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Adam Feibelman

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BANKRUPTCY AND THE STATE

Adam Feibelman[*]

ABSTRACT

Anticipating a wave of bankruptcies caused by the economic and financial effects of the COVID-19 pandemic, numerous commentators proposed measures to expand the institutional capacity of the bankruptcy system. A number of these proposals would represent dramatic and systematic government involvement in the U.S. bankruptcy system. Such involvement by the government in the bankruptcy system is a topic that is largely ignored in the literature on bankruptcy. Where it is observed, it is generally criticized. Among other things, it sits uneasily with dominant theories of bankruptcy that assume the bankruptcy system should be driven by the interests of direct stakeholders in particular cases. This Article argues that involvement or influence by government actors in the bankruptcy system is, in fact, broadly consistent with bankruptcy theory and with the structural relationship between bankruptcy law and other legal and regulatory components of the state. This relationship is subject to some basic ordering principles. Bankruptcy law constrains and adjusts other legal regimes to some extent, but it generally incorporates non-bankruptcy law and yields to government's regulatory actions. These ordering principles reasonably extend to ad hoc government actions or "activism" in the bankruptcy system. In other words, government actors do not contravene bankruptcy policy when they employ the system to advance non-bankruptcy policies within their authority, even when doing so enables the government to take actions and achieve goals that it could not outside of the system. In some circumstances, however, the regulatory policies or concerns motivating government involvement in the bankruptcy system may be too diffuse or attenuated to justify the extent of its intervention, especially if the effect is to discourage use of the bankruptcy system.

This Article develops these claims by focusing in particular on the relationship between bankruptcy and financial regulation. Bankruptcy is part of the architecture of financial markets in a modern economy, and the influence of financial regulators on the bankruptcy system should be viewed as the product

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[*] Sumter Davis Marks Professor of Law, Tulane. Thanks for discussion and comments to Vincent Buccola, Laura Napoli Coordes, Melissa Jacoby, Rafael Pardo, Nadav Orian Peer, Renuka Sane, David Skeel, and participants of the *3d Conference on Law and Macroeconomics*, fall 2020, and the Indian Institute of Management Ahmedabad and World Bank *Research Conference on Financial Distress, Bankruptcy, and Corporate Finance*, fall 2019. All views and errors are mine.

of overlapping regulatory functions, which require a logic of ordering. Such regulatory influence generally operates in the deep background, yet macro-prudential and systemic concerns will sometimes require more direct government intervention and may override the efficiency concerns or stakes of a particular bankruptcy case. This Article describes three episodes of regulatory intervention in the bankruptcy system: (1) "regulatory bankruptcy" during the 2008–09 financial crisis; (2) the efforts by the Reserve Bank of India to force some large commercial firms into India's new insolvency system; and (3) the Chrysler bankruptcy. The ordering principles advanced in this Article generally justify the government involvement in these cases and, to some extent, in the COVID-era proposals as well. However, the degree of regulatory involvement in the bankruptcy system envisioned by some of these recent proposals may be disproportionate to, or attenuated from, their underlying regulatory goals. If so, they may fall beyond the scope of justified government involvement in the bankruptcy system.

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INTRODUCTION

In the initial months of the COVID-19 pandemic, there was widespread concern that the economic effects of the pandemic would cause a dramatic upsurge of corporate and individual bankruptcy cases in the United States and around the globe. Although there have been numerous notable bankruptcy filings in the U.S. since then, and a sizeable caseload more generally, various factors seem to have held a larger surge of filings at bay, at least for the time being.[1] In the meantime, policymakers in the U.S. adopted some modest and targeted reforms to the bankruptcy system to assist some debtors affected by the crisis.[2] Over the course of 2020, numerous commentators proposed other, more significant measures to address a potential upsurge of filings.[3] These measures

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1 These factors include, most notably, massive government financial support across the economy, private standstill agreements, and policies at every level of government to mandate or strongly encourage forbearance by creditors. *See, e.g.*, Jonathon Lipson & Norman M. Powell, *Don't Just Do Something—Stand There! A Modest Proposal for a Model Standstill/Tolling Agreement*, BUS. L. TODAY (Apr. 4, 2020), https://businesslawtoday.org/2020/04/dont-just-something-stand-modest-proposal-model-standstilltolling-agreement/; Anna Gelpern et al., *Debt Standstills Can Help Vulnerable Governments Manage the COVID-19 Crisis*, PETERSON INST. FOR INT'L ECON. (Apr. 7, 2020, 2:45 PM), https://www.piie.com/blogs/realtime-economic-issues-watch/debt-standstills-can-help-vulnerable-governments-manage-covid. For example, the CARES Act provided for mortgage payment forbearance for borrowers with federally backed loans and protection from evictions for those renting property subject to such loans. *See* 15 U.S.C. § 9057 (2018).

2 The CARES Act of 2020, for example, increased the scope of eligibility of the new Small Business Reorganization Act so that more small firms can benefit from its liberalized process. *See* Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136, 134 Stat. 281 (codified as amended in scattered sections of 2, 5, 12, 15, 20, 21, 29, 42, and 45 U.S.C.). The Act also provides that pandemic-related support to individuals will not be counted as income if they file for bankruptcy. *Id.* Excluding support from "current monthly income" potentially impacts individuals' eligibility for chapter 7 and the calculation of disposable income payable to creditors in chapter 13. *Id.* The Act also provides that individuals who experience hardship due to the crisis can modify or extend their chapter 13 plans. *Id.*

3 *See* Peter Conti-Brown & David Skeel, *Using the Federal Reserve's Discount Window for Debtor-in-Possession Financing During the COVID-19 Bankruptcy Crisis,* HUTCHINS CTR. ON FISCAL & MONETARY POL'Y BROOKINGS (July 2020), https://www.brookings.edu/wp-content/uploads/2020/07/Conti-Brown-Skeel.pdf; Peter M. DeMarzo et al., *Debtor-in-Possession Financing Facility (DIPFF) Proposal*, STAN. GRAD. SCH. BUS. (June 20, 2020), https://www.gsb.stanford.edu/sites/default/files/publication-pdf/dipff.pdf; Kathryn Judge, *Congress Should Allow the Fed to Make Loans to Bankrupt Companies*, FORBES (July 22, 2020, 3:06 PM), https://www.forbes.com/sites/kathrynjudge/2020/07/22/congress-should-allow-loans-to-bankrupt-companies/#60e5d7e63a7f; David Skeel, *Bankruptcy and the coronavirus*, ECON. STUD. BROOKINGS (April 21, 2020), https://www.brookings.edu/wp-content/uploads/2020/04/ES-4.21.2020-DSkeel-2.pdf; David Skeel, *Bankruptcy and the coronavirus: Part II*, ECON. STUD. BROOKINGS (June 6, 2020), https://www.brookings.edu/wp-content/uploads/2020/07/ES-6.6.20-Skeel-1.pdf; Kenneth Ayotte & David Skeel, *Bankruptcy Law Needs a Boost for Coronavirus*, WALL ST. J. (March 30, 2020, 6:53 PM), https://www.wsj.com/articles/bankruptcy-law-needs-a-boost-for-coronavirus-11585608800; Edward R. Morrison & Andrea Saavedra, *Bankruptcy's Role in the COVID-19 Crisis* (Colum. L. & Econ., Working Paper No. 624, 2020), https://ssrn.com/abstract=3567127; *see also* Adam J. Levitin et al., *No More Bailouts: A Blueprint for a Standing Emergency Economic Resilience and Stabilization Program*, THE GREAT DEMOCRACY INITIATIVE (June 2020), https://greatdemocracyinitiative.org/wp-content/uploads/2020/06/No-More-Bailouts-Final-Copy-.pdf.

include increasing bankruptcy court personnel and resources;[4] requiring that some firms file for bankruptcy as a condition of financial support from the government;[5] promoting stream-lined pre-packaged bankruptcy filings;[6] and increasing the amount of resources available for debtor in possession ("DIP") financing from the U.S. Treasury or the Federal Reserve.[7]

These proposals may or may not be promising ways to improve the functioning of the bankruptcy system in the event of a systemic economic or financial crisis. But most of them have an important feature in common: they would significantly expand the direct or indirect involvement of government or regulatory actors in the operation of the bankruptcy system. Consider, for example, the proposals to encourage pre-pack filings or to leverage government lending to require firms to file for bankruptcy as a condition for financial support. Both entail regulators directly influencing or determining critical bankruptcy decisions: whether to initiate a proceeding and whether to attempt to pre-arrange fundamental aspects of a case with important creditors. The proposal to augment DIP financing through a Federal Reserve facility would provide support to banks that in turn extend crucial financing to debtors in bankruptcy. The involvement of those banks in the bankruptcies of their borrowers would be subject to ongoing supervision by the government, which would also have at least an indirect financial stake in the outcomes of those bankruptcy cases. The government would have the motivation and various tools for influencing the behavior of banks as DIP lenders in their borrowers' bankruptcies under such a program.

The debate and discussion of these proposals has largely ignored the question of how we should evaluate the government's role in the bankruptcy system that each would likely involve. In fact, this is a question that the literature on bankruptcy theory and policy provides few if any useful insights. Most writing on bankruptcy theory and policy focuses primarily or exclusively on how it impacts the immediate stakeholders in a debtor's case.[8] Bankruptcy theorists

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4 *See, e.g.,* Letter from The Large Corporations Committee of The Bankruptcy and COVID-19 Working Group to Sens. McConnell and Schumer and Reps. Pelosi and McCarthy (May 7, 2020), http://blogs.harvard.edu/bankruptcyroundtable/files/2020/05/xLarge-Corporate-Committee_05.18.2020.pdf; *see also*, Robert K. Rasmussen, *COVID-19 and Bankruptcy Infrastructure*, 131 YALE L.J. FORUM 337 (2021).

5 Morrison & Saavedra, *supra* note 3, at 12–13.

6 Ayotte & Skeel, *supra* note 3 ("[The U.S. Treasury] could encourage some companies to file 'prepackaged' bankruptcies that write down only the company's largest obligations and can be approved by a bankruptcy judge in as few as 30 days.").

7 Conti-Brown & Skeel, *supra* note 3, at 1, 7; DeMarzo et *supra* note 3; Morrison & Saavedra, *supra* note 3; Judge, *supra* note 3.

8 *See infra* note 31 and accompanying text.

who often disagree on critical features of the system have tended to assume that the system serves to resolve the microeconomic problems of debtors, their various creditors, and an array of other direct stakeholders, and that these private actors drive outcomes based on their self-perceived interests within a legal framework created by statutes and courts.[9]

The literature on bankruptcy law primarily addresses how it should balance the goal of facilitating a debtor's recovery with that of maximizing the overall value of the debtor's estate.[10] It generally assumes that, with certain limitations, debtors make basic decisions about whether to seek relief, and under which chapter, in the shadow of a predictable set of rules and requirements. Similarly, it assumes that creditors and affected parties act within the system pursuant to their own financial and economic motivations subject to the substantive and procedural constraints of the bankruptcy system.

Largely absent from this common underlying view of bankruptcy is the fact that government and regulatory actors routinely impact the operation of the bankruptcy system, sometimes directly and dramatically and sometimes indirectly and unobserved. When the engagement of government actors in the bankruptcy system is discussed or observed at all, it is usually in response to a highly visible and controversial case, and the relationship is then generally criticized. At least some scholars have proposed that this type of government involvement is inconsistent with basic theories of bankruptcy law; impairs the efficient operation of a bankruptcy system; or undermines government transparency and accountability.[11]

This Article argues that engagement by government and regulatory actors in a bankruptcy system is, in most cases, a natural feature of bankruptcy law and policy, not a distortion. In fact, interaction between bankruptcy and non-bankruptcy law and regulation is ubiquitous and part of an overarching institutional design. Bankruptcy is properly understood as an extension, component, or qualification of almost every other legal or regulatory regime. These relationships and interactions sometimes involve some tension between the unique institutional goals of bankruptcy law and those of the other legal regimes in question. Such tensions require some ordering among and between

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9 *See infra* note 32 and accompanying text.

10 *See infra* notes 27–30 and accompanying text.

11 *See* Sarah P. Woo, *Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales*, 99 GEO. L.J. 1615, 1661–62 (2011); *see also* Sarah P. Woo, *Simultaneous Distress of Residential Developers and Their Secured Lenders: An Analysis of Bankruptcy and Bank Regulation*, 15 FORDHAM J. CORP. & FIN. L. 617 (2010); Jared A. Ellias & George Triantis, *Government Activism in Bankruptcy*, 37 EMORY BANKR. DEVS. J. 509 (2021) [hereinafter Ellias & Triantis].

these underlying policies. The existing design of bankruptcy and other legal regimes provides some formal ordering, and while this ordering is somewhat complex, it does reflect some general principles. In some circumstances, bankruptcy law is designed to displace or constrain the operation of other legal or regulatory regimes. It generally does so where it is necessary for the bankruptcy system to function or to implement specific substantive policies. In most other circumstances, however, the policies underlying non-bankruptcy regimes will override those specific to bankruptcy law and policy. This makes sense as a background principle: bankruptcy law serves a relatively broad and general function, and most other regimes or policies are more substantively specific in aim and application.

These ordering principles aid in evaluating some of the controversial aspects of many recent high-profile bankruptcies, like those of Purdue Pharma, USA Gymnastics, the Boy Scouts, and various Catholic dioceses. Such cases have focused attention on bankruptcy law as a means for individuals and firms to reduce liability or accountability for wrongdoings.[12] But this outcome, while troubling, is a product of a structural relationship between most tort liability and bankruptcy law, which reflects a system of formal ordering of bankruptcy and non-bankruptcy law. Under non-bankruptcy law, most tort liability creates an unsecured claim. Policymakers have elevated the priority and excluded from discharge some tort claims under bankruptcy law, but a large swath of tort claims—including most claims for negligence—survive in bankruptcy without any change in priority or protection from discharge.[13] As a result, in most of these recent high-profile cases, bankruptcy law has effectively operated as a limitation on the operation and functions of tort law. Much of the criticism of these cases has focused heavily on that use of bankruptcy law or on aspects of bankruptcy law that preclude information-forcing litigation.[14]

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[12] *See, e.g.*, Lindsey D. Simon, *Bankruptcy Grifters*, 131 YALE L.J (forthcoming 2021); Adam J. Levitin, *Purdue's Poison Pill: The Breakdown of Chapter 11 Checks and Balances*, 100 TEX. L. REV. (forthcoming 2022).

[13] Personal liability on obligations is generally discharged in consumer bankruptcies, *see* 11 U.S.C. § 524(a) (2018), but certain debts are excluded from discharge, *see* 11 U.S.C. § 523(a) (2018). Some tort liability is included in this category of non-dischargeable debts—i.e., "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny," 11 U.S.C. § 523(a)(4) (2018); "for willful and malicious injury by the debtor to another entity or to the property of another entity," 11 U.S.C. § 523(a)(4) (2018); and for death or injury caused by operating a vehicle or vessel while intoxicated, 11 U.S.C. § 523(a)(9) (2018). By exclusion, other tort liability—for negligence, for example,—is not excepted from discharge.

