

Bankruptcy on the Side

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I. Introduction

The Bankruptcy Code was designed to resolve coordination problems caused by multiple claims against a common debtor. In broad terms, the Code tries to strike a balance between respecting the individual rights conveyed to creditors, and limiting the negative impact of the exercise of these rights on the value of the company's assets as a whole. Bankruptcy law is most useful when creditors and other stakeholders are dispersed and uncoordinated, making bargaining to a value-maximizing outcome difficult. To encourage coordination, the law suspends individual collection efforts and creates a structured bargaining process in order to realize the most value from the firm's assets.

Resolving coordination problems while respecting individual rights is a challenging task, even in garden variety cases. But recent developments in the financing structure of firms have added additional layers of complexity to the problem. In a spate of recent cases, bankruptcy judges have been asked to resolve disputes regarding side agreements between two or more stakeholders, who form a subset of the overall stakeholder body. An example is an *intercreditor agreement*, whereby two creditor groups, and sometimes the debtor, agree on how cash flow and control rights will be allocated as between the parties to the side agreement when a bankruptcy occurs. Outcomes in large corporate reorganization cases—not only the division of value, but also what happens to the company itself—can turn on the judge's interpretation and enforcement of these side agreements, and the side deals that work around them.

A common theme in these disputes is the allegation that one of the parties to the side agreement breached a promise to be "silent" in some way, by asserting a right or taking an action that would be otherwise permissible under the Bankruptcy Code, but is prohibited by the agreement. Often, the alleged infraction involves one of the parties to the side agreement striking a side deal with another stakeholder that is detrimental to the other party to the side agreement. Thus, while these agreements are purportedly written to encourage coordination and limit unnecessary litigation, in many cases they have done the opposite.

The recent *Momentive* case provides a recent example of the kinds of side agreements and side deals that can arise. *Momentive* entered bankruptcy with a capital structure that included first and second lien secured debt, and other categories of unsecured debt. Prior to bankruptcy, the first and second lien creditors signed an intercreditor agreement that restricted the ability of the second lien noteholders from enforcing certain rights that would have been available to them as secured creditors. After

Momentive filed for bankruptcy, the second lienholders reached a side deal with the debtors (called a *Plan Support Agreement*) that would reorganize the company and give the stock of the reorganized Momentive to the second lienholders. The second liens also intervened in litigation intended to reduce the value to be paid to the first lien. The first lien creditors sued the second lien creditors in state court for violating the IC agreement, but the litigation was removed to the bankruptcy court and decided after the plan was confirmed. The court decided in favor of the second lienholders. In part, the judge reached this decision because the ambiguous language of the intercreditor agreement was read in favor of preserving second lien creditors' rights. According to the judge, it was not "clear beyond peradventure" that the second lien had waived their rights in the agreement.

Radio Shack provides a different example and a different approach by the bankruptcy judge. The electronics retailer entered bankruptcy with two groups of secured creditors and an intercreditor agreement between the two secured lender groups. Adding to the complexity, the creditors within each secured lender group divided themselves into classes via separate side agreements (called *Agreements Among Lenders or AALs*). In one of the AALs, the party in a junior priority position, the hedge fund Salus Capital, was prohibited from objecting to any sale that the senior priority creditors, including the hedge fund Cerberus, agreed to. When Salus raised an objection to a motion by Radio Shack to sell its assets, Cerberus invoked the AAL to argue that Salus had no standing to object, because Cerberus approved the sale. In this case, the judge enforced the agreement specifically, denying standing to Salus because the AAL prohibited the objection.

Disputes like these raise a host of questions that have not yet been fully resolved. When a party agrees to waive a right it would otherwise have in bankruptcy, should the right be enforceable? Should courts interpret ambiguously drafted terms against the party seeking to draft around the Bankruptcy Code? If the waiver of the right is enforceable, what remedies should be available—should the right be specifically enforceable, as in Radio Shack, or enforceable with damages, as was sought in Momentive? Are these disputes that should be adjudicated inside or outside bankruptcy court?

