ESSAY

THE BANKRUPTCY FIRM

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INTRODUCTION

Bankruptcy scholars spend too much time thinking about distributional norms and not enough assessing the impact of bankruptcy rules on the quality of governance in Chapter 11. That, in short, is the thesis of *The Bankruptcy Partition*, the contribution of Professors Baird, Casey, and Picker to this symposium.[1] Of course, the authors being who they are, the Article is about much, much more. This brief response seeks to draw out some of the article's themes and, in the last Part, to suggest an approach to thinking about the nature of the bankrupt firm that could deepen and extend a conversation the authors usefully begin.

I. THE ROLE OF THE FIRM IN BANKRUPTCY

The Bankruptcy Partition flows from a simple premise—that reorganization law seeks (or in any case should seek) to maximize the value of the bankrupt firm.[2] It sounds like a consensus statement of purpose, but in fact it is not so obvious. This is because firm-value maximization is posited in contrast to another plausible norm with which it is often (mistakenly) elided—that of investor-wealth maximization. In a frictionless world, these two norms have identical content. But in the real world, as the authors point out, maximizing firm value often means *not* maximizing investor wealth.[3] More specifically, a focus on firm value

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1 Douglas G. Baird, Anthony J. Casey & Randal C. Picker, *The Bankruptcy Partition*, 166 U. PA. L. REV. 1675 (2018). It is also the point of departure of Professor Rasmussen's contribution. *See generally* Robert K. Rasmussen, *Taking Control Rights Seriously*, 166 U. PA. L. REV. 1749 (2018).

2 Baird, Casey & Picker, *supra* note 1, at 1679.

3 *Id.* at 1682. ("The focus, however, is upon maximizing the value of *the estate*, not on the total return to creditors as a group."); *Id.* at 1683 ("The proper focus is entirely on what goes to creditors *on account of their claims against the estate*.").

implies that bankruptcy decision processes should, insofar as possible, ignore the effects of firm activity on the value of investors' "outside" investments.[4]

To illustrate the contrast between the competing norms, suppose a debtor is looking to sell a factory under § 363.[5] Two potential buyers emerge. One is an existing creditor of the debtor; the other, a stranger. And suppose further that the creditor–-bidder will benefit immensely by acquiring the factory, but, because of liquidity constraints, can afford to pay slightly less than the stranger can. If the aim of bankruptcy were to maximize investor wealth, then this creditor-bidder's plight would matter to the decision calculus. It might make sense to channel the assets his way, even though doing so would promise to reduce other investors' recoveries, because his gains could exceed the sum of the others' losses. Not so under a firm-value maximization norm. Where firm value is the aim, top dollar for the seller is all that counts.

As this example suggests, to assert the firm-value norm is to advocate a conflict resolution process destined to allocate resources inefficiently (viewed ex post). If firm-value maximization is desirable, it is due to the norm's offsetting, salutary effects on ex ante investment decisionmaking. Among other things, a focus on firm value, like the rule of limited liability, helps to make investment interests fungible and so opens up secondary markets. And so one's investment in a firm typically carries with it the implicit agreement that one's private interests other than those embodied in the investment contract itself will be excluded from management's decision calculus.[6] The logic has been central to the literature on asset partitioning for decades.[7] If its implications are striking in this

4 I'll return in Part III to the question of what, in the article's scheme, distinguishes an asset of the firm from an asset held outside the firm. For now, think of outside assets as the set of investors' legal rights other than those that are obligations of the debtor. Because by accounting, identity assets equal liabilities plus equity, saying that bankruptcy should maximize the value of a firm's assets is equivalent to saying bankruptcy should maximize the total returns on all of the firm's securities and other legal obligations. The size of returns on *other* investments—which is to say, investors' outside assets—is irrelevant under this scheme. Thus, unless the value of "outside" assets is positively related to the value of firm assets in a particular case, outcomes under a firm-value and an investor-wealth rule of decision will diverge.

