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# BOYD'S LEGACY AND BLACKSTONE'S GHOST

Great battles are often fought in unlikely places. Last Term, the Supreme Court entertained an ordinary commercial law dispute between a financing bank and a group of real estate investors over the ownership of fifteen floors of an office building in downtown Chicago.[1] At issue was the ability of the partnership to restructure the bank's loan in Chapter 11. The partnership offered a plan that, in its view, left the bank with more than it would receive through a state law foreclosure, yet allowed the prebankruptcy investors in the partnership to remain as owners and enjoy significant tax benefits. When the bank turned down the partnership's plan, the bankruptcy court had to decide whether the plan could be confirmed over the bank's objection.

On its face, it might seem that such a dispute would not occupy the attention of a Supreme Court that now hears only about eighty cases a year. The property was well run, and no one suggested

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[1] *Bank of America National Trust Savings Association v 203 North LaSalle Street Partnership*, 119 S Ct 1411 (1999).

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that its day-to-day operations needed to be revamped.[2] Uncertainty about the value of the building was not a source of dispute either; both the bank and the investors agreed that the remaining balance on the loan far exceeded the market value of the property. Similarly, no one doubted either the existence of substantial tax benefits for the investors or the willingness and ability of the investors to add several million dollars to the pot to retain them. The inability of two sophisticated parties to reach a mutually beneficial bargain had few effects on anyone else. Their failure to make a deal, however, gave the Court the chance to address the most important open question under the Bankruptcy Code.

Everything revolved around on a single clause in Chapter 11 of the Bankruptcy Code. With its statutory and case-law antecedents, the language of this clause addresses the pivotal controversy in the law of corporate reorganizations for most of this century. The interpretation one chooses shapes all of Chapter 11, and the choice among interpretations turns in large part on the interpretative methodology one uses. Hence, a two-party dispute over an ordinary office building in Chicago joins a major debate over statutory interpretation.

The precise legal issue can be set out simply. To the extent that it was owed more than its collateral was worth, the bank held an unsecured claim in addition to its secured claim. Every claim in Chapter 11 is placed into a class, and the bank's claim was of a sort that had to be put in a class by itself.[3] Hence, when the bank voted against the plan, a class of unsecured claims necessarily voted against it as well. Section 1129(b) of the Bankruptcy Code provides, in relevant part, that when a class of unsecured claims dissents from a plan of reorganization, the bankruptcy court can confirm the plan only if:

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[2] Indeed, the bank was concerned because some of the debtor's employees were leaving and it feared that equally able replacements might not be found. See *In re 203 North LaSalle Street Limited Partnership*, 190 Bankr 567, 591–92 (Bankr ND Ill 1995), aff'd, 195 Bankr 692 (ND Ill 1996), aff'd, 126 F3d 955 (7th Cir 1997), rev'd and rem'd, 119 S Ct 1411 (1999). The bank also pointed to one prepetition tax payment that the debtor had mishandled, but the bankruptcy court rejected this complaint, as well as the complaint that the management fee was too high.

[3] We are oversimplifying matters somewhat. The question of whether the bank's deficiency claim ought to be classified separately from other unsecured claims is an issue on which the courts are divided. The question, however, is settled in the Seventh Circuit and was not before the Court in *LaSalle*. See *In re Woodbrook Associates*, 19 F3d 312 (7th Cir 1994).

> [T]be plan . . . is fair and equitable. . . . [T]be condition that a plan be fair and equitable . . . includes the following requirement[ ]: . . . the holder of any [junior] interest . . . will not receive or retain under the plan on account of such junior . . . interest any property.[4]

In other words, to confirm the plan, the court had to find that the plan was "fair and equitable," which, at a minimum, requires that the old investors not receive any "property" "on account of" their old interests. None of these words is defined in the Bankruptcy Code, but the phrase "fair and equitable" had been used in two previous bankruptcy laws and in judicial opinions before then.

In writing for the Court, Justice Souter examined the origins of the "fair and equitable" language and concluded—on the basis of this history—that Section 1129(b) required adherence to "absolute priority."[5] Under a regime of absolute priority, old equity cannot receive anything if a dissenting class was not being paid in full. If old equity could participate at all, it would be required to contribute an infusion of new capital. Old equity could not be given any breaks. Old equity had to pay "top dollar" for the new interest.[6] The bankruptcy court had not taken sufficient steps to ensure that this had in fact been the case.[7] Hence, the plan could not be confirmed and the Court remanded.

Justice Thomas, joined by Justice Scalia, wrote a concurring opinion in which he argued that one could resolve the case without recourse to history, the concept of "absolute priority," or anything beyond the words in the statute. The plan, in substance, gave the old equityholders the exclusive right to the equity of the reorganized entity. Such an exclusive right was a stock option, something ordinarily regarded as "property" and hence "property" within the meaning of the statute.[8] Because the plan gave this option only to the old equityholders, they received it "on account of" their old interest. Hence, the plan did not meet the specific requirement set out in Section 1129. Justice Thomas concluded that the Court

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[4] 11 USC § 1129(b)(2).

[5] 119 S Ct 1416–17.

[6] Id at 1423.

[7] Justice Stevens in dissent agreed with most of this analysis, parting company with the majority only over the issue of whether the thorough and financially sophisticated opinion of the bankruptcy court paid sufficient attention to this specific question.

[8] Id at 1424.

could reject the debtor's plan without having to ask whether, as a general matter, the plan was "fair and equitable." He never had to invoke the principle of absolute priority.

While Justice Thomas reached the same conclusion as Justice Souter, the methodology he advanced would require lower courts to apply the Bankruptcy Code differently as a general matter. For Justice Thomas, the obligation of a reviewing court in bankruptcy cases is to set out "a clear method for interpreting the Bankruptcy Code."[9] This method should eschew exploring the origins of words such as "fair and equitable" when the focus is the meaning of an ordinary word such as "property." Instead of importing the mysticism and uncertainty of common law judging into statutory interpretation, courts should allow the plain language of the statute to speak for itself. An interpretative approach that focuses on words and their ordinary meaning yields more certain outcomes and provides better guidance to lower courts than one that attempts to discover a seamless web woven through decades-old cases and repeated statutory enactments. For every case in which a nuanced common law approach sheds valuable insight, there are ten in which it leads judges astray. We live in a statutory era, and courts should not let open-textured language tempt them to wander about searching for principles immanent in the law. Judges should not chase Blackstone's ghost.

In this article, we examine these two different ways of interpreting the Bankruptcy Code. Similar questions, of course, arise whenever a statute contains fragments of old law. One can use these as landmarks that help organize a statutory regime and discover its internal coherence. Alternatively, one can treat these fragments as vestiges of the past that ought to be confronted only when they are squarely put in issue and not otherwise. Any coherence a statute has must come from a straightforward interpretation of the text. *LaSalle* provides the chance to study how this debate plays out in a specific context.

Many debates over statutory interpretation are debates about judicial restraint. The debate in *LaSalle* is different. Neither Justice Souter nor Justice Thomas is a judicial activist. Neither sees the judge as Hercules nor does either embrace dynamic interpreta-

[9] Id at 1425.

tion.[10] They both want to give guidance to lower courts, while recognizing that, as generalist appellate judges, they lack subject matter expertise. Neither has an interest in boldly reshaping the law. They both want a methodology that ensures lower courts implement faithfully the laws that Congress has passed. Their debate concerns the best methodology after one has made a commitment to judicial moderation.

From Justice Thomas's perspective, Justice Souter's methodology, relying as it does on history and common law precedent, is too uncertain and ignores the institutional and practical constraints under which judges operate. Implicit in Justice Souter's opinion is the belief that Justice Thomas's approach is simpler in appearance only. His methodology depends upon assumptions that, if not grounded in history, must be grounded some place else. Central to understanding Justice Souter's opinion in *LaSalle* and Justice Thomas's critique of it is the question of whether and to what extent history is necessary to interpreting this section of the Bankruptcy Code. We turn first to that history.

## I. Boyd and the Equity Receivership

The modern law of corporate reorganizations begins with *Northern Pacific Railway v Boyd.*[11] In 1886, a man named Spaulding had supplied $25,000 worth of materials and labor to the Coeur D'Alene Railroad for which he was never paid. The assets of the Coeur D'Alene, after several restructurings, ultimately became part of the Northern Pacific Railroad. Spaulding believed he could hold the Northern Pacific Railroad liable for this debt. Before he acquired a judgment against it, however, the Northern Pacific Railroad became insolvent and went through a common law reorganization—an equity receivership—out of which emerged a new entity called the Northern Pacific Railway.

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[10] For an argument that textualism by the Supreme Court would promote better outcomes than dynamic interpretation in bankruptcy cases, see Robert K. Rasmussen, *A Study of the Costs and Benefits of Textualism: The Supreme Court's Bankruptcy Cases*, 71 Wash U L Q 535 (1993).

[11] 228 US 482 (1913). For two excellent accounts of *Boyd* and the evolution of the absolute priority rule, see John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 Mich L Rev 963 (1989); Randolph J. Haines, *The Unwarranted Attack on New Value*, 72 Am Bankr L J 387 (1998).

Spaulding's successor, a man named Boyd, did not participate in the reorganization of the Northern Pacific Railroad and instead sued the new entity. The dispute finally reached the U.S. Supreme Court in 1913. The Court found first that the old Northern Pacific had indeed been responsible for the obligations of Coeur D'Alene. Hence, the Court then had to ask whether the new Northern Pacific was responsible for the debts of the old. Shareholders of the old Northern Pacific remained shareholders of the new.[12] Boyd argued that a reorganization could not allow old shareholders to remain in place and at the same time extinguish his rights as a general creditor. As a general creditor he was entitled to priority over the shareholders.

The matter, however, was not this simple. Shareholders participated with the blessing of the railroad's senior creditors. These senior creditors enjoyed priority over general creditors like Boyd, and the court that oversaw the reorganization had found that they were owed more than the Northern Pacific Railroad was worth. Hence, one could argue, Boyd had nothing to complain about. These senior creditors were entitled to the entire firm. They thus were free to include the shareholders or not as they pleased.

*Boyd v Northern Pacific Railway* is perhaps the most important bankruptcy opinion of the last century.[13] The Supreme Court relied on a doctrine from the law of real estate mortgages to decide the case. This reliance raised the larger question of how many other principles of real estate foreclosure law should be imported into the law of corporate reorganizations. This larger question has still not been completely answered. *Boyd*'s legacy was to make this question the central focus of corporate reorganizations for almost a century.

