IF WE WERE DOING IT AGAIN: REFLECTIONS ON IMPROVING CHAPTER 11 AND CONTRASTING INTERNATIONAL EXPERIENCES

Recalibrating Consent in Bankruptcy

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In bankruptcy, business realities collide with legal rules that themselves create conflicting rights. Unsurprisingly, accommodations are made. Consent bridges gaps among conflicting legal rules and business realities, justifying pragmatic solutions to problems that could not otherwise be imposed under prevailing legal rules. Consent’s transformative power is so essential to the bankruptcy process, that resort to consent, in principle and in rhetoric, is reflexive in bankruptcy. Manufacturing consent to support practical accommodations, rather than simply mirroring prebankruptcy entitlements, is at the heart of bankruptcy law as it has evolved in the United States. Bankruptcy uses a panoply of tools to generate consent: inertia, ambiguity, proxies, relaxed standards for establishing consent, novel procedures and institutional structures, and new substantive rights. New circumstances in the twenty-first century, and the teachings of experience, require close reexamination of how consent operates in bankruptcy, including whether certain consent requirements should be further relaxed or tightened. We critique current consent standards and practices in connection with (i) home mortgage modification; (ii) the one-consenting-class rule; (iii) sale free and clear orders; (iv) third-party releases; (v) sales of substantially all assets; (vi) balloting of conflicted parties; and (vii) proxy consents by official creditors’ committees. Recently, most notoriously in the restructurings of Chrysler and General Motors, the advantages of reaching solutions by manufacturing consent rather than imposition have been too casually abandoned.

INTRODUCTION

Understanding how consent is induced and manipulated in bankruptcy provides critical insight into the bankruptcy process which has heretofore been principally theorized as a process that preserves prebankruptcy entitlements. We gratefully acknowledge the financial and research support of the Hugh & Hazel Darling Law Library and the UCLA Academic Senate. We are also deeply indebted to Stephen R. Munzer, Rakhi Patel, Mary F. Walrath, William D. Warren, Stephen C. Yezell and the participants in the UCLA School of Law Faculty Workshop of Sept. 18, 2009 for their thoughtful comments on earlier drafts. Jonathan Massey, UCLA School of Law Class of 2010, provided valuable research assistance and thoughtful comments and editing assistance as well. ©2009 by Daniel J. Bussel & Kenneth N. Klee. All rights reserved.
ments in the setting of a collective proceeding. In reaching accommodations, however, bankruptcy courts routinely alter parties' rights under otherwise applicable nonbankruptcy law rather than preserve them. In bankruptcy cases, as elsewhere, party consent is generally sufficient and necessary to support alteration of legal rights. Imposing legal outcomes without consent comes at an ideological cost that undermines acceptance of the result by the parties and other actors in the legal system. Bankruptcy law often less-forcibly prefers to finesse conflict among legal rules and business needs by waterering down the quality of the consent it finds necessary or sufficient to alter legal entitlements.

The recent restructurings of Chrysler LLC and General Motors Corporation are important landmarks in the ever-evolving role of consent in bankruptcy. As the financial situations of GM and Chrysler became dire at the end of 2008, and politicians and other leaders began to contemplate the consequences of a chapter 11 filing by one or more of the Big Three automobile manufacturers, some commentators suggested that the scale and scope of the auto industry's problems required dispensing with the consent-laden chapter 11 process altogether in favor of a new statutory procedure less reliant on


3The sufficiency of consent to transform legal rights delimits the positive autonomy of the consenting party to affirmatively seek transformation of its legal entitlement based on its consent. See infra text accompanying notes 45-46. Note that increasingly demanding consent standards burden the positive autonomy of the consenting party.

4The necessity of consent to transform legal rights delimits the negative autonomy of the nonconsenting party to prevent transformation of its legal entitlement without its consent. See infra text accompanying notes 45-46. Increasingly demanding consent standards protect the negative autonomy of the nonconsenting party.
consent. Shifting the forum for building a consensus over the complex restructuring options facing the automobile industry from a bankruptcy court to Congress, however, would only substitute Congressional consent for that of the parties. The Obama Administration preferred the cover of the bankruptcy process in imposing difficult political and economic choices on GM and Chrysler and their respective constituents. Moreover, the Administration determined that even traditional bankruptcy-style consent, at least in the form of consensual chapter 11 plan negotiations was unduly onerous given the urgency and complexity of the economic and political problems raised by the reorganizations of these firms.

In Chrysler’s case, the Administration financed and orchestrated a § 363 sale process of Chrysler’s operating assets to the United Auto Workers and Fiat S.p.A in a transaction that is a reorganization plan in all but name. The nominal buyer, Fiat, holds only a minority stake in New Chrysler and provided no cash consideration. Although § 363 sales ordinarily require the consent of secured creditors, they do not require the class consents or disclosures necessary to confirm a reorganization plan. Initial opposition from certain secured creditors was withdrawn under pressure from the Administration, and, after the United States Supreme Court terminated a brief stay pending its consideration of the application for stay of objectors, the sale was consummated over the objections of certain pension funds, holding relatively small amounts of secured debt, and certain tort claimants. The consent of dissenting secured parties was inferred from standard agency provisions that were construed to substitute the consent of the agent for that of the holder. The doctrine that § 363 sales cannot dictate distribution of value and other terms of a future reorganization plan was somehow found not to be implicated, though the sale accomplished all the Administration’s reorganization objectives which included special treatment of particular constituents, especially labor and certain tort claimants, and left no real reorganizational or distributional issues for resolution through a chapter 11 plan other than to distribute the cash sale proceeds to the secured creditors and routine administration of a liquidating estate.

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6Chrysler LLC, 576 F.3d at 119-20; Beal Sav. Bank v. Sommer, 865 N.E.2d 1210, 1216-17 (N.Y. 2007).
7Cf. In re Braniff Airways, Inc., 700 F.2d 935, 940 (5th Cir. 1983); see also In re Babcock & Wilcox Co., 250 F.3d 955, 960 (5th Cir. 2001) (“Braniff stands merely for
In the General Motors case, the Administration similarly short-circuited the plan process by using § 363 to recapitalize a "Good GM" without obtaining the requisite majorities of the holders of claims and interests to confirm a reorganization plan. In that case no third-party buyer even arguably existed. The United States emerged with 60 percent of the equity in New GM, and the rest was distributed to existing GM constituents, primarily representatives of GM's unionized workforce. Again all the key distributional and reorganizational issues (involving a complex settlement among labor, management, the Administration, tort claimants, secured creditors and unsecured bondholders) were resolved through the sale, though final resolution of the liquidating General Motors chapter 11 estate will remain a complex affair given the enormous size and scope of that firm.

In Part V.C.i, infra, we critique the trend, of which the GM and Chrysler cases are only the most extreme examples, of displacing chapter 11 reorganization plans with § 363 sales. We suggest that legitimacy was unduly sacrificed for expediency in the Chrysler and GM cases. The long-term systemic cost of these cases remains to be seen.

Historically, bankruptcy law's ability to transform rights established by otherwise applicable law by manipulating consent has triggered reforms that resulted in regulation of the particular manner in which consent to such transformation was obtained in particular instances. Competing pressures, for very loose rules relating to transformative consent arising out of the practical exigencies of bankruptcy cases and for stringent rules to control historical abuses in consent-gathering, result in the meaning and quality of consent varying dramatically depending on the context. In descending order of rigor, in bankruptcy cases transformative consent may require:

(i) Informed subjective consent plus formal requirements such as disclo-

the proposition that the provisions of § 363 permitting a trustee to use, sell, or lease the assets do not allow a debtor to gut the bankruptcy estate before reorganization or to change the fundamental nature of the estate's assets in such a way that limits a future reorganization plan.

10Statement of the United States of America Upon the Commencement of General Motors Corporation's Chapter 11 Case, In re General Motors Corp., No. 09-50026, 2009 WL 1169407 (Bankr. S.D.N.Y. June 1, 2009).


12We do not purport to catalogue all the ways in which consent is implicated in bankruptcy or all the ways that courts use the consent construct to justify the creation or alteration of legal rights. The examples we use are illustrative.
asures or advisories, writings, certification of counsel, and court approval;\textsuperscript{13} (ii) informed subjective consent;\textsuperscript{14} (iii) objective manifestations of assent;\textsuperscript{15} (iv) formal actions neither subjectively nor objectively manifesting assent but from which consent is nevertheless presumed;\textsuperscript{16} (v) inaction;\textsuperscript{17} (vi) consent by

\textsuperscript{13}\textbf{See infra} notes 94-105 and accompanying text (discussing regulation of chapter 11 plan solicitation process). Another example is the elaborate set of rituals required under 11 U.S.C. § 524(c), (k) & (l) (2006), to make effective an individual debtor's voluntary reaffirmation of an otherwise dischargeable debt. See infra notes 227-35 and accompanying text.

\textsuperscript{14}In some jurisdictions, third-party releases under confirmed plans are only valid with affirmative informed consent of the holder of the claim. \textit{In re} Lowenschuss, 67 F.3d 1394, 1401-02 (9th Cir. 1995); \textit{In re} W. Real Estate Fund, 922 F.2d 592, 601-02 (10th Cir. 1991), \textit{modified}, 932 F.2d 898 (10th Cir. 1991); but see infra notes 290-94 (detailing the split in authority regarding third-party releases). Some courts employ this standard in determining whether a secured party has consented to the use of its cash collateral. 11 U.S.C. § 363(c)(2) (2006); Freightliner Mkt. Dev. Corp. v. Silver Wheel Freightlines, Inc., 823 F.2d 362, 368-69 (9th Cir. 1987). Similarly, a secured or undersecured creditor may consent (or refuse to consent) to the transfer of its property free and clear of its lien. 11 U.S.C. § 363(f)(2) (2006). At least some courts require affirmative evidence that such consent has been given. See \textit{Local Banker, R. 6004-1(b)} (Bankr. N.D. Cal.) (requiring an affidavit); \textit{In re} Loloee, 241 B.R. 655, 660 n.7 (B.A.P. 9th Cir. 1999) (noting this issue in dictum).

\textsuperscript{15}Some courts employ this standard, for example, in determining whether a secured party has consented to the use of its cash collateral. 11 U.S.C. § 363(c)(2) (2006) (requiring the creditor's prior consent or court order to use of cash collateral); \textit{In re} Bumper Sales, Inc., 907 F.2d 1430, 1441 (4th Cir. 1990). With respect to other forms of property the burden is on the nondebtor party claiming an interest in the collateral to object to the debtor's use or seek adequate protection of its interest at least as long as the bankruptcy trustee or debtor in possession's use is in the ordinary course of business. 11 U.S.C. § 363(b) (2006).


\textsuperscript{17}The failure to object is commonly a basis for inferring consent pursuant to rules of court or court orders. See \textit{e.g.} \textit{Local Banker, R. 9013-1(g)} (Bankr. C.D. Cal. 2008). Specific examples are legion: A creditor's failure to object timely to the debtor's discharge waives any objection under 11 U.S.C. § 523(a)(2), (4) & (6) (2006). \textit{Fed. R. Bankr. P. 4007. See also Espinosa v. United Student Aid Funds, Inc., 553 F.3d 1193, 1198 (9th Cir. 2008) (otherwise nondischargeable student loan discharged under terms of chapter 13 plan to which there was no objection), cert. granted, 129 S. Ct. 2791 (2009). The failure to file a proof of claim waives the creditor's right to a distribution in bankruptcy, even sometimes in circumstances where the defaulting creditor had no actual notice of the bankruptcy case. Jones v. Chemetron Corp., 212 F.3d 199, 209 (3d Cir. 2000). Secured creditors are entitled to adequate protection of their interests in the debtor's property, but except in the case of "cash collateral," the creditor bears the burden of moving the bankruptcy court for that adequate protection. If the creditor fails to act, the debtor or bankruptcy trustee may use the property without providing adequate protection. 11 U.S.C. §§ 361, 363 (2006); see LNC Invs., Inc. v. First Fid. Bank, 247 B.R. 38, 40-41 (S.D.N.Y. 2000), \textit{affd sub nom.} LNC Invs., Inc. v. Nat'l Westminster Bank, 308 F.3d 169, 175-77 (2d Cir. 2002) (indenture trustee's failure to move for adequate protection not negligent given the court's likely denial of motion). Plan modifications are deemed accepted absent timely objection by the holders of claims and interests. 11 U.S.C. § 1127(d)
proxies or similarly situated persons;\textsuperscript{18} (vii) inaction by proxies or similarly situated persons;\textsuperscript{19} or (viii) nothing; that is, consent is conclusively presumed, notwithstanding timely affirmative objection or protest by the "consenting" party.\textsuperscript{20}

We begin our examination of consent in bankruptcy in Part I with an off-the-rack standard model of consent: The uncoerced, undeceived, objective manifestation of assent and briefly describe the threat-offer distinction that grounds the philosophical debate over coercion. Part II describes some of the myriad ways bankruptcy law dilutes the standard consent concept described

\textsuperscript{18}The most notorious example of proxy consent is the class voting on chapter 11 plans which are deemed consensual as to classes that vote to accept the plan by a majority in number and two-thirds in dollar amount of those claims voting. 11 U.S.C. § 1126(c) & (d) (2006). In other situations, the consent of the official creditors' committee or a future claims representative may be taken as sufficient to bind their respective constituencies. See infra notes 106-17, 334-37 and accompanying text. And, of course, the debtor in possession or trustee in bankruptcy, as the official representative of the bankruptcy estate, can effectively bind all parties with a claim against or interest in the estate, in some cases subject to the approval of the bankruptcy court. An additional quandary for incumbent directors and officers of corporate debtors in possession is that they are subject to replacement as fiduciaries by bankruptcy trustees. Upon his appointment or election, the bankruptcy trustee holds the legal power to consent — and waive rights — on behalf of the bankruptcy estate. Thus, a bankruptcy trustee may consent to the waiver of attorney-client privilege previously protecting the communications between the corporate debtor in possession and its lawyers. Commodities Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 352-38 (1985); Heyman v. M.L. Mktg. Co., 116 F.3d 91, 95 (4th Cir. 1997).

\textsuperscript{19}An extreme example is that some courts hold that the failure of all members of an impaired class to cast votes on a reorganization plan effectively binds all members of the class to the plan. Ruti-Sweetwater, Inc., 836 F.2d at 1264; In re Cypresswood Land P'tns. I, 409 B.R. 396, 420 (Bankr. S.D. Tex. 2009); In re Adelphia Commc'ns Corp., 368 B.R. 140, 260-62 (Bankr. S.D.N.Y. 2007), aff'd., 544 F.3d 420 (2d Cir. 2008). More commonly, inaction by the same proxies described supra note 18 after notice and an opportunity (for the proxies) to object may bind their constituents much as their affirmative consent may.

\textsuperscript{20}In these instances "consent" is purely a rhetorical ploy. For example, holders of claims in unimpair classes are deemed to consent to their treatment under a chapter 11 plan. 11 U.S.C. §§ 1124, 1126(f) (2006). Similarly, resolicitation of creditors is not required to confirm an otherwise consensual plan that is modified in ways deemed not to be materially adverse to previously consenting creditors. Fed. R. Bankr. P. 3019(a); In re New Power Co., 438 F. 3d 1113, 1117-18 (11th Cir. 2006); In re Am. Solar King Corp., 90 B.R. 808, 825-26 (Bankr. W.D. Tex. 1988). Of course, "conclusively presumed" consent operates as a mandatory rule. In other cases, the Bankruptcy Code dispenses with any pretense that consent matters. See, e.g., infra notes 196-204 and accompanying text. A particularly controversial area where a mandatory rule may negate contrary consent is so-called gifting, where a senior creditor consents to the assignment of some portion of its distributions to the holders of junior claims or interests without obtaining the consent of intervening classes. See infra notes 214-26 and accompanying text.
in Part I while adopting the rhetoric of consent for the practical end of gaining access to its transformative power. Part III focuses on how the Bankruptcy Code first alters parties' nonbankruptcy baseline rights in order to create incentives for consent that then serve as a further basis for the transformation of rights. We note that frequently bankruptcy law enshrouds its alteration of prebankruptcy rights in ambiguity and uncertainty, generating further pressure for compromise. Part IV suggests that important limitations on the transformative power of consent necessarily and properly stem from third-party effects, fixed policies of the Bankruptcy Code, and experience with past abuse. Finally, in Part V, we discuss several instances in which we can better adapt consent principles to the present-day practical realities of bankruptcy.

Bankruptcy courts regularly confirm "consensual" reorganization plans that permanently alter the rights and liabilities of the parties over bitter opposition. Cloaking practical accommodations with manufactured consent, not simply mirroring prebankruptcy entitlements, is at the heart of bankruptcy law as it has evolved in the United States over the nineteenth and twentieth centuries. Nevertheless, modern circumstances, in some instances, call for further exploitation of these techniques, or more mandatory rules to balance party autonomy against other values more appropriately. We also note, however, that in recent years, perhaps in exaggerated response to the

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21See infra notes 125-32 and accompanying text.
22Donald S. Bernstein, A Reorganization Lawyer's Perspective on Professor Warren's Vanishing Trials: The Bankruptcy Experience, 79 AM. BANKR. L.J. 943, 946-47 (2005) (citing "among many other examples" protracted trials over valuation and other confirmation issues in the chapter 11 proceedings of Conseco, Mirant, Exide Technologies, and Dow Corning, and noting "it is a rare large reorganization case where there are no objections at all to resolve at the [confirmation] hearing").
23See Jackson, supra note 1, at 21-27; Baird, supra note 1, at 822-23. Bankruptcy law is, as Thomas Jackson taught, primarily procedural. Indeed, lawyers and academics in some foreign legal systems, for example Japan, classify bankruptcy law as a branch of civil procedure. See, e.g., CIVIL PROCEDURE IN JAPAN, Ch. 11: Insolvency Proceedings (Yasuhei Taniguchi, Pauline Reich & Hiroto Miyake eds., 2d ed. 2008). Contrary to Professor Jackson's view, however, bankruptcy's animating purpose is not to mirror a hypothetical creditors' bargain by preserving pre-bankruptcy entitlements in the setting of a collective proceeding. Jackson, supra note 1, at 20-27. It is a process for constructing a new, only partly bargained-for, post-bankruptcy accommodation of conflicting rights. Bankruptcy law accomplishes these accommodations by manufacturing consent, by deliberately altering nonbankruptcy rights rather than mirroring them, by creating and then exploiting ambiguity over the content of those rights, by capitalizing on inadvertence and inertia, and by foisting Hobson's choices on parties. When party autonomy stands in the way of that practical accommodation, autonomy values may be honored in the breach to the extent they are honored at all.

Bankruptcy law, at least the most interesting part of bankruptcy law, helps parties sort out unanticipated or complicated messes, not implement hypothetical ex-ante bargains. If the parties can resolve the problem themselves by consent, courts' characteristic response is to get out of the way and approve their deal. Imagined ex-ante bargains do not give practical guidance in the ex-post resolution of conflicting claims of right. Nevertheless, pragmatic ex-post resolutions can be justified through consent. Bankruptcy law relies heavily on this justification, and in doing so creatively finds or obtains consent where previously only conflicting interests lay.
pressures of those same modern circumstances, perhaps inadvertently, the bankruptcy system has unduly diminished the role of consent in some cases.

I. CONSENT GENERALLY

Philosophers and legal scholars have spilled much ink on the concept of consent. "Consent" suggests a state of mind, but legally transformative consent is generally determined by an objective assessment of an individual's behavior rather than subjective state of mind.\(^{24}\) The subordination of a party's subjective intent to the objective manifestations of its assent is central to the so-called objective theory of contracts that became dogma in the twentieth century.\(^{25}\)

Despite the obvious administrative attractions of an objective standard,\(^{26}\) the formulation in the text is shorthand for the standard contract doctrine relating to consent. \textit{Restatement (Second) Contracts} §§ 2 (formation), 174-176 (duress) (1981). Alan Wertheimer has argued powerfully that the "two-pronged theory of coercion" laid out in the original \textit{Restatement of Contracts} §§ 492-493 (1932) "offers the best interpretation of the way the law has adjudicated coercion claims, and that both the proposal prong and the choice prong explicitly advance moral tests." \textit{Wertheimer, Consent, supra note 2, at 308 & more generally at 19-53.} The Second \textit{Restatement} even more clearly focuses on the objective consequences of the conduct of the party exerting the duress rather than the effect of that conduct on the promisor's mental state. \textit{Compare Restatement (Second) Contracts} §§ 174-76 (1981) with \textit{Restatement of Contracts} §§ 492-493 (1932). Moreover, it more clearly delineates the scope of the wrongful act or improper threat concept that lies at the heart of the issue. This objective focus is consistent with the overall thrust of Wertheimer's argument. \textit{Wertheimer, Consent, supra note 2, at 29} ("[D]espite frequent references to 'overborne wills,' that notion seems to do relatively little work. The reason, I think, is this. Although the courts want to invalidate some contracts which [the promisor] makes under pressure, they also want to enforce many contracts to which [the promisor] (even very) reluctantly gives his consent. Because the 'overborne will' theory does not help to make this sort of distinction, courts tend to focus on the nature of [the promisee's] proposal and only secondarily on [the promisor's] state of mind."). Peter Westen has developed a more elaborate ontology of consent that distinguishes between attitudinal and expressive consent in lieu of the more traditional subject-objective distinction. \textit{Westen, supra note 2.} "Attitudinal" consent turns on the subjective intent of the consenting party. \textit{Id.} at 146-48. "Expressive" consent turns on the consenting party's objective manifestations of assent. \textit{Id.} at 141-42. Westen then goes on to distinguish between factual, prescriptive, and imputed consent. \textit{Id.} at 309-27. Factual consent, as its name implies, is consent in fact. \textit{Id.} at 4-5. Prescriptive consent is consent in law predicated on some elaboration of factual consent. \textit{Id.} at 6. Imputed consent of course is no consent at all except by virtue of the existence of a rule of law. \textit{Id.} at 7. In this Article, except as otherwise specified, consent means Westen's factual expressive consent. Westen's prescriptive label applies to situations where legal consent differs from factual expressive consent, but his terminology does not distinguish situations where the law demands less than factual expressive consent from situations where it demands more than factual expressive consent. Because this distinction is central to much of our discussion, we avoid using Westen's "prescriptive" category. Where bankruptcy law lowers the bar by deeming conduct that falls short of factual expressive consent to be sufficient we use the term "deemed consent." Where bankruptcy law requires more than simple factual expressive consent, we use Wertheimer's pithier "consent-plus."

\(^{26}\)\textit{Restatement (Second) Contracts} § 2(1) ("A promise is a manifestation of intention to act or refrain from acting in a specified way, so made as to justify a promisee in understanding that a commitment has been made.") & cmt (b) ("Manifestation of intention. Many contract disputes arise because different people attach different meanings to the same words and conduct. The phrase "manifestation of intention" adopts an external or objective standard for interpreting conduct. It means the external expression of
both subjective and objective perspectives make a claim on the legal system. Where the objective manifestations are unclear, or where we suspect that objectively determined and subjectively determined consent diverge, we sometimes give primacy to a party’s actual state of mind as best we can ascertain it. Although in practice the law sometimes adopts the objective theory and at other times a more subjective approach, and although courts and legislatures blend both perspectives to establish a standard for transformative consent in particular circumstances, the theoretical consensus for at least the past century is that the starting place for establishing legally transformative consent is its objective manifestation.  

The law’s general preference for an objective approach is complicated by three factors. (i) Policies of the law may be implicated by rules waivable by consent. Although those policies may not be so powerful that the judiciary or the legislature renders consent non-transformative, the law often imposes additional requirements beyond a simple objective manifestation of assent to alter legal entitlements, in part to protect those policies. (ii) Transformation of legal rights may affect third parties in ways that call for limiting the transformative effect of consent or regulating the process by which consent is obtained. (iii) In some circumstances objectively manifested assent systematically tends to deviate from the party’s subjective intent in a predictable way. Transformation of legal entitlement in these situations may require additional acts that are directed at assuring or evidencing subjective assent—

intention as distinguished from undisclosed intention.”; see also Zell v. Am. Seating Co., 138 F.2d 641, 646–47 (2d Cir. 1943) (Frank, J):

The policy of stern refusal to consider subjective intention, prevalent in the centralized common law courts of the [17th century], later gave way; in the latter part of the 18th and the early part of the 19th century, the recession from that policy went far, and there was much talk of the “meeting of the minds” in the formation of contracts, of giving effect to the actual “will” of the contracting parties. The obstacles to learning that actual intention have, more recently, induced a partial reversion to the older view. Today a court generally restricts its attention to the outward behavior of the parties; the meaning of their acts is not what either party or both parties intended but the meaning which a “reasonable man” puts on those acts; the expression of mutual assent, not the assent itself, is usually the essential element. We now speak of “externality,” insisting on judicial consideration of only those manifestations of intention which are public (“open to the scrutiny and knowledge of the community”) and not private (“secreted in the heart” of a person). This subjective approach is of great value, for a legal system can be more effectively administered if legal rights and obligations ordinarily attach only to overt conduct.

Revised Restatement (Second) of Contracts § 2(1); see also Wertheimer, Consent, supra note 2, at 144–52 (defending an objective or “performative” view of consent in the context of the law of rape).

See, e.g., infra text accompanying notes 205–26.

See, e.g., infra text accompanying notes 227–51.
a truly voluntary and knowing waiver.\textsuperscript{29}

Alan Wertheimer uses the shorthand "consent-plus" to describe consent rules imposing requirements over and above a simple uncoerced and undereceived objective manifestation of assent by a legally competent person.\textsuperscript{30} Bankruptcy law, like many areas of law, has developed consent-plus rules to govern those situations where the transformation of legal rights by consent implicates other, potentially overriding policies, or rights of nonconsenting parties, or where experience has shown that reliance on plain-vanilla objectively manifested assent may otherwise give rise to abuse.\textsuperscript{31}

Consent may be induced by a credible threat to inflict some harm or withhold some benefit from the consenting party. Philosophers have developed the idea that distinguishing "coercive" threats from "noncoercive" offers requires one to fix a baseline of right or entitlement.\textsuperscript{32} Absent consent, a credible proposal to worsen the putative consenting party's situation, as compared to its baseline, is a threat and coercive. A credible proposal to improve the putative consenting party's situation, as compared to its baseline, is an offer, and, by definition, not coercive.\textsuperscript{33}

\textsuperscript{29}For example, the law has traditionally conditioned enforcement of certain promises on compliance with formal requirements and these formalities have been justified as driving home to the promisor the legally binding nature of the promise, the so-called cautionary effect of formality. James Barr Ames, Law and Morality, 22 Harv. L. Rev. 97, 100-01 (1908); see also Douglas G. Baird, Discharge, Waiver, and the Behavioral Undercurrents of Debtor-Creditor Law, 73 U. Chi. L. Rev. 17, 19 (2006).

