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INSTITUTIONAL CAPTURE: WHY WE'RE OVERDUE FOR A NEW BANKRUPTCY ACT

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"*We have always known that heedless self-interest was bad morals; we know now that it is bad economics.*"
– Franklin Delano Roosevelt[1]

The paper, in short, explores how the structure of the bankruptcy system in the United States serves large corporations. This underlying purpose is shielded in the 'debtor-friendly' model, as the system is theoretically designed to help debtor businesses get back on their feet and serve their creditors and consumers. However, rather than actually being a debtor-friendly system, the Bankruptcy Code is 'large corporation friendly', helping corporate debtors and creditors alike before providing any protections for 'the little guy.' The paper then proposes a "New Bankruptcy Act," with several reforms designed to return to the original debtor-friendly model of the Code, while providing additional protections against abuse and capture.

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1. *Forbes Quotes: Thoughts on the Business of Life*, FORBES, https://www.forbes.com/quotes/3116/.

INTRODUCTION

As Professor Jon Hanson recently proclaimed in the Last Lecture series at Harvard Law School, we currently exist in *the* moment.[2] They do not come often. "They happen every 50 years: a moment when the granite of the system—petrified hierarchy and injustice—is actually in flux, and it is changing rapidly."[3] Injustice does not exist only in matters of civil rights, human dignity, and economic development. Rather, the grains of inequity can be found in all of our institutions, and each must be critically examined to determine the cause of

2. Brett Milano, '*Recommit to your childhood dreams of justice*', HARVARD LAW TODAY (Apr. 27, 2022), https://hls.harvard.edu/today/recommit-to-your-childhood-dreams-of-justice/.
3. *Id.*

systemic injustice and how it may be rectified for the betterment of the whole. The same is true for the U.S. bankruptcy system and Bankruptcy Code ("the Code"). Looking from the outside, the bankruptcy system appears designed to protect crucial stakeholders in the economy, particularly because the Code is the most "debtor-friendly" in the world.[4] However, upon closer view, the deep institutional capture of the system becomes clear. Through a series of exemptions, promises of regulation, and broad drafting, the bankruptcy system has been reduced to nearly a puppet show, orchestrated by powerful corporations and financial institutions. The inequity has become vast, leaving unprotected stakeholder-creditors with little refuge.

The Code, as it stands now, was drafted in 1978 (though there have been amendments since). It comes as no surprise, given the academic discourse during the 1970s, that the Code is corporate-friendly as opposed to debtor-friendly. The previous version of the Code was drafted forty years prior, demonstrating that, if the pattern holds, we may have reached a point on the timeline for a new analysis. The American Bankruptcy Institute shares this view, creating a commission in 2012 to study Chapter 11 reform.[5] The commission then presented a 400-page report to Congress in 2014, outlining changes thought to "better balance the goals of rehabilitating companies, preserve jobs, and provide value to creditors."[6] Even so, we have yet to see significant change in the Code. Though not an easy undertaking, a new Bankruptcy Act would serve to better protect stakeholders and vulnerable debtors than does the current Code.

As evidenced by several features of the Code, including the automatic stay, third-party releases, and safe harbors, it is clear that the purported goal of the bankruptcy system has been warped to protect its strongest players rather than its weakest. Each of these topics could constitute a paper of their own, but each also serves a crucial role in the systemic analysis of the fallacies of the bankruptcy system. The paper then turns

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4. *See generally* Rafael La Porta et al., Law and Finance Working Paper (on file with author).

5. American Bankruptcy Institute, American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (2014).

6. *Id.*

to the increased role (and success) of government intervention in bankruptcy, primarily analyzing the politics of the Chrysler reorganization in the 2000s. Lastly, the paper suggests three major changes to the Code intended to protect the equity and promise of the bankruptcy system.

I.
AMERICA'S UNIQUELY DEBTOR-FRIENDLY MODEL

The Code is well-known as a "debtor-friendly" model for bankruptcy and reorganization.[7] Simply, this means that the Code is drafted in a manner thought to protect debtors (those entering bankruptcy) more so than creditors (those seeking to collect value from the debtor in bankruptcy). Under a microscope, though, comes an important distinction. While the Code purports to protect weakened debtors, it in fact contains a number of loopholes, safe harbors, and other avenues which stronger creditors or tactical debtors may leverage for greater profits.[8] Thus, the Code can more accurately be described as "corporate-friendly" or "institution-friendly" rather than "debtor-friendly."

A. *A Brief History of Chapter 11*

The Code, as we know it, was not actually created until 1978. Prior to that, the system looked much different. The bankruptcy system is only briefly mentioned in the Constitution[9] and has been altered several times throughout the course of American governance. Perhaps unsurprisingly, during the first century of American history, the changes in bankruptcy structure were tied primarily to economic downturns.[10] The Bankruptcy Act of 1898 represented the first attempt to stabilize the bankruptcy system, which was further expanded throughout the 1930s in response to the Great Depression, including expansions in 1933, 1934, and 1938.[11]

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7. *See generally* La Porta et al., *supra* note 4, at 22.
8. *See infra* Parts II–III.
9. U.S. CONST. art. I, § 8.
10. ELIZABETH WARREN, ESSENTIALS, CHAPTER 11: REORGANIZING AMERICAN BUSINESSES 6 (Wolters Kluwer, 3d ed. 2008).
11. *Id.* at 6–7.

In the Chandler Act of 1938,[12] businesses were split into two separate classifications, each with their own procedures for bankruptcy. The Act distinguished between publicly traded companies and small, "local" businesses.[13] Chapter X was for publicly traded companies and involved a much more rigorous process, including a full Securities and Exchange Commission ("SEC") investigation concerning the reasons for the corporation's failure.[14] Alternatively, Chapter XI was available to small businesses and the process was much simpler.[15] The former distinction rested on the complexity of larger corporations and raises policy considerations for evaluating the current Chapter 11 system today.[16] Even so, Chapter X was not without its critics, with many arguing that the SEC requirement delayed proceedings and gave the agency too much power. For instance, Senator Elizabeth Warren wrote that: "[Chapter X] . . . created leverage for the SEC, giving it the power to insist that management be replaced with a trustee to run the business or that public stockholders receive higher payments than they were otherwise due."[17] Chapter X also required replacing management, whereas Chapter XI allowed management to remain.[18] Proponents of Chapter X commended this requirement, arguing that it allowed "bums" to be removed and that one should be wary of a company trying too hard to avoid the scrutiny of a trustee.[19] This is especially critical. Empirical evidence suggests that the requirement to replace management was often nominal: the first act of many trustees was simply to rehire management to consult on the specifics of the business.[20] The positive effect of this structure, though, remains: management could provide institutional knowledge but

12. Bankruptcy Act of 1938, Pub. L. No. 75-696, 52 Stat. 840.
13. WARREN, *supra* note 10, at 7.
14. *Id.*
15. *Id.*
16. The current Code can be distinguished from references to the old Code, as it uses numerical chapters, rather than Roman numerals.
17. WARREN, *supra* note 10, at 7.
18. *Id.* at 7–8. There is evidence, though, that this requirement was often ineffective, as the first act of many trustees was simply to rehire management to consult on the specifics of the business. This, though, seems to be a positive—as management would be there for institutional knowledge, but the trustee in place to ensure equity and honesty.
19. *Id.* at 8.
20. *See id.*

the trustee would ensure equity and honesty in the company's continued operations.

Nonetheless, companies avoided Chapter X at all costs.[21] The SEC permitted companies to stay in Chapter XI so long as public stockholders and bondholders were treated "satisfactorily," with the effect of diverting value from higher-ranking creditors.[22] These maneuvers proved fatal to the former bankruptcy system, leading to the Bankruptcy Reform Act of 1978 and the current Code. By merging the old Chapters X and XI into a single Chapter 11,[23] companies were no longer hesitant or disincentivized to file for bankruptcy. Because Chapter 11 lacks a good faith filing requirement[24] and management no longer faces removal from the SEC, companies may file for Chapter 11 strategically, reaping the benefits with little cost or risk.[25]

Policy is not written in a vacuum; it is crucial to understand the greater context and conversation surrounding any legislative draft. Given that the Code was enacted in 1978, it is unsurprising that it lifted many restrictions on large corporate debtors. The 1970s were a crucial time for American corporate law, with a reinvigorated argument against regulation. 1968 is often deemed "The Year That Changed America"[26] due to the major gains in social movements and resulting backlash among legal theorists. As Professor Hanson stated in reference to that period, the resulting narratives "[a]ll say the same thing: [w]e're going to throw out conceptions of social responsibility and we're going to accept a notion of freedom behind ideas of markets and aversion for regulation. . . . That collection of ideas becomes dominant, and each one of those stories empowers corporations."[27] These narratives all circled the same concept: the role of a corporation is profit and any regu-

21. *See id.* at 8–9.
22. *Id.*
23. *See id.* at 9.
24. *See infra* Section VI.A.
25. Arguably, the biggest cost to companies is reputational—that the stock market will know they filed for bankruptcy and their stock price will decline. However, this is likely a repercussion the company would already face if they were, for example, facing a mass tort, eliminating this argument for the focus of this paper.
26. CNN, *1968: The Year That Changed America*, https://www.cnn.com/shows/1968 (last visited Feb. 13, 2023).
27. Milano, *supra* note 2.

lation or attempt to promote other social benefits is misplaced.

Perhaps most notably, Lewis Powell wrote the infamous "Powell Memo" in 1971, asserting that American values of business and enterprise were "under attack."[28] The Powell Memo is a topic of its own exploration, but the language Powell used is crucial to understanding the influences at the time the Code was drafted. The Powell Memo articulated the view that the American economy was in grave danger of falling apart: "[t]he overriding . . . need is for businessmen to recognize that the ultimate issue may be survival—survival of what we call the free enterprise system, and all that this means for the strength and prosperity of America and the freedom of our people."[29] By framing the prosperity of large corporations as equivalent to the freedom of Americans, Powell's view became the dominant narrative of corporate law.

Thus, the focus became ensuring profitability of corporations at all costs. That focus left no room for regulation or diversion of shareholder funds to other social purposes. As Milton Friedman believed, "[a]ny investment of [corporate] assets toward ends other than profit—like 'spending someone else's money for a general social interest'—is tantamount to 'taxation without representation.'"[30] This argument became ubiquitous, as Professor Mark J. Roe has pontificated, "[a]lthough aggressive when it appeared, Friedman's perspective is now mainstream in American business circles."[31] However, with the rise in Environmental, Social, and Governance

28. *See* Memorandum from Lewis F. Powell, Jr. to Eugene B. Sydnor, Jr., Educ. Comm. Chairman, U.S. Chamber Com., 1–7 (Aug. 23, 1971), https://law2.wlu.edu/deptimages/Powell%20Archives/PowellMemorandumTypescript.pdf (describing the source, nature, and tone of the attack on the system of American enterprise).

29. *Id.* at 10.

30. Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 44 (2004) (citing Milton Friedman, *A Friedman Doctrine – The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES (Sep. 13, 1970), https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html).

31. Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2080 n.2 (2001).

("ESG") practices,[32] as well as broader conversations about corporate responsibilities and expectations,[33] a gateway may exist to reevaluate their role in bankruptcy proceedings.

B. *American 'Exceptionalism:' Debtor Protections*

The current U.S. bankruptcy system "protects" debtors more than any other current bankruptcy system. As it stands, "the U.S. Bankruptcy Code is oriented towards rescuing insolvent businesses and is considered to be 'soft' or 'debtor-friendly,' favoring incumbent management."[34] In a study of forty-nine countries (not including any socialist or transitional economies), the United States was found to have the least protections in place for creditors based on an index of several different creditor "rights".[35] For example, where Chapter 11 in the United States gives management the ability to file for bankruptcy without consulting creditors, other countries require creditor consent in order to file.[36] By creating an aggregate index of four variables, the authors found that:

> The United States is actually one of the most anti-creditor common law countries: it permits automatic stay on assets, allows unimpeded petition for reorganization, and lets managers keep their jobs in reorganization. The average aggregate creditor rights score for common law countries is 3.11—by far the highest among the four families,—but this score is only 1 for the United States.[37]

Thus, the United States (at least nominally) offers some of the lowest protections for creditors in the world.