Before addressing the larger issue, however, we should focus on the holding of *Boyd* proper. *Boyd* relied on a doctrine from the law of fraudulent conveyances. Fraudulent conveyance law voids transfers by a debtor that subvert the rights of creditors. Most significantly, it looks at substance rather than form. The relevant transaction to which it applied in the context of a real estate fore-

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[12] The old shareholders could retain their interests only if they paid an assessment, but the shares they received were worth more than they were assessed.

[13] See, e.g., Randal C. Picker, *Designing Verifiability: Boyd's Implications for Modern Bankruptcy Law* (U Chicago, 1999).

closure takes the following form. First Bank holds a $100 first mortgage on Blackacre and Second Bank holds a $100 second mortgage. Owner defaults and First Bank forecloses. Owner makes the winning bid of $100 at the foreclosure sale. First Bank is paid $100. Owner now enjoys the property, not because of its old interest, but because it was the high bidder at the sale. At this point, Owner returns to First Bank, borrows $100 from it, and gives it a new mortgage on Blackacre.

Owner and First Bank argue that the foreclosure sale extinguished the claim of Second Bank. Once one pierces form and looks at substance, however, nothing has happened, other than the elimination of Second Bank's claim. Fraudulent conveyance law tells us First Bank and Owner cannot engage in a transaction that, in substance, does no more than wipe out the interests of a creditor. Hence, fraudulent conveyance law dictates that Second Bank's claim survives the foreclosure and Second Bank remains free to enforce its claim.

In *Boyd*, a divided court found that the same principle existed in the law of corporate reorganizations:

> As against creditors, [the sale] was a mere form. Though the Northern Pacific Railroad was divested of the legal title, the old stockholders were still owners of the same railroad, encumbered by the same debts. The circumlocution did not better their title against Boyd as a nonassenting creditor. They had changed the name but not the relation.[14]

Nor did it matter that the assets were worth less than what creditors senior to Boyd were owed:

> [T]he question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence as to whether, on the day of sale the property was insufficient to pay prior encumbrances . . .
>
> . . . If the value of the road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. In either event it was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever.[15]

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[14] 228 US at 506–07.

[15] Id at 507–08.

The Court did not go so far as to say that all of real estate foreclosure law should be mechanically transplanted to the law of corporate reorganizations. In a real estate foreclosure, for example, it would not have mattered whether Boyd was actively involved in the process. Moreover, any continuing interest of the old owner after the foreclosure would allow the junior creditor to pursue its claim against the land. Importing this doctrine into the law of corporate reorganizations unmodified would radically unsettle the law of corporate reorganizations. *Boyd*, however, did not do this. The Court held only that a complete freeze-out of an intervening creditor was not permitted. Indeed, the Court itself was quick to note that its holding was narrow:

> [We do not] require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it.[16]

In contrast to real estate foreclosures, a plan of reorganization could include shareholders if the creditor were given a "fair offer" in a "just reorganization." Exactly what this meant, the Court did not explain. Lower courts had to identify on their own the contours of the "fixed principle" that should be at work. They had to decide on their own how much of real estate foreclosure law to use in assessing whether a plan satisfied *Boyd.*

Lower courts soon began to find their way. They found, for example, that old shareholders could participate if the old shareholders were the best source of new capital, if they were putting in new capital equal to the value of the stock they were receiving in return, and if the senior lenders blessed the plan.[17] As long as the general creditors were given a hearing, their interests could be wiped out completely.[18]

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[16] Id at 508.

[17] For example, see *Oehring v Fox Typewriter Co.*, 272 F 833, 835 (6th Cir 1921) (general creditor could not obtain relief where "[e]very new stockholder paid cash in full for his new stock and received nothing in exchange for his old.").

[18] Henry Friendly's observation in a 1934 article reflected the thinking of judges and lawyers of the time:

The most important unanswered question after *Boyd* was whether the old shareholders could receive stock worth *more* than the amount of the new capital they put in. The real estate analogy would suggest that they could not. A real estate foreclosure is a day of reckoning in which the ownership of the property necessarily changes hands. The land is sold for a fixed amount. The creditors stand in line according to the order in which they recorded their interests. The first mortgagee is paid in full, then the second, and so forth until the money is exhausted. Under such a regime of "absolute priority" (as it came to be called[19]), one could not justify giving the shareholders any more than they contributed in new capital. In the wake of *Boyd*, however, lower courts found that the law of corporate reorganizations did not include the rule of absolute priority, but rather another rule, a rule that was eventually called "relative priority." This rule, one that courts were to use for twenty-five years, was shaped in large part by a single lawyer—Robert Swaine.

## II. Robert Swaine and Relative Priority

Robert Swaine went to the Harvard Law School where he was president of the *Law Review* and awarded the Fay Diploma.[20] He was recruited to teach at Harvard by Dean Ames, but that plan fell through when Ames died unexpectedly. Swaine then joined the Cravath firm in 1910 as a litigator, planning to teach after some time in practice. Within a year, however, Swaine had lost his interest in both litigation and teaching. He turned instead to corporate reorganizations. In early 1916, a month before his thirtieth birthday, he was sent to Jefferson City, Missouri, and charged with the task of persuading the district court there to approve a reorganiza-

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> [A] few principles can be regarded as definitely settled. Stockholders who furnish new money required by the reorganized company may be permitted to retain an interest in the company, even though sacrifices from creditors are compelled.

Henry J. Friendly, *Some Comments on the Corporate Reorganizations Act*, 48 Harv L Rev 39, 75–76 (1934). See also James C. Bonbright and Milton M. Bergerman, *Two Rival Theories of the Priority Rights of Security Holders in a Corporate Reorganization*, 28 Colum L Rev 127, 132 (1928); John Gerdes, 2 *Corporate Reorganizations Under Section 77B of the Bankruptcy Act* § 1084 at 1733 n 7 (Callaghan & Co., 1936).

[19] The phrase "absolutely priority" appears to have appeared first in Bonbright and Bergerman, *Two Rival Theories* at 130 (cited in note 18).

[20] See Robert T. Swaine, 2 *The Cravath Firm and Its Predecessors* 162–65 (Ad Press, Ltd., 1948).

tion of the Frisco line.[21] Starting in this case, he began to develop a theory of priority quite different from the one with which real estate lawyers had long been familiar.

We need to look at the financing of railroads in the nineteenth century to understand Swaine's conception of relative priority. Railroads were the first giant privately financed corporations.[22] By 1860, however, private investment in railroads exceeded a billion dollars, and investment bankers such as J. P. Morgan, August Belmont, and Kidder Peabody had to turn to large commercial centers of Europe for the capital to finance the transcontinental railroads that were to be built over the next three decades. These investment bankers sat on the boards of the various railroads and represented the interests of their European investors.[23] Because they counted on repeated dealings with these investors, they had the incentive to represent them well. So too did the lawyers who represented them. Early on, among the most prominent was the Cravath firm.[24]

The period between 1865 and 1890 was one of enormous growth for the railroads. The period also saw the consolidation of different lines in haphazard and unpredictable ways. Over 75,000 miles of track were laid down in the 1880s alone. This was a time of increasing competition.[25] Moreover, there was at the same time increasing government regulation, the most important of which was the Interstate Commerce Act of 1887. Competition among the different lines intensified, cartels came into existence and then fell apart. At the same time, the early 1890s brought on one of the United States's worst economic downturns. All these factors created an industry that by the mid-1890s was insolvent. Most of the railroads that had been built could not meet their fixed obliga-

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[21] For an account of Swaine's role in the reorganization of the Frisco line, see id at 169–75.

[22] For a discussion of the equity receivership and the role that lawyers played in shaping it, see Robert W. Gordon, *Legal Thought and Legal Practice in the Age of American Enterprise, 1870–1920*, in Gerald L. Geison, ed, *Professions and Professional Ideologies in America* 70, 101–10 (U North Carolina Press, 1983).

[23] See Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* 146 (Belknap, 1977).

[24] Even in the 1880s, the railroad reorganization clients of Cravath's predecessor firm included the Deutsche Bank, as well as bondholders in London, Frankfurt, and Amsterdam. See Swaine, 1 *The Cravath Firm* at 377, 614–15 (cited in note 20).

[25] For a discussion of the competition among railroads connecting Chicago with New York during this period, see William Cronon, *Nature's Metropolis: Chicago and the Great West* 81–93 (Norton, 1991).

tions. Over half the railroad tracks in the United States went through reorganization during this period, some more than once.[26]

A paradigmatic railroad in need of reorganization took the following form. There were few general creditors. There were different classes of bonds, each widely held by diverse investors, many of whom were in Europe. One bond was secured by the track between point *A* and point *B*, another secured by track between point *B* and point *C*, a third between *C* and *D*, and so on. Points *B* through *Y* are in the middle of nowhere, and the terminals at points *A* and *Z* connect to solvent railroads owned by the shareholders.[27] The collateral of individual creditors adds value to the ongoing railroad. This value, however, could not be realized by foreclosing on the collateral; rather, only through the active participation of all parties could the value of the constituent parts be maximized.[28]

Bringing about a successful reorganization was hard. The value of the railroad had to be estimated against a background of rapid technological and regulatory change. The claim of the many different kinds of bondholders turned on how much their collateral contributed to the earnings of the railroad as a whole. Moreover, many of the investors lived abroad and could not actively participate in the reorganization. They had to rely on their investment bankers and their lawyers to represent them. While Congress had the power to enact federal bankruptcy law, it had not enacted a corporate reorganization statute. Faced with dispersed interests with uncertain value and no statutory guidance, the lawyers used the equity receivership to reorganize the railroads.

One of the powers of a judge sitting in equity is the ability to

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[26] For a history of railroad reorganizations of the 1890s, see Stuart Daggett, *Railroad Reorganization* (Harvard U Press, 1908).

[27] For an account of the financial structure of one of the railroads that Swaine reorganized, see Swaine, 2 *The Cravath Firm* at 169 (cited in note 20) (the Frisco had thirty different issues of securities other than equipment trusts and terminal bonds, most of them secured by liens on single constituent lines).

[28] As one commentator noted:

> In arriving at the standard which the legislature should set, reasoning based upon the rights of security holders upon bankruptcy or foreclosure if they should insist upon their rights is . . . somewhat beside the point. That kind of argument opens the way to the discussion of what kind of right it is which in most cases the individual security holder in a large reorganization can never insist upon.

