

The University of Chicago Law Review

Volume 77

2010

Special

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ESSAYS

Bankruptcy from Olympus

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INTRODUCTION

On the first day of Kmart's Chapter 11, its CEO asked for and received permission to use \$300 million to satisfy prepetition obligations owed "critical vendors"—prepetition suppliers whom he claimed were essential to Kmart's continued operations.¹ The CEO explained that alternatives to assuring they continued to do business with Kmart—such as cash on delivery or providing them with irrevocable letters of credit—were "not part of [his] business plan."² The general creditors whose own recoveries were diminished by the same amount appealed, ultimately to the Seventh Circuit, where Frank Easterbrook reversed.

Given the casual way in which the bankruptcy judge allowed several hundred million dollars to go to one group of general creditors at the expense of another, the outcome of *In re Kmart Corp*³ should not have surprised anyone. But it did.⁴ Moreover, Easterbrook's decision

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¹ See *In re Kmart Corp*, 359 F3d 866, 868–69 (7th Cir 2004).

² Id at 873.

³ 359 F3d 866 (7th Cir 2004).

⁴ Indeed, some experienced bankruptcy lawyers who should have known better confidently predicted the bankruptcy judge in *Kmart* would be vindicated. They dismissed anyone who thought otherwise as out of touch. See, for example, Richard Cieri, Judith Fitzgerald, and Judith Greenstone Miller, *Forum Shopping, First Day Orders, and Case Management Issues in Bankruptcy*, 1 DePaul Bus & Comm L J 515, 536 (2003) (noting that when an academic disagreed with a lawyer's prediction on a panel that the *Kmart* critical-vendor order would be approved, the lawyer responded dismissively, "Those academics, what are you going to do.").

in *Kmart* has led, in the view of some, to the migration of large Chapter 11 bankruptcies from the Seventh Circuit. In the early 2000s, large Chapter 11 cases were regularly filed in Chicago, including both United Airlines and insurance giant Conesco.⁵ None has been filed there since *Kmart*.

Lawyers have read Easterbrook's opinion to hold that an elaborate evidentiary hearing is needed on the first day before a critical-vendor order can be issued. Instead of tending to the business of signing the dozens of orders needed to keep a large business operating on the first day of the case, a bankruptcy judge in the Seventh Circuit must conduct an elaborate hearing, a hearing that would often be useless, as those adversely affected are often not even in court. But Easterbrook did not do this. He held only that the evidentiary basis for paying out \$300 million was insufficient, a point that was hardly controversial. He never reached the question of how much more was needed. Lawyers have feared that it was a lot, but a closer look at Easterbrook's approach to law in general and bankruptcy in particular tells us this is not so.

Even a casual examination of Easterbrook's quarter century on the bench tells us that he does not second guess lower court judges who apply the right approach to the facts before them as best they can.⁶ Moreover, because he is a judge who regularly brings the tools of law and economics to questions of business law in general and bankruptcy in particular,⁷ one can predict exactly what Easterbrook would want from a judge considering a critical-vendor motion. If π_t represents the firm's earnings, with a growth rate μ and variance σ , then changes in the firm's earnings ($d\pi_t$) can be expressed as follows:

$$d\pi_t = \mu\pi_t dt + \sigma\pi_t dW_t$$

where W_t is a normally distributed Markov process with mean $E[dW_t] = 0$ and variance $E[dW_t^2] = dt$. If we can further represent c as the difference between the cash outflows required by the critical-vendor order and the distribution the recipients would receive in the event the critical-vendor order were not made (their fractional share of L , the present value of the liquidation price), then when faced with

⁵ See Lynn M. LoPucki, *Bankruptcy Research Database*, online at http://lopucki.law.ucla.edu/bankruptcy_research.asp (visited Feb 19, 2010) (query run for the years 2000 to 2009).

⁶ See, for example, *Hoosier Energy Rural Electric Cooperative, Inc v John Hancock Life Insurance Co*, 582 F3d 721, 726 (7th Cir 2009) ("We do not agree with all of the district judge's reasoning, but we do not think that the court erred in thinking Hoosier Energy's claim sufficient for this limited purpose.").

⁷ See, for example, *In re Excello Press, Inc*, 890 F2d 896, 901, 906-07 (7th Cir 1989).

a critical-vendor order, the bankruptcy judge must simply solve the following, where r is the creditors' discount rate:⁸

$$V(\pi_t) = \max \{L, \pi_t dt + e^{-rdt} E_t[V(\pi_{t+dt})] \cdot c\}$$

As long as the bankruptcy judge decides the critical-vendor motion with a modicum of competence in a fashion consistent with this equation and with some basis in the record, she can issue a critical-vendor order on the first day with nothing to fear from Frank Easterbrook. While this might seem to do little to reassure, appearances are deceiving. This Essay explains.

