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The Chapter 11 Efficiency Fallacy

Diane Lourdes Dick

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The Chapter 11 Efficiency Fallacy

*Diane Lourdes Dick**

ABSTRACT

This Article challenges the persistent claim that Chapter 11's increasing utilization of market mechanisms will help facilitate economically efficient resolutions of corporate financial distress. Using two recent case studies, I show that, in fact, these mechanisms are used by stakeholders with existing market power to take control of the restructuring process and extract rents at the expense of other constituents: creditors, equity holders, and—in the case of companies that receive governmental bailouts—taxpayers. These distortionary effects are obscured by a dominant, neoclassical legal paradigm that ignores institutional and political dynamics. I advance a new explanatory model that draws upon modern social science to capture these otherwise-unexplored forces. This new model offers a template for law reform efforts aimed at improving market equality and allocating resources in commercial restructurings more rationally, contributing to an overall increase in social welfare.

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* Diane Lourdes Dick, Assistant Professor of Law, Seattle University School of Law. This Article was one of twelve papers selected from a competitive call for submissions to the third annual Junior Faculty Business and Financial Law Workshop, hosted by the Center for Law, Economics & Finance (C-Leaf) at George Washington University Law School. For helpful comments on earlier drafts, I owe a debt of gratitude to Barry Adler, Kelli Alces, Christine Allie, Dan Awrey, Kent H. Barnett, Barbara Black, Richard Booth, Kara Bruce, Matthew Bruckner, Charlotte Garden, Michelle Harner, Kevin V. Haynes, Joan MacLeod Heminway, Daniel Keating, Tayyab Mahmud, Charles R. O'Kelley, Jr., David A. Skeel, Jr., Faith Stevelman, George Van Cleve, and Danaya Wright, as well as participants of the 2012 Annual Meeting of the Canadian Law & Economics Association, the 2012 National Business Law Scholars Conference, and the Seattle University School of Law Workshop Series.

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I. INTRODUCTION

In the wake of the Great Recession, many U.S. companies defaulted on their loans, necessitating the restructuring of substantial corporate debt via Chapter 11 bankruptcy.¹ Frustrated by the outcomes of some recent high-profile cases,² many observers think that the prevailing legal process for restructuring bankrupt companies is broken and that Chapter 11 ought to be overhauled.³ To this end, the American Bankruptcy Institute recently convened the Commission to Study the Reform of Chapter 11, laying the groundwork for a comprehensive rewriting of Chapter 11.⁴

Almost all critics of the extant legal construct cite the need for a more efficient and equitable commercial bankruptcy process.⁵ But they disagree as to *how* the existing framework ought to be changed.

1. 11 U.S.C. §§ 1101–1174 (2012) (providing for reorganizations of bankrupt persons). Corporate bankruptcies nearly doubled in the wake of the financial crisis. In 2010, more than 90,000 U.S. companies filed for bankruptcy, compared to 46,199 companies in 2007. Eric Morath, *Business Bankruptcies Fell 18% in May But Trend Might Not Hold*, WALL ST. J. (June 10, 2011), <http://online.wsj.com/news/articles/SB10001424052702304259304576377881790360422>.

2. See, e.g., Todd Zywicki, *Bankruptcy Judge Robert Drain on GM, Delphi, and Hostess*, VOLOKH CONSPIRACY (Nov. 29, 2012, 1:43 PM), <http://www.volokh.com/2012/11/29/bankruptcy-judge-robert-drain-on-gm-delphi-and-hostess/>.

3. Katy Stech, *Bankruptcy Leaders Call for Chapter 11 Overhaul*, WALL ST. J. (Apr. 19, 2012), <http://blogs.wsj.com/bankruptcy/2012/04/19/bankruptcy-leaders-call-for-chapter-11-overhaul/>.

4. *Id.*

5. See *id.*; see also Robert Keach & Albert Togut, *Catching Up on Chapter 11 Reform*, ABL ADVISOR (Jan. 15, 2013, 7:00 AM), <http://www.abladvisor.com/articles/1652/catching-up-on-chapter-11-reform-abi-commission-enters-second-year>.

Many industry leaders celebrate Chapter 11's increasing engagement of market mechanisms, and argue that modern reform efforts should focus on further reducing judicial and statutory interference with the market's own verdict.⁶ To be sure, this is not a novel view as there is a rich academic tradition of recommending market-based reforms to Chapter 11.⁷ Proposals of this sort are largely in reaction to the drafters' early optimistic view that party consensus—as opposed to judicial edict—would yield efficient restructuring outcomes in Chapter 11 cases.⁸ Over time, observers leveled the damning critique that, in practice, certain self-interested stakeholders controlled negotiations and crowded out dissent.⁹ To avoid these problems, critics urged greater integration of market mechanisms—such as the sale of the debtor's assets prior to confirmation of a plan—to apportion rights in Chapter 11.¹⁰

But not all observers believe that the market can check the natural tendencies of powerful parties to take control of the restructuring process. Some critics call for closer judicial monitoring of Chapter 11 negotiations, as well as statutory limitations on the use of market-based processes to allocate rights and obligations in

6. Allison Bisbey, *Leveraged Lenders Gear Up for Chapter 11 Reform Fight*, AM. BANKER (Nov. 16, 2012), http://www.americanbanker.com/issues/177_222/leveraged-lenders-gear-up-for-chapter-11-reform-fight-1054439-1.html.

7. See Lucian Ayre Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1998) (proposing a bankruptcy process by which equity security holders and unsecured creditors receive options to purchase shares in the reorganized debtor); David Skeel & Robert Rasmussen, *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 85–115 (1995) (exploring market-based processes in corporate bankruptcy restructurings); Philippe Aghion, Oliver Hart & John Moore, *The Economics of Bankruptcy Reform*, 8 J. L. ECON. & ORG. 523 (1992) (proposing a two-stage, market-based process for identifying residual claims in commercial bankruptcy and choosing a reorganization plan); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 145 (1986) (proposing the sale of the corporate debtor as a going concern as an alternative to Chapter 11 bankruptcy). Arguments in favor of market-based reforms have also been made in other areas of corporate law. JONATHAN R. MACEY, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN* (2008) (arguing that market-driven protections, rather than regulatory oversight, provide a more reliable form of corporate governance).

8. This history is explored in Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. L.J. 431 (1995).

9. Barry E. Adler, *Game-Theoretic Bankruptcy Valuation*, 41 J. LEGAL STUD. 209, 210 (2012) (summarizing early criticisms of Chapter 11).

10. See generally Douglas Baird, *The Hidden Virtues of Chapter 11: An Overview of the Law and Economics of Financially Distressed Firms* (Inst. for Law and Econ., Univ. of Chi. Law Sch., Working Paper No. 43, 1997), available at www.law.uchicago.edu/files/files/43.Baird_Chapter11.pdf.

commercial restructurings.¹¹ Concerns of this sort reflect a long-standing belief that the bankruptcy process also serves a protective function, ensuring that absolute priority is respected.¹² At the same time, they echo an emergent view that restructurings of large companies are highly political and distributional processes that have the potential to generate wide-spanning social welfare burdens.¹³ Indeed, as we've known for some time, financially troubled commercial debtors are often forced to make extreme concessions to avoid liquidation,¹⁴ while their equity holders and creditors typically sustain sizable losses. Recent large-scale bankruptcies also demonstrate that other more diffuse burdens arise by way of job losses,¹⁵ fire-sale externalities,¹⁶ and, in some extreme cases, governmental bail-outs.¹⁷ Thus, to the extent market mechanisms fail to achieve a fair and efficient allocation, there can be substantial ripple effects.

At the center of the modern reform debate are two fundamental questions: How is Chapter 11 bankruptcy used by stakeholders of distressed firms to advance their economic interests, and do market mechanisms foster more efficient and equitable restructurings? Implicitly, these questions require us to revisit the early criticisms

11. See, e.g., Charles Jordan Tabb, *Credit Bidding, Security and the Obsolescence of Chapter 11*, 2013 U. ILL. L. REV. 103 (2013) (arguing in favor of a limited right for secured creditors to engage in credit bidding); Kara J. Bruce, *Rehabilitating Bankruptcy Reform*, 13 NEV. L.J. 174 (2012) (arguing that recent amendments to the Bankruptcy Code reduce judicial discretion and empower certain creditors to force the debtor to liquidate).

12. See, e.g., Ralph Brubaker & Charles Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and GM*, 60 U. ILL. L. REV. 1375, 1379, 1391 (2010) (referring to Chapter 11 as a system based upon "distributional norms," and considering how political forces in recent automotive bankruptcies threatened these norms).

13. This viewpoint is only recently emerging. Professor Adam Levitin explains: "Bankruptcy is ultimately a distributional exercise . . . and [that] makes it inherently political. The shape of bankruptcy law is an expression of distributional norms . . . and interest group politics, rather than an exercise in economic efficiency." Adam Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399, 1405 (2012).

14. See Adler, *supra* note 9, at 210–11.

15. Matthew Leising & Shannon D. Harrington, *MF Global Workers Learn of Firing From Media*, BLOOMBERG (Nov. 11, 2011, 10:01 PM), <http://www.bloomberg.com/news/2011-11-11/some-mf-global-workers-said-to-learn-of-firing-from-news-reports.html> (reporting job losses following MF Global's bankruptcy).

16. Fire sale externalities occur when market disruptions force owners to sell assets to low valuation users. Andrei Shleifer & Robert W. Vishny, *Fire Sales in Finance and Macroeconomics*, 47 J. FIN. 1343 (2011).

17. See Jonathan G. Katz, *Who Benefited from the Bailout?*, 95 MINN. L. REV. 1568 (2011) (exploring financial institution bailouts).

leveled against Chapter 11 and better understand how the legal construct might allow powerful stakeholders to trample the rights of others; only then can we appreciate the role of market mechanisms in this same system. The answers to these questions have the potential to generate legal reforms that completely reshape commercial bankruptcy law. And so it is that these hard times, and their attendant legal controversies, provide an opportunity to study forces that were overlooked in better days. As political economist Peter Gourevitch explains in his work on financial crises, “[h]ard times expose strengths and weaknesses to scrutiny, allowing observers to see relationships that are often blurred in prosperous periods, when good times slake the propensity to contest and challenge.”¹⁸

This Article uses a social science theoretical lens to tackle these questions and to expose the continued entrenchment of what I call the “Efficiency Fallacy”—a flawed assumption that negotiations naturally lead to efficient restructuring outcomes. I argue that the Efficiency Fallacy is a byproduct of Chapter 11’s reliance on an antiquated economic model.¹⁹ While modern corporate and bankruptcy law scholars have come to appreciate the complexity of the large, organizational actors who engage in restructurings,²⁰

18. PETER GOUREVITCH, *POLITICS IN HARD TIMES: COMPARATIVE RESPONSES TO INTERNATIONAL ECONOMIC CRISES* 9 (1986).

19. See *infra* Part II. The influence of neoclassical economic theory on American law is explored in RICHARD A. POSNER, *FRONTIERS OF LEGAL THEORY* 6 (2001) (crediting economic analysis of law to economist Ronald Coase); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (1986) (asserting that law is deeply influenced by efficiency goals).

20. See, e.g., Douglas Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1 (2013) (exploring debtor-side complexities, such as internal corporate governance and other structural factors, on debt restructurings); Sarah Pei Woo, *Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales*, 99 GEO. L.J. 1615 (2011) (exploring creditor-side complexities in bankruptcy cases, including the regulatory pressures that drive bank creditors to favor liquidation rather than reorganization); Douglas G. Baird & Robert K. Rasmussen, *Anti-Bankruptcy*, 119 YALE L.J. 648 (2010) (exploring creditor-side complexities in bankruptcy cases, including the fracturing of creditors as a result of rampant claims trading); Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors’ Objectives*, 16 AM. BANKR. INST. L. REV. 69 (2008) (exploring creditor-side complexities in Chapter 11 reorganizations, including the increasing control asserted by distressed debt investors); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004) (exploring creditor-side complexities in bankruptcy cases, including the unique interests of secured lenders); Ramesh K.S. Rao et al., *Fiduciary Duty à la Lyonnais: An Economic Perspective on Corporate Governance in a Financially Distressed Firm*, 22 J. CORP. L. 53 (1996) (analyzing the influence of fiduciary duty laws on a firm’s ordering of economic interests).

Chapter 11 continues to portray these parties as unitary and rational actors, motivated by clear and deliberate goals. While all models are necessarily reductive, this assumption persists even where the debtor is steered by deeply divided or self-interested stakeholders, and even where there are conflicting factions of creditors jockeying for control.²¹

Meanwhile, social scientists have moved considerably beyond the early neoclassical economic model of decision-making,²² thanks to a growing body of literature in the fields of political economy,²³ behavioral decision theory,²⁴ organizational theory,²⁵ and public choice economics.²⁶ Following decades of scholarship challenging the rational, unitary actor construct,²⁷ modern social scientists

21. See, e.g., Kelsey Butler, *Dynegy Deal Involving More Than \$2.5B in Claims Ok'd*, DEAL PIPELINE (June 6, 2012, 11:53 AM) (describing a settlement between an organizational debtor and its unsecured creditors, each of which is portrayed as a unitary actor); Mia Lamar & Jacqueline Palank, *Friendly's Files for Chapter 11 Bankruptcy*, WALL ST. J., Oct. 6, 2011 (describing a corporate debt restructuring solely with reference to the borrower and its dominant creditors, each of which is portrayed as a unitary actor).

22. See *infra* Part III.

23. For a description of political economy as an analytical approach, see *infra* Part III.A.

24. Behavioral decision theory focuses on individual decision-making in the face of uncertainty. Classics include: B.F. SKINNER, *ABOUT BEHAVIORALISM* (1974) (advancing a scientific method of studying human behavior); Herbert A. Simon, *Rationality as Process and as Product of Thought*, 68 AM. ECON. REV. 1 (1978) (advancing a theory of "bounded rationality"). More recent works include MAX H. BAZERMAN, *JUDGMENT IN MANAGERIAL DECISION MAKING* (2009) (examining cognitive biases in managerial decision-making).

25. Organizational theory examines how individual decisions translate into organizational behavior. Since the late 1960s, organizational theory has been dominated by the systems approach, which "views an organization as a complex set of dynamically intertwined and interconnected elements . . . and the environment in which it operates and with which it continuously interacts." JAY M. SHAFRITZ & J. STEVEN OTT, *CLASSICS OF ORGANIZATION THEORY* 263 (1992). As a result, the field has moved beyond the traditional, one-dimensional model of organizations. *Id.* at 264. Major works that contributed to these advancements include: ROBERT KATZ & DANIEL KAHN, *THE SOCIAL PSYCHOLOGY OF ORGANIZATIONS* (1966) (exploring organizational structure, the individual, and the environment); PAUL R. LAWRENCE & JAY W. LORSCH, *ORGANIZATION AND ENVIRONMENT* (1967) (analyzing organizational structure and exogenous market influences); JAMES D. THOMPSON, *ORGANIZATIONS IN ACTION* (1967) (analyzing the interactions of environmental uncertainties and organizational structure); Fremont E. Kast & James E. Rosenzweig, *General Systems Theory: Applications for Organization and Management*, 15 ACAD. MGMT. J. 447 (1972) (exploring applications of systems theory in organizational management).

26. On public choice theory as a tool for analyzing law, see MAXWELL STEARNS & TODD ZYWICKI, *PUBLIC CHOICE CONCEPTS AND APPLICATIONS IN LAW* (2009); see also DENNIS C. MUELLER, *PUBLIC CHOICE III* (2003) (providing an overview of the field).

27. See, e.g., GRAHAM T. ALLISON, *ESSENCE OF DECISION: EXPLAINING THE CUBAN MISSILE CRISIS 10-14* (1971) (analyzing the decisions of nations through organizational theory, asserting

recognize that institutional dynamics are a key driver of decisional outcomes.²⁸ Drawing upon such literature, this Article advances a new explanatory model of commercial restructurings that highlights institutional and political dynamics. I apply this model to two recent case studies involving distressed commercial debtors in Chapter 11. The case studies demonstrate how institutional and political dynamics introduce market imperfections, such as self-dealing, conflicts of interest, opportunism, information asymmetries, and collective action obstacles that bolster the bargaining power of some stakeholders while limiting the influence of others.

A number of powerful insights emerge. Most provocatively, I argue that, notwithstanding the modern tendency to rely on market-based processes to apportion rights, Chapter 11 remains ill-equipped to facilitate efficient or equitable resolutions of corporate financial distress. Absent deeper structural reform, the overlay of Chapter 11 with market mechanisms continues to enable those with existing market power in the securities and capital markets to control the restructuring process and extract rents at the expense of other constituents. By enhancing market inequalities and enabling the exercise of market power, Chapter 11 causes a misallocation of resources and contributes to an overall reduction in social welfare. Most notably, the distressed firm's scarce resources are redistributed as excess returns to parties in a position to exploit these weaknesses in the legal construct. Modern reformers must be sensitive to these consequences and integrate suitable checks and balances on market-based mechanisms. Otherwise, Chapter 11 will continue to suffer the problems that early critics identified.²⁹

This Article is organized as follows. Part II considers the influence of early neoclassical economic analysis of law in shaping Chapter 11. In an effort to develop a new explanatory model rooted in a more robust theoretical framework, Part III draws upon

that the rational actor construct is overly simplistic); RICHARD M. CYERT & JAMES G. MARCH, *A BEHAVIORAL THEORY OF THE FIRM* (1963) (studying firms through a behaviorist lens, arguing that the firm is a coalition of individuals rather than a unified actor with consistent goals).

28. Recent works include ANDREW MACINTYRE, *THE POWER OF INSTITUTIONS: POLITICAL ARCHITECTURE AND GOVERNANCE* (2003) (analyzing the effect of institutions on governmental responses to crises).

29. These criticisms echo early complaints raised with respect to Chapter 11's predecessor law. *See* SECURITIES AND EXCHANGE COMMISSION, *REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES* (1937).

literature from the fields of political economy, behavioral decision theory, organizational theory, and public choice economics. Part IV utilizes two recent case studies to demonstrate the ways in which modern restructurings depart from relatively thinner conceptions of neoclassical economics. Part IV also leverages an emerging understanding of distressed debt negotiations to ask whether—and how—Chapter 11 should be reformed. Part V concludes.

II. EXPOSING THE EFFICIENCY FALLACY

The modern approach to commercial bankruptcy reorganization in the U.S. is built upon a theoretical assumption (what I call the “Efficiency Fallacy”) that compromise and negotiation in Chapter 11 naturally lead to efficient restructuring outcomes. From its inception as the modern statutory framework for commercial bankruptcy reorganizations, Chapter 11 has largely relied upon party consensus rather than judicial edict. Parties are encouraged to settle related claims as soon as possible³⁰ and agree to a Chapter 11 plan; meanwhile, judges are given relatively little discretion over restructuring outcomes.³¹

The Efficiency Fallacy gained momentum in the course of Chapter 11’s initial adoption in 1978.³² At that time, neoclassical

30. As the influential U.S. Bankruptcy Court for the District of Delaware recently noted, there is a “strong public policy in bankruptcy cases to encourage settlement.” *In re Washington Mut.*, No. 08–12229, 2012 WL 1563880, at *19 (Bankr. D. Del. Feb. 24, 2012). This interest is reflected in FED. R. BANKR. P. 9019 (granting the authority to approve settlements or refer parties to binding arbitration). Additionally, courts, including the U.S. Bankruptcy Court for the District of Delaware, have created specialized mediation procedures or court-annexed mediation programs, through which parties are ordered to attempt resolution of disputes pertaining to a bankruptcy case. *See* Alternative Dispute Resolution Act of 1998, 28 U.S.C. §§ 651–58 (1998); General Order of the U.S. Bankruptcy Court for the District of Delaware dated April 7, 2004 (Walrath, C.J.) (mandating that parties attempt mediation of claims to avoid preferential transfers); General Order of the U.S. District Court for the District of Delaware dated July 23, 2004 (Robinson, C.J.) (mandating that parties attempt mediation of bankruptcy appeals).

31. Ordinarily, a Chapter 11 plan must be confirmed by the Bankruptcy Court unless it fails to meet certain requirements. *See* 11 U.S.C. §1129(a) (2012). Moreover, recent amendments substantially reduced the role of judges in bankruptcy cases. *See* Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8, 119 Stat. 23 (2005); *see also* Bruce, *supra* note 11 (thoroughly analyzing the impact of the revisions on judicial discretion).