Edward H. Levi, *Corporate Reorganization and a Ministry of Justice*, 23 Minn L Rev 3, 19 (1938).

appoint a person (called a receiver) to administer assets over which there is dispute. A creditor, for example, could petition the court to appoint a receiver to gain control over the assets of its debtor and sell them. This device was reshaped to accommodate the nineteenth-century railroads that had obligations so inconsistent with their earnings that they needed a new capital structure. The insiders who ran the railroad, typically also owners of a substantial part of the stock, would find a friendly creditor and have that creditor petition the court to place the assets in the hands of a receiver, usually the same person then managing the railroad.

The receivership provided an umbrella under which those holding different classes of claims and interests could organize themselves. At the end of the process was a court-supervised sale. The period preceding the sale was a time of intense negotiation among the affected parties. Committees would be established to represent each class of claimants. Each committee would persuade individual claimants to deposit their claims with the committee. The committees would then form a reorganization committee, composed of members from the other committees.

The reorganization committee would decide how much each claimant should receive in the reorganized railroad. After negotiating this plan of reorganization, the reorganization committee would attend the sale of the railroad. The market was sufficiently illiquid that the winning bidder would inevitably be the reorganization committee, and the amount bid would typically be only a fraction of the value of the railroad, measured on a going-concern basis. Those who participated in the reorganization would receive what the plan awarded them; those who did not would only get their share of what the assets fetched at the court sale. As a result, anyone who did not participate in the process would receive nothing or only a fraction of the amount of his claim.

The equity receivership depended upon the active cooperation of the old shareholders because they were the ones who actively managed the railroad and kept its books. They would have no incentive to orchestrate the reorganization if its effect would be to wipe out their interests completely. The reorganization, at the very least, could not leave them worse off than if they did nothing other than pray that things would get better. Moreover, the old shareholders were one of the few sources of new capital. As a result, equity receiverships usually produced a plan of reorganization that

allowed the shareholders to retain an equity interest in the railroad, an opportunity often conditioned on their willingness to contribute new funds to the cash-strapped enterprise.

The equity receivership provided a way in which investors could organize themselves and overcome the collective action problem from holdouts. Crucial was the ability to conduct a sale in which the reorganization committee could make a winning bid for less than the going-concern value of the assets. It often had the effect of leaving shareholders in place, even though intervening creditors were not being paid in full. This vehicle worked because the judicial sale created a new owner who took the assets free of all preexisting claims. The bargaining among the committees allowed people to sort out priorities that might not have been clear.

The investors, as a group, were sophisticated parties and repeat players who believed that the system worked to their benefit. A creditor with a nonrecourse junior lien on a spur line could not complain about the rights of the shareholders in the reorganized entity and indeed would not want to, given that its only chance of being paid anything was if it actively participated on a reorganization committee. Most of the general creditors were suppliers with ongoing relationships with the railroad. Several rules (such as the six-month rule and the doctrine of necessity) had the effect of paying such general creditors in full,[29] even though the railroads were typically worth far less than what the secured creditors were owed. Those who objected tended to be people like Boyd who possessed an off-beat claim.

Because the railroads were the first experiments in large aggregations of capital from diverse investors, many of the terms of the investment contracts were left blank or imported mechanically from real estate transactions. The law of equity receiverships had to supply the missing terms, and these had to respond to the distinct problems that arose when the firm needed a new capital structure. The equity receivership provided such a mechanism, but it could work only if the insiders, the holders of the equity, found it in their interest to start the process and provide the new money needed just to pay for the restructuring. The solution that emerged was one in which the shareholders could invoke the process and

[29] See, e.g., *Fosdick v Schall*, 99 US 235 (1878); *Miltenberger v Logansport Railway*, 106 US 286 (1882).

remain in control provided they contributed the capital necessary to pay for the reorganization.

This solution departs radically from current conceptions of debt contracts. Today, debt contracts are thought to include the right of the debtholders to wipe out the shareholders once a firm becomes insolvent.[30] Insolvency triggers an acceleration of the debtor's obligations and sorts out the rights of all the players by collapsing all future values to the present. When liabilities, fairly discounted, exceed assets, the shareholders should be eliminated. The equity receivership, by contrast, is a world that depends upon the old shareholders to take the lead in recapitalizing the insolvent firm and to continue to manage it afterwards. In such a world, we should not expect insolvency itself to trigger a day of reckoning.

Robert Swaine's central contribution to the law of corporate reorganizations was to show that the priority to which creditors are entitled vis-à-vis shareholders does not require that we extinguish the shareholder's interest when a firm's liabilities exceed its assets. An equity interest in an insolvent firm ceases to have value only after we decide to collapse all future assets and liabilities to their present value. In the absence of an event that recognizes gains and losses, equity always possesses an option value. It trades for a positive price *even when liabilities exceed assets.* Allowing equity to initiate a recapitalization and receive in return shares in the new firm that reflect the option value of their old shares is a coherent way to organize the world. Such a recapitalization respects the priority of the bondholders who have no practical ability to force a day of reckoning on their own.[31]

*Boyd* tells us that creditors cannot be wiped out in a reorganiza-

[30] For an economic justification of absolute priority, see Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy,* 72 Wash U L Q 1213 (1994).

[31] See Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade,* 27 Colum L Rev 901, 912–23 (1927); Bonbright and Bergerman, *Two Rival Theories* at 131–32 (cited in note 18). Relative priority turns centrally on protecting the option value of the equity and not treating the reorganization as a recognition event, a realization. Neither Swaine nor his contemporaries, however, presented their view explicitly in these terms, and attacks on relative priority gained much of their power from the belief that relative priority could not be rigorously defended, given the priority to which creditors were contractually entitled. See Address of Abe Fortas, Assistant Director of the Public Utilities Division, Securities and Exchange Commission, July 14, 1938, New York, NY, at p 8.

Modern scholarship, however, has shown that sound rationales might support departures from the absolute priority rule. See, e.g., Thomas H. Jackson and Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain,* 75 Va L Rev 155 (1989).

tion, and that their new interests in the firm have to reflect the value they had relative to the old equity. Nothing in *Boyd*, however, forbids taking into account the option value of equity. We do not have to treat the reorganization itself as a recognition event that collapses the value of all liabilities and assets to fixed sums. This idea of relative priority emerged in the lower courts after *Boyd*. It allowed investors to sort out their rights with a minimum of judicial interference, it ensured the survival of the firm as a going concern, and it provided enough judicial scrutiny at the end to ensure that the rights of dissenters were respected.[32]

In 1926, after these developments in the lower courts, the Supreme Court returned to the issues raised by *Boyd*. In *Kansas City Terminal Railway v Central Union Trust*,[33] the Court found that a reorganization had to recognize the right of all creditors "to be preferred to stockholders against the full value of all property belonging to the debtor corporation."[34] The opinion does not discuss what it means by "full value." It is as consistent with a regime of relative priority, one that recognizes the option value of an insolvent equity interest, as with absolute priority, which does not. At the same time, the opinion seems to endorse the universally accepted practice of allowing shareholders to participate in the new reorganization when they were willing to contribute new capital to the enterprise:

> Generally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them. In such or similar cases the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights.[35]

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[32] Less central, but nevertheless important, was the idea that we should also, to the extent possible, give creditors a type of interest in the firm, such as debentures or preferred stock, that is senior to the old shareholders. Doing this made it easier to value them relative to the equity and it made it hard to dilute their value subsequently. Bonbright and Bergerman, *Two Rival Theories* at 144–45 (cited in note 18).

[33] 271 US 445 (1926).

[34] Id at 454.

[35] Id at 455. The Court in its opinion was answering poorly framed interrogatories from the Circuit Courr. Hence, the exact holding is hard to fathom. Ayer and Haines both conclude that *Kansas City* does not squarely adopt either absolute or relative priority. See Ayer, *Rethinking Absolute Priority* at 1001–07 (cited in note 11); Haines, *Unwarranted Attack* at 405–06 (cited in note 11).

The equity receivership under a regime of relative priority effectively allows creditors as a group to compromise their claims in accord with the realities of bargaining power as well as their nominal legal entitlements. Individual creditors could not, apart from the reorganization committees, insist on the rights they would enjoy in the absence of a receivership.

Such was the view of reorganizations that Robert Swaine put forward after *Boyd*.[36] This regime of "relative priority" was one in which sophisticated Wall Street lawyers and investment bankers occupied center stage. With a minimum of outside involvement, they protected the interests of their clients and ensured that railroads on which the economy depended continued to run. Lower courts continued to confirm plans of reorganizations in which shareholders remained in the picture either without contributing new capital or by contributing an amount worth significantly less than what they put in. A good example is *Jameson v Guaranty Trust*.[37] Holders of refunding bonds challenged a reorganization plan which scaled back their interests and, in exchange for a fresh capital infusion, allowed the old shareholders to retain the equity in the firm and receive bonds senior to those received by the dissenting creditors. In rejecting this challenge, the Seventh Circuit noted:

> As between the stock and the refunding bonds, the advantages of the plan to the latter, in our judgment, will approximately balance whatever concessions the plan requires of them, and, the stock remaining, as before, subordinate to the bonds, we do not see wherein the plan unfairly or inequitably gives material advantage to the stock over these bonds.[38]

## III. Jerome Frank and Absolute Priority

As reorganization practice expanded beyond the railroads, a number of lawyers became increasingly skeptical of relative priority as the proper understanding of *Boyd*. These lawyers had a much less benign view of reorganizations than did Swaine. Chief

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[36] See, e.g., Swaine, *Reorganization of Corporations* at 912–23 (cited in note 31).

[37] 20 F2d 808 (7th Cir), cert denied, 275 US 569 (1927). *Jameson* was included as a principal case is the leading casebook on corporate reorganizations. See William O. Douglas and Carrol M. Shanks, *Cases and Materials on the Law of Corporate Reorganization* 287 (West Pub, 1931).

[38] 20 F2d at 813.

among them was a reorganization lawyer who practiced in Chicago for many years before moving to New York in the late 1920s. His name was Jerome Frank.