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32. *See, e.g.*, Lucian A. Bebchuk & Roberto Tallarita, *Will Corporations Deliver Value to All Stakeholders?*, 75 VAND. L. REV. 1031, 1042 (May 2022).
33. *See generally id.* (discussing changes in corporate responsibilities and the increase in consideration of stakeholders).
34. TIMOTHY FISHER & JOCELYN MARTEL, THE IMPACT OF DEBTOR-FRIENDLY REFORMS ON THE PERFORMANCE OF A REORGANIZATION PROCEDURE 1 (2012), https://hal.archives-ouvertes.fr/hal-00707359/document.
35. La Porta et al., *supra* note 4, at 23.
36. *See id.* at 22.
37. *Id.* at 23.

C. *But Shouldn't Debtors Be Protected?*

Even with the Code's nominal debtor protections, the actual protection of businesses and institutions rests on numerous factors. For instance, the Code requires that repayment to creditors be "fair and equitable," representing the "absolute priority" requirement in repayment.[38] Priority can be determined through a myriad of ways (e.g., security interests, contract, statutory priority, etc.) but ultimately represents the order in which creditors are paid out.[39] In a simple reorganization, this means that creditors with priority (usually from a security interest or other institutional modes) will be paid first, followed by unsecured creditors (such as trade creditors, pension holders, tort claimants, etc.), and lastly shareholders (in the unlikely event that any payout remains). Upon first impression, this seems reasonable: creditors who have contracted for higher priority take it and other stakeholders are still paid out before CEOs and company insiders. However, this priority scheme does not always follow in practice.

For institutional powerhouses, there are avenues through which a company insider may contract into receiving payment before stakeholders. For example, shareholders aware of the reorganization process may purchase stock in the new "reorganized" company and, in-turn, receive a payout for creation of "new value."[40] This practice has faced criticism. The Code specifies that shareholders may not receive value "on account of" their position within the company[41] and many argue (rightfully) that such shareholders would not have received a "new value" deal absent their internal positions during the reorganization.[42] For example, in 1999, the U.S. Supreme Court

38. 11 U.S.C. § 1129; *see also* Gary L. Kaplan, *Understanding the Rules of Bankruptcy Cramdown*, LAW360 (Sept. 4, 2013, 3:31 PM), https://www.friedfrank.com/siteFiles/Publications/Understanding%20The%20Rules%20Of%20Bankruptcy%20Cramdown.pdf.

39. *See* Kaplan, *supra* note 38.

40. Kevin Hellon, *The Absolute Priority Rule and the 'New Value' Exception*, ANAND LAW (Nov. 3, 2022), https://www.anandlaw.com/the-absolute-priority-rule-and-the-new-value-exception/.

41. 11 U.S.C. § 1129(b)(2)(B)(ii). Specifically, the Code states: "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan *on account of* such junior claim or interest any property . . . . " *Id.* (emphasis added).

42. *See, e.g.*, *id.*

held that shareholders who received property after creating "new value" could not adequately show that they were not receiving such "on account of" their junior interest unless there was a market value test in place.[43] The Court articulated that insider shareholders had a structural advantage in the process, which allowed them unfettered access to the reorganized company.[44] Nonetheless, this standard has been criticized and even ignored by some circuit courts.[45]

Some bankruptcy scholars have internalized the underlying protection of creditors, arguing that this is, in fact, the true purpose of bankruptcy proceedings. Under the nominal debtor-friendly model, as they see it, institutional creditors should have the ultimate power in determining reorganization and repayment. For example:

> Professors Thomas Jackson and Douglas Baird advance the "creditor's bargain heuristic" to test whether a certain provision should or should not be part of the bankruptcy scheme. As they see it, bankruptcy rights should be no more—and no less—than the rights the creditors would have bargained for as a group pre-bankruptcy, if they had taken the time to do so.[46]

In promulgating this theory, scholars seem to advocate for what already exists, but wish to make creditors' protections more explicit. By advancing stronger protections for creditors (but only those with bargaining power), Professors Jackson and Baird would produce a more "free-market" system, where actors with bargaining power control the restructuring. This, though, is already the case in practice; the difference is that this free-market system masquerades under the guise of being "debtor-friendly." It is the stakeholders without bargaining power (e.g., securities fraud claimants, tort claimants, public

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43. Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999).

44. *Id.* at 454–55.

45. Paul T. Musser, *Castleton: 7th Circuit's Answer to 203 N. LaSalle's Market Test*, AM. BANKR. INST. J. (Dec. 2015), https://katten.com/Files/133949_Castleton_7th_Circuits_Answer_to_203_N_LaSalles_Market_Test.pdf.

46. WARREN, *supra* note 10, at 13 (first citing Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law*, 100 HARV. L. REV. 2074 (1987); and then citing Douglas G. Baird, *The Uneasy Case for Corporate Reorganization*, 15 J. LEGAL STUD. 127 (1986)).

stockholders, trade creditors, etc.) who are already left unprotected. Those groups often already suffer at the bottom of the reorganization totem pole, even though it is supposedly debtor insiders at the bottom.

II. THE AUTOMATIC STAY

Prioritizing the debtor, or, rather, de-prioritizing unsecured creditors, centers around the automatic stay on litigation. Once a corporation files under Chapter 11, the stay kicks in. To be sure, the automatic stay has a valid legislative purpose: protecting debtors and small creditors from a "race to the courthouse," in which all creditors would sue to collect and be repaid. In theory, the automatic stay prevents such a race from occurring, as creditors are stayed from litigation and myriad other collection activities, and thus encouraged to cooperate with each other and the debtor to create a plan that benefits the most amount of people. In practice, though, the stay provides a malicious incentive for solvent corporations to file and potentially skirt liability that they would otherwise face.

A. *Intended Purpose of the Stay*

The automatic stay, captured in 11 U.S.C. § 362, is drafted in extremely broad terms—so much so that including the entirety of the section here would require pages. However, subsection (a), which outlines the actions prevented by the stay, is as follows:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of—
>
> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor

> that arose before the commencement of the case under this title;
>
> (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
>
> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
>
> (4) any act to create, perfect, or enforce any lien against property of the estate;
>
> (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
>
> (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
>
> (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
>
> (8) the commencement or continuation of a proceeding before the United States Tax Court concerning a tax liability of a debtor that is a corporation for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under this title.[47]

The stay language is intentionally drafted to prevent "all entities" from collecting against the debtor and, in turn, hindering the restructuring process.[48] Some influential bankruptcy scholars believe that the automatic stay is the bedrock of Chapter 11. Senator Warren, for example, described the

47. 11 U.S.C. § 362(a).
48. *See id.*

stay as "[c]ritical to the operation of the bankruptcy system."[49] This is generally uncontroversial: the automatic stay is thought to be the main mechanism in the Code which protects against the "race to the courthouse." In essence, absent the stay on collection and recovery efforts, all creditors would *race* to collect what they are owed. This would produce a poor system of creditor incentives and serve the same on a first-come basis.

The automatic stay carries with it significant force. Any creditor who violates the stay, either by attempting to collect, pursuing litigation, or any other action against the debtor, is subject to punishment by the bankruptcy court.[50] This may include fines and even civil imprisonment until full compliance with the court and its order.[51] Additionally, one who violates the stay is not absolved by a lack of knowledge, as "a violation is a violation; knowledge of the filing is relevant only to the question of willfulness and the scope of an appropriate remedy."[52] Thus, the protection for the debtor is immense. If a debtor is injured while in bankruptcy, it has a clear pathway for reparation.

The same is not necessarily true for creditors or other entities in business with the debtor. While the automatic stay prevents creditors of any kind from attempting to collect against the debtor, the debtor may continue its normal course of business.[53] This includes spending money, pursuing business opportunities, and even initiating lawsuits.[54] This allows the debtor to game the system, for example, by making its business riskier to alter the valuation in a way beneficial to its shareholders. The Hunts, for example, placed their lucrative oil company into Chapter 11 in 1986, but continued spending their financial reserves lavishly, seeking new, risky oil explorations.[55] In doing so, the Hunts used money unavailable to their creditors with the hope of striking rich and saving their company, or altering the valuation of the company in the

49. WARREN, *supra* note 10, at 27.
50. *Id.* at 28.
51. *Id.*
52. *Id.*
53. *See id.* at 29.
54. *Id.*
55. MARK J. ROE & FREDERICK TUNG, BANKRUPTCY AND CORPORATE REORGANIZATION: LEGAL AND FINANCIAL MATERIALS 85–86 (4th ed. 2016).

meantime.[56] Thus, a debtor in Chapter 11 is allowed significant leeway that is not available to others actors in the system.

B. *A Look at Actual Practice*

It is crucial to emphasize that the creditor in a given case is not always a large, diversified institutional lender, such as J.P. Morgan or Apollo Management. Rather, creditors are often parties one would not think of as a creditor. For example, in the Chrysler reorganization, pension fund holders and employee unions constituted creditors.[57] In asbestos cases, creditors are usually everyday citizens with massive medical bills.[58] Thus, the automatic stay prevents more than just the "Big Bad Bank" from blowing down the business.

In fact, those more intuitive creditors—big banks, hedge funds, private equity firms, etc.—are given an additional leg up in this section of the Code by way of their usually having "secured" status. While unsecured creditors (including tort claimants, tradesmen, employees, etc.) are left without any course of action, secured creditors hold a special power to lift the automatic stay. If a secured creditor wants to lift the stay, they can petition the court to lift or modify.[59] This opportunity for relief "centers around permission for a secured creditor to repossess the collateral that is the subject of its security interest notwithstanding the stay imposed in bankruptcy. . . . Unsecured creditors have no corresponding right."[60] Thus, "[s]ecured creditors have somewhat protected status."[61]

Remember, though, that the purported purpose of bankruptcy is protecting the debtor and ensuring equity in the proceeding. Thus, there must be some balancing to determine whether the stay should be lifted for a secured creditor's benefit. Balancing tests, though, are notoriously fact-dependent, allowing a creditor seeking to lift the stay to make arguments based on general equity principles, which may be difficult to

56. *See id.* at 85–87.

57. *See* Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 760 (2010).

58. *See generally* Joe Lahav, *Mesothelioma and Asbestos Trust Funds*, ASBESTOS.COM (Jan. 9, 2023), https://www.asbestos.com/mesothelioma-lawyer/compensation/trust-fund.

59. WARREN, *supra* note 10, at 33.

60. *Id.*

61. *Id.* at 34.

weigh or predict. It is thus difficult to create a test composed of bright-line rules, but, in sum: "[t]he secured party loses some rights (the right of immediate repossession and concomitant cash-out) to enhance the value of the estate, but it retains some rights (e.g., the right to repossess if the debtor cannot ensure adequate protection) that put it ahead of the general unsecured creditors."[62] Though "balance" appears to indicate equity, it remains crucial to consider the systemic influences at play in the proceedings. With an unclear standard, there is an increased likelihood that a better-represented party will fare better in court proceedings than others. Namely, resources are crucial, and those with more are better equipped for a battle of the facts.

There are, of course, some exceptions to the stay's broad protection. Criminal enforcement, for example, can still proceed with an automatic stay in place,[63] as can government enforcement action.[64] Even these exceptions, though, become murky under a microscope. Courts "have struggled to separate debt collection attempts that should be stayed by a bankruptcy petition from criminal penalties that should proceed regardless of the bankruptcy."[65] The same is true for collection under civil enforcement. For example, after the collapse of WorldCom, the SEC sought to fine WorldCom for defrauding creditors and chose an amount significant enough to ensure compensation to fraud claimants (since they would otherwise be unsecured creditors and likely receive nothing).[66] The court approved the fine, stating that it "fairly and reasonably reflects the realities of this complex situation," but noted that the SEC cannot determine the size of a fine primarily based on compensating claimants, which would undermine 11 U.S.C. § 510(b).[67]

Thus, the execution of the automatic stay reflects the deeply rooted bias within the Code as written. Though the goal is to protect going-concern—a valid legislative purpose—the system has fallen victim to puppetry from big business (institutional creditors and large corporate debtors), who are af-

62. *Id.* at 35.
63. *Id.* at 31.
64. *Id.*
65. *Id.*
66. *See* SEC v. WorldCom, Inc., 273 F. Supp. 2d 431 (S.D.N.Y. 2003).
67. *Id.* at 436.

forded a higher status in both general distribution and relief from the automatic stay. Even the government has only a limited ability to act without being encumbered by the stay—that is, where it is acting within its police power and not in pursuit of a "money judgment."[68] Secured creditors, while not immune from the stay, enjoy a multitude of workarounds.[69] Additionally, some debtors may use the stay to their advantage as well, specifically aiming to prevent unsecured creditors from collecting the full value of what they are owed.