I. THE CRITICAL-VENDOR PROBLEM

The *Kmart* problem can be traced back to railroad receiverships in the nineteenth century.⁹ Railroads were the first giant corporations. They possessed complicated capital structures, nearly all of which was secured debt of one type or another. In the typical receivership, the holders of each type of bond formed a committee. The committees in turn appointed representatives to negotiate on their behalf. Even if these negotiations lasted several years, the railroad kept running. Railroads were spread out over thousands of miles, as were their suppliers. The suppliers' claims were usually trivial in the grand scheme of things. More to the point, many of them had the ability to disrupt the operations of the railroad. The person who supplied coal or water in a small town had a credible threat. Bargaining with him was often a game that was not worth the candle. The receiver was empowered to pay off such suppliers. Exactly what standard the receiver was supposed to use under this "doctrine of necessity" was never resolved. Among other things, the stakes were simply too low. While restructuring hundreds of millions in debt, it made no sense to devote resources to the question of the payment of a few thousand here and there.

The law governing the restructuring of small businesses evolved differently. In the typical small business reorganization, the trade creditors were themselves large stakeholders, not rounding errors. Moreo-

⁸ To anticipate the punch line of this Essay, this formula shows that a critical-vendor order is an optimal stopping problem. In confronting lift-stay motions, grants of extensions of exclusivity, and any number of other circumstances, bankruptcy judges face exactly such problems and solve them successfully all the time. For these, Easterbrook shows enormous deference to bankruptcy judges who apply the proper legal rule to the record the parties put before them. We should count on Easterbrook to treat critical-vendor motions the same way he treats their close kin. For a review of the empirical evidence and a formal proof of the idea that much of the work of the bankruptcy judge is solving optimal stopping problems, see Edward R. Morrison, *Bankruptcy Decision-Making: An Empirical Study of Small-Business Bankruptcies* *66-69 (unpublished PhD dissertation, The University of Chicago, 2003).

⁹ See *Miltenberger v Logansport Railway Co*, 106 US 286, 293-94 (1882).

ver, few were comparable to the water supplier in the small town. The typical small businesses could find alternative suppliers. Even though they were in bankruptcy, they could still do business with new suppliers on a cash basis. As a result, in nonrailroad cases, the doctrine of necessity never acquired a secure foothold.¹⁰ Payments were made only irregularly to suppliers on account of prepetition debts before the enactment of the Bankruptcy Code.¹¹ The question of whether such payments were permissible was rarely litigated. And when Congress enacted the Bankruptcy Code, it included no provision dealing explicitly with the problem.

As practice developed after 1978, however, critical-vendor payments began to be made in Chapter 11 cases.¹² At first, many of these payments came in cases that closely resembled the railroad cases, cases in which the negotiations were only over capital structure. A large nonretail business with little in the way of accounts payable goes through a leveraged buyout and then the market it finds itself in sours. There is financial distress (the firm cannot pay its creditors in full), but no economic distress (there are no operational problems with the firm or its managers). A restructuring that reflects the changed economic environment is the sensible course, and the senior and junior tranches of debt strike a deal with each other and the equityholders. To implement the deal, they file a Chapter 11 petition.¹³ As what is involved is a reshaping of the capital structure, mostly at the level of the parent holding company, little is to be gained by interfering with the ongoing operations of the business and its longstanding relationships with vendors, none of whom is owed very much. Everyone with stakes large enough to appear in court is content to pay all the vendors in full, and no one objects when the time comes for the judge to sign the order.

Over time, lawyers and judges grew increasingly accustomed to issuing critical-vendor orders, even when the amounts involved were quite substantial. Astute suppliers began to lobby the debtor before the bankruptcy petition to be treated as critical vendors. The debtor's managers had little incentive to resist. Among other things, those adversely affected were not likely to appear on the first day of the case. In the absence of objection, bankruptcy judges were not likely to push

¹⁰ One of the exceptional cases is *Dudley v Mealey*, 147 F.2d 268, 271 (2d Cir. 1945).

¹¹ 11 USC § 101 et seq.

¹² See Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 Am Bankr L J 75, 98-102 (1991); Russell A. Eisenberg and Frances F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 Marq L Rev 1, 11-17 (1989).

¹³ The bankruptcy petition is necessary because outside of bankruptcy the Trust Indenture Act of 1939, Pub L No 76-253, 53 Stat 1149, codified as amended at 15 USC § 77aaa et seq, prevents a restructuring without unanimous consent of all the bondholders, something that is unusual.

back. Some feared that they would be labeled “toxic judges” and find themselves out of the business of hearing large Chapter 11 cases. But for others it was far simpler. They were inclined to grant motions many support and none oppose. Over the course of the 1990s, the number and size of critical-vendor payments grew, but little effort was made to ground them in the Bankruptcy Code. Many forgot that appellate courts often insist that even well-established practices be anchored in the law.