[14] *See, e.g.,* Simon, *supra* note 12; Ramon Antonio Vargas, *New Orleans Clergy Abuse Plaintiff Aims to Move Bankruptcy-Halted Case out of Federal Court*, THE TIMES-PICAYUNE, July 8, 2020, https://www.nola.com/news/courts/article_63fd3226-c170-11ea-ae7c-13bf33fea547.html.

In at least some of those cases, government officials have been active parties or have influenced the course of proceedings. Such cases complicate any attempt to evaluate the relationship between bankruptcy and tort law and policy. Commentary on Purdue Pharma's bankruptcy case, for example, has focused largely on whether and how the court can extend bankruptcy protections to owners of the debtor firm and effectively limit their liability for their actions in relation to the firm's marketing of Oxycontin.[15] But this issue arises in the context of a settlement that the firm reached with the Department of Justice and a number of state attorneys general. From this perspective, the case is an interesting and illustrative example of government actors using the bankruptcy system to advance a policy or regulatory goal. This dimension of the case is especially complicated because it involves a number of different government actors.

Recently, in this journal, Jared Ellias & George Triantis have given rare attention to government and regulatory involvement in bankruptcy cases, focusing in particular on government's role in the cases of *Chrysler* and *Pacific Gas & Electric*.[16] They describe and evaluate how federal and state executive officials, respectively, exercised influence or control over these bankruptcies to advance regulatory and policy goals.[17] They observe that the U.S. bankruptcy system provided the government with tools to advance these policies that they would not have otherwise had.[18] As they put it, "the bankruptcy system can be a force multiplier for government policymaking."[19]

While Ellias and Triantis' account is generally descriptive, they observe that the advancement of the governments' policies in these cases was "arguably at odds with the bankruptcy goal of maximizing the return to claimholders."[20] They suggest that the government's use or participation in the bankruptcy system in these ways lacks the transparency and accountability that is built into the legislative and regulatory process and in the exercise of executive power.[21] They

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15 Levitin, *supra* note 12; *see also* Ellias & Triantis *supra* note 11, at 549–50.

16 Ellias & Triantis, *supra* note 11, at 522–23.

17 *Id.* at 525–28.

18 *Id.* at 511.

19 *Id.* at 512.

20 *Id.* at 523.

21 *Id.* at 545 ("In the American system, governments have immense powers they exercise through well-defined processes of legislation and administrative regulation (whether through rulemaking or adjudication) that, ideally, provide the checks and balances that come from transparency and accountability. These processes are absent in the bankruptcy process."); *see also* Robert Kenneth Rasmussen, *Bankruptcy and the Administrative State*, 42 HASTINGS L.J. 1567, 1582–84 (1991).

also express concern that bankruptcy judges are, in general, "not experienced in being arbiters of complex policy debates."[22]

This Article takes a more sanguine view of government involvement or activism in the bankruptcy system. The ordering principles it identifies reflect that such involvement is an inevitable or intended product of the structural relationship of bankruptcy and the state. Bankruptcy is a regulatory tool created by the state to advance some unique and independent goals, but also to function in concert with a host of other legal and regulatory regimes. Furthermore, when government actors influence or direct its operation, the degree of transparency and accountability in this context is comparable to many other instances of regulation and executive government law- and policy-making.[23] Ellias and Triantis may be correct that bankruptcy judges are generally not good arbiters of complex policymaking, but that seems to be a good reason for the bankruptcy process to generally yield to the actors who are.[24]

To be clear, this does not mean that every, or even most, government engagement or utilization of the bankruptcy system is wise or justified as a matter of policy. Government officials and policymakers can pursue misguided policies in and through the bankruptcy system just as they can outside of it. When they do, such actions should be understood as errors in policymaking, supervision, or regulation. But engagement by state actors in the bankruptcy system to advance their legal and regulatory aims is itself not structurally inconsistent with bankruptcy law and policy.

This Article develops its central claims by focusing in particular on the interaction of bankruptcy and financial regulation and the engagement of financial regulators in the bankruptcy system. This interaction is one of the most extensive examples of the basic relationship between bankruptcy and non-bankruptcy law and regulation. Financial regulators inevitably exert some influence in the bankruptcy system because the institutions they regulate and supervise are ubiquitous creditors, often dominant ones, within it.

The involvement and influence of financial regulators in a bankruptcy system should be understood as an essential part of the operation of a bankruptcy system, not as an interference acting upon it. This proposition rests initially on

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[22] Ellias & Triantis, *supra* note 11, at 545 (2021).

[23] Theodore Eisenberg, *Bankruptcy in the Administrative State*, LAW & CONTEMP. PROBS., Spring 1987, at 3, 32 ("[S]haring traditional agency decisions with a bankruptcy court . . . does not substantially decrease political accountability.").

[24] *See* Adam Feibelman, *Federal Bankruptcy and State Sovereign Immunity*, 81 TEX. L. REV. 1381, 1405–06 (2003) (making a similar argument with respect to state sovereign immunity and bankruptcy).

an understanding of bankruptcy law as itself a species of financial regulation, a component of the overall framework regulating a modern financial system. Even when it operates through private decision-making of debtors, creditors and other stakeholders, a bankruptcy or insolvency system is itself a regulatory tool designed and adopted by policymakers to advance various social, economic, and financial policies.

As a structural matter, the indirect influence and direct engagement of financial regulators in otherwise private decisions regarding bankruptcy proceedings is a product of overlapping legal and regulatory domains. In most cases, this influence and engagement by the government is consistent with the unique goals and policies of the bankruptcy system and the private interests of stakeholders within that system. This is especially true when financial regulatory goals are microprudential in nature, i.e., focused on the safety and soundness of particular financial institutions. But in some cases, these imperatives run counter to the private interests of stakeholders in particular cases, including those intermediaries—banks—through whom the regulators act. This may occur, for example, in times of financial crises. At such times, financial regulatory goals and policies tend to be macro-prudential, in furtherance of systemic efforts to promote economic and financial stability. The operation of a bankruptcy system may be an important component of these efforts, sometimes involving the direct or indirect intervention by financial regulators and other government actors.

This Article proceeds as follows. Part I sets forth a very general account of the relationship between bankruptcy law and other legal and regulatory regimes. It describes the underlying regulatory function of bankruptcy itself and its relationship to other regulatory regimes, providing an informal typology of bankruptcy's interaction with other legal regimes and engagement by state actors in the bankruptcy system. It observes ordering between bankruptcy and these other regimes in the existing institutional design and draws broader ordering principles from that design. It argues that, as a structural matter, non-bankruptcy legal and regulatory goals prevail over bankruptcy functions unless bankruptcy law is specifically designed to override them. It also argues, however, that such involvement is less justified, and perhaps sometimes overreaching, when the non-bankruptcy regulatory goal is diffuse or attenuated or if that involvement discourages use of the bankruptcy system.

Part II elaborates upon those ordering principles by focusing on the interaction of bankruptcy law and financial regulation and on the involvement of financial regulators in the bankruptcy system. This relationship is both an illustrative and a uniquely important instance of bankruptcy's role as a component or extension of other legal and regulatory regimes. Part II.B. describes three case studies of direct regulatory involvement in a bankruptcy system, two from the U.S. and one from India: the efforts of banking regulators to direct banks to reduce their exposure to commercial real estate during the 2008–09 financial crisis; the U.S. government's involvement in Chrysler's bankruptcy in 2009;[25] and directives by the Reserve Bank of India (the "RBI") to require banks to initiate insolvency proceedings for borrowers with the banking system's largest non-performing loans. The RBI example reflects that the ordering principles developed here are comparatively general if not universal—in any event, they are not a feature limited to the U.S. institutional design and experience. Part II.C. also describes some concerns and criticism that legal scholars have expressed about these interventions, responds to those concerns and criticisms. Part II.D. examines some of the recent pandemic-related proposals for bankruptcy reforms. It concludes that such interventions, though debatable as government policies, would be consistent with bankruptcy policy unless the extent of the interventions were disproportionate to, or too attenuated from, their underlying regulatory goals.

I. A VERY GENERAL THEORY

Any bankruptcy system is an intervention by the state in private affairs, a species of regulation, and an expression of unique policy objectives. These are briefly described in Part I.A. Because bankruptcy law is designed to comprehensively address the financial affairs of insolvent debtors—individuals, corporations, and governments—it is inevitably embedded in a broader fabric comprised of almost all other legal and regulatory systems. Thus, as Part I.B. explains, bankruptcy abuts or overlaps with every other legal and regulatory regime that affects these debtors and other stakeholders in their bankruptcy cases. It can be understood as, among other things, an extension or a component of these other legal and regulatory regimes.

This raises a critical foundational question: how should we understand this relationship between bankruptcy and other manifestations of the state and evaluate the interactions between them? The boundaries and dynamics of this relationship are complex but subject to some general description. In normal times, these relationships are pretty seamless, unobserved, and unremarkable and the goals of bankruptcy and other policies are roughly complimentary or consistent. In some circumstances, however, the policies and functions of bankruptcy and other regimes run in different directions and stand in tension. In

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[25] Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 730 (2010).

such cases, some ordering principles are necessary as a practical matter and useful for evaluating the effect of the operation of bankruptcy law on other regimes and vice versa.

Some ordering has been resolved by policymakers and is settled in the design of bankruptcy law and of other legal regimes. In some ways, bankruptcy law is designed to curtail or adjust aspects of other legal or regulatory regimes; in other ways, it is designed to reinforce and extend their effective reach. Part I.C. derives a set of basic ordering principles from the existing institutional design. To the extent that stakeholders in bankruptcy are subject to other regulatory regimes or state authorities that are not expressly displaced by the operation of bankruptcy law, such external regimes and authority will shape, constrain, guide, or even govern at least some of their behavior and decision-making. Sometimes such influence operates passively and indirectly; at other times it operates actively and directly. Among other things, this means that state actors are ubiquitous participants, and are themselves frequently direct stakeholders, in the bankruptcy system. This general dynamic is, in fact, broadly consistent with prevailing and competing theories of bankruptcy law.[26]

A. *Qua Bankruptcy*

The unique and critical role of a bankruptcy or insolvency system is to provide a collective process for addressing the financial distress of a common debtor that is unable to satisfy all of its obligations. Debtors may experience such distress because they have an unsustainable level of debt or because they cannot pay obligations as they become due or because of some combination of both. In the U.S., the goal of bankruptcy for individuals is generally to provide relief and a fresh start and to allocate losses among creditors in a predictable and timely process. For corporate debtors, it aims to provide a relatively efficient process for determining whether to liquidate or reorganize the debtor and for facilitating that liquidation or reorganization. Major themes in the scholarly literature on corporate bankruptcy have included whether the system adequately protects secured creditors; whether it maximizes the overall returns to creditors from their defaulting debtors; whether the system effectively insures entrepreneurs against the risk of financial distress; and whether it adequately weighs the interests and potential consequences for stakeholders like employees and suppliers of firms that might be liquidated or reorganized.

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26 *See* Feibelman, *supra* note 3, at 1412–16 (making this argument with respect to state governments).

Twenty years ago, Douglas Baird proposed that scholarship on bankruptcy policy was dominated by two competing "axioms," which he characterized as proceduralist and traditionalist.[27] In his view, proceduralists assume that bankruptcy should generally not disturb the non-bankruptcy substantive rights of debtors and creditors and should instead solve a collective action problem among creditors, thereby maximizing their collective recovery from debtors.[28] Traditionalists, in contrast, aim to balance a much wider range of interests in the bankruptcy system, especially including workers and broader communities, in determining the fate of debtor firms.[29] Although Baird's characterization of these axioms has been contested, this terminology has endured, and his general analysis did capture something fundamental about the prevailing and conflicting concerns within bankruptcy scholarship.

Notwithstanding the important differences between these competing approaches to bankruptcy law and theory, they share some important underlying views about the function of a bankruptcy system. They generally agree, for example, that firms should be restructured if they have sufficient value as a going concern and that creditors must be protected enough in the process to avoid disrupting access to credit for productive ventures. The differences among scholars tends to relate to such factors as how the system should determine going concern value, how it should be compared to liquidation value, and how to weigh the importance of supporting efficient credit markets *ex ante*.[30]

Furthermore, with a few notable exceptions,[31] contemporary scholarship and commentary on bankruptcy law on both sides of this debate examines the operation of the bankruptcy system with regard to its most direct stakeholders—debtors, their creditors, and stakeholders like children, former spouses, employees, and taxing authorities. This literature primarily analyzes the rules and processes that do or should apply within the system; the impact of those rules and processes on debtors and their creditors and those stakeholders; how those stakeholders drive the operation of the bankruptcy system and its outcomes; and how the system affects those parties' incentives and orders their

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27 Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 576–77 (1998).

28 *Id.* at 581–82.

29 *Id.* at 583.

30 *See* Melissa B. Jacoby, *Corporate Bankruptcy Hybridity*, 166 U. PA. L. REV. 1715, 1716 n.3 (2018) ("In short, the field of corporate bankruptcy has been redistricted to wealth maximization, voluntary lenders, and investors.") (and citing criticism). *Compare* Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709 (2020), *with* Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199 (2005), *and* Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503 (2001).

31 *See infra* notes 35–44 and accompanying text.

behavior. As Sarah Woo has observed, existing debates over bankruptcy law fall within a "standard paradigm" according to which the behavior of stakeholders can be "explained simply by understanding the economics of the case itself," and that it is the *stakeholders'* understanding of their economic interests that drive their behavior.[32] Participants in normative debates about bankruptcy generally share the assumption that the system operates according to the rules and procedures designed by Congress and the courts, through the actions of bankruptcy judges and trustees and the private parties who order their affairs in relation to the design and operation of that system.

But aspects of bankruptcy systems are designed and adopted by policymakers to serve some other substantive policies as well. They do so, for example, by improving the priority of some specific creditors—such as tort victims of impaired drivers[33]—over their non-bankruptcy position. More generally, bankruptcy law serves macro-economic functions by helping influence or steer private parties' transactions *ex ante* or strategies *ex post*.[34] This regulatory aspect of bankruptcy law is reflected, most often implicitly, in the literature on the topic and often forms the basis of normative views about the proper design and operation of the regime. Thus, for example, scholars have proposed that maximizing returns for creditors promotes economic growth by reducing the cost of credit; that protecting secured creditors in particular promotes efficient allocation of assets in the economy; and that insuring individuals from financial distress and protecting other stakeholders, like employees, can reduce broader social costs and externalities of financial distress.

There is a small but growing literature that has addressed the macro-economic and regulatory functions of bankruptcy more directly.[35] As discussed below in more detail, this view of bankruptcy has been most pronounced in the field of financial regulation and the literature on that topic. But this literature generally views those macro-economic and regulatory functions as deriving

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32 Sarah P. Woo, *Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales*, 99 GEO. L.J. 1615, 1661 (2011).

33 11 U.S.C. § 507(10) (2018).

34 *See infra* note 64–66 and accompanying text.