A company may, for a variety of strategic reasons, file for Chapter 11 without a reorganizational purpose. Perhaps the most common are single asset cases, in which a debtor files with only one asset (usually real estate), few employees, and little unsecured debt.[70] Usually, the debtor files in response to a two-party dispute with an under-secured lender in an attempt to delay foreclosure.[71] A related phenomenon is the new debtor syndrome, which follows a similar fact pattern. Here, the entity itself is usually created on the eve of bankruptcy to shield the single asset from creditors.[72] These scenarios usually involve small debtors, rather than large corporations, seeking to use the bankruptcy system for a relatively clear purpose: shielding assets from creditors in what are otherwise two-party disputes.[73]

In a more complex example of abuse, debtors may file for a litigation advantage. For example, in *SGL Carbon*, the debtor filed for bankruptcy in response to antitrust litigation.[74] The petition was filed in the Third Circuit—a circuit which had already established a good faith filing requirement—but the bankruptcy court refused to dismiss the case on bad faith grounds.[75] Specifically, the lower court found that the litigation was "distracting management," and, if successful, would likely send the company into a tailspin.[76] The Third Circuit

68. *See* 11 U.S.C. § 362(b)(4); *see also* Roe & Tung, *supra* note 55, at 349.
69. *See* discussion *supra* Section II.B.
70. Judith Greenstone Miller, *Amendment to Provide Good Faith Filing Requirement for Chapter 11 Debtors*, 102 Com. L.J. 181, 183 (1997).
71. *Id.*
72. *Id.*
73. *See id.*
74. *In re* SGL Carbon Corp., 200 F.3d 154, 167 (3d Cir. 1999).
75. *Id.* at 158.
76. *Id.*

reversed, finding that the debtor's filing was premature and done for reasons inconsistent with the principles of bankruptcy.[77] More recently, in the same circuit, a bankruptcy court held that a subsidiary of Johnson & Johnson, established solely to acquire company liability related to talc use, had filed for bankruptcy in good faith.[78] To be sure, the case is highly complex, involving Johnson & Johnson's strategic liability shifting and forum shopping. Nonetheless, the bankruptcy court in New Jersey articulated that:

> The Court cannot help but ponder how a bankruptcy filing, which took place in North Carolina and most likely satisfied the good faith standards under the applicable law in that jurisdiction, suddenly morphs post-petition into a bad faith filing simply because the case travels 400 miles up I-95 to Trenton, New Jersey.[79]

Unintentionally, in denying this motion, the District of New Jersey has highlighted why an amendment to the Code is critical to protecting the integrity of the bankruptcy system.[80]

III.
Third-Party Releases

Perhaps the strongest example of corporations warping the Code beyond its original purpose can be found in third-party releases. Third-party releases have split the circuits, receiving various degrees of support, disapproval, and something in the middle.[81] Unlike other examples of distortion, though, there is no explicit foundation for third-party releases within the Code. Rather, courts have found authority for such releases in 11 U.S.C. § 105(a), which states that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[82] Courts have interpreted this provision broadly, with many believing that it permits a third-party release. The theoretical argument is simple: third-party releases extend to parties against which

77. *Id.* at 163.
78. *See In re* LTL Mgmt., LLC, 637 B.R. 396, 400 (Bankr. D.N.J. 2022).
79. *Id.* at 406.
80. *See infra* Section VI.A.
81. *See infra* Section III.A.
82. 11 U.S.C. § 105(a).

collection of assets would be detrimental to the debtor.[83] Namely, if a third party holds an asset that the debtor could draw upon during reorganization, then that asset should be protected. This view is controversial, as it allows a "bankruptcy benefit without the burden of all the bankruptcy rules."[84] The Code, though, takes the controversy further, as it states that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."[85] Section 524(e) seems in tension with the administration of third-party releases, as extending the release to additional parties directly affects their liability. Thus, when presented with differing sections of the Code, courts reach different conclusions on the permissibility of third-party releases.[86] The issue was recently explored in the Purdue Pharma restructuring and the Sackler family's request and possible receiving of a third-party release.[87]

A. *Not in the Code and Unconstitutional*

Third-party releases may be either consensual or non-consensual.[88] The distinction is based on whether consent was obtained by the creditors, as the release would be proposed by the debtor to protect a third party. Consent, though, should not necessarily be taken at face value, as:

> Debtors often utilize third-party releases to incentivize parties to support a plan or to influence others to contribute to and fund the plan. Nondebtor third parties under Chapter 11 are often insiders of the debtor—such as directors and officers—as well as the debtor's insurers or major plan contributors.[89]

Though these incentives are provided to compliant parties who would logically provide their consent, the threat or promise of one may also sway other voting creditors. Thus, institutional creditors and big businesses find themselves with

83. *See* WARREN, *supra* note 10, at 30.
84. *Id.*
85. 11 U.S.C. § 524(e).
86. Dorothy Coco, *Third-Party Bankruptcy Releases: An Analysis of Consent Through the Lenses of Due Process and Contract Law*, 88 FORDHAM L. REV. 231, 236 (2019).
87. *See infra* Section III.B.
88. Coco, *supra* note 86.
89. *Id.* at 235.

yet another leg up on other parties in a system promising equity.

Even more troubling than the skew of consent, though, is the permissibility of non-consensual third-party releases. To be fair to bankruptcy courts, there is a strong statutory argument that courts have the authority to approve a plan generally, and thus approve all aspects of the plan as binding. The plan is viewed as a contractual agreement with strict voting requirements[90] and the threat of a contractual claim if breached. Without consent from the parties, though, the bankruptcy court has no real contract to approve.[91] Courts are split on this matter. Upon conducting a survey of the circuits, W. Glenn Jensen found that:

> The Sixth and Seventh Circuits are the ones recognizing that Sections 105(a) and 1123(b)(6) give bankruptcy judges some "residual authority" to impose releases. The Fourth and Eleventh Circuits have concluded that Section 105(a) authorizes such releases. While the Fifth, Ninth and Tenth Circuits have rejected the notion that a bankruptcy court can authorize non-debtor releases outside of the asbestos context under Section 524(g).[92]

Though the Circuits remain split, there is a strong argument that third-party releases run counter to the U.S. judicial system and its processes. This argument is three-fold: (1) bankruptcy courts may lack jurisdiction; (2) releases impede on

90. "A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan." 11 U.S.C. § 1126(c).

91. *See* Coco, *supra* note 86, at 239.

92. W. Glenn Jensen, *Third-Party Releases Are Not Consistent with Bankruptcy Code: Creditors Can Still Maintain Direct Claims*, NAT'L L. REV. (Dec. 22, 2021), https://www.natlawreview.com/article/third-party-releases-are-not-consistent-bankruptcy-code-creditors-can-still-maintain. 11 U.S.C. § 1123(b)(6) simply articulates that: "Subject to subsection (a) of this section, a plan may . . . include any other appropriate provision not inconsistent with the applicable provisions of this title." 11 U.S.C. § 524(g) is specific to asbestos claims and is not the same provision explored above (§ 524(e)). Rather, § 524(g) provides specific instruction to the court for discharging asbestos claim liability.

due process rights without compensation; and (3) releases violate the inherent right to contract. Each will be analyzed in turn.

1. *Bankruptcy courts may lack adequate jurisdiction*

Though bankruptcy courts have express power to approve a reorganization plan and all that goes with it, bankruptcy judges are not Article III judges. Thus, bankruptcy judges do not have the same breadth of jurisdiction as U.S. district court judges or circuit judges. As Martin Bienenstock[93] explains to his class, one need only ask seven questions to determine if a bankruptcy judge is exercising proper jurisdiction:

(1) Does the bankruptcy power in the U.S. Constitution authorize this relief?
(2) Does 28 U.S.C. § 1334 grant the subject matter jurisdiction necessary to grant relief?
(3) Is the relief constitutional?
(4) Can the bankruptcy judge constitutionally exercise the subject matter jurisdiction?
(5) Can the non-Article III bankruptcy judge constitutionally issue the relief?
(6) Is there reference withdrawal?
(7) Is there personal jurisdiction?[94]

In the case of third-party releases, the inquiry may not go further than question one. As explored in Section III.A., third-party releases lack a clear foundation in the Code,[95] likely because the Constitution's bankruptcy power does not permit such releases. Specifically, the Constitution permits the discharge of debt, but this is limited to the debtor and does not reach third parties.[96] To be sure, discharging debt of third par-

93. "Martin J. Bienenstock is Chair of Proskauer's Business Solutions, Governance, Restructuring & Bankruptcy Department. He also teaches Corporate Reorganization as Lecturer in law at Harvard Law School and as an adjunct professor at University of Michigan Law School." Faculty page of Martin J. Bienenstock, HARV. L. SCH., https://hls.harvard.edu/faculty/martin-j-bienenstock (last visited Jan. 9, 2023).

94. Martin Bienenstock, Corporate Reorganization Class Lecture (2022) (notes on file with author).

95. *See* discussion *supra* Section III.A.

96. Bienenstock, *supra* note 94; *see also* Local Loan Co. v. Hunt, 292 U.S. 234 (1934) (discussing the permissibility and scope of discharge of individual debt through bankruptcy).

ties directly contradicts the explicit purpose of bankruptcy, which is an "equitable remedy" aimed at ensuring the fair distribution of value to creditors.

Beyond question one, third-party releases likely survive question two. Namely, because third-party releases are supposedly given to entities whose success directly relates to the success of the reorganized debtor, jurisdiction is likely granted. Bankruptcy judges possess power over all matters related to the Title 11 case,[97] which likely includes parties so related to the debtor that the release "must be granted" to ensure the success of the reorganized debtor. Still, third-party releases surely fail at question three.

2. *Revocation of due process rights*

By permitting a third-party release, the approving court is granting immunity to a party not subject to bankruptcy, and thus preventing claimants from seeking their day in court against that party. Though debtors enjoy the automatic stay and all claims against the debtors are released, claimants still retain mechanisms to be heard. Though arguably a weak protection, tort claimants, for example, are provided with an agent for their claims during bankruptcy proceedings.[98] The theory is that all claims are handled jointly but all claims are still being heard.[99] The same cannot be said for third parties under a release.

In determining whether due process rights are violated, the examining court would determine whether the claimant has been deprived of life, liberty, or property without an ability or opportunity to be heard.[100] This right is guaranteed by the Fifth Amendment[101] and represents a deeply rooted value in the United States. To be sure, "the Court has stated that the right to be heard before suffering a loss is a basic societal principle."[102] However, a third-party release tramples this guarantee. Given the structure of a third-party release, "the creditors whose claims are under consideration for release are poten-

97. 28 U.S.C. § 1334(a)–(b).
98. *See generally* Frederick Tung, *The Future Claims Representative in Mass Tort Bankruptcy: A Preliminary Inquiry*, 3 CHAP. L. REV. 43 (2000).
99. *See id.*
100. U.S. CONST. amend. V.
101. *Id.*
102. Coco, *supra* note 86, at 249.

tially losing a legitimate claim of entitlement defined by state law and the Constitution—the right to petition."[103]

Even in scenarios where the third-party release is deemed "consensual," and thus more likely to be approved by the bankruptcy judge, a significant possibility remains that not every creditor has, in fact, granted consent. For consent to be granted, each class would have to accept the plan. A class is deemed to have accepted the plan of reorganization if at least two-thirds in dollar amount and more than one-half in number have accepted that plan.[104] Consent is then achieved when each class accepts the plan, but that does not mean every creditor has actually accepted the plan. Rather, up to one-third of creditors could have explicitly not provided their consent but would be deemed to have consented. These non-consenters, then, are bound by a release that they explicitly did not consent to, even if the release itself is deemed "consensual."[105] Even for circuits that have articulated a consent requirement, third-party releases are likely not fully consensual. These non-consenters are undoubtedly being forced to relinquish their due process rights.