32. Prior to the adoption of Chapter 11 in 1978, business reorganizations were completed under chapters X, XI, and XII of the Bankruptcy Act of 1898, as amended by the Chandler Act in 1938. *See* Don J. Miner, *Business Reorganization Under the Bankruptcy Reform Act of 1978: An Analysis of Chapter 11*, 1979 BYU L. REV. 961, 965–68 (1979).

economic analysis of law was gaining ground,³³ with scholars increasingly using price theory and the rational actor model to assess the economic efficiency of legal constructs. For instance, Professor Mark Roe, in a 1983 article assessing commercial restructuring via Chapter 11, summarized the goal of bankruptcy thusly: “The judicial solution [via the bankruptcy process] . . . mimics the market, attempting to reach an idealized value of the bankrupt that the court believes would arise if a perfect market were at work.”³⁴ In response to a proliferation of scholarly works debating the efficiency of Chapter 11,³⁵ Frank Easterbrook concluded,³⁶ and the balance of the scholarly community seemed to agree,³⁷ that bankruptcy was an efficient rather than wealth transferring process. In Easterbrook’s view, this was true precisely because Chapter 11 relied on party consensus rather than judicial resolve.³⁸ The Supreme Court echoed Easterbrook’s conclusions: “Chapter 11 . . . relies on creditors and

33. Neoclassical economic theory can be traced to Adam Smith and David Ricardo, who analyzed markets from the perspective of individual actors. ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* (1776); DAVID RICARDO, *THE PRINCIPLES OF POLITICAL ECONOMY AND TAXATION* (1817). Subsequent theorists offered a number of refinements, and neoclassical economics flourished. See, e.g., CARL Menger, *PRINCIPLES OF ECONOMICS* (1871) (advancing a subjectivist and marginalist view of economic decision-making). Most recently, neoclassical thought was given renewed vigor by economist Milton Friedman and others in the “Chicago School.” See MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* (1962).

34. Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 530 (1983).

35. David T. Brown, *Shareholder Incentive Conflicts in Reorganization: The Role of Bankruptcy Law*, 2 REV. FIN. STUD. 109 (1989) (asserting that bankruptcy reduces holdout problems by forcing compromise); Douglas G. Baird, *A World Without Bankruptcy*, 50 L. & CONTEMP. PROBS. 173, 183 (1987) (contemplating a world without bankruptcy law, finding that “the dynamics of private bargaining that would exist in a world without bankruptcy would make everyone worse off” due to inefficiencies inherent in the negotiation process); THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 8–11 (1986) (arguing that bankruptcy provides mechanisms for overcoming inefficiencies inherent in the process by which creditors would otherwise assert their rights against the debtor).

36. Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 413–14 (1990).

37. Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L.J. 573 (1998) (describing the dominant camps among bankruptcy theorists, both of which are ultimately rooted in efficiency arguments); Vojislav Maksimovic & Gordon Phillips, *Asset Efficiency and Reallocation Decisions of Bankrupt Firms*, 53 J. FIN. 1495 (1998) (testing the efficiency of bankruptcy process in allocating productive resources); Michelle J. White, *Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganizations and Out-of-Court Debt Restructurings*, 10 J.L. ECON. & ORG. 268 (1994) (acknowledging that the primary normative goal of corporate bankruptcy is to liquidate inefficient firms via Chapter 7 and reorganize efficient firms via Chapter 11).

38. Easterbrook, *supra* note 36, at 414–15.

equity holders to engage in negotiations toward resolution of their interests,” because “creditors and equity security holders are very often better judges of the debtor’s economic viability and their own economic self-interest than courts.”³⁹

Decades later, Chapter 11 continues to reflect neoclassical economic analysis of law, including more modern articulations of price theory and the efficient market hypothesis.⁴⁰ The model asserts that persons engage in negotiations as rational actors who make decisions intended to advance self-interest.⁴¹ Thus, parties to Chapter 11 cases are believed to seek a positive (or the least negative)⁴² return on their investments.⁴³ To the extent parties bargain to advance their self-interest in a competitive exchange, the outcome will reflect an ideal, equilibrium price pursuant to which the debtor’s assets will be distributed to the highest-value users. In other words, when firms successfully reorganize in Chapter 11, the debtor must have enjoyed greater value as a going concern.⁴⁴ In contrast, firms that fail to reach a plan of reorganization and are

39. *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 457 n.28 (1999).

40. MARGARET M. BLAIR, *OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY* 94–115 (1995) (describing these modern theories).

41. *See, e.g.*, EDWIN MANSFIELD, *MICROECONOMICS: THEORY AND APPLICATIONS* 55 (1988) (explaining that market participants strive to maximize utility).

42. Courts assume rational actors seek to “cut their losses.” *See Bankr. Serv., Inc. v. Ernst & Young*, 529 F.3d 432, 453 (2d Cir. 2008) (“Even the ‘benefit’ provided by ‘further indebtedness’—capital—‘may provide an illusory financial cushion that lulls shareholders into postponing the decision to dissolve the corporation’ and thus ‘miss an opportunity to cut their losses.’” (quoting *Allard v. Arthur Andersen & Co.*, 924 F. Supp. 488, 494 (S.D.N.Y. 1996))).

43. Patrick D. Fleming, *Credit Derivatives Can Create a Financial Incentive for Creditors to Destroy a Chapter 11 Debtor: Section 1126(E) and Section 105(A) Provide a Solution*, 17 *AM. BANKR. INST. L. REV.* 189, 189 (2009) (“[C]reditors have a desire to maximize the distribution they receive on account of their claims.”); Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 *AM. BANKR. L.J.* 405, 422 (2007) (“In all cases we assume that creditors are motivated to take all available steps to maximize their recoveries in bankruptcy, at least when those steps have a positive net value.”); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Finance*, 154 *U. PA. L. REV.* 1209, 1245–46 (2006) (“Private lenders . . . act to maximize their rate of return.”).

44. David Smith & Per Stromberg, *Maximizing the Value of Distressed Assets: Bankruptcy Law and the Efficiency Reorganization of Firms*, *SYSTEMIC FIN. CRISES* 232–75 (2005); *see also* *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203 (1983) (“[A] troubled enterprise may be restructured to enable it to operate successfully in the future Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if ‘sold for scrap.’”).

instead forced to liquidate must have suffered the harsh determination of a competitive market that the debtor's assets are worth more in an alternative use.⁴⁵

However, while its underlying economic theory has remained relatively consistent, commercial bankruptcy process has evolved considerably in the last thirty-five years. Largely in response to criticisms that Chapter 11 allows self-interested stakeholders to crowd out dissent and trample creditors' state law rights, commercial bankruptcies increasingly utilize market mechanisms. For instance, modern Chapter 11 cases are more likely to include sales of all or substantially all of a debtor's assets prior to confirmation of a Chapter 11 plan,⁴⁶ as well as credit-bidding by secured creditors.⁴⁷ Meanwhile, a vigorous bankruptcy claims trading market has evolved, allowing stakeholders to buy and sell claims against the debtor.⁴⁸ Working together, these mechanisms are believed to maximize the value of the bankruptcy estate for the benefit of its highest-valuing stakeholders, while providing efficient exit for those who prefer to liquidate their investment.⁴⁹ More broadly, they are believed to complement Chapter 11 by providing value-enhancing alternatives to negotiated party consensus, thereby boosting the odds that the most efficient outcome will prevail. The allure of this logic, and the confidence that the market neatly vindicates restructuring outcomes, is captured in a Seventh Circuit opinion: "The judgment of the market vindicates Bank. If more credit would have enabled Debtor to flourish, then other lenders should

45. See, e.g., *In re Comcoach Corp.*, 698 F.2d 571, 573 (2d Cir. 1983) (explaining that one purpose of bankruptcy is to "convert the bankrupt's estate into cash and distribute it among creditors."); see also Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1050-51 (1992) (exploring how courts determine whether a corporate debtor should be liquidated or permitted to reorganize).

46. Such sales are permitted under 11 U.S.C. § 363(b); see also Matthew Bruckner, *Improving Bankruptcy Sales by Raising the Bar: Imposing a Preliminary Injunction Standard on Objections to Section 363 Sales*, 62 CATH. U. L. REV. 1 (2012) (arguing in favor of a more streamlined process for 363 sales to achieve more efficient, market-based outcomes in Chapter 11 cases).

47. Credit-bidding is expressly permitted under 11 U.S.C. § 363(k). The Supreme Court recently reaffirmed the right of secured creditors to credit bid in *RadLAX Gateway Hotel v. Amalgamated Bank*, 132 S. Ct. 2065 (2012). The practice is considered in more detail in Tabb, *supra* note 11.

48. The claims trading market is given recent attention in Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67 (2009).

49. See *supra* notes 46 through 48 and sources cited therein.

have been willing to supply it.”⁵⁰ However, as the following section explores, this logic begins to break down once we consider how Chapter 11’s inherent economic distortions impair the ability of market-based processes to fairly and efficiently apportion rights among constituents in complex commercial bankruptcies.

A. The Fallacy’s Methodological and Theoretical Assumptions

As a legal construct that strives to facilitate consensus, Chapter 11 essentially provides the backdrop against which parties negotiate. But economic theory counsels that negotiations cannot be relied upon to yield efficient outcomes unless they take place in a competitive environment. What is more, the assessment of any particular outcome as efficient is a matter of perspective. Thus, where negotiations take place within Chapter 11, the law can impair competition and introduce a distortionary effect to the extent it privileges or constrains participation in negotiations.

Of course, any legal construct grants structural privileges. As the Supreme Court explained, “Our adversary system is designed around the premise that the parties know what is best for them, and are responsible for advancing the facts and arguments entitling them to relief.”⁵¹ In this way, American law tends to “rely on the parties to frame the issues for decision.”⁵² As a result, only those who are designated by the legal construct as “parties” are afforded the privilege of framing legal disputes.

Who ought to be the “parties” to Chapter 11 cases? To be sure, in situations of financial distress, economic burdens are often disseminated to a range of direct and indirect constituents, such that—at least in theory—a narrative might focus on many potential parties. Clearly, the commercial debtor and its lenders are relevant parties. Once in bankruptcy, the parties might include a bankruptcy trustee, to the extent one is appointed,⁵³ or the debtor in possession.⁵⁴ Whether within or outside of bankruptcy, the debtor’s

50. *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1358 (7th Cir. 1990).

51. *Castro v. United States*, 540 U.S. 375, 386 (2003).

52. *Greenlaw v. United States*, 554 U.S. 237, 243 (2008).

53. Although a trustee is not commonly appointed in Chapter 11 cases, one may be appointed pursuant to 11 U.S.C. § 1104.

54. *See* 11 U.S.C. § 1101(1) (2012) (defining “debtor in possession” to mean the debtor except where a trustee has been appointed). The debtor in possession “generally has the

management and advisors, its affiliated entities and equity security holders,⁵⁵ and its creditors,⁵⁶ including involuntary creditors, may be parties, as well as any other persons with a vested interest in the restructuring outcome.⁵⁷ In each case, parties can be identified as separate legal entities, as in the case of a corporate debtor or institutional lender,⁵⁸ or on the basis of aggregation methods authorized by procedural rules, as in the case of consolidated debtors.⁵⁹ Other parties may be identified collectively pursuant to agency arrangements, such as groups of syndicate lenders contractually bound to collective action mechanisms set forth in their credit agreements.⁶⁰ Finally, parties may be identified collectively pursuant to transitory groupings imposed by law. For instance, in a Chapter 11 case, similarly situated claimants may be recognized collectively in official committees comprising persons holding the largest claims.⁶¹ Each of these parties may be further deconstructed by piercing tiers of entities and unraveling agency relationships to identify all persons with an economic interest in the restructuring.

authority to exercise the same powers as a trustee.” *Weingarten Nostat, Inc. v. Serv. Merch. Co.*, 396 F.3d 737, 742 n.4 (6th Cir. 2005) (citing 11 U.S.C. §§ 1107(a), 1108 (2000)).

55. The term “equity security holder” is defined in the Bankruptcy Code as “holder of an equity security of the debtor.” 11 U.S.C. § 101(17) (2012). An “equity security” means a “share in a corporation, whether or not transferable or denominated ‘stock,’ or similar security; interest of a limited partner in a limited partnership; or warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest of a kind specified.” 11 U.S.C. § 101(16).

56. “Creditor” means an “entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor.” 11 U.S.C. § 101(10).

57. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248–57 (1999) (describing a multiple constituency approach to corporate law).

58. The debtor may be a corporation formed under state law; similarly, a lender may be a national banking association formed under federal law. These and other entities are granted legal personhood. See, e.g., 1 U.S.C. § 1 (2012) (defining “person” to include “corporations, companies, associations, firms, partnerships . . . as well as individuals”).

59. Bankruptcy cases involving affiliated entities are typically consolidated for procedural purposes. FED. R. BANKR. P. 1015(b).

60. See, e.g., *In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009) (showing credit documents intended for collective action by an agent acting on behalf of lenders); *Beal Sav. Bank v. Sommer*, 8 N.Y.3d 318, 332 (N.Y. 2007) (explaining credit documents “intended for collective action”).

61. Committees are appointed to represent the interests of various stakeholders. 11 U.S.C. § 1102 (authorizing the appointment of creditors’ and equity security holders’ committees).

In practice, Chapter 11 confers party status in a more restrictive manner, thereby limiting participation—and, ultimately, competition—in the restructuring process. A “unitary actor”⁶² construct posits that the relevant parties to a restructuring are the principal debtor entity, an aggregated pool of the debtor’s equity security holders, and an aggregated pool of the most powerful creditors (generally, but not always, secured creditors).⁶³ In most restructuring narratives, two of these aggregated actors emerge as the key parties.⁶⁴ The debtor,⁶⁵ on the one hand, is generally constructed as a single, unified, rational actor that takes calculated action in response to corporate distress.⁶⁶ The most influential creditors, on the other hand, are taken collectively as a single, unified group⁶⁷ that also engages in purposive conduct. Within this binary framework, each of these aggregated actors is believed to approach negotiations as it would any other pursuit of deliberate, consistent, and goal-oriented conduct in accordance with its own “single standard of rationality.”⁶⁸ To this end, the legal process

62. The term is referenced in ALLISON, *supra* note 27, at 73 n.111. See also JAMES SAMUEL COLEMAN, FOUNDATIONS OF SOCIAL THEORY 504 (1994) (exploring the “unitary actor”).

63. The acclaimed bankruptcy attorney Harvey Miller likens such parties to “stars” in a bankruptcy case “play.” Miller, *supra* note 8. More recently, Professor Michelle Harner identified these parties to corporate bankruptcies in Michelle M. Harner, *The Search for an Unbiased Fiduciary in Corporate Reorganizations*, 86 NOTRE DAME L. REV. 469, 471 (2011). This conception is also apparent in language used by courts. See, e.g., *Winters v. George Mason Bank*, 94 F.3d 130, 133 (4th Cir. 1996) (“[T]he stay is for the protection of the debtor and its creditors.”).

64. Professor Adam Levitin notes the limited range of constituents who are represented in a typical bankruptcy, acknowledging that the process tends to focus upon the debtor and its creditors. Levitin, *supra* note 13, at 1402.

65. The corporation’s status as an entity, association, and person under the law has been explored in great detail. See Susanna K. Ripken, *Corporations Are People Too: A Multi-Dimensional Approach to the Corporate Personhood Puzzle*, 15 FORDHAM J. CORP. & FIN. L. 97 (2009) (exploring legal theories of corporate personhood).

66. See generally *supra* note 21, and sources cited therein.

67. “In Chapter 11, bankruptcy provides a forum for creditors to make a collective decision about the viability of a firm.” Levitin, *supra* note 13, at 1445. Creditors are frequently assumed to be homogeneous notwithstanding that “creditors” can include traditional lenders, trade creditors and other institutions with divergent investment strategies. See MICHAEL A. JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS 165 (2000).

68. ALEXANDER L. GEORGE & RICHARD SMOKE, DETERRENCE IN AMERICAN FOREIGN POLICY 551 (1974) (identifying conceptual distortions in traditional commitment theory, which are “reinforced by the additional assumptions that each side in the deterrence equation is a unitary, purposive actor and that action choices and payoffs of the actors may be analyzed and calculated by means of a single standard of rationality”). Although the unitary actor model has been developed and critiqued most extensively in the field of international relations, scholars have

focuses strictly upon the interplay of certain unitary actors, who are assumed to “perform large actions for large reasons.”⁶⁹

For instance, similarly situated unsecured creditors are recognized collectively in official committees comprising persons holding the largest claims.⁷⁰ Additional committees may be appointed to represent creditors or equity security holders.⁷¹ What is more, Chapter 11 directs courts to analyze pivotal questions from the perspective of unitary actors. In approving settlements, bankruptcy courts determine whether the arrangement is in the best interests of the debtor, the debtor’s bankruptcy estate, and aggregated groups of similarly-situated creditors and equity security holders.⁷² In confirming a Chapter 11 plan,⁷³ courts examine acceptance of the plan and impairment of claims on a class-by-class basis,⁷⁴ with these classes designated by the debtor based on the legal similarity of claims.⁷⁵ Numerous other provisions of Chapter 11 require that a court consider “the best interests of the creditors and the [Debtor’s] estate,” and the analysis is similarly restricted to these large organizational actors.⁷⁶ The unitary actor construct persists even where the debtor is steered by self-interested managers, and even where there are conflicting factions of creditors or equity security holders jockeying for control.⁷⁷ As Professor Barry

acknowledged the model’s persistent application to corporate decision-making as well. *See, e.g.,* BORIS HOLZER, *MORALIZING THE CORPORATION: TRANSNATIONAL ACTIVISM AND CORPORATE ACCOUNTABILITY* 111 (2010).

69. ALLISON, *supra* note 27, at 5.

70. 11 U.S.C. § 1102 (2012).

71. *See id.*

72. *See, e.g., In re Refco*, 505 F.3d 109, 114 (2d Cir. 2007) (“[T]he bankruptcy court approved the Settlement as being in the best interests of the debtors, their estates and creditors.”).

73. The debtor exits Chapter 11 bankruptcy upon confirmation of a Chapter 11 plan. 11 U.S.C. § 1121.

74. 11 U.S.C. § 1129.

75. *See* 11 U.S.C. § 1122 (authorizing the debtor to classify claims for plan confirmation purposes).

76. *See, e.g.,* 11 U.S.C. § 1112(b) (setting forth the standard of review for motions to convert a case from Chapter 11 to Chapter 7).

77. JENSEN, *supra* note 67 (stating that “[i]ntra-debtholder conflicts over wealth transfers are highly visible in bankruptcy proceedings,” yet scholars tend to “discuss[] the bondholder-stockholder conflict as if there were only two homogenous classes of capital claims on the corporation”); *see also* Antje Brunner & Jan Pieter Krahn, *Corporate Debt Restructuring: Evidence on Lender Coordination in Financial Distress* (C.F.S., Working Paper No. 2001/04, 2001) (examining the difficulty of obtaining consensus among lenders).

Adler explains, the law promotes a unitary actor framework through its reliance on majority rule; for instance, “the right to veto a plan on the basis of unfair discrimination is a class-based right—not available to individual dissenters within an accepting class of claims.”⁷⁸

Courts largely decline to broaden the scope of the analysis. As the Second Circuit explained, “[The bankruptcy court’s] (only) obligations in evaluating the Settlement [are] to the Debtors’ estate, creditors and shareholders.”⁷⁹ Judicial support of the unitary actor construct is best illustrated by the evolving interpretation of laws that govern participation in the restructuring process. In a Chapter 11 case, any “party in interest” may appear and be heard on any issue.⁸⁰ “Party in interest” is defined to include “the debtor, the trustee, a creditors’ committee, an equity security’s committee, a creditor, an equity security holder [of the debtor], or any indenture trustee.”⁸¹ A party in interest may file a Chapter 11 plan where a trustee has been appointed⁸² or where the debtor’s exclusivity period has terminated.⁸³ Similarly, a party in interest may challenge the good faith of persons voting to approve a plan,⁸⁴ object to confirmation of a plan,⁸⁵ or request that a court revoke confirmation of a plan.⁸⁶

As originally drafted, “party in interest” was not intended to be an exclusionary or underinclusive definition.⁸⁷ To the contrary, drafters and early commentators hoped that an expansive definition would allow a broad range of individual and minority interests to

78. Barry E. Adler, *A Reassessment of Bankruptcy Reorganization After Chrysler and General Motors*, 18 AM. BANKR. INST. L. REV. 305, 310 (2010).

79. *In re Refco*, 505 F.3d 109, 115 (2d Cir. 2007).

80. 11 U.S.C. § 1109(b).

81. *Id.* The term “equity security holder” means a “holder of an equity security of the debtor,” thereby excluding shareholders of, or investors in, entities that come within any of the other classifications. 11 U.S.C. § 101(17).

82. 11 U.S.C. § 1121(c)(1).

83. 11 U.S.C. § 1121(c)(2)–(3).

84. 11 U.S.C. § 1126(e).

85. 11 U.S.C. § 1128(b).

86. 11 U.S.C. § 1144.