Simply asserting the existence of a “doctrine of necessity” is not sufficient to persuade an appellate judge in search of well-founded principles. It is a label, “just a fancy name for a power to depart from the Code.”¹⁴ Section 105(a) gives the bankruptcy judge the power to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions” of the Code, but it creates no substantive rights.¹⁵ Section 105 merely enables the judge to carry out the substantive provisions of the Code. It does not give the bankruptcy judge “a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be.”¹⁶ The power to pay critical vendors must be grounded elsewhere in the Code.

While he quickly rejected these efforts to justify critical-vendor orders, Easterbrook recognized that it might be possible to find support for making payments to prepetition creditors in § 363(b) of the Bankruptcy Code. This provision gives the trustee the ability to use assets outside the ordinary course after notice and a hearing.¹⁷ A payment to a prepetition creditor is arguably a “use” of assets of the estate that § 363(b) permits. But payments to critical vendors or any other prepetition creditors threaten to undermine the pro rata sharing rule that is firmly embedded in other parts of the Bankruptcy Code.¹⁸ Hence, according to Easterbrook, “it is prudent to read, and use, § 363(b)(1) to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code.”¹⁹ For this reason, even if § 363(b) permits payments to prepetition creditors, fault can be found with the lower court in *Kmart*.

¹⁴ *Kmart*, 359 F3d at 871.

¹⁵ 11 USC § 105(a).

¹⁶ *Kmart*, 359 F3d at 871, quoting *In re Chicago, Milwaukee, St. Paul and Pacific Railroad Co.*, 791 F2d 524, 528 (7th Cir 1986).

¹⁷ 11 USC § 363(b)(1) (“The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . .”).

¹⁸ See, for example, 11 USC § 726(b) (“Payment of claims . . . specified [elsewhere in this section] . . . shall be made pro rata among claims of the kind specified in each particular paragraph.”).

¹⁹ *Kmart*, 359 F3d at 872.

First, the bankruptcy judge failed to ask the question whether the payments to the prepetition creditors were in any sense “critical.” This matters because there is considerable reason to doubt that many prepetition suppliers are in fact “critical vendors.” A debtor that relies upon a third party for a critical component typically has a contract. After all, if it did not have a contract, it would be exposing itself to a holdup risk outside of bankruptcy. And if the debtor does have a contract, there is no critical-vendor problem. The debtor can simply move to assume the executory contract and, while this motion is pending, the third party is under an obligation to continue performance.

Even if the debtor were foolish enough not to have a contract for a critical component, the supplier’s threat may not be credible. If it is supplying a customized component, the supplier likely has equipment and workers dedicated to doing business with the debtor. It has much to lose if the relationship between it and the debtor ceases. As a rational actor, such a supplier should focus only upon what it stands to gain from dealing with the debtor going forward. Its potential losses for goods shipped and not paid for is a sunk cost.

Later events in the *Kmart* case underscore both points. Several months into the case, Kmart ceased doing business with its single largest “critical” vendor.²⁰ This vendor was immediately forced to file for bankruptcy itself.²¹ A vendor Kmart could ditch so quickly does not seem so “critical.” And even if Kmart could not have afforded to cut it off when it filed for bankruptcy, the critical vendor would not have been able to cut Kmart off either.

Equally troubling for Easterbrook was the failure of the bankruptcy judge to establish any benchmark for her decision. Easterbrook searched in vain for any effort on her part to do this and found none. For example, “The court did not find that discrimination among unsecured creditors was the only way to facilitate a reorganization. It did not find that the disfavored creditors were at least as well off as they would have been had the critical-vendors order not been entered.”²²

Some have assumed that Easterbrook’s long list of benchmarks that the bankruptcy judge might have used, but did not, was in fact a multifactor test of what he would require from the bankruptcy judge before issuing a critical-vendor order.²³ But he does not do this. A close

²⁰ Id at 873.

²¹ Id.

²² Id at 874 (noting that the court did make any findings of harm from potential nonpayment and that “the scant record would not have supported such a finding had one been made”).

²³ See, for example, Mark A. McDermott, *Critical Vendor and Related Orders: Kmart and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 14 Am Bankr Inst L Rev 409, 416 (2006) (interpreting *Kmart* to say that a debtor must specifically show that creditors

reading of the opinion makes clear that he is not requiring that a bankruptcy judge use any of these benchmarks. But anyone who knows Easterbrook does not even need to read the opinion closely. He hates multifactor tests. Easterbrook deliberately stops short of saying exactly what kind of finding the bankruptcy judge needs to make, beyond the basic idea that “preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to other creditors.”²⁴

The immediate consequences of Easterbrook’s opinion were entirely salutary. Critical-vendor orders had gotten completely out of hand. Lawyers and judges were privately relieved that someone had come along to cry foul. We still see critical-vendor orders, but thanks in large part to Easterbrook’s opinion, a widely accepted norm has emerged in the Seventh Circuit and elsewhere that allows suppliers to be paid only after the debtor shows it is in everyone’s interest and, wherever possible, only after other creditors have had a chance to object. The best of the bankruptcy bench and bar—including many who complain about the disappearance of large bankruptcy cases from Chicago—concede privately that “Frank got it right.”