\textsuperscript{30}See Wertheimer, Consent, supra note 2, at 35-36. Like Wertheimer, we think it makes no difference whether the "plus" conditions are specified as additional requirements or built into the consent requirement itself.

\textsuperscript{31}See, e.g., infra text accompanying notes 161-251.

\textsuperscript{32}See infra note 2.

\textsuperscript{33}But see Feinberg, supra note 2, at 229-49 (1986) (distinguishing coercive and exploitative offers); Joel Feinberg, Noncoercive Exploitation in Paternalism 3-18 (Rolf Sartorius, ed., 1983) (same); David Zimmerman, Coercive Wage Offers, 10 Phil. & Pub. Aff. 121-45 (1981) (same). Although not technically coercive under this analysis, some offers that propose alternatives that improve party baselines may be deemed improperly exploitive. Feinberg's classic hypothetical is the "lecherous millionaire" who offers to pay for life-saving medical treatment for the child of an indigent mother if she consents to sexual relations with him. To the extent that the lecherous millionaire's proposal is tantamount to prostitution, it may be unlawful as well as exploitive, but nevertheless remains consensual. These issues are also discussed in New Essays in the Legal and Political Theory of Property 46-52 (Stephen Munzer, ed., 2001). For purposes of this Article we assume that offers that do not propose to lower normative or descriptive baselines, even if exploitive and even if independently unlawful, are not "coercive." We acknowledge, however, that reasonable people may view exploitative offers as coercive because the exploited offeree has no reasonable alternative but to acquiesce to the abusive proposal. Our perception is that bankruptcy law and practice does not systematically countenance more or less exploitation than nonbankruptcy law. Accordingly we focus on baseline alteration rather than exploitation in differentiating the uses of consent in bankruptcy. Some commentators discuss "thoffers" which propose to at once improve the consentor's situation if consent is given and inflict harm if consent is withheld. See, e.g., Wertheimer, Consent, supra note 2, at 179; Peter Westen, "Freedom" and "Coercion"— Virtue Words and Vice Words, 1985 Duke L.J. 541, 582; Hillel Steiner, Individual Liberty, 75 Proc. Aristotelian Soc. 33, 39 (1974-75). Thoffers are certainly employed in bankruptcy restructuring practice. One common gambit in the context of exchange offers is to extract "exit consents" stripping away covenant protection for those who
This analysis, of course, turns on fixing a baseline in order to evaluate whether the proposal threatens to worsen, or offers to improve, the consenting party’s situation. Two kinds of baselines are identified in the literature: A descriptive baseline based on an objective assessment of the putative consenter’s current situation and a prescriptive baseline based on his moral entitlements. One might assume that whatever philosophers might say, courts focus exclusively on legal entitlements as the appropriate baseline, although presumably those legal entitlements often are fixed by reference to moral entitlement. The Second Restatement of Contracts, and, other bodies of law, ranging from extortion and blackmail\(^34\) to rules of professional conduct for lawyers,\(^35\) however, appear to be as ambivalent as the philosophers when it comes to choosing between the competing baselines. Thus, § 176 of the Second Restatement defines an improper threat to include not only proposals to violate the consenting party’s legal rights,\(^36\) but also to include threats of criminal prosecution (even if the consenting party is legally subject to such prosecution),\(^37\) spiteful proposals,\(^38\) “unfair dealing,” or “a use reject the exchange offer and refuse to surrender their existing securities. John C. Coffee, Jr. and William A. Klein, Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations, 58 U. Chi. L. Rev. 1207, 1225-33 (1991). Other well-known devices are so-called “death-trap” or “carrot and stick” provisions in a reorganization plan. A death trap conditions a distribution to a junior class on the plan’s acceptance by senior classes. A carrot and stick plan proposes a modest distribution to a junior class conditioned on that class’s acceptance of the plan. If the class rejects, the plan provides for a cramdown that eliminates any distribution to the class. Compare In re Adelphia Commc’ns Corp., 368 B.R. 140, 275-76 (Bankr. S.D.N.Y. 2007) (approving a “carrot and stick” plan”), aff’d, 544 F.3d 420 (2d Cir. 2008); In re Drexel Burnham Lambert Group, 138 B.R. 714, 716-17 (Bankr. S.D.N.Y.) (same), aff’d, 140 B.R. 137 (S.D.N.Y. 1992) with In re MCorp Fin., Inc., 137 B.R. 219, 236 (Bankr. S.D. Tex. 1992) (finding “death trap” unlawful). In early equity receivership practice, a dissenting member of a consenting class could be cashed out at foreclosure sale value even though consenting members of the class received securities of a greater present value. Chapter 11 prohibits this technique of conditioning an individual’s participation in the reorganization on an affirmative vote, 11 U.S.C. § 1123(a)(4) (2006), presumably on account of its coercive effect. See Bruce Markell, A New Perspective on Unfair Discrimination, 72 AM. BANKR. L.J. 227, 230-31 (1998) (discussing receivership practices); but see In re Journal Register Co., 407 B.R. 520, 536-38 (Bankr. S.D.N.Y. 2009) (authorizing side payments to accepting creditors on SPM theory). Although the existence of a throffer increases the pressure on the putative consenter, the validity of the consent so extracted would seem to turn entirely on the threat component of the throffer. It is unclear, therefore, that the additional category meaningfully aids analysis, at least from a legal perspective.

\(^34\) See e.g. CAL. PENAL CODE § 519 (West 2008) (wrongful threats constituting extortion include threat to “expose . . . any deformity, disgrace or crime . . . [or] any secret affecting [the victim or his family].”

\(^35\) In general, a lawyer may not threaten criminal prosecution to gain advantage in a civil matter. See e.g. CAL. RULES PROF. CONDUCT 5-100 (2009) (barring threats of administrative enforcement also); NY CODE PROF. RESP. 7-105.

\(^36\) RESTATEMENT (SECOND) OF CONTRACTS § 176(1)(a), (c), (d) (1981) (threat to commit crime or tort, malicious civil prosecution, bad faith breach of contract).

\(^37\) Id. at § 176(1)(b).

\(^38\) Id. at § 176(2)(a). For example, proposing to reveal embarrassing private information, the disclosure of which will not benefit the promisee but will inflict significant harm on the promisor, may be the basis for a duress defense.
of power for illegitimate ends. The fact that the party making the proposal may be legally entitled to carry out the proposed action, does not necessarily entitle that party to use that legal entitlement to induce consent.

Conversely, even proposals that clearly threaten to violate legal rights may not be a basis for finding duress. Traditionally, a promisor's duress defense failed if the promisor had an adequate legal remedy to vindicate its rights. Moreover, the Second Restatement also makes clear that repudiating a contractual obligation (as long as it is not done in bad faith) is ordinarily insufficient to establish a duress defense. Accordingly, although courts are, of course, aware of the legal entitlements of the parties, and, in general, consents induced by credible threats not to honor those entitlements are suspect, legal entitlement is not sacrosanct. Proposing to dishonor legal entitlements is not necessarily coercive, especially if an adequate legal remedy is readily available to the consenting party. On the other hand, threats to leave a counterparty the minimum to which it is legally entitled may be deemed impermissible in some circumstances.

Id. at § 176(2)(b)(c). The official comments note that even refusal to deal may, in some circumstances, constitute an improper threat and make a resulting bargain voidable for duress.


For example, the use of a judicial proceeding to seize property based on an illegal claim for payment may not give rise to duress if the victim has a reasonable alternative to payment, to wit asserting his rights in the threatened action. Restatement (Second) of Contracts § 175, cmt. (b) (1981); see also Samuel Williston & Richard A. Lord, A Treatise on the Law of Contracts § 71:15 (4th ed. 2003). Cf. McGee v. Stone, 522 A.2d 211, 214-15 (R.I. 1987) (employee may not assert duress claim to the extent he enjoyed benefits under otherwise voidable employment contract).


Restatement (Second) of Contracts § 176, cmt. (c), § 89 (1981) (good faith modification of contract). Compare Selmer Co. v. Blakeslee-Midwest Co., 704 F.2d 924, 926-27 (7th Cir. 1983) (finding statement of intent to breach did not establish duress with Alaska Packers' Ass'n v. Domenico, 117 F. 99, 102-03 (9th Cir. 1902) (fishermen's refusal to perform contract coercive given cannery's inability to obtain replacement workers or practical legal redress given remote locale and time constraints).

Transforming legal entitlement if, but only if, there is consent protects the consenting party’s autonomy.45 Two kinds of autonomy are at stake: The ability to withhold consent and the ability to give consent. Stringent consent standards protect negative autonomy and limit positive autonomy. Relaxed consent standards limit negative autonomy and protect positive autonomy. In the criminal law, in fixing an appropriate standard for determining consent, the values of negative autonomy and positive autonomy are in tension with one another.46 Too high a standard comes at too much cost to positive autonomy; too low a standard at too much cost to negative autonomy. The practical exigencies of the bankruptcy case, however, encourage courts to make it difficult for parties to withhold consent (placing low value on negative autonomy) and easy for parties to give consent (placing high value on positive autonomy). By relaxing the threshold for consent, the bankruptcy courts can at once facilitate “consensual” resolutions by transforming legal entitlements, while limiting the ability of parties to veto those transformations.

One contested issue is the degree to which nondisclosure vitiates consent. Although the amount of disclosure required varies from context to context, in general, bankruptcy is a very public process and the amount of disclosure required is very high. This is particularly so with respect to anything that touches on employment and compensation of estate professionals, insiders,47 the reorganization plan, and the debtor and its property and financial affairs.48

47The Bankruptcy Code specifies that “insiders” include the debtor firm’s directors and officers, partnerships in which the debtor is a general partner, relatives of these individuals (including all persons within three degrees of consanguinity or affinity), “person[s] in control” of the debtor and “affiliates” and insiders of “affiliates.” “Affiliates” are entities that either directly or indirectly control 20% or more of the debtor’s voting securities or in which the debtor or an affiliate of the debtor controls more than 20% of its voting securities. See 11 U.S.C. § 101(2) (“affiliate”), (31) (“insider”) & (45) (“relative”) (2006).
48The full disclosure regime in bankruptcy includes, for example, the requirement of public filing of not only names and addresses of all potentially interested parties in creditor matrices, but the filing of extensive schedules and statements of financial affairs, 11 U.S.C. § 521 (2006) & Off. Bankr. Forms F6 & F7, and in the case of individual debtors, extensive supporting documentation including federal tax returns. Id.; but see 11 U.S.C. § 112 (2006)(excepting minors’ names from public disclosure requirements). A stream of ongoing financial information must be reported to the United States Trustee and, more importantly, in a chapter 11 case to the debtor’s primary secured lenders and the official committees. In small business cases, the reporting requirements are even more onerous and failure to comply is a ground for prompt dismissal of the case. 11 U.S.C. §§ 308, 1112(b)(4) (2006). With respect to professional persons employed by the estate, “disinterestedness,” 11 U.S.C. §§ 101(14), 327(a) (2006), or the absence of any interest materially adverse to the estate in connection with the matter for which employment is sought, 11 U.S.C. § 327(e), must be established through disclosure of all known relationships with the debtor, its insiders and other interested parties. 11 U.S.C. § 329 (2006); Fed R. Bankr. P. 2014(a). Fee arrangements must be fully disclosed and approved by the bankruptcy court after notice and hearing. 11 U.S.C. §§ 326, 328, 330, 331 & 504 (2006); Fed R. Bankr. P. 2013, 2016 & 2017. Insider compensation ar-
Many times in bankruptcy, contrary to the caveat emptor mores in the transactional world, nondisclosure is more likely to be fatal to transformation of legal rights than the consenting party’s failure to intend to, or objectively manifest, consent.

Disclosure can be used in three ways in bankruptcy. It can provide a necessary foundation for actual consent. It can also serve as a kind of formality, the plus, or part of the plus, in a consent-plus regime. In other instances, however, disclosure serves as a convenient substitute for consent. Consent is one basis for transformation of legal rights. By the same token, an open court-supervised process premised on full disclosure of material information to all interested parties may provide an independent ground for such transformation—one that gains acceptance from the parties and the larger society, not because it furthers party autonomy but because it represents a neutral and


49The classic nondisclosure/caveat emptor case, Laidlaw v. Organ, 15 U.S. 178, 193–94 (1817), actually involved an unwary seller rather than an unwary buyer. The buyer, with private knowledge that the Treaty of Ghent had been signed (and therefore the British blockade of New Orleans would shortly be lifted) bought a large quantity of tobacco in New Orleans at the depressed pre-Treaty price. The Treaty became public the next day and the local price of newly exportable tobacco increased dramatically. The buyer’s failure to disclose his private information to the seller was not a basis for voiding the sale in the view of the Supreme Court of the United States. Sheldon Gardner & Robert Kuehl, Acquiring an Historical Understanding of Duties to Disclose, Fraud, and Warranties, 104 COMM. L.J. 168, 174–76 (1999); Alan Strudler, Moral Complexity in the Law of Nondisclosure, 45 UCLA L. REV. 337, 370–84 (1997).
open (albeit coercive) mechanism, employing disclosure, notice, and an opportunity to be heard, for the adjustment of the parties' rights and liabilities.

The necessity of obtaining consents from unknown and future creditors is a significant theoretical and practical issue in bankruptcy.50 Notwithstanding the significant constitutional, statutory, and policy concerns with either deeming or foregoing consents from those who cannot practically be identified and therefore cannot give or manifest consent,51 courts have invented mechanisms to bind such parties to reorganization plans, injunctions, and discharges. Thus, for example, the fiction of inferring consent by failure to object in response to notice by publication has long been indulged by the bankruptcy system.52

Mass tort cases have proven to be a particularly fertile laboratory for

50 See infra note 53 and accompanying text.
52 The leading case on notice by publication is Mullane v. Cent. Hanover Bank & Trust Co., 339 U.S. 306 (1950). Mullane authorized notice by publication as a practical necessity notwithstanding frankly expressed doubts concerning its utility:

This Court has not hesitated to approve of resort to publication as a customary substitute in another class of cases where it is not reasonably possible or practicable to give more adequate warning. Thus it has been recognized that, in the case of persons missing or unknown, employment of an indirect and even a probably futile means of notification is all that the situation permits and creates no constitutional bar to a final decree foreclosing their rights.

Those beneficiaries represented by appellant whose interests or whereabouts could not with due diligence be ascertained come clearly within this category. As to them the statutory notice is sufficient. However great the odds that publication will never reach the eyes of such unknown parties, it is not in the typical case much more likely to fail than any of the choices open to legislators endeavoring to prescribe the best notice practicable.

Nor do we consider it unreasonable for the State to dispense with more certain notice to those beneficiaries whose interests are either conjectural or future or, although they could be discovered on investigation, do not in due course of business come to knowledge of the common trustee. Whatever searches might be required in another situation under ordinary standards of diligence, in view of the character of the proceedings and the nature of the interests here involved we think them unnecessary. We recognize the practical difficulties and costs that would be attendant on frequent investigations into the status of great numbers of beneficiaries, many of whose interests in the common fund are so remote as to be ephemeral; and we have no doubt that such impracticable and extended searches are not required in the name of due process. The expense of keeping informed from day to day of substitutions among even current income beneficiaries and presumptive remaindermen, to say nothing of the far greater number of contingent beneficiaries, would impose a severe burden on the plan, and would likely dissipate its advantages. These are practical matters in which we should be reluctant to disturb the judgment of the state authorities.

Id. at 317-18. See also Chemetron Corp. v. Jones, 72 F.3d 341, 345–46 (3d Cir. 1995).
methods of dealing with unknown and future claimants. In such cases an otherwise financially healthy, or at least viable, firm is rendered insolvent by existing and projected liability for personal injuries stemming from defective products it has manufactured or placed in the stream of commerce. Notable examples are asbestos products and the Dalkon Shield intrauterine device manufactured by A.H. Robins & Co. In such cases, realizing and preserving the firm’s going concern value and providing equal treatment for otherwise similarly situated present and future claimants requires that future claimants share in and be bound by the reorganization plan.53 Both payment and discharge of future claims, however, ordinarily would require notice, an opportunity to be heard, and some form of consent. Unidentified future claimants, perhaps not manifesting any injury, cannot be given actual notice much less manifest consent. Nevertheless, future claims must be dealt with and discharged in order to resolve effectively a mass tort chapter 11 case. Given the size and importance of such cases and the number of parties that would be adversely affected if no reorganization binding the holders of future claims were possible, the bankruptcy courts find authority to impose such plans based on a combination of disclosure and notice to identifiable claimants (who, it should be noted, can have conflicting interests with future claimants),54 court review of the substantive terms of the proposed plan, and the appointment of a “future claims representative” at the debtor’s expense.55 Notably, outside the bankruptcy context, the Supreme Court has found these same notice, lack of individual consent, and representation issues to be insuperable obstacles to global resolution of mass tort issues.56

II. DEEMING CONSENT IN BANKRUPTCY

Several aspects of the bankruptcy process find transformative consent notwithstanding that actual consent, or at least objectively-manifested contemporaneous consent, is plainly absent. Important examples include plan voting, claims allowance and discharge, and the exercise of bankruptcy court jurisdiction. In each of these areas, strong practical pressures or the policy of the law drive courts to expand the concept of consent beyond the standard


54Nat’l Bankr. Review Comm’n, supra note 53, at § 2.1.4; Smith, supra note 53, at 382-91.


model. Plan voting and claims allowance implicate the collective action and fair distribution problems at the heart of the bankruptcy process. The bankruptcy policy of seeking to resolve all the rights and liabilities of the debtor, its creditors, and other constituents in one forum has led to an expansion of bankruptcy court jurisdiction, not only by statute, but also through expansive notions of consent.

A. Dilution: Jurisdiction

The Supreme Court has determined that in certain contexts Article III of the United States Constitution limits the ability of nontenured judges to exercise jurisdiction over the parties without their consent.57 These constitutional principles impede bankruptcy courts in fulfilling their primary mission of efficiently resolving bankruptcy cases and proceedings. Accordingly, the jurisdictional statutes and bankruptcy rules presume that parties consent to jurisdiction (sometimes in the absence of explicit objection) at the first opportunity, which is usually the initial appearance of the party in the case or proceeding. This presumption applies to parties that choose to litigate in the bankruptcy courts, to parties who simply file proofs of claims, to governmental units asserting Eleventh Amendment immunity from suit in federal court,58 to those claiming a right to trial by jury, and to parties to an appeal asserting their right to appellate review by a life-tenured judge.59

Absent party consent, nontenured bankruptcy judges may enter final judgments only in core matters. In noncore matters related to bankruptcy cases or proceedings,60 absent consent, nontenured bankruptcy judges may only make reports and recommendations to Article III district court judges, who alone have the power to enter final orders in noncore proceedings.61 In

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58. U.S. Const. Amend. XI.
59. See infra notes 79-87 and accompanying text.
60. See 28 U.S.C. §§ 152(a)(1), 157(h)-(c) (2006). In Celotex Corp. v. Edwards, 514 U.S. 300, 308 (1995), the Court adopted the definition of "related to" jurisdiction set forth by the Third Circuit in Pacor, Inc. v. Higgins, 743 F.2d 984, 994 (1984): "[T]he 'related to' language of [28 U.S.C.] § 1334(b) must be read to give district courts (and bankruptcy courts under § 157(a)) jurisdiction over more than simply proceedings involving the property of the debtor or the estate . . . . The usual articulation of the test for determining whether a civil proceeding is related to bankruptcy is whether the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy . . . . Thus, the proceeding need not necessarily be against the debtor or against the debtor’s property. An action is related to bankruptcy if the outcome could alter the debtor’s rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate."
litigating noncore matters in bankruptcy court, therefore, one must determine when parties consent to the exercise of bankruptcy court jurisdiction.

These distinctions hearken back to practices under the Bankruptcy Act of 1898, pursuant to which the bankruptcy courts exercised "summary jurisdiction" over property in their legal custody. If, however, the debtor had neither actual nor constructive possession of the property,\(^6^2\) and if there was no independent basis for federal jurisdiction,\(^6^3\) then the district court lacked jurisdiction over the controversy unless Bankruptcy Act § 23b provided otherwise or the parties consented.\(^6^4\) With the parties' consent,\(^6^5\) however, the district court could exercise summary jurisdiction, even over certain avoiding power actions\(^6^6\) or controversies arising in bankruptcy cases over which it may be precious little difference in how a given district judge reviews cases involving 'recommendations' in non-core matters and those involving 'final judgments' in core matters.\(^\)"

\(^{62}\) Of course if the debtor had actual or constructive possession of the property at the time of the bankruptcy petition, its wrongful postpetition replevy would not ousted the bankruptcy court of summary jurisdiction over the property. See White v. Schloerb, 178 U.S. 542, 548 (1900). C.f. Murphy v. John Hofman Co., 211 U.S. 562, 569-70 (1909) (jurisdiction remains in bankruptcy court despite postpetition replevy). Nor would turnover to the secured party by a temporary bankruptcy receiver acting without an order of the bankruptcy court oust the bankruptcy court of jurisdiction. See Whitney v. Wenman, 198 U.S. 539, 553 (1905) ("We do not think this jurisdiction can be ousted by a surrender of the property by the receiver, without authority of the court . . . . What we hold is that under the allegations of this bill the District Court had the right in a proceeding in the nature of a plenary action . . . . to determine their rights, and to grant full relief . . . . ")

\(^{63}\) For example, diversity of citizenship or the existence of a federal question might ground the district court's exercise of jurisdiction in the absence of bankruptcy. See, e.g., Bush v. Elliott, 202 U.S. 477, 484 (1906). Even so, courts exercising plenary jurisdiction have no power to interfere with claims administration or other matters exclusively within the jurisdiction of the bankruptcy court. See Knauth, Nachod & Kuhne v. Latham & Co., 242 U.S. 426, 428 (1917) (holding that federal court hearing action by bankruptcy trustee to recover fraudulently transferred property had no jurisdiction to hear a cross bill of the transferee seeking to impress a trust on the property based on alleged fraud of the debtor in obtaining money from the transferee).

\(^{64}\) See, e.g., Daniel v. Guar. Trust Co., 285 U.S. 154, 163-64 (1932); Kelley v. Gill, 245 U.S. 116, 121 (1917); Wall v. Cox, 181 U.S. 244, 247 (1901); Hicks v. Knost, 178 U.S. 541, 542 (1900); Mitchell v. McClure, 178 U.S. 539, 540 (1900); Bardes v. First Nat'l Bank of Hawarden, 178 U.S. 524, 536 (1900) (without consent of the defendant, district court lacked jurisdiction over turnover action or fraudulent transfer action to recover money or property from a third party).

\(^{65}\) See, e.g., Schumacher v. Bedler, 293 U.S. 367, 377 (1934) (explaining that consent of parties can confer jurisdiction); MacDonald v. Plymouth County Trust Co., 286 U.S. 263, 267 (1932) (holding that parties could consent to have matters ordinarily subject to trial under plenary jurisdiction before the district court instead tried in summary proceedings before the bankruptcy referee); Bryan v. Bernheimer, 181 U.S. 188, 197 (1901) (creditor consented to summary jurisdiction by filing a proof of claim).

\(^{66}\) Without regard to the debtor's possession or title to property, Bankruptcy Act § 23b granted the district courts plenary jurisdiction over preference, certain fraudulent transfer, and strong arm clause causes of action under Bankruptcy Act §§ 60, 67, 70. See e.g., Flanders v. Coleman, 250 U.S. 223, 227 (1919) (fraudulent transfer cause of action); Collett v. Adams, 249 U.S. 545, 549 (1919) (preference action). This special jurisdictional grant also covered actions to recover the payment of excessive attorneys' fees under § 60d of the Bankruptcy Act. See In re Wood, 210 U.S. 246, 253 (1908). The jurisdictional grant did not cover, however, an action to recover property of the debtor obtained by false pretenses when there was no transfer by the debtor. See Park v. Cameron, 237 U.S. 616, 618 (1915) ("Those [allegations] that we have recited seem to us in their conclusion to import not that the corporation had
would not have had jurisdiction had the bankruptcy case not been filed, and which otherwise fell into the plenary jurisdiction exercised by district courts under the Bankruptcy Act.

Thus, under pre-Code law, in many cases, the nondebtor party’s consent to adjudication in the bankruptcy court was an essential predicate to its jurisdiction. If the party timely objected, summary jurisdiction did not lie. Obviously, an appearance made solely to contest jurisdiction did not waive the jurisdictional objection being asserted. The Supreme Court determined, however, that the filing of a proof of claim or a nondebtor party’s simple failure to object timely to the bankruptcy court’s exercise of jurisdiction did imply consent to summary jurisdiction. Among the bankruptcy cognoscenti, the doctrine that any participation in the bankruptcy case waived jurisdictional objections came to be known affectionately as “jurisdiction by

done anything, but that certain of its officers by false pretenses have withdrawn its funds. If so the suit is not to avoid a transfer by the bankrupt of its property, but a suit against wrongdoers who have appropriated it without the bankrupt’s assent, and therefore not within §§ 23b and 70e of the [Bankruptcy] Act.”


The district court exercising plenary jurisdiction did not necessarily have to be the court in which the bankruptcy petition was filed. Moreover, if the parties consented, an action normally triable as a plenary suit could be adjudicated by the bankruptcy referee in a summary proceeding. See MacDonald v. Plymouth County Trust Co., 286 U.S. 263, 265, 277 (1932).

Under amendments in force from 1903-1926, the bankruptcy court had summary jurisdiction over preference and certain federal fraudulent transfer suits for the recovery of property under Bankruptcy Act §§ 60b & 67e, but unless the defendant consented, no summary jurisdiction for fraudulent transfer suits under Bankruptcy Act § 70e. See, e.g., Wood v. A. Wilbert’s Sons Shingle & Lumber Co., 226 U.S. 384, 388-89 (1912).

See, e.g., Galbraith v. Vallesy, 256 U.S. 46, 49-50 (1921) (although assignee for benefit of creditors appeared in bankruptcy court, filed an accounting and paid over assigned assets net of fees, the bankruptcy court lacked summary jurisdiction to require the assignee to turn over fees and expenses retained and subject to his adverse claim); Louisville Trust Co. v. Cominor, 184 U.S. 18, 26 (1902) (sustaining challenge to summary jurisdiction when assignee for benefit of creditors appeared in the district court but objected to summary jurisdiction before the entry of final order).