87. “Section 102(3) states that the term ‘including’ is not limiting, and thus the use of the word ‘including’ in section 1109(b) does not limit ‘party in interest’ status to those parties referred to in the subsection.” 5 COLLIER ON BANKRUPTCY ¶ 1109.02 at 1109–22. *See also In re Cloud Nine, Ltd.*, 3 B.R. 199 (Bankr. N.M. 1980) (articulating a liberal right to be heard from an early Chapter 11 case).

intervene in Chapter 11 cases, and expressly warned that undue restrictions on who may be a party in interest might enable dominant interests to control the restructuring process.⁸⁸ Yet within a few short years, courts began to construe the definition in a restrictive fashion. For instance, a 1983 opinion by the Second Circuit explained, “Bankruptcy courts were established to provide a forum where creditors and debtors could settle their disputes and thereby effectuate the objectives of the statute. Necessarily, therefore, the Bank must be either a creditor or a debtor to invoke the court’s jurisdiction.”⁸⁹ Similarly, courts have narrowed the participatory role of parties in interest, suggesting that Chapter 11 grants such persons only a right to appear and be heard on issues pertaining to the restructuring, rather than a right to legal standing.⁹⁰ Even more, modern courts rarely grant meaningful participation rights to persons beyond the expressly identified statutory classifications of parties in interest.⁹¹ And, while these classifications may seem broad at first blush, in a complex restructuring these categories are likely to encompass a limited number of persons, such as agents representing an aggregate of entities. As a result, persons are denied direct participation in the bankruptcy process even though they will bear the economic consequences.

The Second Circuit defended this approach in a case declining to recognize standing on behalf of equity security holders of a creditor.

88. Drafters of a predecessor reorganization statute sought to ensure that minority interests have access to the restructuring process. *In re Johns-Manville Corp.*, 36 B.R. 743, 747 (Bankr. S.D.N.Y. 1984) (citing the commentary to 11 U.S.C. § 1109(b) (“[S]ection 1109(b) continues the broad concept of the absolute right to be heard in order to ensure fair representation of the case and prevent excessive control by insider groups. . . .”).

89. *In re Comcoach Corp.*, 698 F.2d 571, 573 (2d Cir. 1983).

90. *In re Sw. Equip. Rental*, 152 B.R. 207, 209 (Bankr. E.D. Tenn. 1992) (“Section 1109 says that any party in interest, including a creditor, may raise and may appear and be heard on any issue in a Chapter 11 case.” However, “[t]he statute does not necessarily mean that every party in interest can obtain relief on every issue. In other words, the right to raise an issue and to appear and be heard is not the same as standing.”).

91. *In re James Wilson Assoc.*, 965 F.2d 160, 169 (7th Cir. 1992) (denying, essentially, the inclusive statutory definition of “party in interest” by conducting a more limited interpretation of the definition for the purposes of federal standing: “[W]e do not think that Section 1109(b) was intended to waive other limitations on standing, such as that the claimant be within the class of intended beneficiaries of the statute that he is relying on for his claim.”); accord *In re Motors Liquidation Co.*, 430 B.R. 65 (S.D.N.Y. 2010); *S. Boulevard, Inc. v. Martin Paint Stores*, 207 B.R. 57, 61 (S.D.N.Y. 1997).

Framing a narrative of corporate financial distress in accordance with the unitary actor construct, the court explained: “Bankruptcy court is a forum where creditors and debtors can settle their disputes *with each other*. Any internal dispute between a creditor and that creditor’s investors belongs elsewhere.”⁹² Similarly, courts have repeatedly declined to give standing to creditors who seek to raise claims that implicate the debtor’s internal governance.⁹³ Even bankruptcy disclosure rules,⁹⁴ which were designed to foster transparency and fairness,⁹⁵ decline to peer into unitary actors. And, notwithstanding recent reform efforts,⁹⁶ disclosure obligations continue to be assigned to agents representing large pools of creditors rather than to each individual creditor.⁹⁷

Courts presiding over Chapter 11 cases also consistently decline to investigate how parties ascend to positions of dominance and assume control of unitary actors.⁹⁸ In this spirit, a fairly pronounced affirmation of the unitary actor construct was made by a United States bankruptcy court: “[A] bankruptcy court’s obligation is to determine whether a settlement is in the best interests of the *estate*, not to ensure that the *creditors’* representatives are honoring their fiduciary duties.”⁹⁹ As the Second Circuit intimated, such a model is rooted in broader judicial efficiency concerns:

[h]ad the bankruptcy court permitted [the creditor’s equity investors] to object to the Settlement and conduct discovery on the

92. *In re Refco, Inc.*, 505 F.3d 109, 110 (2d Cir. 2007).

93. *In re Sw. Equip. Rental*, 152 B.R. at 210 (“[A]s a general rule, a creditor does not have standing to object to a corporation’s voluntary bankruptcy case on the ground that the board of directors did not properly authorize it.”); *see also In re Ives*, 113 F. 911 (6th Cir. 1902) (declining to grant a creditor standing to challenge a partnership’s voluntary petition on the grounds that the general partner lacked mental competency).

94. *See, e.g.*, FED. R. BANKR. P. 2019.

95. *In re Nw. Airlines Corp.*, 363 B.R. 701, 702–04 (Bankr. S.D.N.Y. 2007) (articulating the policy rationale for Rule 2019).

96. *See* Tiffany Kary, *Federal Judge Says Rules Needed To Bar Bankruptcy Failure Bets*, BLOOMBERG, (Feb. 05, 2010, 1:42 PM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=anpx7s.ZUivc>; Proposed Amendments to Federal Rules of Bankruptcy Procedure 2003, 2019, 3001, 4004, and 6003 [hereinafter “Proposed Amendments”]; Proposed Adoption of New Federal Rules of Bankruptcy Procedure 1004.2 and 3002.1, Absent Contrary Congressional Action (Redline Version), 2011 U.S. Order 0018 (C.O. 0018) (Apr. 26, 2011).

97. FED. R. BANKR. P. 2019.

98. *See infra* notes 99 through 107 and accompanying text.

99. *In re Refco Inc.*, 505 F.3d 109, 119 (2d Cir. 2007). *See Nellis v. Shugrue*, 165 B.R. 115, 121 (S.D.N.Y. 1994).

numerous factual issues that . . . would prove that the Settlement “was the product of tortious misconduct, collusion, and fraud by a faithless fiduciary,” . . . the . . . goal of a “speedy and efficient reorganization,” would have been frustrated.¹⁰⁰

Acknowledging the very serious claims of unlawful conduct alleged by the creditor’s equity investors, the court concluded that such a “litany of wrongs . . . is fodder for a lengthy trial itself. It surely would have caused a substantial delay in the . . . bankruptcy proceeding.”¹⁰¹ Declining to grant the creditor’s equity investors standing in the bankruptcy case, the court explained, “[B]ankruptcy court is not the appropriate forum in which to resolve [such] disputes. It may be that the [creditor] violated . . . fiduciary duties by entering a settlement that was not in the best interests of [its equity investors]. That issue, however, is not for the bankruptcy court.”¹⁰²

Justifying a limited focus of this sort, courts generally assume that Chapter 11 participants act in good faith to translate profit-maximization goals into efficient restructuring outcomes.¹⁰³ And, although courts readily acknowledge the propensity for actors to engage in anticompetitive practices in the course of a restructuring,¹⁰⁴ they largely decline to focus upon or take steps to expose such conduct. Trusting a market clearinghouse function, courts typically assume that if an organizational actor were exercising authority in a manner that was detrimental to its constituent members, such members would strip the actor of its authority.¹⁰⁵ Thus, as the First Circuit explained, “If the unsecured

100. *In re Refco*, 505 F.3d at 119.

101. *Id.*

102. *Id.* at 118.

103. *See, e.g., In re C & C Jewelry Mfg., Inc.*, 373 F. App’x 775, 777 (9th Cir. 2010) (“A presumption of good faith accompanies the filing of an involuntary petition” by a creditor, and the debtor has the burden of proving bad faith); *In re Colonial Ford, Inc.*, 24 B.R. 1014, 1016 (Bankr. D. Utah 1982) (“Workouts contemplate . . . participation from all parties in interest, good faith, conciliation, and candor.”).

104. *See, e.g., In re Washington Mut., Inc.*, 419 B.R. 271, 279 (Bankr. D. Del. 2009) (“[C]ollective action by creditors through the use of ad hoc committees or groups allows creditors to utilize other group members’ holdings to obtain a greater degree of influence in a bankruptcy case than single creditors acting alone.”); *In re Gibson Group*, 66 F.3d 1436, 1441 (6th Cir. 1995) (“A debtor-in-possession often acts under the influence of conflicts of interest and may be tempted to use its discretion . . . to favor certain creditors over others . . .”).

105. *See infra* note 106 and accompanying text.

creditors' committee fails to be properly representative of the unsecured creditors, any party in interest can move to have the committee reconstituted."¹⁰⁶ In opinions of this sort, judicial efficiency is a primary justification for restricting focus to organizational actors. As the influential United States Bankruptcy Court for the Southern District of New York explained:

[I]t is important that a bankruptcy court is not too facile in granting applications for standing. Overly lenient standards may potentially over-burden the reorganization process by allowing numerous parties to interject themselves into the case on every issue, thereby thwarting the goal of a speedy and efficient reorganization. . . . Granting peripheral parties status as parties in interest thwarts the traditional purpose of bankruptcy laws which is to provide 'reasonably expeditious rehabilitation of financially distressed debtors with a consequent distribution to creditors.'¹⁰⁷

Notwithstanding these judicial efficiency arguments, the Second Circuit opined that it is not improper to buy a claim to obtain standing in a bankruptcy proceeding.¹⁰⁸ Evidencing the realities of a legal construct that so heavily privileges unitary actors, stakeholders frequently acquire bankruptcy claims not because they value them more highly, but because they can use them for the strategic purpose of "obtain[ing] a seat at the negotiating table."¹⁰⁹ As subsequent sections explore, these constraints on participation have a distortionary effect, thereby undercutting the fairness and efficiency of negotiated restructuring outcomes.

B. Legal and Historical Roots of the Fallacy

As the preceding section articulates, Chapter 11 adopts a largely binary framework whereby issues are framed and negotiated by certain large, unitary actors. This focus upon unitary actors is a product of early neoclassical economic analysis of law, which tended to adopt simplistic assumptions of even the most internally complex

106. *In re SPM Mfg. Corp.*, 984 F.2d 1305, 1317 (1st Cir. 1993) (citing 11 U.S.C. § 1102(a)(2) (2012); *In re Daig Corp.*, 17 B.R. 41, 42 (Bankr. D. Minn. 1981)).

107. *In re Ionosphere Clubs, Inc.*, 101 B.R. 844, 850–51 (Bankr. S.D.N.Y. 1989).

108. *In re DBSD N. Am., Inc.*, 634 F.3d 79 (2d Cir. 2011).

109. Michelle M. Harner & Jamie Marincic, *Behind Closed Doors: The Influence of Creditors in Business Reorganizations*, 34 SEATTLE U. L. REV. 1155, 1158–59 (2011).

organizations.¹¹⁰ In essence, the traditional, neoclassical model portrayed complex organizations, such as firms, as “simple-maximizing” entities, “operating with a set of given prices, technologies and markets.”¹¹¹ What is more, this traditional construction also largely ignored, and even obscured, the conflicts and inefficiencies that occur *within* organizational actors.¹¹²

Despite their persistence in bankruptcy law, many of these core assumptions have been dismantled in the social sciences.¹¹³ For one thing, advancements in organizational theory undercut the assertion that a complex organization can have a single, unified objective.¹¹⁴ Evidencing this changing tide, state-centric political scientist Robert Gilpin concedes, “strictly speaking, states . . . have no interests, or what economists call ‘utility functions,’ nor do bureaucracies, interest groups, or so-called transnational actors, for that matter.”¹¹⁵ Legal scholars have similarly acknowledged the limitations of the

110. Economist Harvey Leibenstein addressed the limitations of the rational actor construct:

According to the strict neoclassical viewpoint, there is no relation between the formal controller of the firm and the behavior of the firm. Thus, a one man firm . . . or a large corporation whose stock is widely distributed . . . are . . . presumed to operate the same way.

HARVEY LEIBENSTEIN, *GENERAL X-EFFICIENCY THEORY AND ECONOMIC DEVELOPMENT* 161 (1978); see also EDWIN MANSFIELD & GARY YOHE, *MICROECONOMICS: THEORY/APPLICATIONS* 290–91 (2004) (speaking of the firm as an “economic decision-making unit” rather than as a collection of individual economic decision-making units); HARVEY LEIBENSTEIN, *ECONOMIC THEORY AND ORGANIZATIONAL ANALYSIS* 28 (1960); JOSEPH W. MCGUIRE, *THEORIES OF BUSINESS BEHAVIOR* 19–20, 46–72 (1964) (neoclassical theory assumes that firms make decisions in the same manner as individuals).

111. J. D. Tomlinson, *Economic and Sociological Theories of the Enterprise and Industrial Democracy*, 35 *BRIT. J. SOC.* 591, 591–92 (1984).

112. Professor David Strauss discusses the unitary actor paradigm in presidential decision-making. He explains: “Often the decision of the President is treated as if it were the act of a unitary, purposive actor. In fact, presidential decisions are routinely the product of interest group and bureaucratic pressures within the executive branch. ‘Presidential’ decisions are not automatically more unitary than ‘congressional’ decisions.” David S. Strauss, *Presidential Interpretation of the Constitution*, 15 *CARDOZO L. REV.* 113, 113 n.1 (1993).

113. The seminal work challenging the unitary actor construct is ALLISON, *ESSENCE OF DECISION*, *supra* note 27; see also Simon Hug, *Nonunitary Actors in Spatial Models: How Far Is Far in Foreign Policy?*, 43 *J. OF CONFLICT RESOL.* 479 (1999) (discussing growing skepticism towards the unitary actor construct in international relations scholarship).

114. Where individuals share common interests, their “unorganized action [will] not be able to advance that common interest at all, or will not be able to advance that interest adequately.” MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 7 (1965).

115. ROBERT GILPIN, *WAR AND CHANGE IN WORLD POLITICS* 18 (1981).

unitary actor construct in work spanning a range of substantive areas.¹¹⁶

For example, corporate law scholars have contributed to an enriched understanding of the complexities of large commercial actors. Seminal works of Adolph Berle identify the agency conflicts that cause large corporations to pursue decisions that are not necessarily in the best interests of the enterprise or its stakeholders.¹¹⁷ Following in Berle's footsteps, a rich and interdisciplinary body of literature explores the effect of managerial ownership on corporate decision-making.¹¹⁸ Broadly speaking, these works suggest that in light of the behavioral tendencies of the humans who operate it, a firm,¹¹⁹ much like a governmental entity,¹²⁰ simply cannot be a unitary actor that acts deliberately to pursue its own economic goals. Recent scholarship in bankruptcy

116. See, e.g., Marcel Kahan & Edward B. Rock, *When the Government Is the Controlling Shareholder*, 89 TEX. L. REV. 1293, 1318 (2011) ("Private controlling shareholders . . . are . . . not unitary actors when they are corporations. But authority within corporations is hierarchical, so if one agent of the controlling shareholder corporation acts . . . her actions can fairly be attributed to the corporation under normal agency law principles."); Matthew C. Stephenson, *The Price of Public Action: Constitutional Doctrine and the Judicial Manipulation of Legislative Enactment Costs*, 118 YALE L.J. 2, 13 n.25 (2008) ("This Article . . . neither assumes a single legislative intent or will, nor relies on the assumption that all members of the legislature have the same information. Rather, this Article assumes that the legislature employs some set of institutional arrangements that generate stable equilibrium policy choices . . . and that the equilibrium policy choice is affected by information that members of the legislature receive and process concerning the impact of various policies on some normatively relevant set of outcomes.").

117. See generally ADOLPH BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) (when shareholders are too dispersed to ensure that managers render decisions that maximize the corporation's value, agency problems arise whereby managers tend to advance their own self-interests); Adolf A. Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932) (exploring these arguments further).

118. See, e.g., J. R. Davies, David Hillier & Patrick McColgan, *Ownership Structure, Managerial Behaviour and Corporate Value*, 11 J. CORP. FIN. 645 (2005); Kenneth A. Kim, Pattanaporn Kitsabunnarat & John R. Nofsinger, *Ownership and Operating Performance in an Emerging Market: Evidence from Thai IPO Firms*, 10 J. CORP. FIN. 355 (2004); Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985).

119. "Under any economic, social, or political system, individuals, business firms, and organizations in general are subject to lapses from efficient, rational, law-abiding, virtuous or otherwise functional behavior." ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* 1 (1969). On the need to align corporate managers' individual economic incentives with the corporation's economic interests, see JEAN TIROLE, *THE THEORY OF CORPORATE FINANCE* 20–27 (2006).

120. Elizabeth Magill & Adrian Vermeule, *Allocating Power Within Agencies*, 120 YALE L.J. 1032, 1036 (2011) ("Even casual observers of the administrative state recognize that agencies, like nearly all large organizations, are not unitary actors. They are fractured internally.").

law continues in this academic tradition, carefully dissecting the conflicting economic motivations of persons engaged in Chapter 11 cases and finding that these competing interests impact restructuring outcomes.¹²¹

Why, then, does the unitary actor framework continue to dominate Chapter 11? For one thing, the model is clearly manifested in the prevailing bankruptcy paradigm known as the “creditors’ bargain” model, which analyzes many issues that arise in bankruptcy cases from the perspective of a fictitious, efficiency-enhancing bargain amongst all creditors.¹²² Yet the model’s roots reach beyond bankruptcy theory. In many ways, the model reflects the relatively conservative legal conceptions of the firm that have dominated corporate law. While the precise contours of the relationship between a firm and its stakeholders have evolved over time, the firm has been largely construed as a privately-negotiated balancing of rights and obligations of stakeholders, such that there is no distinction between the economic interests of the firm as a unitary actor and the aggregated interests of its stakeholders.¹²³

For instance, consider the classic approach to corporate personhood: the “aggregate person” model.¹²⁴ Under this view, the corporate entity should be the exclusive unit of analysis because persons who comprise the corporation “merge” into it, thereby disappearing from view.¹²⁵ The aggregate person model was further amplified in the work of “nexus-of-contract” or “Contractarian” scholars in the 1970s.¹²⁶ These authors and their progeny assert that

121. See *supra* note 20, and sources cited therein.

122. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements and the Creditors’ Bargain*, 91 YALE L.J. 857 (1982) (advancing the creditors’ bargain model); see also Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 778 (1988). Professor Adam Levitin situates the creditors’ bargain model in the law and economics movement, classifying it as a contractarian theory of bankruptcy law. See Levitin, *Bankrupt Politics*, *supra* note 13, at 1405–06.

123. Charles R.T. O’Kelley, *The Entrepreneur and the Theory of the Modern Corporation*, 31 J. OF CORP. L. 753 (2006) (discussing historical perceptions of the corporation); Geoff Lundeen Carter, *Agreements Within Government Entities and Conspiracies Under Section 1985(3)—A New Exception to the Intracorporate Conspiracy Doctrine?*, 63 U. CHI. L. REV. 1139, 1141 (1996) (noting “the common law tradition of regarding corporations as single, unitary actors”).

124. See Ripken, *Corporations Are People Too*, *supra* note 65, at 109–12.

125. See *Hale v. Henkel*, 201 U.S. 43, 76 (1906) (“A corporation is . . . an association of individuals under an assumed name and with a distinct legal entity.”).

126. “Nexus-of-contract” and “Contractarian” scholars include Frank Easterbrook and

because stakeholders contract privately with each other to operate via the firm, the law should respect these private agreements and accept the firm as the pertinent actor, capable of shaping and advancing its own and its stakeholders' economic interests.¹²⁷

Moreover, this view of the firm asserts that efficient private ordering among stakeholders naturally leads organizational actors to engage in efficient transactions with third parties.¹²⁸ In other words, profit-maximizing stakeholders, negotiating with each other in a competitive market, advance organizational decisions that are likely to lead to the greatest net overall increase in stakeholders' welfare.¹²⁹ To the extent the organization pursues some other course, it is assumed that stakeholders would take rapid action to restore efficient exercise of organizational power.¹³⁰ A leading work in political economy reveals the extreme reductionism of such an argument in the analogous context of governmental decision-making: "[t]he logic underlying this view is simple and compelling: if a politician were making transfers in an inefficient manner, he or she would be voted out of office."¹³¹

Over time, this unitary actor conception of the firm came to be associated with powerful normative beliefs as to the relationship between law and transactional activity.¹³² As early defenders of neoclassical economic analysis of law assert, intra-firm dynamics are simply immaterial to the regulation of the firm's ultimate pursuits in

Daniel Fischel. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); see also Jonathan Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1266 (1999).