Easterbrook’s opinion made the critical-vendor problem much less important. Moreover, careful prebankruptcy planning and the 2005 changes to the Bankruptcy Code have dramatically reduced the need for critical-vendor orders.²⁵ But the same principles can arise in many other situations. I review these in Part II and then explore how Easterbrook’s approach to bankruptcy—hinted at in *Kmart* and developed elsewhere—provides us with a way of thinking about them.

II. THE TWO-HAT PROBLEM

The problem of paying general creditors is deeper and more pervasive than the critical-vendor problem raised in *Kmart*. Consider the following case.²⁶ A firm manufactures an IUD birth control device that proves defective. Facing massive tort liability, it files for bankruptcy. The bankruptcy judge removes the job of forming a plan of reorganization from the managers of the business and appoints an examiner to take on this role. The person chosen for the job is Ralph Mabey, a

will cease doing business absent immediate payment and that payment will not leave disfavored creditors “worse off”).

²⁴ *Kmart*, 359 F3d at 874.

²⁵ Congress amended the Bankruptcy Code so that it gives administrative expense priority to suppliers for goods they shipped twenty days before the filing of the petition. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 § 1227(b), Pub L No 109-8, 119 Stat 23, 200, codified at 11 USC § 503(b)(9). This priority is usually enough to keep them sufficiently happy that a critical-vendor order is not necessary.

²⁶ The following fact pattern is drawn from *Official Committee of Equity Security Holders v Mabey*, 832 F2d 299, 299–302 (4th Cir 1987).

former bankruptcy judge who is a repeat player in the world of large bankruptcies. Whether as an examiner or as counsel to the creditor's committee or in a variety of other roles, his career depends upon finding new employment every few months. His livelihood depends upon his reputation as an honest agent of whatever group he is representing. In the IUD case, he is expected to represent the interests of all the creditors as a group.

In the course of crafting the plan of reorganization, Mabey discovers that any delay in implementing a plan of reorganization adversely affects a number of the tort victims and, crucial from his perspective, the size of their claim against the estate. The use of the IUD rendered them infertile. If they have tubal ligation surgery immediately (at a cost of \$15,000), they might be able to have children. If they receive the surgery now and it is successful, their claim is likely little more than the cost of the surgery. But if they are not paid immediately and the surgery is postponed, it will be less likely to succeed. If the victims cannot conceive, they would receive damages *both* for the costs of the surgery and the damages from being rendered infertile, an amount at least an order of magnitude larger than the cost of the surgery.

After considerable research, Mabey concludes that paying these prepetition creditors makes all the creditors as a group better off, as long as the cost of the surgery is less than the distribution the tort victims would receive if they did not get it. Their distributions might be much larger because their claims would be much larger. Mabey seeks to pay for the cost of the surgery, and he has the support of the general creditors as a group. An objection comes, however, from equityholders, a group entitled to be paid only after the tort victims are paid in full. How would Easterbrook expect a bankruptcy judge to approach this question?

In many cases, debtors on the first day of the case ask for permission to issue paychecks for work done before the filing of the petition. Workers are typically entitled to statutory priority.²⁷ If the reorganization is successful, they are likely to be paid anyway. Moreover, if the workforce is left unpaid, the cost of the disruptions to the debtor's operations may be larger than the cost of cutting the checks. (Rational or not, they may not return to work with the stoic equanimity of someone who completely grasps the idea of the sunk-cost fallacy.) Here again, should the bankruptcy judge approve such requests?

We often see another class of creditors being paid as well—buyers with whom the debtor wants to maintain goodwill who have prepaid comparatively modest amounts for goods or services. In prin-

²⁷ See, for example, 11 USC § 507(a)(4)–(5).

ciple, the debtor should be able to require the buyers to pay for future services again and content themselves to a post-confirmation distribution at pennies on the dollar for whatever they have paid before. Sometimes, however, it does not seem worth the trouble. In *In re Marvel Entertainment Group, Inc.*,²⁸ for example, the debtor proposed, and the court approved, to continue shipping to tens of thousands of buyers who had prepaid without demanding additional payment. The reorganization was an ugly takeover battle between Carl Icahn and Ron Perelman.²⁹ The problem with the business was its overleveraged capital structure, not with its day-to-day business operations. More to the point, the product in question was comic books. Apart from the sheer silliness of creating a creditor body consisting largely of twelve- and thirteen-year-olds and allowing them to be heard in the case, the debtor was convinced that cutting off its subscribers would be bad for business over the long run.³⁰

A similar issue arises with respect to frequent flyer miles in airline bankruptcies. The obligation of an airline to provide additional services because of revenues it received before the filing of the petition seems like a prepetition claim that should be cashed out at cents on the dollar just like any other. Again, how does Easterbrook want bankruptcy judges to think about this problem?