See, e.g., In re Tax Serv. Ass’n of Ill., 305 U.S. 160, 164 (1938).

See Cline v. Kaplan, 323 U.S. 97, 99 (1944) (dictum because timely objection to jurisdiction made on facts of this case). Cf. Bankruptcy Act § 2a(7), 11 U.S.C. § 11a(7) (1976) (repealed 1979) (“Where in a controversy arising in a proceeding under this Act an adverse party does not interpose objection to the summary jurisdiction of the court of bankruptcy, by answer or motion filed before the expiration of the time prescribed by law or rule of court[.] . . . he shall be deemed to have consented to such jurisdiction.”).
This doctrine survives under the Bankruptcy Code. Although the Constitution probably does not permit a bankruptcy court to conduct a jury trial without the consent of the parties, bankruptcy courts may, and commonly do, adjudicate controversies without a jury over a creditor's objection if the creditor has filed a proof of claim. Accordingly, the Supreme Court in Granfinanciera, S.A. v. Nordberg, while upholding the parties' Seventh Amendment jury trial rights in adversary proceedings arising in or related to bankruptcy proceedings that are analogous to pre-1791 actions at common law, nevertheless approvingly citing Katchen v. Landy which held that by filing a proof of claim a creditor waives its right to a jury trial in such proceedings filed against it.

74 See Lawrence P. King, Jurisdiction and Procedure Under the Bankruptcy Amendments of 1984, 38 Vand. L. Rev. 675, 692 (1985); 2 Collier on Bankruptcy ¶ 23.08 at 532-60 (Lawrence P. King & Asa Herzog eds. 14th ed. 1977). A recent example of a bankruptcy court using the pressure of a bar date to obtain a waiver of jurisdictional and jury trial rights occurred in the notorious scandal involving Bernard L. Madoff, reputed to be the largest Ponzi scheme in history. Early investors receiving distributions or redemption payments prior to the revelation of the fraud wished to have the bar dates extended in order to avoid the dilemma of choosing between waiving their claims and waiving their right to a jury trial or non-bankruptcy forum in connection with potential fraudulent transfer litigation directed against them. The bankruptcy court refused to solve the dilemma for them by extending the bar date for such claimants until after a final determination of any avoidance action that might be brought against them. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec., LLC, No. 08-01789 (BRL), 2009 WL 458769, at *2 (Bankr. S.D.N.Y. Feb. 24, 2009) (denying extension and noting claimants could file timely protective claims although doing so would subject them to equitable jurisdiction of the bankruptcy court: “observance of a bar date may clearly be required even if it alters the method of fact-finding on the merits of the claim by limiting the availability of a jury trial” quoting In re Hooker Invs., Inc., 937 F.2d 833, 840 (2d Cir. 1991)). Had the matter involved a chapter 11 bar date rather than one set in a Securities Investment Protection Corp. (SIPC) receivership proceeding, an extension would have been afforded to the claimants by statute. 11 U.S.C. § 502(h) (2006).

75 At the Court of Appeals level, only the Second Circuit has found that the Constitution permits a non-tenured bankruptcy judge to conduct a nonconsensual jury trial. Compare In re Ben Cooper, Inc., 924 F.2d 36, 38 (2d Cir. 1991) with Landscape Props., Inc. v. Vogel, 46 F.3d 1416, 1424 (8th Cir. 1995). The Supreme Court has declined to resolve the split between the Second Circuit and other Courts of Appeals on this question. Ins. Co. of Pa. v. Ben Cooper, Inc., 497 U.S. 1023 (1990) (granting certiorari on whether bankruptcy judges may conduct jury trials without the consent of the parties), 498 U.S. 964 (1990) (summarily vacating the judgment below and remanding for consideration of jurisdictional issues), and 500 U.S. 928 (1991) (denying certiorari after the Second Circuit reinstated its opinion on remand).


77 See id. at 58 & n.13 (1989) (citing with approval Katchen v. Landy, 382 U.S. 323, 336 (1966) (“Although petitioner might be entitled to a jury trial on the issue of preference if he presented no claim in the bankruptcy proceeding and awaited a federal plenary action by the trustee, Schoenthal v. Irving Trust Co., 287 U.S. 92, when the same issue arises as part of the process of allowance and disallowance of claims, it is triable in equity.”)). Katchen, in turn, rooted its holding in Alexander v. Hillman, a federal equity receivership case in which the Court allowed the federal district court to adjudicate legal counterclaims filed by receivers against claimants. See Alexander v. Hillman, 296 U.S. 222, 238-39, 242-43 (1935) (claim filed in federal equity receivership submits claimant to court's jurisdiction in respect of all defenses, objections, and counterclaims that might be interposed to the validity, priority, or amount of claims). Since deciding Granfinanciera, the Court has expressly adhered to Katchen's jury trial waiver
Congress has also sought to expand the scope of the appellate jurisdiction of nontenured bankruptcy judges by providing for the implementation of bankruptcy appellate panels (BAP) unless a Circuit affirmatively determines not to participate.\textsuperscript{78} The federal district courts have concurrent appellate jurisdiction over final bankruptcy court decisions,\textsuperscript{79} and discretionary jurisdiction over most interlocutory decisions.\textsuperscript{80} Unless a party timely opts-out of BAP review, however, all appeals are automatically routed to the nontenured appellate panels rather than the federal district courts.\textsuperscript{81} Consent to BAP adjudication is inferred from a party's failure to insist timely on Article III court review. BAPs are institutionally well-situated and designed to fulfill the appellate law-declaring function for the bankruptcy court system.\textsuperscript{82} Indeed, they are better designed to fulfill this role than the federal district courts.\textsuperscript{83} The default rule (routing bankruptcy appeals to BAPs absent timely and specific objection) is surely more about protecting the institutional role of the BAPs than it is about protecting litigants' autonomous choices to assert or waive their right to Article III court review of the final decisions of nontenured bankruptcy judges.

It is easy to get lost in the thicket of case law defining the jurisdiction of the bankruptcy courts. Thicket notwithstanding, however, Congress has sought to confer, and the courts endeavor to preserve, broad jurisdiction for bankruptcy judges to facilitate effective resolution of bankruptcy cases and enforcement of bankruptcy law.\textsuperscript{84} Deemed consent is frequently the tool courts use to bridge the divide between constitutional principles limiting jurisdiction and pragmatic desires to expand the scope of bankruptcy court jurisdiction.

\textsuperscript{78} Although Bankruptcy Appellate Panels (BAPs) were authorized by the 1978 Bankruptcy Code, prior to 1994 only the First Circuit and the Ninth Circuit established BAPs, and the First Circuit abandoned the experiment after only a few years. In 1994, Congress mandated establishment of non-tenured bankruptcy appellate panels in every Circuit unless the Circuit council affirmatively found (on a factual record to be submitted to the Judicial Conference) insufficient judicial resources in the Circuit or that undue delay or increased cost would result. Notwithstanding this prod from Congress, most Circuits continue to route bankruptcy appeals exclusively to district courts (except where certification for direct appeal to the Court of Appeals is available). 28 U.S.C. § 158(d)(2) (2006). Currently BAPs are functioning in the First, Sixth, Eighth, Ninth and Tenth Circuits. 2008 ANNUAL REPORT OF THE DIRECTOR OF THE ADMIN. OFFICE OF THE US COURTS, Tbl. B-10.


\textsuperscript{82} Bussel, supra note 61, at 1094-95.

\textsuperscript{83} Id.

B. INERTIA: SHIFTING BETWEEN OPT-OUT AND OPT-IN RULES

Assuming no transaction costs and perfect information, we are told that default rules should not matter. In the sticky world in which we live, however, default rules matter a great deal. When the Ninth Circuit restructured first tier appellate review from a BAP opt-in to a BAP opt-out, the percentage of appeals heard by the BAP immediately increased from 30 percent to 66 percent. The power of inertia in determining appellate venue is driven home when one reflects that in the economists’ perfect world, no appeals at all would be heard by a BAP: Presumably fully informed rational parties would similarly conclude that BAP review favored one party or the other, and that party’s adversary, acting rationally, would, in accordance with its statutory right and in the absence of transaction costs, insist on district court review.

For purposes of distributing value from the bankruptcy estate, bankruptcy is structured as an opt-in procedure rather than an opt-out procedure. In a chapter 7 liquidation case, for example, a creditor cannot share in the estate unless it affirmatively opts-in to the bankruptcy process by filing a proof of claim. Moreover, as discussed above, the act required to assert a

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87In theory, perhaps, it might be in both parties’ interest to elect BAP review if the BAP disposed of appeals at less cost but without altering each party’s likelihood of success on the merits or the district court appeal was uninviting based on the location of the forum or identity of the judge. BAP review, however, is very unlikely to be less costly than district court review given the geographic remoteness of the BAPs to most districts, and their configuration as three-judge appellate panels rather than single judge district courts. Bussel, supra note 61, at 1075, 1092-93. Many appellees instinctively presume that if their appellant prefers a BAP, they would rather be in district court, especially appellees hoping that a randomly selected non-expert federal district court judge will tend to defer to the specialist bankruptcy judge he is reviewing. Nevertheless, as noted in the text, in 30% of appeals under the Ninth Circuit’s pre-1988 opt-in system, appellees did not exercise their statutory right to have the appeal heard in district court even though their appellant affirmatively opted-in to BAP review. Of course, the assumption that litigants operate in a no-transactions-cost world populated only by fully informed rational actors contains within itself a paradox, for in that Eden how could litigation exist?
88Proofs of claim must be filed under penalty of perjury before the applicable claims bar date which, in chapter 7 cases (subject to certain specified exceptions), is 90 days after the first date set for the meeting of creditors. In chapter 11 cases, unless the debtor schedules the creditor’s claim as disputed, contingent, or unliquidated, the scheduled amount will constitute an allowed claim even if the creditor fails to timely file a proof of claim. 11 U.S.C. § 1111(a) (2006). If the creditor disagrees with the scheduled amount or the claim is scheduled as disputed contingent or unliquidated, then the creditor must file a proof of claim prior to the bar date. In chapter 11 cases, the court generally fixes firm claim bar dates on noticed motion within the first six months or so of the bankruptcy filing. This procedure contrasts with otherwise applicable law which generally does not require creditors to assert claims promptly and formally until just before the running of statutes of limitations, usually at least one year, often longer, from the time the claim accrues and subject to various equitable and legal tolling doctrines. It also starkly contrasts with non-bankruptcy class action procedure which (to the extent optional as to class members) is structured as an
claim, the filing of a proof of claim, also waives jurisdictional objections to the bankruptcy forum and constitutionally guaranteed jury-trial rights. Recognizing and exploiting inertia effects, however, bankruptcy adopts an asymmetrical rule with respect to discharge: All claims, whether or not timely asserted by the creditor, are subject to discharge. Thus a nonfiling creditor is bound by the bankruptcy discharge, but may not share in the bankruptcy estate.

Shifting default rules in order to facilitate reorganization or expand bankruptcy court authority is thus characteristic of the bankruptcy process. In the context of BAP appellate review where the bankruptcy-preferred outcome is BAP review, affirmative opt-out of BAP is required. In the context of claims payment, however, the bankruptcy-preferred outcome is fewer claims, so creditors' rights to distributions are conditioned on an express opt-in to bankruptcy by the filing of proofs of claim in chapter 7 and 13 cases. In the discharge context, where the bankruptcy's fresh-start and finality policies are implicated, bankruptcy law imposes a mandatory rule that, within the confines of the Constitution's due process clause, discharges all claims, opt-out, not opt-in, proceeding. Fed. R. Civ. P. 23. In re Murray, 377 B.R. 464 (Bankr. D. Del. 2007), a small individual debtor case converted from chapter 7 to chapter 13 prior to the belated discovery that the debtor possessed a "low-number" license plate worth $200,000 to $250,000, alludes to the conventional understanding of the opt-in default rule. Because of the lucky license plate the debtor suddenly had the capacity to pay all creditors in full. In moving to reconvert, the former chapter 7 trustee offered to file claims on behalf of otherwise defaulting creditors:

Movant argues that creditors will receive greater repayment through a chapter 7 liquidation than through the Debtor's Amended Plan because only a small fraction of unsecured creditors in typical Chapter 7 and Chapter 13 cases will file claims. Upon conversion back to a Chapter 7 case, however, Movant has offered to file claims on behalf of creditors who do not timely file the claims themselves. At bottom, the Movant wants this Court to ensure and provide for the distribution of estate property to creditors who will not bother to file a claim for themselves. The Court finds this request unavailing. The Debtor's conversion will not alter the creditors' rights to payment in full of their claims upon the filing of an allowed claim.

Id. at 471 (citations omitted).

99See supra notes 57-77 and accompanying text.
9This sharply contrasts with class action procedure under Fed. R. Civ. P. 23 which treats the question of entitlement to share and discharge as symmetrical, and where optional for class members, requires opt-out rather than opt-in. See supra note 56 and accompanying text.
whether filed or not and without opt-in or opt-out elections.93

C. PROXIES

1. Class Voting on Chapter 11 Plans

The most strikingly idiosyncratic means of obtaining consent in bankruptcy is the chapter 11 reorganization plan voting process. Outside bankruptcy, the affirmative consent of individual creditors (sometimes obtained in advance through an intercreditor agreement, although this has not been the historical practice in the United States)94 is necessary to reduce or to defer scheduled debt payments or otherwise alter the central economic terms of creditors' claims.95 The requirement of individual consent complicates out-of-court debt restructurings, which often depend on reducing or deferring principal and interest or releasing collateral. Creditors face a collective action problem in the form of a prisoners' dilemma.96 Each individual has an incentive to withhold consent, even though from a collective point of view the parties can only maximize aggregate wealth through unanimous consent.97 Bankruptcy solves this collective action problem by selectively and conditionally overriding nonbankruptcy consent requirements.98 Thus, the vast major-

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93Bankruptcy law's ability to shift default rules to suit its purposes is reminiscent of the fable of the Bat and the Two Weasels:

A Weasel seized upon a Bat, who begged hard for his life. "No, no," said the Weasel, "I give no quarter to birds." "Birds!" cried the Bat. "I am no bird. I am a mouse. Look at my body." And so she got off that time.

A few days afterward she fell into the clutches of another Weasel, who, unlike the former, had a stronger antipathy to mice than to birds. The Bat cried for mercy. "No," said the Weasel; "I show no mercy to a mouse." "But," said the Bat, "you can see from my wings that I am a bird." And so she escaped that time as well.

CHARLES H. SYLVESTER, JOURNEYS THROUGH BOOKLAND 154 (Bellows-Reeve 1922).


95For asternal specification of the prisoners' dilemma game, see Neil S. Siegel, State Sovereign Immunity and State Decisis: Solving the Prisoners' Dilemma Within the Court, 89 CALIF. L. REV. 1165, 1172-74 & n.34 (2001) (crediting Drescher and Flood of the RAND Corporation with formulating the Prisoners' Dilemma and Albert Tucker as the first to write about it, citing 1 KEN BINMORE, GAME THEORY AND THE SOCIAL CONTRACT: PLAYING FAIR 102 (1994)).

96Coffee & Klein, supra note 33, at 1214 & n.25 (citing evidence that in the context of an out of court public debt restructuring "if as few as five to ten percent of the bondholders hold out, they will soak up the gains from the consensual scaling down by their fellow creditors").

97id. at 1242-51.
ity of chapter 11 plans (which commonly adversely alter central economic terms of secured claims, unsecured claims, and equity interests) are "consensual" only in the artful bankruptcy sense: Each impaired class has accepted the plan by a majority in number of claims in that class actually voted and two-thirds in dollar amount of claims in that class actually voted. Acceptance by the requisite majorities binds all members (including dissenting and nonvoting members) of the class to the plan and waives objections that class members might otherwise make that the plan "unfairly discriminates" or is not "fair and equitable." Dissenting or nonvoting creditors holding claims in impaired classes may insist that they receive the liquidation value of their claims, but anything more, even though others with equal or lower legal priority are getting more than their liquidation values, is subject to waiver by the class vote. In determining whether a class has voted to consent, nonvoting creditors' claims are disregarded and no quorum is required. Moreover, the classes themselves might be constructed by the plan proponent with an eye toward obtaining the requisite majorities for acceptance. Furthermore,


10111 U.S.C. § 1129(b)(1) (2006). "Unfair discrimination" objections are premised on a lack of "horizontal equity" that is the dissenting class is treated unjustifiably worse than another class with comparable legal priority. Bruce A. Markell, A New Perspective on Unfair Discrimination in Chapter 11, 72 Am. Bankr. L.J. 227, 231 (1998). "Fair and equitable" is a bankruptcy term of art that incorporates (i) specific statutory standards for the treatment of secured claims, (ii) a modified version of the "absolute priority rule" developed under federal equity receivership practice, and (iii) other "uncodified" fairness principles. Klee, supra note 44, at 229-41. The absolute priority rule requires that creditors in unsecured dissenting classes receive reorganization value equal to the allowed amount of their claims or the elimination of junior classes. Dissenting secured classes are entitled to retain their liens to secure deferred cash payments with a present value equal to the allowed amount of their secured claims. Under pre-Code law, each dissenting creditor (as opposed to each dissenting class) was entitled to insist on "fair and equitable" treatment in a Chapter X reorganization. See N. Pac. Ry. v. Boyd, 228 U.S. 482, 508-09 (1913). Some courts and commentators view the "new value exception" to the "absolute priority rule" under pre-Code law, Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 117 (1939), as an indirect means of ameliorating the hold-out problem created by Chapter X's absolute priority rule. See Kham & Nate's Shoes No. 2 v. First Bank of Whiting, 908 F.2d 1351, 1360-61 (7th Cir. 1990).


103Section 1122 prohibits the classification of dissimilar claims in the same class, but is silent on the question whether all similar claims must be placed in the same class. 11 U.S.C. § 1122 (2006). In fact, separate classification of legally similar claims is commonplace. Courts purport to frown on the practice of constructing classes solely for the purpose of gerrymandering the vote, but nevertheless generally permit separate classification of similar claims, at least outside the single-asset real estate context, In re Greystone
the plan proponent may seek to designate (that is, disqualify) the vote of a dissenting creditor on the ground of some misconduct in connection with its solicitation or voting, or even remove the claim from a class altogether through equitable subordination. In this way bankruptcy law, although adopting the rhetoric of consent, lowers the consent bar, at some cost to individual autonomy, to realize for the greater good the benefit of debt restructurings that (in the judgment of the majority of debtholders voting in good faith) maximize aggregate wealth for their class.

2. Committees

In contrast to the class voting rules, which are embodied in an elaborate and express statutory compromise and which directly empower constitu-ents, the phenomenon of official creditors’ committees serving as proxies for unsecured creditors has developed entirely outside the statute itself and reinforces the power of self-pronounced “major parties.” The statutory powers and duties of committees nowhere suggest that committee consent may bind its constituency; their statutory role is to investigate on behalf of, and to inform and advise constituents, not consent for them. This limited definition of the committee role is no mere oversight. A central perceived abuse of the pre-1938 equity receivership period was undue committee control over


10611 U.S.C. §§ 1124, 1125, 1126, 1129 (2005); see supra notes 94-105 and accompanying text.

10711 U.S.C. §§ 1102, 1103 (2006). See Kenneth N. Klee & K. John Shaffer, Creditors’ Committees Under Chapter 11 of the Bankruptcy Code, 44 S.C.L. Rev. 995, 1000-01 (1993). By tradition, committees typically act on the basis of the vote of a simple majority of the members, although nothing in the Code expressly constrains them to do so and committees have on occasion adopted by-laws incorporating super-majority or weighted or class voting rules. Id. at 1058.
the reorganization process to the detriment of constituents.\textsuperscript{108}

Nevertheless, in the larger chapter 11 cases, when committees are appointed and able to retain professionals,\textsuperscript{109} with the increasingly anomalous exception of voting on the plan, the committees act as a proxy for their constituencies. Committee consent effectively binds the classes they represent in most of the key events in a chapter 11 case: settlements, financings, sales, and plan modifications.\textsuperscript{110}

With respect to settlements, the established doctrine is that the paramount interest of creditors with respect to the proposed settlement is a primary consideration in obtaining the court approval necessary to bind the bankruptcy estate.\textsuperscript{111} As a practical matter, the bankruptcy courts generally

\textsuperscript{108}Daniel J. Bussel, Coalition Building Through Bankruptcy Creditors Committees, 43 UCLA L. REV. 1547, 1556–58 (1996) (describing SEC objections to equity receivership committees and Chandler Act reforms). In pre-Code equity receivership practice, protective committees would obtain deposit agreements or irrevocable proxies from securities holders and then proceed to negotiate the terms of the reorganization with votes in hand. Committee control of the voting process led to abuses identified by the Securities and Exchange Commission in its landmark study, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1936-1938), 6 Collier on Bankruptcy ¶ 004, at 59 (Lawrence P. King & Asa S. Herzog eds. 14th ed. 1977) ("The activity of the protective committee or committees in the reorganization without proper supervision or restraint afforded opportunity for great abuses of power and through such committees investment houses and large institutional investors were able to control reorganizations in many cases."). The practice of vote-casting by self-appointed protective committees was repudiated in the Chandler Act of 1938, 11 U.S.C. § 176 (1940) (repealed 1979), a policy carried forward in the Bankruptcy Code which vests the right to vote in individual creditors and precludes advance solicitation, other than in the context of a prepackaged or prenegotiated plan. Compare 11 U.S.C. §§ 1125(b) & 1126(a) (2006) (postpetition acceptance or rejection generally must be by holder after receipt of plan and court-approved disclosure statement); Fed. R. Bankr. P. 3017, 3018 with 11 U.S.C. § 1125(g) & 1126(b) (2006) (authorizing postpetition continuation of prepetition solicitation).


\textsuperscript{110}Plan modifications require resolicitation of classes adversely affected by the modification. Fed. R. Bankr. P. 3019(a). However, courts have imposed a materiality limitation on the resolicitation requirement. In re Am. Solar King Corp., 90 B.R. 808, 825-26 (Bankr. W.D. Tex. 1988). Most plan modifications, particularly those supported by the creditors committee, are approved without resolicitation. Lewis U. Davis, Jr. et al., Corporate Reorganization in the 1990s: Guiding Directors of Troubled Corporations Through Uncertain Territory, 47 Bus. L. W. 1, 31 n.28 (1991) ("If a proposed modification is supported by all constituents, a court may be under great pressure to find that the modification is immaterial in order to avoid the time-consuming process of notification, approval of additional disclosure materials and resolicitation.").

\textsuperscript{111}10 Collier on Bankruptcy ¶ 9019.02 at 9019-4 (15th rev. ed. 2008). The Courts of Appeals uniformly agree that, in deciding whether to approve a compromise or settlement under Rule 9019, a bankruptcy court must consider "the paramount interest of the creditors and [give] a proper deference to their reasonable views . . . ." Dreisel v. Loomis, 35 F.2d 800, 806 (8th Cir. 1929). See, e.g., In re RFE Indus., 283 F.3d 159, 165 (3d Cir. 2002); Christo v. Padgett, 223 F.3d 1324, 1335 (11th Cir. 2000); In re Am. Reserve Corp., 841 F.2d 159, 161 (7th Cir. 1987); In re Jackson Brewing Co., 624 F.2d 605, 607 (5th Cir. 1980). Moreover, the proponent of a settlement agreement must provide the Court "with sufficient facts
defer to a creditors’ committee’s expression of that interest. Indeed, it has increasingly become the practice for courts simply to authorize the committee to prosecute or settle much estate litigation, particularly avoiding power litigation and claims against insiders.

More recently, as chapter 11 practice has become more centered on financing orders and § 363 sales to which the statutory solicitation and voting procedures do not apply, the bankruptcy courts increasingly look to the creditors’ committee as the proxy for unsecured creditor interests. So very much of chapter 11 practice, particularly in Delaware and New York, has become bankruptcy court ratification of whatever deal is worked out among secured lenders, the debtor and the unsecured creditors’ committee in the context of settlements, sales, and financings, that those deals pretermit or predetermine the terms of any reorganization plan. Accordingly, the power of a majority of the committee as proxy vis-à-vis a dissenting minority can easily outweigh the power of a majority holder of claims in a class under the

sorted out in a reasonable fashion to permit an adequate analysis of whether the agreement is in the best interest of all creditors.” In re Libreria Alma Mater, Inc., 123 B.R. 698, 700 (Bankr. D.P.R. 1991). The Seventh Circuit, in American Reserve explained: “[T]he bankruptcy judge] may not simply accept the trustee’s word that the settlement is reasonable, nor may he merely rubberstamp the trustee’s proposal.” 841 F.2d 199, 162 (7th Cir. 1987). See also Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968); In re Doctors Hosp. of Hyde Park, Inc., 474 F.3d 421, 426 (7th Cir. 2007); In re Energy Coop., Inc., 886 F.2d 921, 924 (7th Cir. 1989).

Statutory committees have standing to support or oppose Rule 9019 settlement motions. 11 U.S.C. § 1109(b) (2006); Fed. R. Bankr. P. 2018. For example, the bankruptcy court in In re Present Co. sustained objections by the creditors’ committee and refused to approve a settlement agreement, explaining:

The Funds have refused to provide to the Creditors’ Committee full disclosure of materials pertaining to the transactions that are here sought to be compromised and released.... Whatever “arms-length bargaining” occurred that led to this compromise occurred among insiders and their counsel (the debtors and the Funds); tripartite negotiations that would have included the Creditors’ Committee never occurred in this case....

They cannot persuade me to approve this compromise over the objection of the only appearing non-insider parties so long as insiders limit the information available to those parties.