This article provides a helpful framework for thinking about these questions. Using some simple examples, we demonstrate the beneficial and harmful potential of side agreements. To be concrete, we will focus on intercreditor agreements involving a senior creditor and a junior creditor, but the basic principles are general enough to apply to other side agreements involving a subset of stakeholders. One other such side agreement is a so called "bad boy" agreement, whereby a debtor agrees with a subset of creditors not to file for bankruptcy. Another example is special purpose securitization vehicles, whose organizational documents keep some creditors silent by restricting their ability to negotiate with the debtor.

On the benefit side, we show that side agreements can provide effective work-arounds of some of the inefficient mandatory terms in the Bankruptcy Code, as well as solving problems caused by the inherent incompleteness of contracts. It can limit the ability of a party to use a bankruptcy right opportunistically against its side-contract counterparty, where the benefit to exercising a right for one party reduces value to the coalition as a whole. Concretely, a second lien might agree to be silent in order to commit not to raising objections that are allowed under the Bankruptcy Code, but would stall a value-maximizing sale process.

On the cost side, however, we show that side agreements will not always maximize the value of all stakeholders. The parties to a side agreement will only maximize their joint value; they will not take into

account the effect of their agreement on the company's other stakeholders. We show that these externalities can result in parties contracting for specific performance of a right, or excessive stipulated damages, when expectation damages would be preferred from an overall efficiency standpoint. These side agreements can be inefficient because they can shut down an opportunity to strike an efficiency-enhancing side deal. The parties to the side agreement do not take into account the benefits that non-party stakeholders would derive from the side deal; hence, their agreements foreclose these deals too often.

In light of the potential problems associated with enforcing side agreements as written, we recommend a simple proposal that honors the intent of the parties to the side agreement and preserves the efficiency benefits they create, while limiting the negative consequences. Our proposal is the following: breaches of side agreements should be enforced through expectation damages, provided that there is some nontrivial potential for value-destroying externalities at the time of breach. Value-destroying externalities occur when the prohibited action has the potential to alter the disposition of the bankrupt firm's assets, and the change in disposition can negatively affect a stakeholder who is outside the side agreement. If this potential is negligible, the side agreement should be enforceable as written, including stipulated damage clauses or specific performance.

This implies that, with a non-trivial possibility of externalities, a court should hear an objection or allow an action if it is permitted under the Bankruptcy Code, even if it clearly violates an intercreditor agreement that prohibits it. Side deals that violate an intercreditor agreement should not be blocked by the court unless it otherwise conflicts with the Bankruptcy Code. Damages for breach should be payable to the non-breaching party, but they can be decided independently from, and later than, the objection itself.

The efficiency benefits of expectation damages are well-understood in the literature on contracts: when properly calculated, they force the promisor to internalize the costs imposed on the promisee. Moreover, replacing specific performance with damages is a solution employed throughout the Code to limit coordination problems. A secured creditor's right to seize collateral outside of bankruptcy is stayed, and is replaced by the right to adequate protection payments for use of the collateral. Plans can be "crammed down" over a dissenting class of creditors, replacing the right to veto a plan with judicially-valued compensation in the form of new securities. Thus, our proposal is consistent with the way the Bankruptcy Code solves similar problems of fragmented property rights.

In the bankruptcy setting, we show that fully-enforced expectation damages leads to efficient, value-creating side deals, provided that a) the promisor in the side agreement and the side-dealing party can negotiate efficiently--that is, they reach a side deal whenever it increases the joint payoff of the two parties; and b) the side-dealing party's interests are aligned with all other parties outside the side agreement. These conditions will not hold in all circumstances, so ED is not a panacea for all coordination problems in bankruptcy; but, importantly, fully-enforced ED produces outcomes that are the same as would obtain if a single party (the promisor in the side agreement) held all of the claims of the parties to the side agreement. As such, ED can reduce the fragmentation problems that side agreements can create.

We are not the first to consider the issues surrounding intercreditor agreements and propose recommendations. In a recent paper, Edward Morrison argues, as we do, that enforcement of intercreditor agreements should turn on the presence or absence of externalities. He identifies rules of

thumb judges can use to guide decisions on enforcement, and potential actions (vote assignment), in which externalities are more or less likely to be present. Our analysis adds to our understanding of side agreements in several ways. First, our theory analyzes the potential for side bargaining around side agreements, an important phenomenon in many recent, prominent Chapter 11 cases. Second, we analyze the incentives of parties to side agreements at the drafting stage, to better understand why externalities might exist in the first place. Third, we generate some new proposals, which can guide judicial enforcement of side agreements and side deals, and address some complicated jurisdictional questions.

