NEW YORK UNIVERSITY
JOURNAL OF LAW & BUSINESS

VOLUME 16 FALL 2019 NUMBER 1

FROM VULNERABLE TO SOPHISTICATED: THE CHANGING REPRESENTATION OF CREDITORS IN BUSINESS REORGANIZATIONS

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This article narrates the development of the law of business bankruptcy and reorganization from the equity receiverships of the late nineteenth century through the New Deal programs to Chapter 11 of the Bankruptcy Reform Act of 1978 and the more recent turn to market solutions such as asset sales. I argue that the rules applicable to business reorganizations were informed by changing cultural perceptions of corporate property and the needs of investors. For one thing, at the turn of the twentieth century, concerns over the growing separation of ownership from control in large publicly held corporations as well as an image of investors as vulnerable inspired the enactment of Chapter X of the Bankruptcy Amendatory Act of 1938. It sought to protect the individual, passive creditor against potential abuses of power by corporate managers. In turn, in the late twentieth century, a vision of the corporation as a nexus of contracts and of investors as sophisticated and capable of protecting their interests substantiated the 1978 overhaul of the rules applicable to business reorganizations. Rather than protecting creditors from those in control, Chapter 11 of the new bankruptcy code entrusted corporate managers with the task of reorganizing distressed firms through negotiations with the different classes of creditors and claimants. As this article concludes, by the turn of the twenty-first century, sophisticated investors joined with management to reorganize firms, typically outside Chapter 11, while individual, unsophisticated creditors were, for the most part, left defenseless.

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INTRODUCTION

In October 2018, Sears Holding filed for Chapter 11 bankruptcy protection and began searching for funding to avoid liquidation. By the end of December 2018, Eddie Lampert, Sears' chairman (and CEO until the company filed for bankruptcy), "submitted a last-minute [$5.2] . . . billion bid for many of the company's assets, including 425 stores."[1] Most of the bid amount was in the form of debt assumption and credit bid rather than cash.[2] By January 2019, Sears' unsecured creditors ("landlords, suppliers and lenders") have labeled Lampert's bid a "fantasy" and demanded that the company liq-

1. Jessica Tyler, *Sears Chairman Eddie Lampert Submitted a Last-Minute Bid to Save the Company*, BUS. INSIDER (Dec. 30, 2018), https://www.businessinsider.my/sears-files-for-bankruptcy-empty-store-photos-2018-10-3/; Lauren Zumbach, *Pension Agency Criticized Sears' Chairman Edward Lampert's Plan to Buy Bankrupt Retailer*, CHI. TRIB. (Jan. 28, 2019), https://www.chicagotribune.com/business/ct-biz-pension-agency-criticizes-sears-bankruptcy-sale-0129-story.html.

2. Lauren Hirsch, *Sears Chairman Eddie Lampert Submits $4.6 Billion Proposal to Save Sears*, CNBC (Dec. 6, 2018), https://www.cnbc.com/2018/12/06/sears-chairman-eddie-lampert-submits-proposal-to-save-sears.html.

uidate instead.[3] In early February 2019, a bankruptcy court approved Sears' sale to ESL Investments, Lampert's hedge fund. The sale offer promised to "keep about 400 [out of 687] stores open and about 45,000 of Sears' workers (out of 68,000) employed."[4]

Neither the outcome nor the unsecured creditors' objection was surprising.[5] In recent decades, asset sales have become a common means for companies to emerge out of Chapter 11 of the Bankruptcy Reform Act of 1978 (hereinafter "Bankruptcy Code"),[6] either by using section 363 of the Code or by developing a plan of reorganization premised upon sale of all or substantially all of the assets.[7] Section 363 sales, which do not require a plan of reorganization, are typically quicker and thus potentially more efficient.[8] At the same time, section 363 sales enable debtors-in-possession to evade or circumvent some of the requirements of Chapter 11 that are meant to protect creditors—especially passive, unsecured creditors.[9] Sears' unsecured creditors argued that Lampert was trying to skirt the absolute priority rule, a rule meant to preserve the order

3. Lisa Fickenscher, *Sears Creditors call Eddie Lampert Plan 'Fantasy,'* N.Y. Post (Jan. 28, 2019), https://nypost.com/2019/01/28/sears-creditors-call-eddie-lampert-plan-fantasy/.

4. Hayley Peterson, *Eddie Lampert Wins Court Approval to Buy Sears Out of Bankruptcy and Save 45,000 Jobs*, Bus. Insider (Feb. 7, 2019), https://www.businessinsider.com/sears-avoids-liquidation-bankruptcy-2019-1.

5. Nor did the saga end with Lampert's acquisition. Lampert acquired "the strongest [stores] in the fleet. But the stores' performance deteriorated faster than expected . . . . In August [2019], the [New Sears] said it would close 21 Sears and five Kmart stores this fall. In addition, nearly 100 stores are slated for closure by year-end, the majority of them Kmart locations . . . ." As of October 2019, it was also predicted that the estate would "likely be short by as much as $104.5 million" in cash. Meanwhile, the estate brought a suit against "Mr. Lampert, his hedge fund, ESL Investments Inc., and other officials, accusing them of stripping billions of dollars in assets as the retailer's losses mounted." Suzanne Kapner, *Sears Hasn't Fared Better After Bankruptcy as Another 100 Stores Will Soon Close*, Wall St. J., Oct. 13, 2019.

6. Bankruptcy Reform Act, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

7. *See, e.g.*, David A. Skeel, Jr., *From Chrysler and General Motors to Detroit*, 24 Widener L.J. 121, 127–29 (2015).

8. According to section 363(b) of the Code, the debtor "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C § 363(b) (1978).

9. *See, e.g.*, Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and GM*, 2010 U. Ill. L. Rev. 1375, 1378–79 (2010).

in which the assets of a bankrupt corporation should be distributed among its creditors and other claimants.[10] For one thing, Sears' creditors wanted to "'recharacterize' Lampert's loans to Sears through his hedge fund ESL Investments [the same loans Lampert relied upon in his credit bid] as capital contributions subordinating them to creditor claims."[11] The "unsecured creditors' best hope," one commentator noted, "appear[ed] to be legal action over Lampert's dealings with Sears, where he has been controlling shareholder since the 2005 merger of Sears and Kmart, currently serves as chairman and recently held the CEO post."[12]

Throughout the twentieth century, passive and scattered, often unsecured, creditors have relied on the courts to protect their interests against more sophisticated creditors, who were often associated with corporate managements. At the same time, as this Article explores, changing cultural perceptions of the needs of unsophisticated investors have helped shape the rules applicable to business bankruptcy and reorganization. In the first half of the twentieth century, passive investors were seen as vulnerable and subject to corporate management's power. This image inspired the establishment of protective

10. Section 726 of the Code requires strict adherence to the absolute priority rule in liquidations. Section 1129, which is applicable in reorganization, allows the parties to negotiate and work around the absolute priority rule, provided that opposing individual creditors receive in reorganization no less than they would have received in liquidation. In the 1980s, the courts were rather protective of creditors' interests, subjecting section 363 sales, for example, to judicial scrutiny to ensure that companies did not use sales to undermine the requirements of section 1129. *See, e.g.*, *In re* Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983); *In re* Braniff Airways, Inc., 700 F. 2d 935, 940 (5th Cir. 1983). But in recent large bankruptcies, most notably General Motors and Chrysler, the court has allowed section 363 sales to circumvent some of these requirements. *See, e.g.*, Indiana State Pension Trust v. Chrysler, LLC, 576 F.3d 108, 118–19 (2d Cir. 2009). After Chrysler filed for bankruptcy, its assets were sold to a new corporation, owned by Fiat (20%), the US and Canadian governments (~12%) and Chrysler's Voluntary Employee Beneficiary Association (~68%). The new corporation assumed certain of the Old Chrysler's liabilities but not all of them; particularly, the secured creditors received the equivalent of 29% of their claims while unsecured creditors were paid in full. *See also* Brubaker & Tabb, *supra* note 9.

11. Steven R. Strahler, *Sears Creditors Face Wipeout Under Lampert Plan*, CRAIN'S CHI. BUS. (Feb. 4, 2019), https://www.chicagobusiness.com/retail/sears-creditors-face-wipeout-under-lampert-plan.

12. *Id.*

(creditors) committees in the equity receiverships of the late nineteenth century,[13] as well as the enactment of Chapter X of the Bankruptcy Amendatory Act of 1938 (hereinafter "Chandler Act")[14] and the Trust Indenture Act of 1939.[15] Both acts sought to protect the individual, unsophisticated investor against abuse by corporate managers and controlling shareholders.[16] In the second half of the twentieth century, investors came to be seen as sophisticated and capable of protecting their interests in contractual arrangements with debtors. In 1978, this vision substantiated the enactment of the Bankruptcy Code. It entrusted corporate managers with the task of reorganizing distressed firms through negotiations with the different classes of creditors and claimants, all presumed to have equal bargaining power.[17] As this Article concludes, by the early decades of the twenty-first century, sophisticated investors joined with management to reorganize firms while the individual, unsophisticated creditors were, for the most part, left defenseless.[18]

This Article further demonstrates how different cultural depictions of investors corresponded to changing understandings of the nature of the corporation and corporate property. The early twentieth century scholars' description of investors as vulnerable was informed by deep concerns about the separation of ownership from control in large publicly held corporations.[19] In turn, developments in the postwar years were influenced by the idea that the corporation was a nexus of contracts. In such an intellectual milieu, jurists drew a sharp distinction between two forms of corporate capital, describing shareholders as vulnerable owners deserving of fiduciary obligations and creditors as sophisticated investors able to protect and enhance their interests in their negotiations and contracts with corporations.[20]

13. *See* discussion *infra* Section I.A.
14. Bankruptcy Amendatory Act of 1938, ch. 575, 52 Stat. 840.
15. Trust Indenture Act of 1939, ch. 411, 53 Stat. 1149.
16. *See* discussion *infra* Part II.
17. *See* discussion *infra* Section III.B.
18. *See* discussion *infra* Section III.D.
19. *See* discussion *infra* Section I.B.
20. *See* discussion *infra* Section III.C. For a detailed examination of these changing conceptions of property and their impact on the development of

The Article develops as follows: Part I, *The Rise of the Vulnerable Investor*, sets the stage for the analysis. It focuses on the period ranging from the turn of the twentieth century roughly through the 1930s, a period during which American legal institutions were influenced by liberal legal thought, leading jurists to apply traditional common law rules to novel industrial problems. The equity receivership that developed in the late nineteenth century was an attempt to use property and contract rules to address the consequences of business failure. As Part I also explores, beginning with Progressive legal thought at the turn of the twentieth century, calls were made for a solution that would better address the boom and bust cycle that characterized the modern market and with it the modern industrialized state.

Part II, *Investors and the Administrative State: From Organization to Regulation,* examines how Progressive jurists attempted to protect investors, which they viewed as passive and vulnerable. As Part II explains, by the 1920s, Progressive jurists turned to organization as a means of addressing social and economic problems. In a corporate society characterized by the separation of ownership from control, individuals, including investors, were expected to unite with others to protect their interests. Jurists' faith in organization informed their evaluation of the protective (creditors) committees involved in the equity receivership. By the 1930s, however, trust in organization waned. Instead, jurists emphasized that those in control of corporations had to act as fiduciaries toward those subject to their power. This idea influenced many New Deal programs, including the Chandler Act, the first act to explicitly address business bankruptcy and reorganization. Drawing upon the writings and decisions of William O. Douglas, who, as Chairman of the Securities and Exchange Commission ("SEC"), helped draft the act and, as Justice of the Supreme Court, interpreted it, Part II of this Article explores the shift from organization to regulation as a means of protecting vulnerable creditors during times of business failure.

Part III, *The Homecoming of the Sophisticated Investor*, focuses on the period ranging from the postwar years through the enactment of Chapter 11 of the Bankruptcy Code to the present.

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corporate law, see Dalia Tsuk, *From Pluralism to Individualism: Berle and Means and 20th Century American Legal Thought*, 30 L. & SOC. INQUIRY 179 (2005).

This period witnessed a disenchantment with administrative solutions, the embrace of corporate managers as best suited to address corporate problems, and the gradual representation of investors as sophisticated and able to protect their interests. Chapter 11 reflected these developments by enshrining reorganization plans negotiated by different classes of security holders under the supervision and guidance of the debtor corporation's management. Part III concludes by examining the intellectual changes of the last decades of the twentieth century—namely, the impact of neoclassical economics and modern finance theory on law—and their relationship to the rise of market solutions as alternatives to administrative or managerialist means of reorganizing firms. In this context, sophisticated investors joined corporate managers to ensure quick solutions to financial distress, often bypassing important provisions of the Bankruptcy Code.

Viewing bankruptcy law as a reflection of a broader culture allows for a deeper understanding not only of bankruptcy law but also of our society and the way legal rules, particularly those applicable to corporations, are grounded in our social and economic environment at the same time that they help shape it.[21] Such an understanding could offer important tools to contemporary jurists and policymakers seeking novel solutions to new and old problems.

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21. In a recent article, Mark Roe has pointed out to different interpretations of the history of business bankruptcy. According to Roe, some scholars view change as derived from "experiential learning"—as lawyers and judges were faced with new problems, they developed novel solutions to address them. Others focus on the "worldview" of those who write laws and decide cases. Others, still, focus on the demands that creditors placed on lawmakers. To these three narratives, Roe added a market-based interpretation, explaining the history of corporate bankruptcy and reorganization as following three distinct "decision-making methods"—"administration, a deal among existing creditors, and a sale of the firm intact." According to Roe, "if we stretch out the Code over the past century, accordion-like, we see core provisions emerging in practice, dominating for a time, and then fading in importance." Mark J. Roe, *Three Ages of Bankruptcy*, 7 HARV. BUS. L. REV. 188 (2017). Roe explains the different focus of each of the ages of bankruptcy in reference to "underlying market conditions and basic bankruptcy goals, sometimes mapped in political ideology current, and often reflecting the influence of powerful groups." *Id.* at 188. Using a similar periodization, this article adds another historical layer or interpretation, that is, a cultural history focusing on how different images of creditors and property helped shape (and reshape) the rules of business bankruptcy and reorganization.