Finally, consider the following hypothetical.³¹ The debtor is a steel mill that has ceased operations. The only tangible asset with any value is a large quantity of steel ingots. They have a market value of \$75. The debtor also acquired a put on the ingots. It has entered a contract in which a third party is obliged to pay \$125 for the ingots if delivered within a week's time. The general creditors as a group are owed hundreds. The workers are owed \$10. The workers put up a picket line and hire a lawyer to represent them. The lawyer is nicknamed "Fast Louie." In addition to practicing law, he is one of the most powerful politicians in the city and has excellent relations with the city police, the zoning board, and virtually everyone else with whom the debtor's investors might need to deal if they want to do any business in the city again.

Fast Louie listens patiently as the debtor talks about its difficulties. The debtor cannot find anyone willing to cross the picket line

²⁸ 209 BR 832 (D Del 1997).

²⁹ See generally Dan Raviv, *Comic Wars: How Two Tycoons Battled over the Marvel Comics Empire—and Both Lost* (Broadway 2002).

³⁰ For a description of the motions made on the first day in court, see *id.* at 80–83 (noting that the only counterargument made for involving comic book subscribers through individual notifications was the tongue-in-cheek rejoinder: "I think some of these [bankruptcy] notices would help the little tykes go to sleep.")

³¹ These facts are loosely based on *In re EDC Holding Co.*, 676 F2d 945, 946–47 (7th Cir 1982).

without police protection, and the police, it appears, are unusually reluctant to protect anyone who might try to cross it. Fast Louie is completely sympathetic with the debtor's plight, but he expresses some sympathy for the position of the workers too. Not only are they owed \$10, but they now face \$5 in legal fees as well as a result of the bankruptcy. Fast Louie expresses his hope that the debtor will find a way "to do the right thing." He is especially concerned because there are, it appears, some in city government who, unlike him, carry grudges. The last thing he would want would be for the other creditors to have trouble doing business in the city in the future if they appear not to be "cooperative." The debtor asks if paying the workers in full is "the right thing." Fast Louie is noncommittal, noting the "expenses" that the workers have incurred. When the debtor asks about \$15, Fast Louie says that, while he thinks it is the right thing, only the bankruptcy judge can say for sure. Would Easterbrook allow the judge to approve it?

Paying for the tubal ligation surgery, cutting paychecks, shipping comic books, honoring frequent flyer miles, and "doing the right thing" for workers ask us to consider both the limits on the trustee's ability to use assets of the estate and the review that the bankruptcy judge needs to give such decisions. The next Part of the Essay examines the general principles that Easterbrook would likely bring to these issues.

III. VALUE MAXIMIZATION

The Bankruptcy Code allows the bankruptcy judge to authorize any use of the debtor's assets, subject to notice and a hearing, but leaves unspoken both the benchmark against which to assess the trustee's decision and the amount of deference that the trustee is owed. For Easterbrook, the starting place can be found in one of his earliest, most influential, and least cited bankruptcy opinions. The Central Ice Cream Company owed its general creditors about \$12 million.³² It had closed its doors, and its only asset was a lawsuit against McDonald's. Central Ice Cream prevailed at trial and received a \$52 million judg-

³² The following fact pattern is a slight simplification of *In re Central Ice Cream Co.*, 836 F.2d 1068, 1069–70 (7th Cir 1987). This hypothetical and Easterbrook's analysis, one that focused on looking at the interests of both the junior and senior investors together, have been one of the central fixtures of corporate law for nearly two decades. It is set out in *Credit Lyonnais Bank Nederland, NV v Pathe Communications Corp.*, 1991 WL 277613, *34 n 55 (Del Ch) (recounting the *Central Ice Cream* fact pattern in order to comment on the inherent biases held by debt and equityholders), and has been discussed in many cases since. Because the judge in *Credit Lyonnais* inexplicably failed to cite Easterbrook, Easterbrook's influence here has been largely neglected. For further analysis, see Douglas G. Baird and M. Todd Henderson, *Other People's Money*, 60 Stan L Rev 1309, 1323–28 (2008).

ment. At this point, McDonald's made a settlement offer of \$16 million. The general creditors, as one might expect, wanted it accepted post haste. If Central Ice Cream took the offer, they would be paid in full. The shareholders, again none too surprisingly, wanted the offer rejected. They would receive only \$4 million if the settlement offer were accepted, but might become rich if the company prevailed on appeal.