127. See William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 415 (1989) (under the "nexus of contracts" approach, "the firm is a legal fiction that serves as a nexus for a set of contracting relations among individual factors of production"); Michael C. Jensen & Clifford W. Smith, Jr., *Stockholder, Manager, and Creditor Interests: Applications of Agency Theory*, in JENSEN, *A THEORY OF THE FIRM*, *supra* note 67, at 136-37 ("We view the corporation as a legal entity that serves as a nexus for a complex set of explicit and implicit contracts among disparate individuals.").

128. See *infra* notes 129 and 130 and sources cited therein.

129. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (positing that the contractual nature of corporate relationships leads to efficient corporate outcomes).

130. Stephen Coate & Stephen Morris, *On the Form of Transfers to Special Interests*, 103 J. POL. ECON. 1210 (1995) (under the Chicago School, "political competition will ensure that the most efficient method of redistribution available is chosen").

131. *Id.* at 1211.

132. See *infra* notes 134 through 137 and accompanying text.

the marketplace.¹³³ Acknowledging the effects of this view on American law, economist Oliver Williamson used the term “legal forbearance” to refer to the relative unavailability of legal process with respect to intra-firm disputes, noting that such disputes are part of the “implicit contract law of internal organization,” which rests in the domain of private ordering rather than public law.¹³⁴ In essence, the bargaining and exchange of promises that occur in forming and managing the firm are viewed as a matter of private exchange, beyond the reach of the law (other than those laws specifically pertaining to intra-firm governance).¹³⁵ As one prominent work explained, “the behavior of the organization is like the equilibrium behavior of a market.”¹³⁶ It should be no surprise, then, that the aggregate person construct of the firm, as amplified by Contractarians, generally accompanies a *laissez-faire* approach to business law and market regulation.¹³⁷ In particular, this approach wages a powerful resistance to legal reforms that look beyond the needs of dominant constituents.¹³⁸

As a result, by the late 1970s, when Chapter 11 was enacted, the works of Berle and his progeny had been unfittingly relegated to the shelves of those who study corporate governance and other internal, decidedly *private* affairs of the firm. As to the firm’s activities with and among third parties, it was generally assumed that while there may be differences in the underlying goals of stakeholders, such variances were the subject of negotiation in a competitive market and resolved via private agreement.¹³⁹ In the absence of evidence

133. See, e.g., Armen A. Alchian, *Uncertainty, Evolution and Economic Theory*, 58 J. POL. ECON. 211 (1950); Milton Friedman, *The Methodology of Positive Economics*, in *ESSAYS IN POSITIVE ECONOMICS* (1953).

134. Oliver E. Williamson, *Economic Institutions: Spontaneous and Intentional Governance*, 7 J.L. ECON. & ORG. 159 (1991).

135. “The normative implications of the aggregate paradigm are that corporations should be regarded as the product of private initiative and natural market forces, that corporations reflect forms of private property and private contract, and that corporate law should therefore be viewed as private law, not public law.” Ripken, *Corporations Are People Too*, *supra* note 65, at 111.

136. JENSEN, A THEORY OF THE FIRM, *supra* note 67, at 136.

137. William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1489–90 (1989) (“[C]ontract theory was hostile to state regulation and to the management corporation simultaneously For example . . . contractualism served as the vehicle for protecting corporations from government regulation under the equal protection clause.”).

138. *Id.*

139. Professor Michael Klausner contextualizes contractarian theory thusly: “The core

that the actions of the firm are not in compliance with these internal agreements,¹⁴⁰ such actions should be taken as efficient translations of the aggregated stakeholders' interests. In the bankruptcy context, these core tenets of neoclassical economic theory, and especially the unitary actor model, enduringly obscured internal dynamics of complex commercial actors.

III. CHALLENGING THE EFFICIENCY FALLACY

As the previous sections explain, Chapter 11 suffers from structural limitations that introduce a distortionary effect. Namely, it invites to the bargaining table only certain large organizational actors. At the same time, it declines to investigate the internal dynamics that allow certain stakeholders to assume beneficial control of these negotiating parties.

Of course, a richer appraisal of Chapter 11 negotiations requires a deeper exploration of these internal dynamics. Fortunately, a rich body of modern social science literature offers tools to accomplish this very task. In the following sections, I develop an explanatory model that offers a richer alternative to the dominant, neoclassical economic paradigm. This alternative model draws primarily upon approaches utilized in the field of political economy. It also engages with other contemporary social science, spanning the fields of organizational theory, behavioral decision theory, and public choice economics, yielding an analytical framework that more properly accounts for institutional and political dynamics in commercial restructurings. The insights gained from this new explanatory model are particularly relevant to modern Chapter 11 reform efforts.

innovation of the theory was to conceptualize the relationship between management and shareholders of a public company as one of contract—a 'corporate contract'—in which joint wealth would be maximized as a result of atomistic market-mediated actions." Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 779–80 (2006).

140. These principles are fully in evidence in the dichotomy between corporate acts that are "intra vires," and therefore valid, versus those that are "ultra vires" and therefore invalid. In corporate law, the business judgment rule effectively serves as a presumption that a corporate act is lawful, absent a contrary showing. See Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004).

A. Background: Modern Political Economy

The political economy theoretical framework strives to explain how political forces shape economic outcomes, as well as how economic forces shape political outcomes.¹⁴¹ Political economists explore the relationships between governance factors and policy outcomes, focusing on the activities of governmental units, business and political associations, and informal groups and coalitions.¹⁴² In recent decades, the field of political economy has been deeply influenced by scholarship in the areas of behavioral decision theory, organizational theory, and public choice economics.¹⁴³ As a result, the field has become a powerful cross-disciplinary tool for exploring the mechanisms through which institutions and their stakeholders gain authority, dominance, and control to exert pressure and drive outcomes.¹⁴⁴

Professors Eric Posner¹⁴⁵ and David Skeel¹⁴⁶ have made prominent use of insights from political economy in their efforts to analyze the role of powerful pressure groups in the bankruptcy lawmaking process. Most recently, Professor Adam Levitin draws upon theories of political economy to consider the feasibility of a statutory scheme under which states could file for bankruptcy, and to propose a political theory of bankruptcy law more broadly.¹⁴⁷

141. Political economy explores, *inter alia*, “how the wealthy and, in particular, how political decisions and interests influence the location of economic activities and the distribution of the costs and benefits of these activities,” as well as “the effect of markets and economic forces on the distribution of power and welfare among states and other political actors.” ROBERT GILPIN, *THE POLITICAL ECONOMY OF INTERNATIONAL RELATIONS* 10–11 (1987).

142. *Supra* note 23.

143. *See, e.g.*, KEVIN A. CARSON, *ORGANIZATION THEORY: A LIBERTARIAN PERSPECTIVE* (2008) (exploring state intervention in corporate affairs, using a theoretical framework influenced by organizational theory); Thomas Palfrey, *Experiments in Political Economy*, in *OXFORD HANDBOOK OF POLITICAL ECONOMY* (2006) (exploring decision theory and game theoretic models in political economy).

144. Political economy as a mode of analysis has been applied in a range of fields. *See, e.g.*, Johan Arndt, *The Political Economy Paradigm: Foundation for Theory Building in Marketing*, 47 *J. MARKETING* 44 (1983) (applying political economy analyses to marketing theory).

145. *See* Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 *MICH. L. REV.* 47 (1997).

146. *See, e.g.*, DAVID A. SKEEL, JR., *DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* (2007); David A. Skeel, Jr., *Bankruptcy Lawyers and the Shape of American Bankruptcy Law*, 67 *FORDHAM L. REV.* 497 (1998).

147. *See generally* Levitin, *Bankrupt Politics*, *supra* note 13.

However, beyond these works exploring the bankruptcy-lawmaking process and restructurings of governmental entities, legal scholars have not yet applied these modern social science perspectives to critique Chapter 11. In the following section, I explore the methods of modern political economy, and develop an alternative model that more accurately explains commercial restructuring outcomes.

B. A New Model for Exploring Commercial Bankruptcies Under Chapter 11

This section advances a new explanatory model for examining situations of corporate financial distress, which draws upon political economy and related fields of social science to develop a clearer understanding of how Chapter 11 outcomes are negotiated by and among complex organizational actors.¹⁴⁸ In particular, it encourages a more thorough analysis of the parties and interests that shape restructuring outcomes. The approach considers how parties to Chapter 11 cases gain control of organizational actors to promote restructuring outcomes that privilege the economic interests of some stakeholders while subordinating the rights of others. By encouraging a more nuanced analysis of commercial restructurings, it exposes the Efficiency Fallacy and demonstrates the limitations of market mechanisms in commercial restructurings.

As a preliminary matter, the new explanatory model dismantles unitary actors, scrutinizing constituent interests within the “debtor,” “creditors,” or other aggregated actors. In this way, the model looks beyond conceptual barriers imposed by agency relationships to identify the true drivers of organizational decisions.¹⁴⁹ Generally speaking, stakeholders of distressed firms seek to maximize their own profits or minimize their own losses, as the case may be. But in the context of complex commercial restructurings, stakeholders may have additional investments in, or relationships with, the debtor.¹⁵⁰

148. This framework is based upon methodology set forth in JEFFRY FRIEDEN, *DEBT, DEVELOPMENT & DEMOCRACY* 16 (1991).

149. Of course, restructuring outcomes may be framed as beneficial to one group of constituents, when in fact they are intended to benefit a dominant pressure group. Political scientists observe similar dynamics in the lawmaking process. William C. Mitchell & Michael C. Munger, *Economic Models of Interest Groups: An Introductory Survey*, 35 *AM. J. POL. SCI.* 512 (1991).

150. An expanded inquiry is necessary in light of modern financial engineering. For instance, where creditors hold credit default swaps, they have no incentive to consent to a

For instance, in the WorldCom restructuring,¹⁵¹ an SEC inquiry found that a creditor appointed to the creditors' committee, in light of its \$400 million claim, in fact hedged all but \$6.5 million of this investment, and therefore did not possess an economic interest worthy of appointment to the committee over other creditors with far greater actual economic exposure.¹⁵² As this example suggests, stakeholders can have complex economic positions in relation to the Chapter 11 debtor, and such positions necessarily factor into the stakeholder's ultimate preferences.¹⁵³

Furthermore, it is important to consider how stakeholders work together to influence restructuring outcomes. As Professor Gourevitch explains, "[t]he structures set up to manage policy are themselves important allocators of power."¹⁵⁴ Thus, "[d]ecisions about who is represented, how, and with what perquisites affect how policy is formed and implemented."¹⁵⁵ We cannot simply accept at face value the grouping mechanisms imposed by Chapter 11 or pursuant to the parties' own private ordering, since certain stakeholders may take extraordinary predicate steps to capture control within these structures. For instance, whether within or outside of bankruptcy, parties at times make secret deals to buy votes from certain other constituents to meet consent thresholds.¹⁵⁶ Similarly, in Chapter 11, participants at times buy controlling interests in other securities of the debtor to gain the right to vote in plan confirmation proceedings on behalf of additional classes.¹⁵⁷ In

restructuring. Lubben, *supra* note 43, at 427–29.

151. *In re* WorldCom, Inc., No. 02-13533, 2002 WL 1732646 (Bankr. S.D.N.Y. July 22, 2002).

152. *In re* Greenfield, Securities Exchange Act Release No. 52744, at 8 (Nov. 7, 2005), available at <http://www.sec.gov/litigation/admin/34-52744.pdf> (remedial sanctions and cease-and-desist order).

153. Broader appreciation of an actor's interests is needed to overcome the assumptions addressed in Woo, *supra* note 20. In particular, Woo explains that profit maximization assumptions fail to take into consideration the need for financial institutions to comply with regulatory requirements.

154. GOUREVITCH, *supra* note 18, at 231.

155. *Id.*

156. *Highland Crusader Offshore Partners LP v. LifeCare Holdings Inc.*, 377 F. App'x. 422 (5th Cir. 2010) (finding that a borrower offered to pay an increased fee to certain holdout lenders in exchange for consent to an out-of-court restructuring).

157. *In re* DBSD N. Am., Inc., 634 F.3d 79, 102 (2d Cir. 2011) (finding that purchasing claims in bankruptcy "for the purpose of securing the approval or rejection of a plan does not of itself amount to 'bad faith.'" Nor is it improper to buy a claim to obtain standing to file a

cases of this sort, attention must be given to these predicate measures, and to their effects on the overall efficiency of the restructuring process. As economist George Stigler observed in his work on public choice, when dominant interests are left unchecked, they strive to capture institutions so that they can extract rents.¹⁵⁸ In essence, a full appreciation of the social costs requires a richer picture of the strategic exchanges that take place beyond the bargaining table.

Along these lines, collective action principles can be used to better understand how groups of stakeholders are able to influence restructuring outcomes.¹⁵⁹ These insights reveal that some stakeholders are better able to translate their individual profit maximization goals into restructuring outcomes, while other groups struggle with collective action problems.¹⁶⁰ In particular, smaller and more concentrated groups that offer their members appreciable benefits do not typically suffer from a lack of cohesion, whereas large and highly dispersed groups are more susceptible.¹⁶¹ Similarly, as Professor David Skeel has explored,¹⁶² consent mechanisms, voting thresholds, and other institutional dynamics can and do impact the functionality of collective action in Chapter 11.¹⁶³ Consistent with these theoretical models, scholarship by Professor Kelli Alces identifies the collective action problems confronted by equity security holders of large corporations.¹⁶⁴ The following section

competing plan.); *see also* Paul M. Goldschmid, Note, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191 (exploring claims trading as a means of gaining influence over a bankruptcy process); *Figter Ltd. v. Teachers Ins. & Annuity Assoc. of Am. (In re Figter Ltd.)*, 118 F.3d 635, 637 (9th Cir.1997) (creditors in one class arranged for a controlling voice in another class to control the restructuring outcome); *In re WestPoint Stevens, Inc.*, 333 B.R. 30 (S.D.N.Y. 2005) (same), *rev'd*, 600 F.3d 231 (2d Cir. 2010).

158. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

159. Collective action principles are explored in OLSON, *supra* note 114; *see also* ELINOR OSTROM, *GOVERNING THE COMMONS: THE EVOLUTION OF INSTITUTIONS FOR COLLECTIVE ACTION* (1990).

160. OSTROM, *supra* note 159, at 29.

161. OLSON, *supra* note 114, at 48.

162. David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992).

163. The foundational social science work on consent mechanisms is JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* (1962).

164. Kelli A. Alces, *The Equity Trustee*, 42 ARIZ. ST. L.J. 717 (2010).

applies these insights to recent Chapter 11 cases in an effort to expose the limitations of the Efficiency Fallacy and develop a better understanding of Chapter 11 negotiations.

IV. DECONSTRUCTING CORPORATE FINANCIAL DISTRESS

As previous sections argue, the Efficiency Fallacy fails to consider how internal dynamics undercut the ability of market mechanisms to fairly and efficiently apportion rights. The following sections apply insights from political economy to explore the Chapter 11 cases of Washington Mutual Bank, previously one of the nation's largest banking institutions, and General Growth Properties, a leading commercial real estate management company. In both cases, stakeholders disagreed with each other and with the debtors' management on a number of critical issues, and these disagreements needed to be resolved during the course of the Chapter 11 case before the debtors could emerge from bankruptcy. The purpose of these case studies is to reveal possible distortionary effects of Chapter 11 that impair the efficiency of these negotiations and the fairness of the ultimate restructuring outcomes. The insights gained from this analysis are particularly useful in reassessing the normative foundations of the law of corporate financial distress and in proposing legal reforms.

Before turning to the case studies, a few points should be made. Recall that under the early neoclassical economic model, negotiated outcomes are taken to be the efficient result of profit-maximizing choices by large organizational actors who are deemed capable of taking deliberate steps to advance their own interests. The structural privileges afforded to unitary actors (and, by extension, to their controlling stakeholders) are justified by a neoclassical belief that decisions made by organizational actors reflect the aggregated interests of constituents, and negotiations among such actors in a competitive market generate equilibrium.¹⁶⁵ Thus, negotiated outcomes are believed to reflect the underlying value of the debtors' assets versus liabilities, which are assumed to be a function of demand in a competitive market.¹⁶⁶ In this manner, the Efficiency Fallacy declares that negotiated outcomes are most advantageous for all constituents; if a better, more economically productive allocation

165. *See supra* Part II.B.

166. *See supra* Part II.A.

of the debtor's assets were possible, the market clearinghouse functions within each organizational actor and the overall efficiency of the restructuring process would have enabled such other outcome to prevail. In other words, those able to make better use of the debtor's resources would have been willing to pay more for them, yielding a different outcome.

Yet the case studies reveal institutional dynamics that controvert these assumptions. Although the prevailing construct "impl[ies] coincidence of perceptions, control of choice, and coordination of movement" within each organizational actor,¹⁶⁷ the case studies demonstrate that constituent groups are highly fractured, harboring deeply conflicting views regarding the underlying value of the debtor's assets and the proper course for maximizing such value.

Furthermore, certain organizational actors, such as the debtor, are especially subject to capture by dominant, self-interested factions or individuals. And, rather than relying on a true market clearinghouse function to resolve conflicts, powerful stakeholders are able to engage in strategic, opportunistic, and other anticompetitive conduct to obtain control, monopolize restructuring outcomes, and extract rents. As a result, certain persons tend to have greater power and privilege from the outset. Generally speaking, Washington Mutual's restructuring outcome favored parties who obtained concentrated power and authority (such as the company's corporate creditors), at the expense of other parties (such as equity security holders) who were too dispersed to gain meaningful influence. In contrast, General Growth's restructuring favored certain equity security holders, who were able to gain concentrated power early in the process, at the expense of widely dispersed creditors. But the neoclassical paradigm declines to shed light upon these internal dynamics. Thus, not only does the legal construct produce a distortionary effect, it also shields these very distortions from view. These themes will be further dissected in subsequent sections.

A. The Washington Mutual Chapter 11 Case

The Washington Mutual Chapter 11 filing is unique in that it followed on the heels of the largest bank failure in United States history.¹⁶⁸ Seattle-based Washington Mutual, Inc. ("WMI")¹⁶⁹ was a

167. ALLISON, *supra* note 27, at 246.

168. Eric Dash & Andrew Ross Sorkin, *Government Seizes WaMu and Sells Some Assets*, N.Y.

savings and loan holding company that wholly owned its banking subsidiary, Washington Mutual Bank, FA (“WMB”).¹⁷⁰

Originally founded in 1889 after the Great Seattle Fire,¹⁷¹ by 2006 Washington Mutual was the largest thrift holding company in the United States¹⁷² and the eighth largest credit-card issuer.¹⁷³ Industry observers routinely referred to the banking behemoth as a leading U.S. financial institution.¹⁷⁴ In 2006, WMI’s capital stock surged to record highs¹⁷⁵ and by 2008 WMB was the seventh largest among all U.S. bank and thrift holding companies.¹⁷⁶

In the years immediately preceding its demise, Washington Mutual was particularly active in residential mortgage originations.¹⁷⁷ After the United States housing market collapsed in 2007, the value of securities tied to real estate mortgages tumbled.¹⁷⁸ Washington Mutual suffered severe losses, particularly in its riskier subprime lending business.¹⁷⁹

In February 2008, in response to deterioration in Washington Mutual’s financial condition, the Office of Thrift Supervision (“OTS”) and the Federal Deposit Insurance Corporation (“FDIC”)

TIMES, Sept. 25, 2008, at A1.

169. ARTICLES OF INCORPORATION OF WASHINGTON MUTUAL, INC., filed with the Washington Secretary of State on Aug. 17, 1994.

170. The banking subsidiary, Washington Mutual Bank, Henderson, Nevada, was organized as a federal savings association insured under 12 U.S.C. § 1814(a). See OFFICES OF INSPECTOR GENERAL, DEPARTMENT OF THE TREASURY, EVALUATION OF FEDERAL REGULATORY OVERSIGHT OF WASHINGTON MUTUAL BANK [hereinafter “INSPECTOR GENERAL REPORT”], at Appendix 2.

171. George Erb, *JPMorgan Should Donate Its WaMu Artifacts*, PUGET SOUND BUS. J., June 14, 2009. On the institution’s early history, see generally MURRAY MORGAN, *THE FRIEND OF THE FAMILY: 100 YEARS WITH WASHINGTON MUTUAL* (1989).

172. Washington Mutual, Inc., Annual Report (Form 10-K), at 2 (Mar. 14, 2005).

173. Washington Mutual, Inc., Annual Report (Form 10-K), at 14 (Mar. 15, 2006).

174. See, e.g., Robert O’Connor, *That’s Affordable: Seattle-based Washington Mutual Has Built a Serious Business Around Community Outreach and Affordable Lending*, MORTGAGE BANKING, July 31, 2005, at 73 (referring to the “lending giant”).

175. Will Edwards, *Washington Mutual Earnings Rise on Provident Purchase*, BLOOMBERG (Jan. 18, 2006), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aMwatJskzJYE>.

