hard to discover a flaw in the senior creditor's lien, the senior creditor's credit bid will be unchallenged. Negotiations between the committee and the secured creditor ensue. In return for the committee's support of the auction, the senior creditor agrees to pay the professionals of the committee and provide several million dollars to the creditors' committee for distribution to the general creditors.

As expected, no one else appears at the auction and the senior creditor's credit bid prevails. The senior creditor ends up with the business, the priority tax claims are left unpaid, and the general creditors end up with something (though the money they receive will come from the senior lenders, not from property of the estate).[82]

All that may be at work is a tip. The senior creditor was not trying to prevent an auction that secured top dollar, but rather was striking a bargain that avoided unnecessary and costly procedures. On the other hand, these payments might be side payments that distort the process. The secured credit may have, in effect, paid the creditors' committee to look the other way. Defects in the secured

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[81] The Second Circuit put it this way: "[I]f the parties here were less scrupulous or the bankruptcy court less vigilant, a weakened absolute priority rule could allow for serious mischief between senior creditors and existing shareholders." DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 100 (2d Cir. 2011).

[82] For a case with similar facts, see *In re* ICL Holding Co., Inc., 802 F.3d 547 (3d Cir. 2015).

creditors lien that might have come to light remain hidden. The payment to the creditors' committee may have had the effect of short-circuiting the due diligence that a well-run reorganization sale process requires. The trick is distinguishing between legitimate tips that avoid unnecessary process and illegitimate side payments.

Of course, the payment to the creditors' committee does not prevent the tax collector from challenging the liens or finding other buyers, but not all parties are equally well-positioned to take an active role in the case. The government's tax lawyers are not privy to the particulars of the business and lack expertise in reorganization. By contrast, the creditors' committee has access to information about the debtor and the debtor's business, and its professionals are used to the reorganization playing field. They are much better able to assess whether the senior creditor's proposed auction would yield top dollar.

Because the payment is coming from the pocket of the senior creditor, property of the estate and its equal division are not implicated. But this should make no difference. Side payments and bribes are bad whether a distribution is involved or not. The process as a whole is subject to judicial supervision. When the question is one of policing the behavior of creditors during the bankruptcy process, the judge is asking whether the overall negotiations were conducted in a fashion that could be trusted to maximize the value of the assets within the bankruptcy estate.

It is important not to fixate on the question whether the mischief being done takes place as part of the confirmation process or whether the payment violates bankruptcy distribution rules. Protecting the bargaining environment rather than ensuring proper division of the assets is the task at hand. Ensuring that distributional rules are followed is necessary to do this and hence a necessary part of ensuring that the players follow the rules of the game, but it is hardly the only part.

The bankruptcy judge's ability to ensure the integrity of the reorganization process extends beyond transfers from one stakeholder to another. Imagine another case in which a senior creditor wants to buy the firm with a credit bid. The CEO, who ran the firm into the ground and who holds no equity in the firm, is still calling the shots while the firm is in chapter 11. The senior creditor suggests to the CEO that a going-concern sale is the best course for the firm. It tells the CEO how much it values her strategic vision and that it wants to keep the CEO on as a consultant if it proves the high bidder.

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Should the general creditors be able to mount an objection to the going-concern sale? There are two possible explanations for the secured creditor's plan to retain the CEO as a consultant. The secured creditor may value the CEO's acumen and be offering to pay her as it would anyone else who helps it run the business in the future. Alternatively, the secured creditor may be making the payment to the CEO so that, however dim-witted she might be, she understands the wisdom of allowing the secured creditor to obtain the firm at a bargain price.

The judge is empowered to distinguish between these benign and the not-so-benign possibilities. It can bless the transaction if the first explanation holds and prevent it in the case of the second. It is irrelevant that the CEO is not a stakeholder or that no property is being distributed from the estate. What matters is whether the side payment is being made because of the control the CEO exercises over the process. If the side payment is being made to obtain the cooperation of the CEO, the bankruptcy judge can refuse to allow the sale to proceed. The principle is the same as the one that prohibits class-skipping gifts, and it is a part of reorganization law. That the "fair and equitable" language of § 1129(b) is not implicated is irrelevant. Nor does it matter that the principle itself appears nowhere in the Code. It is part of the unwritten law of corporate reorganizations.