The trustee asserted that he could take the offer without considering the position of the shareholders.³³ His duties went to the creditors alone. Hence, he had the power to accept any settlement that paid them in full. Easterbrook rejected this idea out of hand.³⁴ A sensible understanding of bankruptcy requires the trustee to accept the settlement offer if, but only if, it serves to maximize the value of the estate for the benefit of all the stakeholders.³⁵ The trustee must act in the interests of everyone, and the bankruptcy judge must review his actions by the benchmark.

There is a natural way to read the Bankruptcy Code to apply this principle to paying for the tubal ligation surgery, cutting paychecks, shipping comic books, honoring frequent flyer miles, and "doing the right thing." It makes sense to pay the tort victims, the workers, the comic book subscribers, the frequent flyers, and even Fast Louie, if, but only if, it is in everyone's interest to do so. The hard question—and one that Easterbrook does not directly confront—is the standard of review that the judge should bring to these questions.

The business judgment rule outside of bankruptcy takes deference to managerial decisionmaking to an extreme. Henry Ford could spout all sorts of nonsense completely inconsistent with maximizing the value of his business, and the court still deferred to his business judgment.³⁶ But bankruptcy is different. The levers of control that creditors and shareholders have outside of bankruptcy are largely missing.

In the absence of a backstop, some additional scrutiny seems warranted, but the amount depends on the circumstances. The amount should turn not on any absolute metric, but a combination of two things. First, one needs to assess the extent to which the person making the decision has any axe to grind. Second, one must assess the extent to which those adversely affected had a chance to weigh in.

³³ *Central Ice Cream*, 836 F2d at 1072.

³⁴ *Id.*

³⁵ *Id.*

³⁶ See *Dodge v Ford Motor Co*, 170 NW 668, 682–84, 685 (Mich 1919) (approving the construction of a factory even though "the plan does not call for and is not intended to produce immediately a more profitable business, but a less profitable one" and even after the CEO said his ambition was not profit, but rather "to employ still more men, to spread the benefits of this industrial system to the greatest possible number").

Return to the IUD case. Ralph Mabey, the person asking for assets to be directed to some prepetition creditors, did his due diligence in examining the costs and benefits of tubal ligation surgery. Moreover, Mabey is a repeat player in the small world of large bankruptcy cases. His incentives were completely aligned with those of the creditors as a group, as they consist of institutional investors with long memories. They do not mind if Mabey represents some other constituency in a different matter, but they expect him to be loyal with respect to any given matter. Once bought, he is obliged to stay bought.

Finally, Mabey's proposal did not come on the first day, but long after everyone had a chance to organize and weigh in. Even if Mabey were not unbiased, others had a full opportunity to make their case. The judge in an adversary system is not an inquisitor. As long as those adversely affected by the trustee's decision have a chance to appear and present their story, the judge is entitled to draw inferences from silence.³⁷ In the face of a recommendation from an unbiased, highly competent decisionmaker like Mabey with access to all the relevant information and acceptance of his recommendation by the other creditors, those whose money was on the line, there is little work for the bankruptcy judge to do.

Easterbrook is deeply skeptical about the ability of judges to make what are essentially business decisions. He similarly doubts they are even good at deciding whether they know how much information those making such decisions need to gather before making them. "Information is costly, and investors want managers to spend on knowledge only to the point where an additional dollar generates that much in better decisions."³⁸ When the managers have the right incentives, the judicial process is "distinctly inferior."³⁹ Easterbrook would chide a bankruptcy judge who forced an examiner to gather too much information in a case like *Mabey*. Gathering information is costly and again is contrary to the interests of the stakeholders.

For a judge such as Easterbrook, a case such as *Mabey* is easy. The appellate judge has no business looking hard at a decision a bankruptcy judge makes at the behest of a disinterested examiner on the basis of a fully developed record in which the opponents have been given a full opportunity to be heard. Indeed, the only hard issue for a judge like Easterbrook would be whether to sanction the equityholders' committee for bringing the appeal. The equityholders were not concerned with

³⁷ For an analysis of decisionmaking in such contexts, see Paul Milgrom and John Roberts, *Relying on the Information of Interested Parties*, 17 RAND J Econ 18, 24–27 (1986).

³⁸ Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* 107–08 (Harvard 1991).