3. *The right to contract*

Along with jurisdictional concerns and the infringement on due process, third-party releases also raise concerns about the right to contract. Keep in mind the voting requirements discussed *supra* Section III.A.2—two-thirds in amount, and more than one-half in number. The strongest argument for third-party releases is that a bankruptcy judge approves a plan of reorganization, which is essentially a large contract involving multiple parties.[106] If the parties contracted to include the release, it is not the judge's place to remove their contractual terms. With a closer look, though, the issue becomes nuanced.

A debtor will likely present the plan of reorganization as a unilateral contract, and the court would then determine what constitutes acceptance or consent, likely using the plan confir-

103. *Id.* at 248.
104. 11 U.S.C. § 1126(c).
105. Coco, *supra* note 86, at 248–49.
106. *Id.* at 245 ("Some bankruptcy courts analogize bankruptcy plans containing third-party releases to a contract that binds those who vote in favor of it.").

mation standards.[107] Consent, under contract law principles (not specific to bankruptcy) may be given either expressly or through conduct, but contractual rights may only be waived "knowingly, voluntarily, and intentionally."[108] The nuance is that a waiver may also be express or inferred from conduct,[109] which presents a difficulty in ascertaining whether a non-consenting creditor has approved a third-party release. To be sure, the answer remains the same: no. Consider a plan that was confirmed by a judge and is therefore treated as a unilateral contract. If a creditor rejects a plan, but is outvoted, he is then treated as having consented to the plan. By analogy, consider a family that puts their dinner choice to a vote. One child said no, was outvoted, and then complained about the dinner choice making her ill. She would not be told it was her fault for choosing that dinner option, as she clearly had not. Though seemingly a flippant analogy, give this some thought. How, then, can a creditor, who outright voted against providing protection to a party not at all involved in the bankruptcy, be told he contracted away his right to sue that party?

Thus, when analyzing the power of the bankruptcy court, or any court, to approve a third-party release, the release should not be treated as a unilateral contract in which consent is given clearly. Rather, third-party releases squander several constitutional rights of those involved, with the biggest weight falling on under-protected stakeholders seeking their day in court.

B. *Third-Party Releases in Practice: A Look at Purdue Pharma*

"[A]ddiction 'is not caused by drugs.'"[110] At least, that is what Purdue Pharma advertised in promoting its drug, Oxycontin. Purdue Pharma has since been identified as a strong contributor to what became the opioid crisis, with swaths of people from all regions and socioeconomic statuses becoming addicted to the drug.[111] In 2007, Purdue Pharma signed its first plea agreement with the U.S., agreeing to pay $600 mil-

107. *Id.* at 245–46.
108. *Id.* at 246.
109. *Id.*
110. *In re* Purdue Pharma, LP, 635 B.R. 26, 43 (S.D.N.Y. 2021).
111. *See generally* Howard Koh, *What Led to the Opioid Crisis—and How to Fix It*, HARV. T.H. CHAN SCH. PUB. HEALTH (Feb. 9, 2022), https://www.hsph.harvard.edu/news/features/what-led-to-the-opioid-crisis-and-how-to-fix-it.

lion for false marketing.[112] Nonetheless, the company continued marketing the product and increasing profits.[113] By 2019, Purdue Pharma was facing seemingly endless lawsuits from users of its drug.[114] It was not until 2020 that Purdue Pharma admitted to "substantial deliberate wrongful conduct," signing a plea agreement with the Department of Justice.[115] That plea catalyzed the controversy surrounding Purdue Pharma's bankruptcy.

Since, in the 2007 plea, executives of Purdue Pharma accepted personal liability and agreed to pay $34.5 million in personal fines,[116] the 2020 plea agreement raised alarm for the Sackler family, who own Purdue Pharma. Luckily, they had prepared; "[c]oncerned about how their personal financial situation might be affected, the family began what one member described as an 'aggressive[ ]' program of withdrawing money from Purdue almost as soon as the ink was dry on the 2007 papers."[117] The Sackler family was incredibly effective in shoveling funds—pulling $10.4 billion out of the company and substantially affecting its solvency.[118] This money was then invested in accounts, trusts, and ventures that made it nearly impossible to reach.[119] Pulling money from the company was a crucial part of the plan to insulate the family's finances from the company's liabilities. So much so that "Purdue went from distributing less than 15% of its revenue to distributing as much as 70% of revenue."[120] The Sackler family then stepped away from the company to keep their personal finances secure. And it worked. The family knew they had the company, and its creditors, in a stronghold. Once the company reached bankruptcy "the Sacklers offered to contribute toward a settlement, but if—and only if—every member of the family could 'achieve global peace' from all civil (not criminal) litigation,

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112. *See* Barry Meier, *In Guilty Plea, OxyContin Maker to Pay $600 Million*, N.Y. TIMES (May 10, 2007), https://www.nytimes.com/2007/05/10/business/11drug-web.html.
113. *Id.*
114. *See In re Purdue Pharma*, 635 B.R. at 34.
115. *Id.* at 35.
116. Meier, *supra* note 112.
117. *In re Purdue Pharma*, 635 B.R. at 36.
118. *Id.*
119. *See id.*
120. *Id.* at 57.

including litigation by Purdue to claw back the money that had been taken out of the corporation."[121] The injustice need not be spelled out. The Sackler family arguably knew what they were doing, putting victims of their company in a position where they are unable to recover the full amount of money they are owed.

Stuck between a rock and a hard place, the plan was confirmed by a supermajority of each class of creditors and approved by the bankruptcy judge. Remember, though, this does not mean every person provided their consent to what is being treated as a binding contract. Rather, there were several notable objections:

> [N]ot everyone voted yes. Eight states and the District of Columbia [ ], as well as certain Canadian municipalities and Canadian indigenous tribes, the City of Seattle (alone among all voting municipalities in the United States), as well as some 2,683 individual personal injury claimants, voted against the adoption of the Plan. . . . The United States Trustee [ ] in Bankruptcy and the U.S. Attorney's Office for this District on behalf of the United States of America join in their objections.[122]

Thus, the plan reached the District Court, where it was struck down by Judge McMahon.[123]

In so holding, Judge McMahon focused on whether bankruptcy courts had statutory authority to grant third-party releases.[124] Finding none, she noted that she need not address the constitutional and due process claims, rather inviting a higher court to do so; "[t]his opinion will not be the last word on the subject, nor should it be."[125] Noting that the justification for third-party releases is that they are integral to the reorganization, Judge McMahon articulates that:

> The third-party claims at issue neither stem from Purdue's bankruptcy nor can they be resolved in the claims allowance process. Yet those claims are being finally disposed of pursuant to the Plan; they are be-

121. *Id.* at 36.
122. *Id.* at 35–36.
123. *See id.* at 37–38.
124. *Id.*
125. *Id.* at 38.

> ing released and extinguished, without the claimants' consent and without any payment, and the claimants are being enjoined from prosecuting them.[126]

This analysis shifts the focus of the conversation from whether the release is integral to the plan to whether they are allowable at all. To be sure, Judge McMahon pointedly notes that some of the protections the Sackler family is seeking—e.g., personal liability releases—are "claims [that] could not be released if the Sacklers were themselves debtors in bankruptcy."[127] Judge McMahon also hones in on a key issue: the trouble of treating a plan of reorganization as a unilateral contract. By emphasizing all the parties who objected and articulating that such parties would be prevented from seeking justice on their claims, Judge McMahon is carving the way for a successful argument that third-party releases are unconstitutional, not just lacking a statutory foundation. The appeal that will likely result from this holding will be crucial to the future of third-party release doctrine.

IV.
THE SAFE HARBORS

Another method employed by institutional influences to alter the risk and rewards of bankruptcy are the safe harbors placed throughout the Code. These safe harbors remove various liabilities from institutional actors—mainly financial institutions—who game the markets for profit. Importantly, fraudulent conveyance liability allows the trustee of a bankrupt estate to void a transfer of money.[128] A basic example of fraudulent conveyance might look something like the following: Imagine that you knew that you had lost all your money in Vegas and owed some money to your bookie. You have no money to your name, but you do have the signed football from what was thought to be Tom Brady's last touchdown (which sold for $518,628 in 2022).[129] To ensure nobody takes your

126. *Id.* at 81.
127. *Id.* at 36.
128. 11 U.S.C. § 548.
129. Ian Oxborrow, *Tom Brady's last touchdown ball sells for $518,628, then he 'unretired'*, THE NATIONAL NEWS (Mar. 16, 2022), https://www.thenationalnews.com/business/money/2022/03/16/tom-bradys-last-touchdown-ball-sells-for-518628-then-he-unretired.

ball (even though it is not the last touchdown ball anymore), you give it to your cousin. That transfer is a fraudulent conveyance: moving assets away from the debtor to another party to prevent, hinder, or delay creditors' collection. Doing so shifts the value out of a debtor, and thus hinders the creditors at the bottom of the priority list the most, as they are the last to be paid.[130] In many ways and as discussed in the following Sections, financial institutions find themselves exempt from this liability.

A. *The Repo Safe Harbor*

The first of these exemptions, which also provides strong evidence of institutional capture in the Code, is the repurchase agreement (or "repo") safe harbor. A repo is an agreement made by financial institutions in the securities industry, in which Company A will sell a security (usually either a Treasury bond or a mortgage-backed security) to Company B, with an explicit agreement to repurchase that security back at a specified price.[131] In the most typical example, repurchase would occur the next day, and the transaction itself is done for quick cash and loans.[132] Repos are most commonly used by major financial institutions, as well as the Federal Reserve, and account for a significant portion of their financial prosperity.[133] As repo use increased, they became a larger problem for bankruptcy courts. Initially, bankruptcy courts treated repos as a simple secured loan.[134] In *Lombard-Wall*, for example, the bankruptcy court articulated that a repo was a secured loan and deserved no special treatment.[135] Panicked, the banking

130. If this is setting off alarm bells for the *supra* discussion of the Sackler family finances, it should be. In the proceedings, the bankruptcy judge considered this evidence, and "[w]hile he made no finding that these distributions qualified as fraudulent conveyances, or that they could be recouped by Purdue, Judge Drain also acknowledged that the estate had potential claims of 'over $11 billon of assertedly avoidable transfers.'" *In re Purdue Pharma*, 635 B.R. at 40.

131. Jeffrey Cheng & David Wessell, *What is the repo market, and why does it matter?*, BROOKINGS (Jan. 28, 2020), https://www.brookings.edu/blog/up-front/2020/01/28/what-is-the-repo-market-and-why-does-it-matter.

132. *Id.*

133. *See generally id.*

134. ROE & TUNG, *supra* note 55, at 398.

135. *In re* Lombard-Wall, Inc., 23 B.R. 165, 166 (Bankr. S.D.N.Y. 1982), *aff'd* 39 B.R. 958 (Bankr. S.D.N.Y. 1984).

industry turned to Congress, seeking exemption from many debtor protections.[136] Now, the repo market falls under a vast umbrella of protections, including exemption from the automatic stay, exemption from voidable transfer and fraudulent conveyance laws, as well as several other limitations put in place to discourage creditors from self-interested bankruptcy practices.[137]

The special treatment of the repo market has received significant attention in academia. Professor Roe, for example, argues that granting repos priority in bankruptcy "perniciously weakens market discipline . . . because the stronger counterparties know that they often enough will be paid even if their . . . repo counterparty fails."[138] By removing the burden of greater risk from those stronger parties (namely large financial institutions), there is little incentive for those institutions to contain the risk internally.[139] Professor Roe then pinpoints a crucial policy consideration, namely that the federal government is a creditor missing from the repo risk analysis; "[t]he national government is typically distant from the scene until a crisis arises, has diffuse incentives, can face difficulties in hiring those with the relevant expertise, and is often politically constrained from being aggressive. Often the market players themselves influence government policy in their immediate favor."[140] In so highlighting, Professor Roe has identified the motif: policy written by those who are subject to it are likely writing in their own self-interest. By neglecting to anticipate or regulate the fallacies of the repo market, the federal government made itself a central actor in the failures of the financial system.