35 *See, e.g.*, Zachary Liscow, *Counter-Cyclical Bankruptcy Law: An Efficiency Argument for Employment-Preserving Bankruptcy Rules*, 116 COLUM. L. REV. 1461, 1465–66 (2016), *see also* Yair Listokin, *A Theoretical Framework for Law and Macroeconomics*, 21 AM. L. & ECON. REV. 46, 58 (2019) (noting that consumer bankruptcy can have an impact on consumption); John Armour & Douglas Cumming, *Bankruptcy Law and Entrepreneurship*, 10 AM. L. & ECON. REV. 303, 304 (2008); TERENCE C. HALLIDAY & BRUCE G. CARRUTHERS, BANKRUPT: GLOBAL LAWMAKING AND SYSTEMIC FINANCIAL CRISIS at xxi (2009); Adam Feibelman, *Consumer Bankruptcy as Development Policy*, 39 SETON HALL L. REV. 63, 66 (2009).

from the substantive outcomes for stakeholders, i.e., the accumulation of micro-economic effects of bankruptcy for debtors, creditors, and other stakeholders.

There is also an important and growing strand of literature that focuses directly on bankruptcy as a species of regulation and public law.[36] Much of this work compares bankruptcy to other types of regulatory regimes in the United States and its relationship to the administrative state. Theodore Eisenberg provided one of the earliest and most systematic accounts of bankruptcy law as a matter of regulatory theory.[37] He characterized bankruptcy as "supplementary regulatory mechanism"[38] and "suggest[ed] that bankruptcy may provide a useful mechanism for enhancing the goals of administrative law."[39] Robert Rasmussen examined bankruptcy law and formal non-bankruptcy agencies as largely alternative forums for public policymaking and proposed a framework for deciding which forum is best suited to particular disputes involving the government or government policymaking.[40] Rafael Pardo and Kathryn Watts also compare structural aspects of bankruptcy with formal agencies and argue that Congress effectively delegated policymaking responsibility for bankruptcy law to the federal judiciary.[41] More recently, Pardo has further emphasized the regulatory function of bankruptcy law by, for example, characterizing the bankruptcy estate as a federal legal instrumentality[42] and the bankruptcy discharge as a government grant.[43] Melissa Jacoby has made a compelling case that bankruptcy law is properly understood as a public-private partnership in which many important (public) regulatory functions of bankruptcy law are allocated by policymakers to private actors.[44]

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[36] Rafael I. Pardo & Kathryn A. Watts, *The Structural Exceptionalism of Bankruptcy Administration*, 60 U.C.L.A. L. REV. 384 (2012); Jacoby, *supra* note 30; Rafael I. Pardo, *On Bankruptcy's Promethean Gap: Building Enslaving Capacity into the Antebellum Administrative State*, 48 FORDHAM URB. L.J. 801 (2021); *see also* Eisenberg, *supra* note 23; Robert Kenneth Rasmussen, *Bankruptcy and the Administrative State*, 42 HASTINGS L.J. 1567 (1991); Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235, 1241 (2013).

[37] Eisenberg, *supra* note 23, at 3, 20–28.

[38] *Id.* at 3, 29.

[39] *Id.* at 3, 28. Eisenberg argues, among other things, that the bankruptcy system may provide for greater representation of diverse interests in outcomes than non-bankruptcy regulatory practice. *Id.* at 22–26.

[40] Rasmussen, *supra* note 36, at 3, 20–28.

[41] Pardo & Watts, *supra* note 36, at 386–87.

[42] Pardo, *supra* note 36, at 806.

[43] *Id.* at 842.

[44] Jacoby, *supra* note 30, at 1717. Jacoby argues that understanding the public function of bankruptcy law compels that the system "advance public values." *Id.* at 1720; *see also*, Melissa B. Jacoby, *Shocking Business Bankruptcy Law*, 131 YALE L.J. FORUM 409 (2021).

B. Overlaps and Ordering

While bankruptcy is itself a regulatory intervention by the state with its own particular functions and regulatory goals, it is also uniquely intertwined with almost the entire legal and regulatory landscape in most societies, certainly in the United States. This is due, first, to the exceptionally broad scope of eligibility for individuals and entities to be debtors in bankruptcy in the U.S.—most individuals, corporate entities, non-profits, and many government entities in the country can seek bankruptcy protection.[45] They bring to the bankruptcy system the full range of their legal and regulatory relationships, rights, obligations, and interests. Bankruptcy can thus be understood as an arena in which almost every other legal domain is often implicated. This section provides an informal descriptive typology of the relationships that bankruptcy has with other legal and regulatory domains and proposes a set of ordering principles for those relationships.

1. Interactions

The structural arrangement of bankruptcy and non-bankruptcy law, direct government claims in bankruptcy cases, and the exercise of regulatory and executive power by government actors are all examples of a broad category of interaction between bankruptcy and the state. Understanding the scope and types of interaction between bankruptcy and other legal and regulatory regimes is an initial step in evaluating salient or dramatic instances of the involvement of government actors in a bankruptcy system. To be clear, the various types of interaction and modes engagement described below are non-exclusive; any particular case may involve numerous types of interaction and modes of engagement.

As a foundational matter, there is a basic and well-understood structural relationship between bankruptcy law and countless other legal and regulatory regimes that define the rights and responsibilities of stakeholders in the bankruptcy system and the relationships among them. Most obviously and broadly, such regimes include the basic background law of contracts, property, and tort, as well as their subsidiary regimes like rules governing security interests, intellectual property, and various others. Beyond these core background core legal regimes, specialized regulatory regimes like tax law, family law, environmental law, financial regulation, regulation of health care

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45 *See* 11 U.S.C. § 109 (2018).

industry, etc., also routinely define and determine rights and relationships of stakeholders in the bankruptcy system.[46]

Aside from creating and defining the rights and relationships that are directly implicated in bankruptcy cases, non-bankruptcy legal and regulatory regimes also influence parties' strategic interests and their behavior in the bankruptcy system. Decisions that stakeholders make within or regarding the bankruptcy system are motivated at least in some part by the operation of these other regimes. The tax consequences of a bankruptcy filing, for example, may be a significant factor in a debtor's decision to file.[47] Similarly, tax consequences or capital requirements may also influence a creditor's decision to support or resist a debtor's plan of reorganization or their decision to seek relief from the automatic stay.[48]

The types of interaction between bankruptcy and non-bankruptcy legal and regulatory regimes described above are generally passive or indirect, *i.e.*, a product of bankruptcy law generally incorporating pre-existing rights, responsibilities and relationships.[49] But in many circumstances, the relationship involves the active engagement of state officials in the bankruptcy system. Such active engagement most often occurs when governments or government actors have a direct financial or regulatory stake in a bankruptcy case. Frequently, the state engages in the bankruptcy system in a routine fashion because the debtor owes a tax obligation or some type of fee, penalty, or fines to the government, or has a contractual obligation to the government.[50] As a result, government

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[46] *See, e.g.*, Joshua Macey & Jackson Salovaara, *Bankruptcy as Bailout: Coal Company Insolvency and the Erosion of Federal Law*, 71 STAN. L. REV. 879, 893–96 (2019); Lawrence V. Gelber et al., *The Intersection of Environmental and Bankruptcy Laws*, in ENVIRONMENTAL ISSUES IN BUSINESS TRANSACTIONS (AM. BAR. ASSOC. 2011); Laura Napoli Coordes, *Reorganizing Healthcare Bankruptcy*, 61 B.C. L. REV. 419, 425–31 (2020); Shu-Yi Oei, *Taxing Bankrupts*, 55 B.C. L. REV. 375, 381–91 (2014); Jonathon S. Byington, *The Fresh Start Canon*, 69 Florida L. Rev. 115, 118–23 (2017); Lindsey Simon, *Chapter 11 Shapeshifters*, 68 ADMIN. L. REV. 233, 237–41 (2016); Rasmussen, *supra* note 36, at 1567–68; Eisenberg, *supra* note 23, at 3 (examining bankruptcy in relation to public utility regulation); Jacoby, *supra* note 30, at 1724; *see also* 11 U.S.C. §§ 507(a)(1), (8) (2018).

[47] *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. *LaSalle* St. P'ship, 526 U. S. 434, 438 (1999) ("[T]he Debtor responded with a voluntary petition for relief under Chapter 11 . . . [t]he Debtor's principal objective was to ensure that its partners retained title to the property so as to avoid roughly $20 million in personal tax liabilities, which would fall due if the Bank foreclosed."); Diane Lourdes Dick, *Bankruptcy's Corporate Tax Loophole*, 92 FORDHAM L. REV. 2273 (2014); 11 U.S.C. § 1129(d) (2018) (providing that a chapter 11 plan will not be confirmed "if the principal purpose of the plan is the avoidance of taxes").

[48] *See infra* Part II.B(1).

[49] *See infra* notes 61–62 and accompanying text.

[50] *See* Feibelman, *supra* note 24, at 1382 & n.1 (2003) (citing a 1996 study finding that state governments were creditors in over 350,000 bankruptcy cases and filed tax claims valued at approximately $3.6 billion in that year); *see also*, Simon, *supra* note 46, at 281; Oei, *supra* note 46.

actors are regular and frequent claimants in consumer and corporate bankruptcies.[51] They are also sometimes subject to claims and actions in bankruptcy cases.[52]

Government actors may also have regulatory interests in bankruptcy cases aside from any direct financial stake.[53] Sometimes these interests are general and ongoing, such as when a debtor in bankruptcy or some of its activity is subject to regulatory approval or supervision. The debtor may, for example, have one or more licenses issued by a government entity, perhaps a driver's license or a license authorizing a particular activity that comprises some or all of the debtor's profession or business.[54] In other cases, the government's regulatory interest is related to routine enforcement of legal and regulatory policies, like imposing liability for torts or criminal activity. In still other cases, the government's interest may be exceptional in some fashion. This may occur because the case implicates an issue that is not directly related to an existing regime but is within the government's general authority or because the particular case may have unique implications due to the size of the debtor or the scope of its potential impact.

This structural relationship between bankruptcy and other legal and regulatory regimes provides context for such cases in which the government's interest in the operation of the bankruptcy system is either not routine or is more determinative. In some cases, for example, government actors are able to influence or cause the initiation of a bankruptcy case, perhaps because it has leverage as a pre-petition financial creditor or has some regulatory authority over the debtor in question or another party with the power to trigger a case. This presumably happens when a government actor finds that its interest and policies can best be pursued through the bankruptcy system. This should be understood as a decision by the government actor to use the machinery of the bankruptcy system as a regulatory or policy tool.

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51 *See* Feibelman, *supra* note 24, at 1382 & n.1 (2003).

52 In *Katz*, the Supreme Court found that states do not enjoy sovereign immunity from claims in bankruptcy. *Central Virginia Community College v. Katz,* 546 U.S. 356, 359 (2006). The government can also owe obligations to debtors in bankruptcy if, for example, they purchase goods from those debtors on credit. *See* David W. Dykhouse, *The Katz Principle Resurgent: State Sovereign Immunity Remains Abrogated in Bankruptcy*, PATTERSON BELKNAP: BANKR. UPDATE BLOG (Apr. 3, 2020), https://www.pbwt.com/bankruptcy-update-blog/the-katz-principle-resurgent-state-sovereign-immunity-remains-abrogated-in-bankruptcy.

53 *See* Simon, *supra* note 46, at 281 (examining circumstances in which government actors assert both financial claims and regulatory authority).

54 *See, e.g.*, *In re Burgess*, 234 B.R. 793, 795, 798 (D. Nev. 1999).

The government may take this triggering action because the debtor or other private stakeholders will not otherwise initiate a bankruptcy a case.[55] This may be because the private actors who could employ the system do not perceive it to be in their interest to do so. They may misperceive their interests or the likely outcomes for them under bankruptcy law; but they may rightly perceive that the operation of the system is in tension with their own particular interests of the moment.[56] Especially in times of systemic economic or financial stress, regulatory or macro-economic functions of bankruptcy law may require outcomes that are sub-optimal at the case level or from the perspective of critical stakeholders in particular cases.[57]

Similarly, government actors may also aim to steer or influence the operation of the system and its outcomes. They may do this as a dominant claimant or through other leverage they have over the debtor. Such leverage may be a product of the debtor's financial distress or the relevant government actor's authority over the debtor. The government's ability to steer or influence the operation of the bankruptcy in a particular case—like its ability to trigger a case to begin with—may also stem from its relationship to other stakeholders in the case. For example, as discussed in more detail below, a debtor's creditor may itself be a heavily regulated entity.

2. *Ordering Principles*

The interaction of bankruptcy and non-bankruptcy law and the involvement of government entities and actors in the bankruptcy system represent overlapping legal and regulatory domains that inevitably require some ordering and coordination.[58] As Theodore Eisenberg put it over 30 years ago, "Bankruptcy and any particular regulatory scheme are each isolated from the rest of the legal world. When two remote areas require coordination, surprising results can occur."[59] This section describes the extent of formal ordering and

[55] Morrison & Saavedra, *supra* note 3 at 9–10; Michelle J. White, *Why Don't More Households File for Bankruptcy*, 14 J.L. ECON. & ORG. 205, 206 (1998).

[56] *See* Sean Hagan, *Debt Restructuring and Economic Recovery*, *in* SOVEREIGN DEBT MANAGEMENT 359, 360 (Rosa M. Lastra & Lee Bucheit eds., 2014) ("[B]anks are often reluctant to engage in the debt restructuring process simply because the recognition of a loss on their balance sheets will have adverse capital implications. For this reason, vigilant supervision by bank regulators is a necessary feature of any debt restructuring strategy.").

[57] *See infra* note 208 and accompanying text.

[58] *See, e.g.*, Oei, *supra* note 46 (exploring how to balance and coordinate bankruptcy and tax policy goals when tax debtors file for bankruptcy).

[59] Eisenberg, *supra* note 23, at 3, 8.

coordination and derives broader ordering principles from that descriptive account.

The design of existing law and institutions provides a good deal of formal ordering and coordination of bankruptcy and non-bankruptcy law and regulation. Pursuant to this ordering, the operation of bankruptcy and other regimes is generally complementary. The interaction of bankruptcy law and other legal regimes is at least broadly consistent with the underlying policy aims of the various regimes and institutions involved.

The basic foundation of this ordering is the passive structural relationship described above between bankruptcy and other legal regimes that define the rights, obligations, and relationships between debtors and other stakeholders in the bankruptcy system. The Supreme Court famously described this relationship in *Butner v. United States*:

> Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law . . . . Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.[60]

Bankruptcy theorists who might be categorized as either proceduralist or traditionalist would find this statement broadly uncontroversial, though different strands of the literature emphasize different parts of it. Proceduralist theorists draw from *Butner* a general insight that bankruptcy should presumably honor non-bankruptcy rights and priorities; bankruptcy is primarily a procedural mechanism for sorting out non-bankruptcy rights, obligations, claims, and legal relationships.[61] Scholars who embrace a broader role for bankruptcy law emphasize that, in many circumstances, some federal interest requires a different result. Generally, that federal interest is bankruptcy-specific, but sometimes it is related to non-bankruptcy policy.