I.
THE RISE OF THE VULNERABLE INVESTOR

A. *The Equity Receivership*

The late nineteenth century witnessed a dramatic growth in the scale of private business organizations. As most corporations remained regional, competition among corporations, especially the railroads, was fierce, resulting all too often in business failure. Corporate law, as well as bankruptcy law, was rapidly changing as jurists attempted to find solutions to new problems that were coming at them in rapid succession. The equity receivership, which developed to address the financial difficulties of many railroads, was such a solution. The result of creativity on the part of lawyers, bankers, and business managers, it set the foundation for the development of modern business bankruptcy and reorganization laws throughout the twentieth century.[22]

Debt was the primary means of railroad finance. As William Ripley noted in his examination of railroad financing, "prior to the mid-1850s railroads principally capitalized with stock, but . . . following the Civil War, bonds became the principal means of railroad finance," with many of these bonds in the form of European mortgage loans.[23] Why did the railroads finance largely with debt? At least one commentator suggested that "limited disclosure discouraged outside shareholders and the more transparent integrity of some bond houses allowed lenders to rely upon the reputation of the selling bank for repayment."[24]

Default was an inevitable aspect of debt financing. Indeed, the late nineteenth century witnessed both the rise of the large publicly held corporation and its descent into financial distress. Many of the railways, with lines crisscrossing the country, faced bankruptcy, forcing jurists to develop unique, ad-hoc solutions. State and federal policymakers were keenly invested in having the railroads succeed, ensuring the smooth

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22. DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 48–70 (2001).

23. Lawrence E. Mitchell, Who Needs the Stock Market Part I: The Empirical Evidence (Oct. 30, 2008) (citing WILLIAM Z. RIPLEY, RAILROADS, FINANCE AND ORGANIZATION 105, 106 (1923)) (unpublished manuscript) (on file with author).

24. Mitchell, *supra* note 23.

movement of products and goods across the nation. "Politics pressed toward operational continuance," and the courts obliged.[25]

The law of bankruptcy—itself "one of the great legislative battles of the nineteenth century" culminating in 1898 with the first long-lasting federal bankruptcy law—did not address corporate bankruptcies or reorganization.[26] To fill the void—and more importantly, to help rescue the railroads and ensure the growth of the national economy—lawyers and underwriters developed the equity receivership and the courts embraced it.[27]

The equity receivership was premised on the idea that an insolvent corporation or a corporation that was unable to meet its financial obligations was "under an obvious necessity of coming to some arrangement with its bondholders and other creditors if it [were] to continue to function."[28] A typical equity receivership involved "moderately large railroads—railroads whose tracks crossed several state lines, and which has issued common stock, preferred stock, and several different mortgage bonds to raise money over the years."[29] When a railroad defaulted, a creditor, typically at the suggestion of the railroad's management, would file "a creditor's bill" requesting that the court "appoint a receiver to oversee the defaulting railroad's property."[30] A foreclosure bill would then be filed "ask[ing] the court to schedule a sale of the property," which would be postponed so that the parties—that is, committees representing the different classes of bondholders as well as the stockholders—could negotiate a reorganization plan.[31]

A reorganization plan would involve a reworking of the railroad's capital structure, especially its debt obligations. Converting debt into equity, reducing interest rates, and extending maturity were common examples of such restructur-

25. Roe, *supra* note 21, at 194.
26. SKEEL, *supra* note 22, at 23; David S. Kennedy & Erno Lindner, *The Bankruptcy Amendatory Act of 1938: The Legacy of the Honorable Walter Chandler*, 41 U. MEM. L. REV. 769, 776 (2011).
27. SKEEL, *supra* note 22, at 48.
28. E. Merrick Dodd, Jr., *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780, 780 (1942).
29. SKEEL, *supra* note 22, at 58.
30. *Id.*
31. *Id.* at 58.

ing. Once a plan was agreed upon by the different classes of interest, a single reorganization committee, combined of the different representative committees, would bid the face value of the old securities to purchase the assets of the railroad. The assets would then be transferred to a new corporation, the securities of which would be distributed to the old investors according to their agreed-upon reorganization plan.[32]

In a typical industrial corporation, one expects that managers, shareholders, and employees would rally behind reorganization efforts as they stand to lose their jobs or investments if the corporation liquidates. The secured creditors' enthusiasm often depends on how effectively they protected their interest *ex ante*. If the value of their collateral is sufficient to pay the corporation's obligation to them, secured creditors are unlikely to be interested in reorganization.[33] The railroads' secured creditors, however, were different. Often, these secured creditors held "discrete sections of track" as collateral, with different classes of bonds secured by different segments of track in different parts of a state or states.[34] As David Skeel writes, "[u]nraveling the respective priorities of the bond issues in order to distribute the proceeds of a liquidation would have been a nightmare for a railroad of any size."[35] Moreover, "the collateral for any given bond issuance—say, one hundred miles of track in the middle of nowhere—was essentially worthless unless the railroad remained intact."[36] The railroads' secured creditors thus joined the railroads' other constituencies to support reorganization.[37]

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32. *Id.* at 58–59; *see also* Note, *Bondholders Committees in Reorganization*, 41 HARV. L. REV. 377, 377–78 (1928). It is important to note that the sale of the railroad in the equity receivership was not akin to the market sales that have come to dominate business reorganizations at the turn of the twenty-first century (see discussion *infra* Part III). As Mark Roe explains: "[[N]ot only were there] too few strategic buyers who wanted to add the bankrupt's business to their own, [but also] financial markets were too primitive for competitive bidding syndicates to emerge." Roe, *supra* note 21, at 195. Instead, the equity receivership was a form of a negotiated deal with minimal judicial oversight. *Id.*

33. SKEEL, *supra* note 22, at 61–62.

34. *Id.* at 62.

35. *Id.*

36. *Id.*

37. *Id.* at 61–62. While the railroads had a unique financial structure for which the equity receivership was suited, it is important to note that large

Wall Street bankers and lawyers helped devise the equity receivership, at least in part to help the secured creditors with whom they were typically associated, many of whom were European investors. At the end of the nineteenth century, few, if any, American middle-class families owned stock or bonds in the railroads, hence the financial firms that underwrote and distributed these securities typically ignored them. J.P. Morgan Co. and other leading investment bankers helped "reorganize[ ] bankrupt American railroads, then underwrote and distributed the securities of those new consolidated systems mainly to institutional and European investors."[38]

Given the consensus (among different corporate constituencies) that railroads facing financial difficulties were valued more as going concerns (rather than in piecemeal liquidation), given also the involvement of Wall Street bankers and lawyers in devising the equity receivership, it is perhaps not surprising that "[a] standard practice in receiverships . . . was to give old bondholders a stake in the new company, to ask shareholders to contribute new cash in return for a continuing interest, but to exclude general unsecured creditors."[39] The practice was grounded in the assumption that the participation of the junior claimants, in this case the shareholders, did not disturb relative priority because they were entitled to buy an option to participate in the reorganized company.[40] It was this practice that brought the plight of the individual, unsecured creditors (and with them—the equity receivership) to the U.S. Supreme Court's attention.[41]

In 1913, ten years after the Northern Pacific Railway was reorganized, Boyd, a former unsecured creditor, challenged its receivership. "Because unsecured creditors have a higher priority interest in the firm than shareholders," Boyd argued,

industrial corporations at the end of the nineteenth century were often the result of vertical integration of several large corporations. Just as it was impossible to remove and replace a secured track to satisfy the demands of one group of railway bondholders, "interacting industrial parts inside a firm could not easily be removed and replaced." Roe, *supra* note 21, at 193.

38. JULIA C. OTT, WHEN WALL STREET MET MAIN STREET: THE QUEST FOR AN INVESTORS' DEMOCRACY 18 (2011).

39. SKEEL, *supra* note 22, at 67.

40. On relative and absolute priority, see Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785 (2017).

41. SKEEL, *supra* note 22, at 62–67.

"the reorganizers should not be permitted to give an ongoing interest to shareholders without giving anything to unsecured creditors."[42] As Section I.B will elaborate, the early twentieth century was a time of major changes in the definition and understanding of the concept of property. Yet, the Supreme Court remained keen on defending traditional common law jurisprudence as manifested in the strict rules applicable to liquidation (even though, as Theodore Eisenberg writes, "classical liquidation doctrine developed when corporations either did not exist or were not large enough to be worth saving"[43]). Relative priority was rejected as the court held that "any device, whether by private contract or judicial sale under consent decree, whereby stockholders were preferred before the creditor was invalid . . . ."[44] "It would seem that if Boyd had sued before the damage was done," Adolf A. Berle, Jr. wrote a decade later, "he might have obtained injunctive relief preventing the original wrong."[45]

At the core of *Boyd* was the broader question as to who should bear the cost of financial failure. Faced with novel situations, namely the failure of large-scale corporations with a variety of constituencies, Wall Street lawyers and bankers attempted to find workable solutions. For the most part, they chose to satisfy the interests of secured creditors and shareholders, often at the expense of unsecured, maybe voiceless, creditors. The U.S. Supreme Court saw matters differently. But the business community would not budge. For one thing, Wall Street and corporate management found ways to adjust to *Boyd*, specifically by requiring unsecured creditors and shareholders to contribute cash in exchange for continuing interest in the reorganized firm.[46]

Moreover, *Boyd* addressed the rights of unsecured creditors whom the secured creditors and shareholders excluded from participation in a reorganization plan. The question was more complicated when an unsecured creditor objected to a plan of reorganization, even though the class to which the

42. *Id.* at 67.

43. Theodore Eisenberg, *Baseline Problems in Assessing Chapter 11*, 43 U. TORONTO L.J. 633, 634 (1993).

44. N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 504 (1913).

45. Adolf A. Berle, Jr., *Subsidiary Corporations and Control of Credit Resources*, *in* STUDIES IN THE LAW OF CORPORATION FINANCE 153, 161 (1928).

46. SKEEL, *supra* note 22, at 67–68.

creditor belonged voted to approve the plan. Some state and federal courts viewed "the acceptance of the plan by a substantial majority of the bondholders as very strong evidence of its fairness."[47] A plan still had to pass the test of fairness, but "judges were naturally reluctant to overturn plans which had secured majority assent and were wont to justify their unwillingness to upset the apple cart by assuming that majority assent is strong evidence of fairness."[48] Others felt that a property owner—in this case a security holder—should not be subject to majoritarian decisions.

As Section I.B elaborates, at the beginning of the twentieth century, the protection of vulnerable or minority creditors became an aspect of the broader discussion about corporations and the changing understandings of property. Just as business managers, bankers, and lawyers attempted to protect the interests of their constituencies, Progressive jurists were expressing grave concerns about Wall Street's control over the property of others. For them, an absolute priority rule was necessary not as a relic of the property rules of years past but as a means of protecting minority investors, the scattered minority creditors, in the equity receivership. Protecting the vulnerable in a rapidly changing industrial society was the cornerstone of Progressive legal thought. As Part II of this Article will explore, the concern for the underdog would ultimately lead the New Dealers to overhaul the rules applicable to business bankruptcy and reorganization.

B. *The Modern Corporation and Passive Property*

Nineteenth century Americans viewed investment with disdain. Buyers and sellers of bonds were seen as "traitors to proprietary democracy," that is, the idea that responsible citizenship depended on ownership of productive property. Bond (or stock) owners "warranted little consideration in a political-economic system that valorized independent proprietorship and production."[49] The growth of corporations and banks beginning in the mid-nineteenth century, coupled with the gradual abolition of "property qualifications for suffrage," broad-

47. Dodd, *supra* note 28, at 785.
48. *Id.* at 785–86.
49. OTT, *supra* note 38, at 12.

ened "the category of producer-proprietor, yet it remained counterpoised against speculators and idle moneyed men."[50]

The financing of the railroads in the mid-nineteenth century introduced public security financing of industry and helped change public opinion, even though, up to the 1880s, there was no important class of small individual or institutional investors in securities.[51] Beginning in the merger wave of the 1880s, however, rapid industrial and business growth increased the demand for capital and "stimulated the use of security financing as the most flexible and productive method of supplying capital needs."[52] Seeking to maximize their profits, entrepreneurs found ways to convince the American public to invest in their enterprises, first in railroad bonds and industrial preferred stock, and then, by the second decade of the twentieth century, in common stock.[53] In the process, "the practice of investment [became linked] with national citizenship, democracy and the public interest."[54]

World War I loan campaigns brought about a dramatic change in the market for securities. Before World War I, no more than "0.5% of the population or 2.5% of households owned any type of security—corporate or government, bond or stock."[55] But during World War I, the federal government was able to distribute "its small-denomination bonds to roughly 30 million Americans,"[56] about a third of the popula-

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50. *Id.* at 14.

51. *Bills to Suspend the Authority of the Securities and Exchange Commission under Section 14(A) and Section 14(B) of the Securities Exchange Act to Issue Rules Relating to the Solicitation of Proxies, Consents, and Authorizations During the Period of War Emergency: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the Interstate and Foreign Commerce*, 78th Cong. (June 9–11, 1943), at 2.

52. *Id.* at 3.

53. Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 WASH. & LEE L. REV. 1503, 1519–20 (2006).

54. KAREN HO, LIQUIDATED: AN ETHNOGRAPHY OF WALL STREET 180–81 (2009). As Julia Ott notes, prominent economists (including Jeremiah Jenks, John Bates Clark, and Richard Ely), who embraced the large modern corporation with its concentrated power and focused on taming laissez-faire economics, argued that by ensuring that every person could invest in the securities markets, the working- and middle-class could share in the wealth produced by the new corporate system. In their writings, the hopes for massive participation in the securities markets helped reconcile collective ownership with classical American liberalism. OTT, *supra* note 38, at 24–27.

55. OTT, *supra* note 38, at 17.

56. *Id.* at 2.

tion, thus "enhanc[ing] the allure of the small investor in the eyes of the New York Stock Exchange (NYSE) commission houses."[57] An "ideal of an investors' democracy" began its ascendance as "millions of American citizen-investors acquired war bonds and dramatized the nation as a financial market in War Loan pageantry and publicity."[58] Low-wage employees, women, and recent immigrants were all equally welcomed into and included within a new nation of investors.[59] Rapidly individual investors entered the broader market for securities, moving their assets from government bonds to corporate securities.

As investors entered the market, the corporation became the "legal 'owner'" of capital collected first from "investors pooling their individual contributions" and then from its retained earnings; more important, perhaps, the corporation had "complete decision-making power" over this capital. Management was rapidly becoming "the uncontrolled administrator of a kind of trust having the privilege of perpetual accumulation."[60] And, by virtue of their capital and social networks, investment bankers became, as Louis Brandeis put it in 1914, "[t]he dominant element in our financial oligarchy."[61] They became promoters and directors of corporations, and were able, through their economic power, to control even those boards on which they did not sit.[62]

A separation of ownership from control, coupled with a dramatic growth in the scale of private business organizations at the turn of the twentieth century (as trusts, holding companies, and mergers became common, even if often contested in state courts), helped undermine the traditional understanding of property.[63] "The shifting relationship of property and enterprise in American industry," Adolf A. Berle and Gardiner C. Means wrote in *The Modern Corporation and Private Property*,

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57. *Id.* at 53.

58. *Id.* at 54.