Jerome Frank's initial experiences with the law were not at all like Swaine's. Frank's first job was as a secretary to a reform Chicago alderman. "Against the likes of aldermen popularly known as Hinky Dink and Bath House John, Frank honed a political style that was never to be known for its subtlety nor its reticence."[39] Frank soon turned to private practice in Chicago. Like Swaine, he focused on corporate reorganizations, but his practice involved not only the restructuring of great railroads, but also industrial firms that were financed with publicly traded securities. The debt tended to be diversely held while the stock was often in the hands of those who ran the firm.

The capital structure of these firms was simple and hierarchical. The corporation in reorganization might be a holding company that had issued a single class of bond. Each creditor held the same instrument and differed only in the amount that they held. Insiders would hold the equity of the holding company, and its sole asset would be the stock of the subsidiary. The subsidiary would be a manufacturer or some other industrial firm. The holders of the equity of the parent sat on the boards of both the parent and the subsidiary.

The crazy quilt capital structures seen in railroads in the nineteenth century had largely disappeared. Moreover, bondholders were no longer sophisticated European investors represented by major Wall Street law firms. Rather, in Frank's view, they were too often diverse members of the public with neither the time nor the expertise to protect themselves. They were largely at the mercy of the shareholders and a variety of professionals, ranging from indenture trustees to bankers to lawyers, who appeared once the reorganization began and who stood to profit from restructuring.

Frank believed that, by the 1930s, the receivership had become a vehicle by which the old shareholders and professionals could extract value at the expense of unsophisticated investors.[40] The le-

[39] Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* 215 (Northeastern U Press, rev ed 1995).

[40] Jerome Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 Va L Rev 541 (1933). Frank's views were shared by fellow New Dealers. Max Lowenthal casts reorganization lawyers like Swaine in a negative light in his account of the Chicago,

gal system needed to protect the latter group. Frank rejected Swaine's theory of relative priority. He argued that the paradigm from real estate law should apply with full force. The reorganization of a firm should be a day of reckoning on which we establish the value of the assets and sort out all the claims according to the priority they enjoy upon default outside of bankruptcy. If the firm is insolvent, the old equity should be wiped out. Priority for Frank was absolute:

> If the property of the old company cannot on any conceivable basis be shown to be worth more than its debts, there is no excuse for allowing . . . participation by stockholders where essential new funds can be as advantageously procured without recourse to the stockholders. To hold otherwise would be to eviscerate the "law of fraudulent conveyances."[41]

Frank found the analogy to foreclosure compelling and thought relative priority too vague. Lawyers could present a plan to the court as a fait accompli and the court would be hard pressed to find that the plan was not, in the language of *Boyd*, "just" if the "fixed principle" at work was relative priority. While Swaine thought relative priority was needed to ensure the cooperation of the insiders who held the equity, Frank advocated absolute priority because it best protected the public investors:

> Courts of equity have a tradition of aiding the helpless, such as infants, idiots and drunkards. The average security holder in a corporate reorganization is of like kind.[42]

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Milwaukee & St. Paul Railway. See Max Lowenthal, *The Investor Pays* (Knopf, 1933). Thurman Arnold paints the following picture:

> Large fees in such situations are the rule rather than the exception. Generally counsel fees in reorganizations constitute the largest single item for all service and usually exceed the compensation of the officers or groups which the attorney represents. The fees represent high-class boondoggling and bureaucratic red tape of so complicated a nature that it is almost impossible to say at what point they are unjustified. Moral judgments can scarcely be made. In addition to fees, key places in any reorganization offer opportunities for distribution of valuable patronage. The stakes of participation in reorganization have become so high that they often are a greater objective that the reorganization itself.
>
> The situation is very similar to the control of a municipal government by a political machine, with the possible exception that the public opinion does not permit politicians to take any such percentage of the income of the municipality which they control.

Thurman W. Arnold, *The Folklore of Capitalism* 258–59 (Yale U Press, 1937).

[41] Frank, *Some Realistic Reflections* at 560 (cited in note 40).

[42] Id at 569.

Swaine, the establishment Wall Street lawyer, saw negotiation and compromise among professionals like him as the essential feature of corporate reorganization. Frank, the zealous New Deal lawyer, saw the need to recognize legal entitlements and regulate the entire process so as to ensure that small investors were protected. Swaine cared most about preserving going concern value; Frank cared about respecting the rights of individual investors through government regulation. Swaine thought that the process could be lawyer-driven with a judge arriving on the scene after the fact to confirm that the overall process was fair. Frank thought that a lawyer-driven process was too cozy and too easy to manipulate at the expense of the unsophisticated.

The differences between Swaine and Frank rarely surfaced in court. The entire process was one in which the players avoided valuations and other mechanisms that would require the issue to be confronted. In many cases, the lower courts were not squarely faced with the obligation to find that a firm was insolvent. As long as the court did not find that the firm was insolvent, one could argue that a plan that included shareholders still complied with absolute priority. Moreover, a plan that includes shareholders complies with absolute priority when the shareholders are contributing new capital needed for the reorganization and their new stake is reasonably tied to their contribution.

Against this ongoing struggle over the continued evolution of reorganization practice, Congress enacted a reorganization statute in 1934.[43] The statute required, inter alia, that two-thirds of each class of claimant approve the plan, and that the plan be "fair and equitable." The Supreme Court had never used "fair and equitable" in *Boyd* or in any other opinion. The courts that used "fair and equitable" and similar language had, for the most part, adopted relative priority. These courts, however, were using *Boyd* and *Kansas City* as their benchmarks. One could argne that if these courts were told that *Boyd* mandated absolute priority, they would agree that only a plan that satisfied absolute priority was "fair and equitable." By using "fair and equitable," neither this legislation

[43] For David Skeel's fine account of the emergence of modern reorganization law out of the equity receivership, see David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 Vand L Rev 1325, 1353–76 (1998); David A. Skeel, Jr., *The Rise and Fall of the SEC in Bankruptcy*, University of Pennsylvania Law School Institute for Law and Economics Working Paper No 267, 5–12 (Nov 1999).

nor its successor in 1938 resolved the different interpretations of *Boyd* put forward by Swaine and Frank.[44]

## IV. William O. Douglas and Los Angeles Lumber Products

The Supreme Court did not face the question of whether "fair and equitable" required absolute or relative priority until the end of the 1930s.[45] At issue was the reorganization of a holding company whose principal asset was the Los Angeles Shipbuilding & Drydock Corporation. This shipyard had built ships for the Navy during World War I, but had languished during the isolationism of the 1920s and 1930s. The only creditors were holders of twenty-year bonds issued in 1924 and due in 1944. Over 92% of the face amount of the bondholders voted in favor of the plan. The plan of reorganization gave 23% of the stock in the new corporation to the old shareholders. They planned to continue to play a managerial role in operating the business, but they were not contributing any new cash.

The District Court had held that the plan was "fair and equitable." It noted that only two bondholders had objected to the plan, and the court did not want to give a few dissenters the ability to hold up a reorganization approved by a substantial majority of the bondholders. As to continued participation of the old equityholders, the district court justified their inclusion on the ground that they were willing to assume managerial responsibilities in the company and they were "the only persons who [were] familiar with the company's operations and who [had] experience in shipbuilding." In addition, the Court noted:

> Most of the present bondholders are widely scattered with small holdings, and their position would be benefited by being

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[44] Commentators faulted the legislation on exactly this ground. See, e.g., Levi, *Corporate Reorganization* at 3, 6, 18–19 (cited in note 28). After rehearsing how the fair and equitable test leaves "uncertainty as to how much the intermediate class may demand," Levi later notes that the "failure of chapter X further to elaborate the standards for a 'fair and equitable' plan seems a mistake."

[45] *Case v Los Angeles Lumber Products Co.*, 308 US 106 (1939). The Court had already found that shareholders of an insolvent firm could not insist upon being included in the new firm as a right. *In re 629 Church Street Building Corp.*, 299 US 24 (1936). Hence, the Court had already decided that shareholders could not insist upon relative priority as of right, but it had not established the converse, that creditors had a right to insist on absolute priority.

> associated with old stockholders of financial influence and stability who might be able to assist in proper financing.[46]

The reorganization was brought about, it seems, from the need for additional capital, not the threat of foreclosure by existing creditors. Due to a previous workout, interest payments were owed only if earned, and the creditors lacked the power to foreclose until 1944.

From Swaine's perspective, the approval of the plan by 90% of the creditors would have been sufficient.[47] Requiring unanimity was unreasonable, and the old equity had to be given some of the going-concern value or they would not cooperate in reorganizing the firm. Nor did including the shareholders violate the terms of the debt contract, given that the creditors' contract did not give them a right to reach the assets until 1944. From the vantage point of early 1938, when the District Court confirmed the plan, the expected value of the shipyard in 1944 was less than what the creditors were owed. If, as expected, the economy remained much the same, there would be nothing for the shareholders. But one could not be sure. The world was at peace, but war clouds loomed in Europe. An increase in the demand for naval vessels or an unexpected decline in the existing stock was possible and, if the shipyard were in the right hands, it might increase in value enough to pay the creditors in full and still leave something for the shareholders. Giving the shareholders a small minority interest in the stock of the new firm was a sensible way to account for this possibility. The dissenting creditors may have thought the amount of equity given the old shareholders was too large, but they had had a full opportunity to voice their objections during the reorganization. Moreover, the overwhelming majority of those in the position of the creditors favored the reorganization plan.

Those who accepted Jerome Frank's view saw the case altogether differently. Modern firms are no different from parcels of

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[46] *In re Los Angeles Lumber Products Co.*, 24 F Supp 501, 513 (SD Calif 1938), aff'd, 100 F2d 963 (9th Cir), rev'd, 308 US 106 (1939). The District Court's opinion tracked practice in the lower courts. See Bonbright and Bergerman, *Two Rival Theories* at 154 (cited in note 18).

[47] See also *Jameson*, 20 F2d at 815 ("While in such matters majorities do not govern, the approval thus signified by this vastly greater number, whose interests are identical in kind with those of the objectors, is entitled to much weight in determining whether or not the plan is equitable and fair.").

real estate. Defaults justify having a day of reckoning in which the equity should be wiped out if the firm has liabilities that, at fair valuation, exceed the assets. Allowing the old shareholders to continue was a source of mischief that took away from public investors value that properly belonged to them. If the old shareholders could sabotage the reorganization, then the solution was not to pay them off, but rather to empower the judge or others to step in and remove them. In large firms, the shareholders would not control the day-to-day operations in any event. Professionals could be brought in to do the job. Government regulators such as the S.E.C. (of which Frank was then chair) could assist the court in ensuring the process was fair. Only in the narrowest of circumstances should old equity continue in the face of any dissent. There was no threat to the going concern remotely comparable to those a railroad faced when it had dozens of different kinds of secured debt scattered across many jurisdictions.