Professor Roe is not alone in this analysis. Professor Kenneth C. Kettering published a scathing 200-page exposé of the financial market's failures, as well as the government's failure

136. ROE & TUNG, *supra* note 55, at 398.
137. All told, the repo market is awarded special treatment in 11 U.S.C. §§ 362(b), 559, 549, 546, executory contract rejections, and setoff restrictions.
138. Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 542 (2011).
139. *Id.* at 555.
140. *Id.* at 559.

to regulate them.[141] In explaining the evolution of repo protections, Professor Kettering states "[t]he repo experience also suggests that if a financial product with shaky legal underpinnings becomes sufficiently well established, those who are invested in the success of the product may find powerful allies in the financial regulators. . . ."[142] Though rationales for repo market protections in bankruptcy do exist, they are not convincing. The strongest "micro" theory is the importance of *timing* in the repo market. Repos are designed to be quick turnaround loans and cannot survive the delay of bankruptcy.[143] On the "macro" side, allowing repo protections allegedly works against systemic risk, namely the risk that if one financial institution were to fail, the rest would fall like dominos.[144] More likely, as Professors Roe and Kettering identified, the regulations themselves are drafted by players in the market and therefore benefit those players.

B. *The Settlement Safe Harbor*

An additional safe harbor drafted by and for the securities industry is the settlement safe harbor. The Code articulates that settlement payments are exempt from other regulations in the Code,[145] such as fraudulent conveyance liability, like the repo exemptions outlined *supra* Section IV.A. However, determining what constitutes a "settlement payment" is akin to Justice Stewart's "I know it when I see it" standard.[146] The Code provides the following guidance: "[A] 'settlement payment' means a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade. . . ."[147] Essentially, as Professor Roe states, "a settlement payment is a settlement payment is a settlement payment."[148] Keeping in

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141. Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1,553 (2008).
142. *Id.* at 1,645; *see also* ROE & TUNG, *supra* note 55, at 399.
143. *See* ROE & TUNG, *supra* note 55, at 399.
144. *See id.* at 398.
145. 11 U.S.C. § 546(e).
146. *See* Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).
147. 11 U.S.C. §741(8).
148. ROE & TUNG, *supra* note 55, at 587.

mind that the Code is often drafted by the securities industry,[149] a vague definition is logical. Like the automatic stay's broad and vague definition,[150] the settlement safe harbor rests on a similar type of definition, and thus is susceptible to broad application for the benefit of the industry.

The exemptions have since been applied to shareholders, namely large management-owners of corporations, who received payment in a financial transaction called a "leveraged buyout" ("LBO"). An LBO is a commonly used transaction in which the stock of the "target company" is bought by a purchasing company (usually a shell created for this purpose) in order to switch the ownership of the company.[151] Often, manager-owners of the target stay on in the new company, but still receive the payout that other shareholders receive.[152] The transaction, though, often renders the target insolvent, preventing creditors from collecting the money placed in owner-managers' pockets.[153] Thus, LBOs have increasingly come under fraudulent conveyance liability, with creditors suing to recover the money from owner-managers.

To avoid liability, parties involved in LBOs have asserted that the settlement safe harbor applies and have largely been successful. Of the six circuits who have heard this argument, five have agreed that the LBO transaction falls under the settlement safe harbor (including the manager-owners' profits).[154] The winning streak ended in 2018, when the Supreme Court heard *Merit Management Group v. FTI Consulting, Inc.*[155] The Court reasoned that these exemptions did not protect all parties in the transaction, as the language states that it is only for financial institutions.[156] Specifically, the Code articulates that "the trustee may not avoid a transfer that . . . [a] settlement payment, as defined in section 101 or 741 of this title, *made by or to (or for the benefit of)* a commodity broker, forward contract merchant, stockbroker, *financial institution*, financial

149. *See supra* Introduction.
150. *See supra* Section II.A.
151. *See* ROE & TUNG*, supra* note 55, at 563.
152. *See id.* at 563.
153. *See id.* at 564.
154. *See id.* at 600.
155. Merit Mgmt. Grp., LP v. FTI Consulting, Inc., 138 S. Ct. 883 (2018).
156. *Id.* at 887.

participant, or securities clearing agency. . . ."[157] Again, the language is incredibly broad and, as a result, unclear. However, the key phrasing for the Court was that the payment be made "by or to" a "financial institution." In its holding, the Court stated "[b]ecause the parties do not contend that either [party] is a [financial institution or other] covered entity, the transfer falls outside of the § 546(e) safe harbor."[158] The language, though, leaves room for a new argument, namely, that those parties are "financial institutions."

Professor Roe has explored this idea, highlighting that the Code defines a "financial institution" as including the "customer" of a financial institution.[159] In doing so, the Code allows for all parties who merely employ a financial institution for such a transaction to seek refuge in its settlement harbor. To be sure, the U.S. District Court for the Southern District of New York—the financial capital—has already reached this conclusion.[160] The implications of this are vast—indicating that owner-managers may safely orchestrate LBOs to line their pockets and reduce payments to creditors. Seeing as financial institutions are necessary to complete these transactions, non-financial institution creditors will likely be those lower on the priority totem pole, namely unsecured creditors who would already be paid last.

V.
A Signal for Change: The Appetite for Intervention

Government activism in bankruptcy proceedings is a rather new phenomenon. However, the principles that it represents are crucial to understanding how (and why) a new Bankruptcy Act must be drafted. Over a decade has passed since the federal government first dared to step into a bankruptcy proceeding with the goal of assisting the industry and, more importantly, its stakeholders.[161] Since then, some state

157. 11 U.S.C. § 546(e) (emphasis added).

158. *FTI*, 138 S. Ct. at 887.

159. Mark J. Roe & Frederick Tung, Bankruptcy and Corporate Reorganization: Legal and Financial Materials, Spring 2022 Supplement 107 (Dec. 2021).

160. *In re* Trib. Co. Fraudulent Conv. Litig., 2019 WL 1771786, at *8 (S.D.N.Y. 2019), *aff'd*, 10 F.4th 147 (2d Cir. 2021).

161. *See generally* Roe & Skeel, *supra* note 57.

government actors have followed suit[162] and academics have taken notice.[163] With an increasing conversation surrounding government activism and regulation through bankruptcy proceedings, we are able to make note of what drives actors, as well as what concerns them. These factors, then, can be addressed and accounted for in the amended Bankruptcy Act.

The first notable example of government using bankruptcy to protect public stakeholders occurred during the automotive industry crisis of the 2000s—namely, the cases of Chrysler and General Motors ("GM"). Chrysler received significantly more attention than GM, as the federal government was much bolder in its involvement of that reorganization. In the Chrysler reorganization, the federal government ultimately orchestrated a sale to Fiat, which would allow Chrysler to be reorganized both financially and managerially for long-term success.[164] In doing so, the Chrysler plan (not just the assets, but liabilities such as the pension fund) was offered to the highest bidder.[165] Though a business-savvy decision intended to avoid a federal buyout that would cost taxpayers millions,[166] the sale was controversial on Wall Street.[167] The issue was simple: the government's structured plan subverted some absolute priority rules by paying back unsecured creditors before secured creditors were paid in full.[168] It is worth noting, though, that many of these creditors agreed to the plan as written.[169]

Chrysler became a highly politicized restructuring endeavor. In his announcement of the reorganization plan, President Obama utilized some phrases used by economists in the

162. *See* Jared A. Ellias & George Triantis, *Government Activism in Bankruptcy*, 37 EMORY BANKR. DEV. J. 509, 509 (2021).
163. *See generally id.*
164. *See* Roe & Skeel, *supra* note 57, at 733.
165. *Id.*
166. *Id.* at 760.
167. *See, e.g.*, Mark Roe, *The Chrysler Bankruptcy Sale: An Assessment*, FORBES (June 15, 2009, 12:00 AM), https://www.forbes.com/2009/06/14/chrysler-uaw-bankruptcy-fiat-opinions-contributors-general-motors.html?sh=4c5e75a35c75.
168. Austan D. Goolsbee & Alan B. Krueger, *A Retrospective Look at Rescuing and Restructuring General Motors and Chrysler* 30 (Nat'l Bureau of Econ. Rsch., Working Paper No. 21000, 2015).
169. *Id.* at 30–31.

1970s[170] (arguing for lesser regulations, corporate power, etc.) to showcase the importance of Chrysler to its stakeholders. In introducing the company, President Obama remarked, "it's been responsible for helping build our middle class, giving countless Americans the chance to provide for their families, sending their kids to college, saving for a secure retirement."[171] President Obama thus drew upon an ideal that had previously been used by the opposing political side, but for stakeholders. By taking control of the narrative, President Obama was able to gain traction, and even went so far as to note specifically that the plan protected "Chrysler's largest stakeholders, including auto workers and its largest lenders."[172] Positioning auto workers first after the word "stakeholders" was a subtle, yet powerful, political statement about who should be prioritized in restructurings. President Obama then made a powerful statement, listing all of the actors and their concessions throughout the process,[173] and then juxtaposed that by saying, "while many stakeholders made sacrifices and worked constructively, I have to tell you some did not."[174] He went on to elaborate that "a group of investment bankers and hedge funds decided to hold out," hoping that the government would conduct a bailout resemblant of the financial crisis, noting that "they were hoping everyone else would make sacrifices and they would have to make none."[175] He stated, clearly, "I don't stand with them."[176]

In a similar speech to the United Auto Workers, the union involved in and protected through the Chrysler restructuring, President Obama again showed the power of his hand:

> The heartbeat of American manufacturing was flatlining and we had to make a choice. With the economy in complete free fall there were no private inves-

170. *See supra* Section I.A.
171. *Presidential Remarks on the Auto Industry*, C-SPAN (Apr. 30, 2009), https://www.c-span.org/video/?285605-4/presidential-remarks-auto-industry.
172. *Id.* at 4:05.
173. Notably, this includes a specific mention of a group of banks, led by J.P. Morgan, who President Obama thanked for their cooperation and concessions. *Id.* at 6:30.
174. *Id.* at 7:08.
175. *Id.* at 7:24.
176. *Id.* at 7:29.

> tors or companies out there willing to take a chance on the auto industry. . . . And all of you, the men and women who built these companies with your own hands, would have been hung out to dry.[177]

In so stating, President Obama again highlighted the failures of the private market during times of financial crisis: the weight falls on those who are least equipped to handle it. This general motif need not be applied only to economy-wide crisis. Rather, it is the unprotected stakeholders that receive the least protections in bankruptcy. Each bankruptcy is its own miniature financial crisis, regardless of whether the company is solvent or not, and needs to be considered as such when determining who is most deserving of protections.

VI.
THE NEW BANKRUPTCY ACT

The signaling through Chrysler is clear: both governmental and non-governmental actors (including some banks and financial institutions) are willing to protect stakeholders in bankruptcy in ways they have not been previously. While not universal, this sentiment suggests a growing concern about the imbalance of power within bankruptcy proceedings. Through a handful of case studies, one theme has become clear: though the debtor is promised prioritization, the true power resides in big business, whether it be a large corporate debtor, institutional creditors such as hedge funds and big banks, or even a powerful family with a third-party release. In order to make good on that promise, as well as protect stakeholders who do not have the institutional power of other creditors, it is time for an amended code. Taking lessons from prior versions of the bankruptcy system,[178] as well as other governmental and business entities, we can structure a bankruptcy system that both protects going-concern and prevents abuse.

Briefly, the structure is as follows:

(1) Reflecting an understanding of incentives and Federal Circuit trends, the amended code will include a

177. Barack Obama, U.S. President, Remarks by the President to UAW Conference, Office of the Press Sec'y (Feb. 28, 2012, 11:30 AM), https://obamawhitehouse.archives.gov/the-press-office/2012/02/28/remarks-president-uaw-conference.

178. *See supra* Section I.A.

good faith filing requirement, rather than only requiring good faith at the plan proposal stage.

(2) Taking note from the Chandler Act, the amended code will split businesses based on market capitalization. This is crucial, as mom-and-pop businesses will not have the same concerns as large corporate entities.

(3) The control of the large corporation who enters bankruptcy will be passed over to the federal government. The government, then, will handle the bankruptcy proceedings while the corporation remains in bankruptcy.