Thus, the design of bankruptcy and other legal regimes imposes a basic, if complex, background order in which non-bankruptcy legal regimes largely determine the operation of the bankruptcy system and bankruptcy law constrains and sometimes alters the operation of those other regimes. Some of the most familiar and important bankruptcy constraints or alterations to non-bankruptcy regimes are the automatic stay, the discharge of most unsecured claims, adjustments to the rights of secured claimants, and the ability to cure contractual

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60 Butner v. United States, 440 U.S. 48, 54–55 (1979).

61 *See, e.g.*, DOUGLAS BAIRD, ELEMENTS OF BANKRUPTCY 5 (6th ed., Foundation Press 2014).

defaults.[62] Bankruptcy adjusts some priorities among unsecured claims and exempted some from discharge, but, as discussed immediately below, some of these priorities and exemptions largely reflect practical priorities or leverage outside of bankruptcy.[63]

Existing law also reflects a similarly complex arrangement in the treatment of state actors when they engage directly in the bankruptcy system as stakeholders in pursuit of either their financial or regulatory goals. When the government is a creditor to a debtor in bankruptcy, it must generally follow basic bankruptcy rules, and it is treated as other claimants.[64] In most circumstances, for example, the government creditor must discontinue debt collection efforts during the case pursuant to the automatic stay.

On the other hand, some government claims, especially many recent tax claims, enjoy formal priority over other unsecured claims[65] and are exempted from the bankruptcy discharge.[66] Recent tax penalties do not enjoy priority but some are non-dischargeable.[67] As noted above, like most other priorities and advantages under bankruptcy law, most of these particular rules reflect priorities and advantages that such claims enjoy outside of bankruptcy compared to other unsecured claims.[68] But many other government claims are not accorded priority over other unsecured claims and are dischargeable in bankruptcy.[69]

Government actors that engage in the bankruptcy system more directly in pursuit of their regulatory policies enjoy significantly more deference under

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[62] Ellias & Triantis, *supra* note 11, at 514–15 ("Bankruptcy law undermines systems of regulation with three tools: (1) the automatic stay on enforcement actions; (2) the prohibition on discriminating against insolvent or bankrupt debtors in some forms of regulatory enforcement; and (3) the discharge of claims after confirmation of a reorganization plan.").

[63] In consumer bankruptcies, domestic support obligations, such as child support, enjoy priority over all other unsecured claims, 11 U.S.C. § 507(a)(1), and are non-dischargeable, 11 U.S.C. § 523(a)(5). Outside of bankruptcy, child support claims enjoy various priorities over other debts, including potential criminal liability and exceptions to limits on wage garnishment. 11 U.S.C. § 507(a)(1) (2018).

[64] *See supra* note 53 and accompanying test.

[65] *See* Oei, *supra* note 46, at 382–85 (defending the existing scheme of priority for tax claims under the U.S. Bankruptcy Code); 11 U.S.C. § 507(a)(8) (2018).

[66] *See* Oei, *supra* note 46, at 388–90; 11 U.S.C. § 523(a)(7) (2018). Some other government claims are also exempt from discharge, such as some student loan obligations, 11 U.S.C. § 523(a)(8) (2018), and some fines and penalties, 11 U.S.C. § 523(a)(7), (14B) (2018), for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.

[67] 11 U.S.C. § 523(a)(7) (2018).

[68] Failure to pay federal taxes, for example, results automatically in a tax lien. 26 U.S.C. § 6321 (2018). Tax liens are not subject to state law exemptions, and perfected liens enjoy priority over other creditors, including other secured creditors, 26 U.S.C. § 6323(a) (2018). *See also* Oei, *supra* note 46, at 400–01.

[69] Simon, *supra* note 46, at Part II (2016) (observing, however, that government agencies may be able to adopt "shapeshifting" strategies to collect claims in administrative settings without violating the automatic stay).

bankruptcy law. Where the government's engagement or involvement in a bankruptcy is based on its police or regulatory power, it enjoys an exception from the automatic stay; it can take actions against the debtor or the debtor's estate that are enjoined for other parties.[70] A government entity that is entitled to this exception may voluntarily stay its activities but need not do so. The government bears the burden of showing that its actions fall within the exception, however, and courts carefully review these claims. In some cases, government actions are found to fall outside the exception,[71] but presumably at least some number of government actions subject to the exception are not challenged in the first place. The government is also prohibited from discriminating against a debtor simply because the debtor has filed for bankruptcy protection, even if the government actor would otherwise be acting under its legal or regulatory authority.[72] Finally, Title 28 U.S.C. § 959(b) provides that a debtor or trust must "manage and operate the property in [their] possession . . . according to the requirements of the valid laws of the State in which such property is situated,"[73] which is "designed to limit the extent to which an insolvent debtor can use a bankruptcy proceeding to avoid the operation of state regulatory laws."[74]

In sum, as a matter of formal ordering, government actors are generally subject to the basic rules of bankruptcy. For some claims, they enjoy advantages

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[70] Actions by government and regulatory actors are excepted from the automatic stay if they are "to enforce such governmental unit's or organization's police and regulatory power." 11 U.S.C. § 362(b)(4) (2018). Section 362(b)(4) requires "the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's or organization's police or regulatory power." 11 U.S.C. § 362(b)(4) (2018); *see* Simon, *supra* note 46, at 238–39 (2016); Eisenberg, *supra* note 23, at 3, 12 (suggesting, however, that this exception "is a slender foundation on which to construct a legal relationship between bankruptcy and regulation.").

[71] *See* Ellias & Triantis, *supra* note 11, at 515–17 (reviewing judicial approaches to the exception); *see also* Feibelman, *supra* note 24, at 1426–27.

[72] 11 U.S.C. § 525(a) (2018).

> [A] governmental unit may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to, discriminate with respect to such a grant against, deny employment to, terminate the employment of, or discriminate with respect to employment against, a person that is or has been a debtor under this title or a bankrupt or a debtor under the Bankruptcy Act, or another person with whom such bankrupt or debtor has been associated, solely because such bankrupt or debtor is or has been a debtor under this title or a bankrupt or debtor under the Bankruptcy Act, has been insolvent before the commencement of the case under this title, or during the case but before the debtor is granted or denied a discharge, or has not paid a debt that is dischargeable in the case under this title or that was discharged under the Bankruptcy Act.

Id.

[73] 28 U.S.C. § 959(b) (2018).

[74] Feibelman, *supra* note 24, at 1423.

over private stakeholders in the form of priorities and non-dischargeability, but these advantages are limited and roughly track those available to the government outside of bankruptcy. The exception of regulatory actions from operation of the automatic stay, on the other hand, reflects a clear and concrete policy choice that the machinery of bankruptcy law should bend to genuine external regulatory imperatives.

Taken together with the underlying structural relationship between bankruptcy and non-bankruptcy law and regulation, these elements of institutional design reveal an ordering principle and a broader logic of coordination between bankruptcy law and other legal and regulatory regimes.[75] Bankruptcy is a general scheme with unique goals and functions, which inevitably implicate and incorporate non-bankruptcy policies with more particular substantive goals and functions.[76] Bankruptcy imposes some meaningful constraints on other legal regimes and government actors, yet it generally gives effect to the particular policies of non-bankruptcy law. While government actors must often follow bankruptcy rules when pursuing their specific competencies, they should be expected to utilize the bankruptcy system to pursue those objectives. When they do, and if their objectives deviate from the internal logic or goals of the bankruptcy system, that should not be understood as a distortion of bankruptcy policy.[77]

These principles provide their own limitation or corollary, i.e., that the government should yield more to bankruptcy law and policy when it is not pursuing regulatory aims, perhaps when it is acting to advance its financial interests, or when its regulatory interest is minor compared to the bankruptcy function. This is especially true if such state actions will have the effect of deterring stakeholders from utilizing the bankruptcy system in the first place. If state actors are engaging with the bankruptcy system in ways that are attenuated or disconnected from their regulatory remit, such as pursuing purely compensatory or financial objectives, their interventions in the bankruptcy system should be viewed with skepticism.[78]

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[75] Butner v. United States, 440 U.S. 48, 54–55 (1979).

[76] Ellias & Triantis*, supra* note 11, at 516 ("The exercise of discretion by bankruptcy judges under these exceptions effectively shape the boundaries between those regulatory actions that are subordinated to bankruptcy's goals and those that are not.").

[77] *See* Eisenberg, *supra* note 23, at 3, 9 (arguing that when a regulated firm is in the bankruptcy system, its regulator's "role in bankruptcy is likely to be especially interesting and important). Eisenberg examined the relationship between public utility regulators and the bankruptcy system and noted debate over the proper ordering of those regulatory spheres. *See* Eisenberg, *supra* note 23, at n.47.

[78] *See* Simon, *supra* note 46, at 233.

Government actors' pecuniary interests are arguably never purely so and are at least partly regulatory in nature.[79] To be sure, some financial claims are clearly regulatory in nature. Tax policy, for example, incorporates a variety of regulatory goals; rates, penalties, and fines are often designed and adopted to affect taxpayers' incentives to engage in or avoid certain activities.[80] In some circumstances when government entities are pursuing claims for money, however, such as claims for compensation, they are less likely to be designed to directly advance regulatory policies. Such claims do generally help fund the regulatory enterprise,[81] but this is attenuated from any particular legal or regulatory goal. This distinction between government's pecuniary and regulatory interests is reflected in bankruptcy doctrine, especially the fact that the government's regulatory exception to the automatic stay does not extend to pecuniary matters.

The ordering principles described above provide a basis for evaluating *ad hoc* engagement by government entities or actors in the bankruptcy system. As a structural matter, such interventions are presumably justified if the government is acting in pursuit of policies within its authority. It is certainly possible that a regulatory influence or intervention on the bankruptcy system might end up being unwise as a matter of policy. If so, however, it will not be because it improperly interferes with the role of bankruptcy law or contravenes the structural relationship between bankruptcy and other legal or regulatory regimes.

As Ellias and Triantis suggest, the government may occasionally use the bankruptcy as a "long-term opportunit[y] that outweigh[s] the short-term challenges of the bankruptcy stay and discharge."[82] As noted above, they question whether "bankruptcy [is] the appropriate forum for regulation by activist government executives" because it may decrease the transparency and accountability of government actions.[83] They also note that the cost of government involvement is often borne by other private stakeholders in the bankruptcy system.[84]

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[79] Feibelman, *supra* note 24, at 1408–09 (noting as well that government creditors cannot adjust to losses as easily as private creditors).

[80] *See, e.g.*, Daniel Mandel, *Tax Expenditures and Social Policy: A Primer*, *in* SMART SUBSIDY FOR COMMUNITY DEVELOPMENT 28, (Fed. Rsrv. Bank of Bos. & The Aspen Inst. eds., 2011), available at https://www.bostonfed.org/publications/one-time-pubs/smart-subsidy-for-community-development.aspx.

[81] *See* Oei, *supra* note 46, at 402 ("Unlike private creditors, the government plays an important role outside of bankruptcy in providing public goods, smoothing consumption, and absorbing economic shocks.").

[82] Ellias & Triantis, *supra* note 11, at 512.

[83] *See supra* note 21 and accompanying text.

[84] Ellias & Triantis, *supra* note 11, at, 547.

The forgoing principles suggest instead that bankruptcy is often and appropriately a forum for government action. Given the often-opaque nature of modern regulatory practice, decisions made in the context of a bankruptcy case are at least comparably transparent and subject to input and influence by stakeholders.[85] Furthermore, it should be expected that the cost of such action will sometimes be borne by other stakeholders, especially when the government's action is in tension with bankruptcy policies that would maximize insolvency returns for them. This can be thought of as a tax like any other cost imposed by government action in other contexts.

These principles provide a useful perspective on various high-profile cases, such as Purdue Pharma's bankruptcy. The settlement of claims against the Sacklers illustrates controversial aspects of bankruptcy practice, including third-party releases, the strategic use pre-bankruptcy transactions, scarce opportunities for appellate review, and judge-shopping.[86] But the settlement should also be understood as a use of the bankruptcy system by the DOJ and state attorneys general to police behavior within their legal and regulatory authority. It should not be surprising or particularly controversial that their regulatory goals should drive the bankruptcy process and perhaps be given some additional weight in close questions like whether to extend protections to third parties. To be sure, the settlement was not initially supported by some state attorneys general. But that should be understood as another ordering problem among other overlapping authorities in a federal system. In other words, if the Purdue settlement is problematic, the problem is largely with the DOJ's substantive policy, not its decision to employ the bankruptcy system or its structural role or strategy in the firm's bankruptcy case. Similarly, it may be that some bankruptcy protections should not be extended to third-party non-debtors. But this is a general question of bankruptcy law and policy. If it is to be allowed as a tool of bankruptcy law at all, then it should be available to advance government or regulatory policy; and perhaps the government interest should be a thumb on the scale in favor of its use in an otherwise close case.

> What these foci of government influence have in common is that the financial cost, if any, of pursuing such policy goals is borne by another claimholder in bankruptcy. Arguably, this is an unlegislated tax or unfunded mandate, implemented in the bankruptcy reorganization plan and imposed on one or more classes of other creditors.

Id. at 521.

[85] *See generally* Eisenberg, *supra* note 23, at 3*; see also*, Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking"*, 63 U. MIAMI L. REV. 1041 (2009).

[86] *See generally* Levitin, *supra* note 12; s*ee also*, Jacoby, *supra* note 44, at 419–22.

II. Financial Regulation and Bankruptcy

This Part further develops the conceptual framework set forth above by focusing on one of the most important areas of interaction between bankruptcy and the state: the relationship between bankruptcy and financial regulation and the involvement of financial regulators in the bankruptcy system. Part II.A describes the deep structural relationship between bankruptcy law and financial regulation, which, if rarely examined, is an essential and mutually defining aspect of both fields. This is because bankruptcy itself is an important part of the architecture of financial markets.

This subset of government involvement or influence over the bankruptcy system is ubiquitous but only occasionally observable. That opacity is partly a function of the informality and relative lack of transparency of financial regulation and supervision.[87] It is also due to the fact that financial regulators are most often involved in the bankruptcy system through intermediaries—the banks they regulate and supervise and who are regularly creditors in the bankruptcy system. When financial regulators' involvement in bankruptcy is observable and direct, it is often in pursuit of macro-prudential policy to promote or restore systemic stability. Such actions tend to be controversial and sometimes stand in significant tension with bankruptcy-specific policy.

Part II.B describes three episodes of direct regulatory involvement and influence in a bankruptcy system: regulators' direction of U.S. banks' behavior in the bankruptcies of commercial real estate borrowers during the financial crisis of 2008–09; the U.S. government's involvement in Chrysler's 2009 bankruptcy; and the Reserve Bank of India's requiring banks to initiate insolvency cases for their largest non-performing accounts in 2017–2018.