See infra notes 334–37 and accompanying text.
class voting rules. Those rules only apply to plans, whose shape may be predetermined by preconfirmation sales, financings and settlements. Moreover, in the plan voting process significant dissenters may amass blocking positions and seek to rally opposition. Although objectors may be heard in opposition to motions to approve sales, settlements, and financings, little deference may be paid to objectors’ views on the business merits of a committee-supported deal. As long as dissenters’ legal rights are not violated, they may have little ability to veto what they perceive as an unfavorable or unfair transaction. Moreover, members of the committee, perhaps even a majority, may well have interests directly adverse to some holders of claims and may receive treatment quite different from those holders. For example, a committee composed of a majority of trade creditors (whose claims, since 2005,\textsuperscript{116} are in significant measure entitled to priority treatment) may well be more concerned about favorable treatment of postpetition administrative claims, priority prepetition claims, and ongoing business relationships, than maximizing general creditor recovery. Or a committee dominated by senior unsecured creditors, may be unconcerned by a sales price that leaves subordinated holders out-of-the-money. Constituencies whose representatives do not control the committee have far more leverage over the terms of a reorganization plan than a settlement, sale, or refinancing authorized on noticed motion.\textsuperscript{117}

III. FACILITATING CONSENT BY ALTERING BASELINES

Bankruptcy is a time for adjustment and renegotiation of legal rights. New procedures are put in place on filing that affect the outcome of that renegotiation and remove obstacles to its success. Perhaps even more importantly, however, substantive entitlements are also altered, sometimes dramatically.\textsuperscript{118} New rights are created and established entitlements altered, often in unclear ways. Debtors in possession can reinstate defaulted contracts they previously had no right to reinstate over the nondebtor party’s objection\textsuperscript{119} or assign rights to third parties even though otherwise enforceable contrac-


\textsuperscript{117}Lee R. Bogdanoff, The Purchase and Sale of Assets in Reorganization Cases—Of Interest and Principal, of Principles and Interests, 47 BUS. LAW. 1367, 1388-95 (1992).


tual anti-assignment clauses forbid it. \(^{120}\) Previously settled transfers can be unwound, in some cases notwithstanding that the transfers were entirely lawful and unavoidable at the time they were made. \(^{121}\) The rights of creditors are altered and new bankruptcy remedies substituted for those available under otherwise applicable law, \(^{122}\) priorities among creditors are reordered, and otherwise valid claims subordinated or disallowed on bases unknown to otherwise applicable nonbankruptcy law. \(^{123}\) Claims against the debtor are subject to a bankruptcy discharge also unknown to otherwise applicable nonbankruptcy law. In short, alteration of legal entitlements is a matter of course in bankruptcy.

Those substantive alterations, as much as the altered procedural posture, provide the context for a massive, concurrent renegotiation of the parties’ rights and liabilities. Adverse changes in nondebtors’ baselines and the introduction of uncertainty as to what exactly the new baseline is make previously unattractive proposals more appealing. Depending on how much worse the nondebtor party’s baseline has become, a previously unattractive proposal may suddenly be seen as one “he couldn’t refuse.” \(^{124}\) After discussing generally how bankruptcy law exploits uncertainty and ambiguity in establishing new baselines, we illustrate how bankruptcy law sets the stage for renegotia-

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\(^{120}\) 11 U.S.C. § 365(f) (2006); see Bussel & Friedler, supra note 119, at 323–25.


\(^{122}\) For example, secured creditors’ state law rights to foreclose on their collateral are subject to stay and their other rights are subject to modification as long as adequate protection is provided and the value of the collateral securing the claims, as determined by the court, is preserved. 11 U.S.C. §§ 361-364, 1129(b) (2006).

\(^{123}\) See, e.g., 11 U.S.C. §§ 507(a) (statutory bankruptcy priorities); 502(b)(2) (disallowing unmatured interest claims); 502(b)(6) (capping lease termination damage claims); 502(b)(7) (capping employment contract termination claims); 510(b) (subordinating certain securities law claims); 510(c) (equitable subordination); 724(a) (subordinating penalties and fines); 724(b) (subordinating certain tax liens); 1114 (special protection for certain retiree benefits) (2006).

\(^{124}\) The Godfather (Alfar Prod./Paramount Pictures 1972) (Michael Corleone (Al Pacino): “My father made him an offer he couldn’t refuse.” Kay Adams (Diane Keeton): “What was that?” Michael: “Luca Brasi held a gun to his head, and my father assured him that either his brains or his signature would be on the contract.”).
ation and accommodation of competing rights by altering baselines through the fair and equitable and best interest of creditors standards. Consent can be manufactured more effectively, it turns out, if the consenting party is first softened up by a downward adjustment in its substantive entitlement. In the Appendix we examine in greater depth how this softening-up has evolved over time in the context of landlords.

A. Creating Ambiguity and Uncertainty Over Baseline Rights

Commercial law commentators insist on decrying vague and uncertain legal rules as an impediment to efficient allocation of resources.\textsuperscript{125} Bankruptcy law, however, has long depended on vague and uncertain legal rules as a primary means of forcing parties into a renegotiation of legal rights to facilitate reorganization.\textsuperscript{126} Plans must be "fair and equitable"\textsuperscript{127} and secured parties are entitled to "adequate protection"\textsuperscript{128} of property interests securing their claims which may be restructured according to a standard of "indubitable equivalence."\textsuperscript{129} Parties' rights are frequently made to turn on valuation


\textsuperscript{127} 11 U.S.C. § 1129(b)(1) (2006). The fair and equitable test is derived from \textit{In re Muriel Holding Co.}, 75 F.2d 941, 942 (2d Cir. 1935) (L. Hand, J.) and is the court-determined substitute for the secured creditor's state law rights to foreclose and otherwise exercise dominion over its collateral. \textit{Id.} at §§ 362-363. The concept also defines the entitlement of the secured party in objecting to the post-petition creation of liens of equal or senior rank in its collateral. 11 U.S.C. § 364(d)(2) (2006).

\textsuperscript{128} Also derived from \textit{In re Muriel Holding Corp.}, 75 F.2d 941, 942 (2d Cir. 1935) (L. Hand, J.), this standard applies to the alteration of liens in the permanent restructuring of secured claims under 11 U.S.C. § 1129(b)(2)(A)(iii) and to the interim use of collateral on a basis other than cash adequate protection payment or replacement liens. See 11 U.S.C. § 361(3) (2006). Although it certainly sounds stringent ("indubitable"), it has been used to justify permanent alteration of liens on the basis of judicial valuations that purport to establish that the value of the secured party's interest in its collateral is not at risk. \textit{In re Sandy Ridge Dev. Corp.}, 881 F.2d 1346, 1353-54 (5th Cir. 1989) (approving cram down based on judicial valuation); \textit{In re May}, 174 B.R. 832, 839-40 (Bankr. S.D. Ga. 1994) (placing risk of incorrect valuation on secured creditor because "a court cannot be the guarantor of the values it sets") in determining indubitable equivalence by a preponderance of the evidence; \textit{In re Atlanta S. Bus. Park}, 173 B.R. 444, 450-51 (Bankr. N.D. Ga. 1994). On occasion those judicial valuations have proved to be, indubitably, overly-optimistic.
of firms and collateral, although these are among the thorniest factual issues that courts regularly encounter. Moreover, bankruptcy courts determine value on the basis of testimony, and not current market bids.130 “Though this be madness, yet there is method in’t.”131 By creating uncertainty, especially factual uncertainty, about the parties’ rights, bankruptcy law provides an environment where parties are encouraged to compromise rather than to stand on their legal rights. Transformation of legal rights becomes a two-step process where rights are first muddied up, and then clarified based on a negotiated solution. By focusing on the second step, bankruptcy law manages to appear to accommodate conflicting rights by legally transforming them on the basis of consent rather than imposition.132

B. CRAMDOWN

Bankruptcy’s most notorious baseline alteration is the chapter 11 cramdown power which authorizes the bankruptcy court to impose a debt restructuring on a creditor even over the opposition of a rejecting class as long as certain minimum legal standards are met. The need for a nonconsensual reorganization option is not new and can be traced through the Bankruptcy Act of 1898 to nineteenth century equity receivership practice. For example, in Case v. Los Angeles Lumber Products Co.,133 the debtor, a holding

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130Elizabeth Warren, A Theory of Absolute Priority, 1991 ANN. SURV. AM. L. 9, 13-14; Klee, supra note 44, at 244:

The vice of the new value exception is that it enables the debtor’s owners to purchase an ownership interest based on a court approved valuation without validation of the price in the market place. Valuation by the court is, of course the norm for distribution of reorganization securities under the fair and equitable test. But when a reorganization security is to be sold, in effect, for a new contribution, rather than distributed in satisfaction of claims or interests to a class of creditors or owners under a plan, perhaps a market test should be applied as would be done with the sale of any other asset of the estate. At the very least, to maintain the balance of relative right, chapter 11 creditors who argue that the proposed capital contribution is too low should have the opportunity to match or exceed the pending offer.


company for a shipbuilding corporation, filed under § 77B of the Bankruptcy Act to implement a reorganization plan negotiated out of court. Over 90 percent of both bondholders and stockholders accepted the plan. Certain bondholders, however, dissented from the plan on the basis that it was not fair and equitable. The Court refused to confirm the plan, noting that Bankruptcy Act § 77B(f) required that the plan be “fair and equitable.” These “words of art,” said the Court, “had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations,” to wit the “fixed principle” of Northern Pacific Ry. v. Boyd.

Implicit in Los Angeles Lumber, however, is the idea that a plan that complied with the Boyd rule would be confirmable over the objections of the dissenting minority bondholders. Moreover, Los Angeles Lumber went on to declare that even a plan under which old shareholders retained an equity interest was permissible over the objections of creditors that had not received payment in full if (i) sufficient class consents had been obtained, (ii) the value of the equity retained by old shareholders was reasonably proportionate to their fresh contribution to the reorganization, (iii) the form of the shareholders’ new contribution was “money or moneys’ worth” and (iv) that contribution was necessary for effective reorganization. Thus, in bankruptcy court, even the “fixed principle” of “absolute priority” may be evaded by a (perhaps dubiously inflated) judicial valuation, and remains subject to waiver by vote of others similarly situated, based on judicial findings of the adequacy and necessity of the contribution justifying the continuing participation of otherwise out-of-the-money junior interests.

Cram down is also a perfect example of how, in altering baselines, bankruptcy law generates and exploits uncertainty which incentivizes and facilitates renegotiation. The absolute priority rule requires that unsecured creditor classes be compensated in full before the former stockholders of the debtor receive anything. Whether a creditor class receiving securities in the

135 308 U.S. at 110.
136 Id. at 111-12.
137 Id. at 112.
138 Id. at 115-16 (citing N. Pac. Ry. v. Boyd, 228 U.S. 482 (1913)). The Boyd rule is generally known as the “absolute priority rule.”
139 Id. at 121-22. Notably, statutory changes made by the 1978 Bankruptcy Code would reverse the Los Angeles Lumber result today because acceptance of the plan by the classes of bondholders and stockholders (without any further finding in respect to the adequacy or necessity of a new value contribution in money or money’s worth) would bind dissenters and render the absolute priority rule inapplicable. 11 U.S.C. § 1129(a)(8), (b); cf. Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship, 526 U.S. 434, 456-58 (1999) (requiring “some form” of market test to confirm a new value plan). Thus, today the “consent” of the class substitutes for the consent of the particular creditors and shareholders, even as to plans that do not otherwise meet the baseline standard of being “fair and equitable.”
reorganized debtor is compensated in full, however, depends on the value of the reorganized corporation as a going concern. Enterprise valuation is a notoriously vexing and factually uncertain issue.\textsuperscript{140} Traditionally, this valuation is done judicially on the basis of expert testimony employing the discounted cash flow method or some variant.\textsuperscript{141} Courts determine value by estimating future earnings of the reorganized corporation and by applying a discount rate to them, rather than by soliciting bids for the firm. The discount rate is determined by considering the risk factors for the reorganized corporation and for the industry in which the corporation was competing on the basis of often conflicting expert testimony. Future annual earnings are then "determined" by weighing competing and necessarily speculative expert testimony, a notoriously uncertain task. Professors Walter Blum and Stanley Kaplan's critique of the valuation process is as cogent today as in 1974:\textsuperscript{142}

The valuation procedure always produces a dollars and cents figure. Although that figure looks mathematically exact, it actually reflects in a single number a whole series of highly conjectural and even speculative judgments concerning long range business expectations and hazards as well as future social and general economic conditions. To exclude a class of creditors or investors from participation in a reorganization plan based on so illusory a figure is criticized as capricious. The process is said to deceive by treating "soft" information as if it were "hard" and by cloaking predictions in the guise of mathematical certainty, under circumstances where consequences are drastic and final.

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The imprecision of the valuation process has also led to the argument that valuation is so malleable that the entire process is perverse—that, in actuality, it is the reverse of what it seems to be. On this view, valuation is not an objective process by which projected earnings are capitalized to reach

\textsuperscript{140}\textsuperscript{Douglas G. Baird & Donald S. Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bar 


\textsuperscript{143}\textsuperscript{Walter Blum & Stanley Kaplan, The Absolute Priority Doctrine in Corporate Reorganizations, 41 U. Chi. L. Rev. 651, 656-57 (1974).}
an ultimate figure under a procedure that has admitted infirmities. Instead, these critics assert, the trustees or the courts first determine the classes of claimants that should participate in the reorganization plan—on the basis of rough judgment or visceral reactions or other unexpressed or even unexpressable criteria—and then select the projection of earnings or the capitalization ratio necessary to reach a valuation figure that will include the preselected groups. The valuation process is not viewed as unduly harsh or rigid, but rather as so flexible that it is subject to abuse.

Comparing this process to nonbankruptcy debt collection procedures, which generally entitle creditors to repayment in full of their claims out of the proceeds of forced sales of the debtor’s property, there is little wonder that creditors are far more amenable to compromising their claims in the insolvency context than otherwise.

The legal standards for cram down vary depending on whether the class being involuntarily restructured includes secured claims, unsecured claims, or equity. Secured claims are limited to the value of the collateral securing that claim and the payment terms may be restructured to defer maturity of principal and reduce interest rates. Less frequently, plans may substitute or alter the collateral securing the claim if the court determines that the collateral retained is the indubitable equivalent of the prepetition lien. Unsecured creditors are even more vulnerable in a bankruptcy restructuring. Both principal and interest may be reduced and unsecured claims may be involuntarily exchanged for equity interests of perhaps dubious value. Unsecured claims may even be eliminated without compensation as long as there is compliance with the unfair discrimination and fair and equitable rules, including, in particular, the absolute priority rule’s requirement that the class receive reorganization value determined by the court to be at least equal to

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143 In the case of secured parties, collection through forced sale takes place through judicial or nonjudicial foreclosure. See, e.g., GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 8.1, at 933 (5th ed. 2007); UNIF. COMM. CODE §§ 9-601 et seq. In the case of unsecured creditors, such collection takes place through the processes of prejudgment or post-judgment levy and execution.


the amount of their claims on liquidation before junior classes may participate in the reorganization. Equity interests are subject to elimination as long as no senior class receives reorganization value exceeding the amount of its claims.

None of this is possible outside of bankruptcy without the parties’ consent. The fact that it is possible in bankruptcy provides all parties with an incentive to renegotiate their entitlements in light of the possibility that those entitlements will be subject to involuntary restructuring in accordance with the new cram down entitlements subject to determination through valuation at trial. The pervasive influence of the possibility of cram down has caused some commentators to characterize the bankruptcy process as one of “bargaining in the shadow of the law.” The shadows grow longer and the bargaining more intense, however, as the law becomes vaguer, valuation more difficult, and the alternative to a negotiated resolution looms more uncertain.

C. The Best Interest of Creditors Test

Although acceptance of a plan by an impaired class operates as consent, thereby eliminating the requirement that a plan be fair and equitable, even a consensual plan must still meet the best interest of creditors test with respect to each particular dissenting creditor. That is, each creditor holding a claim in an impaired class has an individual right to demand or to waive compliance with the best interest of creditors test as to its claim. Absolute priority or unfair discrimination protections may be waivable by others, or subject to ambiguity and manipulation through the judicial valuation process, or evasion through gifting or new value plans, but at least the best interest test sets a hard floor for each particular creditor. So the theory goes. In practice, however, the best interest test proves to be just as ambiguous and manipulable—if not more so—than absolute priority itself.

From the point of view of secured creditors, liquidation in chapter 7 has

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148Id.
150Broude, supra note 99, at 450-54.
151This phrase was coined in the family law context. Robert H. Mnookin & Lewis Kornhauser, Bargaining in the Shadow of the Law: The Case of Divorce, 88 YALE L.J. 930 (1979). Professor Jackson aptly imported the metaphor into bankruptcy scholarship, JACKSON, supra note 1, at 17 n.23, where it has been justly embraced.
152Creditors holding claims in unimpaired classes, however, are denied protection of the best interest of creditors test. See 11 U.S.C. § 1129(a)(7)(A) (2006). In many cases, denying holders of unimpaired claims liquidation values is an alteration of their nonbankruptcy legal rights because the Bankruptcy Code authorizes a plan proponent to reverse the effects of prepetition acceleration of the debt although otherwise leaving the holder’s rights “unaltered.” 11 U.S.C. § 1124(2)(B) & (D) (2006). See infra notes 196-204 and accompanying text.
153See infra notes 214-26 and accompanying text.
154See supra note 139 and accompanying text.
many virtues in practice: (i) Quick but orderly sale unconstrained by rigid value-reducing foreclosure sale procedures[155] and state law regulations applicable under nonbankruptcy law;[156] (ii) reasonable protection of the value of collateral pending sale (trustees are unlikely to engage in deliberate waste); (iii) a shield from liability that even temporary ownership and control of collateral carries with it; (iv) market valuations of collateral rather than judicial ones; and (v) secured party control over the price and timing of sale of the collateral to a third party (a secured party may veto a sale for less than the amount of its undisputed secured obligation and may choose to acquire the collateral by credit bid rather than allow the collateral to be sold for cash in a depressed market).

Notwithstanding these desirable features of actual chapter 7 liquidations, the hypothetical liquidation value used as the measure of the rights of the dissenting members of a consenting secured class is generally a judicially determined foreclosure sale value net of liquidation costs. [157] Thus, nonvoting

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[155] BFP v. Resolution Trust Corp., 511 U.S. 531, 539 (1994) ("No one would pay as much to own [property that must be sold within the time and manner strictures of state-prescribed foreclosure] as he would pay to own real estate that could be sold at leisure and pursuant to normal marketing techniques.").


and dissenting creditors in consenting classes have their entitlement baseline further reduced to the piecemeal liquidation value of their interests in a hypothetical chapter 7 case. This value is typically established on the basis of expert testimony offered by the plan proponent (often the debtor’s own officers), not appraisals or actual bids. Courts applying the best interest test frankly acknowledge that the task is speculative.\textsuperscript{158} Moreover, the plan proponent has every incentive to minimize liquidation values in its effort to gain confirmation of its plan. So too, the bankruptcy judge has every incentive to go along with low-ball liquidation values to overcome objections to an otherwise confirmable plan that has gathered the support of the requisite majorities of the impaired classes, given that the alternative would involve the court’s extended supervision of an actual chapter 7 liquidation.\textsuperscript{159} In short, the hypothetical chapter 7 baseline for chapter 11 plan negotiations is artificially depressed: Dissenters may well fare better in actual than in hypothetical liquidations. The chapter 11 baseline for a dissenting member of a secured class is related to, but to some uncertain degree less desirable than, an actual chapter 7 liquidation.

With respect to the nonvoting and dissenting members of unsecured classes, the best interest test offers even less protection.\textsuperscript{160} The liquidation analysis offered by plan proponents frequently show little or no value to unsecured creditors based on hypothetical values. Accordingly, successful challenges to plan confirmation based on the best interest test are few and far between.

IV. LIMITING CONSENT

A. RATIONALES FOR LIMITING TRANSFORMATIVE CONSENT

Notwithstanding the generally expansive role for consent in bankruptcy and the tendency to alter and muddy up parties’ rights so as to induce it, bankruptcy law also regulates the process by which consent may be obtained


\textsuperscript{158}Natalie Regoli, Confirmation of Chapter 11 Bankruptcy: A Practical Guide to the Best Interest of Creditors Test, 41 Tex. J. Bus. L. 7, 27-28 (2005); Hicks, supra note 157, at 838.

\textsuperscript{159}LoPucki & Whitford, supra note 99, at 171-72; Broude, supra note 99, at 448-50.

\textsuperscript{160}This is notoriously so in chapter 13 cases, at least pre-2005, in which standard application of the best interest test often yielded nothing for unsecured creditors. In the chapter 13 context, no negotiations take place between debtor and creditors over the terms of the plan but courts might refuse to confirm zero-payment plans that at least facially complied with the net disposable income and best interest tests but nevertheless provided for no payment on account of unsecured claims. William D. Warren & Daniel J. Bussell, Bankruptcy 523 (8th ed. 2009) ("Judicial tolerance for zero payment plans has been low, and some courts rejected them as not being proposed in good faith under § 1325(a)(3). But judicial reaction has been uneven and unpredictable."); Broude, supra note 99, at 448-49.
and in some instances makes consent irrelevant. In particular, uncoerced, undeceived, objective manifestations of assent, or even compliance with "consent-plus" standards, may lack legally transformative effect in order to protect (i) bankruptcy policies; (ii) third-party interests; and (iii) the putative consenting party. In this Part we examine examples of each in turn.

Because protection of third parties or the consenter often implicates bankruptcy policies, these categories are not watertight compartments, but rather blend seamlessly into one another. Thus, bankruptcy's automatic stay,\[^{161}\] to take one example, embodies a core bankruptcy policy, maintaining the status quo among competing constituents pending reorganization or liquidation, but also directly protects both third-party and debtor interests.\[^{162}\] Nevertheless it is waivable by a bankruptcy trustee or debtor in possession, or, in limited circumstances, by a (perhaps vulnerable or desperate) prepetition debtor.\[^{163}\] Unsurprisingly, in light of these overlapping considerations, limitations are placed on the waiver of its protections.\[^{164}\] Similarly, the bankruptcy discharge\[^{165}\] furthers the rehabilitative and "fresh start" goals of bankruptcy,\[^{166}\] but also protects third parties and the debtor itself. Notwithstanding the overlap, it is useful to distinguish areas in which consent-plus requirements or mandatory rules are put in place primarily for the protection of the process itself, third parties, or the putative consenting party. We find as the focus moves from the process, to third parties, and then to the consenter, that mandatory rules are most likely to be employed to protect the process, and consent-plus restrictions to protect the parties.

B. Protecting Bankruptcy Policies

Bankruptcy law has long employed collective execution principles that require protection against an individual creditor's ability to opt out.\[^{167}\] Thus, bankruptcy law restricts infringement of the debtor's fresh start by precluding waivers of exemptions and discharge\[^{168}\] as well as the debtor's right to file a bankruptcy petition.

\[^{162}\]See infra note 184, (quoting H.R. Rep. No. 95-595 at 340 (1977)).
\[^{163}\]See infra notes 183-95.
\[^{164}\]See infra notes 183-86 and accompanying text.
\[^{166}\]H.R. Rep. No. 95-595 at 180 (1978) ("The [1978 Bankruptcy Code] will permit a complete settlement of the affairs of a bankrupt debtor, and a complete discharge and fresh start."); Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) ("One of the primary purposes of the Bankruptcy Act is to relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.") (citations omitted).
\[^{167}\]Jackson, supra note 1, at 123-38.
1. Prebankruptcy Waivers of Bankruptcy Protections

i. The Right to File a Petition

Somewhat surprisingly, despite express statutory protections of exemptions and the discharge, the Bankruptcy Code contains no provision making unenforceable a debtor’s prebankruptcy waiver of the right to file a bankruptcy petition. Courts nevertheless have long provided this protection and extended it to business entities as well as individual debtors. Thus, courts will not enforce contractual waivers of the right to file for bankruptcy.

Although corporate debtors have a nonwaivable right to file a bankruptcy petition, state law determines who is authorized to file a voluntary bankruptcy petition on behalf of the corporation. Thus, in *Price v. Gurney*, the Supreme Court held that a dissident shareholder could not file a bankruptcy petition under Chapter X of the Bankruptcy Act on behalf of the corporation because state corporate law dictated that only the directors had the power to authorize the filing of a petition. Typically, unless the corporation's charter or bylaws provide otherwise, the corporation's filing must be authorized by a resolution of the board of directors at a duly convened meeting. If there is a deadlocked board or a dispute, shareholders may call a special meeting to elect a new board of directors. Further, if a creditor holding the right to vote the corporation's shares elects a new board of directors, the old board and officers lack capacity to file a bankruptcy petition on behalf of the corporation. As a general proposition, however, orders of nonbankruptcy courts enjoining debtors from filing bankruptcy petitions are unenforceable as void against public policy.

Lawyers have attempted to fetter a corporate debtor’s ability to file for bankruptcy relief by using state law to require all directors to consent to the filing. Bankruptcy courts have refused to honor these provisions where a sole dissenting director is found to have breached fiduciary duties by voting

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170 *324 U.S. 100* (1945).

171 See id. at 104 (“[T]he initiation of the proceedings, like the run of corporate activities, is left to the corporation itself, i.e. to those who have the power of management.”) and at 106 (“If the District Court finds that those who purport to act on behalf of the corporation have not been granted authority by local law to institute the proceedings, it has no alternative but to dismiss the petition.”)


against a resolution to file a bankruptcy petition. And courts have also allowed circumvention of contractual consent requirements limiting access to bankruptcy by validating the filing of a friendly involuntary petition instigated by some of the debtor’s insiders.

Although generally debtors may not waive bankruptcy protection, Congress has determined that, in the absence of actual fraud, the ability of the financial markets to function smoothly trumps matters of bankruptcy law and policy. Thus, when the debtor enters into certain financial contracts consenting to liquidation, termination, or acceleration on the advent of bankruptcy or insolvency, Congress permits the counterparty to exercise its rights notwithstanding the bankruptcy filing or the automatic stay. Moreover, these transactions, and payments made incidental to them, are insulated from attack under the trustee’s avoiding powers such that counterparties will not be liable to disgorge preferences or constructively fraudulent transfers, but they remain liable to disgorge fraudulent transfers made with actual in-


177 In re Tri-River Trading, LLC, 329 B.R. 252, 266–67 (B.A.P. 8th Cir. 2003), aff'd, 452 F.3d 756 (8th Cir. 2006); In re Kingston Square Assoc., 214 B.R. 713, 725–26 (Bankr. S.D.N.Y. 1997) (refusing to find bad faith filing even though debtor orchestrated the filing of the involuntary petition to evade corporate charter bankruptcy remote provisions).