CONCLUSION

In the first few decades of the Code, experienced reorganization professionals followed a set of norms that ensured that parties, notwithstanding their conflicting positions, would continue bargaining with each other. For example, it was understood that you never sent a threatening letter or filed an aggressive pleading without giving opposing counsel the courtesy of a telephone call first. When you stab someone in the reorganization arena, you stab them in the chest, not the back. Such norms helped keep the parties bargaining with each other, and these norms followed a few familiar patterns. While there were many possible deals, the players naturally gravitated toward only a few.[83]

But many of these norms are evaporating, and old patterns of deal-making may no longer hold. In the new environment, with different players holding different stakes, there are no longer organized groups (like agented lenders or even creditors' committees), but instead investors have "one-off" relationships

[83] To cast things in the language of game theory, there were many possible equilibrium agreements, but comparatively few were focal points. For the classic discussion of focal points, *see* THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 57–58 (1960).

with the debtor entity (for example, counterparties with individual repos or swaps). The types of institutions vary—from banks and broker-dealers to hedge funds and private equity firms. 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.[84]

The challenges of policing bargaining in this brave new world is what faces us today. Solving these challenges does not involve tinkering with the distributional rules of the Code. What appear to be departures from distributional rules may be completely innocuous efforts to acquire assets that do not belong to the estate—such as the good will of future customers. To acquire such good will, something the estate does not own, it may be appropriate to use assets of the estate to acquire it. The assets may be cash used to pay for an advertising campaign, but it may also be resources spent honoring warranties or frequent flyer miles.

When the debtor pays prepetition creditors, it is possible (and often likely) that the payments are not being made to acquire benefits to which the debtor would otherwise have no right, but rather are side payments that distort negotiations. But to focus entirely on whether the transfer is to a prepetition creditor is wrong. Such a focus gives the false illusion that the distribution is the vice, rather than the corruption of the bargaining. Distributional irregularities are usually a symptom, not the disease. The prime directive is ensuring the integrity of the process.

The law of corporate reorganizations provides a collective forum in which investors can work together to find a sensible capital structure for the business. The job of the bankruptcy judge is to police these negotiations and make sure that they are done according to Hoyle.[85] This is reorganization law's biggest

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[84] In the *Adelphia* reorganization, for example, infighting among at least twelve unofficial groups of creditors resulted in seven proposed reorganization plans, and professional fees and expenses initially sought by these twelve groups alone totaled more than $100 million. *See* Marshall S. Huebner & Benjamin A. Tisdell, *As the Wheel Turns: New Dynamics in the Coming Restructuring Cycle*, DAVIS POLK & WARDWELL, THE AMERICAS RESTRUCTURING AND INSOLVENCY GUIDE 2008/2009 77, 80 (2008), https://www.davispolk.com/files/files/Publication/c054df87-9113-421d-9fa3-6c236f3c94c2/Preview/PublicationAttachment/84209c53-2d67-4469-93f2-77ee307035e4/huebner.insol.america.as.the.wheel.turns.nov09.pdf.

[85] Edmund Hoyle's *A Short Treatise on the Game of Whist* (1742) established the rules by which everyone played the game. All games, including the game of corporate reorganizations, must be played according to Hoyle—that is, according to the specific rules that govern them, whether written or unwritten.

In invoking Hoyle in the context the unwritten rules of corporate reorganization, I am echoing Thomas Ambro. One of the great commercial law judges of our time, Ambro once reversed a case on the ground that the

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challenge and has for centuries and will likely remain the domain of unwritten law.

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unwritten doctrine of substantive consolidation had not been applied, in his words, "according to Hoyle." *See In re* Owens Corning, 419 F.3d 195, 216 (3d Cir. 2005). Substantive consolidation could be done, he allowed, but not in the fashion it was done in the case before him. Rules are rules and must be followed, whether written or not.

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