59. *Id.* at 56; *see, e.g.*, Mitchell, *supra* note 53, at 1521–22.

60. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *The Modern Corporation and Private Property* xiv–xv (rev. ed. 1968, 1932).

61. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY: AND HOW THE BANKERS USE IT 4 (1914).

62. *Id.* at 1–27 (discussing the confluence of factors supporting the concentration of power in investment bankers).

63. *See* Mitchell, *supra* note 53, at 1514–15.

"raise in share relief legal, economic and social questions which must now be squarely faced."[64] The traditional idea of property as a form of ownership and control over the means of production was replaced with a fluid conception of property as an interest or security in a corporation. As legal historian Morton Horwitz explains:

> The gradual collapse of a physicalist definition of property after 1870 revived all of the contradictions that had been barely suppressed in traditional doctrine. For as the definition of a property right became divorced from concrete physical objects with bright-line boundaries and came to turn more and more on abstract idea of individual expectations of stable market values, the very conception of property became infinitely expandable.[65]

Most important, perhaps, such a fluid conception of property undermined the idea that "modern property could continue to be represented as a pre-political right and not as a creature of social choice."[66] Indeed, as discussed in this Section, Progressives' concerns over the fate of creditors, and investors more generally, were informed by their particular social and political vision—their concern for the vulnerable individual. As the following Part II will elaborate, when Franklin D. Roosevelt was elected President, many of these Progressive legal scholars joined his administration seeking to turn their vision into laws.

In the classical model of market relations, individuals owned and controlled the means of production, and competition between individual entrepreneurs was presumed to result in the efficient distribution of market sources. Progressives feared not only the power that large corporations were able to amass but also that corporations were wearing away the function of the individual producer and, thus, the power of markets equally to "distribute the rewards of individual industry" and to help "conform individual liberty" to socially beneficial

64. BERLE & MEANS, *supra* note 60, at 293.

65. MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1870–1960: THE CRISIS OF LEGAL ORTHODOXY 151 (1992).

66. *Id.* at 167.

ends.[67] As Berle and Means emphasized, the divergence between the interests of investors and those who managed the corporation severed the ties between self-interest and efficiency.[68]

Shareholders, passive since the turn of the twentieth century, were viewed as being at the whim of corporate managements. Having an interest in an enterprise no longer meant having power over the enterprise. Individual shareholders lost control not only to management, but also to larger investors who, even without owning a majority of the shares, were able to elect the board of directors.[69] Throughout the twentieth century, scholars would continue to emphasize the powerlessness of the individual, passive shareholders and thus the need to extend fiduciary obligations toward then.[70]

The individual bondholder was similarly vulnerable to managerial power. Indeed, for Progressive legal scholars, there was little distinction between individual shareholders and individual bondholders. For one thing, in 1895, William H. Taft, then a Judge of the United States Sixth Circuit Court of Appeals, argued that bondholders should be viewed as the true owners of the corporation. As Taft put it:

> Another evil has been the injustice done to the real owners of corporate property by the reckless and dishonest management of its nominal owners. The great liberality of the general laws for the formation of corporations, and the entire failure to exercise any stringent visitorial powers over them, have enabled the active promoters and managers of large enterprises carried on at a distance from the homes of the real owners to increase the corporate indebtedness and capital stock so far beyond any fair valuation of their property as to put the entire control of it in the hands of the holders of worthless stock, who have

67. L.S. Zacharias, *Repaving the Brandeis Way: The Decline of Developmental Property*, 82 NW. U. L. REV. 596, 618 (1988).

68. BERLE & MEANS, *supra* note 60, at 9; *see also* Robert Hessen, *The Modern Corporation and Private Property: A Reappraisal*, 26 J.L. & ECON. 273, 276 (1983).

69. BERLE & MEANS, *supra* note 60, at 66–111 (detailing the changing composition of the control group).

70. Mitchell, *supra* note 53 (exploring the twentieth century's scholarly debates about means to protect the interests of passive shareholders).

> nothing at stake in the corporate success. The real owners, the bondholders, are at the mercy of this irresponsible management till insolvency.[71]

Taft's concerns about the evils associated with the management of corporations fit with the widespread Populist, and later Progressive, concerns about Wall Street and the oppression of different classes of Americans such as workers, farmers, and the poor.[72] In 1928, Adolf A. Berle echoed these concerns, noting that, "as a matter of finance," there was little difference between shareholders and bondholders.[73] "Investors who purchase long-term obligations of a corporate enterprise just as surely embark their funds in that enterprise as do stockholders," Berle wrote.[74] Shareholders and bondholders alike, Berle emphasized, relied upon "the fidelity and business integrity" of corporate management.[75] According to Berle, a creditor should thus have "standing to complain of credit manipulation" even if it "does not technically violate some covenant of the obligation which he holds."[76]

Four years later, Berle and Means, writing about the separation of ownership and control in the large publicly held corporation reiterated Berle's earlier concerns. As they explained with respect to bondholders, "the typical bondholder comes to rely increasingly on the success of a going enterprise and less on items of his property (whether mortgaged to him or not) which may, and usually do, become almost valueless if the enterprise is discontinued."[77] "Though the law still maintains the conception of a share dividing line recognizing the bondholder as a lender of capital and the stockholder as a quasi-

71. William H. Taft, *Recent Criticism of the Federal Judiciary*, 43 AM. L. REG. & REV. 576, 583 (1895). It is worth noting that Taft found that the "administrative problems" of business reorganization "overburdened the courts" and suggested "the transfer of such proceedings to administrative or quasi-judicial agencies." Jerome Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U. L. Q. REV. 317, 322 (1941).

72. *See, e.g.*, RICHARD HOFSTADTER, THE AGE OF REFORM: FROM BRYAN TO F.D.R. (1955).

73. Berle, *supra* note 45, at 156.

74. *Id.*

75. *Id.*

76. *Id.*

77. BERLE & MEANS, *supra* note 60, at 245–46.

partner in the enterprise," Berle and Means wrote, "economically the position of the two have been drawn together."[78]

As Berle saw it, the concept property was divided into two categories: the first category was active property, "which the owner can himself possess, manage, and deal with."[79] The second category was passive property—"a set of economic expectations evidenced by a stock certificate or a bond, each representing an infinitesimal claim on massed industrial wealth and funneled income-stream."[80] Viewing bondholders and shareholders as similarly situated, Berle and Means suggested that all security holders should be regarded

> as a hierarchy of individuals all of whom have supplied capital to the enterprise, and all of whom expect a return from it. These expectations are based, *prima facie*—upon their legal rights—that is to say, upon the words of the contract. The bondholder expects his coupons regularly paid and his principal paid at maturity; . . . the common stockholder expects a participation in all of the profits of the corporation, as and when they are distributed, and after the needs of the senior securities have been met.[81]

At the core of Berle's and Means's concerns, as well as Taft's, was the realization that the large publicly held corporation had transformed our understanding of property. Instead of the nineteenth century ideal of individually owned land, investors held rights in a collectively owned property (that is, the

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78. *Id.* at 246.

79. Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1369 (1932).

80. *Id.* at 1369–70.

81. BERLE & MEANS, *supra* note 60, at 246. Even in his famous debate with E. Merrick Dodd about the scope of directors' fiduciary obligations, Berle continued to emphasize that corporate managers owed duties toward all investors. As he wrote:

> Roughly speaking there are between five and eight million stockholders in the country . . . ; to which must be added a very large group of bondholders and many millions of individuals who have an interest in corporate securities through the medium of life insurance companies and saving banks. . . . Nothing is accomplished, either as a matter of law or of economics, merely by saying that the claim of this group ought not to be "emphasized." Either you have a system based on individual ownership of property or you do not.

Berle, *supra* note 79, at 1367–68.

corporation). All investors—bondholders, preferred stockholders, and common stockholders—were thus vulnerable to the actions of those who managed their corporations. In this vein, Berle and Means stressed that "[t]he expectations of bondholders, preferred stockholders, or common shareholders must all be satisfied to some degree if an enterprise is to grow."[82]

It was, at the time, "undisputed" that when a corporation was insolvent, creditors could "apply to a court of equity to enjoin misapplication of corporate funds, or to recover from the officers funds which have been wrongfully misapplied."[83] Yet, as Berle noted in his 1928 *Studies in the Law of Corporation Finance*, viewing managers as trustees for the creditors when the corporation was insolvent was akin to "lock[ing] the stable door after the horse has gone."[84] In fact, as Berle described it, insolvency could at times be prevented if bondholders were allowed to sue for injunctive relief before funds were misapplied or appropriated.[85]

Despite the concerns articulated by Progressive legal scholars about the fate of scattered, passive creditors, by the 1920s, businesses continued to evade the absolute priority rule established in *Boyd* by requiring shareholders and unsecured creditors to contribute new value to secure an interest in the reorganized corporation. At the same time, courts began expressing unwillingness to use the equity receivership rules to address financial failures of industrial corporations.[86] After the stock market crash of 1929, momentum began developing for the modernization of the bankruptcy laws so as to better protect vulnerable, minority creditors.

As the following Part II explores, William O. Douglas, first as the Chairman of the SEC and then as Justice of the U.S. Supreme Court, led the movement for change in business bankruptcy laws. As I argue in Section II.A, Douglas, like many Progressive legal scholars, initially trusted organization and collective action to protect the interests of minority investors.[87]

82. BERLE & MEANS, *supra* note 60, at 247.
83. Berle, *supra* note 45, at 160.
84. *Id.* at 160.
85. *Id.* at 160–61.
86. SKEEL, *supra* note 22, at 104–05.
87. Indeed, as farmers, workers, professionals, consumers, women, and ethno-cultural groups began to form a variety of associations to protect and

His work thus examined the protective committees as a means of guarding the interests of individual creditors in the reorganization of business. As Section II.B will demonstrate, the 1929 stock market crash helped shift the attention of Progressive jurists from organization to administration. Instead of relying on private organizations, Progressives turned New Dealers preferred government collaboration with business as a means to protect different participants in the market. Such was indeed Douglas's solution when he helped draft the Chandler Act as well as the Trust Indenture Act. Section II.C will conclude by exploring Justice Douglas's opinions interpreting some of the foundational requirements of the Chandler Act. Embracing a strict interpretation of the absolute priority rule, Douglas made the protection of the individual, minority creditor the foundation of business reorganization under the Act.

II. Investors and the Administrative State: From Organization to Regulation

A. *Organization*

The laws applicable to business bankruptcy and reorganization were due for a major overhaul by the early 1930s. Many came to view the equity receivership as prone to "champerty, conflicts of interest, abuse of process, and other violations of professional ethics," and the U.S. Supreme Court had indicated that "federal equity receivership was not a proper vehicle for effecting a corporate reorganization, except in the case of 'railroads and other public utilities where continued operation of the property and preservation of its unity seemed to be required in the public interest.'"[88] The panic that followed the

advance their interests at the early twentieth century, social scientists viewed groups as loci where individuals found meanings for ideas and action and as such centers of participation and representation and a powerful tool to promote the interests of the vulnerable. They added groups, organizations, and associations to the traditional array of national, state and local governments. For a detailed analysis of the idea that groups were seen as the foundation of the modern state, including the impact of this idea on corporate law, see, e.g., Dalia Tsuk, *Corporations Without Labor: The Politics of Progressive Corporate Law,* 151 U. PA. L. REV. 1861, 1875–78 (2003).

88. Richard W. Jennings, *Mr. Justice Douglas: His Influence on Corporate and Securities Regulation,* 73 YALE L.J. 920, 931 (1964) (quoting First Nat'l Bank v. Flershem, 290 U.S. 504, 515 n.7 (1934)).

crash of 1929 witnessed "Liberty bonds, Status bonds, railroad mortgage bonds, foreign government bonds, and drainage-ditch bonds . . . indiscriminately thrown on the market for sale."[89] And by 1933, "more than fifty railroads owning in excess of twenty thousand miles of track were . . . in receivership; other railroads had millions of outstanding debt securities with impending maturities and a seeming lack of capacity to pay; and the market for new issues for the purpose of refunding issues soon to become due was stagnant. Many industrial corporations were also in deep financial trouble."[90] A brewing storm was awaiting a savior.

William O. Douglas grew up in Yakima, Washington. His father, a Protestant minister, died when Douglas was a young child, "plunging the family into dire poverty."[91] Douglas's "youthful struggles against poverty and poor health . . . [having contracted polio as a boy]" led to a strong identification "with outsiders, even to the extent of joining hoboes who slipped into railroad boxcars for trips across the country."[92] "Empathy for the poor and the socially scorned," Morton Horwitz writes, "marked Douglas's legal worldview."[93] And while it would become apparent in his first amendment jurisprudence years later, in the 1930s, Douglas's concern was focused on the vulnerable investors, both shareholders and bondholders.

Douglas graduated from Columbia Law School in 1925 and, after a short stint at the Wall Street law firm of Cravath, Henderson & De Gersdorf, joined the teaching faculty, first of Columbia Law School, and then, in 1928, of Yale Law School.[94] At Cravath, Douglas worked on the reorganization of the Chicago, Milwaukee & St. Paul Railway Co., "one of the biggest receiverships in American history and destined to become a *cause célèbre* on the abuses of receiverships." (It resulted in investigations before the Interstate Commerce Committee and Congress as well as litigation.)[95] Douglas's mentor at

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89. JAMES GRANT, MONEY OF THE MIND: BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN 200 (1992).
90. Jennings, *supra* note 88, at 931.
91. MORTON J. HORWITZ, THE WARREN COURT AND THE PURSUIT OF JUSTICE 6 (1998).
92. *Id.*
93. *Id.*
94. Jennings, *supra* note 88, at 921–22.
95. *Id.*

Cravath was Robert Swaine, a proponent of a relative priority rule in equity receiverships, the rule rejected in *Boyd*.[96]

In 1928, just after he moved to Yale Law School and shortly before the stock market crash of 1929, Douglas turned to the study of business failures.[97] Informed by the turn to social sciences in law, Douglas was keenly interested in studying how law and institutions functioned and conducted several studies on matters related to business bankruptcy.[98] Particularly relevant was a study in which he chose to focus on two aspects of inquiry: "the efficiency of the various methods of liquidating and salvaging a business and the extent of fraudulent practices in bankruptcy."[99] These questions were meant to be the foundation for a study of the "functioning of the whole credit system."[100] But, a year into the study, Douglas's focus narrowed, and he determined to examine "the causes of business failures," "the efficiency of the administrative machinery employed in reorganizing or liquidating a business," and "the incidences of the [business] failure as measured by the effect on the owners, the creditors, the employees and other groups in the community."[101]

Douglas's study was never complete, but in 1934, shortly after the enactment of sections 77 and 77B of the Bankruptcy Act of 1933, Douglas drew upon his study to explore "the utility of protective committees in railroad reorganization."[102] Section 77 addressed railroad reorganizations, requiring, among other things, "a binding two-thirds vote by classes of creditors" organized in committees, while section 77B imposed a similar requirement on the reorganization of firms other than rail-

96. SKEEL, *supra* note 22, at 67.

97. Jennings, *supra* note 88, at 928.

98. JOHN HENRY SCHLEGEL, AMERICAN LEGAL REALISM AND EMPIRICAL SOCIAL SCIENCE 99–102 (1995). On legal realism and social science, see generally LAURA KALMAN, LEGAL REALISM AT YALE, 1927–1960 (1986).