5 *See* 11 U.S.C. § 363(b) (2012) (authorizing, with judicial consent, the use or sale of debtor property outside the ordinary course of business).

6 In her contribution to this symposium, Professor Jacoby calls attention to another defect of the investor-wealth maximization norm—namely, its tendency in practice, if not theory, to disregard the interests of constituents with relatively little voice. Melissa B. Jacoby, *Corporate Bankruptcy Hybridity*, 166 U. PA. L. REV. 1715,1730-31 (2018).

7 *See, e.g.*, Kenneth Ayotte & Henry Hansmann, *Legal Entities as Transferable Bundles of Contracts*, 111 MICH. L. REV. 715, 748 (2013); Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1, 4-5 (2013); Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement*, 124 YALE L.J. 2680, 2683-84 (2015); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 390 (2000); Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515, 517-18 (2007); George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1104 (2004).

context, it is only because bankruptcy scholarship and case law have seldom taken seriously the distinction between a firm's value and the aggregate creditor recovery its reorganization produces.[8] *The Bankruptcy Partition* does a valuable service in bringing this distinction to the surface.

In any case, the firm-value maximization norm does a lot of work in the article. One thing it does is to analytically decompose the creditors' bargain. Bankruptcy law, under the authors' approach, is implicitly modeled as having three distinctive functions: first, to define a "firm"; second, to charge the bankruptcy court with the task of maximizing the value of that firm, and to give it the tools necessary to do so; and third, to distribute claims on the reorganized firm. The authors set aside this third step—distribution—and focus on the first two functions, to which I will now turn, in reverse order.

II. INFORMATION PRODUCTION

A major aim of *The Bankruptcy Partition* is to persuade readers that the imperative to maximize *firm* value animates much of what is most interesting in reorganization law today. The article thus seeks to reorient debate about controversial practices, away from questions of cash flow rights (or distribution) and toward the design of control and influence rights. And the article makes a strong case that a number of features of reorganization practice are best judged by their capacity to produce reliable information about the effect of a proposed action on firm value *rather than* investor wealth—what the authors call "policing" the partition.

The intuition is developed mainly with examples. Thus, for instance, critical vendor orders and roll-ups are assessed according to their expected effect on firm value rather than their aberrant tendency to violate distributional norms.[9] The article's practical conclusions on these topics are not inconsistent with leading authorities, such as *In re Kmart*.[10] To the extent paying a prepetition claim in full is likely to increase the debtor's value, doing so is presumptively proper.[11] But the article's approach helps to explain where and why bankruptcy judges should be skeptical about payments to some prepetition creditors more than others.

8 For a more general evaluation of the tradeoff between ex ante and ex post efficiency in bankruptcy, see David A. Skeel, Jr. & George Triantis, *Bankruptcy's Uneasy Shift to a Contract Paradigm*, 166 U. PA. L. REV. 1777 (2018).

9 Baird, Casey & Picker, *supra* note 1, at 1705-14.

10 *In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004).

11 A puzzle *The Bankruptcy Partition* exposes but which it does not seek to resolve is why debtors in possession should have flexibility to pay prepetition creditors during the pendency of a bankruptcy but not through a plan of reorganization. More generally, why might a bankruptcy judge's application of discretion be expected to maximize firm value in the early days of bankruptcy but not at its end? For a speculative explanation, see Vincent S.J. Buccola, *The Janus Faces of Reorganization Law*, 44 J. CORP. L. 1, 27-28 (2018).

To maximize firm value, the bankruptcy judge needs tools to harness investors' private information and check their self-interest. A number of discretionary powers are explained instrumentally along these lines. To take just one of the authors' examples, consider the power to designate votes cast in bad faith. There is general agreement that it is proper to designate the vote of a creditor holding a large short interest—to prevent the creditor from willfully tanking the debtor.[12] Without recourse to the firm-value maximization objective, however, this intuition and the designation power itself are hard to square with ordinary norms of commercial self-interest.