176. Washington Mutual, Inc., Annual Report (Form 10-K), at 1 (Feb. 29, 2008).

177. *Id.* at 69 (“For the year ended December 31, 2007, proceeds from the sale of loans originated and held for sale were approximately \$78.93 billion.”).

178. The subprime lending crisis, and Washington Mutual’s role in particular, are explored in KATHLEEN C. ENGEL & PATRICIA A. MCCOY, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS* (2011).

179. See *id.*

lowered the bank's safety and soundness rating to a 3, on a scale of 1 to 5, signaling it was a troubled institution.¹⁸⁰ By late summer 2008, Washington Mutual estimated it could face \$19 billion in losses over the next several years from underperforming and defaulting mortgage loans.¹⁸¹ As investor confidence sank, the parent company's stock price began to tumble.¹⁸² In mid-September 2008, a bank run drained the institution of more than \$17 billion in deposits in an eight-day period.¹⁸³ OTS and the FDIC lowered the bank's safety and soundness rating once again, signaling that the bank could fail.¹⁸⁴

On September 25, 2008, WMB was seized by OTS.¹⁸⁵ OTS appointed the FDIC as receiver,¹⁸⁶ and as such the FDIC "by operation of law, succeed[ed] to all rights, titles, powers, and privileges" of WMB, and of any "stockholder, member, accountholder, depositor, officer, or director of such institution with respect to the institution and the assets of the institution"¹⁸⁷ In essence, under federal law the FDIC stepped into the shoes of WMB and WMI, to the extent WMI owned the outstanding stock of WMB, and, in that capacity, was entitled to "marshal[] assets of [the] failed institution[] for the benefit of its creditors."¹⁸⁸

Washington Mutual's failure threatened to deplete the FDIC's \$45 billion Deposit Insurance Fund.¹⁸⁹ Acting under its broad

180. Letter from OTS to Washington Mutual Bank (Feb. 28, 2008) (on file with author).

181. Washington Mutual, Inc., Current Report (Form 8-K), at (July 22, 2008).

182. Eric Dash & Geraldine Fabrikant, *Washington Mutual Stock Falls on Investor Fears*, N.Y. TIMES, Sept. 10, 2008, at C1.

183. Press Release, Senate Subcommittee Holds Second Hearing on Wall Street and the Financial Crisis: The Role of Bank Regulators, 1848 PLI/CORP 363, (Apr. 15, 2010), available at <http://www.levin.senate.gov/newsroom/press/release/?id=9c58e384-4c2f-4151-bc2b-0b21e5070b0b>.

184. INSPECTOR GENERAL REPORT, *supra* note 170, at 18.

185. OTS, Order Number 2008-36, Sept. 25, 2008.

186. Letter from OTS to WMB (Sept. 25, 2008) (notifying WSB of the FDIC's appointment as receiver) (on file with author).

187. 12 U.S.C. § 1821(d)(2)(A)(i) (2012); *see also* 12 U.S.C. § 1821(c)(2)(A)(ii).

188. U.S. *ex rel.* RTC v. Schroeder, 86 F.3d 114, 117 (8th Cir. 1996); *see also* Courtney v. Halleran, No. 02-C-6926, 2004 U.S. Dist. LEXIS 18795, at *11-12 (N.D. Ill. Sept. 14, 2004) ("[W]hen the FDIC is appointed receiver of an insolvent bank, it essentially 'steps into the shoes' of that bank and assumes control of the bank's rights and assets, including certain causes of action the bank might have against other parties.").

189. Marcy Gordon, *Federal Bank Insurance Fund Slips Below Target Level*, USA TODAY (Sept. 17, 2008), http://usatoday30.usatoday.com/money/industries/banking/2008-09-17-fdic-fund-below-target-amount_N.htm; Linda Shen, *WaMu's Bank Split From Holding Company, Sparing*

power, the FDIC determined that a sale of all of the assets, deposits, and other liabilities of WMB would be the best course. A sale of this sort was made feasible by Washington Mutual's corporate structure. The company's banking-related assets and liabilities were titled in the subsidiary, WMB, rather than in the parent company, WMI. In contrast, much of the corporate debt of Washington Mutual was in the name of the corporate parent, WMI. Similarly, Washington Mutual's publicly-traded common and preferred equity security interests were issued by the parent company. However, notwithstanding the legal separateness of WMI and WMB, the two entities historically had identical and overlapping management and treated their assets and liabilities as "connected[,] . . . commingled and intertwined."¹⁹⁰

Thus, on the same day as the bank seizure, the FDIC orchestrated the sale of substantially all of WMB's assets to JPMorgan Chase Bank ("JPMorgan"), in exchange for JPMorgan paying WMI \$1.88 billion in cash plus JPMorgan's assumption of more than \$145 billion in bank deposits, covered bonds and other secured liabilities of WMB.¹⁹¹ Thanks to the sale transaction, WMB's collapse "came at 'zero cost' to the insurance fund"¹⁹² in the form of payments from the deposit insurance fund.¹⁹³ In the wake of the sale, JPMorgan disclosed that it realized nearly \$12 billion from the transaction.¹⁹⁴

FDIC (Update 1), BLOOMBERG (Sep. 26, 2008), www.bloomberg.com/apps/news?pid=newsarchive&sid=a2VofC5midrw; see also *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse. Hearing Before the Permanent Subcomm. on Investigations of the Comm. on Homeland Security & Governmental Affairs, 112th Cong.* (2011) [hereinafter *Wall Street Hearing*].

190. Complaint at 11–12, *JPMorgan Chase Bank, N.A. v. Washington Mut., Inc.*, Bankr. No. 08-12229, Adv. No. 09-50551 (Bankr. D. Del. Mar. 24, 2009).

191. Fed. Deposit Ins. Corp. & JPMorgan Chase Bank, Purchase and Assumption Agreement: Whole Bank (Sept. 25, 2008), http://www.fdic.gov/about/freedom/Washington_Mutual_P_and_A.pdf [hereinafter *Purchase Agreement*].

192. Shen, *supra* note 189.

193. However, the FDIC provided indemnification for claims based on the rights of any shareholders, creditors, officers, employees and depositors of Washington Mutual. See *Purchase Agreement, supra* note 191, at 25–26. The FDIC justified indemnification on the grounds that "such assistance is necessary to meet the obligations of the [FDIC] to provide insurance coverage for the insured deposits in [WMB]," and indemnification was the "least costly . . . method[] for meeting such obligation." *Id.* at 1. Indemnification is permitted under 12 U.S.C. § 1823(c)(2)(A).

194. JP Morgan Chase Bank, Annual Report (Form 10-K), at 166 (Feb. 28, 2011).

The sale of WMB to JPMorgan was accomplished on an expedited basis in part because JPMorgan had been standing by as a ready and willing buyer. In fact, the New York-based banking giant made its first attempt to acquire WMB five months before the bank's September 2008 failure.¹⁹⁵ In March 2008, at the invitation of OTS and the FDIC, several prospective buyers of Washington Mutual reviewed the bank's books and records.¹⁹⁶ In April 2008, JPMorgan made a public offer to acquire Washington Mutual from WMI's shareholders for \$8 per share, payable in JPMorgan stock.¹⁹⁷ Washington Mutual was able to resist this allegedly "low-ball bid"¹⁹⁸ by obtaining a capital infusion from a private equity firm.¹⁹⁹

Although the infusion allowed the ailing bank to temporarily comply with banking capitalization requirements, regulatory pressure continued. In fact, Washington Mutual bondholders allege that in the months following JPMorgan's April 2008 acquisition attempt, JPMorgan used and disclosed WMI's confidential financial information to both pressure federal regulators to increase oversight of WMB and to harvest negative sentiments about WMI among rating agencies, media and investors.²⁰⁰ In particular, bondholders allege that JPMorgan engaged in a "lobbying effort to convince federal regulators to seize and sell off Washington Mutual's assets at a fire-sale price that [JPMorgan] would be strategically positioned to take advantage of."²⁰¹ WMI echoed these accusations in its own lawsuit against the FDIC and also complained that the assets of WMB sold to JPMorgan, less the liabilities assumed, were worth substantially more than the \$1.88 billion cash consideration received in the deal.²⁰²

In the wake of the September 2008 acquisition, corporate parent WMI was stripped of its key operating subsidiary and business assets. Since JPMorgan did not assume Washington Mutual's

195. *Am. Nat. Ins. Co. v. JPMorgan Chase & Co.*, 705 F. Supp. 2d 17, 18 (D.D.C. 2010).

196. *Wall Street Hearing*, *supra* note 189, at 57.

197. *In TPG's WaMu Deal, a New Playbook for Regulators?*, DEALBOOK, Apr. 10, 2008, <http://dealbook.nytimes.com/2008/04/10/in-tpgs-wamu-deal-a-new-playbook-for-regulators/>.

198. *Id.*

199. *Id.*

200. These claims are made in *Am. Nat. Ins. Co.*, 705 F. Supp. 2d at 19.

201. Debtor's Motion for an Order Directing the Production of Documents from Knowledgeable Parties at 6, *In re Washington Mut., Inc.*, No. 08-12229 (Bankr. D. Del. Dec. 14, 2009), ECF No. 1997.

202. Complaint, *Wash. Mut., Inc. v. F.D.I.C.*, No. 1:09-cv-00533 (D.D.C. Mar. 20, 2009).

corporate debts, WMI was rendered insolvent and filed for Chapter 11 bankruptcy protection the next day in Delaware.²⁰³ In disclosures to the court, the company reported no secured liabilities, unsecured liabilities of approximately \$8 billion, and assets of approximately \$4.5 billion.²⁰⁴ Additionally, while not formally disclosed as an asset, WMI possessed approximately \$20 billion dollars in consolidated net operating loss carryforwards, which could be preserved by Chapter 11 reorganization and used to offset future income.²⁰⁵ Soon after the bankruptcy filing, WMI pursued civil claims against JPMorgan and the FDIC regarding the ownership of certain assets, including WMB's share of these valuable tax attributes and \$4 billion of trust securities.²⁰⁶ Extensive litigation ensued, both within and outside of bankruptcy court, among WMI and certain of its stakeholders, JPMorgan, the FDIC and certain of WMI's largest creditors.²⁰⁷

203. Voluntary Petition of WMI Investment Corp., *In re* WMI Investment Corp., No. 08-12228 (Bankr. D. Del. Sep. 26, 2008), ECF No. 1; Voluntary Petition of Washington Mutual, Inc., *In re* Washington Mut., Inc., No. 08-12229 (Bankr. D. Del. Sep. 26, 2008), ECF No. 1. The cases were consolidated pursuant to FED. R. BANKR. P. 1015(b) under Case No. 08-12229.

204. Schedule of Assets and Liabilities for WMI, at 10, *In re* Washington Mut., Inc., No. 08-12229 (Bankr. D. Del. Dec. 19, 2008), ECF No. 477.

205. Interim Order Pursuant to Sections 105(a) and 362 of the Bankruptcy Code (i) Establishing Notification Procedures and Approving Restriction on Certain Transfers of Interests in the Debtors' Estates, and (ii) Scheduling a Final Hearing, *In re* Washington Mut., Inc., No. 08-12229 (Bankr. D. Del. Nov. 7, 2008), ECF No. 243.

206. The FDIC ordered that \$4 billion of outstanding publicly-traded trust preferred securities issued by a special purpose entity of WMB be exchanged for preferred stock of WMI. The trust securities were then transferred to WMB, and sold to JPMorgan as part of the assets of WMB. This aspect of the acquisition is described in greater detail in Complaint, *supra* note 202 at 10-11.

207. *Am. Nat'l Ins. Co. v. JPMorgan Chase & Co.*, 705 F. Supp. 2d 17 (D.D.C. 2010) (discussing Washington Mutual bondholders that alleged JPMorgan tortiously interfered with their contractual rights by engineering a campaign to distort market and regulatory perception of Washington Mutual's financial health); *Black Horse Capital LP, et al. v. JPMorgan Chase Bank, N.A.*, Bankr. No. 08-12229, Adv. No. 10-51387 (Bankr. D. Del. July 6, 2010) (stating that Washington Mutual trust-preferred securities holders allege that WMI improperly converted their shares from debt to equity, and engaged in rampant fraud and misrepresentations with respect to these securities); *Washington Mut., Inc.*, No. 1:09-cv-00533 (stating that WMI alleges that the FDIC conducted the sale in an unlawful and unreasonable manner, and that the actions of the FDIC constituted an unlawful taking); *Broadbill Investment Corp. v. Washington Mut., Inc.*, Bankr. No. 08-12229, Adv. No. 10-50911 (Bankr. D. Del. Apr. 12, 2010) (finding that holders of litigation tracking warrants relating to a \$350 million judgment in favor of Washington Mutual claim that the funds should be awarded to them, while WMI claims that the warrants were converted to WMI common stock); *Washington Mut., Inc. v. JPMorgan Chase Bank, N.A.*, Bankr. No. 08-12229, Adv. No. 09-50934 (Bankr. D. Del. 2009) (stating that WMI

In March 2010, WMI reached an agreement with JPMorgan, the FDIC, WMI's largest creditors (referred to collectively as the "Settlement Noteholders"), and the Official Committee of Unsecured Creditors to settle outstanding lawsuits, including an agreement to recognize JPMorgan as the owner of the \$4 billion trust securities.²⁰⁸ As part of that settlement, JPMorgan would transfer to WMI approximately \$4 billion in deposit funds, free and clear of all claims.²⁰⁹ Additionally, JPMorgan would relinquish its claims on approximately \$2.5 billion in tax refunds relating to the banking business.²¹⁰ Finally, WMI would grant releases to JPMorgan for all claims arising out of JPMorgan's alleged misconduct. In total, the global settlement would enable the bankruptcy estate to distribute approximately \$7.5 billion—an amount nearly sufficient to pay WMI's creditors, but insufficient to provide any residual benefit to equity security holders.²¹¹

The settlement agreement was a principal component of WMI's sixth amended Chapter 11 plan, which was initially filed with the bankruptcy court in March 2010²¹² and subjected to a vote by all classes of WMI's company's creditors and equity security holders.²¹³ In some Chapter 11 cases, the debtor is able to put together a plan that all classes vote to accept. However, WMI was not such a case. Accordingly, WMI asked the court to confirm the sixth amended plan over the objections of dissenting classes.²¹⁴ Courts may exercise this power so long as certain technical requirements are met. Chief among these is a requirement that the plan is approved by at least one class of any claimants who are "impaired" under the

alleges that JPMorgan failed to return over \$4 billion in deposit liabilities that JPMorgan owes WMI); *JPMorgan Chase Bank, N.A. v. Washington Mut., Inc.*, Bankr. No. 08-12229, Adv. No. 09-50551 (Bankr. D. Del. Mar. 24, 2009) (stating that JPMorgan alleges that the suit filed by WMI against JPMorgan places in jeopardy its economic interests in the assets it acquired in the sale).

208. See Section 2.3 of the Draft of Settlement Agreement, included as Exhibit I to the Sixth Amended Plan of Reorganization, *In re Washington Mut., Inc.*, No. 08-12229 (Bankr. D. Del. Mar. 26, 2010).

209. *Id.* at Section 2.1.

210. *Id.* at Section 2.4.

211. Letters to Creditors, et al. from WMI (Oct. 19, 2010) (on file with author).

212. Sixth Amended Plan of Reorganization, *In re Washington Mut., Inc.*, No. 08-12229 (Bankr. D. Del. Mar. 26, 2010).

213. 11 U.S.C. § 1126 (2012).

214. The requirements are set forth in 11 U.S.C. § 1129(a)(7)(8).

plan.²¹⁵ A class is considered to be impaired to the extent the plan changes the claimant's legal, equitable and contractual rights.²¹⁶ The impaired classes under the sixth amended plan included equity security holders and holders of PIERS Claims (a specific group of WMI's unsecured creditors).²¹⁷ Equity security holders would receive no distributions, and PIERS claimants would recover approximately seventy-three percent of their claims.²¹⁸ The PIERS claimants voted to accept the sixth amended plan, while equity security holders vehemently objected.²¹⁹

Despite the PIERS claimants' satisfactory vote, the court was unable to confirm the sixth amended plan because of a host of disputes.²²⁰ In one such dispute, the Official Committee of Equity Security Holders (the "Equity Committee") alleged that WMI allowed the Settlement Noteholders to dominate the restructuring process, steering WMI to settle claims in amounts sufficient to enable the bankruptcy estate to satisfy only creditor claims.²²¹ In particular, the Equity Committee alleged that WMI did not adequately pursue claims against JPMorgan because the economic benefit of any damages awarded would accrue to WMI's equity security holders rather than to the more powerful creditor groups.²²² Finally, the Equity Committee challenged the proposed members of

215. 11 U.S.C. § 1129(a)(10); *In re Townco Realty Inc.*, 81 B.R. 707 (Bankr. S.D. Fla. 1988).

216. 11 U.S.C. § 1129(a)(8); 11 U.S.C. § 1124(1). Under 11 U.S.C. § 1129(b)(2)(A)(ii), a debtor may under certain circumstances "cram down" a plan notwithstanding rejection by a creditor class.

217. The PIERS are Preferred Income Equity Redeemable Securities issued by Washington Mutual Capital Trust 2001 ("WMCT 2001"), a special purpose trust. The only assets of WMCT 2001 are subordinated debentures issued by WMI. Thus, WMCT 2001 is a creditor of WMI, and WMCT 2001's beneficial owners are treated as general unsecured creditors of WMI. *See* Post-Hearing Brief of Wells Fargo Bank, N.A., in its Capacity as Indenture Trustee and Guarantee Trustee, in Support of Confirmation, *In re Washington Mut., Inc.*, No. 08-12229 (Bankr. D. Del. Aug. 10, 2011), ECF No. 8414.

218. Letters to Creditors, et al. from WMI (Oct. 19, 2010) (on file with author).

219. *In re Washington Mut., Inc.*, 461 B.R. 200, 212-13 (Bankr. D. Del. 2011).

220. In two successive opinions, the court concluded that the global settlement agreement was fair and reasonable, but declined to confirm the plan because of other deficiencies. *In re Washington Mut.*, 461 B.R. 200; *In re Washington Mut., Inc.*, 442 B.R. 314, 344-45, 365 (Bankr. D. Del. 2011).

221. Objection of the Committee of Equity Security Holders to Confirmation of the Modified Sixth Amended Plan of Reorganization, *In re Washington Mut., Inc.*, No. 08-12229 (Bankr. D. Del. July 12, 2011), ECF No. 8192.

222. *See id.*

the WMI liquidating trust's advisory board, claiming that members were appointed by constituencies that would receive a full or near-full recovery and therefore could not be counted upon to pursue claims that would benefit other classes and constituencies.²²³

However, one of the most heated disputes pertained to allegations initially raised by a thirty-three-year-old equity security holder, described by one journalist as a "day trading hipster."²²⁴ The investor closely monitored the case and, in a rather unusual move, filed his own objection to the sixth amended plan, alleging that the plan was not proposed in good faith.²²⁵ Specifically, he claimed that WMI's management breached duties of loyalty and care owed to equity security holders by "continually act[ing] adversely to equity, while simultaneously representing to the court . . . that equity's interests are adequately represented"²²⁶ and by "work[ing] closely with the [Settlement Noteholders] to the exclusion . . . [and] detriment" of equity security holders.²²⁷ He further alleged that the plan confirmation votes of the Settlement Noteholders should be set aside because Settlement Noteholders did not vote on the plan in good faith²²⁸ and that, because of these alleged defects, the plan could not be confirmed by the court.²²⁹

The investor also asserted that the Settlement Noteholders hold nearly seventy percent of the PIERS Claims and therefore strategically crafted an impaired class to affirm the plan.²³⁰ Finally,

223. *See id.*

224. Bess Levin, *Day Trading Hipster Takes on David Tepper*, DEALBREAKER (June 13, 2011), <http://dealbreaker.com/2011/06/day-trading-hipster-takes-on-david-tepper/>.

225. Objection to the Plan of Reorganization, filed by Nate Thoma, *In re Washington Mut., Inc.*, No. 08-12229 (Bankr. D. Del. Nov. 19, 2010), ECF No. 6058. The objection alleges that the plan violates 11 U.S.C. § 1129(a)(3).

226. Objection to the Plan of Reorganization, *supra* note 225, at 1.

227. *Id.* at 2.

228. Under 11 U.S.C. § 1126(e), "[o]n request of a party in interest . . . the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title." In addition, 11 U.S.C. § 1126(c), (d) provides that the vote of any entity designated by the bankruptcy court is to be excluded in assessing whether the requisite majorities for class acceptance have been achieved.