99. SCHLEGEL, *supra* note 98, at 99.

100. *Id.*

101. *Id.* at 102. Shortly before he began this project, Douglas, at the request of Judge Thomas D. Thatcher of the District Court for the Southern District of New York, prepared "a comparative study of bankruptcy administration in the United States, England, Canada, France, and Germany, and an analysis of the various rules adopted by district courts for administering the Bankruptcy Act." *Id.* at 100–01.

102. Jennings, *supra* note 88, at 932–33.

roads.[103] Douglas's study concluded that, in order for the committees to avoid the abuses that plagued the equity receivership, "a balance between governmental oversight and private negotiation in railroad reorganization" was necessary.[104]

According to Douglas, creditors were "paralyzed into inactivity and unconcern."[105] "[T]he predominance of absentee creditors [made] it difficult for the creditors as a group to know intimately the affairs of the debtor" or, when they did know, "to give to the administration a personal and dominating influence."[106] Because each creditor was "one of many security holders involved in an intricate difficult situation," and because each creditor held a small amount of debt, none would "undertake the burdensome expense of active participation in court proceedings for reorganization or in the negotiations that lead to a completed reorganization."[107] More significantly, "the dividends on average" from pursuing a course of action were "so small, and in so many cases non-existent, that the time and expense of an active interest and concern would be tantamount to throwing good money after bad."[108] Even if the cost was not prohibitive, "the average investor [did] not possess the training, the experience, or the skill which these complicated problems demand."[109]

As to the protective committees—in 1934, Douglas pointed out that these committees were "constituted by the inside groups, those affiliated with or drawn from the old management or the financial interests associated with it."[110] As a consequence, individual creditors found themselves, even

103. SKEEL, *supra* note 22, at 106; *see also* Jacob J. Kaplan, *Corporate Reorganization Under Section 77B of the Bankruptcy Act*, 33 MICH. L. REV. 77, 78–81 (1934).

104. David A. Skeel, Jr., *Rediscovering Corporate Governance in Bankruptcy*, 87 TEMP. L. REV. 1015, 1017 (2015).

105. William O. Douglas & J. Howard Marshall, *A Factual Study of Bankruptcy Administration and Some Suggestions*, 32 COLUM. L. REV. 25, 26 (1932).

106. *Id.*

107. William O. Douglas, *Protective Committees (Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees), in* DEMOCRACY AND FINANCE: THE ADDRESSES AND PUBLIC STATEMENTS OF WILLIAM O. DOUGLAS 198–99 (James Allen ed., 1940).

108. Douglas & Marshall, *supra* note 105, at 26.

109. Douglas, *supra* note 107, at 199.

110. William O. Douglas, *Protective Committees in Railroad Reorganizations*, 47 HARV. L. REV. 565, 567 (1934).

more acutely than the shareholders, with no control over the usage of the funds they invested in the corporation and subject to exploitation of their economic interests.[111]

Some scholars, most notably Max Lowenthal, were ready to dispense with the committees. As Lowenthal put it, the way the protective committees were constituted "deprived the security holders of any voice" in formulating and ratifying the plan of reorganization.[112] The small investors were thus not adequately protected by the "large institutional investors who are too closely tied to the banking and speculative equity groups" who controlled the protective committees and were also "in a position to profit from the use of inside information, not generally available to security holders."[113]

While Douglas admitted Lowenthal's criticism was accurate, he initially had faith in the committees. For him, as it was for other Progressive thinkers, organization was the solution for many of the problems associated with the large publicly held corporation.[114] Only a few years before Douglas's study, scholars such as William Ripley and Adolf Berle recommended creating federal organizations to represent shareholders so as to ensure that their interests were protected.[115] Douglas, too, drew upon the British Corporation of Foreign Bondholders and the British Shareholders Protection Association to call for the creation of a federal organization, which would protect "stockholders against the board or the officers by gaining control over the proxy machinery, by investigating the affairs of a company, or by other methods."[116] But Douglas went further, the organization he envisioned as protecting stockholders was also meant to "serve as effectively in any case where bond-

111. *Id.* at 567–68.
112. Jennings, *supra* note 88, at 933 (citing MAX LOWENTHAL, THE INVESTOR PAYS (1933); Max Lowenthal, *The Railroad Reorganization Act*, 47 HARV. L. REV. 18 (1933)).
113. *Id.*
114. *See, e.g.*, William O. Douglas, *Protecting the Investor*, 23 YALE REV. 521 (1934) (criticizing the Securities Act for failing to recognize that modern forms of organization such as corporations require collectivist regulatory solutions).
115. Mitchell, *supra* note 53, at 1532–33.
116. William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1333 (1934).

holder, debenture holder, note holder, creditor, or stockholder needed protection."[117]

It is thus not surprising that Douglas did not recommend abolishing the protective committees. Rather, in 1934 he believed that the appropriate solution to the problem of committees ridden with conflicts of interest was to create committees "whose interest is solely that of the protection of the bonds for which they act."[118] That typically meant that institutional investors would be placed at the helm of the committees, but Douglas did not find that troubling, as such institutions were "heavily interested as investors in these issues."[119] As Douglas put it,

> [i]ndependent, well organized, vigilant committees are additional guarantee that the power of the former financial administration will be curbed or controlled. They also can act as an additional check on the operation during bankruptcy and supply further assurance that claims against officers and associates of the old company will be prosecuted. In this regard they will probably be the most effective agency to supply the initiative and drive.[120]

This was Douglas's vision when Chairman of the SEC, Joseph P. Kennedy, and Commissioner James M. Landis selected him to conduct the SEC's study on the equity receivership.[121] In addition to sections 77 and 77B of the Bankruptcy Act, the Securities and Exchange Act of 1934 included a section requiring the SEC "to make a study and investigation of the work, activities, personnel and functions of protective and reorganization committees . . . to report the result of its studies and investigations and its recommendations to the Congress."[122] Douglas's earlier studies made him the "obvious choice to oversee the protective committee study."[123]

As Section II.B explores, in 1934, as the "Director of the SEC Protective Committee Study," Douglas undertook a comprehensive study of the equity receivership.[124] When, several

117. *Id.*
118. Douglas, *supra* note 110, at 574.
119. *Id.*
120. *Id.* at 577.
121. Jennings, *supra* note 88, at 934.
122. *Id.*; *see also* SKEEL, *supra* note 22, at 108; Skeel, *supra* note 104, at 1018.
123. SKEEL, *supra* note 22, at 109.
124. Jennings, *supra* note 88, at 934.

years later, the study was complete, his vision for the protection of scattered creditors had changed. Rather than his initial trust in organization, Douglas, like many Progressive scholars turned New Dealers, embraced a unique administrative approach, one premised on collaboration between government and business. It was a vision that underlay many of the first New Deal programs. It expected that, with federal coordination, corporations could protect their constituencies from the uncertainties of the market while ensuring against disasters that could sweep through a national economy.

B. *The Protective Committee Study and the Chandler Act*

The protective and reorganization committees study began with an extensive investigation. A detailed questionnaire was sent to "lawyers and banks in nearly every large reorganization case in the country," followed by interviews.[125] Together, the questionnaire and interviews revealed the large role played by Wall Street investment bankers and lawyers in effecting reorganization, including in the works of the protective committees. "[R]eorganization managers allied with the corporation's management or its bankers" typically "masterminded" reorganization.[126] Rather than vigorously protecting the interests of investors by pursuing litigation against mismanaging managers, the bankers and lawyers whose relationship with corporate managers typically predated bankruptcy "simply looked the other way."[127] The consents of security holders were often "solicited under deposit agreements" that prevented investors from uniting together potentially to suggest a different reorganization plan, "permitted the insiders to trade in the securities on the basis of inside information, and gave to the managers untrammeled power to fix the expenses of reorganization including attorneys' fees, free of judicial supervision."[128] With

125. SKEEL, *supra* note 22, at 110.
126. Jennings, *supra* note 88, at 935–36; *see also* Douglas, *supra* note 107, at 200 (noting that the "sponsors [of the committees] are usually the management of the debtor company and its investment bankers, not security holders or their authorized representatives"); *see also* Benjamin Wham, *Chapter X of the Chandler Act: A Study in Reconciliation of Conflicting Views*, 25 VA. L. REV. 389 (1938).
127. SKEEL, *supra* note 22, at 110–11; *see also* Douglas, *supra* note 107, at 204–06.
128. Jennings, *supra* note 88, at 936.

consents so secured, courts were often "prevailed upon to confirm the plan against attacks of unfairness on the theory that the creditors and shareholders had freely consented and were in the best position to protect their own interests."[129] Adding fuel to fire, the study further revealed the high fees these professionals were paid.[130] As Douglas and his colleagues saw it, "[t]he whole affair thus became a 'lawless' operation masquerading under a facade of legitimacy."[131] "In the welter of conflicting interests, ulterior objectives, and self-serving actions which flow from investment banker-management dominance over committees," Douglas wrote, "these committees have lost sight of their essential functions which they can perform to advance the interests of investors."[132]

In retrospect, scholars agree that the report had probably exaggerated many of its conclusions. While bankers often had ongoing relationships with management, they also had "reputational interest" in ensuring that bondholders and other investors continue to purchase securities they underwrote. They were thus unlikely to ignore or undermine investors' interests. As Robert Rasmussen explains, typically, bankers sat on the protective committees and "guarded their reputation as looking out for their investors . . . Buying a bond underwritten by J.P. Morgan meant that Morgan would represent your interest should financial distress occur."[133] Moreover, while Douglas was keen on arguing that bankers and lawyers did not protect the interests of the individual, passive investor, bondholders seemed to have fared quite well during the early decades of

129. *Id.*; *see also* Douglas, *supra* note 107, at 209–12; Wilber G. Katz, *The Protection of Minority Bondholders in Foreclosures and Receiverships*, 3 U. CHI. L. REV. 517, 522 (1936) (noting that "the majority committee, with its inevitable monopoly of the bidding, might on the one hand deny the minority participation in the reorganization plan or offer only an unfair plan, and on the other hand make a low bid which would give to the minority a cash distribution substantially less than the fair value of their interest in the property").

130. SKEEL, *supra* note 22, at 110–11. For an earlier, similar critique of the fees paid to bankers and promoters, see Adolf A. Berle, Jr., *Compensation of Bankers and Promoters through Stock Profits*, 42 HARV. L. REV. 748 (1929).

131. Jennings, *supra* note 88, at 936.

132. Douglas, *supra* note 107, at 202–03.

133. Robert K. Rasmussen, *The Story of Case v. Los Angeles Lumber Products: Old Equity Holders and the Reorganized Corporation*, *in* BANKRUPTCY LAW STORIES 147, 160 (Robert K. Rasmussen ed., 2007).

the twentieth century, including during default. In fact, one study suggested that "some of the best buys in the bond market [between 1900–1943] were low-grade bonds near the date of default."[134]

Still, the report sat well with the New Dealers' concern for the individual investor as well as their suspicion of Wall Street bankers and lawyers. As Abe Fortas, Douglas's "principal assistant" in conducting the study explained:

> I need not relate how corporate reorganization was . . . a state . . . of nature in the Hobbesian sense: where substantive rules of law were virtually suspended; where . . . contract rights might be freely violated; and where diplomacy was devious, covenants secret and the rights of thousands of ordinary citizens disposed of by and for their ruling minorities. These were the actualities in hundreds of cases . . .[135]

Douglas was determined to change the status quo by ensuring, through administrative oversight, that "representatives of security holders in reorganizations occupy a fiduciary position."[136] According to Douglas, as fiduciaries, protective committee members "owe exclusive loyalty to the class of investors they represent. They owe that class diligence efficiency, and single-minded devotion."[137]

In 1938, informed by Douglas's vision, Congress passed the Chandler Act. Rather than codifying the practices of the equity receivership, Chapter X of the Chandler Act required that the reorganization of business (with the exception of small businesses, covered under Chapter XI of the Act) unfold under the supervision of an independent trustee with review powers vested in the SEC and the judiciary. The trustee, who could not be a former manager, banker or lawyer of the corporation, was to be responsible for overseeing the bankruptcy es-

134. SKEEL, *supra* note 22, at 111–12.

135. Roe, *supra* note 21, at 199 (citing Abe Fortas, Ass't Dir., Pub. Utils. Div., Sec. and Exch. Comm'n, Address before a Legal Seminar: Corporate Reorganizations and the Holding Company Act, at 1 (July 14, 1938)). It is important to note that the New Dealers, especially Douglas, similarly sought to protect the interests of scattered individual shareholders. *See* Mitchell, *supra* note 53, at 1525.

136. Douglas, *supra* note 107, at 214.

137. *Id.* at 202.

tate as well as proposing a reorganization plan.[138] No votes could be solicited for acceptance of the plan until it was approved by the court as being feasible as well as "fair and equitable."[139] Before determining that these requirements were met, the court, in turn, was required to submit every plan to the SEC "for investigation, examination or report."[140] The SEC would also ensure that security holders had appropriate representation in the process.[141] In short, the Chandler Act envisioned an independent trustee in charge of the process and the current managers of the corporation, as well as its Wall Street underwriters and lawyers "sent packing."[142] The trustee would propose a reorganization plan and the SEC, as the court's assistant, would ensure that "there were no surprises."[143]

No longer trusting in privately organized protective committees, Douglas assigned the independent trustee—the New Deal expert—the leading role in the administration of business reorganizations. "The creditors and stockholders of a corporation," Douglas wrote about the Chandler Act, "as the real owners of the enterprise, are given more appropriate recognition by Chapter X."[144] Seeking to empower creditors, the committees, for one, were to be appointed by the court with access to records and ability fully to represent the interests of the creditors.[145] As commentators noted at the time, "if the process of recasting corporate financial structures is to be facilitated by enabling plans to be effected which deal arbitrarily and summarily with dissenting minorities" it was both wise and necessary to substitute "responsible public agencies" for "private financiers in control of the machinery of reorganization."[146]

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138. SKEEL, *supra* note 22, at 119–20.
139. *Id.* at 120.
140. *Id.* at 122.
141. *Id.*
142. *Id.*
143. *Id.* at 119–22; *see also* Roe, *supra* note 21, at 195–98.
144. William O. Douglas, *Improvement in Federal Procedure for Corporate Reorganizations*, 24 AM. BAR ASSOC. J. 875, 876 (1938).
145. *See* Edward B. Levy, *The Chandler Act for Creditors*, 43 COM. L.J. 464 (1938).
146. Paul M. O'Leary et al., *Financial Control of Large-Scale Enterprises*, 29 AM. ECON. REV. 109, 116 (1939); *see also* Symposium, *The Chandler Act*, 43 COM. L.J. 326 (1938).