The opinion in *Los Angeles Lumber* was among the first opinions assigned to William O. Douglas. Indeed, as he had never sat on the bench before, *Los Angeles Lumber* may have been the first opinion he ever wrote. The controversy turned on the merits of absolute and relative priority, and courts had never addressed the issue. Indeed, at the time Justice Douglas wrote his opinion, none ever even used the words "absolute priority."[48] Justice Douglas, however, was no stranger to the controversy over the "fair and equitable" standard. After law school, Douglas worked on corporate reorganizations at the Cravath firm for Robert Swaine.[49] He then took his expertise in corporate reorganizations to the Columbia and Yale law schools where he taught corporate reorganizations, wrote the leading casebook in the field, and did path-breaking empirical studies of equity receiverships and business bankruptcies.[50]

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[48] *In re Utilities Power & Light Corp.*, 29 F Supp 763 (ND Ill 1939), rather than *Los Angeles Lumber*, is the first reported opinion we have found that uses the words "absolute priority" in assessing the rights of creditors and shareholders. It was decided only ten days before *Los Angeles Lumber*, however, and hence was very likely unavailable to Justice Douglas.

[49] In his autobiography, Justice Douglas recalled that Swaine thought well of his work and, just before he left, tried to persuade him to stay. "He had a full expectation that in a few years I would be a junior partner, and from there on, the world was my oyster." William O. Douglas, *Go East, Young Man* 156 (Random House, 1974).

[50] See William O. Douglas and John H. Weir, *Equity Receiverships in the United States District Court for Connecticut: 1920–29*, 4 Conn Bar J 1 (1930); William O. Douglas and Dorothy S. Thomas, *The Business Failures Project—II. An Analysis of Methods of Investigation*,

Douglas then went to Washington where he wrote an eight-volume report on corporate reorganizations. He drafted Chapter X of the Bankruptcy Act and pushed it through Congress. (Chapter X was the reorganization law that succeeded the statute involved in *Los Angeles Lumber.* It carried forward the language "fair and equitable.") In short, along with Robert Swaine and Jerome Frank, William O. Douglas was the country's foremost authority on the meaning of the words "fair and equitable."

Writing for a unanimous Court, Justice Douglas acknowledged that the plan in *Los Angeles Lumber* complied with relative priority,[51] but went on to hold that this was not enough. The words "fair and equitable" required adherence to absolute priority. The approval of the plan by the vast majority of security holders "was immaterial on the basic issue of [the plan's] fairness."[52] "Fair and equitable," Justice Douglas asserted, were "words of art" that had taken on a settled meaning in *Boyd* and *Kansas City Terminal.*[53] This meaning was the "rule of full or absolute priority." "The fact that bondholders might fare worse as a result of a foreclosure and liquidation than they would by taking a debtor's plan . . . can have no relevant bearing on whether a proposed plan is 'fair and equitable'. . . ."[54] When the firm is insolvent, the interests of old equity must be extinguished:

> [W]here the debtor is insolvent, the stockholder's participation must be based on a contribution in money or money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.[55]

The plan of reorganization before the Court could not be confirmed because the shareholders retained their old interests and were not putting in any new cash.

The words "fair and equitable" were, however, very far from

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40 Yale L J 1034 (1931). Indeed, these studies brought Douglas to prominence and led him to Washington. See Douglas, *Go East* at 258 (cited in note 49).

[51] 308 US at 119–20; see also *Consolidated Rock Products Co. v Du Bois,* 312 US 510, 527 (1941) ("And we indicated in [*Los Angeles Lumber*] that the ["fair and equitable"] rule was not satisfied even though the 'relative priorities' of creditors and stockholders were maintained.") (opinion per Justice Douglas).

[52] 308 US at 115.

[53] Id.

[54] Id at 123.

[55] Id at 122.

being "words of art." They were simply one among a number of different phrases that had been used to identify the *Boyd* legacy. The Court itself had never used the words "fair and equitable" in *Boyd* or any other case. Justice Douglas for his own part had used a different formulation when he testified about the law in front of Congress as the chair of the S.E.C.[56] Justice Douglas asserted that "fair and equitable" and its alternative formulations had come to mean "absolute priority." But a number of the lower courts he cited for this proposition had actually adopted "relative priority." These include *Jameson*, a leading case on relative priority that Justice Douglas himself had used in his own casebook on corporate reorganizations.

The opinion on its face gives no trace of it, but Justice Douglas set out an interpretation of "fair and equitable" that was controversial and ideologically charged. Nothing separates William O. Douglas's view of "fair and equitable" from Jerome Frank's. Indeed, *Los Angeles Lumber* tracks the brief submitted by the United States that had been prepared by the S.E.C. under Jerome Frank's supervision, who at the time had just become its chair.

That Douglas's views tracked Frank's should not have come as a surprise. Douglas's list of the people who most shaped his view of the law at the start of his career contained only six names. On this list, one that included the likes of Franklin Roosevelt, Louis Brandeis, and Hugo Black,[57] was Jerome Frank. Moreover, William O. Douglas had already written an article with Frank on *Boyd* and the absolute priority rule.[58] Douglas and Frank were longtime colleagues, kindred spirits, and close friends.[59]

Before *Los Angeles Lumber*, the idea that "fair and equitable" meant absolute priority was at best only one of several defensible interpretations, but as soon as the opinion was issued, the competing interpretations disappeared. What was an open question prior to *Los Angeles Lumber*—whether "fair and equitable" meant rela-

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[56] He used the formulation "fairness, soundness, and equity" when he testified before Congress on Chapter X. See Hearings Before the Committee on the Judiciary, House of Representatives, on HR 6439, 75th Cong 182–83 (1937) (statement of William O. Douglas).

[57] See Douglas, *Go East* at 182 (cited in note 49).

[58] See William O. Douglas and Jerome Frank, *Landlords' Claims in Reorganizations*, 42 Yale L J 1003, 1012–13 (1933).

[59] See Seligman, *Transformation of Wall Street* at 214–15 (cited in note 39).

tive or absolute priority—was settled decisively. Nevertheless, readers of this opinion today who are unfamiliar with the evolution of the law of corporate reorganizations, something that exists largely outside of reported opinions, are left with the distinct impression that the absolute priority rule was settled long before.[60]

## V. Absolute Priority and the Bankruptcy Reform Act

For purposes of understanding present law, however, the uncertainty that existed before 1939 no longer matters. *Los Angeles Lumber* pushed corporate reorganization law toward the real estate foreclosure model by forging a link between the words "fair and equitable" and absolute priority, a link that lawyers, judges, and Congress itself accepted during the decades between *Los Angeles Lumber* and the Bankruptcy Reform Act of 1978.[61] When one interprets Chapter 11, one can therefore read into Section 1129(b) the idea of absolute priority through its use of "fair and equitable." This interpretation in turn affects how we should interpret the requirement that old equity not receive any "property" "on account of" their old interests.

Section 1129(b)(2) does not say: (1) a plan has to be fair and equitable, *and* (2) that old investors cannot receive any property on account of their old interests. Rather, it provides: (1) the plan must be "fair and equitable," and (2) "fair and equitable" "*includes*" within it the idea that old investors cannot receive property on account of their old interest. The structure of the clause invites us to see the specific requirement that equityholders receive nothing on account of their prior interest as an integral component of

[60] Because of the way it is written and the way it characterizes its largely inaccessible antecedents, *Los Angeles Lumber* is often characterized as the opinion that introduces the new value exception to the absolute priority rule. In fact, it is better characterized as the source of the absolute priority rule itself. Several scholars have written about this peculiar state of affairs. See Ayer, *Rethinking Absolute Priority* at 974–76 (cited in note 11); Haines, *The Unwarranted Attack* at 407–14 (cited in note 11); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 Stan L Rev 69, 84–85 (1991).

[61] Justice Douglas's interpretation was implicitly accepted by Congress. Chapter XI, which dealt with the reorganization of smaller firms, had never been thought to embody the absolute priority rule, yet it too contained the requirement that a plan be "fair and equitable." In 1952, Congress deleted this requirement from Chapter XI to ensure that the absolute priority rule would not be imported into it. See Act of July 7, 1952, ch 579 §§ 35 & 43, 66 Stat 433 & 435. Reconciling other legislation with the holding of *Los Angeles Lumber* reenforced Justice Douglas's judicial gloss equating "fair and equitable" with absolute priority.

a "fair and equitable" plan. The most straightforward way of doing this is to read this clause as a mandate that the "fair and equitable" language, notwithstanding its inherent malleability, retains the gloss that the Court placed upon it in *Los Angeles Lumber.* However much judges continue to refine the "fair and equitable" standard, they cannot return to a regime of relative priority. If a firm does not have sufficient assets to pay its creditors in full, the shareholders cannot receive property simply because they had once been shareholders. A relative priority regime would allow shareholders to receive property without more because it permits the option value of the shareholder's interest to be recognized.

Justice Souter's opinion for the Court in *LaSalle* recognized the historical pedigree of the "fair and equitable" requirement:

> [Section] 77B (and its successor, Chapter X) of the old Act [required] that an reorganization plan be "fair and equitable." The reason for such a limitation was the danger inherent in any reorganization plan proposed by a debtor, then and now, that the plan will simply turn out to be too good a deal for the debtor's owners. Hence the pre-Code judicial response known as the absolute priority rule, that fairness and equity required that "the creditors . . . be paid before the stockholders retain [equity interests] for any purpose whatever."[62]

The Court then made its own addition to the *Boyd* tradition by finding that it was not enough, when shareholders are given exclusive rights to the equity, for the bankruptcy judge merely to find that the value the shareholders received was equal in value to their new contribution:

> [It would be] a fatal flaw if old equity acquired or retained the property interest without paying full value. It would thus be necessary for old equity to demonstrate its payment of top dollar, but this it could not satisfactorily do when it would receive or retain its property under a plan giving it exclusive rights and in the absence of a competing plan of any sort. Under a plan granting an exclusive right, making no provision for competing bids or competing plans, any determination that the price was top dollar would necessarily be made by a judge in

[62] 119 S Ct at 1417 (citations omitted). The Court also considered and, while it called it "starchy," did not decisively reject an approach advanced by the bank and the government as *amicus curiae.* Id at 1420. That approach would find that the Code's prohibition of retaining "property" "on account of" a prior interest dooms any plan where there is any causal relationship between the prior interest and new one.

bankruptcy court, whereas the best way to determine value is exposure to a market.[63]

*Boyd* told us that nonparticipating general creditors cannot be excluded when old shareholders remain in place. *Los Angeles Lumber* told us that old shareholders cannot participate, at least if they are not contributing an amount equal in value to the equity they receive. *LaSalle* tells us that, at the very least, the bankruptcy judge must use the market or some other test to establish that the old shareholders are in fact paying more for the equity than anyone else. The majority's opinion exemplifies common law judging in a statutory age. It looks to a chain of precedents because of statutory text that is itself derived from them.