229. Objection to the Plan of Reorganization, *supra* note 225, at 4.

230. *Id.* The investor alleged that the Settlement Noteholders engaged in "class gerrymandering," which has been a contentious issue in bankruptcy. *See, e.g., In re Machne Menachem, Inc.*, 233 F. App'x 119, 121 (3d Cir. 2007) (reasoning that a plan will be rendered unconfirmable "by the impermissible gerrymandering of classes," since "vote manipulation by the gerrymandering of classes seriously undermines the critical requirements set out in Section

he claimed that Settlement Noteholders traded extensively in debt securities of WMI throughout the pendency of the case, despite possession of material, non-public information obtained during negotiations.²³¹ Based upon the allegations raised by the investor, the Equity Committee subsequently filed a motion to conduct an examination of the Settlement Noteholders.²³² In February 2011, the Court granted the Equity Committee's request, permitting a limited examination of the Settlement Noteholders.²³³

The investor's bold attempts to influence the proceedings were met with significant opposition. One of the Settlement Noteholders, a hedge fund that invests with a focus on distressed debt, served a reciprocal examination request upon the individual investor.²³⁴ The request for production, which was prepared by one of the nation's largest commercial law firms and served upon the investor at his uncle's apartment, demanded access to "[a]ll documents or communications concerning and/or reflecting communications between [the investor] and the Equity Committee . . . [and] any other person relating to [the] Objection and/or subsequent proffers to the Court" and "all documents and communications sufficient to reflect . . . past or present holdings in any securities of the Debtors."²³⁵ When timely responses from the investor were not received, the hedge fund moved for an order compelling him to produce documents and respond to interrogatories.²³⁶

1129(a)(8)").

231. Objection to the Plan of Reorganization, *supra* note 225.

232. Motion of the Official Committee of Equity Security Holders for an Order Pursuant to Bankruptcy Rule 2004 and Local Bankruptcy Rule 2004-1 Directing the Examination of the Washington Mutual, Inc. Settlement Note Holders, *In re* Washington Mut., Inc., No. 08-12229 (Bankr. D. Del. Jan. 18, 2011), ECF No. 6567. FED. R. BANKR. P. 2004 authorizes examinations of this sort.

233. Order Granting, in Part, Motion of the Official Committee of Equity Security Holders for an Order Pursuant to Bankruptcy Rule 2004 and Local Bankruptcy Rule 2004-1 Directing the Examination of the Washington Mutual, Inc. Settlement Note Holders Group, *In re* Washington Mut., Inc., No. 08-12229 (Bankr. D. Del. Feb. 11, 2011), ECF No. 6725.

234. Objection of Appaloosa Management L.P. to the Motion of the Equity Committee for an Order Pursuant to Bankruptcy Rule 2004 and Local Bankruptcy Rule 2004-1 Directing the Examination of the Washington Mutual, Inc. Settlement Note Holders Group at 17, *In re* Washington Mut., Inc., No. 08-12229 (Bankr. D. Del. Jan. 31, 2011), ECF No. 6645.

235. Appaloosa Management L.P.'s First Request for Production of Documents to Nate Thoma at 4-5, *In re* Washington Mut., Inc., No. 08-12229 (Bankr. D. Del. Mar. 8, 2011), ECF No. 6887.

236. Motion of Appaloosa Management L.P. for an Order Compelling Nate Thoma to Search for and Produce Documents and to Respond to Interrogatory Requests, *In re* Washington

Struggling to overcome substantial collective action obstacles, equity security holders from around the world rallied in the private investor's defense. Approximately one hundred and eighty individual investors, mostly from Europe, flooded the court with objections to the hedge fund's motion.²³⁷ One such objection asserts that, pursuant to an "exceptionally questionable motion," the hedge fund "intends to proceed against a small investor and examine him."²³⁸ The objection further argues that "instead of initiating a parallel, senseless examination of a small, private investor, the [Settlement Noteholders] should . . . provide the requested documents to the Equity Committee."²³⁹ Finally, at least one objection notes the hardship imposed by the hedge fund's demands, given that the investor is not receiving reimbursement from the debtor's estate of expenses and attorneys' fees.²⁴⁰

In July 2011, the Equity Committee filed an additional objection to the sixth amended plan, further asserting that Settlement Noteholders traded in WMI securities on the basis of material, nonpublic information and arguing that the Settlement Noteholders "hijacked" negotiations and controlled WMI during the bankruptcy process.²⁴¹ In September 2011, after several hearings, the court refused to confirm the sixth amended plan, citing a number of defects.²⁴² The court found that the equity security holders had a colorable claim of insider trading, and granted a motion authorizing

Mut., Inc., No. 08-12229 (Bankr. D. Del. Apr. 19, 2011), ECF No. 7160.

237. See *In re* Washington Mut., Inc., No. 08-12229 (Bankr. D. Del.) (reflecting the objections on the docket).

238. Objection of Thomas Dresel to the Motion of Appaloosa Management L.P. (cf. Docket Number 7160) for an Order Compelling Mr. Nate Thoma to Search for and Produce Documents and to Respond to Interrogatory Requests and as Consequence of it [sic] Motion for (a) Allowance for Mr. Thoma of Reimbursement for all Costs in this Matter (b) Trading Restrictions for all Parties, *In re* Washington Mut., Inc., No. 08-12229 (Bankr. D. Del. Apr. 27, 2011), ECF No. 7197.

239. *Id.* at 2.

240. *Id.* at 4.

241. Objection of the Official Committee of Equity Security Holders to Confirmation of the Modified Sixth Amended Plan of Reorganization, *In re* Washington Mut., Inc., No. 08-12229 (Bankr. D. Del. Jul. 1, 2011), ECF No. 8073. This is not the first time a claim of insider trading has been made in a bankruptcy case. For instance, a creditor was accused of trading on the basis of material, nonpublic information gained from its service on a committee in *In re* Galey & Lord, Ch. 7 Case No. 04-43098 (Bankr. N.D. Ga. Aug. 19, 2004).

242. *In re* Washington Mut., Inc., 461 B.R. 200, 267 (Bankr. D. Del. 2011).

the Equity Committee to pursue the claim.²⁴³ However, “concerned that the case [would] devolve into a litigation morass” and citing the potential economic futility of prosecuting the claim of insider trading, the court ordered the parties to engage in mediation to resolve lingering disputes.²⁴⁴

In December 2011, the Debtors announced that the mediation had been successful and that a newly proposed seventh amended Chapter 11 plan contained a global settlement of all outstanding claims, including those of the equity security holders.²⁴⁵ Under the new plan, the Settlement Noteholders would contribute \$75 million to the reorganized WMI.²⁴⁶ Holders of WMI’s common stock would receive their pro rata share of twenty-five percent of the equity of the new company, while holders of WMI’s preferred stock would receive their pro rata share of seventy-five percent of the new company.²⁴⁷ The plan also included releases from the equity securities holders, J.P. Morgan, and the FDIC of all legal claims.²⁴⁸ The court confirmed the seventh amended plan in February 2012.²⁴⁹

B. The General Growth Chapter 11 Case

Originally formed in 1954 to operate a single retail property in Iowa, the Chicago-based retail mall owner General Growth Properties, Inc., a publicly-traded real estate investment trust, steadily grew to become one of the nation’s largest retail mall owners.²⁵⁰ General Growth featured a multi-tiered corporate

243. *Id.* at 254–67.

244. *Id.* at 267.

245. Motion of Debtors for an Order, Pursuant to Sections 105, 502, 1125 and 1128 of the Bankruptcy Code and Bankruptcy Rules 2002, 3003, 3017, 3018, 3019, 3020, and 9006, (I) Approving the Proposed Disclosure Statement and the Form and Manner of the Notice of the Proposed Disclosure Statement Hearing, (II) Establishing Solicitation and Voting Procedures, (III) Scheduling a Confirmation Hearing, and (IV) Establishing Notice and Objection Procedures for Confirmation of the Debtors’ Seventh Amended Plan, *In re Washington Mut., Inc.*, No. 08-12229 (Bankr. D. Del. Dec. 13, 2011), ECF No. 9181.

246. *Id.*

247. *Id.*

248. *Id.*

249. *In re Washington Mut., Inc.*, 2012 WL 1563880 (Bankr. D. Del. 2012); *see also* Peg Brickley, *WaMu Bankruptcy Plan Advances*, WALL ST. J. (Feb. 17, 2012), <http://online.wsj.com/article/SB10001424052970204880404577229153649046724.html>.

250. Iliana Jonas & Emily Chasan, *General Growth files historic real estate bankruptcy*, REUTERS (April 16, 2009), <http://www.reuters.com/article/2009/04/16/us-generalgrowth-bankruptcy-idUSLG52607220090416>.

structure, with certain assets and liabilities titled in upper-level holding companies,²⁵¹ and the balance of assets and liabilities titled in hundreds of bankruptcy remote “special-purpose entities” (“SPEs”). The parent company (“GGP”) was publicly-traded.²⁵²

Across a complex corporate structure, the company held a large amount of debt secured primarily by commercial real estate. As real estate values plummeted in 2007 and 2008, the company’s debt-to-asset ratios became a source for concern.²⁵³ As of December 31, 2008, General Growth reported nearly \$30 billion in assets and just over \$27 billion in liabilities.²⁵⁴ At that time, approximately \$25 billion of General Growth’s liabilities pertained to debt instruments.²⁵⁵ Of this amount, approximately \$18 billion consisted of mortgages on the SPEs’ property, and nearly \$7 billion consisted of unsecured corporate-level debt.²⁵⁶

In better economic times, the company managed cash flow by regularly obtaining mortgage loans secured by the SPEs’ properties, structured with medium-term maturities and balloon payments.²⁵⁷ However, in the aftermath of the financial crisis and recession, General Growth found it increasingly difficult to obtain mortgage loans with acceptable terms. When installment payments on its corporate debt and approximately \$15 billion of mortgage loans came due in 2009,²⁵⁸ the company found itself in default of its obligations.²⁵⁹ Making matters worse, the company was unable to

251. GGP’s “corporate-level” debt is in fact held by a number of upper-tier holding companies.

252. Pershing Square Capital Management, L.P., *The Buck’s Rebound Begins Here*, Presentation at Ira Sohn Conference, May 29, 2009.

253. General Growth’s business suffered from the bursting of the real estate bubble and the subsequent global recession. *See supra* note 178, and source cited therein.

254. General Growth Properties, Inc., Annual Report (Form 10-K) (Dec. 31, 2008).

255. *See id.*

256. *Id.*

257. *In re* Gen. Growth Props., Inc., 409 B.R. 43, 53 (Bankr. S.D.N.Y. 2009).

258. *See* Kris Hudson, *General Growth Switches Its Bankruptcy Counsel*, WALL ST. J. (Jan. 5, 2009), <http://online.wsj.com/article/SB123111371319952447.html> (detailing the company’s struggles); Kelly Johnson, *General Growth Reports \$1.2B in Overdue Debt*, PAC. BUS. NEWS (Feb. 24, 2009), <http://www.bizjournals.com/pacific/stories/2009/02/23/daily26.html?page=all>.

259. Iliana Jonas, *General Growth Says Has Defaulted on Loans*, REUTERS (Feb. 20, 2009), <http://www.reuters.com/article/2009/02/21/generalgrowth-idINN2050986920090221?rpc=44> (describing the termination of a forbearance agreement and the resultant cross-default of corporate debt).

refinance or sell assets to generate cash flow.²⁶⁰

In what would later be dubbed “one of the biggest commercial real estate collapses in United States history,”²⁶¹ General Growth commenced its restructuring process via protracted, out-of-court negotiations. GGP and its corporate-level lenders spent seven months trying to reach a deal.²⁶² When lenders refused to consent to GGP’s proposed out-of-court restructuring,²⁶³ the company and hundreds of its project-level affiliates filed for Chapter 11 bankruptcy in waves commencing in April 2009.²⁶⁴

The decision to file for bankruptcy was strongly encouraged by a new, dominant stakeholder in GGP. In the months leading up to the bankruptcy filing, a hedge fund known for taking activist positions in distressed companies acquired interests amounting to nearly 25% of legal and beneficial ownership of GGP, including the largest (7.5%) stake in the company’s publicly-traded equity security interests. The hedge fund also held approximately \$225 million of GGP’s corporate-level debt, \$177 million of which was acquired for approximately thirty cents on the dollar.²⁶⁵

Additionally, in contemplation of the bankruptcy filing, the hedge fund sought to become GGP’s debtor-in-possession financing lender,²⁶⁶ and received a \$15 million payment for its commitment to

260. David Roeder, *Mall Owner Mauled by Debt*, CHI. SUN-TIMES, Apr. 17, 2009.

261. Michael J. de la Merced, *General Growth Properties Files for Bankruptcy*, DEALBOOK (Apr. 16, 2009), <http://dealbook.nytimes.com/2009/04/16/general-growth-properties-files-for-bankruptcy/>.

262. Daniel Taub & Brian Louis, *General Growth Files Biggest U.S. Property Bankruptcy*, BLOOMBERG (Apr. 16, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=anaZwxRpYcTw>.

263. Ilaina Jonas, *General Growth Fails to Win Bondholder Support*, REUTERS (Mar. 30, 2009), <http://in.reuters.com/article/2009/03/30/us-generalgrowth-idINTRE52T4FV20090330>.

264. *See, e.g.*, Voluntary Petition of General Growth Properties, Inc., *In re* Gen. Growth Props. Inc., No. 09-11977 (Bankr. S.D.N.Y. Apr. 16, 2009), ECF No. 1. Pursuant to FED. R. BANKR. P. 1015(b), the cases were consolidated for procedural purposes under Case No. 09-11977.

265. Dan Wilchins, *Ackman Bets General Growth is Fundamentally Healthy*, REUTERS (Apr. 16, 2009), <http://www.reuters.com/article/2009/04/16/us-generalgrowth-ackman-interview-sb-idUSTRE53F7EH20090416>.

266. The prospective debtor-in-possession financing arrangement was announced by GGP on the same day that it announced its bankruptcy filing, thereby strongly suggesting that the debtor and the hedge fund had been working together to develop the debtor’s Chapter 11 strategy. *See* Press Release, General Growth Properties, Inc., *General Growth Properties, Inc. Files for Chapter 11 Protection; Broken Credit Markets Require GGP to Reduce and Restructure Debt* (Apr. 16, 2009), available at <http://investor.ggp.com/releasedetail.cfm?releaseid=377629>.

lend \$375 million to the company on terms that included interest at a rate equal to LIBOR plus 12% and warrants to buy 4.9% of a reorganized GGP.²⁶⁷ These expensive loan terms do not necessarily reflect the risk of default; with court approval, debtor-in-possession financing arrangements receive a priming lien that effectively ensures repayment.²⁶⁸

However, just before the hearing to consider the proposal, the debtor entertained additional financing proposals from other related parties.²⁶⁹ At the hearing, the hedge fund, through its attorney, pushed to obtain the financing deal: “We made dramatic concessions to get to where we are today We expect the debtors to live by the rules.”²⁷⁰ Notwithstanding these efforts, the court ultimately approved a financing deal from a group of lenders that included certain of GGP’s unsecured creditors.²⁷¹ The approved debtor-in-possession financing contained substantially similar terms, except that the lenders would not receive stock warrants.²⁷²

Following the loss of the financing deal, the hedge fund’s manager began lobbying for a position on the company’s board of directors,²⁷³ and was elected to the board in late May 2009.²⁷⁴ The hedge fund also lobbied on the company’s behalf on Wall Street. In presentations to investors and Wall Street analysts, the fund’s manager asserted that GGP’s publicly-traded common stock was worth substantially more than its trading range.²⁷⁵ In the May 2009

267. Ilaina Jonas, *U.S. Judge OKs Bankruptcy Loan for General Growth*, REUTERS (May 13, 2009), <http://www.reuters.com/article/2009/05/13/generalgrowth-idUSN1343594820090513>.

268. *See* 11 U.S.C. § 364(d) (2012).

269. Helen Chernikoff, *General Growth Bankruptcy Financing Hearing Delayed*, ALIBABA.COM (May 10, 2009), <http://news.alibaba.com/article/detail/markets/100099552-1-update-2-general-growth-bankruptcy-financing.html>

270. *Id.*

271. Press Release, General Growth Properties, Inc., *General Growth Properties, Inc. Announces Court Approval of DIP Financing* (May 13, 2009), available at <http://investor.ggp.com/releasedetail.cfm?releaseid=383933>.

272. Kris Hudson, *General Growth Returns to Farallon for Bankruptcy Financing*, WALL ST. J. (May 13, 2009), <http://online.wsj.com/article/SB124215538672711783.html>.

273. *See, e.g., Ackman Expects to Join General Growth Board*, DEALBOOK (Mar. 17, 2009), <http://dealbook.nytimes.com/2009/03/17/ackman-expects-to-join-general-growth-board/>;

Zachery Kouwe, *A Hedge Fund Manager Wins and Moves On*, N.Y. TIMES (Apr. 16, 2009), <http://www.nytimes.com/2009/04/17/business/economy/17ackman.html>.

274. Nick Zieminski, *Bill Ackman Appointed to General Growth Board*, REUTERS (Jun. 8, 2009), <http://www.reuters.com/article/2009/06/08/generalgrowth-ackman-idUSN0830570020090608>.

275. Daniel Taub, *General Growth Bidding War Looms After Simon Offer*, BLOOMBERG (Feb.

presentation, the manager argued that conditions were ripe for substantial growth in the value of equity security interests during the pendency of, and immediately following, the Chapter 11 reorganization.²⁷⁶ Among the many factors supporting this assertion, the fund's manager noted the fund's dual status as a director and investor, characterizing its role as that of a "shareholder advocate."²⁷⁷

It was perhaps the advocacy of this dominant shareholder that enabled the company to advance an aggressive restructuring plan that turned upon a creative exercise of contract interpretation.²⁷⁸ The company's hundreds of SPEs were, by definition, originally structured as bankruptcy remote. These SPEs had been created to own individual commercial real estate properties in the company's portfolio, most of which secured mortgage loans.²⁷⁹ Since many of these mortgage loans were sold to third-party investors in the form of commercial mortgage-backed securities, ratings firms required that each SPE contractually promise (in its governing documents as well as in corresponding debt instruments) to limit operations in ways that would make the likelihood of bankruptcy remote.²⁸⁰

In particular, the governing documents of the SPEs required unanimous consent of each SPE's managers, including two independent managers, before the SPE could ever file for bankruptcy.²⁸¹ The independent managers were required to "consider only the interests of the Company, including its respective creditors, in acting or otherwise voting on" a bankruptcy filing.²⁸² Finally, most of the agreements provided that the independent managers have a fiduciary duty of loyalty and care similar to that of a

17, 2010), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aMGHfjgIleRI>.

276. Pershing Square Conference Presentation, *supra* note 252, at 26–30.

277. *Id.* at 30.

278. Press Release, AlixPartners, *AlixPartners Honored by the Turnaround Management Association for its Work at General Growth Properties and Neff Rental* (Oct. 10, 2011) ("[A] strategy of sequencing negotiations was . . . employed to establish certainty around [GGP's] ability to reorganize and retain properties with acceptable financing terms on a bottom-up basis within the organizational structure.").

279. Amended Brief of Amici Curiae with Respect to the Filing of Voluntary Petitions in Bankruptcy by the Individual Property Owner Subsidiaries, *In re Gen. Growth Props. Inc.*, No. 09-11977 (Bankr. S.D.N.Y. May 1, 2009), ECF No. 289.

280. *Id.* at 7 (describing the "twin components of asset isolation").

281. *In re Gen. Growth Props.*, 409 B.R. 43, 63 (Bankr. S.D.N.Y. 2009).

282. *Id.* (emphasis omitted).

director of a corporation organized under Delaware law.²⁸³

Just prior to the General Growth bankruptcy filing, approximately 159 of the independent managers were terminated from the boards of their respective SPEs, and new independent managers were appointed.²⁸⁴ The newly appointed independent managers consented to the SPE bankruptcy filings; in many cases, the former independent managers were not even aware of their termination until after the bankruptcy filing.²⁸⁵

Not surprisingly, the SPEs' bankruptcy petitions were met with strong objections from their mortgage lenders.²⁸⁶ These secured creditors filed motions to dismiss the SPEs' bankruptcy cases, arguing that the SPEs were not financially distressed and had filed for bankruptcy solely to benefit GGP in a manner detrimental to the SPEs' mortgage lenders.²⁸⁷ Attempting to assist the SPEs' secured creditors via an amicus brief, an attorney representing the Commercial Mortgage Securities Association characterized the SPE bankruptcies as "GGP's attempt to ignore organizational formalities."²⁸⁸

However, the bankruptcy court approved the SPEs' Chapter 11 petitions, finding that the secured creditors had not demonstrated objective futility of the filings.²⁸⁹ Specifically, the court rejected the secured creditors' argument that the question of whether a filing is made in good faith should be viewed only from each individual debtor's perspective.²⁹⁰ Instead, the court looked to the interests of the enterprise as a whole, finding that a subsidiary may be included in the bankruptcy of its parent regardless of the financial health of

283. *Id.*

284. *Id.* at 67–68.