Each of these episodes has generated some criticism of the role of government actors and financial regulators in bankruptcy. Along with the the recent contribution by Ellias and Triantis discussed above, this criticism represents most of the commentary directly addressing the topic to date. Part II.C argues that, while these interventions may be justly subject to criticism as matters of regulatory policy, they did not contravene the structural role of bankruptcy or insolvency in the broader landscape of financial regulation. It generally defends "regulation driven" bankruptcy decision-making as a general proposition, one that derives from an understanding of bankruptcy law as itself

87 *See generally* Lev Menand, *Why Supervise Banks? The Foundations of the American Monetary Settlement*, 74 VAND. L. REV. 951 (2021) (describing the unique institutional framework and function of bank supervision).

a component of financial market architecture in a modern economy. As Part II.D explains, this aspect of bankruptcy law provides useful context for evaluating recent COVID-related proposals that would increase the involvement of financial regulators and other government actors in the bankruptcy system.

A. The Relationship

If bankruptcy is effectively an extension or a component of almost every other legal and regulatory regime, this is especially true with respect to financial regulation. As with most other regulatory regimes, bankruptcy law intersects with financial regulation in countless ways. But, in this case, the relationship runs even deeper than might be apparent to the casual observer or from most scholarship and commentary on bankruptcy law.

In the wake of recent international financial crises, policymakers and scholars have grown increasingly interested in the systemic functions of bankruptcy law as a utility-type component of the legal and regulatory architecture of financial markets.[88] This contemporary understanding of the role and function of bankruptcy law emerged in the wake of the collapse of the Soviet Union as various countries around the world began transitioning to market-based economies. As Halliday & Carruthers observe, "starting at the end of the 1980s, and throughout the 1990s, bankruptcy law became a topic of concern to major international financial institutions, global lawmaking bodies, and international professional associations."[89] These institutions and actors "shared a belief that bankruptcy law, appropriately enacted and implemented, played an important role in supporting a market economy,"[90] and they promoted global standards of insolvency and bankruptcy law.[91] As a result of this ongoing effort, there has been a discernable global convergence on institutional design for bankruptcy and insolvency systems,[92] which is largely reflected in the United Nations Commission on International Trade Law's Legislative Guide to Insolvency Law.[93]

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[88] HALLIDAY & CARRUTHERS, *supra* note 35 (noting that bankruptcy and insolvency regimes may be properly understood as part of the legal structure of financial markets); Katharina Pistor, *A Legal Theory of Finance* 3 (Colum. L. Sch., Working Paper No. 13-348, 2013).

[89] *Id.* at xv "Bankruptcy law constitutes the hard budget constraints that distinguish capitalist from command economies." *Id.* at xv.

[90] *Id.* at xxii.

[91] *Id.* at xv–xxii.

[92] *Id.* at 33; *see* Hagan, *supra* note 56, at 359, 360.

[93] *See generally* U.N. GAOR, COMM ON INT'L TRADE L., LEGISLATIVE GUIDE TO INSOLVENCY, at 9–38, U.N. Sales No. E.05.V.10 (2005), available at https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/05-80722_ebook.pdf. This global convergence has some local variations. HALLIDAY &

A series of financial crises beginning in the late 1990's, including both the recent global financial crisis and the current COVID-related economic crisis, have underscored for scholars and global policymakers an additional important function of bankruptcy law as a tool for preventing and managing financial crisis and for restoring financial stability.[94] These crises have been characterized by levels of both corporate and household over-indebtedness that threatened financial systemic stability and, in turn, the strength and functioning of the real economy.[95] Among other things, as waves of private debtors become unable to service their obligations, they impose losses on banks, increasing the risk of a banking crisis. A banking crisis can in turn cause or exacerbate general economic crises and sometimes require a government rescue, increasing the risk of a sovereign debt crises.[96]

Thus, a critical function of a bankruptcy or insolvency systems is to help insulate or rescue domestic financial systems, especially the banking system, from destabilizing over-indebtedness in the economy. It can, for example, provide a tool for clearing bad assets from the banks' portfolios, thereby improving bank capital across the system, discussed below in more detail.[97] Bankruptcy or insolvency law can also help avoid the disorderly collapse of systemically important firms[98] and the broad collateral effects or contagion that such a collapse would entail.

In sum, bankruptcy law is a necessary component of a modern financial system, one that serves various foundational regulatory and macro-economic

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CARRUTHERS, *supra* note 35, at 35.

[94] HALLIDAY &. CARRUTHERS, *supra* note 35, at 3.

> Although the repercussions of multinational collapses and the reconstruction of Eastern European economies brought bankruptcy law closer to center stage, it was the Asian Financial Crisis that finally made global actors realize that a concerted campaign was necessary to protect financial sectors, countries, and the world economy from financial shocks.

Id.; *see also* Hagan, *supra* note 56, at 361 ("[T]he Asian crisis highlighted an important question: can a legal and institutional framework designed to address the failure of individual enterprises also assist in resolving crises of systemic proportions, in which a significant portion of the corporate sector is in distress?"). *But see*, Anthony J. Casey, *Bankruptcy & Bailouts; Subsidies & Stimulus: The Government Toolset for Responding to Market Distress* 23–25 (Eur. Corp. Gov. Inst., Working Paper No. 578, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3783422 (arguing that the potentially beneficial role of bankruptcy in addressing market distress is often over-estimated and that it is generally limited to addressing "specific financial distress").

[95] Hagan, *supra* note 56, at 359. Widespread underlying private over-indebtedness may, for example, limit the space available for monetary and fiscal policies to resolve an unfolding crisis. *Id.* at 359–60.

[96] *Id.* at 359.

[97] *See infra* notes 180–83 and accompanying text.

[98] *See, e.g.*, Adam Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 485–86 (2011) (discussing the General Motors and Chrysler bankruptcies but arguing that "bankruptcy will not be used for the cases that truly present systemic risk").

functions. In most circumstances, a bankruptcy regime serves these functions through the actions and decisions of participants within the regime as a product or by-product of the technical design and operation of the system itself. In other words, regulatory policies are embedded in the substance of a bankruptcy regime and are usually deployed through the aggregate effects of individual cases and through the *ex ante* incentives that it creates for households, firms, governments, and financial institutions.[99] The machinery of a bankruptcy system itself serves crucial functions within the broader financial system as well, by facilitating the allocation of losses in an organized and timely manner. In times of stress, a bankruptcy regime can serve a crucial role in promoting or restoring systemic stability, either through its operation in the aggregate or with regard to systemically significant entities or both.

B. Three Episodes

Beyond the structural relationship between bankruptcy and financial regulatory architecture, government and regulatory actors also act in various ways to influence the operation of a bankruptcy system to promote financial regulatory goals. As two of the episodes described below illustrate, perhaps the most important if under-appreciated way that financial regulators do so is by supervising and enforcing bank capital requirements and other banking laws and regulations. Capital requirements, a critical pillar of bank regulation, effectively regulate the quality and composition of banks' loans and other assets. They help determine a wide range of banks' practices with regard to renegotiation, forbearance, and collection of obligations owed to them. They sometimes effectively require realization and allocation of losses, unclogging the system of non-performing assets, perhaps to allow for recapitalization.[100] This in turn can influence how banks participate in the bankruptcy system as creditors in their borrowers' bankruptcy cases. Through this channel, banking regulators can influence or direct the practices of private banks in the operation of the bankruptcy system. This type of engagement by banking regulators with the bankruptcy system is usually in the deep background, routine, and in pursuit of micro-prudential policies to promote the safety and soundness of particular banks.

As the Chrysler episode described below illustrates, regulators sometimes engage with the bankruptcy system even more actively to pursue macro-prudential goals, perhaps to resolve systemically significant commercial firms

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99 *See supra* note 34 and accompanying text.

100 Hagan, *supra* note 56, at 359.

or to address other systemic risks to the financial system.[101] These interactions between financial regulation, micro- and macro-economic policies, and bankruptcy law represent another dimension along which to evaluate the long-standing debates among bankruptcy scholars about institutional design.[102] They can also help inform our understanding of the relationship between a bankruptcy system and other regulatory regimes, including direct interventions from other regulatory domains in the operation of the bankruptcy system.

1. *Commercial Real Estate and the Financial Crisis of 2008–09*

In the years leading up to the financial crisis of 2008–09, commercial real estate loans, which include loans for construction and development, were a growing and particularly important component of secured lending by U.S. banks.[103] As Sarah Woo recounts in a careful study of this episode, banking regulators became increasingly concerned that the accumulated concentration of commercial loan in banks' portfolios—and thus across the banking system—posed an increasingly heightened risk, greater than the isolated risk of failure of these loans when considered individually.[104] The regulators began to impose a series of "specific regulatory measures that shaped the reactions of banks in dealing with their portfolios of loans and thereby their position as secured creditors vis-à-vis debtors. These regulatory measures . . . [included] intensive monitoring, which centered on capital adequacy and another key component: concentration risk."[105] As Woo relates:

> In February 2008, the FDIC's Office of Inspector General released a report concluding that commercial real estate concentrations had "reached record levels that could create safety and soundness concerns." In response, the FDIC . . . strongly recommended that banks with such concentrations "increase capital to provide ample protection from unexpected losses if market conditions [were to] deteriorate further." . . . Throughout 2008, banks were subject to extensive on-site supervision to monitor their credit concentrations and establish mechanisms to report internal concentration limits.[106]

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[101] *See* Patricia McCoy, *Countercyclical Regulation and Its Challenges*, 47 ARIZ. ST. L.J. 1181, 1182 n.1 (noting that macro-prudential tools, like countercyclical policies "serve macroprudential purposes because they apply to all financial institutions within a class based on macro indicators, without regard to an individual firm's financial condition").

[102] Liscow, *supra* note 35 (arguing for institutional design changes in bankruptcy law to promote counter-cyclical macro-economic outcomes, perhaps the clearest recent example of precisely this type of analysis).

[103] Woo, *Regulatory Bankruptcy*, *supra* note 11, at 1628.

[104] *Id.* at 1631–32.

[105] *Id.* at 1629.

[106] *Id.* (alteration in original) (citation omitted).

As the crisis began, the banking sector was still effectively over-exposed to the commercial real estate sector, which "attracted intense regulatory scrutiny."[107] One of Woo's important contributions to our understanding of this episode is data she reported about the behavior of banks[108] in the bankruptcies of commercial real estate firms during this period. In particular, she studied the instances of banks moving to lift the automatic stay in these bankruptcies, presumably to be able to begin foreclosure proceedings to divest from their exposures to the underlying real estate assets.[109] She found a notable increase in such actions by banks in the period of 2007-09 over the period of 2004-06.[110]

Furthermore, she found that this increase was driven by banks' concern about the risk of concentration of commercial real estate loans in their portfolios rather than individualized assessment of the liquidation value of the underlying real estate assets in each particular case.[111] This concern, she found, was "regulation-driven."[112] As she explained:

> a rational secured creditor, when faced with a bankruptcy case, would normally be hard-pressed to choose liquidation of incomplete residential developments and settle for repayment from the low as-is liquidation value . . . . The main takeaway is that an exogenous factor clearly influences secured creditors to favor liquidation when reorganization is preferable; this paper identifies financial regulation as a major suspect.[113]

Although she did not report evidence that banking regulators had specifically or expressly directed banks to move to lift the automatic stay in their debtors' bankruptcy, she "provided the first evidence, to the best of the author's knowledge, that the financial regulatory regime affects creditors' behavior in bankruptcy."[114]

Unfortunately, it appears that this policy of pushing banks to divest from commercial real estate assets exacerbated the underlying problem posed by their concentration in the banking system. The actions of banks in response to this regulatory pressure, including what Woo termed "bankruptcy contagion,"[115]

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107 *Id.* at 1618.
108 *See id.* at 1628–31.
109 *See id.*
110 *Id.* at 1641.
111 *Id.* at 1646.
112 *Id.*
113 *Id.* at 1652–53.
114 *Id.* at 1646.
115 *Id.* at 1655 ("This process deserves the term bankruptcy contagion because the exogenous factor affecting bankruptcy proceedings–the microprudential regulatory regime–is not an idiosyncratic factor, but

further depressed the value of those assets, in turn further eroding bank capital.[116] This assessment was quickly made as well by the banking regulators,[117] and they reversed their regulatory policy.[118]

2. *The Chrysler Bankruptcy*

In April of 2009, Chrysler LLC and its subsidiaries, which together comprised one of the world's largest manufacturers and distributors of automobiles, filed for bankruptcy in the Southern District of New York.[119] At that time, the company had approximately 55,000 hourly and salaried employees in the U.S. and abroad.[120] In 2008, it had a net operating loss of nearly $17 billion.[121] By that time, the company had been struggling to maintain its position in the automotive industry for many years and had been facing acute financial challenges for many months. It had merged with Daimler-Benz, the German auto firm, in 1998, and in May 2007 that firm sold an eighty percent stake to Cerberus Capital Management, a U.S. private equity firm.[122] Around that time, the firm initiated an effort to restructure its operations and to develop a strategic partnership with another auto firm to manufacture more energy efficient vehicles.[123] Although the firm approached numerous possible partners, it was unable to reach agreement on such a partnership.[124] This effort took on greater urgency in 2008, first because of a spike in gas prices that summer,[125] and then

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rather a systemic factor that affects the banking industry all at once.").

116 *Id.* at 1656–57.

117 *Id.* at 1653–54.

118 *Id.* at 1656.

> [I]n reaction to bankruptcy contagion, U.S. regulators by the end of 2009 issued a policy statement on commercial real estate loans, making clear that prudent workouts are "often in the best interest of the financial institution and the borrower," and that loans should not be subject to adverse classification and write-downs "solely because the value of the underlying collateral has declined to an amount that is less than the loan balance."

Id.

119 *In re* Chrysler LLC, 405 B.R. 84, 87 (Bankr. S.D.N.Y. 2009). General Motors, another major U.S. automobile manufacturer, filed for bankruptcy as well and employed a similar strategy as Chrysler's, following the *Chrysler* court's approval of the approach. *See* Roe & Skeel, *supra* note 25, at 731 (citing *In re* Gen. Motors Corp., 407 B.R. 463,497–98 (Bankr. S.D.N.Y. 2009)).

120 *In re* Chrysler LLC, 405 B.R. at 88.

121 *Id.* at 89.

122 *DaimlerChrysler Dawns*, CNN: MONEY (May 7, 1998), https://money.cnn.com/1998/05/07/deals/benz/; Bill Vlasic & Nelson D. Schwartz, *Chrysler and Fiat Have Hopes for Happy Relationship*, N.Y. TIMES (May 4, 2005), https://www.nytimes.com/2009/05/05/business/05auto.html.

123 *In re* Chrysler, LLC, 405 B.R. at 90.

124 *See id.* at 90–92.