The Chandler Act fit within the general scheme of the New Deal. As Morton Horwitz explains, the legitimacy of administrative agencies was a major concern of early-twentieth century scholars. Thus, when "new administrative agencies were created, they were not treated as coordinate or parallel governmental entities but instead were pressed to conform to court centered conceptions of legitimacy."[147] Indeed, Chapter X placed the ultimate decision power in the courts, with advisory role reserved to the SEC. "The manner in which the SEC now functions in a case of corporate reorganization" is an example of the new "administrative law" Jerome Frank explained at the time.[148] Frank, "a Douglas protégé who would succeed Douglas as chair of the SEC,"[149] described the SEC as the "judge's assistant":

> Using its staff of experts—engineers, accountants and the like—the Commission gathers a multitude of data concerning the case and presents that data to the judge. Other parties are free to dispute the evidence presented by the SEC, and the judge is free to deal with the SEC's evidence, in the traditional judicial manner, in reaching his decision. But the court, with the aid of persons who specialize in a certain kind of fact-gathering, is thus far better able than it otherwise would be to approximate the facts and arrive at a fairly just conclusion.[150]

Not everyone shared Frank's enthusiasm. The former dean of Harvard Law School, Roscoe Pound, acting as Chairman of the Special Committee on Administrative Law to the American Bar Association, expressed grave concerns about the SEC—"a government body" intruding "in private litigation involving no public question and take sides as between the par-

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147. HORWITZ, *supra* note 65, at 222.

148. Jerome Frank, *The Place of the Expert in a Democratic Society*, 16 PHIL. SCI. 3, 23–24 (1947).

149. Roe, *supra* note 21, at 199; *see also* Douglas, *supra* note 107.

150. Frank, *supra* note 148, at 24; *see also* O'Leary et al., *supra* note 146, at 116 (noting the importance of ensuring that the trustee, the SEC and the judge be "equipped to fulfill their responsibilities"); *see also* Roe, *supra* note 21, at 200 (noting that as the New Dealers saw it, "an administrative apparatus of experts was needed to handle the problem [of reorganization] not a deal and not a marketplace sale.").

ties to that litigation."[151] According to Pound, the Chandler Act reflected a "tendency . . . to subject the management of all individual property and enterprise to an unchecked administrative control."[152]

But that was Douglas's point. His inquiry into the actions of the protective committees began with the assumption that "reorganization involves all the problems of corporate finance and management." Accordingly, reorganization required not only investigation into the "causes of the financial collapse of the corporation" and its potential value as a going concern, but also into its management failures[153] and the SEC, according to Douglas was the perfect body so to investigate.

For Douglas, in short, the novel administrative process was a means to an end—that is, the goal of protecting vulnerable shareholders and creditors. As Abe Fortas wrote three decades later:

> So it is that to Mr. Justice Douglas the pattern of our system is clear, logical and direct. To him . . . government must assure that individuals do not infringe the freedom of other individuals. . . . Our basic economic and financial statutes, deeply imbedded in the nation's legal system, require government to protect the economically small from aggressions by the great: to prevent the development of monopolies, to thwart the price-fixer and the market-rigger, to defend the small stockholder from the predators of the marketplace and of the directors' room. As Douglas views it, only by the faithful performance of this economic duty can government achieve a strong nation of sturdy individuals.[154]

151. Frank, *supra* note 71, at 320–21.

152. *Id.* at 321.

153. *Id.* at 318 (quoting U.S. SEC. & EXCH. COMM'N, SEC REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937)).

154. Abe Fortas, *Mr. Justice Douglas*, 73 YALE L.J. 917, 918–19 (1964); *see also* John Gerdes, *Introduction*, 18 N.Y.U. L. Q. REV. 313, 313 (1941) ("The so-called democratic principle of rule by majorities, when coupled with a laissez-faire attitude on the part of government and courts, has been found wanting. The opposite extreme—paternalistic reorganization of insolvent corporations by governmental agencies—runs counter to fundamental and deep-seated American concepts. Chapter X represents, it is hoped, a combi-

In this fashion, Douglas sought to ensure that investors had "the right to be heard on all matters arising in the proceeding," were encouraged jointly to act to further their interests and had the right to receive information, as well as benefit from a report of the SEC and a court validation, before voting on a plan.[155]

"The scaling down of creditors' claims in reorganization is . . . an essential and entirely proper feature of reorganizations," E. Merrick Dodd, Jr. wrote shortly after the enactment of the Chandler Act.[156] "Effective control" by the judiciary or an administrative agency was necessary to prevent corporate managers from using "reorganization as a means of scaling down creditors' claims for less justifiable reasons."[157] Given that managers were elected by shareholders, it was particularly important to prevent them from "mold[ing] reorganization plans in such a way as to shift some part of the loss . . . from the . . . shareholders to . . . the creditors."[158]

To ensure that Wall Street bankers and corporate managers would not circumvent or undermine the role of the independent trustee and the court's supervision by restructuring businesses outside bankruptcy, the New Dealers also passed the Trust Indenture Act; it guaranteed to each holder of an "indenture security" veto power over potential changes to the indenture or security (outside of bankruptcy) affecting "the right to receive payment of the principal of and interest on such indenture security."[159] Together the Chandler Act and the Trust Indenture Act ensured that the restructuring of debt could only take place under the supervision of a judge (in Chapter X) or by securing unanimous consent of the security holders.[160]

Still, it was left for Douglas, by then a Justice of the U.S. Supreme Court, to solidify the protection both acts afforded individual creditors. As Section II.C elaborates, in a memora-

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nation of the best elements of both of these procedures." (internal quotation marks omitted)).

155. Douglas, *supra* note 144, at 876.

156. Dodd, *supra* note 28, at 781.

157. *Id.*

158. *Id.*

159. Trust Indenture Act of 1939, ch. 38, § 316(b), 53 Stat. 1172 (1939) (codified as amended at 15 U.S.C. § 77ppp(b) (2012)).

160. SKEEL, *supra* note 22, at 121.

ble case—*Case v. Los Angeles Lumber Products Corporation*[161]—heard before the Court shortly after the enactment of these federal statutes, Douglas offered an interpretation of the requirement that reorganization plans had to be "fair and equitable"; it held the interests of the passive, scattered creditors paramount. As the discussion in this Section II.B indicates, The Chandler Act's administrative solution was unique in its reliance on the courts. In *Case v. Los Angeles Lumber,* Douglas, following *Boyd,*[162] secured for the court a veto power over every reorganization plan.

C. *Fair and Equitable: The Enduring Legacy of the Vulnerable Investor*

Los Angeles Lumber Products Corporation was based in the Los Angeles Harbor in San Pedro, California. The corporation, which began as a ship-building operation in 1916, made an unsuccessful and short-lived venture into lumber in 1922, leaving it desperate for cash. On March 8, 1924, its parent company "issued a tad less than $4 million worth of bonds to the public."[163] The raised capital was to be used to "pay off the loans that were undertaken [a few years earlier] to build the lumber operations."[164] The company continued to deteriorate and in 1938 suggested to its security holders an out-of-court restructuring that would turn the company into an all-equity company. According to the restructuring plan, holders of the long-term debt were to receive 71% of the new company's stock with holders of stock receiving the remaining 29%.[165]

Being unable to secure unanimous consent for its out-of-court restructuring, Los Angeles Lumber Products Corporation filed for reorganization under section 77B of the Bankruptcy Act, which required the court to determine whether the plan was feasible as well as fair and equitable.

The security holders of Los Angeles Lumber Products Corporation were overwhelmingly in favor of the reorganization plan. 88.9% of the bondholders and 99.7% of the share-

161. Case v. L.A. Lumber Prods. Co., 308 U.S. 106 (1938).
162. N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913). *See* discussion *supra* Part I.A.
163. Rasmussen, *supra* note 133, at 147–53.
164. *Id.* at 153.
165. *Id.* at 147–59.

holders voted to approve it. Not all of the remaining 11% of the bondholders opposed the plan, "some could not be found or contacted."[166] Two bondholders, however, vehemently opposed the plan: Thomas K. Case, who "held bonds with a face amount of $13,000," and Adele M. Cowan, who held bonds with "a face amount of $5,000."[167] Neither would budge unless they were paid "the face value of the bonds, accumulated interest, and expenses" totaling $36,000.[168] Employees of the shipyard attempted to raise funds to pay off Case and Cowan but were only able to raise $28,000.[169]

Given the overwhelming support, the corporation sought to effectuate the plan under section 77B of the Bankruptcy Act.[170] The special master appointed by the district court recommended the approval of the plan and the district court affirmed. "While a court of equity will not allow minority bondholders to be disregarded or unfairly treated in a reorganization plan," the Special Master Report noted, "it will not lend its aid to schemes by minority bondholders opposing a fair reorganization solely as a means of obtaining greater value or more favorable terms" than those given to the other bondholders.[171] The Circuit Court of Appeals for the Ninth Circuit affirmed.

On May 22, 1939, the Supreme Court granted certiorari, at which time, the United States presented an amicus curiae brief, "signed by the Solicitor General, by two Special Assistants to the Attorney-General, by the Chief Counsel of the Interstate Commerce Commission and by the General Counsel and five attorneys for the Securities and Exchange Commission."[172] In its brief the government stated its support for a strict interpretation of the absolute priority rule. As the brief noted, "the requirement of Section 77B of the Bankruptcy Act that a plan of reorganization be 'fair and equitable' necessitates completely compensatory treatment for senior securities

166. *Id.* at 162.
167. *Id.*
168. *Id.*
169. *Id.* at 162.
170. E. Merrick Jr. Dodd, *The Los Angeles Lumber Products Company Case and Its Implications*, 53 HARV. L. REV. 713, 714 (1940).
171. Rasmussen, *supra* note 133, at 163 (citing Report of the Special Master at 95, *In re* L.A. Lumber Prods. Co., 24 F. Supp. 501 (S.D. Cal. 1938)).
172. Dodd, *supra* note 170, at 718.

before junior securities may participate in the reorganized enterprise."[173]

The case was assigned to Justice William Douglas, who took the opportunity to solidify his protection for the individual, minority bondholder. "At the outset," Douglas wrote, giving the court a decisive role in business reorganization, "it should be stated that, where a plan is not fair and equitable as a matter of law, it cannot be approved by the court even though the percentage of the various classes of security holders required by § 77B(f) for confirmation of the plan has consented."[174] Accordingly, the court was "not merely a ministerial register of the vote of the several classes of security holders," but rather the protector of "all those interested in the estate."[175]

As to the fair and equitable requirement, according to Douglas, these were "words of art, which prior to the advent of Section 77B had acquired a fixed meaning through judicial interpretation in the field of equity receivership reorganizations." Referencing *Boyd*, among other cases, Douglas held that fair and equitable meant that creditors had absolute priority over investors ranked lower than they were.[176] By allowing shareholders to participate even though the creditors were not paid in full, the plan proposed by Los Angeles Lumber Products Corporation, according to Douglas, failed to meet the absolute priority rule.

Reviewing the decision at the time, E. Merrick Dodd noted the significant protection that it afforded creditors. "Scattered bondholders," Dodd wrote, "are often compelled to entrust their interests to an incompetent or to a far-from-disinterested committee." Therefore, "it is easier to protect them by

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173. *Id.* at 717–19. The brief also stated that "the 'consideration' furnished by the shareholders in this case" did not constitute "a contribution adequate to justify their participation under the reorganization plan." *Id* at 718. This "new value" requirement, while important for the understanding of the absolute priority rule, is beyond the scope of this article.

174. Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 114 (1938).

175. *Id.*; *see also* Case Comment, *Bankruptcy Reform and the Chancellor Bill*, 46 YALE L.J. 1177, 1183 (1937) (noting that "if minority creditors and debtors forced by creditor pressure to accept unconscionable terms are to be protected, it seems wise to ignore suggestions that court confirmation be dispensed with where a large proportion of creditors approve an agreement").

176. *Case*, 308 U.S. at 115–16; *see also* Rasmussen, *supra* note 133, at 164–65.

establishing a rule of law such as that laid down in the case than by attempting to assure them a devoted and competent committee."[177] As Dodd saw it, the rule set in *Case* could protect minority bondholders from actions of majority bondholders as well as actions of shareholders and corporate managers.[178]

Dodd was nonetheless concerned that a strict adherence to the absolute priority rule might harm investors such as shareholders, who like the bondholders were often vulnerable to the actions and power of management.[179] "The purpose of Section 77B is to provide a method for preserving property rights, insofar as such preservation is possible in view of the financial condition of the enterprise," Dodd wrote:

> Lien creditors who file a reorganization petition against a corporation thereby surrender their usual legal remedy of foreclosure, but the economic value of their lien must be taken into consideration in determining the fairness to them of any reorganization plan which may subsequently come before the court for confirmation . . . once the shareholders, through the voluntary act of their management group, surrender possession to the court, they lose any right to claim that their possessory interest is a property right for which they are entitled to compensation under the plan.[180]

But Douglas and his colleagues were insistent. "We think that the emphasis on enforcement of strict priority and on exclusion of junior classes for whom no value exists is fundamentally conservative doctrine," Jerome Frank explained in 1941.[181] "Like all of the statutes administered by the SEC, we think it is the type of enlightened conservatism which seeks to preserve our capitalistic system by protecting the investor so that the system will work."[182]

In a relatively short time, Douglas, almost single-handedly, had made the absolute priority rule and the protection of mi-

177. Dodd, *supra* note 170, at 722–23.
178. *Id.* at 723.
179. *Id.* at 723–25.
180. *Id.* at 723–24.
181. Frank, *supra* note 71, at 340.
182. *Id.*

nority creditors through administrative control under court supervision the focal point of business bankruptcy law. Yet, as others have explored, Douglas's and the New Dealers' novel approach to corporate reorganizations would ultimately fail to achieve results. The Chandler Act gave the SEC "a prominent role as policeman on investors' behalf of all large-size corporate reorganizations" at the same time that it removed corporate managers, their investment bankers and lawyers from the process.[183] As Section III.A elaborates, in the years immediately following the enactment of the Chandler Act and the Trust Indenture Act, business participation in the Second World War effort helped change the public image of corporations and their managers. Concerns about minority investors dissipated and, in their place, a cultural (and legal) embrace of managerial discretion began to dominate discussions about corporations. As Section III.B explains, the idea that management had no role in the reorganization process went out of vogue, and, in 1978, Chapter 11 of the Bankruptcy Code adopted a managerialist solution to business bankruptcy and reorganization.