By focusing on this idea—that a judge's goal is to maximize firm value and *not* creditors' total returns—*The Bankruptcy Partition* helps to explain and unify what otherwise might seem to be puzzling or unrelated features of reorganization law. The judge wants to maximize the value of the firm, but the investors, who exert influence over the ultimate disposition of the estate's assets, each seek to maximize their respective private returns. The imperfect correlation between firm value and investors' total returns causes problems. Of course, we have long understood that conflict in bankruptcy naturally results from the hierarchical nature of investors' claims. Neither the fully secured senior lender nor the underwater junior interest wants strictly to maximize firm value, and bankruptcy supplies a means to adjudicate their disagreement. A significant contribution of the article is to highlight the ways bankruptcy law must also, and for the same reason, take account of creditor interests altogether outside the bankruptcy. The more likely it is that the value of an investor's outside investments are inversely related to the value of the bankrupt firm, the more skeptically the judge must view that investor's influence over the debtor in possession and, eventually, plan confirmation.

III. Defining the Firm in Bankruptcy

Let me turn now to the antecedent issue I have so far bracketed: what exactly is this firm (or what should it be) whose value the bankruptcy process is meant to maximize?[13] The article answers this question—what defines the firm in bankruptcy?—by introducing a new analytical construct: the bankruptcy partition. The authors do not explicitly define the partition, so I will take the liberty of interpretation. The bankruptcy partition describes a pool of assets over which the trustee and bankruptcy judge have, or may assert, control rights. This

12 Baird, Casey & Picker, *supra* note 1, at 1695-96. *See also* 11 U.S.C. § 1126(e) (2012) ("On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.").

13 Note that this question arises only under the firm-value maximization norm and not under the investor-wealth maximization norm. That is, we care what counts as "the firm" only if the boundary itself supplies reasons for acting in certain ways, which it does not do under a general wealth-maximization norm.

pool of assets is closely related to, but not identical with and systematically greater than, the assets that would belong to the debtor firm outside bankruptcy in a counterfactual world where no petition for relief was filed. For the authors, it is this broader, bankruptcy-specific set of assets whose joint value reorganization law should seek to maximize.

Inside the partition lies, first, the entirety of the statutorily defined "estate"—roughly speaking, all of the inventory, equipment, leases, contracts, and so on, that the debtor held before bankruptcy—and, second, all property held by others but subject to the trustee's avoidance powers.[14] So far, so good. Think what one will about the avoidance powers as a normative matter; at least one can agree that under existing law they in fact bring assets within the control of the trustee and court.

Additional items that lie inside the partition warrant further discussion.[15] Some of these additional items are brought within the bankruptcy partition as a matter of course in every case. The security interest is a prime example.[16] Under ordinary principles of commercial law, the security interest allows a lender to foreclose on collateral upon the debtor's default. A major function of the automatic stay, however, is to divest secured lenders of this very right.[17] The stay can thus be recast as a transfer of state-contingent control rights over the collateral from the lender to the trustee. In the article's idiom, bankruptcy sweeps the security interest inside the partition. To be sure, the law protects the lender's distributional interest by requiring that she be adequately protected during the bankruptcy and that she receive the "indubitable equivalent" of her secured claim under a plan of reorganization.[18] But the law also invests the trustee and the court with control of the foreclosure right, and consequently it is within the pool of assets whose value bankruptcy ought, in the authors' view, to maximize.[19]

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14 *See* 11 U.S.C. § 541(a) (2012) (describing the estate); *Id.* §§ 544–45, 547–49 (enumerating the trustee's avoidance powers).