285. *See id.*

286. Mark S. Edelstein, et. al., *Bad Boy Guaranty Update: Lenders on a Winning Streak*, in *Real Estate Weekly* (Mar. 3, 2010), at 285–86 (PLI Negotiating Real Estate Deals, Course Handbook Ser. No. N-591, 2011) (exploring bankruptcy remote entities as credit enhancements).

287. *See, e.g.*, Motion of ING Clarion Capital Loan Services LLC, Pursuant to 11 U.S.C. § 1112(b), to Dismiss the Cases of Bakersfield Mall, LLC, RASCCAP Realty, Ltd.; Visalia Mall, L.P.; GGP-Tucson Mall L.L.C.; Lancaster Trust; HO Retail Properties II Limited Partnership; RS Properties Inc.; Stonestown Shopping Center L.P.; and Fashion Place, LLC, Amended Brief of Amici Curiae with Respect to the Filing of Voluntary Petitions in Bankruptcy by the Individual Property Owner Subsidiaries, *In re Gen. Growth Props. Inc.*, No. 09-11977 (Bankr. S.D.N.Y. May 4, 2009), ECF No. 334.

288. Brief of Amicus Curiae, *supra* note 279, at 19.

289. *In re Gen. Growth Props.*, 409 B.R. 43, 65 (Bankr. S.D.N.Y. 2009).

290. *Id.* at 69–70.

the subsidiary.²⁹¹

What is more, with respect to the SPEs' independent managers, the court found that the termination, while "admittedly surreptitious," was not indicative of subjective bad faith on the part of the debtors sufficient to require dismissal of the bankruptcy cases.²⁹² The court applied the reasoning of Delaware cases, asserting that directors of a solvent corporation owe their fiduciary duties to the corporation and its shareholders.²⁹³ Thus, the independent managers could lawfully approve the bankruptcy filings notwithstanding the entities' bankruptcy remote status, since the decision to file for bankruptcy was made at a time when each SPE was a solvent corporation and the decision was in the best interests of GGP as shareholder.²⁹⁴

Finally, GGP requested authorization to use rents collected from the SPEs' mall tenants.²⁹⁵ Although these rents constituted the secured creditors' cash collateral,²⁹⁶ GGP argued that access to this cash flow was necessary to enable the company to continue its business operations.²⁹⁷ The SPE lenders objected, claiming that it would violate principles of legal separateness for GGP to "upstream cash from the individual properties for use at the parent-level entity."²⁹⁸ In granting GGP's request to use the cash, the court ruled that the company may upstream cash "at a time it was needed most by the Group," and that the SPE lenders would receive adequate protection in exchange for permitting GGP to use the cash

291. *See id.*

292. *Id.* at 68.

293. *Id.* at 64–65.

294. *Id.*

295. *In re Gen. Growth Props.*, 409 B.R. at 55; *see also* Debtors' Motion for Interim and Final Orders Pursuant to Sections 105(a), 363(b), 363(c) and 364(a) of the Bankruptcy Code and Bankruptcy Rules 6003 and 6004 (a) for Authorization to (I) Continue Using Existing Centralized Cash Management System (II) Honor Certain Prepetition Obligations Related to the Use of the Cash Management System, and (III) Maintain Existing Bank Accounts and Business Forms; (B) for An Extension of Time to Comply with Section 345(b) of the Bankruptcy Code; and (C) Scheduling a Final Hearing, *In re Gen. Growth Props. Inc.*, No. 09-11977 (Bankr. S.D.N.Y. Apr. 16, 2009), ECF No. 8.

296. Under 11 U.S.C. § 363(a), "cash collateral" includes cash, cash equivalents, proceeds and accounts receivable. A debtor is prohibited from using cash collateral without a secured lender's consent or a court order authorizing the debtor's use. 11 U.S.C. § 363(c)(2) (2012).

297. *See supra* note 295 and sources cited therein.

298. *In re Gen. Growth Props.*, 409 B.R. at 55.

collateral.²⁹⁹

With the SPEs safely in bankruptcy and GGP authorized to use the SPEs' rental income, SPE creditors were highly incentivized to agree to a restructuring of the mortgage loans. By February 2010, General Growth completed negotiations with 231 of the SPE creditors.³⁰⁰ In most cases, the restructuring entailed a modification of loan terms, including extension of the maturity date.³⁰¹

As General Growth's SPE-level debt burdens were gradually alleviated via the SPE restructurings, focus shifted to restructuring GGP's corporate-level debt and planning the parent company's reemergence from bankruptcy. To this end, the company explored strategic opportunities, such as a sale of the entire company.³⁰² General Growth received an unsolicited acquisition offer from its competitor, retail mall operator Simon Property Group ("Simon").³⁰³ Pursuant to the offer, all corporate-level creditors would be paid in full and equity security holders would receive approximately \$9 per share.³⁰⁴ GGP rejected the offer, citing a desire to explore all strategic options.³⁰⁵ In the days following Simon's bid,

299. *Id.*; see also 11 U.S.C. § 363(c)(2), (e).

300. General Growth Properties, Inc., Annual Report (Form 8-K) (Mar. 1, 2010).

301. See, e.g., Press Release, General Growth Properties, Inc., General Growth Properties Announces Bankruptcy Court Confirmation of Plans of Reorganization for Approximately \$10.25 Billion of Secured Mortgage Loans (Dec. 15, 2009), available at <http://www.ggp.com/about-ggp/press-releases/general-growth-properties-announces-bankruptcy-court-confirmation-of-plans-of-reorganization-for>; Press Release, General Growth Properties, Inc., General Growth Properties Reaches Agreement in Principle on Certain Mortgage Related Debt (Nov. 19, 2009), available at <http://investor.ggp.com/releasedetail.cfm?ReleaseID=425484>.

302. See Press Release, General Growth Properties, Inc., General Growth Properties Announces Next Steps in Restructuring Process (Dec. 17, 2009), available at <http://www.businesswire.com/news/home/20091217005359/en/General-Growth-Properties-Announces-Steps-Restructuring-Process> ("[T]he Board of Directors and management are considering all indications of interest in the Company.").

303. Michael J. de la Merced, *With Big Takeover Bid, Simon Aims to Control 30% of U.S. Malls*, N.Y. TIMES (Feb. 16, 2010), <http://www.nytimes.com/2010/02/17/business/17mall.html>; see also Press Release, General Growth Properties, Inc., General Growth Properties Responds To Simon Property Group and Reaffirms Bankruptcy Emergence Process (Feb. 16, 2010), available at <http://www.businesswire.com/news/home/20100216007615/en/General-Growth-Properties-Responds-Simon-Property-Group>.

304. Taub, *supra* note 275.

305. Press Release, *supra* note 303 (quoting GGP's letter to Simon: "We and our board of directors have given considerable thought to your indication of interest and have concluded based on discussions with other interested parties that it is not sufficient to preempt the process

GGP's stock price soared.³⁰⁶ Wall Street analysts reiterated positive ratings on the bankrupt company, citing a belief that "management will do what maximizes the value for its shareholders."³⁰⁷

In the months that followed, Simon revised its bid and lobbied for support among GGP's stakeholders.³⁰⁸ GGP's unsecured creditors backed the proposal, alleging that the General Growth restructuring was mired by conflicts of interest caused by the hedge fund's position as a director of the company, a dominant creditor, and its largest equity security holder.³⁰⁹ In a motion filed in the bankruptcy court, the Official Committee of Unsecured Creditors (the "Unsecured Creditors Committee") expressed its concern that the debtors were "attempting to . . . force upon their creditors a lengthy and uncertain Capital Raise/M&A Process, rather than pursue a transaction that would guarantee . . . creditors . . . cash payment in full and provide . . . equity holders with a substantial distribution."³¹⁰ What is more, the Unsecured Creditors Committee accused the debtors of "ignoring their fiduciary duty to creditors by . . . pursu[ing] a Capital Raise/M&A Process designed solely to benefit equity holders at great risk to creditors' recoveries."³¹¹ The Unsecured Creditors Committee expressed a preference for the Simon offer because it would provide a timely and more certain cash recovery; in contrast, the pursuit of other strategic alternatives would bring delays, risks, uncertainty and substantial transaction costs.³¹² In addition, the Unsecured Creditors Committee accused

we are undertaking to explore all avenues to emerge from Chapter 11 and maximize value for all the Company's stakeholders.").

306. Kris Hudson, *Simon Offers \$10 Billion for General Growth*, WALL ST. J. (Feb. 17, 2010), <http://online.wsj.com/article/SB10001424052748704804204575069081644845898.html> ("Investors expect a sweetened bid from either Simon or from any competing plan General Growth offers for its exit from bankruptcy. On Tuesday they pushed General Growth's stock up \$2.62 to \$12.02—more than \$3 above the offer price—in 4 p.m. trading on the so-called Pink Sheets electronic trading system.").

307. *Id.*

308. Barton Eckert, *Simon Property Enhances Bid for General Growth Properties*, WASH. BUS. J. (Apr. 23, 2010), <http://www.bizjournals.com/washington/stories/2010/04/19/daily81.html>.

309. *See infra* note 310 and source cited therein.

310. Objection of the Official Committee of Unsecured Creditors to Debtors' Motion Pursuant to Section 1121(d) of the Bankruptcy Code Requesting a Second Extension of Exclusive Periods for Filing a Chapter 11 Plan and Solicitation of Acceptances Thereto at 2, *In re Gen. Growth Props. Inc.*, No. 09-11977 (Bankr. S.D.N.Y. Feb. 24, 2010), ECF No. 4486.

311. *Id.*

312. *Id.* at 4–6.

the debtors of attempting to “inflate value for their equity holders” by raising, through strategic alternatives, “only the minimum amount of capital needed to achieve . . . emergence from chapter 11 and to equitize large portions of [corporate level] unsecured debt at an artificially high equity value.”³¹³

In essence, the Unsecured Creditors Committee accused the company’s dominant equity security holders—and in particular, the hedge fund—of controlling General Growth’s bankruptcy and engaging in dilatory measures in the hopes of benefiting equity at the potential expense of creditors.³¹⁴ Indeed, neither GGP nor the hedge fund ever expressly denied delaying the company’s exit from bankruptcy; for instance, in its motion for an extension, GGP noted that it could not yet file a Chapter 11 plan because it needed to give “the marketplace . . . an opportunity to fairly value General Growth’s enterprise.”³¹⁵

In May 2010, Simon made a “last-ditch offer” valued at approximately \$20 per share.³¹⁶ GGP avoided Simon’s bid by entering into a stalking horse arrangement for approximately \$10.50 per share, also granting Pershing Square and several other investors warrants worth approximately \$688 million to acquire stock in the reorganized company in exchange for financing.³¹⁷ In October 2010, GGP advanced a Chapter 11 plan that was accepted by majorities in all classes entitled to vote. Under the plan, all creditor claims would be satisfied, equity security holders would receive approximately \$15 per share, and the company would be recapitalized pursuant to an equity infusion of \$7 to \$8.5 billion.³¹⁸ In accordance with the plan, GGP exited bankruptcy in November 2010 and followed through with a proposed split of the company into two separate, publicly-

313. *Id.* at 5.

314. *Id.* at 20–21.

315. Debtors’ Motion Pursuant to Section 1121(d) of the Bankruptcy Code Requesting a Second Extension of Exclusive Periods for Filing a Chapter 11 Plan and Soliciting Acceptances Thereof at 2, *In re Gen. Growth Props. Inc.*, No. 09-11977 (Bankr. S.D.N.Y. Jan. 29, 2010), ECF No. 4296.

316. Robert Carr, *Court Agreement Ends GGP Bankruptcy Bid Battle*, AMLAW DAILY (May 7, 2010), http://www.law.com/jsp/article.jsp?id=1202457889043&Court_Agreement_Ends_General_Growth_Bankruptcy_Bid_Battle.

317. Tiffany Kary & Daniel Taub, *General Growth Wins Court Approval of Brookfield-Led Bid Over Simon Offer*, BLOOMBERG (May 7, 2010), <http://www.bloomberg.com/news/2010-05-07/general-growth-wins-court-approval-of-brookfield-led-bid-over-simon-offer.html>.

318. Press Release, *supra* note 278.

traded companies.³¹⁹ The hedge fund's manager was appointed chairman of one of the spinoff companies.³²⁰

C. Insights Gained from the New Explanatory Model

A central claim of this Article is that a broader explanatory model, drawing on the analytical tools of modern political economy, allows thicker narratives of Chapter 11 negotiations. Examining the two case studies under this alternative framework, it appears that the outcomes of Chapter 11 cases are very much driven by internal dynamics. These dynamics, which take place beyond the myopic view of the unitary actor model, undercut the persistent claim that negotiated Chapter 11 outcomes yield fair and efficient resolutions of corporate financial distress. And as the current bankruptcy process relies on such an Efficiency Fallacy, our judicial approach to Chapter 11 stands in stark need of reform.

As a preliminary matter, the case studies reveal some shortcomings of neoclassical economic theory as a foundation of commercial bankruptcy law. In particular, the model's persistent unitary actor construct is inadequate when applied to complex organizations. For instance, in the Washington Mutual restructuring, it is misleading to conceptualize the debtor as the same deliberate, rational actor that previously led a successful business enterprise. Prior to the FDIC's sale of the bank to JPMorgan, Washington Mutual was a family of business entities with an extensive infrastructure to oversee a large banking and investment business.³²¹ In contrast, during the Chapter 11 case, Washington Mutual was a decimated corporate shell, with negotiations largely handled on its

319. A new company was formed to own indirectly substantially all of the equity of reorganized GGP. Another new company, The Howard Hughes Corporation, was formed to hold a portfolio of developing properties. *Id.* at 2; see also Daniel J. Sernovitz, *Park Meadows Owner General Growth Properties Exits Bankruptcy*, DENVER BUS. J. (Nov. 10, 2010, 7:09 AM), <http://www.bizjournals.com/denver/news/2010/11/10/general-growth.html>.

320. Adam Castiglioni, *Faneuil Hall Operator Out of Ch. 11*, BOSTON HERALD (Nov. 10, 2010), <http://www.bostonherald.com/business/general/view.bg?articleid=1295271>.

321. Washington Mutual, Inc., Annual Report (Form 10-K), *supra* note 176, at 1.

behalf by dominant creditors. Similar recognition must be made as to purportedly unitary classes of “creditors” and “equity security holders.” For instance, in the WMI restructuring, the Settlement Noteholders assumed a dominant position among “creditors”; likewise, in the GGP restructuring, a hedge fund assumed a dominant position among “equity security holders.”

Having identified some of the individuals and pressure groups driving collective action in the two case studies, the new explanatory model next invites us to identify the economic decision-making preferences of such persons. In the WMI restructuring, dominant creditors clearly sought full satisfaction of their claims. At a minimum, full satisfaction would make the creditors whole. However, to the extent individual creditors purchased their claims on the secondary market for less than face value, full satisfaction would enable them to profit from the restructuring. In contrast, in their secondary role as PIERS claimants, the dominant creditors did not desire full satisfaction of claims, but rather sought some degree of impairment sufficient to meet statutory requirements for plan approval.³²² What is more, it is important to note that these dominant creditors had no economic incentive to advance a restructuring outcome that would increase the bankruptcy estate beyond the face value of all unimpaired creditor claims—particularly if such an outcome would require protracted litigation, delays, and uncertainties.

In contrast, in the General Growth restructuring, a hedge fund that specialized in distressed company investing sought to take advantage of the full upside potential of its equity security investments. In an effort to obtain formal authority to act on behalf of the debtor, the fund’s manager increased its equity share, sought and obtained a seat on the board of directors, and attempted to become the company’s debtor-in-possession lender. The hedge fund’s desire to realize GGP’s full upside potential steered the restructuring away from the more immediate Simon offer, towards less certain outcomes that had the potential to generate higher long-term profits. Although the fund’s profit maximization goals were to some extent correlated with the profit maximization goals of other

322. Of course, given that the dominant creditors allegedly acquired PIERS claims on the secondary market, it is possible that they would achieve a profit even from partial satisfaction of the face value.

equity security holders, the fund's investments in the debtor also included substantial debt positions, a position on the board of directors, a prospective position as the debtor-in-possession lender, and a prospective position as a large stakeholder in a post-bankruptcy spinoff company. Thus, while the ultimate restructuring outcome may have been beneficial to all equity security holders, it also included components that would only benefit certain equity security holders.

As collective action principles suggest, organizational actors that represent more concentrated constituents and operate with clear authority can be expected to take more decisive steps in restructurings. Thus, the FDIC, acting under a statutory grant of complete authority, was able to rapidly coordinate the sale of WMB to JPMorgan to avoid depletion of its Deposit Insurance Fund.³²³ The FDIC accomplished this task without the need to negotiate with Washington Mutual's stakeholders and without reference to "an idealized value . . . that . . . would arise if a perfect market were at work."³²⁴ Indeed, there appear to have been minimal market checks on the sale. Similarly, the Settlement Noteholders were able to rise to a position of dominance in the Washington Mutual restructuring because they were similarly situated hedge funds holding large shares of corporate-level debts. In contrast, WMI's equity security holders were widely dispersed, and although they eventually mobilized, their coalition-building process was much slower and required bold action and even personal exposure to reach the level of influence that other persons enjoyed from the very beginning.

Having identified the profit maximization goals of these dominant individuals and pressure groups, we can better understand the effect of these interests on the Chapter 11 case outcomes. In the Washington Mutual restructuring, the Settlement Noteholders sought to advance their own profit maximization goals related to debt and equity investments made immediately before and during WMI's bankruptcy. After a lengthy battle, the Settlement Noteholders offered a modest settlement to equity security holders in an effort to obtain their buy-in to the Chapter 11 plan. Similarly, in the General Growth restructuring, a hedge fund with a dominant

323. See *supra* note 189 and accompanying text.

324. Roe, *supra* note 34, at 530.

equity stake pushed to obtain a restructuring outcome that secured maximum returns on equity investments.

The new explanatory model also allows us to more readily identify potential economic rents. In the Washington Mutual restructuring, dominant creditors allegedly used information asymmetries to profit from insider trading in the debtor's securities, extracting economic rents from other, less knowledgeable traders in the securities market. Similarly, in the General Growth restructuring, dominant equity security holders arguably extracted economic rents from other constituents in the form of additional equity conversions as well as a large commitment fee for debtor-in-possession financing.³²⁵

In essence, the new explanatory model offers a different account of negotiated outcomes in Chapter 11, which stands in contrast to the account provided by neoclassical economic theory. Consistent with the early criticisms of Chapter 11, rather than reflecting the price equilibrium of a competitive market, outcomes continue to reflect the successful occupation of large organizational actors by certain dominant individuals and pressure groups, who seek to advance their own profit maximization goals.³²⁶

What is more, it appears from the case studies that when these individuals and pressure groups obtain control of large organizational actors, they do not in fact rely upon negotiation to reach restructuring outcomes. Somewhat counter intuitively, it appears that dominant interests strategically use Chapter 11 to overturn the customary commercial expectations of less powerful parties. For instance, in the Washington Mutual restructuring, rather than seek to negotiate with equity security holders, dominant creditors initially sought to utilize the legal process to discourage and stifle their efforts. Similar challenges were faced by General Growth's mortgage lenders, whose claims were dispersed across hundreds of SPE entities; indeed, dominant equity security holders successfully used Chapter 11 to interfere with the SPE lenders'

325. And, as hinted by strong advocacy efforts to obtain the debtor-in-possession financing deal, these dominant interests also sought rents in the form of high rates of interest and additional loan fees—common features of debtor-in-possession financings arranged by insiders.

326. Themes of this sort are explored empirically in Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11 Bankruptcy*, 1 J. LEGAL ANALYSIS 511 (2009) (examining data on 153 large companies' Chapter 11 cases to show that creditors largely control Chapter 11 restructurings and that such control distorts the efficiency of case outcomes).

customary commercial expectations with respect to SPE covenants they previously agreed upon in routine mortgage securitization transactions. Taken together, these observations not only reaffirm the early criticisms of Chapter 11, but also reveal new insights about commercial restructurings that were previously omitted from the narratives that shape law and policy. For one thing, the case studies suggest that the Chapter 11 process favors powerful actors,³²⁷ such as hedge funds acting under streamlined management by charismatic leaders, and governmental agencies operating under strong statutory grants of power.