Douglas's insistence on a strict application of the absolute priority rule was similarly problematic. Not only did it prevent corporate constituencies from reaching out-of-court agreements that they deemed fair and equitable, it was also rooted, conceptually, in a sharp distinction between shareholders and creditors (a distinction foreign to Progressive legal thought). As Section III.C explores, this distinction allowed late twentieth century jurists to insist that the duties owed creditors were contractual (rather than fiduciary) in nature. As Section III.D explicates, gradually, a path was paved for sophisticated investors to develop *ex ante* arrangements outside bankruptcy to ensure that their interests were protected. By the turn of the twenty-first century, the vulnerable, minority creditors were largely forgotten.

183. SKEEL, *supra* note 22, at 122.

III.
THE HOMECOMING OF THE SOPHISTICATED INVESTOR

A. *The Managerialist Corporation*

By the mid-1940s, concern for investors began to wane and with it the notion that the government should protect minority investors. After the unexpected economic recession of 1937, New Dealers abandoned their regulatory vision of the modern state and instead adopted a compensatory vision.[184] They no longer wanted the federal government to coordinate economic activity, but rather envisioned the government as redressing the "weaknesses and imbalances in the private economy without directly confronting the internal workings of capitalism."[185] The state was to "manage the economy without managing the institutions of the economy."[186] As President Roosevelt pointedly put it, the government's role was to spend capital "to increase [the] public wealth and to build up the health and strength of the people," in order "to help [the] system of private enterprise to function."[187] A vision of a free market, compensated by the state's fiscal hand on rare occasions, began to dominate economic thought.[188]

At the same time, the corporation had changed. By the end of the New Deal, as Herbert Hovenkamp explained, "little was left of the classical corporation": The federal securities acts regulated its relationship with shareholders and creditors, federal labor laws regulated its dealings with workers, while antitrust laws and the Federal Trade Commission regulated the corporation's relationship to consumers and suppliers.[189] The concerns about the power of corporations and their control

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184. Alan Brinkley, *The New Deal and the Idea of the State*, *in* THE RISE AND FALL OF THE NEW DEAL ORDER 1930–1980 87–121 (Steve Fraser & Gary Gerstle eds., 1989).
185. *Id.* at 94.
186. *Id.*
187. *Id.* at 97 (quoting FRANKLIN D. ROOSEVELT, THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT (1914)).
188. For more on these developments, see *id.* at 87–121; see also ALAN BRINKLEY, THE END OF REFORM: NEW DEAL LIBERALISM IN RECESSION AND WAR 154–65 (1995); MICHAEL J. SANDEL, DEMOCRACY'S DISCONTENT: AMERICA IN SEARCH OF A PUBLIC PHILOSOPHY 250–73 (1996).
189. Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593, 1688–89 (1988).

group, concerns that informed the earlier decades' focus on minority investors, were quickly pushed away.

The Second World War also improved the public image of corporations and their managements, further dissipating the concerns about minority investors. War production and the development of new industries (particularly electronics and communications) helped eliminate corporate debt and allowed corporations to cut prices and introduce new management techniques.[190] In the 1930s, many corporations faced maturing liabilities and potential insolvency. They survived only if their creditors agreed to extend the maturity dates on bonds. But during the War, "and the business activity which resulted therefrom, [corporations] enjoyed a very prosperous period. The abnormal profits of the 1940s enabled them to pay their maturing obligations and to settle down to a new period of low earnings."[191]

Most important, perhaps, corporations were embraced as dominant economic, social, and political institutions. The concerns of earlier decades were forgotten and the alliance between business and the federal government strengthened.[192] The corporation, Peter Drucker wrote shortly after the War, was "the institution which sets the standard for the way of life and the mode of living of our citizens; which leads, molds and directs; which determines our perspective on our own society; around which crystallize our social problems and to which we look for their solution."[193]

The economic boom following the war helped sustain not only the corporation's positive image, but also the image of corporate managers.[194] Focusing on management's expertise and its function or status within the corporation, social scien-

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190. JACK BEATTY, COLOSSUS: HOW THE CORPORATION CHANGED AMERICA 265–66 (2001).

191. Katie Avery White, A Study of the Leading Cases Under Chapter XI of the Federal Bankruptcy Act with Particular Reference to their Financial Limitations 6–7 (1966) (unpublished Ph.D. dissertation, University of Illinois) (on file with author).

192. BEATTY, *supra* note 190, at 265–66.

193. PETER DRUCKER, CONCEPT OF THE CORPORATION 6 (1946).

194. Harwell Wells, *"Corporation Law Is Dead": Heroic Managerialism, Legal Change, and the Puzzle of Corporation Law at the Height of the American Century*, 15 U. PA. J. BUS. L. 305, 322 (2013); Richard Hofstadter, *What Happened to the Antitrust Movement?*, *in* THE PARANOID STYLE IN AMERICAN POLITICS AND OTHER ESSAYS 188, 212–15 (1965); ROLAND MARCHAND, CREATING THE COR-

tists advocated empowering corporate managers to control business affairs, to use authority over others in the corporate structure, and to exercise corporate power over those outside the firm.[195] At the same time, the practice of retaining earnings and loan financing from banks that dominated corporate finance through the first half of the twentieth century kept corporations from returning to the public market and allowed them to finance primarily from within, protecting managements from external scrutiny.[196]

As investors grew multiple (and passive), corporate managers, shielded as they were from scrutiny, became the "strategic center" of the large publicly held corporation.[197] As historian Richard Hofstadter pointed out, "business structure has brought into life a managerial class of immense social and political as well as market power."[198] Management dominated the corporate bureaucracy, organized production, and exercised power over individual lives within the corporation and market transactions outside it.[199] Business experts asserted that corporations were to be managed by multiple loyal leaders, "men of ability and initiative" capable of fighting or evading "bureaucratic ossification and bureaucratic timidity" and pursuing corporate policy,[200] and the term "free enterprise"—in use since the 1930s—came to symbolize the free reign of managers, who in cultural imagination replaced the small producers and entrepreneurs of the nineteenth century.[201] In 1957, reflecting

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PORATE SOUL: THE RISE OF PUBLIC RELATIONS AND CORPORATE IMAGERY IN AMERICAN BIG BUSINESS 358 (2000); BEATTY, *supra* note 190, at 267.

195. William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 413 (1989).

196. Lawrence E. Mitchell & Dalia T. Mitchell, *The Financial Determinants of American Corporate Governance: A Brief History*, *in* H. KENT BAKER & RONALD ANDERSON, CORPORATE GOVERNANCE: A SYNTHESIS OF THEORY, RESEARCH, AND PRACTICE 19, 24 (2010).

197. William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1476 (1989).

198. Hofstadter, *supra* note 194, at 236.

199. Bratton, *supra* note 197, at 1476; *see also* SCOTT R. BOWMAN, THE MODERN CORPORATION AND AMERICAN POLITICAL THOUGHT: LAW, POWER AND IDEOLOGY 198 (1996).

200. DRUCKER, *supra* note 193, at 33, 36; *see also* C.A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-First Century*, 51 KAN. L. REV. 77, 105–06 (2002).

201. *See, e.g.*, Nelson Lichtenstein, *Taft-Hartley: A Slave Labor Law?*, 47 CATH U. L. REV. 763, 771 (1998).

this transformation, Carl Kaysen celebrated professional managers, noting that management no longer viewed itself as "the agent of proprietorship seeking to maximize return on investment." Rather, management saw itself "as responsible to stockholders, employees, customers, the general public, and, perhaps most important, the firm itself as an institution."[202] As the following Section III.B elaborates, this was the intellectual milieu in which, in 1978, Congress enacted Chapter 11 of the Bankruptcy Code.

B. *Managerialism and the Bankruptcy Code*

In corporate law, managerialism informed the courts' rapid expansion of the business judgment rule to shield corporate directors, as experts, from liability.[203] As to business bankruptcy and reorganization—the almost irrelevance of public investors to corporations' success in the midcentury years, coupled with the wide acceptance of corporate managers as capable experts, supported a rapid disenchantment with Douglas's solutions. Chapter X's "ushering out" of the debtor's management and its Wall Street lawyers and bankers did not fare well; neither did the Supreme Court's strict adherence to the absolute priority rule. As David Skeel writes, Chapter X "gave managers an incentive to avoid Chapter X."[204] Since the Chandler Act did not explicitly require all publicly-held corporations to reorganize under Chapter X, businesses and their managers were quick to find a way to file for bankruptcy under Chapter XI of the act, a chapter intended for closely held corporations.[205] Under Chapter XI, the debtor's management and its lawyers could stay in control, propose a reorganization plan and confirm it without fulfilling the requirements of Chapter X. The SEC did not have an oversight role and the company's shareholders were allowed to keep their stock in the company.[206]

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202. Carl Kaysen, *The Social Significance of the Modern Corporation*, AM. ECON. REV., May 1957, at 311, 313; *see also* Gerald F. Davis, *The Twilight of the Berle and Means Corporation*, 34 SEATTLE U. L. REV. 1121, 1125 (2011).

203. *See* Dalia Tsuk Mitchell, *Status Bound: The Twentieth Century Evolution of Directors' Liability*, 5 N.Y.U. J.L. & BUS. 63, 118–120 (2009).

204. SKEEL, *supra* note 22, at 161.

205. *See, e.g.*, S. REP. NO. 95-989, at 9 (1978) (noting that the Chandler Act failed "to include a definition of 'public company' ").

206. SKEEL, *supra* note 22, at 122–27.

Interestingly, Douglas refused to prohibit managers of publicly held corporations from filing under Chapter XI. In *General Stores Corporation v. Shlensky* (1956), Douglas rejected the SEC's argument that corporate debtors with public securities could not file for reorganization under Chapter XI. "The character of the debtor is not the controlling consideration in a choice between [chapter] X and [chapter] XI. Nor is the nature of the capital structure," Douglas wrote.[207] "The essential difference is not between the small company and the large company but between the needs to be served."[208] Determining the appropriate chapter for any given company thus required "a case-by-case factual inquiry focusing on the 'needs to be met.' "[209]

Some commentators have argued that the decision in *Shlensky* was not surprising because Douglas, despite his legal-realist and SEC background, had always been keen on maintaining an important role for the court in any reorganization. This was apparent in his interpretation of the "fair and equitable" requirement, giving the court a veto power over a reorganization plan even when an overwhelming majority of the security holders supported it. This was also clear in *Shlensky* where Douglas insisted that the court, rather than the SEC, determine the appropriate chapter under which a case should unfold.[210] Indeed, in 1956, Douglas also published his *We the Judges*, lauding the importance of an independent judiciary not merely for the resolution of conflicts but also for sustaining a peaceful and orderly society.[211]

It is also important to remember that Douglas was always of two minds when it came to his assessment of corporate management. On the one hand, as a commentator noted at the time, the protective committee study, seemed to suggest that "security holders were to be enlisted in a war on corporate management."[212] At the same time, however, in a memorable 1934 article entitled "Directors Who Do Not Direct," Douglas

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207. General Stores Corp. v. Shlensky, 350 U.S. 462, 466 (1956).
208. *Id.*
209. SKEEL, *supra* note 22, at 164.
210. *Id.* at 166–68.
211. *See* M. Ramaswamy, Book Review, 8 STAN. L. REV. 756, 757 (1956) (Reviewing WILLIAM O. DOUGLAS, WE THE JUDGES: STUDIES IN AMERICAN AND INDIAN CONSTITUTIONAL LAW FROM MARSHALL TO MUKHERJEA (1956)).
212. Wham, *supra* note 126, at 390–91.

stressed the need to develop "adequate administrative controls so that the domain of regulation will be neither wholly in the courts nor largely *ex post facto*."[213] Explicitly, Douglas wanted to see the development of a professional managerial class, "skilled in the technique of business, the art of law, and the skill of government."[214] It might well be that, by the 1950s, Douglas (like other New Dealers[215]) was persuaded by the growing influence of managerialism, coupled with a dissatisfaction with the administrative state, to trust even the managers of companies in financial distress to make appropriate choices, case-by-case, for their corporations.[216]

Whether or not Douglas was inspired by midcentury managerialism, the ultimate triumph of managerialism in business bankruptcy and reorganization was realized in 1978 with the passage of the Bankruptcy Reform Act. It was signed into law by President Jimmy Carter, who "extolled the virtues of small government, deregulation, and zero-based government budgeting."[217] Purportedly, the bill, "like Chapter X, [was] designed to counteract the natural tendency of debtor in distress to pacify large creditors, with whom the debtor would expect to do business, at the expense of the small and scattered public investors."[218] "In a large public company, whose interests are diverse and complex," the Senate Report read, "the most vulnerable today are public investors who own subordinated debt or equity securities."[219] Yet, if in 1938, an expert trustee was seen as the appropriate medium to protect the interests of these public investors, in 1978, the task was left to corporate managers. (As we will see in the following sections, by turning to management, the bill inadvertently paved the path for undermining the interests of the public investors it purported to help.)

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213. Douglas, *supra* note 116, at 1328.

214. *Id.*

215. *See, e.g.*, ADOLF A. BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION (1954).

216. For Douglas's 1950s view of the corporation, see, e.g., William O. Douglas, *Review of the 20th Century Capitalist Revolution*, 103 U. PA. L. REV. 1108, 1108–09 (1955). On the scholarly disenchantment with the administrative state, see, e.g., HORWITZ, *supra* note 65, at 214, 225.

217. Kennedy & Lindner, *supra* note 26, at 781; Roe, *supra* note 21, at 202.

218. S. REP. NO. 95-989, at 10 (1978).

219. *Id.*

Consolidating the provisions applicable to the reorganization of business into one chapter, known as Chapter 11, the 1978 Act brought the management of the bankrupt corporation back into the reorganization process, allowing management to maintain its position (rather than be replaced by a trustee) and granting management an exclusive period of time during which it, and it only, could propose a plan of reorganization. In addition to rendering the independent trustee "presumptive rather than mandatory,"[220] the Act also ensured that reorganization plans that were negotiated and approved by the required votes of the different classes would be affirmed by the court. Only when a plan was not approved by all the required classes (and provided that one impaired class voted in its favor), would the court address the question as to whether the plan was fair and equitable so as to determine whether it should be forced on the non-consenting parties (in a process known as cramdown). Negotiations among different classes of creditors under the direction of the debtor's management became the centerpiece of business reorganization.[221]

"When Congress enacted the 1978 Code," Mark Roe writes, "the business judgment of the parties was thought to be good enough."[222] Government intervention was seen as the problem rather than the solution. The Code's provisions were meant to reflect "the deal that creditors would have made beforehand (had transaction costs been low enough for creditors to specify the terms that would govern if a firm failed)."[223] Despite the statements in the Senate Report, investors were no longer viewed as vulnerable but rather seen as active and capable of protecting their interests under the expert guidance of their corporate managers.