15 The authors distinguish municipal bankruptcy, saying that deviations from joint-value maximization there are more acceptable, on the ground that Chapter 9 does not create an estate. Baird, Casey & Picker, *supra* note 1, at 1713. It is an accurate description of the law, but the existence of a statutory estate is neither here nor there under the article's schema. What matters for the schema is the authors' analytical construct, the partition, and not the "estate" with which bankruptcy lawyers are familiar. The better explanation of the uneven distributions in Detroit's bankruptcy, to which the authors refer, is Chapter 9's "legislative" character. *See generally* Vincent S.J. Buccola, *Law and Legislation in Municipal Bankruptcy*, 38 CARDOZO L. REV. 1301 (2017).

16 Baird, Casey & Picker, *supra* note 1, at 1684.

17 11 U.S.C. § 362(a) (2012).

18 *Id.* § 362(d)(adequate protection); § 1129(b)(2)(A)(iii) (indubitable equivalent).

19 Note that, as a descriptive matter, it is not clear that bankruptcy judges are to *jointly* maximize the value of security interests and property belonging formally to the estate. If the debtor cannot adequately protect the value of the creditor's secured claim, the court is to allow repossession under 11 U.S.C. § 362(d)—even where doing so fails to maximize joint value. As a descriptive matter, security interests might more accurately be imagined as constraints on the firm-value maximization norm.

Other items seem to come inside the partition selectively, by assertion of judicial authority. An example—about which the authors are ambivalent—is a cause of action belonging to one or more of a debtor's creditors against a third party.[20] This is the familiar problem of the third-party release.[21] Its descriptive logic parallels that of the security interest. A judge who enjoins creditor litigation or compromises a creditor's claim effectively brings that claim inside the partition—she asserts control of it—and should therefore seek to maximize its value alongside the debtor's other assets.

But should a bankruptcy court have control over creditors' claims in the first place? The article acknowledges the case against third-party releases, especially where the claims to be released belong (outside bankruptcy) to only one or a minority of creditors.[22] But the article also credits third-party releases with the capacity to achieve what it calls "global peace" where collective-action dynamics might otherwise overwhelm.[23] And the authors point out that a rule of full compensation for those whose nonbankruptcy rights are compromised can, at least in principle, eliminate the prospect of strategic "commandeering."[24] On balance, at least on my reading, the authors seem to be moderate supporters of a third-party release power.

But on what principle? How is the partition to be defined? What, in other words, distinguishes the assets that bankruptcy should "bring inside" the partition from those that should remain under the control of their nonbankruptcy owners? The article discusses "bankruptcy purposes," but it could be more explicit about what those are. Indeed, if I have a complaint about the article, it is the lack of a limiting principle on the bankruptcy partition's scope. The problem is this: any time one asset's disposition could affect the value of an asset belonging to the debtor, there is, under the authors' mode of analysis, at least a prima facie case for bringing the outside asset inside the partition. This is because there is always a chance that a Pareto-efficient trade—*across the partition*, so to speak—will fail to materialize if the court does not assert control over both assets concurrently. As soon as three parties

20 *See* Baird, Casey & Picker, *supra* note 1, at 1687-90 (discussing third-party releases).

21 *Compare, e.g.*, Resorts Int'l, Inc. v. Lowenschuss (*In re* Lowenschuss), 67 F.3d 1394, 1402 (9th Cir. 1995) (holding that § 524(e) of the Code prohibits third-party releases), *with* MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89, 90 (2d Cir. 1988) (affirming the bankruptcy court's release of some of the debtor's insurers from future litigation).

22 Baird, Casey & Picker, *supra* note 1, at 1687-88.

23 *Id.* at 1688.

24 *Id.* In this sense, the article's analysis of third-party releases looks much like its analysis of the security interest. *Cf. id.* at 1684 ("[T]he requirement that the secured creditor be given the indubitable equivalent of its collateral ensures that the partition is not shifted simply to give general creditors value that they could not enjoy outside of bankruptcy."). Indeed, compensation might be a constitutional requirement under the Takings Clause. *Cf.* Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 601-02 (1935) (holding that mortgagee's interest is property interest within the meaning of the Takings Clause).

are involved, there is always a collective-action problem to be solved, always a "global peace" to be brokered.