125 Associated Press, *Gas Prices Put Detroit Big Three Crisis Mode*, NBC NEWS (May 30, 2008), http://www.nbcnews.com/id/24896359/ns/business-autos/t/gas-prices-put-detroit-big-three-crisis-mode/.

as the global financial crisis of 2008-09 began to affect the real economy and especially the availability of credit to the company and to consumers.[126]

In late 2008, Chrysler borrowed $4 billion from the U.S. Treasury, pursuant to Treasury's Troubled Asset Repurchase Program ("TARP").[127] Significantly, the terms of the loan required Chrysler to develop and submit to Treasury a plan "showing that it was able to achieve and sustain long-term viability, energy efficiency, rationalization of costs and competitiveness in the U.S. marketplace . . ., which would indicate Chrysler's ability to repay the TARP Financing."[128] In January of 2009, Chrysler reached an agreement for a "strategic alliance" with Fiat, in which Fiat would acquire a stake in Chrysler, and the following month Chrysler submitted to Treasury its viability plan proposing the arrangement with Fiat.[129] President Barack Obama created a task force to evaluate Chrysler's viability plan and, subsequently, to help negotiate the terms of the Chrysler-Fiat alliance and the process for establishing it.[130] This process involved, among other things, reaching settlements with its current and retired employees; obtaining consent from Chrysler's senior secured creditors; and creating a third company (commonly known as New Chrysler), which acquired almost all of Chrysler's assets and a portion of its liabilities.[131] The new company transferred $2 billion to (old) Chrysler, which was used to pay its senior secured creditors approximately twenty-nine percent of their claims.[132] Fiat would acquire a twenty percent stake in the new Chrysler, with the right to obtain up to thirty-one percent; the company's retirees' association would have a fifty-five percent stake; and the governments of the U.S. and Canada would have eight and two percent stakes, respectively.[133]

Together, the task force, Chrysler, and Fiat decided that the transaction would be conducted pursuant to a bankruptcy filing by Chrysler, contingent on the U.S. Treasury's willingness to fund the transaction and the restructuring.[134] Chrysler filed for bankruptcy on April 30, 2009 and, that day, Chrysler, Fiat and New Chrysler formally entered into their agreement for the sale of Chrysler to

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126 *See In re* Chrysler LLC, 405 B.R. at 90.
127 *Id.* at 89–90.
128 *Id.* at 90.
129 *Id.* at 90, 91.
130 *Id.* at 91.
131 *Id.* at 92–98.
132 Roe & Skeel, *supra* note 25, at 733.
133 *In re* Chrysler LLC, 405 B.R. at 92.
134 *See* Roe & Skeel, *supra* note 25, at 760 (suggesting that the U.S. Treasury determined that Chrysler would be rescued through a bankruptcy process); *In re* Chrysler LLC, 405 B.R. at 91.

New Chrysler.[135] The next day, Chrysler filed a motion in bankruptcy court to schedule a hearing on the transaction.[136] Three of the holders of Chrysler's senior secured claims, accounting for $42 million of the $6.9 billion in those claims, objected to the sale.[137]

The sale of all of Chrysler's assets to New Chrysler was proposed pursuant to Section 363 of the U.S. Bankruptcy Code,[138] which provides that a debtor or trustee "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate."[139] Generally, as in the Chrysler case, sales of assets pursuant to Section 363 are proposed at the very early stages of a bankruptcy case, well before a reorganization plan has been negotiated or proposed.[140] Courts routinely authorize the sale of assets of the bankruptcy estate out of the ordinary course of business under such circumstances.[141] Most often, such assets are discrete items or portions of the estate.[142] Those assets are sold and the proceeds from the sale become part of the estate and are distributed to creditors pursuant to a reorganization plan in chapter 11 or liquidation in chapter 7.[143]

Sometimes, however, corporate debtors seek to sell essentially the entire firm pursuant to section 363, and the estate is then comprised primarily or exclusively of the proceeds of the sale.[144] In some of these cases, the newly acquired firm voluntarily adopts some portion of the obligations of the debtor in bankruptcy, leaving other creditors to claim only whatever they may recover in the debtor's bankruptcy proceedings.[145] Recognizing that such transactions are occasionally efficient, courts will approve them but generally require a sound business justification for the sale, notice to affected parties, a fair price, and a good faith sale procedure.[146] As Mark Roe and David Skeel have explained,

135 *In re* Chrysler LLC, 405 B.R. at 92.

136 *Id.* at 97.

137 *Id.* at 93.

138 *See* Roe & Skeel, *supra* note 25, at 751.

139 11 U.S.C. § 363(b) (2018). A debtor or trustee is furthermore authorized to "use, sell, or lease . . . property of the estate in the ordinary course of business without notice or a hearing." *Id.* § 363(c) (2018).

140 *See, e.g.*, Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014).

141 *See* 11 U.S.C. § 363 (2018).

142 Jacoby & Janger, *supra* note 140, at 874–76.

143 *See* Roe & Skeel, *supra* note 25, at 737.

144 *See* Jacoby &. Janger, *supra* note 140, at 876–80 (discussing *In re* Lionel Corp., 722 F.2d 1063 (2d Cir. 1983)).

145 Such an arrangement can enable the parties to benefit from the debtor's power under the Bankruptcy Code to sell assets free and clear of liens or other claims and then effectively reorganize the debtor's firm outside of the process otherwise required under chapter 11.

146 *See* Roe & Skeel, *supra* note 25, at 739 (quoting Scott D. Cousins, *Chapter 11 Asset Sales*, 27 DEL. J.

these requirements are "safeguards [that] can reconcile a Section 363 sale with core protections of [chapter 11]: judicial valuation, creditor consent, and a contested auction."[147]

In Chrysler's proposed sale of all of its assets to New Chrysler, the bankruptcy court judge and the U.S. Second Circuit Court of Appeals both found that these conditions were met.[148] Furthermore, the bankruptcy court found that the objecting creditors effectively consented to the transaction in deciding that Chrysler could sell its assets free and clear of liens and other interests pursuant to Section 363(f).[149] The court found that they had consented as participants in a large secured loan agreement.[150] Their administrative agent had approved Chrysler's transaction with Fiat, and creditors holding over ninety percent of the secured loan amount outstanding voted to approve the administrative agent's decision.[151] These senior secured claims were secured by all of Chrysler's assets; as a practical matter, they were the only creditors who had a claim on the proceeds of the sale of the firm.[152]

The creditors objecting to Chrysler's sale to New Chrysler questioned the legitimacy of this vote by the senior secured claimants.[153] Among the consenting creditors were some of the country's largest banks who together held over seventy percent of the loan amount outstanding under the lending agreement.[154] These banks were all recipients of investments by the U.S. Treasury pursuant to TARP.[155] In other words, these banks owed significant obligations to the major proponent of Chrysler's proposed sale and the firm's largest single creditor, the U.S. Treasury, under terms that gave Treasury significant potential direct power

CORP. L. 835, 839–40 (2002)).

> The Second Circuit U.S. Court of Appeals has articulated various factors to assess in determining whether there is a sound business justification for a § 363(b) sale. These include: "the proportionate value of the asset to the estate as a whole[;] the amount of elapsed time since the filing[;] the likelihood that a plan of reorganization will be proposed and confirmed in the near future[;] . . . and . . . whether the asset is increasing or decreasing in value.

In re Chrysler, LLC, 405 B.R. 84, 95 (Bankr. S.D.N.Y. 2009) (quoting Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983)).

147 Roe & Skeel, *supra* note 25, at 739.

148 *In re* Chrysler LLC, 405 B.R. at 94–100, 119; *In re* Chrysler LLC, 576 F.3d 108 (2d Cir. 2009).

149 *In re* Chrysler LLC, 405 B.R. at 113.

150 *Id.* at 102.

151 *Id.*

152 *See id.* at 101–02.

153 *Id.* at 103.

154 *Id.* at 89–90.

155 *See* Roe & Skeel, *supra* note 25, at 743.

over them.[156] The objecting creditors essentially argued that the government had, and had exercised, the power to direct these creditors to consent to the transaction. The Court dismissed this argument for lack of evidentiary support.[157]

3. *The "RBI 12"*

The Reserve Bank of India's ("RBI") involvement in that country's bankruptcy and insolvency system is one of the most dramatic of recent examples of regulatory intervention in an insolvency or bankruptcy system anywhere around the globe.[158] In May of 2016, India adopted a new comprehensive Insolvency and Bankruptcy Code ("IBC").[159] The IBC's provisions for business debtors, which were notified in August 2016,[160] created a new regime for corporate reorganizations and liquidations, replacing a number of pre-existing laws.[161] Very briefly, the regime is structured as a gateway restructuring chapter with a liquidation chapter backstop.[162] Cases can be initiated by creditors or debtors,[163] but the design of the IBC effectively ensures that creditors will generally do so. Firms that enter the system are taken over by an insolvency professional and a committee of "financial" creditors who have a few months—180 days, which can be extended to 270 days—to specify and approve a plan of reorganization. In practice, such plans usually provide for a sale of the firm as a going concern pursuant to a bidding process.[164] If a plan is

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156 *Id.* at 743.

157 *See infra* note 214 and accompanying text.

158 *See, e.g.*, *Government interference undermines RBI's functional autonomy: Viral Acharya,* THE ECON. TIMES (OCT. 27, 2018, 8:56 AM), https://economictimes.indiatimes.com/industry/banking/finance/banking/government-interference-undermines-rbis-functional-autonomy-viral-acharya/articleshow/66383480.cms?from=mdr.

159 The Insolvency and Bankruptcy Code, 2016, (India).

160 Insolvency and Bankruptcy Code, *supra* note 159, at Part II, https://ibbi.gov.in//webadmin/pdf/legalframwork/2017/Jul/Notificationdated05.08.2016.pdf.; https://ibbi.gov.in//webadmin/pdf/legalframwork/2017/Jul/Notification_22092016_1.pdf. As with other legislative acts, the IBC provides that, "It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint." Insolvency and Bankruptcy Code, *supra* note 159, at 1.3. The Official Gazette, published by the Government of India Press, is generally used by the government to publish official notices. *See* THE GAZETTE OF INDIA, http://egazette.nic.in/.

161 Adam Feibelman, *Legal Shock or False Start: The Future of India's New Consumer Insolvency and Bankruptcy Regime,* 93 AM. BANKR. L.J. 429, 442 & n.78 (2019).

162 *Id.* at 443.

163 *Id.*

164 Anirudh Burman, India's Sustained Economic Recovery Will Require Changes to Its Bankruptcy Law 8 (Apr. 2021) (Carnegie India working paper), https://carnegieendowment.org/files/Indias_Sustained_Economic_Recovery_Carnegie_v1_web.pdf.

not approved within the allotted time, the firm is to be liquidated pursuant to the IBC.[165]

Thus, as designed, the IBC provides that a firm will generally enter the insolvency and bankruptcy system if at least one creditor decides to trigger the process, and the firm's fate will be determined by a subset of its creditors, subject to the substantive rules of the IBC, with relatively limited interference by an adjudicating authority.[166] To implement this new regime, the IBC created a number of new major institutional entities and actors, the most important of which is the Insolvency and Bankruptcy Board of India ("Board").[167] The Board is responsible for adopting rules and regulations to implement numerous aspects of the new regime and for supervising many of its components.[168]

The IBC was drafted and enacted in a surprisingly short period of time for such a consequential and comprehensive legal regime.[169] The drafters of the IBC and policymakers who enacted it had two primary motivations for adopting the new IBC, both of which drove many of the important design choices that shaped it, and both of which reflect the unique policy and regulatory functions of bankruptcy law described above in Parts I.A and II.A. The first of these goals was somewhat conventional, *i.e.*, that the new system would increase, clarify, or accelerate lenders' returns from their debtors who experience financial troubles.[170] Policymakers hoped that if the new system could succeed in this regard, it would promote the development of domestic credit markets, especially the domestic corporate bond market.[171] They also hoped that the new regime would help attract foreign investors by improving and clarifying the legal environment for firms or projects they might invest in as well as their ability to recover capital if those firms or projects fail.

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165 Feibelman, *supra* note 161, at 443.

166 *See infra* note 184 and accompanying text.

167 Feibelman, *supra* note 161, at 437–38.

168 Insolvency and Bankruptcy Code, *supra* note 159, at §§ 188–198. Among other things, the Insolvency and Bankruptcy Board of India is charged with regulating and supervising newly created insolvency professionals and issuing rules and regulations related to these professionals and that implement numerous other substantive aspects of the Code. Insolvency and Bankruptcy Code, *supra* note 159, at §§ 196, 240. The Board is also responsible for gathering and disseminating data related to the new insolvency and bankruptcy system. *The Insolvency and Bankruptcy Code*, 2016, § 196. (India). The powers of the Board are "subject to the general direction of the central government." Insolvency and Bankruptcy Code, *supra* note 159, at § 196.

169 Feibelman, *supra* note 161, at 435.

170 *Id.* at 457.

171 *Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design*, at 33–34 (2015) available at http://dea.gov.in/sites/default/files/BLRCReportVol1_04112015.pdf.

Policymakers' second, and perhaps more acute, motivation for enacting the IBC was to address a specific and intractable problem of nonperforming assets that had accumulated and persisted in the country's banking system.[172] At that time, non-performing assets had reached the level of nearly five percent of bank assets in the country.[173] Policymakers hoped that the IBC would enable the long-needed resolution or rehabilitation of the firms that owed banks these non-performing loans and thus clear these assets from the banks' balance sheets, helping to improve the capital position of the entire system.[174] As a result of these related goals, the regime for corporate debtors was expressly designed to improve the speed and predictability of allocating losses from commercial ventures, either through expeditious restructuring of debts or liquidation.[175] The choice to maximize the role of creditors and to reduce the role of judicial officers in making critical decisions throughout the system is an important feature of this design.[176]

In June of 2017, less than a year after the IBC went into effect, the RBI directed banks under its supervision to force firms owing the largest non-performing loans in the banking system into insolvency.[177] Specifically, an internal advisory committee of the RBI recommended that banks should initiate insolvency cases for all debtors who owed more than 5,000 rupees crore (50 billion rupees, approximately $720 million) if more than sixty percent of their debt was non-performing.[178] At the time, this criteria applied to 12 accounts owed to Indian banks that represented roughly a quarter of the gross non-performing assets in the country's banking system.[179] Most of the firms

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172 Feibelman, *supra* note 161, at 457.

173 *See* Vastal Khullar, *The Rise of Non-Performing Assets in India*, THE PRS BLOG (May 11, 2016), http://www.prsindia.org/theprsblog/the-rise-of-non-performing-assets-in-india.

174 *See, e.g.*, *Resolve 55 Accounts In Six Months Under Bankruptcy Code: RBI to Banks*, THE ECON. TIMES (June 22, 2017, 6:34 PM), http://economictimes.indiatimes.com/industry/banking/finance/banking/resolve-55-accounts-in-six-months-under-bankruptcy-code-rbi-to-banks/articleshow/59271821.cms.

175 *Report of the Bankruptcy Law Reforms Committee supra* note 171, at 14–15.

176 *See, e.g.*, *id.* at 12 ("In the past, laws in India have brought arms of the government (legislature, executive or judiciary) into this question [of how to resolve a commercial firm in financial distress]. This has been strictly avoided by the Committee. The appropriate disposition of a defaulting firm is a business decision, and only the creditors should make it.").