And, most provocatively, the case studies suggest that against this backdrop, market mechanisms are used by those with existing “market power”³²⁸ in the securities and capital markets to gain a considerable advantage in negotiations. Specifically, these actors use their existing market power to take extraordinary predicate measures to enhance their bargaining power or gain increased control over restructuring outcomes. For instance, such persons may strategically acquire additional interests in (or claims against) the debtor via the debt and securities markets, or exert pressure to gain managerial control over the debtor to steer prospective financing or acquisition deals.³²⁹

Even more damning to the Efficiency Fallacy and the modern faith in market mechanisms, the case studies suggest that actors are able to utilize market power to engage in opportunistic and

327. Such parties are reminiscent of the cartels that are the focus of antitrust law.

328. Market power is the ability of a market participant to alter market prices—typically above competitive levels. In a perfectly competitive market, no participant has this power. Participants gain market power by controlling a dominant share of the market. For instance, in a monopoly, a single participant controls the entire market and thus enjoys market power. Similarly, participants in a highly concentrated market may enjoy market power where there are significant barriers to entry for prospective competitors. See Massimiliano Vatrio, *An Institutional Explanation of Market Dominances*, 32 L. & ECON. REV. 221 (2009).

329. See generally Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703 (2008). For examples of these phenomena, see Joann S. Lublin, *Delphi Names Directors; No Board Seat for CEO*, WALL ST. J. (Nov. 4, 2009), <http://online.wsj.com/article/SB10001424052748703294004574513832241231354.html> (describing the post-Chapter 11 bankruptcy overhaul of Delphi Automotive LLP orchestrated by General Motors Co. and dominant lenders); Simeon Gold & Daniel Holzman, *Shopping for Distressed Companies*, METRO. CORP. COUNSEL 42 (2008) (describing strategic purchases of claims against the debtor in commercial bankruptcies); see also Nathan Bomey, *Hedge Funds Seeking to Capitalize on Detroit's Bankruptcy*, DETROIT FREE PRESS (Aug. 25, 2013), <http://www.freep.com/article/20130825/NEWS01/308250060/Detroit-bankruptcy-hedge-funds-investors> (noting similar behavior by hedge funds in a recent municipal bankruptcy).

anticompetitive tactics during the course of the restructuring. For instance, in both case studies, surreptitious efforts were made to reconfigure the boards of various organizational actors so that they would serve the needs of dominant individuals and pressure groups. Similarly, dominant creditors in the Washington Mutual case study may have engaged in “class gerrymandering” to ensure that a plan advancing their profit maximization goals would achieve requisite approvals.³³⁰ In each example, dominant interests utilized their existing market power to effectively curtail any genuine market clearinghouse function that might exist for control of organizational actors or of the restructuring generally. In this way, dominant stakeholders are able to essentially operate as a cartel, colluding to restrict access to, and raise the price of, restructuring outcomes. Such steps are taken to maximize individual profits and extract rents.

What is more, by these inefficiencies, Chapter 11 carries tremendous deadweight and opportunity costs, as parties divert productive resources away from market activity and instead focus such resources on gaining control of the restructuring and extracting rents.³³¹ The market failure is aided by a legal construct that grants structural privileges to large, organizational actors and those stakeholders who can use their existing market power to gain control. Thus, far from being a competitive environment, commercial restructurings under Chapter 11 may have more in common with monopolistic environments.

As political economists have argued for decades, hierarchy, authority to act on behalf of others, and the exercise of power all create inefficiencies.³³² Once analyzed under the new explanatory model, Chapter 11 evidences these concerns, as *both* its consensus- and market-based processes appear to be mired by self-dealing, conflicts of interest,³³³ and information asymmetries.³³⁴ More to the

330. See *supra* note 230 and accompanying text.

331. These themes are explored in Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, AM. ECON. REV., June 1974, at 291; Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967).

332. CARSON, *supra* note 143, at 2–3.

333. Conflicts of interest are common in corporate reorganizations. In a recent empirical study, a “majority of professionals and [creditors’] committee members reported being involved in cases where . . . a member of the committee possessed a conflict of interest (67.6% of professionals and 52.4% of committee members).” Harner & Marincic, *supra* note 109, at 1172. Conflicts arise because committee members harbor conflicting self-interest or consistently

point, if the exchanges that occur in Chapter 11 restructurings are imperfect or fundamentally anticompetitive, we can paraphrase a question raised by Professor Allison with respect to rational actor models of state policy decisions: to whose objectives does the neoclassical paradigm refer?³³⁵ Indeed, the Efficiency Fallacy, and the Chapter 11 framework it supports, are undoubtedly called into question.

In essence, even with its modern reliance on market mechanisms, Chapter 11 still does not come any closer to achieving “an idealized value of the bankrupt that . . . would arise if a perfect market were at work,”³³⁶ but rather draws upon principles of “instrumental rationality”³³⁷ to privilege the profit maximization goals of powerful parties. The Efficiency Fallacy provides a “calculation that makes plausible the character of the action chosen,” drawing primarily upon the observer’s “reasoning,” or ability to think through the restructuring problem.³³⁸ In other words, the Efficiency Fallacy endures, notwithstanding its shortcomings, because it is intellectually convenient. It provides justification for otherwise unjustifiable extractions of rents from, and assignments of economic burdens to, constituents who are largely excluded from the legal process. In light of the insights gained from decades of social science and legal scholarship in the areas of corporate law and bankruptcy, this antiquated and flawed paradigm cannot be sustained. Certainly, it cannot be relied upon to guide modern efforts to reform Chapter 11. A new explanatory model can generate legal reforms that have the power to produce efficiency gains.

Of course, having argued that Chapter 11 is not necessarily a competitive (and therefore efficient) legal mechanism, a deeper question emerges: to what extent *should* Chapter 11 promote

promote the interests of a favored member over the objections of other members. *See id.* at 1172–73. These concerns are further explored in Michelle M. Harner, *Committee Capture? An Empirical Analysis of the Role of Creditors’ Committees in Business Reorganizations*, 64 *VAND. L. REV.* 749 (2011).

334. Information asymmetries in corporate bankruptcies are explored in Harner, *supra* note 63. For instance, “Committee members . . . have access to and may use the corporation’s confidential information to advance their own business agendas.” *Id.* at 474.

335. ALLISON, *supra* note 27, at 247.

336. Roe, *supra* note 34, at 530.

337. Instrumental rationality is explored in Owen M. Fiss, *Reason in all its Splendor*, 56 *BROOK. L. REV.* 789 (1990).

338. ALLISON, *supra* note 27, at 247.

economic efficiency? To be sure, economic efficiency is an important consideration because sound commercial restructuring procedures facilitate the smooth operation of credit markets. However, even if economic efficiency is the desired goal of law and policy, which definition of efficiency ought to prevail?³³⁹ Finally, to what extent should economic efficiency concede to other important societal goals, such as equity and fairness? The discourse on the normative foundations of Chapter 11 (and corporate finance more broadly) is still very much evolving in the wake of the recent financial crisis, and a broader, interdisciplinary perspective is needed. By acknowledging that the prevailing theoretical construct is not sufficiently complex to address the nuances of modern restructurings, we move closer to fully engaging these and other essential questions.

D. Opportunities for Legal Reform

Broadly speaking, the insights gained from the new explanatory model reveal that deeper legal and structural changes are needed before we can expect either consensus- or market-based processes to yield efficient outcomes in Chapter 11 cases. There is likely a need for an enhanced role of the judge in Chapter 11, to monitor negotiations and conduct within firms, committees and other organizational actors. The case studies suggest that internal governance mechanisms do not necessarily create effective clearinghouse functions that lead to efficient decision-making by organizational actors. Although courts have traditionally directed injured stakeholders to pursue their claims via expensive suits to recover monetary damages, such recourse ignores the fact that internal dynamics can have a direct influence on restructuring outcomes. This is particularly true of the debtor's internal dynamics, because in most cases the debtor has the exclusive right to file a Chapter 11 plan for a period of 120 days.³⁴⁰

As one potential solution, bankruptcy courts could more readily use their existing statutory powers to address problems that arise

339. Alternatives to the total welfare model include allocative efficiency and consumer welfare models. See Wolfgang Kerber, *Should Competition Law Promote Efficiency? Some Reflections of an Economist on the Normative Foundations of Competition Law*, in JOSEF DREXL, ET. AL., *ECONOMIC THEORY AND COMPETITION LAW* 93 (2008).

340. 11 U.S.C. § 1121(b) (2012).

among the debtor's constituents and its management.³⁴¹ In particular, courts could utilize their investigative powers to ensure that control of large organizational actors is obtained and exercised in a legitimate and transparent manner. At a minimum, bankruptcy rules should allow the court to routinely pierce the unitary actor construct and should strive to expand the scope of persons with standing to appear. Where it seems that the debtor is steered by faithless fiduciaries or persons who are utilizing market power to gain control of the restructuring, then the court might appoint a trustee in a full or limited capacity to monitor the proceedings and ensure that the goals of Chapter 11 bankruptcy process are being protected and promoted by the parties.³⁴² In the same fashion, the court might appoint an examiner to negotiate on the debtor's behalf, supervise the negotiations, assess potential causes of action or file a Chapter 11 plan.³⁴³ Alternatively, the court could more carefully supervise or replace, where necessary, committees and other agents that are entrusted with a fiduciary obligation to represent constituent interests.

Similarly, legal reforms should focus upon ensuring greater transparency and accountability, which are essential for the proper functioning of market mechanisms.³⁴⁴ As a starting place, reform efforts should focus upon enhancing required disclosures of organizational actors, with a particular emphasis on more fully identifying their constituents' actual economic interests. For instance, Rule 2019 disclosure requirements were updated in 2011 to include disclosure of hedging transactions and other forms of modern financial engineering, to the extent such transactions have the potential to impact a person's actual economic interest in relation to the restructuring.³⁴⁵ However, simultaneous

341. The court has such powers under 11 U.S.C. § 1104.

342. Kelli Alces explores the potential role of a trustee to address situations where the debtor's constituents are highly fractured and/or there are allegations of breaches of fiduciary duties. Kelli A. Alces, *Enforcing Corporate Fiduciary Duties in Bankruptcy*, 56 U. KAN. L. REV. 83 (2007).

343. Bankruptcy courts are authorized to appoint examiners to carry out any duties of a trustee that the court orders the debtor in possession not to perform. 11 U.S.C. § 1106.

344. IAN BREMMER, *THE END OF THE FREE MARKET: WHO WINS THE WAR BETWEEN STATES AND CORPORATIONS?* 29 (2010).

345. FED. R. BANKR. P. 2019(a)(1) (reflecting 2011 amendments). This is a substantial break from tradition, as derivative transactions typically slip through the cracks of most disclosure requirements. Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit*

amendments exclude from the rule's coverage certain entities that represent multiple creditors or equity security holders under formal legal arrangements of trust or contract law.³⁴⁶ This exclusion bolsters the unitary actor model in the creditor context and also allows certain participants in the bankruptcy proceeding to avoid the expanded disclosure obligations that are imposed on other, direct participants. Thus, in an effort to increase transparency, the more expansive, proposed amendment to the rule ought to be reconsidered.³⁴⁷

Likewise, the practice of claims trading should be carefully scrutinized, particularly given its potential to further privilege those parties who are able to use their market power to "accumulate a debtor's unsecured debt to obtain a seat at the negotiating table."³⁴⁸ Such conduct can be detrimental: "Because the creditor is not required to disclose its position, and because only select parties are privy to the debtor's restructuring negotiations, the creditor may be able to leverage the process to its distinct advantage."³⁴⁹ In fact, recent empirical research suggests a rising degree of influence by single creditors or factions of dominant creditors in the restructuring process.³⁵⁰ As a result, "[T]he interests of junior stakeholders and the company itself may be harmed."³⁵¹ The case studies demonstrate that claims trading can be utilized for strategic purposes by a variety of participants in a Chapter 11 proceeding; and, when combined with the practice of class gerrymandering, it allows persons with market power to control the plan confirmation process. Specific reforms might include increased disclosure requirements to identify new ownership in claims and to identify each person's actual economic interest in acquired claims,³⁵² as well as limitations specifically designed to curb insider trading violations and strategic acquisition of majority stakes for plan confirmation purposes.

Derivatives, 75 U. CIN. L. REV. 1019, 1036 (2007).

346. FED. R. BANKR. P. 2019(a)(1) (reflecting 2011 amendments).

347. See Proposed Amendments, *supra* note 96.

348. Harner & Marincic, *supra* note 109, at 1158-59.

349. *Id.* at 1159.

350. *Id.* at 1170.

351. *Id.* at 1159.

352. Proposals of this sort are considered in Joy Flowers Conti, Raymond F. Kozlowski, Jr. & Leonard S. Ferleger, *Claims Trafficking in Chapter 11— Has the Pendulum Swung Too Far?*, 9 BANKR. DEV. J. 281 (1992).

Of course, reform proposals of this sort have faced resistance in the past. Courts and rule-makers have been sensitive to arguments raised by industry groups representing hedge funds and other sophisticated investors, who claim that burdensome disclosure requirements will impair the functioning of the securities market by revealing trading strategies and other confidential investor information.³⁵³ Similarly, rule-makers have heeded the warning that limitations on claims trading will impair the market-based exit and entry mechanisms that theoretically enable bankruptcy claims to reach the highest value end-users.

In weighing these policy considerations, modern reformers should consider that wherever persons with an interest in a Chapter 11 case are permitted to organize collectively and act as a group to advance positions and gain a seat at the bargaining table, their collective action confers benefits that privilege the interests of certain stakeholders over those of other stakeholders who are not able to effectively organize. These benefits might justify some degree of burden, including heightened disclosure requirements or trading limitations. In other words, the normative debate must acknowledge that while it may be true that increased regulatory requirements in commercial bankruptcy can lead to adverse market consequences, there are also more immediate inefficiencies that can arise when there are no checks on anticompetitive conduct. The key question for reformers is not *whether* inefficiencies will arise, but rather *who* should bear the cost of the inevitable inefficiencies.

A more dramatic overhaul of Chapter 11 may be necessary. The inefficiencies examined in this Article seem likely to worsen in a world where secured creditors often claim all of a debtor's business assets,³⁵⁴ and where Chapter 11 is increasingly used to conduct corporate liquidations³⁵⁵ or "quasi-liquidations."³⁵⁶ In such a world,

353. See, e.g., Brief of Amici Curiae SIFMA and LSTA in Support of Noteholder Group's Objection to Scotia Pacific Company LLC's Motion for Order Compelling Ad Hoc Committee to Fully Comply with Rule 2019(a) by Filing Complete and Proper Verified Statement Disclosing Its Membership and Their Interests at 2, *In re* Scotia Development, LLC, No. 07-20027 (Bankr. S.D. Tex. Apr. 9, 2007).

354. This new reality is eloquently described in Harvey R. Miller, *Bankruptcy and Reorganization Through the Looking Glass of 50 Years (1960-2010)*, 19 J. BANKR. L. & PRAC. 3 art. 1 (2010).

355. Business debtors increasingly conduct liquidations under Chapter 11 rather than Chapter 7. See, e.g., H. Jason Gold & Dylan G. Trache, *Liquidation of Troubled Businesses: Chapter 11 Liquidations Increasing*, METRO. CORP. COUNSEL 10 (2009); Michael Cooley, *How to Succeed at*

commercial restructurings do not turn on the debtor's future ability to generate income to repay creditors, as Chapter 11 originally contemplated. Rather, they often devolve into disputes over less readily calculable and intangible assets, such as contracts and pending litigation claims, or the future ability to utilize tax benefits, such as net operating loss carryforwards.³⁵⁷ As a result, the restructuring process becomes even more political, with negotiations focusing on the distribution of economic burdens, on one hand, and the exploitation of rent-seeking opportunities, on the other. In situations of this sort, the risk of self-dealing, conflicts of interest, opportunism, information asymmetries and collective action obstacles becomes even higher, as parties stand to gain substantial advantages by aligning early in the process with the debtor and its management or with powerful stakeholders who control the debtor.³⁵⁸

Thus, perhaps the present model, which relies upon and facilitates the formation of coalitions to reach negotiated settlements in Chapter 11 proceedings ought to be reconsidered. Similarly, perhaps the debtor-in-possession model, which allows the distressed company and its management to initially advance a Chapter 11 plan,³⁵⁹ is not the most efficient model—particularly in cases such as Washington Mutual, where the debtor bears little resemblance to the business enterprise that prospered in better days. Rather, a trustee or court-appointed chief restructuring officer might better serve these essential functions. Similarly, reliance on committees composed of the largest claim holders to advance claimants' interests may no longer be appropriate in a world where sophisticated persons routinely hedge large investments, and where distressed debt investors trade in the debtor's securities throughout the pendency of

Chapter 11 Without Really Reorganizing, J. OF CORP. RENEWAL (Aug. 27, 2008), <http://www.turnaround.org/Publications/Articles.aspx?objectId=9654>; Stephen J. Lubben, *Business Liquidation*, 81 AM. BANKR. L.J. 65 (2007); see also 9C Am. Jur. 2d *Bankruptcy* §2818; BEN BRANCH ET AL., *LAST RIGHTS: LIQUIDATING A COMPANY* (2007).

356. In a so-called quasi-liquidation, the debtor liquidates its operating subsidiary and reorganizes the corporate parent—typically to preserve the future benefit of valuable tax attributes. See *The Solyndra Memorial Tax Break*, WALL ST. J. (Oct. 17, 2012), <http://online.wsj.com/article/SB10000872396390444799904578050803545600588.html>.

357. See *id.* Loss carryforwards are determined under 26 U.S.C. § 172.

358. These early alliances enable stakeholders to influence the Chapter 11 plan during the debtor's exclusivity period. See *supra* note 340 and source cited therein.

359. See *supra* note 340 and source cited therein.

the case. It might better serve the goals of bankruptcy if parties advocated separately for their own interests.

Finally, while market-based processes may in theory offer the potential for increased participation in the restructuring by a broader range of constituents, they take place within a legal framework that grants structural privileges to certain parties. Accordingly, they are susceptible to the same problems that early critics of Chapter 11 identified, and in fact they can provide a ready mechanism for parties to use their market power to gain more opportunities to crowd out dissent to their desired restructuring outcome. Thus, notwithstanding increasing integration of market mechanisms, negotiations by parties to Chapter 11 cases must be carefully monitored to ensure that they do not enhance market inequalities and enable the exercise of market power.

To be sure, reforms of this sort would in many cases add to the existing litigation burdens of the bankruptcy process. However, the distributional and burden-assigning effects of Chapter 11 must be recognized, in addition to its inherent inefficiencies. As reform efforts take shape, protective rules and policies should be considered to allow meaningful participation in Chapter 11 restructurings by persons other than dominant parties with market power. Moreover, given bankruptcy law's historic deference to efficiency goals, Chapter 11 must be carefully assessed to ensure that it does not "permit[] private actors with powerful economic interests to pursue self-interest free of community norms."³⁶⁰ Of course, in the wake of the recent financial crisis, the law of corporate financial distress is simply one component of a much larger space that demands careful attention from scholars and reformers.

V. CONCLUSION

Professor Owen Fiss observed, "To say . . . that 'law is efficiency,' implicitly hypothesizes a single, uncontested end and relegates the judge to formulating rules—the instruments—that best serve that end."³⁶¹ Chapter 11 rests upon a neoclassical economic paradigm that promises efficient outcomes to the extent market

360. Andrew McThenia & Thomas Shaffer, *For Reconciliation*, 94 YALE L.J. 1660, 1665 n.33 (1985).

361. Fiss, *supra* note 337, at 792.

mechanisms are utilized. Through its reliance on outmoded and facile theoretical assumptions, Chapter 11 relegates not judges, but certain privileged parties to formulating the instruments that best serve their own profit maximization goals. But when more comprehensive narratives of corporate financial distress are told, the extant legal process reveals itself to be anything but economically efficient.

In reality, the structural limitations of Chapter 11 produce distortions that cause even the most sensibly designed market mechanisms to yield inefficient case outcomes. By obscuring these inefficiencies, the legal construct achieves a largely unquestioned distributional effect, privileging certain actors and enabling them to dominate restructuring outcomes and extract rents. In light of the distributional functions achieved by Chapter 11, constituents are routinely forced to bear economic burdens even though they have been effectively barred from the legal process. To this end, it is difficult to argue—particularly in the wake of the Great Recession—that the restructuring process offered by Chapter 11 advances overall societal welfare by any measure.

Once the Efficiency Fallacy is exposed and set aside, we are left with tremendous opportunities for law reform. And there is much work to be done. As other scholars have observed, the commercial restructuring process needs to be more inclusive and transparent,³⁶² and efforts to reform Chapter 11 are underway. A new explanatory model, drawing on the analytical tools of modern political economy, allows an expanded narrative of corporate financial distress. The stories that emerge might pave the way for an overhauled legal construct that achieves more efficient restructurings. More importantly, these stories permit acknowledgment of—and thus an opportunity to ameliorate—the inequitable distributional effects that worsen financial distress and ultimately undercut economic progress.

362. “Encouraging more parties to participate may enhance that dialogue by introducing additional and potentially different perspectives on value creation. The challenge is preserving a relatively level and fair playing field among the stakeholders so that all voices are heard.” Harner & Marincic, *supra* note 109, at 1182.