178 The financial services sector has obtained bankruptcy protection for many different kinds of financial market transactions including securities contracts, commodities contracts, forward contracts, repurchase agreements, reverse repurchase agreements, swap agreements, and master netting agreements. See 11 U.S.C. §§ 101(25), (38A), (47) & (53B), 741(7) & 761(4) (2006). The courts are struggling to delimit the extraordinary 2005 expansion of the definition of "swap agreement" in 11 U.S.C. § 101(53B) (2006). The new definition threatens to swallow wholesale many agreements that are neither swaps nor financial derivatives, as those instruments have been traditionally understood, with the effect of exempting this wide array of agreements from the Bankruptcy Code’s stay and avoidance provisions. See Hutson v. E.I. du Pont de Nemours & Co. (In re Nat’l Gas Distribrs. LLC), 556 F.3d 247, 260–61 (4th Cir. 2009) ("Thus insofar as our holding precludes the bankruptcy court from requiring, in defining a ‘commodity forward agreement,’ that the contract be traded in a market or on an exchange or that it not involve physical delivery of the commodity, our holding does not define that instrument or hold that the contracts in this case are commodity forward agreements. We leave that to further legal and factual development on remand.")


181 11 U.S.C. §§ 546(e), (f), (g) & (j) & 548(d)(2)(B)-(E) (2006). See also Enron Creditors Recovery Corp. v. J.P. Morgan Sec. (In re Enron Creditors Recovery Corp.), 407 B.R. 17, 30 (Bankr. S.D.N.Y. 2009) ("In enacting the § 546(e) exception to the avoidance powers, the goal was to preserve the stability of . . . settled transactions to the extent that they are not fraudulent . . . (in order to avoid a) ‘ripple effect’ of bankruptcy filings by other participants in the chain of guarantees" but distinguishing issuers’ redemption of commercial paper from the settlement of other financial contracts).
tent to hinder, delay or defraud creditors. Wall Street’s largely successful decades-long campaign for broad exemptions from bankruptcy process for these financial contracts is an implicit recognition by these actors that bankruptcy-style consent diverges sharply from the consent necessary to alter legal entitlements under otherwise applicable law.

ii. Stay Waivers

The statutory and judicial response to waivers of automatic stay protection also reflects a concerted effort to limit debtors’ ability to bargain away one of the principal Bankruptcy Code protections for the process itself, third-party creditors, and the debtor. The automatic stay protects both debtors and creditors, by allowing for the orderly restructuring or liquidation of debt, and, in turn, the interests of creditors that would otherwise be handicapped by a race to gain access to the bankruptcy estate’s assets. Courts have read the Bankruptcy Code’s stay provisions broadly and consistently, though not unanimously, to deny the ability of debtors and creditors to contract around this protection.

Bankruptcy law did not always reject the transformative power of consent in this realm. Prior to 1978, debtors were free to waive the protections of the automatic stay. The Bankruptcy Reform Act of 1978 shifted the power to modify or to lift automatic stays from private agreements between debtors and creditors to the bankruptcy courts in order to protect third-party creditor interests and the reorganization process itself from a rush by creditors to gain preference for their claims. Courts have rendered prebankruptcy consent to the modification or waiver of the automatic stay

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The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drive him into bankruptcy.

The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor’s property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors.

186 See Hayhoe v. Cole (In re Cole), 226 B.R. 647, 651-52 & n.7 (B.A.P. 9th Cir. 1998); In re Pease, 195 B.R. 431, 433-34 (Bankr. D. Neb. 1996) (holding that “the debtor does not have the capacity to waive the rights bestowed by the Bankruptcy Code upon a Chapter 11 debtor in possession”).
almost entirely ineffective in order to safeguard the entitlements of third-party creditors and further the bankruptcy policy favoring orderly liquidation or restructuring.

The ban on the ability to waive stay protections is not absolute, however. Contrary to the recommendations of the National Bankruptcy Review Commission, a few courts have carved out important exceptions to foster out of court settlements or to deter bad faith filings. Some courts have recognized the validity of stay waivers in situations that do not violate bankruptcy policy. One thing that remains constant throughout these cases is the ability of third parties to object to the waivers. Though a debtor may relinquish the Code’s protections for itself, it may not do so on behalf of third-party creditors without giving them notice of the waiver and the ability to object to the stay being lifted. Even if there are no objections, the Code permits the court to alter the scope of the stay only for good cause or in other limited circumstances.

2. Deemed Consent of the Unimpaired

Consent requirements are properly limited to proposals to alter the consenting party’s legal rights. The Bankruptcy Code generally does not require a party’s consent if its rights are left unaltered. The legal standards of absolute priority, unfair discrimination or best interest of creditors limit the non-consensual transformation of legal right; they have no proper application when creditors’ rights are left unaltered.

189 Nat’l Bankr. Review Comm’n, supra note 53, at § 2.4.5.
190 In re Darrell Creek Assocs., 187 B.R. 908, 912–13 (Bankr. D.S.C. 1995) (finding exception to automatic stay in support of settlement); In re Cheeks, 167 B.R. 817, 819 (Bankr. D.S.C. 1994) (“Perhaps the most compelling reason for enforcement of the forbearance agreement is to further the public policy in favor of encouraging out of court restructuring settlements.”).
191 In re Myers, 491 F.3d 120, 125–26 (3d Cir. 2007) (annulling stay protection, ratifying creditor’s action against stay that would otherwise be void, and dismissing debtor’s chapter 13 petition because it was filed in bad faith); In re Laguna Assocs., 30 F.3d 734, 738 (6th Cir. 1994) (“[A] lack of good faith (in filing) constitutes ‘cause’ for lifting an automatic stay.”); In re Citadel Props., Inc., 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988) (holding that “a bad faith filing is cause for relief from an automatic stay”).
192 In re Shady Grove Tech Ctr. Assocs., 227 B.R. 422, 425 (Bankr. D. Md. 1998) (“The party seeking to enforce the waiver must demonstrate that under the specific facts of the case, the public policy encouraging workout agreements overcomes the policy in favor of affording the debtor the respite accorded by the automatic stay in bankruptcy.”); In re Atrium High Point Ltd. P’ship, 189 B.R. 599, 607-08 (Bankr. M.D.N.C. 1995) (holding that although prepetition waivers of automatic stay may be enforceable in circumstances that do not contravene public policy, they are not binding on third-party creditors).
196 Creditors rights are “unimpaired” within the meaning of the Bankruptcy Code when their legal and equitable rights are left unaltered, and past defaults cured, or in the case of certain “ipso facto” defaults, excused. 11 U.S.C. § 1124 (2006).
Accordingly, since 1984, the Bankruptcy Code has conclusively presumed that each unimpaired class, and each member of an unimpaired class, accepts the plan. Courts have enforced this conclusive presumption even where a creditor or class of claims votes to reject the plan. When the Bankruptcy Code was enacted in 1978, § 1126(f) deemed unimpaired classes to accept the plan. In the early days of the Code, some courts interpreted § 1126(f) to allow the actual negative vote of a class to override the statutory deemed consent of an unimpaired class. These courts reasoned that the deemed acceptance provided for in the statute amounted to a rebuttable presumption that could be negated by the actual negative vote of the unimpaired class: “To deem that a party has accepted a plan when the fact is that it has rejected the plan, is Alice in Wonderland reasoning which this court cannot accept.” Perhaps so, but, Wonderland or not, Congress in 1984 evinced a firm congressional intent that an unimpaired class and each member in the class was deemed to accept the plan, whether it liked it or not. As a result, under the current Bankruptcy Code, not only is the unimpaired class considered an accepting class, but each member of the class is considered to accept the plan and to waive application of the best interest of creditors test.

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198 Evidently the amendment to § 1126(f) was designed to overrule those cases holding that a class deemed to accept the plan could actually vote to reject it. See, e.g., In re Spirited, Inc., 23 B.R. 1004, 1008 (Bankr. E.D. Pa. 1982); In re Marston Enters., Inc., 13 B.R. 514, 518–21 (Bankr. E.D.N.Y. 1981).
199 See, e.g., In re Wonder Corp. of Am., 70 B.R. 1018, 1021 (Bankr. D. Conn. 1987) (interpreting § 1126(f) in pari materia with § 1124(3) to deprive creditor of negative vote, noting the creditor’s “lack of opposition, however, might be the consequence of statutory acceptance rather than actual creditor consent.”). Cf. In re Magnatrix Corp., No. 03-11402(PJW), 2003 Bankr. LEXIS 2264, at *15 (Bankr. D. Del. Sept. 17, 2003) (ordering solicitation materials not to include a ballot for § 1126(f) class); In re Waterways Barge P’ship, 104 B.R. 776, 783 (Bankr. N.D. Miss. 1989) (ignoring the acceptance of a class that is presumed to reject the plan under Bankruptcy Code § 1126(g)).
200 See Pub L No. 95-598, § 101, 92 Stat. 2535-36 (1978) (enacting 11 U.S.C. § 1126(f) (1982): “Notwithstanding any other provision of this section, a class that is not impaired under a plan is deemed to have accepted the plan . . . .” & 11 U.S.C. § 1129(a)(8)(B) (1982): “With respect to each class . . . such class is not impaired under the plan.”).
202 Marston Enters., 13 B.R. at 520.
204 Before the Bankruptcy Code was amended in 1984 to exempt unimpaired classes from the best interest of creditors test in § 1129(a)(7), the deemed acceptance of the unimpaired class under § 1126(f) might have satisfied the acceptance prong of the best interest test in § 1129(a)(7)(A)(i), thereby rendering the rest of the best interest test inapplicable. Since a primary reason for a plan proponent to invoke § 1124 and reinstate a claim is that the original payment terms are more favorable to the debtor than are currently available in the market, holders of fully secured unimpaired classes of claims might well prefer a distribution of cash based on hypothetical chapter 7 liquidation values over reinstatement on the basis of below market prepetition terms. In 1984, Congress mooted whether an unimpaired class might be held to
C. Protecting Third-Party Interests

1. Financing Orders

Emergency financing agreements present a classic bankruptcy problem. The Bankruptcy Code requires secured lender consent to the use of cash collateral\textsuperscript{205} or the provision of adequate protection for the secured claim.\textsuperscript{206} Moreover, debtors commonly require additional financing on the commencement of a chapter 11 case. Stipulated use of cash collateral, adequate protection, and supplemental debtor in possession financing are generally negotiated prebankruptcy between the senior secured lender and debtor and presented for court approval on an emergency basis on highly truncated notice and prior to the formation of a creditors' committee.\textsuperscript{207}

Secured parties generally view the necessitous debtor's request for consent to use cash collateral and interim financing as an opportunity to exercise a substantial degree of control over the course of the reorganization proceedings and to improve their positions in both relative and absolute terms.\textsuperscript{208} Postpetition lenders seek to condition the debtor's access to credit on roll-ups,\textsuperscript{209} releases, sale and reorganization timelines, prohibitions on nonconsen-
usual use of collateral or priming, additional collateral grants, stipulated claims allowance, current payment of interest, in addition to the standard budgetary controls, and statutory adequate protection and priorities available to postpetition lenders. Debtors frequently acquiesce. In some measure this reflects debtors' desperate need for postpetition credit and lack of alternatives. In many of the particulars, however, debtors have no incentive to resist the demands. Often the postpetition lender is primarily concerned with its rela-

immediately repays the outstanding prepetition claim on entry of the interim or final financing order. In some cases, the parties dispense with the pointless instantaneous advance and repayment and simply deem the prepetition secured debt "rolled up" into a postpetition loan. As this discussion, and the appellation "roll-up" itself, both suggest, roll-ups were first employed in the context of revolving credit facilities and part of the justification of the practice was to simplify administration of such facilities. More recently, practice in many courts has evolved to permit term loans as well as revolving facilities to be "rolled-up." Obviously, roll-ups are in tension with the general bankruptcy principle that prepetition claims are generally only paid pursuant to a confirmed plan of reorganization, In re Kmart Corp., 359 F.3d 866, 871 (7th Cir. 2004), and the few published decisions that comment on the practice are skeptical of it. See In re Appliance Store, Inc., 181 B.R. 237, 243 (Bankr. W.D. Pa. 1993) (describing a roll-up provision in a proposed cash collateral stipulation as a "contract of adhesion" whereby the prepetition lender "wished to extract a pound of flesh without immediately inflicting a mortal wound upon the debtors"); but see Simon & Schuster, Inc. v. Advanced Mktg. Servs. (In re Advanced Mktg. Servs.), 360 B.R. 421, 425 (Bankr. D. Del. 2007) (noting that the DIP loan agreement contemplated a "creeping roll-up," but not discussing the enforceability of such roll-up); In re FCX, Inc., 54 B.R. 833, 842 (Bankr. E.D.N.C. 1985) (authorizing roll-up of a lender's prepetition loan, subject to proof of the existence, perfection, and priority of the lien); In re Gen. Oil Distrib., Inc., 20 B.R. 873, 877 (Bankr. E.D.N.Y. 1982). Nevertheless, roll-ups are common practice in many bankruptcy courts including both the Southern District of New York and the District of Delaware which collectively handle the great majority of the large chapter 11 cases. See Marcia L. Goldstein & Victoria Vron, Current Issues in Debtor-in-Possession Financing, SM014 ALI-ABA 74, 84-86 (Mar. 2007), earlier version available at SK092 ALI-ABA 115, 127-29 (June 2005) (Westlaw, ALI-ABA Database); James J. White, Death and Resurrection of Secured Credit, 12 AM. BANKR. INST. L. REV. 139, 180-83 (2004). Roll-ups became increasingly fashionable as courts began to reject forward cross-collateralization, that is, the conditioning of postpetition lending on providing postpetition collateral for prepetition secured claims held by the postpetition lender. Id. (citing inter alia In re Saybrook Mfg. Co., 963 F.2d 1490, 1496 (11th Cir. 1992)). It is unclear why any court that rejects forward cross-collateralization would be more sympathetic to roll-ups, which appear to have precisely the same effect.

210Under the statute, postpetition interest may accrue in favor of oversecured creditors to the extent of any collateral cushion they hold, but otherwise postpetition interest is disallowed except in the unusual circumstance of a solvent bankruptcy estate. Nothing in the Bankruptcy Code expressly authorizes current payment of postpetition interest on account of prepetition claims even for oversecured creditors. 11 U.S.C. §§ 506(b), 726(a)(5), 1129(a)(7) & 1129(b) (2006); see also United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assoc., 484 U.S. 365, 371-74 (1988), but see Klee, supra note 44, at 234-36 (suggesting that fair and equitable test of § 1129(b)(1) may require payment of interest in some circumstances). Nevertheless, bankruptcy courts commonly authorize current payment of "adequate protection" in amounts corresponding to accruing interest. One justification put forward is that current payment benefits the estate by avoiding accrual of penalty interest, but sometimes current payment at default rates is also authorized. Another justification is that current payment of interest is necessary to prevent erosion of the secured creditor's "equity cushion." The "equity cushion" rationale has been criticized as inconsistent with both the statutory scheme and the Supreme Court's holding in Timbers. Tabb, supra note 121, at 315-17; In re T-H New Orleans Ltd. P'ship, 116 F.3d 790, 797-98 (5th Cir. 1997); In re Delta Res., Inc., 54 F.3d 722, 730 (11th Cir. 1995); New York Life Ins. Co. v. Revco D.S., Inc. (In re Revco D.S., Inc.), 901 F.2d 1359, 1364-67 (6th Cir. 1990); In re McCombs Prop. VI, Ltd., 88 B.R. 261, 266 (Bankr. C.D. Cal. 1988).
tive position vis-à-vis general unsecured creditors rather than the debtor, and few debtors expect to reorganize successfully around litigation against their primary prepetition lender. So cross-collateralization, roll-ups, liens on avoidance actions, releases, surcharge waivers, and stipulations as to the validity, priority, and extent of claims and collateral are easy concessions for the debtor, at least for a debtor that expects that it is going to have pay the claims of its primary senior secured lender.

Judicial concerns that debtors may too easily acquiesce in prebankruptcy negotiations over cash collateral and financing stipulations has led to procedural protections to insure that third party interests have a chance to be heard and to place substantive limits on how far the debtor can go in bargaining away third-party creditor protections. In 1984, Bankruptcy Rule 4001 was amended to require at least fifteen days’ notice before final approval of financing stipulations and motions.\textsuperscript{211} Thereafter, through case decisions, local rules, general orders and in Delaware by a well-known (to bankruptcy lawyers) public letter,\textsuperscript{212} the courts established substantive standards permitting, but regulating, roll-ups, releases, waivers, scope of postpetition collateral and the like. In general, these substantive limitations may be bargained away, but usually only by the statutory creditors’ committee. Financing orders are routinely viewed as a two-step process in large chapter 11 case practice. Roll-ups, at least first-day roll-ups,\textsuperscript{213} are reserved for the final hearing as are surcharge waivers, and other controversial provisions affecting general creditors. Stipulations and releases concerning the validity, extent, and priority of liens and claims are binding on the debtor, but not the estate unless the creditors’ committee subsequently consents, or, if a trustee is elected or appointed, the bankruptcy trustee consents. The elaborate compromise that has evolved over financing orders is wholly outside the statute, and substitutes the consent of “major parties” purporting to act on behalf of the estate generally for the legal rights of each particular creditor, while partially divesting the debtor in possession, to the extent its incentives are deemed suspect, of its statutory authority to represent the estate in connection with the financing transaction.

2. Interclass Gifting

Interclass gifting raises fundamental issues concerning whose consent suf-


\textsuperscript{213}See \textit{supra} note 209 (distinguishing “creeping” and “first-day” roll-ups).
fices to effect a final resolution of a bankruptcy case and the scope of protection for those whose consent is not sought. In the reorganization context it was long thought that this issue had been decisively resolved in 1913 by the Boyd case.214 Boyd required that no member of a junior class could share in reorganization value without either providing reorganization value equal to the claim or obtaining the consent of each senior creditor (before 1979) or each senior class of claims (after 1979). In short, no side deals would be approved that skip over intervening classes.

When Boyd was decided the immediate reaction of the reorganization bar was panic and despair.215 In time, however, the system adjusted,216 and, particularly after class consent was substituted for individual consent in 1978, the balance of power between senior creditors and intervening creditors appeared stable. Classes receiving consideration less than the full amount of their claims held a veto over junior class participation in the reorganization.217

Both before and after Boyd, senior creditors took the view that all out-of-the-money juniors—that is both out-of-the-money intervening juniors and out-of-the-money junior juniors—were out-of-the-money, that is to say entitled to nothing and therefore should have no legal right to block any deal that allowed the senior creditors to maximize the value of their claims.

214 See supra notes 138, 147-48 and accompanying text. N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 507-10 (1913). Boyd, of course, had 19th century precursors. Louisville Trust Co., v. Louisville, New Albany & Chi. Ry. Co., 174 U.S. 674, 688 (1899) ("It is no answer to these objections to say that a bondholder may foreclose in his own separate interest, and, after acquiring title to the mortgaged property, may give what interest he pleases to any one, whether stockholder or not, and so these several mortgagors foreclosure their mortgages, if proceeding in their own interest, if acquiring title for themselves alone, may donate what interest in the property acquired by foreclosure they desire. But human nature is something whose action can never be ignored in the courts, and parties who have acquired full and absolute title to property are not as a rule donating any interest therein to strangers. It is one thing for a bondholder who has acquired absolute title by foreclosure to mortgage property to thereafter give of his interest to others, and an entirely different thing whether such bondholder, to destroy the interest of all unsecured creditors, to secure a waiver of all objections on the part of the stockholder and consummate speedily the foreclosure, may proffer to him an interest in the property after the foreclosure. The former may be beyond the power of the courts to inquire into or condemn. The latter is something which on the face of it deserves the condemnation of every court, and should never be aided by any decree or order thereof. It involves an offer, a temptation, to the mortgagor, the purchase price thereof to be paid, not by the mortgagee, but in fact by the unsecured creditor."); R.R. Co. v. Howard, 74 U.S. (7 Wall.) 392, 409-10 (1869). See KENNETH N. KLEE, BANKRUPTCY AND THE SUPREME COURT 370-75 (LexisNexis 2008).


216 Skel, supra note 215, at 67-68; Bussel, supra note 108, at 1555.

In 1993, after eighty long years of plaintive wails in the wilderness, the First Circuit (perhaps not fully appreciating the significance of its decision) responded to the pleas of secured creditors faced with the demands of out-of-the-money juniors. In *In re SPM Mfg. Co.*, a senior secured creditor asserting a lien against over-encumbered collateral owned by the bankruptcy estate and the bankruptcy trustee agreed (i) the trustee would sell the secured creditor's collateral (ii) the senior creditor agreed that some of those sale proceeds (which since the property was over-encumbered would otherwise be distributed to it) would be distributed to general unsecured creditors. The Court overruled the objection of the Internal Revenue Service whose intervening priority tax claim (out-of-the-money to be sure) would be skipped over and not receive any distribution under the arrangement between the secured lender and the bankruptcy trustee even though such tax claims are senior to the claims of general creditors under the bankruptcy distribution scheme.

Of course, once the reorganization bar realized that at least some courts permitted senior creditors to do deals with junior juniors without providing for out-of-the-money intervening creditors, SPM-ing became all the rage. Cutting out intervening classes certainly simplifies the negotiation process and conserves value for the consenting parties.

More recently there has been a reaction against SPM and attempts to distinguish and limit its reach. Some courts purport to prohibit "gifting" for "improper ends." Some courts find that SPM has no application to plan confirmation, or perhaps anywhere in the chapter 11 context, or to cases that do not involve gifting by creditors holding indisputably perfected and unavoidable security interests in the collateral being downstreamed to preferred junior classes. Nevertheless, courts continue to apply SPM (or more correctly, the logic of SPM that a senior secured party is entitled to redirect "its" distributions to whom it pleases, notwithstanding the requirements of

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absolute priority, the bar of unfair discrimination and the general distrubutional provisions of the Bankruptcy Code) in numerous cases in order to facilitate agreements that benefit certain preferred classes of administrative claimants and general unsecured creditors.\textsuperscript{222} Even the \textit{Iridium} case,\textsuperscript{223} which reversed an application of SPM in a chapter 11 case that did not involve gifting of collateral subject to a perfected security interest, found that no per se rule against gifting existed and that distribution of settlement proceeds to the bankruptcy estate pursuant to agreement with the nondebtor party in a manner that was inconsistent with the bankruptcy distribution scheme might be permitted if doing so was "fair and equitable" and "not a means to avoid the priority strictures of the Bankruptcy Code."\textsuperscript{224}

Perhaps nowhere is the trade-off between efficiency and legitimacy required by the consent principle more graphically illustrated than in the case of interclass gifting. Broad consensus confers legitimacy, but achieving it can be costly. The veto held by the intervening classes under the \textit{Boyd} rule can obstruct some efficient resolutions, but, more commonly, history shows it simply results in a broader distribution of reorganization value away from the most senior classes. The reservation price of the senior creditor is a function of the value of its next best alternative to an agreement with the intervening classes, which is generally a forced liquidation under chapter 7. There is no clear right answer to the allocation of the surplus value that can be realized through such an agreement,\textsuperscript{225} but this allocation problem does have a well-


\textsuperscript{223}\textit{Iridium Operating LLC}, 478 F.3d 452.

\textsuperscript{224}\textit{Iridium Operating LLC}, 478 F.3d at 464-65. Note that a senior party may, by acquiring junior claims and then voting them in favor of its preferred plan effectively achieve the result of imposing a plan on an intervening class in derogation of that class's absolute priority rights. In doing so, of course it must provide value to the holders of the claims acquired and it must acquire sufficient claims to meet the statutory consent requirement of two-thirds in amount and one-half in number. This strategy is, however, fraught with peril. For one thing the senior creditor must go out of pocket to acquire the claims without any assurance that it will succeed in acquiring sufficient claims to confirm its plan. Moreover, the claims acquired by the creditor remain vulnerable to equitable subordination, see 11 U.S.C. § 510(c) (2006); designation for bad faith, see 11 U.S.C. § 1126(e) (2006) and infra notes 104 & 322-33 and accompanying text; and possible limitations on the amount and number for purposes of voting and distribution. \textit{In re Figter Ltd.}, 118 F.3d 635, 638-40 (9th Cir. 1997) (finding purchase of junior shares was in good faith and not for the purpose of frustrating vote for an alternate reorganization plan and holding that each acquired claim would be counted separately for purposes of numerosity); \textit{In re Allegheny Int'l, Inc.}, 118 B.R. 282, 289-90 (Bankr. W.D. Pa. 1990) (finding purchase of junior claims to control vote was in bad faith); Chaim J. Fortgang & Thomas Moers Mayer, \textit{Trading Claims Pts I, II & III}, 12 Cardozo L. Rev. 1, 86-91 (1990), 13 Cardozo L. Rev. 1, 31-32 (1991) and 15 Cardozo L. Rev. 733, 761-62 (1993). Accordingly, the claim-buying strategy has been employed infrequently, at least outside the context of the single-asset real estate cases where it may be possible for a mortgagee to gain control of general unsecured claims for relatively insignificant sums.

\textsuperscript{225}See Walgreen Co. v. Sara Creek Prop. Co., 966 F.2d 273, 276-77 (7th Cir. 1992) (discussing bilateral monopoly problem in allocating gains from trade).
known legal solution, to wit the Boyd rule, as subsequently glossed and modified. If, as many commentators have argued, modern conditions limit the chapter 11 surplus and make chapter 7 liquidations a more realistic alternative,\textsuperscript{226} it would seem there is little cause simultaneously to abandon the Boyd rule and encourage settlement, sale, or reorganization in chapter 11 that does not meet traditional standards of fairness and consent in reorganization cases.

D. PROTECTING THE CONSENTING PARTY

1. Reaffirmation

One concern that shapes consent-plus rules in bankruptcy is the suspicion that consents are sometimes obtained from relatively unsophisticated parties under circumstances where no economically rational person would give consent. Longstanding legal doctrine permits enforcement of debts reaffirmed notwithstanding the discharge of such debts in bankruptcy.\textsuperscript{227} Reaffirmation may be (although it usually is not) in the debtor’s interest in cases where a creditor credibly threatens, absent reaffirmation, to repossess collateral that the debtor wishes to retain or to pursue undischarged co-debtors or guarantors that the debtor wishes to protect.\textsuperscript{228} On the other hand, it is almost never in the interest of a debtor to reaffirm unsecured debt on which he is solely liable. Of course, the debtor may voluntarily repay such a debt on the basis of felt moral obligation. Voluntary repayment, however, does not require formal waiver of the discharge, and no competent lawyer would advise his client to reaffirm in such a circumstance. Following a spectacular series of revelations involving widespread noncompliance with the court-approval requirement of waivers of discharge by the voluntary reaffirmation of unsecured debts by many of the largest retailers and credit providers in the


\textsuperscript{227}See RESTATEMENT (SECOND) CONTRACTS § 83 (1981) (enforcing a promise to repay a discharged debt notwithstanding want of fresh consideration).