177 *See* Press Release, Reserve Bank of India, RBI identifies Accounts for Reference by Banks under the Insolvency and Bankruptcy Code (IBC) (June 13, 2017) (https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR3363482A1FF9229F4B9A92EA0090D5D71518PDF); *see also* Khullar, *supra* note 173.

178 Press Release, Reserve Bank of India, RBI Identifies Accounts for Reference by Banks Under the Insolvency and Bankruptcy Code (IBC) (June 13, 2017) (https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR3363482A1FF9229F4B9A92EA0090D5D71518.PDF).

179 *RBI Lists 12 NPA Accounts for Insolvency Proceedings*, THE HINDU BUSINESS LINE: MONEY & BANKING, available at https://www.thehindubusinessline.com/money-and-banking/rbi-lists-12-npa-accounts-for-insolvency-proceedings/article9726354.ece (last updated Jan. 12, 2018).

representing those twelve accounts were in the steel, metals, and construction industries, and all had been through at least one unsuccessful restructuring effort.[180] As the Governor of the RBI stated at the time:

> [t]he size and nature of the NPA problem necessitated concomitant measures to signal intent and commitment of the Government and the Reserve Bank to meet the challenge squarely. The IBC was in place but the required action in respect of the large stressed accounts was not forthcoming on the part of banks . . . . Part of the inertia may have to do with the initial days of the IBC; but part of it was also the typical (and severe) agency and moral hazard problems of not resolving NPAs when the banking sector is majorly government-owned.[181]

Soon thereafter, in July and August 2017, the relevant banks initiated insolvency cases for the firms representing 11 of these accounts; the twelfth was initiated in May 2018.[182] At that point, India's new insolvency and bankruptcy system was still very much in the initial phase of implementation.[183] These large cases proved to be—and some continue to be—important and challenging tests for the new regime, providing numerous occasions for institution building and refinement as well as some substantive legal reforms.[184] These cases quickly became the focus of significant public attention, causing the new insolvency and bankruptcy to become and remain a very salient topic of public interest and concern.[185]

By August of 2018—well beyond the time frame set forth under the IBC, after which firms should be transferred to the liquidation process—resolution plans had been approved by adjudicating authorities for four of the initial twelve, and the other cases were ongoing. Meanwhile, in February of 2018, the RBI published a circular expanding its policy of requiring banks to initiate cases

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[180] Joshua Felman, Varun Marwah, & Anjali Sharma, presentation at IBBI—IGIDR Conference on Insolvency and Bankruptcy Reforms: The Reserve Bank of India (RBI) - 12 Cases Under the Insolvency and Bankruptcy Code (IBC) (Aug. 3, 2018), available at https://ifrogs.org/EVENTS/IBC_Confference/PRESENTATIONS/sl_201808_watchingRBI12_Anjali.pdf.

[181] Urjit R. Patel, Governor, Reserve Bank of India, Speech at the Inaugural Session of the "National Conference on Insolvency and Bankruptcy: Changing Paradigm" (Aug. 19, 2017).

[182] Pragya Srivastava, *'Dirty Dozen' NPA resolution*, FIN. EXPRESS (July 26, 2018), available at https://www.financialexpress.com/economy/dirty-dozen-npa-resolution-4-done-8-under-process-heres-ibc-update-for-12-big-accounts/1258908/.

[183] Ajay Shah, *Sequencing Issues in Building Jurisprudence: The Problems of Large Bankruptcy Cases*, THE LEAP BLOG (July 7, 2018), https://blog.theleapjournal.org/2018/07/sequencing-issues-in-building.html.

[184] *See* Ajay Shah & Susan Thomas*, The Indian Bankruptcy Reform: The State of the Art, 2018*, THE LEAP BLOG (Dec. 22, 2018), https://blog.theleapjournal.org/2018/12/the-indian-bankruptcy-reform-state-of.html. *See also* Shah, *supra* note 183.

[185] *See* Shah, *supra* note 183; Shah & Thomas, *supra* note 184.

against firms that owe non-performing loans.[186] Among other things, the RBI announced at that time that banks must initiate insolvency proceedings against firms with loans over 2,000 rupees crore (20 billion rupees, roughly $288 million) within 180 days after a default if a resolution plan has not otherwise been implemented.[187]

In April of 2019, in the case of *Dharani Sugars and Chemicals v. Union of India*, the Supreme Court of India found the RBI's policy announced in the February 2018 circular to be unconstitutional.[188] In brief, the RBI had issued the relevant part of the circular pursuant to sections 35A and 35AA of the Banking Regulation Act of 1949.[189] Section 35A, part of the original Act sets forth broad powers of the RBI over the banks it regulates; in dicta, the Supreme Court of India noted that, by itself, that section could have authorized the RBI to direct banks to initiate insolvency cases against their borrowers.[190] But sections 35AA were added to the Act by the Central Government pursuant to an ordinance amending the Act on May 4, 2017, after the IBC was enacted.[191] Section 35AA provides that Central Government may "authorize the RBI to issue directions to any banking company or banking companies when it comes to initiating the insolvency resolution process under the provisions of the [IBC]."[192] On May 5, 2017, the Ministry of Finance formally gave the RBI this authority.[193]

In *Dharani*, the Court held, first, that section 35AA itself is constitutional.[194] But it found that the RBI's circular of February 2018 was not constitutional and,

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[186] Reserve Bank of India, Circular on Resolution of Stressed Assets—Revised Framework, RBI/2017-18/131 (Issued on Feb. 12, 2018), https://rbidocs.rbi.org.in/rdocs/Notification/PDFs/131DBRCEC9D8FEED1C467C9FC15C74D01745A7.PDF.

[187] *Id.*

[188] Dharani Sugars and Chemicals v. Union of India, (2019) 5 SCC 480 (India).

[189] Reserve Bank of India, Circular on Resolution of Stressed Assets, *supra* note 186.

[190] Dharani Sugars and Chemicals v. Union of India, 5 SCC at 516–18 ("A cursory reading of Section 35A makes it clear that there is nothing in the aforesaid provision which would indicate that the power of the RBI to give directions, when it comes to the [IBC], cannot be so given.").

[191] Debopam Dutta & Vishesh Arora, *Supreme Court Strikes Down RBI's Framework On Resolution Of Stressed Assets*, Argus Partners (May 2, 2019), https://www.mondaq.com/india/financial-services/802852/supreme-court-strikes-down-rbi39s-framework-on-resolution-of-stressed-assets.

[192] Dharani Sugars and Chemicals v. Union of India, 5 SCC at 521.

[193] Ministry of Finance, S.O.1435(E) (issued on May 5, 2015) (India).

> In exercise of the powers conferred by Section 35AA of the Banking Regulation Act, 1949 (10 of 1949), the Central Government hereby authorizes the RBI to issue such directions to any banking company or banking companies which may be considered necessary to initiate insolvency resolution process in respect of a default, under the provisions of the Insolvency and Bankruptcy Code, 2016.

Id.

[194] Dharani Sugars and Chemicals v. Union of India, 5 SCC at 506–07.

as a consequence, "all actions taken under the said circular, including actions by which the [IBC] has been triggered must fall along with the said circular."[195] The Court found that section 35AA required that the RBI receive authorization from the Central Government to force banks to initiate IBC proceedings against their debtors[196] and that the government only authorized the RBI to do so with respect to specific defaults related to specific borrowers.[197]

Thus, India's Central Government has the power to direct banks to initiate insolvency proceedings against their borrowers, and it has extended that power to RBI, but only in specific cases, not as a general policy. It arguably remains an open question whether the RBI's directive to banks in 2017 to initiate proceedings against the firms holding the twelve largest non-performing accounts would pass muster as specific directives or whether those early directives might also be subject to the same fate as the RBI's February 2018 circular.[198] Furthermore, on June 7, the RBI issued a new circular to replace the February 2018 circular. The new circular increases provisioning requirements for loans that remain in default, require banks to resolve non-performing loans over 2000 rupees crore within 180 days, and gives banks the discretion to initiate insolvency or bankruptcy cases against their debtors "within 30 days of a default."[199] While this policy does not require banks to initiate insolvency proceedings, it is clearly designed to create regulatory pressure to do so and to thereby steer banks in that direction, a striking example of the "regulatory bankruptcy" that Woo observed in the U.S. during the previous financial crisis.

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[195] *Id.* at 564.

[196] *Id.* at 524–25. Notably, the Court found that Banking Regulation Act also authorizes the Central Government to do this on its own. *Id.*

[197] *Id.* at 546.

> [I]t is clear that the RBI can only direct banking institutions to move under the Insolvency Code if two conditions precedent are specified, namely, (i) that there is a Central Government authorisation [sic] to do so; and (ii) that it should be in respect of specific defaults. The Section, therefore, by necessary implication, prohibits this power from being exercised in any manner other than the manner set out in Section 35AA.

Id.; *see also* Manu Sebastian, *Authorization From Central Govt Necessary For RBI To Direct Insolvency Process Against Stressed Assets: SC*, LIVE LAW (April 2, 2019), https://www.livelaw.in/top-stories/authorization-central-govt-necessary-rbi-to-insolvency-process-against-stressed-assets-144019.

[198] *See* Vindod Jain, *The Road Ahead for IBC, Post SC Judgment*, THE HINDU BUS. LINE: MONEY & BANKING (Apr. 20, 2019), https://www.thehindubusinessline.com/opinion/the-road-ahead-for-ibc-post-sc-judgment/article26995077.ece.

[199] *RBI Issues Revised Circular on Stressed Loans: Here are All the Details*, THE ECON. TIMES (June 7, 2019, 7:30 PM), https://economictimes.indiatimes.com/news/economy/policy/rbi-issues-revised-circular-on-resolution-of-stressed-loans/articleshow/69691738.cms.

4. *Summary*

Mapping these episodes to the typology from Part I, Woo's account of financial regulators directing or influencing banks' behavior in bankruptcy during the financial crisis of 2008–09 is an important illustration of a ubiquitous and routine but often unobserved influence of regulators on the bankruptcy system. In this case, the influence is not upon the debtor in bankruptcy, but upon other stakeholders: banks that the regulators supervise. The RBI's directives to require banks in India to initiate bankruptcy proceedings against their debtors with large non-performing loans is another example of this type of regulatory influence on the bankruptcy system. In that case, the intervention was not routine but starkly observable. The creation of the IBC itself exemplifies a two-step process in the intersection of bankruptcy and financial regulation; the law was adopted largely to help address non-performing loans in the country's banking sector and then the RBI stepped in to prompt this function by requiring banks to initiate insolvency cases.

The Chrysler episode reflects a number of modes in which the government can influence and engage with the bankruptcy system. As an initial matter, the government effectively directed the bankruptcy filing itself. The initial loan from Treasury and the participation of the government task force set conditions which steered Chrysler to conduct its transaction with Fiat through a bankruptcy process. And the bankruptcy filing appears to have been a condition of Treasury for its financial support for the transaction. The government's role as a pre- and post-petition creditor probably gave it sufficient leverage to play a prominent or dominant role in determining the process and outcome. In exercising this leverage, the government was not motivated primarily to recover its financial stake, but to advance its regulatory concerns. It is also possible that Chrysler's secured creditors consented to Chrysler's proposed bankruptcy sale to New Chrysler at least in part because of the leverage the government had over them as TARP recipients.

C. *Criticism*

Although much has been written about various aspects of these episodes, surprisingly little work has specifically examined the government's intervention in the bankruptcy or insolvency system in each case. The few writers who have directly addressed this aspect of these episodes have been critical of the government's involvement. Their views can fairly be said to represent the current conventional wisdom on the matter.

Woo's account of the U.S. banking regulators pushing banks to divest from commercial real estate exposure in the mid-2000's is primarily a descriptive one. Woo also explains how this influence on the bankruptcy system by regulators is in tension with existing strands of bankruptcy theory. Although it was not the primary aim of her study, Woo left no doubt that she was critical of the government's action in this episode, and she advanced a normative view on regulatory driven decision-making in bankruptcy. She emphasized the risks of such activity, especially to the extent that it caused parties to make decisions that were not determined by their own direct economic or financial interests. It was, in her words, a "misguided attempt[] to use regulatory power . . ., interfering with investment expectations and diminishing asset values."[200]

Roe and Skeel are much more adamant in their objections to the government's role in the Chrysler bankruptcy.[201] In general, they are highly critical of the government's involvement in Chrysler's use of the Section 363 sale and *sub rosa* reorganization; they compare the government unfavorably to dominant creditors in the abusive equity receiverships of the early 20th Century.[202] In that context, they are particularly concerned about the possibility that the government employed its power over Chrysler's largest secured creditors to effectively cause them to consent to the deal, undermining an important check on the potential dangers of the type of maneuver employed in the case. According to Roe and Skeel, these creditors were "beholden to the U.S. Treasury" and their votes to consent to Chrysler's sale to New Chrysler were "tainted" such that they would be designated as a bad-faith vote in a formal chapter 11 proceeding.[203] As they write:

> There's another, more severe, way to look at the big banks' votes. One or more of these banks could plausibly be viewed as controlled by the U.S. Treasury at the time . . . .
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> . . . .
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> . . . If the Treasury was a controlling person of one or more the major banks, how should we look at the banks' consent? We'd then have to see Chrysler's major bankruptcy lender as controlling the votes of Chrysler's major prebankruptcy creditors, on a plan the lender itself designed. Normally this conflict is reason for serious concern.[204]

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200 Woo, *Regulatory Bankruptcy, supra* note 11, at 1618.

201 *See* Roe & Skeel, *supra* note 25, at 763.

202 *Id.* at 735.

203 *Id.* at 743; *see also* Neil King, Jr. & Jeffrey McCracken, *USA Inc.: U.S. Forced Chrysler's Creditors to Blink*, WALL ST. J., (May 11, 2009), https://www.wsj.com/articles/SB124199948894005017.

204 *See* Roe & Skeel, *supra* note 25, at 743–44.

As noted above,[205] the bankruptcy court had briefly addressed this argument, also made by the objecting creditors, and dismissed it as "without any evidentiary support" and "mere speculation and without merit."[206] Roe and Skeel criticize this as a "weak, possibly naive standard."[207]

Given the significance of the action at the time and in retrospect, it is surprising how little critical assessment there has been of the RBI's move to push banks to initiate insolvency cases in 2018-19. There has been some commentary on the wisdom of the policy and some critical analysis of the legal basis of the RBI's actions. Its actions have been criticized, for example, as a misstep on the road to building capacity for the new insolvency and bankruptcy system.[208] The particular policy of the RBI's February 2018 circular was criticized in the litigation leading to the *Dharani* opinion. The debtor argued, for example, that setting a relatively rigid policy for all accounts meeting the circular's criteria was over-inclusive and did not allow for unique circumstances in particular cases that might make an insolvency case inadvisable.[209] Yet these concerns did not touch upon the precise question of whether the RBI should exercise this type of involvement in the insolvency system in general or to what extent. There has been little other public discussion in India on the merits of the general authority given to the Central Government and, by delegation, to the RBI, to interfere in creditors' decisions about whether to initiate insolvency proceedings for their debtors.