These three key steps—requiring good faith, separating businesses by market capitalization, and then passing the reigns to an unbiased government actor—will ameliorate the abuses we have seen previously.

A. *A Good Faith Filing Requirement*

As the Code is currently written, the eligibility for a company to file for bankruptcy is near limitless. Eligibility is governed by § 109,[179] which articulates the types of entities who may file,[180] but includes neither a requirement of insolvency nor a requirement the petition be filed in good faith.[181] In fact, "[t]he minutes of the Commission on the Bankruptcy Law of the United States, the original draftsmen of the Bankruptcy Code, suggest that this omission was intentional," as drafters feared abuse of such a requirement.[182] Thus, the only explicit good faith requirement is that the plan of reorganization be proposed in good faith,[183] which often occurs long after the company has entered and reaped the benefits of Chapter 11. Additionally, though the Code requires a plan be proposed in good faith, it does not provide a definition of "good

179. 11 U.S.C. § 109.

180. Patrick A. Jackson & Robert S. Brady, *Dismissal for Bad-Faith Filing Under § 1112(b)(1): Whose Burden Is It, Anyway?*, 28 AM. BANKR. INST. J. 63, 64 (Dec./Jan. 2010).

181. *Id.*

182. *Id.*

183. William Thomas Thurman & Brett P. Johnson, *Bankruptcy and the Bad Faith Filing*, 10 UTAH BAR J. 12, 13 (Dec. 1997).

faith" or "bad faith."[184] Thus, the current requirements are few and vague.

That is not to say, though, that the bankruptcy system has not implemented mechanisms to protect the integrity of the Chapter 11 system, despite the (perhaps intentional) omission of a good faith requirement. Rather, though there is "no explicit statutory good faith filing requirement [ ], bankruptcy relief is considered an equitable remedy and *courts have imposed by judicial interpretation* the requirement that debtors file petitions in good faith."[185] To be sure, every federal circuit court that has directly addressed the issue of a good faith filing requirement has held that it is a necessity for ensuring equity in the system.[186] This includes ten of the thirteen federal circuits: the First,[187] the Second,[188] the Third,[189] the Fourth,[190] the Fifth,[191] the Sixth,[192] the Seventh,[193] the Eighth,[194] the Ninth,[195] and the Eleventh.[196] Notably, the Third Circuit, often thought of as home to corporate law norms, was the most recent to implement a good faith filing expectation in 2004.[197] Additionally, a district in the Third Circuit, the Dis-

184. *Id.*

185. *Id.* (emphasis added).

186. Greenstone Miller, *supra* note 70, at 181.

187. *See* Connell v. Coastal Cable T.V., Inc. (*In re* Coastal Cable T.V., Inc.), 709 F.2d 762, 764 (1st Cir. 1983).

188. *See* Sonnax Indus., Inc. v. Tri Component Products Corp. (*In re* Sonnax Indus., Inc.), 907 F.2d 1280, 1286 (2d Cir. 1990).

189. *See* Integrated Technology Express Inc. v. Integrated Telecom Express, Inc. (*In re* Integrated Telecom Express, Inc.), 384 F.3d 108, 112 (3d Cir. 2004); *see also* Mem'l Corp. v. Bepco, L.P. (*In re* 15375 Memorial Corp.), 589 F.3d 605, 608 (3d Cir. 2009).

190. *See* Carolin Corp. v. Miller, 886 F.2d 693, 694 (4th Cir. 1989).

191. *See* Little Creek Dev. Co. v. Commonwealth Mortg. Corp. (*In re* Little Creek Dev. Co.), 779 F.2d 1068, 1072 (5th Cir. 1986).

192. *See* Laguna Assocs. Ltd. P'ship v. Aetna Casualty & Surety Co. (*In re* Laguna Assocs. Ltd. P'ship), 30 F.3d 734, 737 (6th Cir. 1994), *as amended on denial of reh'g and reh'g en banc* (Sept. 9, 1994); *see also* Trident Assocs. Ltd. P'ship v. Metro. Life Ins. Co. (*In re* Trident Assocs. Ltd. P'ship), 52 F.3d 127, 131 (6th Cir. 1995), *cert. denied*, 116 S. Ct. 188 (1995).

193. *See In re* Madison Hotel Assocs., 749 F.2d 410, 425 (7th Cir. 1984).

194. *See* Prod. Credit Assoc. v. Wieseler (*In re* Wieseler), 934 F.2d 965 (8th Cir. 1991).

195. *See* Idaho Dep't of Lands v. Arnold (*In re* Arnold), 806 F.2d 937, 939 (9th Cir. 1986).

196. *In re* Phoenix Piccadilly, Ltd., 849 F.2d 1393 (11th Cir. 1988).

197. *In re* Integrated Telecom, 384 F.3d 108, 118 (3d Cir. 2004).

trict of New Jersey, recently held that a Johnson & Johnson subsidiary responsible for talc claimants filed in good faith,[198] making it clear that the good faith filing requirement is still an amorphous standard.

Though the Commission appears to have intentionally left a good faith filing requirement out of the Code, that does not prevent bankruptcy practitioners and academics from amending the Code to include one. As ten of the thirteen circuits are in agreement, there is no valid argument as to why the amended code should not include an express definition and requirement of good faith in filing for Chapter 11.

1. *The Purpose of the Requirement*

Even though the federal circuits are relatively clear[199]—a good faith filing purpose is necessary to preserve equitable treatment in bankruptcy—this does not eliminate the need to amend the Code. Though the conclusion of the circuits is the same, the means are drastically different. For example, the Ninth Circuit articulated that the "test is whether a debtor is attempting to unreasonably deter and harass creditors or attempting to effect a speedy, efficient reorganization on a feasible basis," or is "seek[ing] to achieve objectives outside the legitimate scope of bankruptcy laws."[200] In contrast, the Third Circuit explained the standard as requiring a "valid reorganizational purpose," that "falls along the spectrum ranging from the clearly acceptable to the patently abusive."[201] The Fourth Circuit addressed the amorphous nature of the standard directly, stating "[d]espite widespread judicial acceptance and application of the good faith filing requirement, no gen-

198. *In re* LTL Mgmt., LLC, 637 B.R. at 429–30. When presented to the Third Circuit, the appellate court yet again emphasized the importance of good faith filing, dismissing the bankruptcy of the subsidiary. *See In re* LTL Mgmt., LLC, 58 F.4th 738 (3d Cir. 2023).

199. As explored *supra*, ten of the thirteen federal circuits have come to the conclusion that filings need to be made in good faith. As this represents all of the circuits that have directly addressed the issue, they will be referred to generally as the 'federal circuits.'

200. Robert J. Keach, *Solvent Debtors and Myths of Good Faith and Fiduciary Duty*, 23 AM. BANKR. INST. J. 36 nn.13–14 (Dec./Jan. 2004) (citing In re Marsch, 36 F.3d 825, 828 (9th Cir. 1994)).

201. *Id.* nn.15–16 (citing *In re* SGL Carbon Corp., 200 F. 3d 154, 162, 165 (3d Cir. 1999)).

erally accepted proof requirements have emerged."[202] The Eleventh Circuit attempted to overcome this hurdle by outlining clear factors: "(1) a one-asset debtor; (2) improper prepetition conduct of the debtor; (3) relatively few unsecured creditors; (4) posting of the debtor's property for foreclosure . . .; (5) two-party dispute; (6) evasion of a state court order; (7) no ongoing business or employees of the debtor; and (8) insufficient cash flow and no available income to fund a plan of reorganization."[203] Thus, the circuits have not reached a consensus on application of the good faith standard, and as a result, possible bad faith debtors can forum shop for an interpretation favorable to their specific facts.

Additionally, though there appears to be agreement among the federal circuits that good faith is required, courts do not uniformly apply a specific standard. Because of the fact-intensive nature of the circuit court tests, it is difficult to draw a bright line indicating when a lower court should dismiss a filing for bad faith. As a result, not all courts do. In the District of Massachusetts, for example, Bankruptcy Judge Queenan notoriously denied a motion to dismiss on good faith filing grounds, stating that "[g]ood faith, like apple pie, is difficult to oppose. The good faith of this doctrine, however, has nothing to do with honesty. When its true content is revealed, the doctrine is exposed as being in conflict with the Bankruptcy Code, its legislative history, Supreme Court precedent, and logic."[204] Though the case is decades old, the principle is not outdated.[205] Many bankruptcy judges and practitioners recognize that a good faith filing requirement is a judge-made law and one that, arguably, contradicts the plain language of the Code as written. Thus, some judges may choose not to apply a good faith requirement, as they "ha[ve] no express authority under the Code to make decisions affecting eligibility to seek Chapter 11 relief. Article 1, Section 8 of the United States Constitution reserves this role specifically for the United States

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202. Carolin Corp. v. Miller, 886 F.2d 693, 701 (4th Cir. 1989).

203. Greenstone Miller, *supra* note 70, at 184 (citing In re Phoenix Piccadilly, Ltd., 849 F.2d 1393 (11th Cir. 1988)).

204. *In re* Victoria Ltd. P'ship, 187 B.R. 54, 54 (Bankr. D. Mass. 1995).

205. This case has been cited as recently as 2021 by the First Circuit. *See, e.g.*, La Trinidad Elderly LP SE, 627 B.R. 779 (B.A.P. 1st Cir. 2021) (citing *In re* Victoria Ltd. P'ship as an example of a court not permitting a bad faith objection).

Congress and not Article III judges, let alone Article I bankruptcy judges."[206] Current circuit unanimity aside, there remains a need to amend the Code to include an express good faith filing requirement. Bankruptcy judges cannot be expected to act beyond their authority, even if applying a principle established by a higher court. In arguing for an amended Code, Judith Greenstone Miller articulates three reasons that circuit standards must be codified: (1) clarifying the precedent and current "rule" would encourage consistency across circuits; (2) codifying the rule will provide bankruptcy judges the express authority they need to uphold this standard; and (3) preventing abuse of Chapter 11 filings will strengthen the overall integrity of the bankruptcy system.[207] In considering these arguments, the objective of the bankruptcy system remains crucial.

The bankruptcy system is designed around the successful and equitable reorganization of a company's debt. Specifically, the "Chapter 11 system is designed to preserve the 'going concern' value—that is, to maximize the value of the business so that more value is available for the repayment of the creditors."[208] In order to achieve this goal, the system is designed to encourage cooperation between creditors and the debtor through various mechanisms that remove self-interested incentives (e.g., the automatic stay, the period of exclusivity, etc.). Thus, "[i]n effect, bankruptcy is a constant struggle involving both allocative efficiency (eliminating waste and raising total collective value) and distributive justice (distributing the value of a reorganized business among all the stakeholders according to normative principles."[209] Given the balance between the transactional and litigious aspects of the bankruptcy system, there is a high standard for meeting expectations and cooperating with other parties in each matter. This goal provides a crucial factor for consideration: clear norms for parties to observe. If uncertainty around acceptable norms for filing remain, "the expectations of the parties will forever be dashed . . . . Commercial parties cannot adjust to such a fluid doctrine

206. Miller, *supra* note 70, at 182.
207. *Id.* at 181–82.
208. WARREN, *supra* note 10, at 12.
209. *Id.* at 17.

that is constantly evolving."[210] Rather than only considering the judges' need for clear standards, proponents must anticipate the needs of commercial parties as well.

In drafting the requirement for the Code, proponents have weighed an objective-subjective model.[211] Specifically:

> [t]he principal inquiry under the objective-subjective test is whether the goals of the reorganization case are consistent with the policies underlying the Code. The objective part of the test is intended to ensure that the debtor has the ability to reorganize. The subjective part of the test is designed to prevent the debtor from abusing Chapter 11 and the creditors.[212]

This model for a good faith requirement guarantees that the integrity and objective of the bankruptcy system is left intact, while allowing for a combination of fact-based and normative assessments by the bankruptcy judge. To reflect a "totality of the circumstances"[213] standard, Greenstone Miller highlights the faults of using only an objective or subjective standard.[214] With just an objective test, the debtor's intents become irrelevant to the calculus. However, Greenstone Miller notes that, "[b]ecause the debtor's motives are often difficult to ascertain absent a lie detector test, using the subjective test is too reliant on the whims of judicial fiat."[215] Anticipating and responding to criticisms, Greenstone Miller elaborates that, "[u]sing only the subjective test also undermines the principles of rule of law, uniformity and certainty, and public confidence in the predictability of the system."[216] Thus, an ideal good faith requirement would account for both the need for uniformity and equity through an objective test, as well as the debtor's motivations through a subjective test. This would promulgate the expectations and goals of the bankruptcy system for all actors.