\textsuperscript{228}In some instances, repossession of collateral is more important as a lever to extract reaffirmation of otherwise dischargeable debts than as a means of collecting proceeds. For example, recognizing that repossession of household goods is typically threatened to exert leverage over the debtor rather than to realize meaningful proceeds, the Bankruptcy Code invalidates nonpurchase money nonpossessionary security interests in otherwise exempt household goods. 11 U.S.C. § 322(f)(2) (2006); United States v. Sec. Indus. Bank, 459 U.S. 70, 78 (1982) (noting that arguably “the resale value of household goods is generally low, and ... creditors therefore view the principal value of their security as a lever to negotiate for reaffirmation of the debt rather than as a vehicle for foreclosure”). Interestingly, empirical research shows that reaffirmation of debts secured by household goods remains more common than any other category of secured debt, including automobiles. Marianne B. Culhane & Michaela M. White, Debt after Discharge: An Empirical Study of Reaffirmation, 73 Am. Bankr. L.J. 709, 715 (1999).
nated. At the same time, in its 1997 Commission Report, the National Bankruptcy Review Commission recommended, among other things, permitting reaffirmation agreements only where the amount of the secured debt the debtor seeks to reaffirm does not exceed the allowed secured claim. Although Congress refused to go this far, BAPCPA further regulated the process of obtaining consent in this context by mandating specific terms in written reaffirmation agreements themselves, creating a presumption against the validity of the agreements in certain circumstances, providing for judicial review even where debtors are represented by counsel in their negotiation, and a host of other protections including specific and elaborate written disclosures, court approval before the granting of a discharge, and attestations from counsel regarding the voluntariness, advisability, and reasonableness of the agreement, and, in the absence of representation of counsel, appropriate court findings with respect to whether the agreement is in the best interests of the debtor and does not impose an undue hardship on him.

Judicial scrutiny of reaffirmation agreements and heightened formal requirements for reaffirmation aim to ensure that the consent obtained is real, knowing, and informed. Reaffirmation (particularly of unsecured debt) is hardly necessary to the functioning of the bankruptcy process. Indeed, it stands as an anomaly within that process, at once conferring special priority on an ad hoc, extra-statutory basis on certain creditors to the detriment of others, while impairing the debtor’s fresh start. Weighing against permitting reaffirmation, in addition to these core bankruptcy policies, are nagging doubts about the reality and rationality of debtor consent in this context and an historical experience rife with overreaching by creditors and the futility of past policing efforts. Moreover, it would be very simple to ban reaffirmation outright. Nevertheless, reaffirmation still flourishes as a testament to ideological and institutional reliance on the consent principle. Presumably, positive autonomy values have led Congress to rely on a consent-plus regime to protect consenting debtors from abuse in this area. The efficacy of consent-plus rules in limiting abuse in the reaffirmation context, however, re-

233 Culhane & White, supra note 228, at 715.
mains questionable.235

2. Chapter 11 Solicitation

Another instance in which the Bankruptcy Code paternalistically restricts parties' power to consent is in the chapter 11 postpetition solicitation and voting process. The Code disqualifies most236 postpetition solicitations of votes for or against a plan unless the solicitation has been accompanied or preceded by transmission to the voter of the plan (or a summary of the plan) and an elaborate written disclosure statement approved in advance by the bankruptcy court, after notice and a hearing, setting forth adequate information sufficient to enable a hypothetical reasonable investor to make an informed judgment about the plan.237 "Adequate information" means "information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records . . . that would enable a hypothetical investor of the relevant class to make an informed judgment about the plan . . . ."238 Evidently, Congress was concerned that voters could not cast an informed vote unless they first received and had the opportunity to read adequate information about the plan.239 Even sophisticated creditors may not bind themselves postpetition to accept the treatment for which they have negotiated, or even demanded, prior to their receipt of a court-approved disclosure statement.240 Although the bankruptcy requirement to disclose adequate information serves a similar purpose to the disclosure requirements under the securities laws,241 the Bankruptcy Code specifically preempts "any otherwise applicable nonbankruptcy law, rule, or regulation."242 Rather than seek gui-

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232 Since 2005, Bankruptcy Code § 1125(g) has permitted postpetition solicitations without dissemination of a court approved disclosure statement when the solicitation commenced prepetition as part of a prepackaged or prenegotiated plan. See 11 U.S.C. § 1125(g) (2006).
235 See H.R. Rep. No. 95-595 at 226 (1977) ("If adequate disclosure is provided to all creditors and stockholders whose rights are to be affected, then they should be able to make an informed judgment of their own, rather than having the court or the Securities and Exchange Commission inform them in advance of whether the proposed plan is a good plan.").
237 See, e.g., 15 U.S.C. § 77 (2006); Regulation S-K, 17 C.F.R. 228; Regulation S-X, 17 C.F.R. 210 (2008); SEC Rule 408, 17 C.F.R. § 230.408 (2008) (requiring that registration statements contain "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading").
238 See 11 U.S.C. § 1125(d) (2006). The section provides that "an agency or official whose duty is to administer or enforce such a law, rule, or regulation may be heard on the issue of whether a disclosure statement contains adequate information." Agency interference in the disclosure statement process is rare.
dance from securities law, many bankruptcy courts require most disclosure statements to cover a nineteen-point list of information.\textsuperscript{243}

Parties sometimes go to great lengths to evade these formal limitations on creditor consent.\textsuperscript{244} The value of the creditor protection afforded by these formal limitations is questionable and in many circumstances they appear to encumber unnecessarily the process of negotiating and confirming a plan. Negotiation is the lifeblood of a chapter 11 case. Most courts recognize that statutory restrictions on solicitation must be narrowly construed lest they chill or prohibit negotiations.\textsuperscript{245}

There comes a time, hopefully, in the negotiation process where the parties desire to bind one another to an agreement. The inability of either party to bind itself effectively to a particular agreement can itself inhibit, even preclude, a settlement, particularly if the parties distrust one another based on past dealings. Even if the parties to the preliminary agreement feel bound, creditors that negotiate a particular treatment of a claim may sell their claims in the market following announcement of the settlement, and the new holder of the claim may feel free to reopen negotiations or reject settlement altogether.

Accordingly, notwithstanding the statutory regulation of solicitation, parties sometimes enter into lock-up agreements binding the holder of a claim (and successors) to an agreed treatment to be implemented through a reorganization plan or other action of the bankruptcy court. Nonbankruptcy law allows these agreements, and bankruptcy courts enforce them where they are made prepetition.\textsuperscript{246} Drawing Talmudic distinctions, courts have enforced lock-up agreements that commit the consenting creditor to support a conforming plan (and oppose all other plans) as long as the creditor does not


\textsuperscript{244}Trans World Airlines v. Texaco Inc. (In re Texaco Inc.), 81 B.R. 813, 815-16 (Bankr. S.D.N.Y. 1988) ("lock-up" agreement requiring Pennzoil to support Texaco's forthcoming plan and refrain from voting for, consenting, supporting or participating in any other plan held not an improper solicitation, notwithstanding absence of court-approved disclosure statement).


purport to bind itself to cast a ballot accepting the plan. See Texaco Inc., 81 B.R. at 815–16.


See, e.g., In re Kellogg Square P’ship, 160 B.R. 336, 340 (Bankr. D. Minn. 1993) (holding that contract which called for creditor to cast ballot in favor of debtor’s plan did not amount to improper solicitation).

See supra note 108.

See infra notes 311–21 and accompanying text.

A. Relevant Factors.

Fixing specific rules governing consent is a contextualized inquiry that draws on both experience and judgment. Useful factors that a court or legislature should consider in establishing the extent to which consent is a necessary or sufficient predicate to the transformation of legal rights in the light of such experience and judgment include:

- The sophistication, knowledge and bargaining power of the putative consenting parties;
- The number, and degree of geographical or other dispersion, of the putative consenting parties;
- The availability of good proxies;
- The nature, value and absolute or relative importance of the putative consenting parties’ protectable legal interest;
- The difficulty and cost of obtaining consent both in out of pocket terms and in terms of burdening (or even precluding) effective reorganization;
- The public policy favoring reorganization and the interests of third parties in facilitating effective reorganization;
- The need to control abuse by insiders in both obtaining consents and imposing nonconsensual resolutions;
- The risk of strategic (“rent-seeking”) behavior in the exercise of consent rights by those holding the entitlement;
- The cost (including delay and legitimacy costs) of imposing coercive rather than consensual solutions to the problem; and
- The value of providing flexibility to the parties in fashioning consensual, particularized solutions to the problem.

In deviating from the standard consent model of uncoerced, undeceived, objective manifestation of assent, the consent bar can be manipulated downward by deeming consent effective on lesser showings, by relying on proxy consents, by altering party baselines, and by creating uncertainty about the enforcement or content of legal rights. Mandatory rules are always an alternative to consent requirements, assuming an acceptable generally applicable rule can be confidently framed. Experience cautions, however, against too quickly jumping toward mandatory rules. For one thing, rules that seem appropriate in the abstract may not work in concrete cases. Congress or the judiciary may not actually know what the right answer is, even if they think they do, or the right answer may be different given unanticipated or unusual

253The irrational and arbitrary effects of the rigid BAPCPA means-test is one prime example. The failure of the means test is marked by the re-emergence of the “totality of the circumstances” test as the principal gate-keeper to chapter 7 for individual consumer debtors. See Warren & Bussel, supra note 160, at 490–91.
circumstances. Even if we can confidently frame an appropriate mandatory rule, legitimacy and autonomy values must be weighed against the efficiency of dictating a given result by mandatory rule. The experience in bankruptcy law has been that facilitating party consent to a preferred resolution by lowering the consent bar is often a better road leading to the same destination.\(^{254}\)

We also should be wary of sacrificing too quickly the legitimacy consent confers on the altar of efficient administration or other bankruptcy values. Autonomy still does count for something, even in the highly regulated and monitored society in which we live. The slippery slope is not entirely a myth;\(^{255}\) easing consent requirements for expediency’s sake sacrifices some bit of freedom. Freedom is not only an inherent good, its sacrifice also entails loss of the flexibility, power and legitimacy that consent-based solutions bring to complex problems calling for the accommodation of competing rights in the context of insolvency.

The sophistication of the parties and their ex-ante knowledge of their legal rights directly affects the degree and kind of notice and disclosure appropriate in soliciting and obtaining their consent. A sophisticated institutional repeat player in the bankruptcy system (generally represented by sophisticated legal counsel) may require little protection in comparison to smaller creditors with little familiarity with the chapter 11 process. It may be appropriate to grant those with constitutionally protected property interests (or other special interests) greater protection than ordinary creditors. Procedures may need to be relaxed in circumstances where genuine emergency exists, or the public interest or important third-party interests are implicated. The level of notice or disclosure information necessary to confirm a plan or approve a \$ 363 sale involving an apartment building with a single mortgagee and a handful of unsecured creditors ordinarily would be far less than that required to sell or reorganize a multi-national company. The history of reorganization law is itself an object lesson in balancing the necessity and value of reorganization against the potential for abuse of the coercive power of the court and the process to alter legal rights nonconsensually. Fixing too high a consent threshold can unduly burden or preclude efficient dispute resolution or successful business reorganization. Moreover, consent requirements can lead to strategic behavior in which parties exercise holdout leverage in order to extract value to which they are not otherwise entitled.\(^{256}\)


\(^{256}\)Coffee & Klein, supra note 33, at 1263-68.
B. DEVELOPMENTS THAT FAVOR ALTERING THE CONSENT BAR

Technology has vastly reduced the cost of communicating with and organizing dispersed constituencies. While new technologies facilitate gathering of consents, however, they also facilitate the orchestration of dissent. Whether the net effect is to make consent gathering easier or more difficult is unclear, but the force of inertia, although still powerful, is certainly reduced.\textsuperscript{257} Moreover, the general public’s current reality of overwhelmingly cheap and easy access through the Internet to large quantities of public information reduces creditor dependence on, or use for, certain traditional forms of disclosure.

Other changes clearly make it more difficult today to obtain individual consent. The world of finance is vastly more complex today than in 1938, or even 1978, with the development of vast markets for securitizations and financial derivatives, and this complexity breeds conflicts of interest that may greatly complicate the process of obtaining consent.\textsuperscript{258} Legal and technological changes make it easy to perfect security interests in substantially all of a firm’s property.\textsuperscript{259} Few debtors enter bankruptcy with significant unencumbered assets given legal and market evolution in secured financing. The importance of trade credit has commensurately diminished as firms have turned to capital markets for financing and embraced practices that reduce working capital, such as just-in-time inventory.\textsuperscript{260} On the other hand, with the growth of mass tort litigation and large judgments, tort claimants (who are

\textsuperscript{257}The extraordinary twentieth century developments in communications, data processing, storage and retrieval, transportation, and the like, obviously reach far, far beyond the little world of bankruptcy law. Among other things, the long-term net effect of these developments appears to be eroding individual autonomy values in our society.

\textsuperscript{258}See infra notes 322-33 and accompanying text. See also John Eggum, Katherine Porter & Tara Twomey, Saving Homes In Bankruptcy: Housing Affordability and Loan Modification, 2008 UTAH L. REV. 1123, 1166–67 (2008).

\textsuperscript{259}Lois R. Lupica, The Impact of Revised Article 9, 93 KY. L.J. 867, 912–13 (2004) ("As a result of the Article 9 revisions, when a debtor files for bankruptcy, assets that are inadvertently encumbered, assets acquired post-petition, assets described in flawed documentation, and the debtor’s cash flow, are all diverted from unsecured to secured creditors to a far greater degree than was the case under former Article 9."); G. Ray Warner, The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy, 9 AM. BANKR. INST. L. REV. 3, 41–42 (2001); Kenneth N. Klee, Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal, 82 CORNELL L. REV. 1466, 1467 & n.2 (1997); Lynn M. LoPucki, The Unsecured Creditors: Bargain, 80 VA. L. REV. 1887, 1917-19 (1994). The early twenty-first century explosion in the issuance of second-lien financing in lieu of traditional unsecured public debt is discussed and documented in Harvey R. Miller, Chapter 11 in Transition-From Boom to Bust and Into the Future, 81 AM. BANKR. L.J. 375, 378-83 (2007).

\textsuperscript{260}Vicente Cunat, Trade Credit: Suppliers as Debt Collectors, 20 REV. FIN'L STUD. 491, 523 (2007) ("The empirical results also show that trade credit is used at the margin, when other forms of credit have already been exhausted."); Mitchell A. Petersen & Raghubur G. Rajan, Trade Credit: Theories and Evidence, 10 REV. FIN'L STUD. 661-692 (1997) ("medium term borrowing against trade credit is a form of financing of last resort"); FEDERAL RESERVE BOARD, NATIONAL SURVEY ON SMALL BUSINESS FINANCE 1987-2003, available at http://www.federalreserve.gov/Pubs/Oss/Oss3/nasbftoc.htm.
involuntary creditors) have become an increasingly important part of the mix in large bankruptcy cases. Claims trading is common today, and as claims trade new parties whose consent must be obtained emerge just as previously consenting or passive parties exit.261 Strategic behavior is even more a problem than in the past as bankruptcy processes are better understood and the sophisticated parties best able to engage in such behavior, while employing the tools of modern financial engineering, are less restrained by gentlemen’s agreements (backed by social and economic sanctions) than the bankers of old.262

Other scholars (writing before the financial panic of Fall 2008) have argued at length that the increased depth and liquidity of modern capital markets make resolution of bankruptcy cases by negotiated restructuring (rather than by sale and distribution in accordance with legal priorities) less advantageous than in the past.263

So, on balance, perhaps from a very broad perspective, consent is somewhat harder to obtain and less necessary to effective resolution of a bankruptcy case than in earlier times. From this broad perspective, greater scope for mandatory rules, a general lowering of the bar for transformative consent, and a greater alteration of party baselines may make sense under modern circumstances. Too high a consent threshold may unduly burden or even preclude efficient dispute resolution or successful business reorganization as parties engage in strategic behavior to extract value to which they are not otherwise entitled, perhaps by obstructing an otherwise desirable plan.264

With these general propositions in mind, we examine some features of bankruptcy law that are candidates for further downward manipulation of consent standards and other instances where consent standards might plausibly be further tightened in light of changed circumstances or to better reflect underlying policies. The discussion is intended to be provocative and illustrative, not exhaustive.

261 Compare Martin Mayer, The Bankers 321 (Weybright & Talley 1974) ("The vital difference between a loan and an investment is the fact that there is (probably) a market for an investment and (probably) not for a loan") with Martin Mayer, The Bankers: The Next Generation 17 (Truman Talley 1997) ("Both large and small loans are sold to others.")


264 Coffee & Klein, supra note 33, at 1263-68.
C. RELAXING CERTAIN CONSENT REQUIREMENTS

1. Home Mortgage Modification

In 1978, when the insurance industry obtained anti-cramdown protection for first mortgages on principal residences, the standard home loan was a first mortgage limited to no more than 80 percent of the value of the home.265 Banking and insurance regulations once required as much.266 Then mortgage lending was deregulated and increasing securitization of home mortgages insulated mortgage originators from credit risk. Indeed, somewhat perversely, mortgage originators were paid handsome fees to originate loans without much regard to the quality of the loans or the borrowers’ ability to repay. Although in the long run and in the aggregate these practices proved disastrous, they developed in an environment where the originator did not expect to bear the credit risk being underwritten since the loans were to be promptly packaged and resold in an anonymous securitization market where credit risk was supposed to be mitigated by diversification and tranching. The highest expression of this folly was the subprime lending marketplace where some homeowners, specially selected for their poor credit histories, could borrow up to 125 percent of the value of their home (arguably based on the expectation that ever rising equity values would serve as adequate security).267 As a result, from inception, some mortgages on debtors’ principal residences were undersecured. With the recent plunge of values in the residential housing market in many sections of the country by thirty to forty percent or more,268 the percentage of underwater mortgages has soared.269 Yet chapter 13270 retains an outdated prohibition on the modification of first mortgages on principal residences unless the lender consents.271 This requirement has scuttled confirmation of chapter 13 plans and debtor rehabilita-
tion. Moreover, since more often than not, home mortgages are pooled and securitized with the beneficial interests in the pool held by dispersed investors, often debtors cannot even identify, let alone negotiate with, the beneficial holders, and thus, have no meaningful way to obtain lender consent to loan modification. Mortgage loan servicers with whom the homeowner is directed to deal often have limited discretion and less economic incentive to modify home mortgages in light of changes in the housing market or the homeowner's circumstances.

Accordingly, the time has come to amend chapter 13 to allow modification of first mortgages on principal residences and to install the same cram down standard applicable to other secured claims. The possibility of cram down based upon uncertain judicial valuation historically has led—in an overwhelming majority of cases—to a realistic consensual renegotiation of the terms of secured claims in light of the present value of collateral, and there is every reason to believe that extending the general rule to the special case of home mortgages will have the same result.

Academic theory and past experience, even if compelling, does not always overcome political realities. Although Congress considered amending the Bankruptcy Code to permit some form of cram down on home lenders, pressure from the lending industry limited the proposed amendment to existing home mortgages. Even though that amended legislation easily passed the House of Representatives, the Senate voted against it. A renewed effort failed as this Article went to press.

2. The One-consenting Class Rule

The Bankruptcy Code effectively requires that at least one impaired class of claims consent to a reorganization plan before it can be confirmed. This

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272 Nelson & Whitman, supra note 143, § 8.15, at 1051; Eggum et al., supra note 258, at 1157–59.
274 Friedman, supra note 44, at 1499.
requirement has lived a tortured existence. The Senate proposed the one-consenting-class rule\textsuperscript{277} to ensure some meaningful creditor consent to a chapter 11 plan.\textsuperscript{278} The House, on the other hand, insisted on providing that an unimpaired class was deemed to accept the plan.\textsuperscript{279} Predictably, courts disagreed on whether the deemed acceptance of an unimpaired class satisfied the one-consenting-class rule.\textsuperscript{280} In 1984, Congress amended the Code to require the acceptance of an impaired class.\textsuperscript{281} This temporarily resolved the dispute in favor of the Senate position, at least if the plan impaired one or more classes of claims. The amendment also gave birth, however, to an unproductive debate over the permissibility of artificial impairment: The unnecessary and immaterial alteration of the rights of class of creditors solely for the purpose of having that impaired class's consent satisfy the one-consenting-class rule.\textsuperscript{282} In 1994, Congress deleted § 1124(3), which provided that if the allowed claims of a class were paid in full and in cash, the class was unimpaired.\textsuperscript{283} Apparently one consequence of this amendment is that a class of unsecured claims paid in full and in cash on the effective date of the plan may vote as an impaired class based on the nonpayment of postpetition interest, disallowed by § 502(b)(2), to which those creditors would have been entitled under nonbankruptcy law.\textsuperscript{284} Frequently, a § 1122(b) convenience

\textsuperscript{277}Compare S. Rep. No. 95-989 at 128 (1978) (interpreting § 1130(a)(12), the forebear to § 1129(a)(10), to require that at least one class accept the plan) with H.R. Rep. No. 95-595 (1977) (containing no such requirement).


\textsuperscript{279}See 124 CONG. REC. 32,406 (1978) (Statement of Rep. Edwards) ("Section 1126(f) of the House amendment adopts a provision contained in section 1127(f) of the Senate bill indicating that a class that is not impaired under a plan is deemed to have accepted a plan"); 124 CONG. REC. 34006 (1978) (statement of Sen. DeConcini) (same).

\textsuperscript{280}See In re Marston Enter., Inc., 13 B.R. 514, 518-20 (Bankr. E.D.N.Y. 1981) (holding that § 1129(a)(10) requires actual affirmative consent by at least one class, and deemed consent by unimpaired class under § 1126(f) is at best a prima facie case for satisfying § 1129(a)(10)); but see The Midland Mut. Life Ins. Co. v. Mansnorth Corp. (In re Mansnorth Corp.), 28 B.R. 892, 899 (Bankr. N.D. Ga. 1983) (rejecting the reasoning of Marston and its progeny in ruling that deemed acceptance under § 1126(f) satisfies § 1129(a)(10)).

\textsuperscript{281}See Pub. L. No. 98-353, 98 Stat. 333 § 512(a)(9) (1984) (amending § 1129(a)(10) to apply to impaired classes of claims if a class of claims is impaired under the plan).

\textsuperscript{282}In re Windsor on the River, Ltd., 7 F.3d 127, 131 (8th Cir. 1993).

\textsuperscript{283}See Pub. L. No. 103-394, § 213(d)(3), 108 Stat. 4106, 4126 (1994) (repealing § 1124(3)). The legislative history states that the purpose of this amendment was to ensure that creditors received postpetition interest on their claims in the reorganization of solvent estates, overruling In re New Valley Corp., 168 B.R. 73, 79 (Bankr. D.N.J. 1994). See The Bankruptcy Reform Act of 1994—Section-by-Section Description, 140 CONG. REC. H10752, H10764 (1994) (describing § 213(d)).

class of small claims can be designated for this purpose.\textsuperscript{285} Thus, plans may now satisfy the one-consenting-class rule by paying a convenience class of small claims in cash and in full, but without postpetition interest, on the effective date.\textsuperscript{286} There is no logical basis to make the validity of a cram down on one class turn on whether some other class, any other class, consents by the requisite majorities to accept some other treatment on their distinct claims. No justifiable policy is served by requiring a plan proponent to jump through this hoop. The practice of satisfying the one-consenting-class rule by counting the consent of a class whose legally dissimilar rights are only marginally affected makes the requirement a sham in any case. The one-consenting-class rule has out-lived any useful purpose it ever might have served and, as one of us has previously noted, should be repealed.\textsuperscript{287}

3. Third-party Releases

Perhaps there is no area of chapter 11 practice where courts are more divided than in the permissible scope of third-party releases or channeling injunctions under reorganization plans.\textsuperscript{288} Typically, plan proponents seek to condition the plan on the release of estate or debtor claims against parties that are critical to the successful reorganization or otherwise have leverage over “the deal.” The plan proponent and these released parties may seek to condition the deal further on obtaining a general release of claims not only of the debtor and the estate but of other constituents whether claiming through the estate or independently. The common justification is that the deal is


\textsuperscript{286}See In re G & C Foundry Co., No. 06-30601, 2008 WL 4350741, at *3, (Bankr. N.D. Ohio Oct. 9, 2008) (rejecting argument that § 1122 class may not satisfy § 1129(a)(10)); In re Crosscreek Apts., Ltd., 213 B.R. 521, 532-34 (Bankr. E.D. Tenn. 1997) (allowing § 1122 class to satisfy § 1129(a)(10)), but see In re Paolini, 312 B.R. 295, 314-15 (Bankr. E.D. Va. 2004) (convenience class under § 1122(b) may not be created solely to satisfy § 1129(a)(10)); In re 625 Corp., 228 B.R. 758, 761 (Bankr. M.D. Fla. 1998) (same). Ironically, the repeal of § 1124(3), although it has made convenience classes useful as a work around for § 1129(a)(10), had another unintended effect: undermining the convenience of designating convenience classes. If a convenience class must be solicited because it is being impaired—even if it receives cash payment in full on the effective date—little administrative convenience is achieved. It would certainly make more sense to authorize expressly cash payment in full of small claims for purposes of convenience without requiring solicitation, if and when § 1129(a)(10) is repealed.


intended to establish global peace which requires broad general releases. Often insiders' cooperation is conditioned on such a release. Insurers, lenders, or others making cash or other contributions to the reorganization effort may also seek to condition their participation in the reorganization on obtaining such a release.