True to the spirit of common law judging, *LaSalle*'s contribution to the absolute priority rule is both small and process oriented. Adherence to the absolute priority rule requires that any shareholder participation be no more than justified by the amount of new capital contributed. Moreover, an objective mechanism must be put in place to ensure that this is so. A judicial finding that the two are equal is not enough. The exact mechanism is one that the lower courts must now discover, just as they had to shape the contours of a "fair" offer and a "just" reorganization after *Boyd*. With *Boyd*, the Court provided general principles to protect creditors that lower courts then had to refine and develop. *LaSalle* continues that tradition.

This modest advancement, complete with its failure to resolve definitely the continued role of "new value" in corporate reorganizations, comports with the Supreme Court's institutional role. Our legal system relies upon generalist appellate judges to interpret statutes and ensure consistency across types of cases. An interpretative methodology is sound only if it reflects the competence of the typical generalist appellate judge and the constraints under which she operates. A generalist appellate judge, aided only by the submissions of interested parties and the assistance of newly minted lawyers, cannot hope to become a master of the antecedents of the Bankruptcy Code (or indeed the antecedents of any intricate statutory regime). An interpretative methodology is suspect if it points most judges toward lines of inquiry that they are ill-equipped to conduct and empowers others in ways that are hard

[63] Id at 1423.

to control. Justice Souter's opinion avoids these flaws by articulating the general principle distilled from the prior cases, extending this principle to resolve the case at hand, and leaving for further development the ultimate fate of "new value."

Contrast *Los Angeles Lumber*. No one else on the Supreme Court at that time possessed an understanding of corporate reorganizations remotely comparable to that of Justice Douglas. The perceived comparative advantage that Justice Douglas had may have led the rest of the Court to be too inclined to take what their new colleague wrote at face value. A bold judge, ostensibly hewing to the signposts already laid down, can reshape the law in ways that are hard to detect and control, especially when the judges who must review the opinion are generalists.[64] Judges who believe that their common law powers entitle them to shape boldly a dynamic and evolving law are hard to rein in. Justice Douglas reshaped corporate reorganization law in *Los Angeles Lumber*. By purporting to follow law already established in other cases, Justice Douglas may well have been able to obscure from his colleagues on the Court the dramatic step that they were taking.

One should not, however, measure the potential of a measured common law approach solely by the performance of Justice Douglas. If the opinion had been assigned to a different Justice and were written in the same spirit as *LaSalle*, it likely would have focused only on the matter at hand. It could have reached the same outcome by clarifying that *Kansas City Terminal* and *Boyd* require that whenever old equity participates in a reorganization, it had to bring something new to the table. Such a modest extension would have disposed of the reorganization plan before the Court, and would have been agnostic on the relative priority/absolute priority debate.

Justice Douglas, however, held an a priori commitment to the ascendancy of the absolute priority rule over the competing theory of relative priority. Given this commitment, any interpretative methodology might have brought as unyielding an opinion. Moreover, we no longer live in a world where the path to the Supreme Court is through becoming an expert in bankruptcy law or other area of private law. Most Justices today are more likely to enjoy reputations as generalist appellate judges. They see their mission

[64] See, e.g., Grant Gilmore's description of Benjamin Cardozo's tenure on the New York Court of Appeals. Grant Gilmore, *The Ages of American Law* 75 (Yale U Press, 1977).

in private law cases as giving guidance to other appellate judges and to experts in lower tribunals.

For the Justice who does not have an intellectual stake in bankruptcy law, a common law approach can offer a way to guide lower courts, impart coherence to the law, and yet not require a subject matter competence that she does not have. This careful and measured form of common law reasoning insulates the judge from mistakes. As have many before him, Justice Souter misunderstood *Boyd* and *Kansas City Terminal.* He assumed that they held what Justice Douglas asserted they held—that "fair and equitable" had by 1939 become terms of art meaning absolute priority. Nevertheless, the guidance that emanates from the Court's opinion in *LaSalle* depends only on the idea that absolute priority had become part of *Boyd*'s legacy at the time of the 1978 Bankruptcy Reform Act. The principle extracted from the history is so central to it that, even when much of the history is wrong, the principle that is abstracted from it is still sound.[65]

None of this, however, is to suggest that looking toward history in the wrong way or at the wrong time insulates judges from error. Justice Thomas in his concurring opinion in *LaSalle* rightly points to *Dewsnup v Timm*[66] as an example how pre-Code antecedents can lead courts astray, even when the Court focuses upon narrow questions. To understand the force of this objection, it is necessary recount the problem presented by *Dewsnup.* Debtor borrows $100 from Bank, uses it to buy Blackacre, and gives Bank a mortgage on Blackacre. Real estate values collapse and Debtor files a bankruptcy petition. The bankruptcy court finds that Blackacre is now worth only $60. Debtor, having procured funds from another source, wants to pay Bank $60, and leave Chapter 7 as the owner of Blackacre free and clear.[67] The question under the Bankruptcy Code is whether debtors can "strip down" liens in this fashion.

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[65] See Cass R. Sunstein, *One Case at a Time: Judicial Minimalism on the Supreme Court* 46–60 (Harv U Press, 1999).

[66] 502 US 410 (1992).

[67] Alternatively, Debtor may, after a judicial valuation, seek to end the Chapter 7 case, and then file a Chapter 13 case before Bank can foreclose. To the extent that Blackacre is not a personal residence, and to the extent that Debtor can strip down Bank's lien to judicially determined value of the property, Debtor can use Chapter 13 to force a payment plan on Bank. See Barry E. Adler, *Creditor Rights After Johnson and Dewsnup,* 10 Bankr Dev J 1, 4–5 (1993–94). This strategy, like the one in text, disadvantages creditors in that it allows debtors to take advantage of low judicial valuations.

Stripping down a lien in bankruptcy has the effect after the fact of benefiting debtors at the expense of creditors. If the bankruptcy judge places too high a value on the land, the debtor can always surrender the land to the secured creditor. If the bankruptcy judge errs on the low side, the debtor can pay the bank this amount and keep the land. In other words, debtors can systematically take advantage of those judicial valuations that are too low, but not be stuck with those valuations which are too high. Lien stripping also runs contrary to established practice in bankruptcy before the 1978 Bankruptcy Act. Finally, it runs contrary to the notion in real estate law that, when a debtor defaults, the value of the land is set through a foreclosure sale rather than through a judicial valuation. But one cannot say that the result is absurd. Statutes passed in the 1930s involving moratoria on mortgages often used such devices to protect debtors,[68] and consumer advocates have long promoted lien strip-down.

Against this background, we look at the language of the Bankruptcy Code. All agree that Bank has an "allowed secured claim" for the amount the judge sets (or $60 in our case). Similarly, there is an "allowed unsecured claim" of $40.[69] The controversy is over what happens to the lien that supports the "allowed secured claim." Section 506(d), the relevant provision, reads:

> To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void.

This language seems to provide that Bank's lien is void to the extent that it is more than the amount of its secured claim. Debtor owes Bank $100, but Bank's secured claim is for only $60. Hence, the lien is void to the extent it exceeds $60. Debtor could thus pay Bank $60, and remove the lien on Blackacre.

Bank, however, argued that this section was not aimed at lien strip-down at all. Rather, the provision was designed to prevent liens ftom surviving bankruptcy if the underlying claim was disallowed. To see this, consider the following. Lawyer provides legal services at an exorbitant fee and secures it with a lien on Debtor's property. Another section of the Bankruptcy Code disallows Law-

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[68] These statutes were not always constitutional, but there was no colorable constitutional objection to lien strip-down in *Dewsnup*.

[69] See 11 USC § 506(a).

yer's claim, but only this provision voids Lawyer's lien. Under this view, the purpose of Section 506(d) was not to strip down liens, but rather to make sure that a creditor's lien fares no better than her claim. Section 506(d) ensures that Lawyer is both denied a pro rata share of Debtor's assets in bankruptcy and prevented from seizing collateral after the bankruptcy is over. The language, aimed at this specific kind of abuse, was never intended to deal with the ability of a debtor to reduce the amount of an otherwise valid creditor's lien and should not be read to do so.

The Court adopted this interpretation in *Dewsnup*. The majority's opinion noted that, had it simply looked at Section 506 "on a clean slate," it would have agreed with the debtor and stripped down the lien to the value of the property. However, in light of the historical practice of not stripping down liens in bankruptcy, and the fact that the Bank could make a plausible argument that the text was aimed at an altogether different problem, the majority concluded that strip-down was not allowed.

In his dissent, Justice Scalia rejected the interpretation Bank offered for Section 506(d). To have the effect that Bank claimed, it should have been written differently. It should have provided:

> To the extent that a lien secures a claim against the debtor that is not an allowed claim, such lien is void.

We should not treat the "allowed secured claims" of creditors like Bank as if they were the same as "allowed claims." The result here may be undesirable from the perspective of creditors and unsound as a matter of bankruptcy policy and contrary to pre-existing practice, but it was not beyond what some had advocated or what other insolvency laws had done. It might be a bad idea with dubious pedigree, but this should not be enough to deny the statutory language the meaning that both makes sense on its own and is consistent with the way the language is used elsewhere in the Code.