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210. Miller, *supra* note 70, at 188.
211. *Id.* at 196.
212. *Id.* at 194.
213. *See, e.g.*, *In re* Integrated Telecom, 384 F.3d 108, 108 (3d Cir. 2004).
214. Miller, *supra* note 70, at 188.
215. *Id.*
216. *Id.*

2. *Criticisms and Counterarguments*

As Judge Queenan stated, "good faith, like apple pie, is difficult to oppose."[217] That does not, though, mean that the standard of good faith is without critics—himself included. Judge Queenan has also written that, "[a] rule of law should be susceptible to clear statement, so that the result of its application to particular facts can be predicted with reasonable certainty," arguing the good faith filing requirement "fails this test miserably."[218] Though cherry-picking a few common criticisms, Judge Queenan serves as an example of the multifaceted nature of opposition to a good faith filing requirement. However, these counterarguments can be addressed as easily as they have been raised. Predictability, as raised by Judge Queenan, is solved through the implementation of a clear standard for good faith filing in the amended code. As explored in Section VI.A., the various circuits have attempted to articulate specific standards for what constitutes "good faith" or "bad faith."[219] This necessarily creates discrepancies across circuits, allowing for forum shopping, different standards, and inconsistent application of those standards. However, if the Code were amended to include specific factors to be applied by all circuits, this disparity would drastically decrease. Though there can be no guarantee for complete uniformity, as very few legal principles are applied in a truly uniform fashion, clear expectations in an amended code would alleviate these concerns.

Perhaps the most pervasive, and most convincing, counterargument is that a good faith filing requirement would initiate unnecessary litigation in an early stage of the proceeding. This argument, in fact, may have defeated a good faith filing requirement in the existing Code. Greenstone Miller articulates that:

> During the formulation of its report leading to the adoption of the Code, the Commission on the Bankruptcy Laws of the United States believed a good faith requirement would lead to needless litigation with secured creditors early in the case and was a harsh obstacle for a debtor undergoing operational

217. *In re* Victoria Ltd. P'ship, 187 B.R. 54, 54 (Bankr. D. Mass. 1995).
218. Keach, *supra* note 200, at 3.
219. *See supra* Section VI.A.

> changes. The Commission did not recommend that good faith be eliminated altogether, but left it as a plan confirmation issue.[220]

The argument, however, was and is misplaced. Though, admittedly, the concern is valid—imprecise standards surely will lead to litigants seeking a clear articulation of the standard—the lack of a good faith requirement has not fended off unnecessary litigation. Rather, it has simply shifted the placement of that litigation.

Take, for example, any number of cases attempting to decipher a clear standard for the good faith filing expectation. By not articulating the standard in the Code, the Commission has merely shifted the burden of litigation to the federal circuits to determine a standard. By clearly setting a test in an amended code, this litigation would cease. Additionally, beyond litigation around the precise standard, the lack of a good faith expectations allows for additional unnecessary litigation. Without clear eligibility requirements or thresholds, creditors seek relief from the automatic stay or more general dismissals for debtors believed to not belong in Chapter 11.[221] Thus, while the Commission was concerned about excess litigation with a good faith requirement, that repercussion exists even without the requirement. By including a clear standard, much of this litigation can be easily dismissed or will not be brought with frequency in the first place.

Lastly, there is an argument that a good faith filing requirement may be translated into an insolvency or lack of liquidity requirement.[222] This is a distinct issue, one that cannot be conflated with a good faith requirement. An insolvency requirement has clear downfalls; particularly, it would require companies to file too late in the process, almost guaranteeing their failure to restructure successfully. Given that the objective of Chapter 11 is to provide for an equitable restructuring which promotes sustainable success of the company, the requirement that a company be insolvent or illiquid upon entering would set this objective on fire. Rather, a good faith requirement would not be equated to insolvency. In fact, "courts applying the 'good faith filing' doctrine are also uniform in

220. Miller, *supra* note 70, at 185–86.
221. Miller, *supra* note 70, at 186.
222. Keach, *supra* note 200, at 36–37.

stating that insolvency is not a prerequisite to seeking [C]hapter 11 relief and that solvency alone will not result in dismissal for an absence of good faith."[223] Nonetheless, because the criticism remains, the need for express requirements is further apparent. With a clear standard in an amended code, no room would exist for misrepresentations or misstatements of what "good faith" means.

As articulated by Judge Edith H. Jones of the Fifth Circuit, "[t]he debtor must be in bankruptcy because there is an entity to reorganize and because such a reorganization is reasonably possible within a reasonable period of time. Absent such proof, the reorganization goal of Chapter 11 is meaningless."[224] The federal circuits have reached the same conclusion: a good faith filing requirement is necessary to ensure the integrity and equity of the bankruptcy system. There is no convincing counterargument to the contrary. By articulating a clear standard and granting bankruptcy judges clear authority to dismiss cases filed in bad faith, the amended code would better protect the bankruptcy system for the foreseeable future.

B. *Separation by Market Capitalization*

A separation of companies filing for bankruptcy would resemble that in the Chandler Act of 1938.[225] When Chapter X and Chapter XI were both in effect, companies spent significant time and resources attempting to switch to Chapter XI (the less restrictive bankruptcy system designed for small, mom-and-pop-type businesses).[226] It was this effort that made Chapter X less efficient. In self-interest (which can be expected of businesses in a capitalist structure), these companies wasted their own resources along with those of the courts and SEC, simply in an effort to skirt requirements. In drafting the amended code, the distinction between the two bankruptcy pathways should be simple: a clean market capitalization cutoff. By using market capitalization to determine the appropriate pathway, the burden of bankruptcy filings rest appropri-

223. *Id.* at 36.

224. Edith H. Jones, *The "Good Faith" Requirement in Bankruptcy*, 1988 ANN. SURV. OF BANKR. L. 45, 48 (1988).

225. *See generally* Chandler Act, Pub. L. No. 75-696.

226. *See supra* Section I.A.

ately on companies. Small town restaurants would progress through bankruptcy more quickly due to less-stringent requirements than those explored *infra*,[227] justified by their lesser resources and (likely) stronger need for leeway. On the other hand, large corporations, the failure of which would have monumental effects, would undergo a more stringent process, designed to ensure that failure is not replicated and that the bankruptcy proceedings are conducted in good faith.

A bias towards small businesses is both common and rooted in logical policy. For example, the Small Business Reorganization Act sets out different requirements for bankruptcy proceedings of "small" businesses, which are those with less than $2.7 million in debt.[228] Confirmation requirements differ and shareholders are left with more power than is the case in larger restructurings.[229] This follows logically, as small businesses likely have fewer assets and creditors, and the shareholders are usually just the full-time owners of the business itself. Despite this general trend, the 2005 amendment to the Code[230] was unique in that it made bankruptcy filings more difficult specifically for small businesses owners and individual debtors.[231]

A split by company size was also more effective. Discounting the loss in efficiency, which is largely a result of the actions of companies trying to get out of Chapter X, the confirmation rates tell a story different than the dominant narrative. Under the current Chapter 11, the plan confirmation rate rests quite

227. *See infra* Section VI.C.
228. Small Business Reorganization Act, Pub. L. No. 116-54.
229. *Id.*
230. 11 U.S.C. § 105(51D)(A).
231. The amendment was drafted with the specific goal of making bankruptcy proceedings less accessible to the individual, harming small business owners and low-income citizens disproportionately. *See* Matthew Notowidigdo, *Assessing the Bankruptcy Law of 2005*, NORTHWESTERN INST. FOR POL'Y RSCH. (Dec. 16, 2019) https://www.ipr.northwestern.edu/news/2019/assessing-the-bankruptcy-law-of-2005.html#:~:text=IN%202005%2C%20Congress%20passed%20the,well%20as%20less%20financially%20advantageous ("The new law was designed to deter people from pursuing bankruptcy by making filing for it more difficult and expensive, as well as less financially advantageous.").

low at 17%.[232] Comparatively, plans filed under the predecessor Chapter XI[233] had a confirmation rate of 33%.[234] It could be argued that the confirmation rate does not reflect the Chandler Act's success, largely due to the fact that this is only the Chapter XI rate (not Chapter X) and does not account for time progressed. However, that argument fails to capture the bigger picture: a split by company size is *effective*. In fact, a split can be expected to be even more effective when the parameters are made clearer, because that anticipates and attempts to prevent excessive litigation from companies trying to be declared small businesses. With a clear market capitalization cutoff, this litigation will be moot, and the system will be more efficient and likely retain its efficacy.

C. *Government control of the proceedings*

The most radical step in the proposal is also the most crucial—passing control of the debtor (only those in the large market capitalization track) over to a truly neutral government entity. Whether it takes the form of a subdivision of an existing governmental entity or an entirely new entity, the policy justification remains. Instilling a good faith filing requirement is commonsense policy, but will not solve the overarching incentive structure for businesses considering bankruptcy. Rather, by requiring a company to install a truly neutral party—a government employee—the equity promised by the bankruptcy system can be achieved more wholly. The evidence of success is apparent from the Chrysler reorganization,[235] where the federal government effectively protected middle class jobs while also gaining the support of major banks, such as J.P. Morgan.[236] Rather than being the anomaly, this type of restructuring should be the standard.

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232. Warren, supra note 10, at 17 (citing Ed Flynn, Administrative Office of the U.S. Courts, Statistical Analysis of Chapter 11, at 10–11 (1989)).

233. Even though Chapter XI was initially designed for small businesses, most companies switched over. *See supra* Section I.A.

234. Warren, *supra* note 10, at 17 (citing David Stanley and Marjorie Girth, *Bankruptcy: Problem, Process, Reform*, Brookings, 109, 115, 143, tbl. 7–8 (1971)).

235. *See supra* Part III.

236. *See* Roe, *supra* note 167.

1. *Lessons from the Reconstruction Finance Corporation*

In envisioning government or quasi-government control of the bankruptcy process, one would be remiss not to look first to the Reconstruction Finance Corporation ("RFC") of the 1930s. In short, "[t]he RFC was a quasi-public corporation, staffed by professionals recruited outside of the civil service system but owned by the federal government, which appointed the corporation's executive officers and board of directors."[237] The RFC was originally submitted by the Hoover Administration to Congress in 1931, and received broad, bipartisan support, with Congress expediting the relevant legislation.[238] The initial funding for the RFC came from bond offerings sold by the Treasury, which allowed the RFC to get off the ground.[239] The goal of the RFC was to aid corporations during reconstruction, providing loans to promote a company's successful reorganization.[240] The RFC was specifically looking for "solvent but illiquid institutions whose assets appeared to have sufficient long-term value to pay all creditors but in the short run could not be sold at a price high enough to repay current obligations,"[241] as loans would provide the temporary assistance these companies needed to exit bankruptcy.

The RFC was focused specifically on providing immediate assistance to companies most in need. In President Hoover's words, "[i]t [was] not created for the aid of big banks or big industries. . . amply able to take care of themselves. . . . It [was] created for the smaller banks and financial institutions. . . to give renewed support to business, industry, and agriculture."[242] President Hoover's description reflects his awareness of a need for government intervention in reconstruction and, thus, restructuring of industries. President Franklin D. Roosevelt later expanded the program, encouraging the RFC to make direct business loans to stimulate industrial expan-

237. Michael Gou, et al., *Reconstruction Finance Corporation Act*, FEDERAL RESERVE HISTORY (Nov. 22, 2013), https://www.federalreservehistory.org/essays/reconstruction-finance-corporation.

238. *Id.*

239. *Id.*

240. Lisa Thompson, *Reconstruction Finance Corporation*, THE LIVING NEW DEAL (May 31, 2019), https://livingnewdeal.org/glossary/reconstruction-finance-corporation-1932-1957.