Although § 524(e) indicates that a discharge will not affect a creditor's rights against a third party, some courts have nevertheless confirmed plans enjoining creditors from exercising those rights, often over the objection of the holders of the released claims. In mass-asbestos chapter 11 cases, § 524(g)(4)(A)(ii) expressly authorizes the court to grant this relief in certain circumstances, notwithstanding § 524(e). In 1994, at the same time it enacted § 524(g), Congress specifically negated any inference that this express grant might otherwise have had on a bankruptcy court's power to enjoin the exercise of third-party guarantees in non-asbestos chapter 11 cases. Before and after this amendment, bankruptcy courts confirmed plans enjoining creditors from enforcing claims against third-parties in various situations. Some courts determined that since the chapter 11 plan confirmation process must occur in conformity with the Bankruptcy Code, parties could not contractually consent to injunctions or releases not authorized by the Bankruptcy Code under a chapter 11 plan. Others allowed the parties to agree to waive rights against third-parties or consent to an injunction under a plan. Still other courts went further and authorized plan proponents to condition plan acceptances on such a waiver, effectively forcing the plan and a waiver on the holder of the claim as a take-it-or-leave-it package deal. Some courts

289 See Pub. L. No. 103-394, 108 Stat. 4106, § 111(b) (1994) (uncodified rule of construction of § 524(g)). The House Report explained that "[s]ection 111 contains a rule of construction to make clear that the special rule being devised for the asbestos claims trust/injunction mechanism is not intended to alter any authority bankruptcy courts may already have to issue injunctions in connection with a plan of reorganization."). H.R. REP. NO. 103-834, at 8-12 (1994). See also Pub. L. No. 103-394, § 213(d)(3), 108 Stat. 4106, 4126 (1994) (amending § 1124(3)).

290 See, e.g., In re Lewenschuss, 67 F.3d 1394, 1401-02 (9th Cir. 1995) (holding that a bankruptcy court has no power to enjoin permanently creditors from suing third parties); In re W. Real Estate Fund, Inc., 922 F.2d 392, 601-02 (10th Cir. 1990) (same); In re Am. Hardwoods, Inc., 885 F.2d 621, 626 (9th Cir. 1989) (same); Underhill v. Royal, 769 F.2d 1426, 1432 (9th Cir. 1985) (disallowing a consensual third-party release), overruled on other grounds by, Reves v. Ernst & Young, 494 U.S. 55 (1990); Union Carbide Corp. v. Newboles, 686 F.2d 593 (7th Cir. 1982) (same) (overruled sub silentio by In re Specialty Equip. Cos., 3 F.3d 1043, 1046-47 (allowing consensual release of liabilities under a confirmed chapter 11 plan)).

291 See, e.g., Specialty Equip. Cos., 3 F.3d at 1046-47 (7th Cir. 1993) (allowing consensual release of liabilities under confirmed chapter 11 plan); Republic Supply Co. v. Shoaf, 815 F.2d 1046, 1050 (5th Cir. 1987) (allowing temporary injunction of enforcement of third party claims "when it has been accepted and confirmed as an integral part of a plan of reorganization.").

292 See, e.g., In re A.H. Robins Co., 880 F.2d 694, 702 (4th Cir. 1989) (enjoining parties partaking in a settlement under a confirmed plan from suing, inter alia, the debtor as well as its directors, attorneys and affiliates). But see In re Boston Harbor Marina Co., 157 B.R. 726, 730-31 (Bankr. D. Mass. 1993) (refusing to confirm plan that coercively tied acceptance of the plan to release of claims against third parties).
allowed accepting classes of claims to bind dissenters so that the entire class would release claims against designated third parties. \(^{293}\) Finally, some courts went so far as to cram down plans forcing the release of third-party claims on an entire dissenting class on the basis that a settlement that was a crucial part of the plan was binding pursuant to § 1141(a), rather than pursuant to (and limited in scope by) the bankruptcy discharge. \(^{294}\)

Recently, in the asbestos context, the Supreme Court was poised to address whether a bankruptcy court may enjoin creditors from suing third-parties on claims that are independent of claims that the creditor holds against the debtor or the bankruptcy estate. The Second Circuit had determined that the bankruptcy court did not have jurisdiction to do so. \(^{295}\) The Supreme Court, however, disposed of the matter on narrow res judicata grounds leaving unresolved the scope of the bankruptcy court’s jurisdiction to enjoin claims against third parties. \(^{296}\)

In light of § 524(e), historical understandings and practices with regard to proper scope of third-party releases, and more general policy considerations, it is difficult to justify extending the cram down power to encompass discharge of claims against third parties over the objections of an entire dissenting class. \(^{297}\) Third-party releases may be the grease necessary to resolve a reorganization case, but there is a significant difference between imposing that release nonconsensually and conditioning the final deal on individual or class consent to global peace. Outright cram down of a third-party release

\(^{293}\) See In re Dow Corning Corp., 280 F.3d 648, 658 (6th Cir. 2002) (enjoining a non-consenting creditor’s claim is only appropriate in “unusual circumstances.”). But see In re AOV Indus. Inc., 792 F.2d 1140, 1151–54 (D.C. Cir. 1986) (rejecting third party release where only one class member of a consenting class had meaningful rights against third parties, that member dissented and all class members shared pro rata in the consideration furnished by the release under the terms of the plan).

\(^{294}\) See, e.g., In re Drexel Burnham Lambert Group, 960 F.2d 285, 293 (2d Cir. 1992) (“In bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor’s reorganization plan.”). Cf. In re Metromedia Fiber Network Inc., 416 F.3d 136, 143 (2d Cir. 2005) (reversing a plan confirmation order and finding that though the nondebtor seeking the release “made a ‘material contribution’ to the estate . . . there [was] no finding (or evidence presented) that the [release] was itself important to the [plan].”)

\(^{295}\) See In re Johns-Manville, 517 F.3d 52, 66 (2d Cir. 2008) (relying on In re Combustion Eng’g, Inc., 391 F.3d 190, 228 (3d Cir. 2004) to hold that a bankruptcy court’s jurisdiction can only extend “to enjoin non-debtor claims that directly affect the res of the bankruptcy estate,” and does not extend to a claim based on alleged misconduct asserted under state law), rev’d on other grounds, Travelers Indem. Co. v. Bailey, 129 S. Ct. 2195, 2205–07 (2009).

\(^{296}\) Bailey, 129 S. Ct. at 2205–07.

\(^{297}\) Indeed, in the asbestos context, where Congress has gone to the trouble of expressly authorizing limited third-party releases pursuant to 11 U.S.C. § 524(g) (2006), the special channeling injunction available under that procedure can only be imposed with the affirmative vote of 75% (as opposed to the usual two-thirds in amount and one-half in number) of voting creditors (as well as the approval of the federal district court). Cram downs of channeling injunctions are not available under § 524(g). 11 U.S.C. § 524(g)(2)(B)(ii)(IV) (2006) (requiring the affirmative 75% vote of separately classified mass-asbestos claimants).
does not appear to be authorized by the Bankruptcy Code or any other applicable law. On the other hand, the affirmative, informed, objectively manifested consent of a particular creditor to a release obviously should be sufficient to make that release binding on that creditor. Moreover, there is no apparent reason to require that that contractual release be obtained outside the reorganization plan process when it is more efficient and convenient to solicit it within that process.

So the contestable issue that remains is whether class consent should bind dissenters to third-party releases. In bankruptcy, class consents commonly effectuate all sorts of settlements not only vis-à-vis the bankruptcy estate and the debtor, but among the classes themselves, with respect to such matters as plan settlements, avoiding power claims and subordination disputes. The acceptance of an offer of settlement from a third party conditioned on global peace may be little different. In an appropriate context a class vote should be sufficient to bind dissenting members of the class to the release. However, there is reason for special caution: Unlike most intercreditor disputes (and disputes relating to estate or derivative claims or claims against the estate), class members may not share similar interests with respect to third-party releases. Classification generally turns on whether the class members hold similar rights against the debtor. Those with dissimilar rights against the debtor may not be classified together, but parties holding dissimilar rights against the putative third-party releasees may be classified together.

The propriety of imposing a third-party release by class vote on dissenting class members turns on whether all members of the class hold similar rights against the putative releasee. If those with no third-party claim are classified together with those that do hold such claims, those without the third-party claim may be happily bargaining away the rights of fellow class members to obtain an otherwise favorable plan treatment. Third-party releases should be a permissible part of a deal, but consent to the deal should be measured by requisite majorities of classes of creditors and interest holders composed of members with similar rights against the putative releasees.

4. Sales Free and Clear

The Bankruptcy Code, as drafted, provided that an “underwater” lien could be “stripped.” Secured claims were expressly limited to the value of the collateral. Section 506(d) provided, with certain exceptions not relevant

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299 In re AOV Indus. Inc., 792 F.2d 1140, 1151-54 (D.C. Cir. 1986) (rejecting third party release where only one class member of a consenting class had meaningful rights against third parties, that member dissented and all class members shared pro rata in the consideration furnished by the releasee under the terms of the plan consented to).
300 11 U.S.C. § 506(d) (2006) (“To the extent that a lien secures a claim against the debtor that is not
here, that a lien was void except to the extent it secured an allowed secured claim as so measured. Thus an underwater lien (that is a lien against collateral whose value was exhausted by senior liens) was void. As such, property subject to an undersecured first mortgage and a fully underwater second lien could be sold with the consent of the first lien creditor. Consent of the underwater junior lien holder was not required once the lien was stripped.

*Dewsnup v. Timm* upended this result by construing the Bankruptcy Code (notwithstanding its plain language to the contrary) to prevent the voiding of an underwater lien in chapter 7. This was of little moment in confirming chapter 11 plans because a lien could be stripped under a chapter 11 plan notwithstanding *Dewsnup,* but the *Dewsnup* rule inadvertently gave the underwater lienholder (who until plan confirmation retained an interest in the collateral under § 363(f)) a veto power over § 363 sales. Consent of the undersecured first lien no longer sufficed to authorize a sale under § 363 because the underwater junior lienholder had an interest in the property to be sold. With no equity in the property, the chapter 7 trustee could simply abandon the property or grant the senior lienholder relief from the automatic stay to commence foreclosure proceedings. This result is seldom problematic for chapter 7 case administration.

Recently, however, some courts have upheld the veto power of the underwater junior lienholder over § 363 sales in chapter 11 cases outside the context of a plan. The Bankruptcy Code presumes confirmation of a chapter 11 plan is the norm and § 363 sales the exception, and in its early years so did the courts. In the past fifteen years, however, there has been a trend

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303 Id. at 420-36 (Scalia, J., dissenting); Margaret Howard, Secured Claims in Bankruptcy: An Essay on Missing the Point, 23 CAP. U. L. REV. 313, 317-23 (1994); Margaret Howard, Dewsnupping the Bankruptcy Code, 1 J. BANKR. L. & PRAC. 513, 518-22 (1992).


306 See, e.g., In re PW, LLC, 391 B.R. 25, 41-46 (B.A.P. 9th Cir. 2008). But see Jolan, 403 B.R. at 869 (authorizing sale free and clear under § 363(f)(5)).
toward using § 363 sales followed by liquidating plans or conversions to chapter 7 in lieu of reorganization or sale under a chapter 11 plan.\textsuperscript{308} We suggest below that this trend has gone too far and threatens to undermine chapter 11's delicate balance between consent and coercion.\textsuperscript{309} Nevertheless, there are certainly situations where preplan sales under § 363 are amply justified,\textsuperscript{310} and there is no reason to give an out-of-the-money second lien an absolute veto over an otherwise desirable § 363 sale. Thus, the confluence of \textit{Deusenbyp} and increased reliance on § 363 sales in chapter 11 cases confers undue leverage on the underwater junior lienholder. It is time to eliminate this unintended consequence and make clear that property may be sold free and clear of an underwater junior lien without the junior lienholder's consent.

D. Bolstering Certain Consent Requirements

1. Sales of Substantially All Assets

When the Bankruptcy Code was enacted, sales of all assets outside the ordinary course of business were exceptional situations. In order to conduct such a sale and to avoid the strictures of a plan and disclosure statement and the confirmation requirements, the debtor in possession had to demonstrate the existence of circumstances, such as rapidly wasting assets, that made prompt sale an urgent necessity.\textsuperscript{311} As time passed, courts allowed such sales even in the absence of an emergency if supported by an articulated business purpose, but not simply in response to creditor pressure.\textsuperscript{312} Later, courts simply balanced the interests of creditors, the debtor, and equity security holders in deciding whether to authorize the sale.\textsuperscript{313} Although sales that involved a significant restructuring of creditors' rights could be disapproved as a sub rosa plan,\textsuperscript{314} sales leaving the proceeds for distribution under a plan usually were not condemned on this basis.\textsuperscript{315} Currently, sales under § 363

\footnotesize{\textsuperscript{308} Baird, supra note 114, at 96–97.\\
\textsuperscript{309} See infra notes 311-21 and accompanying text. See also supra notes 5-11 and accompanying text (discussing the Chrysler and GM cases).\\
\textsuperscript{310} To take an uncontroversial example, consider sales of wasting assets to third parties, for cash, that do not otherwise dictate treatment of creditors under a plan. See \textit{In re Sire Plan, Inc.}, 332 F.2d 497, 499 (2d Cir. 1964) (describing wasting-asset rule under the Bankruptcy Act); \textit{In re White Motor Credit Corp.}, 14 B.R. 584, 590-91 (Bankr. N.D. Ohio 1981) (discussing emergency exception).\\
\textsuperscript{311} See, e.g., \textit{In re Brookfield Clothes, Inc.}, 31 B.R. 978, 983 (Bankr. S.D.N.Y. 1983); \textit{White Motor Credit Corp.}, 14 B.R. at 590-91.\\
\textsuperscript{312} See, e.g., \textit{Lionel Corp.}, 722 F.2d at 1068–69; \textit{In re Equity Funding Corp. of Am.}, 492 F.2d 793, 794 (9th Cir. 1974).\\
\textsuperscript{313} See Stephens Indus. v. McClung, 789 F.2d 386, 390 (6th Cir. 1986).\\
\textsuperscript{314} See, e.g., \textit{In re Braniff Airways, Inc.}, 700 F.2d 935, 939-40 (5th Cir. 1983).\\
\textsuperscript{315} See \textit{In re Continental Air Lines, Inc.}, 780 F.2d 1223, 1227–28 (5th Cir. 1986) (preventing a debtor in possession from entering into significant aircraft lease transactions even when creditors' distributional rights not directly affected).}
have increasingly displaced the chapter 11 plan process. When the debtor in possession seeks court approval of a § 363 sale, unsecured creditors do not vote. Rather, only secured creditor consent is required, and then only in the limited case where there is no equity in the property and the lien is not subject to bona fide dispute. Frequently the buyer is an entity controlled by the secured party sometimes acting in concert with other constituents, who are usually insiders. When the buyer is the secured party or acting in concert with the secured party the sale bears more than a passing resemblance to the foreclosure sale in old equity receivership practice. In such transactions, the secured party as buyer will capture post-sale future appreciation; it is motivated to keep the sale price low. Interestingly, recent empirical work by Professors Lynn LoPucki and Joseph Doherty suggests that § 363 sales on average yield less value to constituents than comparable chapter 11 reorganizations.

It is time to bolster general creditors' (and interest holders') consent to a sale of substantially all of the assets of a debtor outside the plan process, particularly where the buyer credit bids or teams up with insiders. Rushed sales under manufactured emergencies deny due process and preclude meaningful creditor input. They also preclude meaningful appellate review because of the statutory bar on the review of sale orders. Postpetition lenders (frequently the prepetition secured lenders themselves or institutions in league with them) have exacerbated the difficulty in maximizing value by insisting on very short sale periods as a condition of financing. And more recently, lenders or purchasers have preferred certain unsecured creditors by requiring that their debts be assumed and paid by the purchaser in derogation of the sub rosa plan doctrine. Practically, this reduces the purchase price, reorders the distributional priorities of the Bankruptcy Code, preempts bargaining over a plan, and unfairly treats those creditors left behind.

One obvious solution is to require sales (or at least sales to constituents or parties related to constituents) to take place under a plan subject to the

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319 11 U.S.C. § 363(m) (2006). Appellate review of confirmation orders is also limited by equitable mootness principles, In re Cont’l Airlines, 203 F.3d 203, 209–10 (3d Cir. 2000); In re Roberts Farms, Inc., 652 F.2d 793, 797 (9th Cir. 1981), but no outright statutory bar to appellate review exists in the plan context.
various constraints of that process, many of which were born of the abuses that attended the orchestrated foreclosure sales in the equity receiverships of old. Alternatively, § 363 sales can be conditioned on greater regulation, and longer time frames that make that process look more like the traditional chapter 11 process. That approach, however, amounts to reinventing the wheel by selectively incorporating elements of the established chapter 11 plan process into § 363. We prefer to limit the circumstances under which a sale of substantially all of the debtor's assets may be made outside of a plan to a true emergency, such as when the firm as a whole constitutes a rapidly wasting asset or when the stalking-horse buyer is a genuine third party and the sale outside a plan is broadly supported by all the key constituencies. Otherwise, sales should take place pursuant to a plan, subject to the established voting requirements, statutory protections, and consent rights that exist under that process.

2. Policing Proxy Voting

Bankruptcy's sophisticated use of proxies unauthorized by conventional rules of contract or agency law to bind their putative principals is a signature feature of American reorganization law upon which rests much of its legitimacy. Yet we perceive growing gaps between the interest of the consenting proxies and their bound constituents. These gaps threaten to undermine the legitimacy of the process.

i. Conflicts of Interest in Voting

The rise of "hedge funds," the advent of claims trading, financial deriv-
tives, the transformation of the banking industry through disintermediation and deregulation, all work together to multiply conflicts of interest in reorganization cases. It is common for holders to acquire claims and interests at many different levels of the debtor’s capital structure and to hedge those interests through options and forwards in ways that obscure the true net position of the holder of any particular claim or interest. Moreover the claims and interests are frequently transferred (sometimes multiple times) during the course of a reorganization case.

Bankruptcy law’s reliance on the consent of proxies, successors, or others similarly situated has become especially problematic in recent years as consent rights increasingly have been divorced from economic rights through modern financial engineering. This separation is not an entirely new phenomenon: Certainly, the robber barons of old understood that control of the vote of one constituency might advantage their other economic interests to the detriment of the voting class. The ability, however, to engage in undisclosed and nontransparent hedging transactions through derivatives has multiplied the opportunities for this sort of manipulation and degraded the ability of the courts to control abuse. Through options, swaps, and participations, security holders can and do commonly acquire or dispose of substantially all the underlying economic interests (or even short the relevant interest) without transferring the correlative right to vote on a reorganiza-

with funds that engage in classic hedging or arbitrage strategies, and though they sometimes employ those strategies themselves, most often they seek to profit from mispricing of distressed assets rather than pure arbitrage.

323 Discussing Jay Gould, Matthew Josephson wrote:

To understand the scope of the man’s tactics one must note that his domination was carried on by strategic “working controls” rather than by ponderous outright investments. He was an “absolute master,” as a shrewd investigator for President Cleveland reported “of the art of creating coordinate boards of directors that had complete control of adverse interests.” Thus the ruin of certain properties which he controlled at a slight expense might be turned to his own pecuniary gain.

MATTHEW JOSEPHSON, THE ROBBER BARONS 195 (Harcourt Brace & World 1934). See also id. at 122-24 (discussing the machinations of Daniel Drew in connection with the Erie Railroad (a firm known as “The Scarlet Woman of Wall Street”) wherein while serving as a director of the Erie, Drew participated in a scheme to water (that is massively dilute) and sell short Erie stock).

324 Stephen J. Lubben, Credit Derivatives and the Future of Chapter 11, 81 AM. BANKR. L.J. 405, 425-26 (2007). Thus bondholders may actually profit when “their” bonds lose if they happen to hold larger offsetting positions in credit-default swaps issued against those same securities. The notional values of credit default swaps are commonly many times greater than the aggregate amount of the bond issues on which they are based. Compare International Swaps & Derivatives Association, ISDA Mid-Year Market Survey Shows Credit Derivatives at $54.6 Trillion (Sept. 24, 2008), http://www.isda.org/press/press092508.html (stating that the aggregate outstanding notional amount of credit default swaps as of July, 2008 was $54.6 trillion) with Bank for International Settlements, Statistical Annex—Securities Markets—Table 16B: Domestic Debt Securities (noting that the aggregate outstanding U.S. corporate bond debt as of December 2008 was $2.914 trillion) available at: http://www.bis.org/publ/qtrpdf/r_qa0906.pdf#page=97.
tion plan or other legal consent rights.\textsuperscript{325}

Bankruptcy law will have to take account of these developments in determining whose consent is, or should be, relevant or transformative to avoid undermining the credibility of the bankruptcy process. To date, the complexity of the issues, coupled with a general ideological commitment to deregulated financial markets, has effectively deterred meaningful changes in law to address these concerns. The Great Recession of 2008-2009, and resulting disrepute into which financial deregulation has fallen, may open a window to begin to address this issue. More disclosure and more aggressive use of the court’s power to disqualify or designate votes under § 1126(e)\textsuperscript{326} are likely starting places. Greater regulation of the over-the-counter markets in financial derivatives may also mitigate some of these problems. Currently, the House of Representatives is considering legislation to bring regulation of over-the-counter derivatives more in line with the regulation of other publicly-traded financial instruments.\textsuperscript{327}

Disclosure of conflicts, and, in appropriate cases, disqualification from voting or committee service are obvious remedies. Requiring affirmative and ongoing timely disclosure of all long and short positions for all major creditor constituencies (including secured creditors or bondholders), insiders of the debtor and committee members and their respective affiliates would seem to be an easy first step.\textsuperscript{328} Similarly, disclosure should be required of all parties that appear in support or in opposition to critical motions to approve financ-


\textsuperscript{328} Currently Bankruptcy Rule 2019(a) does require significant disclosures where a group of creditors or interest holders is acting in concert as an unofficial committee in a chapter 11 case. See, e.g., In re Northwest Airlines Corp., 363 B.R. 701 (Bankr. S.D.N.Y. 2007); Fed. R. Bankr. P. 2019(a) (requiring disclosure of the name of each creditor, the nature and amount of each claim or interest held, the time the claim or interest was acquired—unless it was acquired more than one year prepetition—and the amount paid for the claim or interest). Although there was a significant effort by certain institutional investors to amend the Rule to delete these disclosure requirements, the proposed amendments to the Rule instead require even more disclosure of the real economic interest of the members of any group acting in concert in a chapter 11 case. See generally Report of the Advisory Comm. on Bankr. Rules, App. B (May 11, 2009), available at, http://www.uscourts.gov/rules/proposed0809/BK_Rules_Forms_Amendments.pdf.
ing, sales, or reorganization plans. Ethical walls may be of questionable efficacy for many hedge funds: Decisionmaking is not effectively compartmentalized in many of these institutions. Nevertheless, ethical walls may play a useful role in some cases if the institution suffering from the conflict of interest is large enough and decisionmaking within the institution sufficiently compartmentalized to make information barriers workable and enforceable.

The more difficult problem is whether holding claims and interests in different classes or short positions should disqualify a holder’s vote. Traditionally, the answer has been that each creditor is entitled to vote its claims and interests in accordance with its own economic interests as it sees them. Courts have authorized the holders of claims in multiple classes to vote those claims as they see fit in the holder’s aggregate economic interest. Greater scrutiny has sometimes been applied to claims acquired after bankruptcy for strategic purposes, but even in such cases courts have generally allowed creditors to vote claims in a junior class to advantage a senior position. Courts have been more skeptical of attempts to advantage junior interests or to acquire equity in a debtor by strategically acquiring and voting senior claims. Nevertheless, courts are understandably reluctant to disenfranchise large holders. The uncertainty regarding the voting rights of holders in these circumstances has no doubt deterred creditors from pursuing these strategies in some instances. Here again bankruptcy law has used ambiguity and uncertainty to induce settlements that avoid adjudication of difficult questions that may not be susceptible to ex-ante rule making.

For now the best available solution to control abuses of this kind may be to continue to rely on existing vague standards and ambiguities as a sword of Damocles over the heads of the parties. Nevertheless, the ever-increasing incidence of these conflicts of interest raises the question whether the traditional chapter 11 model of making reorganization turn on generating a broad consensus among the real economic parties in interest will remain viable in the long-term. That process hinges on identifying who the real economic interest holders are and bringing them to the bargaining table or at least the ballot box, an increasingly daunting enterprise. Thus, the lure of mandatory


330 In re Figter Ltd., 118 F.3d 635, 638–40 (9th Cir. 1997). A subsidiary issue is how the acceptances or rejections of acquired claims should be counted for purposes of determining acceptance by a majority in number. Id. at 640–41.


333 See supra note 332.
rules, or fiduciary models, or sales in lieu of plans, all of which seek to impose solutions on economic constituents outside the chapter 11 plan process.

ii. Committee as Proxy

Creditors' committees serve important functions and can act as a valuable check on debtors and secured creditors. The Bankruptcy Code, however, does not expressly contemplate the current practice of looking to the committee to give de facto binding consent to preplan case-dispositive settlements, financings and sales. Certainly the most salutary check on overweening committee power to consent to case-dispositive sales and financings would be to limit the scope of such proceedings and require case-dispositive restructuring transactions to take place generally through the plan process (over which committee powers are properly circumscribed) rather than on motion. To the extent, however, that committees assume the key proxy role of granting or withholding consent to case-dispositive transactions, even greater care must be taken in structuring representative committees. When serving as the de facto final decisionmaker, less emphasis on the coalition-building function of the committee and greater emphasis on its ability to represent faithfully the interests of a particular constituency is warranted. Important elements of the unsecured creditor body may have sharply divergent legal or economic interests. If so, multiple committees or subcommittees each representing a more unified constituency may be more appropriate surrogates than a single, divided, and conflicted committee when the case is likely to turn on whether the committee will consent to a particular motion rather than negotiate the terms of a plan that in turn must garner the consent of the requisite majorities of the holders. As the chapter 11 practice has moved away from plans toward case-dispositive financings, settlements and sales, a rethinking of the role, number and structure of committees is appropriate.

CONCLUSION

Thurman Arnold once famously described the bankruptcy reorganization process as:

a combination of a municipal election, a historical pageant, an antivice crusade, a graduate-school seminar, a judicial proceeding, and a series of horse trades, all rolled into one—thoroughly buttered with learning and frosted with distin-


335See supra notes 94-105 and accompanying text.

336See generally Bussel, supra note 108, at 1562–66.

337Cf. id. at 1609–10; Klee & Shaffer, supra note 107, at 1016.

338Thurman Arnold, The Folklore of Capitalism 230 (Yale 1937).
guished names. Here the union of law and economics is celebrated by one of the wildest orgies in intellectual history. Men work all night preparing endless documents in answer to other endless documents, which other men read in order to make solemn arguments. At the same time, practical politicians utilize every resource of patronage, demagoguery and coercion beneath the solemn smoke screen. The purpose of all this is (1) to prove that when corporations can not pay their debts they must surrender all their property to their creditors like other individuals, thus vindicating inexorable economic law; (2) to permit a practical treatment of a political situation without violating this folklore.