Justice Scalia faulted the majority in *Dewsnup* for repairing to pre-Code law without a sufficient justification for doing so. Nothing in the text of the law suggests recourse to history. "Allowed secured claim" is a concept unique to the 1978 Act and has no statutory or caselaw antecedents. These words are carefully defined and repeatedly and consistently used in other parts of the 1978 Act. There was a pre-Code tradition of how liens were treated in bankruptcy, but there is no landmark in the Code that invites a

court to draw upon this history. The drafting of the Act was exceedingly careful, and these provisions were not last-minute additions. Courts should assume that drafters knew what they were doing, especially with respect to a term that has a consistent meaning every other place it appears. Competent drafters are unlikely to make such mistakes with terms that are a fundamental part of the architecture of the statute. (The chance that a judge would attribute an error when none occurred might be as great as the chance that an error would remain unchanged.)[70]

It is this complaint that Justice Thomas carries forward in his concurrence in *LaSalle*. The job of a generalist reviewing court is to ensure consistency in the lower courts. Insisting that lower courts follow the dictates of statutory text gives them clear instruction about what they should do and makes it easy to tell whether they have done it. This approach both respects the institutional role that Congress plays and recognizes the constraints of the institution that a reviewing judge oversees. If a judge attempts to engage in a more searching inquiry without a clear reason as to why she is doing it, she may be wrong more often than not.

The objection raised by Justices Scalia and Thomas to *Dewsnup* has force in that case, but it does not extend to *LaSalle*. One must not confuse the use of common law methodology to interpret Section 1129(b) and the departure from plain meaning in Section 506. In *Dewsnup*, the words at issue had never been used by anyone before 1978. In *LaSalle*, the words had a history stretching back many decades. In *Dewsnup*, the language is best seen as a case in which the Court mistakenly thinks it has found a drafting error.[71]

[70] For a similar point regarding legislative history, see Adrian Vermeule, *Legislative History and the Limits of Judicial Competence: The Untold Story of Holy Trinity Church*, 50 Stan L Rev 1833, 1857–77 (1998).

[71] Justice Scalia seems to admit the possibility of "scrivener's errors," but he defines them narrowly. See, e.g., *Union Bank v Wolas*, 502 US 151, 163 (1991) (concurring opinion). There were some provisions of the 1978 Bankruptcy Reform Act that might nevertheless qualify even under the narrowest conception of a "scrivener's error." For example, the bill as passed by the House and the Senate provided that "stockbrokers" could not file Chapter 11 petitions. (This provision ensured that cases involving stockbrokers would be heard using the special rules designed specifically for stockbrokers set out in Subchapter III of Chapter 7.) The enrolled bill, however, provided that "stock*holders*" could not file Chapter 11 petitions. This mistake was made by someone in the congressional printing office and was not caught before the enrolled bill was transmitted to the President. Read literally, the version of the Bankruptcy Reform Act actually signed by the President provided that no corporation with a subsidiary could ever file in Chapter 11. Whether a committed textualist would admit the reading of "stock*broker*" for stock*holder*, however, is not clear, given the primacy she is likely to give to the enrolled bill.

If the Court interpreted the language correctly, everyone would agree that it would have been better if the drafters had written it differently. Not so with *LaSalle.* The language is open-textured, and there are a number of reasons why Congress may choose to use such language.[72] While one can decide *Dewsnup* merely by exploring the internal structure of the Bankruptcy Code, one cannot do so in *LaSalle.*

Hewing to statutory text provides clear guidance to the lower court judges with respect to words like "allowed secured claim." Nevertheless, it does little with respect to open-textured language such as "ordinary course,"[73] or "reasonably equivalent value."[74] One needs to find benchmarks against which to ask whether something is "ordinary"; to know whether something is "equivalent," one must know what to compare it with.

Cases like *LaSalle* demand an interpretative methodology that allows one to choose among competing interpretations. To make a critique of Justice Souter's opinion in *LaSalle* compelling, a textualist must confront provisions of the Bankruptcy Code that are subject to competing interpretations. Textualists who fail to understand how such provisions work can embarrass themselves as much as the Court in *Dewsnup.*

## VI. Judicial Minimalism and the Common Law Tradition in Bankruptcy

In his concurring opinion in *LaSalle,* Justice Thomas believed that he could resolve the case without exploring the common law background to the "fair and equitable" language. The exact contours of the "fair and equitable" test were unimportant because we can find that the old investors received "property" "on account of" their old interest without reference to the more general requirement that the plan be "fair and equitable."

Justice Thomas criticized the majority opinion for its long review of the history of the "fair and equitable" principle. The plan of reorganization in *LaSalle* in substance gave the old equityholders the equivalent of an exclusive option to acquire equity at a fixed

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[72] See Sunstein, *One Case at a Time* 219–27 (cited in note 65).

[73] See *Union Bank v Wolas,* 502 US 151 (1991).

[74] See *BFP v Resolution Trust Corp.,* 511 US 531 (1994).

price the day the plan of reorganization was confirmed. The majority found that this option was "property." Once it reached this conclusion, the Court had only to use a common sense interpretation of the words "on account of" to resolve the case. Hence, its discussion of the "fair and equitable" standard was not only unnecessary, but suggested a methodology for interpreting the Bankruptcy Code that was confusing and rudderless.

The matter, however, is not so simple. The majority's conclusion that the equityholders were receiving "property" depended crucially on the link it made between the common law background of the "fair and equitable" standard and the absolute priority rule.[75] Without this link, it is much harder to conclude that the equityholders were receiving "property" under the plan.

Section 1129(a) requires that plans of reorganization be "feasible." Hence, anyone who proposes a plan has to be able to show that it will work. Some claims, principally administrative expenses, need to be paid in cash. In *LaSalle*, the plan also provided that debt other than that owed Bank would be paid in cash. Hence, for the plan in *LaSalle* to be "feasible," it had to identify the source of the cash needed to implement it. The old investors were willing to make a binding commitment to fund the plan in the event that it was confirmed, and the debtor took advantage of this willingness. Indeed, the debtor had to, given that the plan had to identify the source of the funds needed to implement it and no other source was available. Far from giving something of value to the old investors, the debtor was getting something from them. After all, when third parties commit themselves to funding a plan of reorganization before it is confirmed, they are typically paid a fee. To induce new investors to commit capital in advance, one must ordinarily pay them something.

From this perspective, the old investors did not receive an option or "property" of any sort. Indeed, it was the other way around. Under this view, far from giving property *to* the old investors, it was the debtor that had acquired a valuable asset—the com-

[75] Some courts have found that an exclusive option is property without relying on history. These courts have justified their interpretations by invoking the absolute priority rule. See, e.g., *Kham & Nate's Shoes No. 2, Inc. v First Bank*, 908 F2d 1351, 1360 (7th Cir 1990). But if one invokes the idea of absolute priority and does not link it to history, one must ground it in some other source. This is no easy task as the words "absolute priority" appear nowhere in the Bankruptcy Code.

mitment—*from* them. The old investors incurred an obligation to the debtor, while the debtor made none in return. The obligation was a *liability* to the old investors and an *asset* to the debtor.[76] For this arrangement to count as "property" in the old investors' hands, exactly the opposite would have to be true. The only "property" the old investors received were the interests in the new partnership they received after the plan was confirmed. These they received not on account of their old interests, but on account of the $4.1 million they contributed.

To decide a case such as *LaSalle*, a judge needs some way of choosing between these competing characterizations. The principle of absolute priority, as implemented in the text of the statute through the words "fair and equitable," is one way of doing this. This history attached to "fair and equitable" is replete with skepticism of any reorganization, regardless of how it is implemented, that is likely to leave old equity with a special deal. But this route is not available once one adopts a methodology that refuses to draw links to the past in interpreting words like "property." The text of the Bankruptcy Code does not provide for "absolute priority." It becomes easy to conclude that the old investors received property only *after* one accepts the idea that the Bankruptcy Code favors a theory of absolute priority over relative priority.

A statute like Chapter 11 that regulates the conduct of commercially sophisticated parties has to take account of their ability to adjust to whatever interpretative methodology the Court adopts. *LaSalle* is a good example. Lower courts had already noted that old investors received "property" if a plan gave them the exclusive option to buy equity at the value the bankruptcy judge set. Hence, the debtor in *LaSalle* structured things such that the old investors were not explicitly given an option. They made commitments in advance of plan confirmation. Hence, they had no "option" to exercise at the time the plan was confirmed. Justice Thomas recognized, quite correctly, that what the plan provided investors was substantively no different from what the shareholders would have received if they had been given options explicitly. Yet whenever

[76] Note that this characterization depends crucially on maintaining the legal distinction between the debtor and the old investors in much the same way that the equity receivership depended on maintaining the fiction that it was the creditors, and not the old shareholders, who were running the process.

one adopts a rule that looks to substance rather than form, one needs to know when such recharacterizations are permissible and when they are not. Recharacterization is simple in *LaSalle* once one is committed to the absolute priority rule, but not if one is committed to relative priority. Again, the text, separated from history, provides no way of choosing between them.

Ideas such as the absolute priority rule provide organizing principles that offer a way of seeing each of the provisions of the Bankruptcy Code as part of a coherent framework. A minimalist common law judge is cautious about choosing any organizing principles. Such a judge, for example, would not have written *Los Angeles Lumber.* Once such an opinion exists and the principle of absolute priority had been ratified by Congress, however, the principle ceases to be controversial. It has become part of the warp and woof of the law. Ignoring it is to discard a useful tool that may make the Bankruptcy Code easier to interpret, not harder.

The usefulness of this tool can be seen by considering the question that remains open afrer *LaSalle:* Are there any circumstances where old equityholders could participate in a reorganization over the dissent of a class of unsecured creditors? To explore this question, assume that on remand in *LaSalle* the bankruptcy court were to terminate the debtor's exclusive right to file a plan of reorganization and the bank were to offer its own plan of reorganization. This plan provides that, on the day of plan confirmation, the bank will deposit $90 million in cash with the bankruptcy court. These funds would, of course, be distributed according to the absolute priority rule, which would give the bank the entire $90 million. The bank votes in favor of the plan, and the general creditors and the former equityholders dissent. The plan, however, can be confirmed under the Code because it does not run afoul of Section 1129(b).

The debtor again files its plan. Recall that this plan gives the bank the entire economic value of the real estate, a set of promises valued at $4.1 million, and pays off the general creditors in full. No one else submits a third plan. To the extent that the debtor's plan can be confirmed, Section 1129(c) instructs the bankruptcy court to confirm one of the plans. In doing so, "the court shall consider the preferences of creditors and equity security holders . . . ."[77]

[77] 11 USC 1129(c).