³⁹ Id at 108.

the merits at all. Their opposition was a shot across the bow, a signal that they would make trouble unless the examiner came up with a plan that gave them a generous piece of the pie. When parties litigate for reasons that are deliberately wasteful and have nothing to do with the merits, Easterbrook is among the first to think sanctions appropriate.⁴⁰

The other problems, however, are not as easy as *Mabey*. The person charged with making the decision to pay prepetition creditors is usually not a disinterested examiner, but the debtor-in-possession (DIP). She cares about keeping her job and keeping the most powerful players happy. Advancing both interests comes most easily when she can use other people's money. Moreover, she often wants the bankruptcy judge to act very early in the case, well before those adversely affected can gather their forces. In this environment, the judge must put greater burdens on the party bringing the motion than something akin to the business judgment rule, but what exactly should those be? What sort of factual record is necessary?

But orders on the first day are not once-and-for-all affairs. The only decision that must be made on the first day is whether to spend the resources necessary to maintain the status quo until there is an adversary proceeding where those who oppose the motion have an opportunity to present their objections. Put in the language of economics, a judge who is asked for authority to pay workers, ship comic books, or honor frequent flyer miles must decide whether to preserve a real option.⁴¹ In the extreme case, refusing to make the payment is the same as a decision to shut down the firm today.⁴² Making the payment allows the judge to postpone the shutdown decision. Liquidating today gives up not only the long-term revenues of the going concern, but also the chance to wait. It often makes sense to take stock and make the final decision at a time when more information is available and the judge can rely on the adversary process—including the failure of anyone to file an objection.

Consider the case in which the workers are unpaid and where everything suggests that there will be a distribution of some sort to

⁴⁰ See, for example, *Rose v Franchetti*, 979 F2d 81, 84, 85–87 (7th Cir 1992) (affirming the imposition of sanctions on a defendant based on the district court's findings that the defendant filed a false affidavit and deliberately wasted the court's time).

⁴¹ See Douglas G. Baird and Edward R. Morrison, *Bankruptcy Decision Making*, 17 J L, Econ, & Org 356, 358–66 (2001).

⁴² Of course, in many cases, the choice is not between shutting down the firm or allowing it to continue as a going concern, but rather a choice of continuing the firm as a going concern, but with a diminished income stream. This choice is also one of whether to preserve the real option embedded in the value of the difference between the two income streams. Analytically, the two problems are the same. Nothing is lost by the simplifying assumption that reduces the problem to a stark choice between liquidating and reorganizing.

general creditors. Because the workers have statutory priority over the general creditors,⁴³ paying them in full today is likely to cost the general creditors as a group nothing. As long as it is worth waiting to find out if the business has value as a going concern and where there is a significant chance that refusing to pay the workers will shut down the business, paying the workers on the first day makes sense. The court is preserving the value of a real option at virtually no cost.

Shipping comics to twelve-year-olds or honoring frequent flyer miles is only slightly more difficult. To be sure, making these payments is not costless from the perspective of the general creditors. Their claims are being honored at one-hundred cents on the dollar, and the general creditors of an insolvent business will receive something less. But the cost is again modest, as the question is not whether to honor the frequent flyer miles or subscription obligations forever, but only whether to do so until there can be a full-scale hearing in a few weeks time. As long as the option value of waiting is substantial, these costs are worth incurring.

This returns to the formula set out above. It captures the idea that critical-vendor orders are a species of the optimal stopping problem. The math here is not exactly simple. Linear programming problems requiring stochastic calculus rarely are. But solving such equations explicitly is quite different from making decisions in a way that is consistent with them. (An outfielder behaves as if he can solve quadratic equations and that is all we care about.) What the formula reveals—and what matters for someone like Easterbrook—is the nature of the problem. The critical-vendor problem is identical, apart from the need to subtract the constant c , from questions that bankruptcy judges face all the time, such as lift stay motions, motions to extend exclusivity, DIP financing orders, and the like. They are all optimal stopping problems.⁴⁴

At every hearing, the bankruptcy judge is charged with deciding whether it makes sense to spend resources to keep the option of reorganizing the business alive or to shut it down. The critical-vendor problem is merely a subset of these. The money being spent on the critical-vendor order or other payment is being made in exchange for another asset—the real option. The bankruptcy judge is pricing a real option, not valuing the firm as a whole. She is asking whether what the estate is spending— c —is worth what the estate is receiving in return.

As it happens, bankruptcy judges are good at solving this class of problems. Indeed, the growing empirical evidence suggests that they solve these problems as well as a profit-maximizing rational actor sub-

⁴³ See 11 USC § 507(a)(4).

⁴⁴ See Baird and Morrison, 17 *J L, Econ, & Org* at 358–66 (cited in note 41).

ject to the same constraints.⁴⁵ The review we use for critical-vendor orders should therefore parallel the review we use for these others. As long as the judge's focus is on whether this exchange is a value-maximizing one, Easterbrook will not second guess her, just as he does not for the other optimal stopping problems she faces.