Law's trust in the different parties to reach appropriate solutions, especially its trust in corporate management, reached further. Take, for example, asset sales. Under the Chandler Act, a bankruptcy judge could authorize a sale of all or substantially all the assets of a company in Chapter X, typically when the property in question was perishing or deterio-

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220. SKEEL, *supra* note 22, at 177.

221. *Id.*; Anne Webber Epstein, *From Debtor's Shield to Creditor's Sword: Cram Down Under the Chandler Act and the Bankruptcy Reform Act*, 55 CHI.-KENT L. REV. 713 (1979).

222. Roe, *supra* note 21, at 202–03.

223. *Id.*

rating or wasting.[224] The 1978 Code did not impose "strict limitations on a bankruptcy judge's authority to order disposition of the estate's property."[225] Rather, section 363(b) "on its face seem[ed] to confer upon the bankruptcy judge virtually unfettered discretion to authorize the use, sale or lease, other than in the ordinary course of business, of property of the estate."[226] In *In re Lionel Corporation*, the United States Court of Appeals for the Second Circuit interpreted section 363(b), holding that a judge would authorize a 363(b) sale if the debtor in possession could show a "good business reason" for it.[227] Business judgment, the symbol of managerialism in corporate law and a rule justified by the shareholders power to elect directors,[228] found its way into the laws affecting creditors, who do not have such power, in business bankruptcy and reorganization.

Not everyone celebrated managerialism or negotiated deals. Critics of the Code were quick to argue that Chapter 11 entrenched the managers who brought about the firm's failure.[229] Others questioned the plausibility of negotiated deals "because parties who are stuck with one another will not strike deals as effectively as parties who are not already embedded in the firm."[230] Others, still, pointed out that the financial markets offered better and faster solutions to financially struggling firms, namely mergers, sales of assets and similar transactions.[231] As Roe succinctly put it, "the 1980s critique was that the 1978 Code deferred to a deal that allowed strategically-placed players—inside management—to extract excessive value in the bargaining process at the expense of creditors and the best repositioning of the firm."[232]

These critiques reflected the influence of a broader jurisprudential change. As I argue in Section III.C, by the time the

224. *In re* Lionel Corp., 722 F.2d 1063, 1066 (2d Cir. 1983).
225. *Id.* at 1069.
226. *Id.* at 1069.
227. *Id.* at 1071.
228. Mitchell, *supra* note 53, at 1575–76.
229. Roe, *supra* note 21, at 203.
230. *Id.*
231. *Id.* at 203–04.
232. *Id.* at 204; *see also id.* at 189 (noting that this was "bankruptcy's business-judgment-rule phase . . . No corporate law judge would second-guess the dutiful board and similarly no bankruptcy judge in this age of bankruptcy would second-guess the ordinary bankruptcy deal.").

Bankruptcy Code embraced managerialism, a different understanding of corporations, their property and their investors have reached its apogee in legal academia. Grounded in neoclassical economics, this new vision put the market at the center of both corporate law and business bankruptcy and reorganization law. Informed by this vision, the Delaware courts recharacterized creditors' relationship to the corporation as strictly contractual and distinct from the shareholders' relationship (which remained grounded in property rules). By characterizing the relationship of creditors to their corporation as contractual, the courts helped undermine the protections afforded creditors not only in corporate law but also in insolvency. As Section III.D will conclude, these developments incentivized those who could—typically large, sophisticated investors—to protect their interests, to the exclusion of others, gradually undermining the protections afforded smaller and less sophisticated creditors in Chapter 11.

C. *The Return of the Market*

By the 1970s, managerialism was under attack. For one thing, studies indicated that management-controlled firms were just as profitable as owner-controlled firms.[233] Corporate managements were also seen as responsible, at least in part, for the "economic distress" that characterized the 1970s.[234] "External economic shocks, compounded by a drop-in productivity growth, cost-of-living adjustments built into union contracts, and an economy shifting toward services" led to dramatic wage and profitability drop.[235] Industrial corporations began a rapid "drift from the center toward the periphery of the economy," and were replaced by "newcomers from the technology and service sectors."[236] Americans lost faith in their federal and state governments as well as in their industrial corporations and their ability to improve the economy.[237]

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233. Mark S. Mizruchi, *Berle and Means Revisited: The Governance and Power of Large U.S. Corporations*, 33 THEORY & SOC'Y 579, 587–88 (2004).

234. RAKESH KHURANA, FROM HIGHER AIMS TO HIRED HANDS: THE SOCIAL TRANSFORMATION OF AMERICAN BUSINESS SCHOOLS AND THE UNFULFILLED PROMISE OF MANAGEMENT AS A PROFESSION 297–98 (2007).

235. *Id.*

236. *Id.* at 298.

237. *Id.* at 298–99.

Attacks on managerialism went hand in hand with growing academic faith in the power of economic and political markets to serve (and produce) the common good, which in turn opened a door for the introduction of economics into corporate law.[238] Neo-classical economists, who thus far had focused their theorizing efforts on markets, turned to the corporation's internal structure. Their new economic theory of the firm offered a picture of the corporation that fit the market-centered economic policies of the postwar years.[239] Rather than putting management hierarchies or the need to constrain corporate power at the center of the corporate paradigm, the new economic theory of the firm found a way around hierarchical power and its consequent need for regulation. Drawing on microeconomics, it painted a picture of the corporation as a nexus of private, contractual relationships. This cleared the way for egalitarian economic markets to become the relevant focal point.[240] The corporation was a collection of "disaggregated but interrelated transactions" among individuals or the convenient fiction of corporate entity in free and efficient markets.[241] Business bankruptcy laws were to apply only where market transactions could not succeed. As Alan Schwartz put it, "Bankruptcy systems create mechanisms to facilitate Coasean bargaining."[242]

Among the corporate constituencies to feel the impact of the shift from managerialism to economics were bondholders. Historically, bonds were deemed to provide "fixed, assured income for lenders," while the bond markets were viewed as providing "ready liquidity or cash for both lenders and borrow-

238. Bratton, *supra* note 197, at 1476–80.

239. Patrick J. Akard, *Corporate Mobilization and Political Power: The Transformation of U.S. Economic Policy in the 1970s*, 57 AM. SOC. REV. 597, 597 (1992) (noting that despite "record inflation," "the worst recession since the 1930s," and multiple proposals for economic planning at the state and federal levels, by the early 1980s, U.S. economic policy heavily relied on market allocation of resources).

240. Bratton, *supra* note 195, at 416–20; Bratton, *supra* note 197, at 1498; Oliver E. Williamson, *Organization Form, Residual Claimants, and Corporate Control*, 26 J.L. & ECON. 351, 365 (1983).

241. Bratton, *supra* note 195, at 420.

242. Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1809 (1998); *see also* David A. Skeel, Jr. & George Triantis, *Bankruptcy Uneasy Shift to a Contract Paradigm*, 166 U. PA L. REV. 1777 (2018).

ers."[243] By the 1980s, however, markets were different. Like stock, bonds were bought for profit; their buyers, like shareholders, were for the most part speculators.[244] (This transformation was fueled by the inflation of the 1970s, coupled with the role that junk bonds played in the takeovers of the 1980s.[245]). In addressing the obligations of corporate managers towards shareholders and bondholders, the Delaware courts, however, did not dwell upon financial similarities but rather on neoliberal legal conclusions. While, as early-twentieth scholars had recognized, in modern securities markets, shareholders and debtholders were similarly situated, the Delaware courts drew upon the idea that the corporation was a nexus of contracts to create a sharp distinction between shareholders and bondholders. Shareholders were described as vulnerable, passive property owners to whom fiduciary duties should be extended while bondholders (and other creditors) were seen as capable of protecting their own interests in negotiations with their corporations.

Take, for example, *Simons v. Cogan* (1988), a case in which the Supreme Court of Delaware addressed an attempt by a holder of convertible subordinated debentures to hold directors liable for breach of fiduciary duties associated with a cash-out merger.[246] Declining to extend the fiduciary obligations of corporate management to holders of convertible debentures, Justice Walsh reasoned: "A debenture is a credit instrument which does not devolve upon its holder an equity interest in the issuing corporation."[247] A convertible debenture was not different. It represented "a contractual entitlement to the repayment of a debt and . . . not . . . an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties."[248] To trigger a fiduciary duty, Walsh concluded, "an existing property right or equitable interest supporting such a duty must exist."[249]

243. E. Ray Canterbery, Wall Street Capitalism: The Theory of the Bondholding Class 33 (2000).
244. On this transformation, see *id.* at 33–45.
245. *Id.* at 67–68.
246. Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988).
247. *Id.* at 303.
248. *Id.*
249. *Id.* at 304.

The debentures in *Simons*, like many other debentures and bonds, were publicly issued and thus subject to an indenture, a contract (and in publicly held corporations typically standardized contract) to which the issuing corporation and a trustee, nominated by the issuer to represent the interests of the debenture-holders, were parties. The contract upon which Justice Walsh relied was drafted and negotiated by the issuing corporation's management. Louise Simons and those in her class did not negotiate this contract, nor could they enforce it (the trustee represented them for that purpose). As Lawrence Mitchell writes, "the consequence for bondholders is that their rights are determined by the same persons who are to bear the corresponding duties and who hold all of the power in defining and regulating the relationship."[250]

Moreover, with the exception of the debt terms and interest payments, which fall under section 316(b) of the Trust Indenture Act, almost all the terms of the (presumably contractual) indenture could be modified by a majority or super majority of the debenture holders, allowing corporations to manipulate collective action problems to their (and their shareholders') benefit. Take, for example, *Katz v. Oak Industries, Inc.* (1986).[251] As part of a planned restructuring and recapitalization negotiated with Allied Signal, Oak Industries, a company "in deep trouble," extended cash and common stock exchange offers to its six classes of long-term debt securities.[252] Tendering note-holders had to "consent to amendments in the indentures governing the securities," amendments that would remove "significant negotiated protections to holders of the Company's long-term debt including the deletion of all financial covenants" and thus negatively impact their value.[253] These modifications would affect note-holders who chose not to tender into the exchange offers, but not the ones who received cash or stock in the exchange. Failure to obtain the required consents from the note-holders would have allowed Allied-Signal to decline to complete the planned acquisition.[254] An owner of long-term debt securities sought to enjoin con-

250. Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1167–68 (1990).

251. Katz v. Oak Indus., 308 A.2d 873, 877 (Del. Ch. 1988).

252. *Id.* at 875–76.

253. *Id.* at 877.

254. *Id.*

summation of Oak Industries' exchange offers, arguing that they were coercive and therefore "a breach of a contractual obligation that Oak owe[d] to its bondholders to act in good faith."[255]

Reiterating the Delaware courts' characterization of debt as a contractual relationship, Chancellor Allen began his decision by noting that "arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented . . . The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligations to its bondholders."[256] Accordingly, while acknowledging that the "purpose and effect" of Oak Industries' exchange offers were to "benefit Oak's common stockholders at the expense of the holders of its debt," Allen did not find the plaintiff's claims to "allege any cognizable wrong."[257] As Allen put it, "it is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders."[258] That they do so "at the expense" of others, here the debtholders, "does not for that reason constitute a breach of duty."[259]

Reducing the plaintiff's rights to contractual, rather than fiduciary, claims, Allen also held that Oak Industries did not breach the implied covenant of good faith in its dealing with its debtholders.[260] "While it is clear that Oak has fashioned the exchange offer and consent solicitation in a way designed to encourage consents," Allen wrote, the exchange offer did not "violate[ ] the intendment of any of the express contractual provisions . . . or . . . an implied obligation of good faith and fair dealing."[261] In short, while the requirements of section 316(b) of the Trust Indenture Act remained the law, corporations were allowed to alter any and all the terms not specified

255. *Id.* at 878.
256. *Id.* at 879.
257. *Id.*
258. *Id.*
259. *Id.*
260. *Id.* at 879–82.
261. *Id.* at 881.

in section 316(b), even through the use of exchange offers that some might describe as coercive.[262]

Given the Delaware courts' refusal to extend fiduciary duties toward creditors under corporate law, and their narrow interpretation of the contractual obligations of corporations toward their creditors, the question of potential duties toward creditors in bankruptcy became pertinent. Yet, in a series of cases decided in the early twenty-first century, the Delaware courts also ensured that, even in insolvency, corporate managements' fiduciary obligations toward creditors would be rather limited.

In *Credit Lyonnais Bank Nederland, N.V.* v. *Pathe Communication Corp.* (1991), a case involving a failed leverage buyout, Chancellor Allen coined the term "vicinity of insolvency" to hold that "at least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers [the shareholders], but owes its duty to the corporate enterprise."[263] Accordingly, directors of a corporation in the vicinity of insolvency "had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."[264] Creditors, presumably, could bring direct and derivative suits to enforce these duties as soon as the corporation entered the vicinity of insolvency.

In 2015, however, addressing a creditor's derivative suit for breach of fiduciary duties by corporate managers, Vice Chancellor Laster held that "there is no legally recognized 'zone of insolvency.'"[265] Only when a corporation was insolvent, could creditors bring claims of breach of fiduciary obligations and even then, creditors only had "standing to assert claims derivatively for breach of fiduciary duty."[266] In a passage

262. *See, e.g.*, Assenagon Asset Mgmt. S.A. v. Irish Bank Resolution Corp. [2012] EWHC 2090 (Eng.) (holding a similar exchange offer coercive); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (declaring that a similar tender offer to shareholders was coercive).

263. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns. Corp., 1991 Del. Ch. LEXIS 215, 109 (1991).