The bank, however, argues that the court cannot get to Section 1129(c) because the debtor's plan does not comport with Section 1129(b)(2) because it gives "property" to the former investors "on account of" their prior equity interest. The debtor responds that the plan gives equity to the former owners only in exchange for the new capital infusion, and not "on account of" their old interest. *LaSalle* is satisfied because the debtor's plan has been exposed to the market, and, the debtor argues, it provides "top dollar" to the creditors. After all, both the bank and the general creditors receive more economic value under the debtor's plan than under the bank's plan. Moreover, the ability of the bank to offer a competing plan means that the old partners are not receiving property because of their old interest; rather, it is because they submitted the better plan.

The textualist cannot get a purchase on these facts. *LaSalle* no longer dictates that the old owners are receiving "property" under the debtor's plan. The conclusion that the debtor's plan, in effect, gave an option to the old equityholders turned on the exclusive nature of the process. On our hypothetical, however, that exclusivity has been removed. Moreover, is what the old partuers seek to acquire "on account of" their old interest, or is it "on account of" the capital infusion that allows the debtor to offer the better plan? We see no way in which the text can offer any legitimate guidance on this issue.

Compare this linguistic dead end with the avenues available to the judge who approaches "fair and equitable" in a common law fashion. The history of "fair and equitable" makes one think twice about embracing a blanket prohibition against such shareholder participation. From shortly after *Boyd* was decided until the adoption of the Bankruptcy Code, there was one aspect of "fair and equitable" on which everyone from Jerome Frank to Robert Swaine agreed. A plan could be "fair and equitable" and yet still allow old equity to participate. Hence, a court ought to hesitate before finding that Section 1129(b) prohibits old shareholders from participating altogether. Such an interpretation would create the odd result that the "fair and equitable" standard "includes" a prohibition that no one ever thought it had.

The history of "fair and equitable" thus suggests caution before concluding that shareholders cannot participate over the dissent of a class of creditors; it does not, however, mandate that conclusion.

The enactment of Chapter 11 significantly changed the voting rules governing the approval of a plan of reorganization. Earlier legislation required that all classes of creditors approve a plan of reorganization *and* that the plan be "fair and equitable." In other words, "fair and equitable" became an issue only after all classes of creditors bad approved the plan. By contrast, under Chapter 11 a court never has to probe whether a plan is "fair and equitable" unless a class of unsecured creditors has voted against it. By allowing creditor classes to approve a plan of reorganization, Chapter 11 allows for plans to be confirmed that are not "fair and equitable" even in the face of the objection by a isolated creditor. When every class approves the plan, the fair and equitable test is not reached. The Code thus allows creditors, by class, to approve equity participation in the reorganized firm. Hence, the plan in *Los Angles Lumber* would have been confirmed under today's Chapter 11 notwithstanding the dissenting creditors and no matter how one interpreted "fair and equitable."[78]

This change of when creditors can invoke the "fair and equitable" test is combined with the fact that today the disputes over whether a plan is "fair and equitable" arise for firms that are altogether different from the paradigms of either Swaine or Frank. In the typical case, a single creditor will hold all the claims in a particular class. Indeed, many are cases such as *LaSalle* in which one creditor has a claim that dwarfs all the others.[79] This claim vests the creditor with control over the class of which it is a member. None of Frank's concerns about protecting unsophisticated creditors are implicated, as the only creditor is itself a large bank or other investor. But Swaine's concerns are not implicated either. Because there is only one creditor, there is no danger that a small creditor will thwart the entire process. Even if there were a small creditor, as long as its claim was classified with others, it will be bound by the majority. These differences present a set of risks that neither Frank nor Swaine had to confront.

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[78] Such participation by former shareholders seems to be the norm in the reorganization of publicly held enterprises. See Lynn M. LoPucki and William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy of Large, Publicly Held Companies*, 139 U Pa L Rev 125, 142 (1990) (creditors agreed to allow shareholder recovery in 21 of 30 cases).

[79] In 51 cases involving the new value question since 1986, 25 were single-asset cases, and four more were Chapter 11 cases involving farms. Three cases involved plans confirmed by bankruptcy courts which allowed old equityholders to participate, over the objections of a class of creditors, based on fresh capital contributions.

There is another way of making the point that pre-Code doctrine cannot be transplanted wholesale into the Code. The question in *Boyd* was the extent to which the real estate foreclosure rules should apply in railroad reorganizations. Today, most of the cases under Section 1129(b) are like *LaSalle*. The underlying asset is a piece of real property. Arguing that ordinary foreclosure rules should not apply in this environment is necessarily harder than making such an argument in the case of nineteenth-century railroads.

For all these reasons, we want to be precise in our claims about the potential of common law methodology in bankruptcy: it provides guidance, not guarantees. On the question left open after *LaSalle*, it tells us that Section 1129(b) mandates absolute priority, and it also suggests that a court should hesitate before banning participation by old shareholders completely. We do not claim, however, that this approach relieves a judge from making judgments. The virtue of this approach is that it allows a generalist judge to understand the commitment to absolute priority, and to make a judgment as to how that commitment is implemented in the Code.[80] The common law approach frames the choice; it does not force it.

Minimalist common law judging in bankruptcy directs the court's attention to the relevant decision to be made. An added virtue is that it may also respond better to the institutional relationship between Congress and the courts. Congress faces a budget constraint in monitoring the evolution of bankruptcy law. It can pass a limited number of laws each session, and imposing coherence on a statutory scheme is a time-consuming endeavor. Congress amends the Bankruptcy Code almost every year. By contrast, systemic revisions to the bankruptcy law occur roughly every twenty years. There were major revisions in 1938, 1952, and 1978. A similar large-scale revision is now before Congress.

The systemic reforms address a central failing of individual amendments. Individual amendments tend to tear at the fabric of the system. They often reflect the pressing needs of a certain interest group. In the early 1980s, for example, some courts found that when a firm entered bankruptcy it had the power to cancel con-

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[80] On history as providing a guide to judgment rather than inescapable answers, see Rebecca L. Brown, *Tradition and Insight*, 103 Yale L J 177 (1993).

tracts that licensed its technology to other firms.[81] Firms were soon tempted to use Chapter 11 to renegotiate technology licenses. In response, firms became reluctant to acquire licenses from start-up firms or those in financial distress. In response to heavy lobbying, Congress quickly amended the Bankruptcy Code to straighten out this disruption.[82]

Finding that firms had the right to rid themselves of unfavorable technology licenses and other contracts did no violence to the text of the Bankruptcy Code. Nevertheless, these interpretations were hard to square with the conception of "rejection" of executory contracts that had been developed in the caselaw before the 1978 Act.[83] When opinions are sufficiently out of step with commercial practice, Congress often amends the law, and it did so here. But the congressional response focused on a narrow problem is imperfect. Congress's amendment addressed technology licenses only, the arena in which the interpretation caused the greatest problems. The interest groups that pushed the amendment had little incentive to ensure that its provision handled related problems, such as trademark licenses, franchise agreements, or covenants not to compete. Nor were they likely to be attentive to the way in which their amendment interacted with other parts of the Bankruptcy Code with respect to issues that did not affect them.

Such amendments make a statutory regime increasingly unwieldy over time. When courts focus on text to the exclusion of the principles that animate them, statutory regimes tend to lose their coherence more quickly. The provision that gave rise to the technology mess provides a good illustration. Courts, for the most part, have interpreted the section governing executory contracts in light of a handful of principles firmly rooted in bankruptcy precedent. (The most important one being that the trustee's power to "reject" an executory contract is merely the nonbankruptcy power to breach transplanted into the bankruptcy environment.) As a result, the section is more coherent and considerably less controversial than it might have been otherwise. An unyielding textualist

[81] See, e.g., *Lubrizol Enterprises Inc. v Richmond Metal Finishers Inc.*, 756 F2d 1043 (4th Cir 1985), cert denied, 475 US 1057.

[82] See 11 USC § 365(n).

[83] See Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* 105–21 (Harv U Press, 1986); Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U Colo L Rev 845, 931–32 (1988).

approach to the same section could not have done the same work. It could not have pointed in a consistent direction.

The Bankruptcy Code may be more likely to retain coherence over time when appellate judges adopt a minimalist common law methodology. Congress cannot monitor systematically judicial interpretation of the Bankruptcy Code. Its attention is focused on other matters. Given two interpretative methodologies that are equally easy to apply, we are better off with one that best maintains the coherence of the Code as a whole during the interregnum.

Finally, a minimalist common law method may perform better than textualism in our hierarchical judicial system. Such a methodology by appellate courts may also allow better oversight of lower tribunals over the course of many cases. When we tell a bankruptcy judge that the principle of the absolute priority rule is to be meticulously observed, we keep her in tighter check than when we tell her to focus upon the text of the statute. At the same time, we take advantage of her expertise. She has the ability to implement a procedure that ensures adherence to absolute priority in a way that the appellate court does not. Indeed, Justice Souter's principal contribution in *LaSalle* was to ensure not only that absolute priority will guide the bankruptcy judge, but also that the bankruptcy judge will implement the idea of absolute priority in a way that allows generalist appellate judges to review it.

To be sure, when an appellate judge uses common law methodologies to interpret the Bankruptcy Code, she may reshape the law in the process. Justice Douglas dramatically transformed our understanding of *Boyd* without many people, perhaps not even his fellow Justices, knowing it. But other methodologies may prove no more able to check strong-willed judges. Moreover, a methodology that insists on history and the articulation of general principles requires the strong-willed judge to make a large target. The absolute priority rule could not have been a bad rule and still found such ready acceptance in so many quarters so quickly. In other words, this methodology may be, to some extent, self-correcting. When one is forced to articulate general principles (such as the absolute priority rule) and show how they flow from words such as "fair and equitable," there is a limit to how far one can stray without drawing attention. As aggressive as Justice Douglas may have been in *Los Angeles Lumber*, he nevertheless still put forward an interpretation that was sufficiently sensible to win general ac-

ceptance. The deficiency of textualism in bankruptcy cases is that it sets out too few landmarks. In its hands, bankruptcy law can become both diffuse and inaccessible, and it may be harder to hold judges accountable.

*LaSalle* tells us that Section 1129(b) embodies the absolute priority rule and that bankruptcy judges must implement that provision in a way that allows generalist appellate judges to ensure that former equity holders have not evaded the strictures of capital structure that they have created. This, we now know, is *Boyd*'s legacy. Such a holding offers guidance that, while sensible, clear, and uncontroversial, is simply not available to the textualist judge. At least in bankruptcy cases, the common law tradition illuminates.