241. Gou, et al., *supra* note 237.

242. Thompson, *supra* note 240.

sion.[243] In sum, the RFC provided funds to struggling small businesses to ensure their successful growth in the future.

The RFC was largely viewed as a success.[244] The responsibilities of the RFC slowly diverged, dissolving the organization into several distinct agencies, notably including the Small Business Administration.[245] However, the success of the organization provides a framework for envisioning how a potential bankruptcy agency or sub-division would operate. First, it highlights that government intervention in financial transactions is beneficial so long as such intervention is done properly. It also suggests possibilities for funding, hiring, and other administrative concerns.

The goal of the RFC was similar, but not the same, as would be the goal for the new agency or subdivision on bankruptcy, but the processes would be similar. With the RFC focusing on providing financial support to small businesses, the new agency or subdivision would be providing financial and governance support to only large corporations, those in the higher market capitalization channel. The structure of the RFC, though, provides a crucial datapoint; namely, that specialists were hired from outside civil service, and funding was initially secured through bonds offered by the Treasury.

2. *The Creation of an Agency or Subdivision*

Specialization is undoubtedly necessary to the success of any agency or subdivision devoted to moving companies through bankruptcy. Thus, reminiscent of the RFC, specialized attorneys and investment bankers would be hired from outside civil service. Whether it be a new agency or a subdivision of an existing one, the creation of an organization devoted to the execution of bankruptcy proceedings will allow for greater efficiency and equity in the process. Though certain agencies and organizations (such as the SEC or the U.S. Trustee) are currently dedicated to specific aspects of bankruptcy, this new organization would specialize in operating companies while they are in bankruptcy. Accordingly, it would not face the limitations of current agencies nor be focused solely on civil or criminal enforcement. Rather, its focus would

243. *Id.*
244. Gou, et al., *supra* note 237.
245. Thompson, *supra* note 240.

be operating the business and orchestrating a restructuring plan that it deems equitable under the circumstances. Initial funding for the agency, like in the case of the RFC, can come from bond issuances. For continued funding, a progressive corporate tax may be instituted. Thus, almost like buying insurance, a corporation is paying into a fund that it may use in the event of insolvency or a valid restructuring. The organization would remain well-funded and well-equipped to execute its mission.

Beyond the structure of the agency or subdivision, its purpose remains critical. By replacing the current debtor-in-possession model with an agency-in-possession model, the amended code instills a very clear (and likely strong) disincentive to file for bankruptcy. As discussed *supra* Section II.B., a company may file for Chapter 11 for myriad reasons unrelated to reorganization. Creating an explicit good faith filing requirement will deter some of these filers, but such requirement is still just a legal architecture response and unlikely to *significantly* deter debtors from filing. More likely, debtors who have determined they need to file will do so and ensure that they meet the test included in the good faith requirement. These debtors have significant resources and surely excellent attorneys, and thus likely require a stronger disincentive touching upon business motivation.

This incentive analysis necessitates the government control aspect of the amended code. By forcing major debtors to pass over the reins after filing for bankruptcy, there is a strong deterrent effect in filing. No company looking to utilize bankruptcy for, say, a litigation tactic, would be able to do so if their CEO is no longer in control of the operations. This, then, would alter the calculus of companies considering filing for bankruptcy. Rather than being able to enter, absorb protections, and then leave with restructured debt, the company would have to consider the effect of passing over control, even if briefly. This should not, though, be considered a be-all-end-all, as there is some value in retaining management for the success of the company. Accordingly, like the Chandler Act,[246] the government actor in control should have the discretion to retain management if deemed suitable. This provides the best middle ground: a truly neutral party retains control, but man-

246. *See* Pub. L. No. 75-696.

agement remains available for the nuanced aspects of their business.

D. *Criticisms and Counterarguments*

Of course, replacing management as the default with a government organization is a drastic remedy. To be sure, some may argue that this remedy is *too* drastic and does not carry water when analyzed closely. In support, many have deemed the SEC's role in the Chandler Act a failure, as it was inefficient and often resulted in incorrect valuations. Take, for example, Atlas Pipeline.[247] Atlas Pipeline filed for bankruptcy in 1939, and initially the judge had conducted a market test with a valuation of $1.2 million to no avail.[248] Thereafter, the judge sought valuation opinions from the trustee and the SEC.[249] The trustee determined that Atlas Pipeline could continue as a perpetuity, averaging $170,000 per year with a 10% discount rate, thus valuing the company at $1.7 million.[250] The SEC, presented with the same information as the trustee, produced a significantly lower valuation, ultimately reaching the conclusion that a reorganization was not feasible nor wise.[251] The SEC reasoned that Atlas Pipeline would last no longer than five years, gave it a higher discount rate, determined its margins to be razor-thin, and included an account of freight rate deductions.[252] The SEC arguably double counted some of these deductions, for example only counting earnings up to year five while also increasing the capitalization rate for the first five years because of this prediction.[253]

In any event, the bankruptcy judge determined that the SEC was wrong, adopting the trustee's valuation and ultimately producing a very successful company.[254] It is likely that the SEC did not make any unintentional errors. Rather, the SEC could have chosen a low valuation due to a sense that insiders

247. *See* ROE & TUNG, *supra* note 55, at 91.
248. *Id.* at 91–95.
249. *Id.*
250. *Id.* at 104–05.
251. *Id.* at 102–04.
252. *Id.*
253. *Id.*
254. *Id.* at 104–05.

were receiving more profit than was just.[255] With a close look at the plan of reorganization for Atlas Pipeline, this becomes readily apparent:[256]

Security Holder	Amount	Annual Income	Rate of return
Bonds	$1M (4.5%)	$45K	4.5%
Preferred	$435K (4%)	$17K	4%
Common Stock	$100K	$108K (170-45-17)	108%
Enterprise total	$1.7M	$170K	10%

With other creditors all receiving rates of returns below 5% in the trustee's plan, the shareholders of Atlas Pipeline received a 108% return. Thus, the dominant narrative is challenged: was the SEC wrong, or were the other parties just corrupt?

This challenges the narrative that the SEC failed, or at least the extent of such failure. First, the SEC was pursuing objectives that simply digressed from the objectives of private financiers. Whether the focus is discouraging corruption,[257] protecting securities fraud claimants,[258] or promoting beneficial public policy overall,[259] the motivations of a government actor are simply different than private parties. Additionally, while there is some merit to the argument that the SEC was slow or inefficient, this cannot be heard in a vacuum. It was private companies that pursued endless litigation in an effort to switch into Chapter XI, which necessarily drew out the process.[260] Additionally, a significant portion of the SEC's role was to investigate *why* the company failed, an objective which takes time and is often not accounted for in the explanation of delay.[261] Regardless, many of these efficiency concerns would be

255. The SEC hints at this possibility in their advisory opinion, stating "they are to place the fate of their investment in the hands of the Producers Group despite the latter's conflicting interests. . . leading in our opinion to the conclusion that the plan cannot be considered fair." *Id.* at 103.

256. *Id.* at 96.

257. *See In re* Atlas Pipeline Corp., 39 F. Supp. 846 (W.D. La. 1941).

258. *See* SEC v. WorldCom, Inc., 273 F. Supp. 2d 431 (S.D.N.Y. 2003).

259. *Id.*

260. *See supra* Section I.A.

261. *Id.*

ameliorated by creating a specific agency or subdivision devoted to executing bankruptcy proceedings. Rather than it being the responsibility of an entire agency, particularly one with a broad mandate in securities regulation, the amended code would provide for an organization that specializes in bankruptcy and *only* handles bankruptcy.

Certain middle ground approaches could also be successful, but would likely not achieve the same deterrent effect. For one, the power of the U.S. Trustee Program ("USTP") could be expanded. As stated on their website, the mission of the USTP is "to address fraud and abuse by debtors, creditors, and others in the bankruptcy system by taking both formal and informal civil enforcement actions and making criminal referrals to U.S. Attorneys as appropriate."[262] However, in doing so, the USTP is limited by the previous discussion on the difficulty of government enforcement measures balanced against the automatic stay.[263] It is possible, however, that the proposed subdivision would sit within the USTP. This arrangement would provide several benefits, including the established relationship between the USTP and the U.S. Attorney's Offices. It would also, however, centralize the bankruptcy functions in a manner that may make the new division more vulnerable to corporate capture.

Alternatively, with the current prevalence § 363 sales, stakeholders may have some faith in a market valuation or bankruptcy judge valuation. Thus, rather than bringing on an agency or subdivision, the power to value the debtor (or to hire an expert to value) could be granted to the bankruptcy judge. A bankruptcy judge, though, also does not exist in a vacuum. Several scholars note a "race to the bottom" phenomenon whereby certain bankruptcy judges are thought to be lenient to debtors in order to attract more high-profile debtors to their district.[264] This incentive structure can be beneficial,

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262. U.S. DEP'T. OF JUST., UNITED STATES TRUSTEE PROGRAM (USTP), https://www.justice.gov/legal-careers/job/law-student-volunteer-academic-year-65. This analysis is not to minimalize the work of the US trustee, rather the proposal of a new division could be seen as an expansion of the powers of the trustee.

263. *See supra* Section II.B.

264. *See, e.g.*, Kenneth M. Ayotte & David A. Skeel Jr., *Why Do Distressed Companies Choose Delaware? An Empirical Analysis of Venue Choice in Bankruptcy*, FACULTY SCHOLARSHIP AT PENN L. (2003); David A. Skeel Jr., Bankruptcy

as was the case for Delaware courts, whose noted efficiency attracted many debtors seeking speedy resolution.[265] Alternatively, such incentives could distort the judges valuation and impact his decision regarding whether to install a trustee in place of current management. Because removing management is already thought to be a drastic remedy, it is unlikely that a judge would promote that as the new norm. Thus, the deterrent effect of removing management would likely fail, and it is possible that valuations would be affected given a judge's stake in his district's popularity.

Another potential counterargument to government control is its potential to chill investment by financiers, as they may hesitate to invest in a company whose management may be removed in bankruptcy. A similar argument was raised by Wall Street after the Chrysler organization, discussed *supra* Part V, in which financiers believed that secured creditors would no longer invest in companies because there was no guarantee that their security would be honored.[266] Warren Buffet, for example, warned ominously that the federal government's actions in the proceeding would have "a whole lot of consequences" for Wall Street deal-making.[267] This criticism has proven meritless.[268] In fact, one may argue that Chrysler's restructuring had a beneficial financial impact for those who needed it most. In analyzing senior debt securities traded over a two-year period following the Chrysler reorganization, Deniz Anginer and A. Joseph Warburton found no evidence of a negative financial reaction to unionized firms.[269] Instead, they observed a positive impact on returns, indicating that "bondholders interpreted the Chrysler bailout not as a threat to bankruptcy priorities, but rather as a signal that the government will stand behind the obligations of unionized firms."[270] Thus,

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Judges and Bankruptcy Venue: Some Thoughts on Delaware, FACULTY SCHOLARSHIP AT PENN L. (1998).

265. *Id.*

266. Deniz Anginer & A. Joseph Warburton, The Chrysler Effect: The Impact of the Chrysler Bailout on Borrowing Costs, (World Bank Pol'y Rsch., Working Paper No. 5462, 2011), https://law.stanford.edu/wp-content/uploads/sites/dfault/files/event/265497/media/slspublic/The_Chrysler_Effect_The_Impact_of_the_Chrysler_Bailout_on_Borrowing_Costs.pdf.

267. *Id.* at 2.

268. *Id.*

269. *Id.* at 5.

270. *Id.*

a similar increased confidence in debtor firms may be seen with the proposal of neutral government action.

Conclusion

All told, it is clear that the same feeling of inequity that plagues other legal disciplines can be found within the bankruptcy system and traced back to similar stakeholders. That is not to say that all parties are consciously gaming the system. Rather, the underlying systemic forces and distribution of resources has led to a warped interpretation of provisions within the Code, which threaten to undermine bankruptcy's standing as an equitable remedy. Though aiming to protect the weakened company, the implementation of the Code now leaves its weakened stakeholders with little protection and even fewer remedies. By making three key adjustments—a good faith filing requirement, a split of filing companies based on market capitalization, and increased government involvement—an amended code would be better equipped to return to (and remain) an equitable remedy.