The authors are the people who taught me Coase, so I am sure they recognize my challenge as a restatement of the question underlying his 1937 paper.[25] Coase supplies the general answer, too: the limit on the partition's scope is the price of knowledge.

How, in particular, does this limit manifest? As the authors point out, the act of bringing an asset inside the partition will have a redistributive tinge and so will provoke strategic reaction unless the person whose control rights are to be nullified is fully compensated[26]—hence the "indubitable equivalent" rule discussed above. But compensation requires an appraisal of the asset's value. Valuing collateral on a lift-stay motion is hard enough, even with a number of market checks often being available. How much more appraisal should one wish for? I don't know. But I do know that if one ignores the informational burden courts face in valuing assets and the error costs valuation generates, one cannot define an upper bound to the size of the bankruptcy firm. In this sense, the appropriate scope of the firm in bankruptcy is intimately bound up with, and can't be separated from, the effectiveness of the information-forcing mechanisms at the bankruptcy judge's disposal—the effectiveness of the rules used to "police the partition." Other things being equal, the more effectively a judge can induce investors to reveal their private valuations, the more extensive her control rights should be.

The Goldilocks maxim once again yields the optimal solution. The bankruptcy partition should be not too big and not too small. But what concretely does this entail? The place to start is with the firm that investors in fact constituted outside bankruptcy. Solvent firms, like the bankruptcy partition, exist to ameliorate opportunistic behavior endemic in disintegrated markets, and solvent firms, too, are limited in scope by information problems. Markets work, however imperfectly, to locate a balance. Control rights over most asset classes are easy to assign, even on a state-contingent basis, so the burden is on the one who wants to shift control rights in bankruptcy to show (1) why the bankruptcy decision process is apt to do a better job valuing the relevant asset class than the parties could do ex ante and (2), if bankruptcy is better at valuation, what kind of contracting failure would have prevented investors from replicating its decision process in flush times.

My suggested approach to defining the partition points to a minimal bankruptcy regime because its logic applies with equal force to the secured

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25 R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

26 The proceeds of a transfer avoided under §§ 544(b) or 548 are shared by all creditors of the debtor, not only the creditors entitled to avoid the transfer under state law. *See* Baird, Casey & Picker, *supra* note 1, at 1685 n.27. This asymmetry has long bothered commentators. *See, e.g.*, Vincent S.J. Buccola, *Beyond Insolvency*, 62 KAN. L. REV. 1, 35 n.99 (2013). But the authors are probably right to say the sharing rule does rough justice in most cases.

creditor's foreclosure rights. But let me conclude by proposing a principle, in need of future elaboration, that is roughly consistent with existing law. The bankruptcy partition should embrace two and only two kinds of assets—those that belong to the debtor outside bankruptcy and those that *would* belong to the debtor outside bankruptcy but for its financial distress. The first category is straightforward. The second category would include, for example, a secured lender's foreclosure rights (which are activated only by default), as well as property transferred preferentially or fraudulently (which typically would not have been transferred but for financial distress). The third-party release power does not make the cut, however, because a bankruptcy court doesn't sit to resolve all collective-action problems. The optimal amount of opportunism, in bankruptcy and out, is greater than zero.

CONCLUSION

The Bankruptcy Partition is framed around the claim that scholars spill too much ink on arguments about bankruptcy's distributional rules. I doubt whether that case has been proved. If nothing else, investors' distributional expectations affect their propensity to generate and disclose information about the debtor's prospects, which must in turn influence the efficacy of the rules for "policing the partition." But ultimately the article's contribution, which is substantial, has nothing to do with its nominal thesis. Its contribution is to identify and provoke research on the interdependency of three functions of bankruptcy law—deciding which assets are subject to bankruptcy's decision processes; preventing investors' interests in other, outside assets from coloring bankruptcy decisionmaking; and distributing value among the investors. More can, should, and will be said about each function. A major lesson of this paper is that changing the settings on one function is bound to impact the performance of the others.

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