264. *Id.*

265. Quadrant Structured Prods. Co. v. Vertin, 115 A.3d 535, 545, 546 (Del. Ch. 2015).

266. *Id.*

illustrating the combined effect of midcentury managerialism and the late-twentieth century fixation with market theories, Laster noted:

> The directors of an insolvent firm do not owe any particular duties to creditors. They continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category which now includes creditors. They do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximize the firm's value.[267]

The vulnerable, scattered creditors, that, after *Katz*, could not rely upon contractual terms to protect their interests, also lost the ability to use the law of fiduciary duties even as their company deteriorated toward insolvency. Corporations were run by managers with full discretion to determine the appropriate courses of action, both outside and in insolvency. In this manner, according to Laster, "directors can, as a matter of business judgment, favor certain non-insider creditors over others of similar priority without breaching their fiduciary duties."[268] They also "cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors."[269] This was true even when the directors themselves owned common stock and thus could benefit from potential increase in profitability but stood to lose little if the plan failed.[270]

The only safeguards creditors could presumably rely upon were those explicitly stated in the Bankruptcy Code, including, for example, the automatic stay, which prevents creditors from reaching the debtor's assets after it had filed for bankruptcy, thus allowing the debtor and its different claimants a breathing space to negotiate and approve a reorganization plan.[271] Yet, as Section III.D details, in recent decades, sophisticated investors were able significantly to undermine the power of

267. *Id.* at 546–47.
268. *Id.* at 547.
269. *Id.*
270. *Id.*
271. 11 U.S.C. § 362 (1978).

the automatic stay. Using *ex ante* contractual arrangements that excluded their claims from the reach of the stay, they not only ensured their priority as far as the allocation of the corporation's assets but also derailed the possibility of reorganization by removing these assets from the bankruptcy estate. As Section III.D concludes, given the proliferation of such *ex ante* agreements and their collective impact, it is perhaps not surprising that nowadays debtors (like Sears) often turn to section 363(b) sale (or a fundamental transaction outside bankruptcy) for a quick escape from financial distress.

D. *The Rise of the Sophisticated Investor*

Through the 1960s, corporations relied upon internal finance and loans from banks to fund their operations.[272] Stock ownership was not widespread—roughly five percent of the population owned stock. Trading volume was also low, indicating that these shareholders did not trade often, preferring instead long-term investment for appreciation and income. On average, between fifteen and twenty percent of the shares listed on the New York Stock Exchange (NYSE) traded each year, compared to over one hundred percent in the early 2000s.[273] In 1954, riding the waves of "patriotism and renewed appreciation of capitalism" that characterized the 1950s, the NYSE embarked upon a campaign for mass marketing stock.[274] Labeled "Own Your Share of American Business," the campaign used sophisticated advertising tools attempting to associate investment in stock with steady income, gradually "transforming many citizens' image of equity investing from a sinful, foolish pursuit akin to gambling to a wholesome activity as quintessentially American as . . . apple pie."[275] The bullish market growth in the succeeding decade demonstrated the success of the NYSE's programs.[276]

The development of modern finance theory coincided with the NYSE efforts. In the first part of the twentieth century, economists justified investment by reference to the intrinsic

272. Mitchell, *supra* note 23, at 12–15.
273. HO, *supra* note 54, at 200–01.
274. Janice Traflet, *"Own Your Share of American Business": Public Relations at the NYSE During the Cold War*, 1 BUS. & ECON. HIST. 1, 3–4 (2003), http://www.thebhc.org/sites/default/files/Traflet_0.pdf.
275. *Id.* at 20–21.
276. *Id.*

value of corporations. Beginning in the 1950s, however, the newly developed modern portfolio theory suggested that investors could create "an efficient portfolio," that is, a portfolio that would achieve maximum return by diversifying non-systematic risk, and that the portfolio, rather than individual corporations, should be the focus of investment analysis.[277] The Capital Asset Pricing Model, which was developed in the 1960s, offered a regression analysis of any security's historical movement in relation to the market to help investors diversify even the systematic risk inherent in the market. Rather than study the fundamentals of companies in which they were interested, investors were told to study the historical performance of their companies' securities prices.[278] Seeking ample diversification of both systematic and non-systematic risks, investors, in turn, chose mutual funds over direct investment in corporate stock. Within a few decades, the percentage of households that owned securities through mutual funds dramatically increased.[279]

By the 1980s, with rapid growth in the number of institutional investors, finance capitalism displaced managerial capitalism. This "did not mean that public company executives were relegated to irrelevance."[280] Rather, they were tasked with a different role. Instead of the "effective and loyal 'organization man'" of the midcentury years, managers were ex-

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277. Lawrence E. Mitchell, *The Morals of the Marketplace: A Cautionary Essay for Our Time*, 20 STAN. L. & POL'Y REV. 171, 176–78 (2009).

278. *See id.* at 178–79; Roberta Romano, *Corporate Law After the Revolution in Corporate Law*, 55 J. LEGAL EDUC. 342, 345–46 (2005).

279. Ronald Gilson and Jeffrey Gordon note that while the percentage of households that directly own equities has remained about 20% since the late 1970s, mutual funds investment (including but not limited to retirement investment) "has increased the percentage of households that own equities directly or through mutual funds by 30% to a total of 50%" by the middle of the first decade of the twenty-first century. Moreover, while in the 1950s, "equities were still held predominantly by households" with institutional investors holding "only approximately 6.1% of U.S. equities," by the 1980s, "institutional investors held 28.4% of U.S. equities." By the end of the first decade of the twenty-first century, "institutional investors held 50.6% of all U.S. public equities, and 73% of the equity of the thousand largest U.S. corporations." Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Reevaluation of Governance Rights*, 113 COLUM. L. REV. 863, 874–84 (2013).

280. BRIAN R. CHEFFINS, THE PUBLIC COMPANY TRANSFORMED 156–57 (2018).

pected to embrace "an entrepreneurial ethos."[281] Managers were no longer entrusted with the task of making expert business decisions. Rather, they were responsible for maximizing value for their investors. The stock market was becoming the principal governor of corporate behavior and stock price appreciation—an end in and of itself. Corporations began using their retained earnings and, rapidly, debt to return value to shareholders. Takeovers, stock buybacks, and leverage became management's principal techniques to satisfy stock price appreciation, and stockholders—especially institutional shareholders—demanded it.[282]

The bond market was growing and with it the debt to equity ratio in U.S. corporations, engendering deep concerns about potential conflicts of interest between shareholders and creditors and the possibility that directors would prefer to satisfy shareholders' demands at the expense of their corporations' creditors. The Delaware courts' swift and unequivocal response (as described in Section III.C), refusing to extend fiduciary obligations to holders of debt securities and assuring shareholders that their corporations were managed in their benefit, encouraged sophisticated creditors to take matters to their hands to guarantee that, even if a corporation faced financial difficulties, their interests will be fully protected.

Take, for example, the special purpose vehicle (SPV) or entity (SPE). In any bankruptcy and reorganization, the interests of secured creditors are to a large extent protected by the value of their collateral. They are subject, however, to the automatic stay. In the last decades of the twentieth century, corporations developed the SPV or SPE, a firm created for the purpose of purchasing an asset such as accounts receivables or inventory from a debtor. A bank would loan money to the SPV, which the latter would use to purchase the accounts receivable from the originating debtor. The debtor typically guaranteed the SPV's payment on the bank loan. Because the SPV was a separate legal entity, in the event that the originating debtor filed for bankruptcy, assuming the court recognized a true sale had indeed occurred, the bank would not be subject to the automatic stay affecting the assets of the debtor. The other creditors of the originating debtor would face the prospects of

281. *Id.* at 161.
282. Mitchell, *supra* note 23.

reorganization with a bankruptcy estate stripped of one of its major assets.[283]

In a similar manner, the financial industry developed derivatives, such as forward and future contracts, swaps, and financial repurchase agreements ("repo"), which courts have protected under the Code's safe harbors provisions. Thus, unlike typical creditors, counterparties to derivatives and repos could potentially "seize and liquidate collateral, net out gains and losses, terminate their contracts with the bankrupt, and keep both preferential eve-of-bankruptcy payments and fraudulent conveyances they obtained from the debtor, which other creditors would have to return to the bankrupt."[284]

As far as corporations and their other creditors were concerned, these *ex ante*, protective tools often had devastating consequences. First, they reduced the sophisticated investors' incentive to monitor the actions of the counterparty or the accounts receivables' originator, the corporation. Then, when bankruptcy struck, the ability of these sophisticated investors quickly to seize and liquidate collateral, left other, less sophisticated creditors with a smaller bankruptcy estate to share. Take, for example, the collapse of AIG. AIG sold "as many credit default swaps as it possibly could, without worrying too much about any sort of risk management of those swaps."[285] When AIG began facing financial difficulties, the counterparties on these swaps "had a contractual right to demand that AIG post cash or other assets as collateral to back up the swaps."[286]

283. This scenario assumes that the court would determine that a true sale, as distinguished from simple securitization, had occurred. While the true sale doctrine has remained somewhat murky and confusing, given the history narrated in this article, one could venture to suggest that investors would continue to use the SPV/SPE and indeed follow the requirements set by the few cases addressing true sales to ensure that the courts would hold the sale true and valid. On the doctrine of true sale, see Heather Hughes, *Property and the True Sale Doctrine*, 19 U. PA. J. BUS. L. 870 (2017).

284. Mark J. Roe, Derivative Markets in Bankruptcy (Apr. 17, 2012), https://ssrn.com/abstract=2040864. As with the true sale doctrine, the safe harbors doctrine is still developing with some decisions recently appearing to limit its scope, *see, e.g.*, Merit Mgmt. Grp. v. FTI Consulting, Inc., 138 S.Ct. 883 (2018), and others broadening it, *see, e.g.*, Lehman Bros. Special Fin. Inc. v. Bank of America NA, No. 17 Civ. 1224, 2018 WL 1322225 (S.D.N.Y. Mar. 14, 2018).

285. Stephen J. Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319, 319 (2010).

286. *Id.* at 319–20.

Quickly, they were able to convert their "previously unsecured claims on the swaps into secured claims," pushing AIG into liquidity difficulties.[287] Because swaps are subject to safe harbors, filing for bankruptcy would not have solved the problem. As Stephen Lubben writes, by terminating swaps or withholding performance, counterparties can "destroy going concern value in the debtor—either by taking assets out of the estate or stopping cashflows that would otherwise benefit the debtor."[288]

The impact of *ex ante* arrangements such as derivatives reached further. Given the ability of sophisticated creditors quickly to grab the firm's assets even after it had filed for bankruptcy, companies began to face slim chances of emerging successfully out of Chapter 11. It is perhaps not surprising that sales of all or substantially all of the company's assets, transactions that became more popular after the Chrysler and GM bankruptcies, are now common means of addressing financial distress and insolvency.[289] Earlier cases such as *In re Lionel* (discussed in Section III.B) focused on the sale of a significant asset but did not authorize the sale of the company as a whole, reflecting the Code's stated goal of encouraging creditor-negotiated deals. By the early decade of the twenty-first century, however, over third of the reorganized public corporations were sold using section 363(b).[290]

Like mergers and takeovers, bankruptcy sales have become a means of taking control over a company. Instead of a reorganization plan negotiated among the firm's creditors guided by management's business judgment, today we see sales to the highest bidder (typically in collaboration with the debtor's management) as the most common solution to financial difficulties.[291] Perhaps, we are simply back where we began—in a world where managers, their Wall Street bankers and lawyers seek market solutions to financial hardship. Instead of the procedures of the equity receivership, they now use section 363(b) of the Bankruptcy Code.

287. *Id.* at 320.

288. *Id.*; *see also* Roe, *supra* note 284.

289. For a different explanation of the growing popularity of sales, see Roe, *supra* note 21; Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002).

290. Roe, *supra* note 21, at 206.

291. *Id* at 205–06.

EPILOGUE

In 1931, Ms. Pepper sued the Dixie Splint Coal Company and Mr. Litton, its controlling shareholder, "for an accounting of royalties due Pepper under a lease."[292] Anticipating that Pepper would prevail, "Litton caused Dixie Splint Coal Company to confess a judgment in Litton's favor in the amount of $33,468.89, representing alleged accumulated salary claims dating back at least five years."[293] When Pepper, as expected, obtained judgment, Litton "caused an execution to issue on his confessed judgment and levy to be made thereunder."[294] Litton then caused the company to file for bankruptcy, the sole purpose of which was to avoid payment to Pepper.[295]

Writing for the court, Justice Douglas not only subordinated Litton's claim, but also used the opportunity to provide a strong and memorable statement about the duties of corporate fiduciaries. The powers of directors, officers and controlling shareholders, Douglas wrote, "are powers in trust . . . Their dealings with the corporation are subjected to rigorous scrutiny" and when challenged, "the burden is on the director or stockholder not only to prove the good faith of the transaction, but also to show its inherent fairness from the viewpoint of the corporation and those interested therein."[296] Moreover,

> while normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders . . . [297]

Douglas's statement was grounded in the Progressives' belief that those in control of a corporation owed fiduciary duties to all of the corporation's investors. Shareholders could enforce such duties when the corporation was solvent, while the trustee in bankruptcy enforced them in insolvency. Whoever

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292. Pepper v. Litton, 308 U.S. 295, 298 (1939).
293. *Id.*
294. *Id.*
295. *Id.* at 298.
296. *Id.* at 306.
297. *Id.* at 307.

enforced them, the duties of those in control always ran to the entire corporate community, including, most significantly, the passive, vulnerable shareholders and creditors.

Much has changed since Douglas wrote his opinion in *Pepper v. Litton*. The Bankruptcy Code replaced the Chandler Act; large investors have become more numerous and sophisticated while the image of the vulnerable investor lost its sway as courts embraced the twin ideas that markets are efficient and that investors can protect their own interests; more recently, market solutions to financial distress have become common. Still, and perhaps because of these developments, Douglas's (and his contemporaries') vision remains potent.

Sears did not arrive at bankruptcy overnight. "It has been struggling to survive for years," with its sales "tumbl[ing] from $53 billion in 2006 to less than $17 billion in 2017."[298] Lampert, Sears' chairman, kept the company afloat, among other means, "through billions of dollars in loans" from Lampert's hedge fund, ESL investments.[299] Such insider loans have become common, especially as corporations deteriorate into insolvency. Boards of directors often "lock the corporation into an all-encompassing secured loan" in a last-ditch attempt to evade bankruptcy, only to end up in Chapter 11 with so few assets that the only way out is a quick section 363(b) sale.[300]

Echoing Douglas's sentiment in *Pepper v. Litton*, Stephen Lubben has recently argued that the way to prevent last-minute loans from further harming the corporation was to be found not in bankruptcy law but in the rules of corporate governance. "State corporate law," Lubben wrote, "imposes a duty on the board to carefully consider any decision that will foreclose a future board's choices. In times of financial distress, this duty includes an obligation to carefully consider the effects of a particular decision on future restructuring options."[301]

More broadly, as the history explored in this Article suggests, placing the burden on corporate managers, when they

298. Peterson, *supra* note 4.

299. *Id.*

300. Stephen J. Lubben, *The Board's Duty to Keep Its Options Open*, 2015 UNIV. ILL. L. REV. 817, 819 (2015).

301. *Id.*

can still save their corporation, to consider the needs of shareholders and creditors alike, is the only means of ensuring that the promise of Chapter 11 is fulfilled—that is, that the interests of all creditors, including the less sophisticated and more vulnerable creditors, are protected.