Arnold saw clearly. Practical accommodation is not ideologically pure, but nothing in the experience of bankruptcy practice suggests that the bankruptcy court should be a temple of ideological purity. Practically accommodating conflicting rights is a perfectly sensible way of dealing with the issues of business failure and financial distress. That practical accommodation of conflicting legal rights is accomplished partly by consent and partly by imposition.

Thus, although bankruptcy law generally determines consent on ordinary contract law standards, it relaxes, or, less commonly, heightens the showing required in a variety circumstances. Perhaps more importantly, bankruptcy law creates an environment that facilitates consent by exploiting inertia effects, by putting consent-generating structures in place (for example, committees, futures representatives, class voting rules, and stays of litigation), and by substituting vague standards that depend heavily on judicial discretion for more crisply defined nonbankruptcy rights. By diluting, reallocating, and inducing consent, bankruptcy law subtly alters the meaning of consent to achieve its ends. Sometimes, this manufactured consent, disguised by elaborate ritual and reinforced by the symbols of judicial authority, masks imposition. Other times, consent operates as a tool to be manipulated rather than an obstacle to be overcome. Finally, in some instances, bankruptcy law substitutes mandatory rules for consent to advance certain goals of the bankruptcy process, protect the rights of nonconsenting third parties or protect the putative consenting party itself.

Understanding and improving bankruptcy law requires continued sensitivity to the bankruptcy system's traditional reliance on party consent. Changes in the legal, business and social environment place pressure on the system to lower the bar further by enacting more mandatory rules, diluting the content of consent, altering party baselines and increasing judicial discretion by substituting vague standards for crisp rights. In some cases, bank-
Bankruptcy law has failed to respond promptly to these pressures and the system is saddled with overly-restrictive consent standards as we have seen in the home mortgage area, the one-consenting-class rule, the sale free and clear rules and some aspects of the chapter 11 solicitation process. In others, that pressure to lower the bar has resulted in an overreaction that unduly and unnecessarily devalues consent for expediency’s sake most particularly in connection with the substitution of settlement, financing and sale motions for chapter 11 reorganization. Sound bankruptcy reform requires an appreciation of the power, limits and application of the consent concept in the accommodation of conflicting rights and interests. Carefully recalibrating the uses of consent in bankruptcy will remain central to the evolution and legitimacy of bankruptcy law in the twenty-first century.
APPENDIX: THE CASE OF LANDLORDS.

The bankruptcy treatment of landlord interests and claims is a wonderful example of how clearly defined rights and liabilities can exacerbate collective action problems that bankruptcy may solve by altering baseline rights, creating ambiguity, exploiting inertia effects, and overriding consent requirements that exist under otherwise applicable nonbankruptcy law. Interestingly, it may also be a case where the commercial landlord lobby’s recent legislative victories, limiting the alteration of rights and ambiguity bankruptcy law previously imposed upon them, have turned pyrrhic.

Business bankruptcy debtors commonly lease commercial real property. Some enterprises, like large retail distribution businesses, lease large numbers of dispersed locations. The leases can be long term and involve a significant financial commitment on the part of the tenant. Moreover, leases customarily contain landlord-friendly provisions with respect to security, damages, and forfeiture of the leasehold. Although nonbankruptcy law to some degree regulates the harshest of these provisions, in general, such terms are enforceable outside bankruptcy. Even more importantly, on default by the tenant, landlords generally have ready recourse to prompt summary eviction proceedings in order to regain possession of the premises. On default, under nonbankruptcy law, a commercial landlord has a positive incentive to terminate promptly the defaulting party’s leasehold: Nonbankruptcy law entitles landlords to expedited repossession and also damages, which, in some jurisdictions, are measured by the entire future rent stream without discount to present value or mitigation. If the lease is below-market, the incentive to terminate and repossess is even greater. The rational response to these incentives is generally to oust defaulting tenants promptly. If the premises can be relet and damages collected, tenant default can permit the diligent landlord to collect rent twice for the same property. Even if damages cannot be collected, tenant default may provide the landlord with an opportunity to terminate a below market lease.

Since at least 1978, if not since the beginning of time, commercial landlords have complained that bankruptcy law improperly lowers and muddies up these clear, landlord-favorable nonbankruptcy rules. (Landlords are much more sanguine about features of bankruptcy law that alter the nonbank-

339 Milton R. Friedman & Patrick A. Randolph, Jr., Friedman on Leases §§ 20:4, at 20-31 to -32 (“New York and other states have statutes limiting landlord’s interests in and uses of security deposits”), 96, at 9-44 (cancellation of lease for damage or destruction to premises must be in good faith), 16:5.1, at 16-102 to -03 (notwithstanding anti-waiver clause, landlord may waive his right to penalties by conduct) (5th ed. 2004). See also Cal. Code Civ. P. § 1179 (antiforeclosure statute).
340 See e.g., Cal. Civ. P. Code § 1161(2) (West 2004); see also Friedman & Randolph, supra note 339, § 16:2.2, at 16-18 to -20.
341 Friedman & Randolph, supra note 339 at § 5.3.
ructy rights of mortgagees). The Bankruptcy Code alters landlords’ non-bankruptcy rights in several respects.

As a matter of policy, the Bankruptcy Code overrides or limits nonbankruptcy law that grants summary eviction rights; creates statutory liens or common law actions for distress for rent; enforces so-called ipso facto defaults; precludes cure and reinstatement of otherwise defaulted leases and provides damage claims for future rent (even if the damage claim is secured). The Bankruptcy Code also overrides or limits the operation of other contractual provisions commonly found in commercial leases that are generally enforceable under otherwise applicable nonbankruptcy law: (i) Anti-assignment clauses; (ii) covenants to maintain continuous operations or prohibit going out of business sales; and (iii) claims for future rent following lease termination. Finally, the Bankruptcy Code as originally enacted measured administrative rent by reasonable value (as opposed to contract rate), authorized extensions of the time for assumption and rejection in chapter 11 cases for cause up through the confirmation of a plan and permitted assignment in derogation of anti-assignment and use restrictions as long as the change in tenants did not undermine the basic economics for the landlord.

Starting with the 1984 amendments and culminating in 2005’s BAPCPA, Congress has drawn increasingly bright lines to protect landlords from these

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342 See supra notes 118-32 and accompanying text.

343 Courts are split whether a solvent debtor may properly file a bankruptcy petition for the primary purpose of taking advantage of Bankruptcy Code § 502(b)(6). 11 U.S.C. § 502(b)(6) (2006). Compare, e.g., In re Integrated Telecom Express, Inc., 384 F.3d 108, 118-20 (3d Cir. 2004) (chapter 11 petition filed by solvent debtor solely to use § 502(b)(6) to limit landlord’s recovery on lease was not filed in good faith and was subject to dismissal under § 1112(b) as a bad faith filing) with, e.g., In re PPI Enters. (U.S.), Inc., 324 F.3d 197, 211-12 (3d Cir. 2003) (holding that it is not necessarily bad faith for the debtor to file a chapter 11 petition for the primary purpose of capping a landlord’s lease rejection claim under § 502(b)(6)).


346 U.S.C. § 365(b)(2)(A)-(C), (e)(1) (2006). In contrast, for many years, the Bankruptcy Act of 1898 enforced clauses terminating leases automatically on the filing of a bankruptcy case. See Finn v. Meighan, 325 U.S. 300, 301-02 (1945) (Chapter X reorganization case interpreting Bankruptcy Act § 70b, 11 U.S.C. § 110b (1940) (repealed 1979) ("an express covenant that an assignment by operation of law or the bankruptcy of a specified party thereto or of either party shall terminate the lease . . . is enforceable"). Accord Smith v. Hoboken R.R., 328 U.S. 123, 126-28 (1946) (applying Bankruptcy Act § 70b in a § 77 railroad reorganization case, subject to other statutory requirements).


349 Hall v. Perry (In re Cochise Coll. Park, Inc.), 703 F.2d 1339, 1354-55 (9th Cir. 1983); Brown v. Danning (In re Frederick Meats, Inc.), 483 F.2d 951, 952 (9th Cir. 1973) (per curiam).


vague standards that encouraged renegotiation or reinstatement of leases.\textsuperscript{352} The result has been to undermine significantly access to chapter 11 reorganization for major retailers and other parties with large numbers of commercial leaseholds. Moreover, the changes in law strengthening landlord consent rights create perverse incentives for landlords to hold out even if repossession is not in their economic interest.\textsuperscript{353} We discuss specific current alterations of landlord nonbankruptcy baselines below.

1. Damages Cap

Ironically, the statutory limitation on landlords’ rejection damage claims, derives from an amendment to the Bankruptcy Act of 1898 supported by landlords,\textsuperscript{354} to overcome the now-obsolete requirement of provability! Under the Bankruptcy Act of 1898, in straight bankruptcy cases only “probable” claims\textsuperscript{355} could be allowed.\textsuperscript{356} Arguably, valid state law claims (such as a claim for future rents under a terminated lease) might not be provable in bankruptcy.

In 1934, the Supreme Court held that a landlord’s claim for loss of future rents, based on the trustee’s rejection of the lease, was not provable under the Bankruptcy Act.\textsuperscript{357} The Court found that the statute establishing provability of contingent claims based on contracts did not extend to real property leases.\textsuperscript{358} The Court acknowledged that “[t]he issue is not one of power, for plainly Congress may permit such claims or exclude them.”\textsuperscript{359} Congress promptly amended the Act, making a landlord’s claim for future rent (and other damages) under a lease of realty provable in straight bankruptcy cases,


\textsuperscript{354}See Oldden v. Tonto Realty Corp., 143 F.2d 916, 919-20 (2d Cir. 1944) (recounting the competing interests leading to the legislative compromise).

\textsuperscript{355}The concept of “provability” was defined in Bankruptcy Act § 63, 11 U.S.C. § 103 (1976) (repealed 1979). As such, the Supreme Court has ruled that whether a claim is provable is a federal question. See, e.g., Tindle v. Birkett, 205 U.S. 183, 185-86 (1907).


\textsuperscript{358}Bankruptcy Act § 63a(4), 11 U.S.C. § 103a(4) (1940) (repealed 1979). See Manhattan Props., Inc., 291 U.S. at 332 (stating that “[T]he sole inquiry is the intent of the Act” and discussing a detailed history of the proof and allowance of contingent claims in bankruptcy).

\textsuperscript{359}See Manhattan Props., Inc., 291 U.S. at 332.
but capped the claim in dollar amount at one year's rent.\textsuperscript{360} In 1938, Congress re-enacted this provision,\textsuperscript{361} and applied it in reorganization cases,\textsuperscript{362} capping a landlord's rejection damages claim in reorganization cases at three years' rent.\textsuperscript{363}

The 1978 Code eliminated the provability concept, but retained the cap on a landlord's claim for rejection damages\textsuperscript{364} in a modified form.\textsuperscript{365} The 1978 Code combined the Bankruptcy Act formulae\textsuperscript{366} so that in both liquidations and reorganizations, a landlord's rejection damages claim is capped at the greater of one year's rent or 15 percent of the remainder of the term of the lease, not to exceed three years' rent.\textsuperscript{367} The legislative history notes that the cap "is designed to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering a dividend from the estate."\textsuperscript{368}

Although this description of the cap refers to other unsecured claims, the legislative history expressly disclaims any intention to overrule Oldden v. Tonto Realty Co.,\textsuperscript{369} which Congress summarized as holding that "to the extent that a landlord has a security deposit in excess of the amount of his [capped] claim ... , the excess comes into the estate."\textsuperscript{370} Accordingly, under the Bankruptcy Code, courts uniformly cap both a landlord's secured and its


\textsuperscript{361}11 U.S.C. § 103a(9) (1940) (repealed 1979).


\textsuperscript{364}Importantly, courts have held that the cap applies only to a landlord's rejection damage claim and not to claims that the landlord would have had against the tenant even in the absence of rejection. See Saddleback Valley Cnty. Church v. El Toro Materials Co. (In re El Toro Materials Co.), 504 F.3d 978, 981-82 (9th Cir. 2007) (refusing to apply statutory cap to limit environmental clean up claim); Leslie Fay Cos. v. Corp. Prop. Assocs. (In re Leslie Fay Cos.), 166 B.R. 802, 810-11 (Bankr. S.D.N.Y. 1994) (refusing to cap landlord's claim for damages from breach of exercised option to purchase contained in lease because exercised option gave rise to independent land sales contract not subject to § 502(b)(6)).


\textsuperscript{366}See Staff of Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 95th Cong., Table of Derivation of H.R. 8200, 7 (Comm. Print 1977) (identifying Bankruptcy Act §§ 63a(9), 202, 353 & 458 as sources for the limitation on landlords' rejection damage claims).

\textsuperscript{367}H.R. Rep. No. 95-595, at 353 (1977) ("The sliding scale formula is new, is designed to protect the long-term lessor, and is included as a replacement of the dual provisions in current law of a three-year test for reorganization cases and a one-year test for liquidation cases.").

\textsuperscript{368}Id.

\textsuperscript{369}143 F.2d 916, 921 (2d Cir. 1944).

unsecured rejection damages claim, at least when the claim is secured by a security deposit or other property of the estate.\textsuperscript{371} When a landlord has a letter of credit to secure the rejection damages claim, however, courts have split on whether to apply the cap to the letter of credit. Some courts apply the cap, reasoning that the letter of credit is the functional equivalent of a security deposit.\textsuperscript{372} Other courts, relying on the independence principle of letter of credit law, allow the landlord to recover third-party collateral or indebtedness without reducing the capped claim,\textsuperscript{373} at least where the letter of credit is not secured by property of the estate.\textsuperscript{374}

2. Assignment

Outside bankruptcy, a landlord may contractually prohibit assignment of a tenant's leasehold interest or condition the assignment on the landlord's written consent (which in some states may not be unreasonably withheld).\textsuperscript{375} Lease provisions discouraging assignment by allocating any economic benefit to the landlord,\textsuperscript{376} restrictive use clauses,\textsuperscript{377} or cross default clauses that per-

\textsuperscript{371}See, e.g., In re Handy Andy Home Improvement Ctrs., 222 B.R. 571, 574 n.6 (Bankr. N.D. Ill. 1998) ("Courts addressing this issue have invariably reached this result."). See also Olden v. Tonto Realty Corp., 143 F.2d 916, 920 (2d Cir. 1944) ("Nor should a landlord obtain an advantage beyond that usually accorded under the statute merely because he has been shrewd or economically powerful enough to have obtained a substantial deposit as security. The contrary result would mean that a landlord with security would be able to exceed the statutory limit by as much as the security he holds, and that landlords would receive different treatment in bankruptcy proceedings, depending upon the existence and size of the security in their possession.").

\textsuperscript{372}See e.g., In re PPI Enters. (U.S.), 324 F.3d 197, 210 (3d Cir. 2003) (interpreting language of lease to evidence parties' intent to have letter of credit serve as security deposit); In re Mayan Networks Corp., 306 B.R. 295, 300-01 (B.A.P. 9th Cir. 2004) (treat[ing] secured letter of credit as equivalent of security deposit based on the impact that a draw on the letter of credit would have on the bankruptcy estate); but see also id. at 301 (Klein J., concurring) ("The caps cannot be construed to reduce what landlords and former employees can recover from sources other than the property of the estate."). Cf. In re AB Liquidating Corp., 416 F.3d 961, 965 (9th Cir. 2005) (subtracting the proceeds of a letter of credit from the landlord's capped rejection damages claim).

\textsuperscript{373}See In re Stonebridge Techs., Inc., 430 F.3d 260, 269-71 (5th Cir. 2005) (holding that under the independence principle landlord may draw full amount of the letter of credit unless he also seeks to recover damages from the estate based on termination of lease supported by the letter of credit). Cf Ivanhoe Bldg & Loan Ass'n v. Orr, 295 U.S. 243, 245-46 (1935) (holding that the presence of and realization on third party collateral securing an unsecured claim against the debtor does not diminish a creditor's allowed unsecured claim against the bankruptcy estate).

\textsuperscript{374}See Mayan Networks Corp., 306 B.R. at 300-01 (treat[ing] secured letter of credit as equivalent of security deposit based on the impact that a draw on the collateralized letter of credit would have on the bankruptcy estate).

\textsuperscript{375}Friedman & Randolph, supra note 339, at § 7:3.4(a)(d) (5th ed. 2004); Restatement (Second) of Property: Landlord Tenant § 15.2(2) (1977) ("A restraint on alienation without consent of the landlord of the tenant's interest in the leased property is valid but the landlord's consent to an alienation by the tenant cannot be withheld unreasonably, unless a freely negotiated provision in the lease gives the landlord an absolute right to withhold consent.").

\textsuperscript{376}Cal. Civ. Code §§ 1995.010-270 (West 2008); see also Food Pantry Ltd. v. Waikiki Bus. Plaza, 575 P.2d 869, 877-78 (Haw. 1978) (finding that upon tenant's breach of non-assignment covenant, lessee must either rescind assignment or pay landlord excess rents generated by assignment). But see Ilkchoooyi
mit termination or acceleration of all leases between the landlord and tenant on the occurrence of any default in any of the leases, are all generally enforceable under nonbankruptcy law.378

A tenant’s bankruptcy filing substantially alters the landlord’s baseline rights in commercial leases, somewhat less so in the special case of shopping center leases.379 The Bankruptcy Code broadly invalidates anti-assignment provisions permitting a debtor in possession to assume and to assign unexpired real property leases “notwithstanding a provision in an . . . unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such . . . lease . . . .”380 Moreover, the Bankruptcy Code overrides contractual or legal provisions purporting to alter or terminate a lease or a right or obligation thereunder on account of assumption or assignment of the lease.381 Accordingly, notwithstanding contractual lease term or applicable nonbankruptcy law restricting or conditioning assignment, a debtor in possession who can establish by a preponderance of the evidence adequate assurance of future performance by the assignee may freely assign an assumed lease.382 Moreover, unlike the case under nonbankruptcy law, following the assignment, the bankruptcy estate is released from any obligation under the lease.383

Just as Congress chose to override ipso facto defaults because they would deprive the estate of valuable assets simply on account of the debtor’s bankruptcy filing, it overrode anti-assignment clauses that would otherwise deprive the bankruptcy estate of the economic value of its leaseholds if the leased premises were not needed by the reorganized firm. This is particularly

v. Best, 37 Cal. App. 4th 395, 45 Cal. Rptr. 2d 766 (1995) (finding lease provision requiring tenant to remit 75% of consideration received from transferee in respect of covenant not to compete unconscionable).


37911 U.S.C. § 365(a)-(g) & (k)-(m) (2006).


38311 U.S.C. § 363(k) (2006). In general, under nonbankruptcy law an assignor remains liable to the landlord unless the landlord affirmatively releases the assignor in consenting to the assignment. The assignor, of course, will ordinarily have rights of reimbursement or indemnity from the defaulting assignee. FRIEDMAN & RANDOLPH, supra note 339, § 7.3.1(b) at 7-99 to -100.
important if leased premises are a vital part of business units that the estate desires to sell as a going concern.

Landlords have not embraced this policy decision and have devised numerous lease provisions to more or less openly discourage or obstruct assignment. Nevertheless, where the bankruptcy court determines that a lease provision in essence operates as an anti-assignment clause, it will override the clause and permit the assignment. Thus, bankruptcy courts have struck down overly restrictive use clauses as anti-assignment clauses. Likewise, bankruptcy courts have refused to enforce provisions terminating the lease on a change in ownership, increasing the rent on assignment, or allocating to the landlord 75% of the appreciated value of a lease as a condition to its assignment. Courts are split, however, over whether a provision giving a landlord a right of first refusal operates as an anti-assignment clause. Likewise cross-default clauses, while inherently suspect, are not per se invalid as anti-assignment clauses.

3. Going Dark

Commercial leases commonly provide that the landlord may terminate the lease if the tenant fails to use the premises as set forth in the lease. In particular, leases frequently prohibit a tenant from conducting a going out of business sale or failing to operate its business at the premises for a specified time interval. The former clause is often referred to as a "going out of busi-

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384 See In re U.L. Radio Corp., 19 B.R. 537, 544-45 (Bankr. S.D.N.Y. 1982) (permitting premises let as an electronics sales and service store to be used as a bistro); In re Johns, 5 Bankr. Ct. Dec. 1074 (Bankr. D. Nev. 1979), available at: 1979 Bankr. LEXIS 687, at *6-7 (permitting premises let to adult discotheque to be used as male striptease house). But see In re Grudoski, 33 B.R. 154, 155-56 (Bankr. D. Haw. 1983) (finding that the landlord's refusal to consent to change in use from delicatessen to sushi restaurant was unreasonable); In re Evelyn Byrnes, Inc., 32 B.R. 825, 831 (Bankr. S.D.N.Y. 1983) (excusing literal compliance with lease use clause).

385 See In re Crow Winthrop Operating P'ship, 241 F.3d 1121, 1123-24 (9th Cir. 2001) (finding change-in-ownership provision unenforceable because it effectively served as an anti-assignment clause).


390 See In re Liljeborg Enters., 304 F.3d 410, 444-45 (5th Cir. 2002) (cross-default provision in executory contract was enforceable so that incurable breach of lease agreement by debtor's affiliate precluded debtor from assuming pharmacy agreement; although cross-default clauses are inherently suspect, they are not per se invalid where the nondebtor party would not have entered into the transaction absent the cross-default clause).
ness" or "GOB" clause and the latter a "going dark" clause. Applicable nonbankruptcy law may grant the landlord the right to terminate the lease for breach of such clauses.\(^{391}\)

If the lease provides for percentage rents based on revenue generated at the premises, GOB or going dark clause violations may deprive the landlord of rent and could be considered monetary defaults that must be cured incident to assumption, subject of course to a showing of adequate assurance of future performance upon assignment. Historically, however, landlords contended, with mixed success, that violation of such clauses also created incurable nonmonetary defaults precluding assumption or assignment of the lease in bankruptcy.\(^{392}\)

In 2005, Congress enacted a complex amendment to the Bankruptcy Code setting forth three different rules regarding the requirement to cure nonmonetary defaults on assumption of executory contracts and unexpired real property leases.\(^{393}\) With respect to executory contracts other than leases, the amendment only excused cure of nonmonetary defaults that involved a penalty rate or penalty provision. For real property leases, Congress distinguished between residential and nonresidential leases. Defaults arising from any failure to perform nonmonetary obligations (penalty or not) in residential leases are excused if the trustee cannot cure such defaults by performing at and after the time of assumption. For nonresidential real property leases, however, nonmonetary defaults, other than going dark defaults or penalties, must be cured. Going dark is treated specially: The trustee must perform in accordance with the lease from the time of assumption and compensate the landlord for pecuniary losses caused by the default, but need not otherwise cure past going-dark defaults.

The net effect of these provisions is clouded when the real property lease is part and parcel of a larger executory relationship such as a franchise agree-


\(^{392}\)Compare In re Joshua Slocum, Ltd., 99 B.R. 250, 259 (Bankr. E.D. Pa.) (overriding going dark provision and going-out-of-business provision unless these are monetary defaults and the landlord can show economic detriment), aff’d, 121 B.R. 442 (E.D. Pa. 1989), rev’d on other grounds, 922 F.2d 1081, 1090-92 (3d Cir. 1990) (enforcing minimum sales provision in shopping center context) with In re Claremont Acquisition Corp., 113 F.3d 1029, 1034-35 (9th Cir. 1997) (holding that Bankruptcy Code excuses compliance with penal nonmonetary defaults, but not ordinary incurable defaults such as failure to operate); In re Deppe, 110 B.R. 898, 904-05 (Bankr. D. Minn. 1990) (holding that failure to operate gasoline service stations for nineteen days created incurable default under Petroleum Marketing Practices Act).

ment. If the debtor violates a going-dark clause in a nonresidential real property lease, then the bankruptcy estate may nevertheless assume the lease if the trustee operates the premises in accordance with the lease from the time of assumption and compensates the landlord for pecuniary losses caused by the default.\textsuperscript{394} If the debtor also violates a going-dark clause in the related franchise agreement, however, then the landlord/franchisor may assert that the bankruptcy estate may not assume the franchise agreement based on the incurable default (unless it is a penalty provision).\textsuperscript{395} As a matter of bankruptcy policy, however, when the lease is an integral part of a related franchise agreement, overriding the going-dark default makes sense as long as the landlord/franchisor is protected on a going forward basis as in a stand-alone real property lease. We expect most courts will interpret the relevant statutes to alter the parties’ nonbankruptcy baseline in this respect, much as the law overrides ipso facto clauses and anti-assignment clauses.

4. Summary.

As we have seen, the Bankruptcy Code alters the nonbankruptcy rights and remedies of landlords in numerous respects. Under nonbankruptcy law, landlords enjoy clear and crisp rights upon default and can promptly enforce the terms of their leases or regain possession of their premises. After bankruptcy, however, landlords’ rights generally become far murkier, in some sense constituting a wealth transfer from the landlord to the reorganizing debtor or its creditors. These changes may induce landlords to renegotiate the terms of leases to facilitate the continued operation of the reorganized business rather than repossess. As amendments to the Bankruptcy Code have strengthened and clarified the rights of landlords, however, it has become increasingly difficult to reorganize firms whose value is tied to continued operation at leased premises. For example, unless the landlord agrees to an extension, one 2005 amendment absolutely limits to 210 days the time within which the estate may assume or reject a nonresidential real property lease under which the debtor is the lessee.\textsuperscript{396} This seven-month period is unreasonably short in many chapter 11 cases particularly those filed by large retailers with numerous widely dispersed leased locations. It may be that Circuit City was doomed to liquidate in the economic climate of 2008-2009,\textsuperscript{397} but its landlords are hardly better off for being promptly put back in possession of their (depreciated and vacant) properties in a distressed market,


\textsuperscript{395} 11 U.S.C. § 365(b)(2)(D) (2006). See also In re BankVest Capital Corp., 360 F.3d 291, 301 (1st Cir. 2001); Claremont Acquisition Corp., 113 F.3d at 1034-35.


\textsuperscript{397} But see supra note 353.
as the BAPCPA amendments de facto required, rather than earn administrative rent. Although landlords may consent to further extensions of the time for assumption and rejection, collective action problems may well preclude obtaining those consents. Individual landlords may find it in their interest to withhold consent or may withhold consent strategically, and as other landlords observe that opt-out behavior it may be increasingly difficult to obtain consents to extensions beyond the statutory limit, even if it is in all parties collective interest that the debtor occupy leased premises in exchange for paying timely administrative rent pending the reorganization effort.