Bhargavi Zaveri has provided one of the few direct assessments of the Central Government's ordinance amending the Banking Regulation Act and adding Section 35AA. Specifically, she has questioned whether the use of an ordinance rather than parliamentary law-making was warranted and has argued that the amendment has the effect of "enhanc[ing] the powers of the Central Government vis-a-vis the banking regulator."[210] Furthermore, in criticizing the ordinance and the particular policy imposed by RBI's February 2018 circular, Zaveri writes "[s]ince liberalization, the overarching regulatory philosophy has

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205 *See supra* note 165 and accompanying text.

206 *In re* Chrysler LLC, 405 B.R. 84, 104 (Bankr. S.D.N.Y. 2009).

207 Roe & Skeel, *supra* note 25, at 745–46 (observing that under state corporate law, courts have found directors conflicted based on ties between their employer and the company on whose board they sit).

208 *See* Shah & Thomas, *supra* note 184.

209 *See* Dharani Sugars and Chemicals v. Union of India, (2019) 5 SCC 480, 506–07 (India).

210 *See* Bhargavi Zaveri, *The Centre's Approach to Insolvency and Bankruptcy Code Has Costs*, MINT (June 14, 2018), https://www.livemint.com/Opinion/57zH4H7fU5sgo5xPnmz5bN/The-Centres-approach-to-Insolvency-and-Bankruptcy-Code-has.html.

been to reduce state intervention in commerce. The ordinance is a backward step in this arduous journey."[211]

As noted above, Ellias and Triantis have also expressed concern about aggressive government involvement in the bankruptcy system as an end-run around constraints to government authority and an opaque means for executive policy-making.[212] In particular, they worry that it is harder to hold government actors accountable for their actions in the bankruptcy system and that bankruptcy judges are not well equipped to make non-bankruptcy policy decisions.

In contrast to this small but growing body of commentary, this Article argues that government involvement or "activism" in the bankruptcy system is a natural manifestation of the structural relationship between bankruptcy and the rest of the government's legal and regulatory apparatus. Such government involvement in the bankruptcy system should be subject to the same careful and critical assessment as would be any government policy or action. But the use of bankruptcy as a tool of government influence and authority, in and of itself, should be understood as an intended product of the institutional relationship between bankruptcy and non-bankruptcy law and the basic ordering between them.

D. Recent Pandemic Proposals

Setting aside the general merits of the pandemic-related bankruptcy proposals, many of them would likely represent the most dramatic and systematic government involvement in the U.S. bankruptcy system in modern history. It is surprising, therefore, that this aspect of their proposals has not been noted or evaluated as a matter of bankruptcy policy. While those proposals may seem to have been rendered moot by the subsequent economic recovery, they warrant continued attention. Unfortunately, it is fair to assume that other crises will emerge, and these efforts to anticipate the role of the bankruptcy system in response will likely be valuable. Furthermore, in any event, these proposals are useful and illuminating for what they reveal about our current understanding about the role of the bankruptcy system and its relationship to other policy responses to financial distress.

This section examines in particular the role of government actors that would be involved in some of these proposals. It addresses two types of proposals in particular: the proposals to have the government, through the Treasury or the

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211 *Id.*

212 *See supra* notes 16–22 and accompanying text.

Federal Reserve, provide funds for debtor-in-possession financing[213] and the proposal to condition any financial support to firms from the government on the recipient filing for bankruptcy.[214]

These proposals were motivated in part by the concern that there may not be sufficient financial resources available for firms in bankruptcy if filings increase substantially.[215] Such financing is generally essential for firms to sustain themselves during their bankruptcy cases and to transition or bridge to their post-bankruptcy operations. It is thus an essential resource for allowing the bankruptcy system to perform its basic functions of determining which firms should be reorganized and then facilitating their reorganization.[216] Currently, a handful of large banks provide most of the DIP financing in the U.S., with non-bank institutions providing a growing portion.[217]

Some writers proposed that the government should directly provide DIP financing to firms in bankruptcy, with some proposals envisioning a facility like the ones created under the CARES Act.[218] This would presumably require some reforms to the existing legal framework because the Federal Reserve Act prohibits the Federal Reserve from providing financing to firms in bankruptcy.[219] Peter Conti-Brown and David Skeel have proposed having the Federal Reserve create a facility for lending to banks who would then provide DIP financing to firms in bankruptcy. In their view, this would not require any changes to existing law.[220] In addition to providing more resources for DIP

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213 DeMarzo et al., *supra* note 3; Conti-Brown & Skeel, *supra* note 3, at 2; Judge, *supra* note 3; Morrison & Saavedra, *supra* note 3, ("[I]f a stressed banking sector is unwilling to finance firms in Chapter 11, the government can play an essential role in providing that financing.").

214 Morrison & Andrea Saavedra, *supra* note 3.

215 Conti-Brown & Skeel, *supra* note 3, at 2 ("[M]any businesses, especially small and medium-sized businesses, may find it impossible to arrange the financing they need to fund their operations during the bankruptcy process.").

216 *See, e.g.*, DeMarzo *supra* note 3 ("The goal is not to stop Chapter 11 restructurings from occurring but rather to limit their deadweight costs when they do occur . . . to minimize inefficient liquidations.").

217 *See* Conti-Brown & Skeel, *supra* note 3, at 5.

218 *See* Judge, *supra* note 3; Morrison & Saavedra, *supra* note 3, at 7–8 ("[I]f a stressed banking sector is unwilling to finance firms in Chapter 11, the government can play an essential role in providing that financing."); DeMarzo, *supra* note 3 (proposing that the U.S. Treasury would help support such a facility through an equity investment). Levitin, et al., have proposed a permanent alternative to bankruptcy for large firms that would also address the increasing need for financing firms in distress in times of crisis.); Levitin et al., *supra* note 3.

219 *See* Conti-Brown & Skeel, *supra* note 3, at 3; Judge, *supra* note 3.

220 It does appear, however, that the proposal is premised on courts granting "priming liens" to banks providing DIP loans funded by this facility pursuant to 11 U.S.C. § 363(d) (2018), which is otherwise a rare occurrence. Conti-Brown & Skeel, *supra* note 3, at 14–15.

lending, they argue that the facility would help draw more banks into this activity.[221]

Morrison and Saavedra have also proposed that recipients of government support during the COVID-19 pandemic, particularly large corporations, should be required to file for bankruptcy.[222] Pursuant to this approach, the government would be steering firms into the bankruptcy system, making that decision only a semi-voluntary one. Furthermore, in these cases, as in *Chrysler*, the government would be a creditor in these bankruptcies; depending on the timing of the support and the bankruptcy filing, it would either be a pre-petition creditor or a DIP lender. Among the rationales for this proposal is the fact that many of these firms in distress would require assistance because of pre-pandemic problems. In Morrison and Saavedra's view, providing support without requiring a bankruptcy filing "would allow these firms to use public funds to further delay a necessary restructuring."[223] They also argue that requiring crisis support through the bankruptcy system would also ensure that investors bear some costs of the firm's distress.[224] As they write:

> the speed of a bankruptcy case is largely dictated by the institution providing the liquidity. Cash is king. The government, therefore, could play an important role in preventing unnecessary asset fires sales and pushing the process toward a reorganization that preserves viable firms (and American jobs). This is precisely what we saw in the Chrysler and GM cases.[225]

The typology and ordering principles describe above provide tools and a framework for fully evaluating these proposals as a matter of bankruptcy policy. Requiring that government support only be given to firms if they enter bankruptcy, for example, would be a striking example of the government directly triggering the use of the bankruptcy system. The proposals for the government to create a facility for DIP lending inevitably implicates two different categories of engagement. First, they involve the government having a direct or indirect financial stake in cases within the bankruptcy system, depending on whether the government lends to debtor firms in bankruptcy or to banks that lend to firms, respectively. Second, they would inevitably involve the government steering the operation of the system in significant ways. The facility proposed by DeMarzo, Krishnamurthy, and Rauh, for example, would provide

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221 Conti-Brown & Skeel, *supra* note 3, at 3.

222 Morrison & Saavedra, *supra* note 3, at 12–13.

223 *Id.* at 13–14.

224 *Id.* at 13.

225 *Id.* at 13–14.

no- or low-interest DIP lending to firms in bankruptcy upon approval by the bankruptcy court and the facility itself, pursuant to a template for the structure of reorganizations that qualify for support.[226] Conti-Brown and Skeel envision that the Federal Reserve "advocate for banks' participation in these programs as part of the supervisory process."[227] Both proposals envision that the support provided would be fully collateralized; this, in effect, will generally require that it be provided a priming lien over pre-existing secured creditors.[228]

The ordering principles advanced in this Article suggest that the involvement by the government in the bankruptcy system envisioned by these proposals could be consistent with bankruptcy policy, even though it may "distort" private decision-making, potentially direct the operation of the bankruptcy system, and perhaps generate some micro-economic costs or inefficiency. As an initial matter, one of the primary goals of these proposals is to improve the functioning of the bankruptcy system and thus to advance bankruptcy-specific goals. To the extent that these proposals aim to advance non-bankruptcy policies, those policies are within the authority of the relevant government entities and should presumptively outweigh the bankruptcy-specific functions they may displace. But at some point, this presumption fades: when the regulatory goal is too attenuated or obviously minor compared to the costs experienced by stakeholders in bankruptcy system.

These proposals raise at least some concerns that the government's non-bankruptcy regulatory goals might be somewhat attenuated from its actual engagement in the bankruptcy system or outweighed by degree of its intervention. They are all envisioned as general programs with more government involvement than the "regulatory bankruptcy" observed by Woo. They are not focused on particular cases or narrow categories of cases like the Chrysler episode or the RBI's targeting of largest NPA's. Thus, there is less certainty of a close regulatory fit with the universe of cases affected by the proposed policies. This may suggest that there is more likelihood that the aggregate impact on the operation of the bankruptcy system may be significant compared to the non-bankruptcy regulatory benefit. This is exacerbated if the government becomes concerned about limiting its own losses under the program, motivated by pecuniary interests rather than the regulatory aim.

To the extent that the proponents of such plans have addressed the implications and potential dangers of the government's involvement in the

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226 DeMarzo *supra* note 3.

227 Conti-Brown & Skeel, *supra* note 3, 14.

228 DeMarzo, *supra* note 3; Conti-Brown & Skeel, *supra* note 3, at 14–16.

bankruptcy system, they have tended to focus on the impact on the government, not the bankruptcy system. Conti-Brown and Skeel argue that part of the advantage of their proposal derives from the fact that these banking institutions are subject to supervision and regulation. The facility, they argue, will expand the amount of DIP financing in "the bank regulatory and supervisory framework rather than in shadow banking"[229] and "will give the Fed[ederal Reserve] useful insights into the operations of bankrupt institutions, insights that will be essential in both monetary policy and financial regulation."[230] They rightly worry about the Federal Reserve's involvement in the politically fraught realm of credit policy and the reputational risks to it from participating in controversial aspects of credit allocation, debt collection, and bankruptcy maneuvering. They acknowledge that such a facility would draw the Federal Reserve into the process of "business credit policy," exposing the Federal Reserve to what is generally a fiscal, and thus political government function. They propose, however, that the risk of involving the Federal Reserve in such political activity is attenuated because it is indirect, *i.e.*, intermediated through private banks, and is only justified in a time of crisis.[231]

But they have not given similar attention to the stakes of the Federal Reserve's involvement in the bankruptcy system for the latter. What, for example, would be the impact on the bankruptcy system of bringing DIP financing more directly into the bank regulatory and supervisory framework"?[232] One should expect that, in implementing a DIP lending facility, the Federal Reserve would engage in some kind of steering or conditioning the behavior of DIP lenders in the bankruptcies of their borrowers. One should also expect that the Federal Reserve would be influenced by its concern for recovery of its financial support, which must be "secured to the satisfaction" of the Federal Reserve Bank providing any such support.[233] In either case, the Federal Reserve's involvement will presumably influence or displace the decisions of direct stakeholders to at least some extent. If the regulatory aims of its actions are too diffuse across cases or distorted by its own financial stake, then the justification for its involvement will weaken.

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[229] Conti-Brown & Skeel, *supra* note 3, at 4. They also note that increasing bank involvement in DIP lending would help "provid[e] useful assets for banks in an otherwise uncertain time." *Id.* at 4.

[230] *Id.* at 4.

[231] *See id.* at 4, 18–20.

[232] *See supra* note 240 and accompanying text.

[233] *See* 12 U.S.C. §§ 347, 343 (2018)

CONCLUSION

Anticipating a wave of bankruptcies caused by the economic and financial effects of the COVID-19 pandemic, numerous commentators proposed measures to expand the institutional capacity of the bankruptcy system. A number of these proposals would represent dramatic and systematic government involvement in the U.S. bankruptcy system. Such involvement by the government in the bankruptcy system is a topic that is largely ignored in the literature on bankruptcy. Where it is observed, it is generally criticized. Among other things, it sits uneasily with dominant theories of bankruptcy that assume the bankruptcy system should be driven by the interests of direct stakeholders in particular cases.

This Article argues that involvement or influence by government actors in the bankruptcy system is, in fact, broadly consistent with bankruptcy theory and with the structural relationship between bankruptcy law and other legal and regulatory components of the state. This relationship is subject to some basic ordering principles. Bankruptcy law constrains and adjusts other legal regimes to some extent, but it generally incorporates non-bankruptcy law and yields to government's regulatory actions. These ordering principles reasonably extend to ad hoc government actions or "activism" in the bankruptcy system. In other words, government actors do not contravene bankruptcy policy when they employ the system to advance non-bankruptcy policies within their authority, even when doing so enables the government to take actions and achieve goals that it could not outside of the system. In some circumstances, however, the regulatory policies or concerns motivating government involvement in the bankruptcy system may be too diffuse or attenuated to justify the extent of its intervention, especially if the effect is to discourage use of the bankruptcy system. These ordering principles help clarify the relationship between bankruptcy and other legal and regulatory regimes and provides a framework for evaluating instances of government involvement in the bankruptcy system.

This Article elaborates upon these ordering principles by focusing in particular on the relationship between bankruptcy and financial regulation. Bankruptcy is part of the architecture of financial markets in a modern economy, and the influence of financial regulators on the bankruptcy system should be viewed as the product of overlapping regulatory functions, which require a logic of ordering. Such regulatory influence generally operates in the deep background, yet macro-prudential and systemic concerns will sometimes require more direct government intervention and may override the efficiency concerns or stakes of a particular bankruptcy case. This Article describes three episodes of regulatory intervention in the bankruptcy system—"regulatory bankruptcy" during the 2008-09 financial crisis; the efforts by the Reserve Bank of India to force some large commercial firms into India's new insolvency system; and the Chrysler bankruptcy. The ordering principles advanced in this Article generally justify the government involvement in these cases and, to some extent, in the COVID-era proposals as well. However, the degree of regulatory involvement in the bankruptcy system envisioned by some of these recent proposals may be disproportionate to, or attenuated from, their underlying regulatory goals. If so, they may fall beyond the scope of justified government involvement in the bankruptcy system.