At this point, we can return to the problem of Fast Louie. The tort victims, the workers, the comic book subscribers, and the frequent flyers differed from him in a crucial respect. There is no strategic behavior on their part. They were not the ones demanding payment. The examiner or the DIP made the motion without prompting. The debtor was better off making the payments regardless of whether anyone asked for it. Not so with Fast Louie. The debtor wants to pay him off because he is holding an asset of the estate hostage and is demanding ransom.⁴⁶

What matters is whether his threat to keep the picket line in place is credible. The answer is that it is. Because of the Norris-LaGuardia Act,⁴⁷ the court lacks the power to order the picket line removed. The workers have nothing to lose by keeping the picket line in place, as the steel mill is shutting down and they will receive virtually nothing even if the option is exercised. Moreover, Fast Louie has a reputation for carrying out his threats. He is better off receiving nothing in this case than compromising his reputation for tough dealing in the future.

The question becomes not whether to cut a deal with Fast Louie, but rather the terms of the deal. But strictly speaking it has nothing to do with whether paying prepetition creditors is permissible. Fast Louie couches his demand as the sum of the back wages and his fee. The first is a prepetition claim and the other is not a claim at all.⁴⁸ But nothing turns on the distinction. Fast Louie controls the ingots and is demanding ransom for their return. That he cannot convert the ransom demand into a claim against the estate is irrelevant. The only question is whether the debtor is better off paying the ransom than not.

Here too the question is whether making the payment makes the creditors better off. Often the choice is not binary. One can try bargaining with Fast Louie. One can ask the court to hold him in contempt for violating the automatic stay. Assessing whether the debtor

⁴⁵ This is the Morrison conjecture. See Morrison, *Bankruptcy Decision-Making* at *43 (cited in note 8). Morrison gathered the first empirical evidence nearly a decade ago, see id at *20–31 (reviewing a dataset culled from Northern District of Illinois bankruptcy cases in 1998), and others have replicated his results since.

⁴⁶ Fast Louie's actions, if made explicit, would violate the automatic stay, see 11 USC § 362(a)(3), but he was careful not to be explicit.

⁴⁷ Norris-LaGuardia Act, Pub L No 72-65, 47 Stat 70 (1932), codified as amended at 29 USC § 101 et seq.

⁴⁸ Debtors are under no obligation to pay the fees of their creditors. See, for example, *In re Farmland Industries, Inc.*, 286 BR 895, 898–900 (Bankr WD Mo 2002).

has engaged in effective strategic bargaining is considerably harder than pricing a real option. Among other things, in games of this type, the equilibrium often exists only in mixed strategies.⁴⁹ A value-maximizing trustee should bargain hard and risk failure. A failure by the trustee to do this when confronting strategic behavior is evidence that he is not looking out for everyone's interests. A bankruptcy judge listening to the debtor who must deal with Fast Louie should take this into account, as should the judge listening to the CEO in *Kmart*.

But there is nothing special about strategic behavior. What is necessary—and what was ultimately found missing in *Kmart*—is a focus on trying to maximize value for the benefit of the stakeholders. The bankruptcy judge must be able to say, and have some basis in the record for saying, “I have seen enough to satisfy me that the trustee is looking after everyone's interest. I can defer to his judgment that the stakeholders as a group are better off if we make this payment. Therefore I authorize the trustee to use assets of the estate for this purpose as provided by § 363(b).” Fast Louie—and *Kmart*—are different from the tort victims only in that the additional element of strategic behavior must enter the trustee's value-maximizing calculus.

If the bankruptcy judge had merely confronted the critical-vendor motion in *Kmart* from this point of view, she would have been unlikely to approve it. At the very least, she would have forced the debtor to isolate just those expenditures that could not be put off and put a price tag on those. At the full-dress hearing, she would revisit the same question, this time putting a greater burden on those who objected to make their case. This is exactly the practice that has emerged in the wake of *Kmart*.⁵⁰

CONCLUSION

Many of the critical-vendor payments that flourished before *Kmart* were in no sense “critical.” After *Kmart*, debtors found it easier to push back and call the bluffs of supposedly critical vendors. They were better off with their hands somewhat tied. Far from excluding critical-vendor orders categorically as some feared, Easterbrook provided a limited rationale for them, one that is both sensible and grounded in statutory text. *Kmart* is one example (among many) in Easterbrook's jurisprudence in which he draws on the principles of economics to make the law work. His opinions tend to be far removed from the messy business

⁴⁹ See Douglas G. Baird, Robert H. Gertner, and Randal C. Picker, *Game Theory and the Law* 43–44 (Harvard 1994).

⁵⁰ See, for example, *In re Tropical Sportswear International Corp.*, 320 BR 15, 17 (Bankr MD Fla 2005).

of running an actual case, but they should be. Making the law work in action is not properly the mission of the appellate court. A large part of what the appellate court does is to articulate clear legal principles and seed norms about sound practice.