Our paper will proceed as follows. In Section II, we summarize some of the recent prominent cases involving intercreditor agreements and note the common themes in these cases. In Section III, we present our theoretical framework, which is based on a series of simple numerical examples to generate intuition about the costs and benefits of enforcing intercreditor agreements. In Section IV, we discuss normative implications of the theory and apply the theory to some concrete recent controversies.

II. The Current State of the Law

Subordination agreements have been a familiar feature of bankruptcy for decades, at least since the early years of the Bankruptcy Act of 1898. The Bankruptcy Code explicitly endorses these arrangements, stating that a subordination agreement “is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable bankruptcy law.”¹ Because many intercreditor agreements do more than simply subordinate second lien creditors, however, courts cannot simply point to the Code’s pro-subordination agreement policy as resolving the senior and junior lender’s disputes. They must determine whether the agreement covers the dispute in question, and if it does, whether the term in question is permissible.

Bankruptcy courts’ handling of the disputes has been quite inconsistent. Some courts have refused to enforce provisions that seem to interfere with the Chapter 11 negotiating and voting process. In *In re 203 N. LaSalle Street Partnership*,² for instance, the court invalidated a provision that transferred a junior lender’s voting rights to the senior lender.³ But other courts have enforced these provisions.⁴ Even courts that purport to be willing to enforce the terms of an intercreditor agreement often conclude that the senior lender is not entitled to relief.

In the discussion that follows, we try to make sense of the leading recent cases. Although the cases continue to reach divergent outcomes, several recurring themes seem to be emerging.⁵

¹ 11 U.S.C. 510(a).

² 246 B.R. 325 (Bankr. N.D. Ill. 2000).

³ See also *In re SW Boston Hotel Venture*, 460 B.R. 4, 4 (Bankr. D. Mass. 2011), *vacated in part on other grounds*, 479 B.R. 210 (B.A.P. 1st Cir. 2012); *but see*.

⁴ *In re Aerosol Packaging, LLC*, 362 B.R. 43 (Bankr. N.D. Ga. 2006)(enforcing vote assignment).

⁵ Morrison divides the intercreditor agreement cases into three categories, those that “ignore provisions that reorder the bargaining environment, leaving aggrieved senior creditors to seek breach-of-contract damages in state court actions,” those that enforce the provisions, and those that “take a middle road.” Edward R. Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015 U. ILL. L. REV. 721, 723-25. In the discussion below, we focus

A. The *Boston Generating* Approach: “Clear Beyond Peradventure”

The decision in *Boston Generating* seems to have set the tone for courts’ recent handling of disputes over the implications of intercreditor agreements. *Boston Generating* was a wholesale electricity provider in Boston and its environs, with the third largest generation operations in New England. For eighteen months before its August 18, 2010 bankruptcy filing, the debtors sought to find a buyer for most or all of their assets. After initially contacting 199 potential buyers, *Boston Generating* winnowed the potential bidders down to six, actively negotiated with two, and selected Constellation. Under the parties’ agreement, Constellation would pay \$1.1 billion for the assets of *Boston Generating*, and *Boston Generating* would file for bankruptcy and seek prompt bankruptcy court approval of the sale under section 363.

As of the bankruptcy filing, *Boston Generating* had \$2 billion of debt, including \$1.13 billion of First Lien Debt under a First Lien Credit Agreement, \$350 million of Second Lien Debt, and \$422 million of unsecured debt. Under the proposed sale, the First Lien creditors would be paid nearly in full, while Second Lien lenders and unsecured creditors would receive little or nothing. Not surprisingly, the Second Lien lenders were much less enthusiastic about the proposed sale than the First Lien holders. When the debtors asked the bankruptcy court to approve the sale to Constellation after an auction process that produced one other bid, the agent for the Second Lien lenders and several of the Second Lien lenders objected. The agent for the First Lien lenders pointed to the parties’ intercreditor agreement as precluding the objection, since the agreement gave the First Lien lenders the exclusive right to “enforce rights, exercise remedies ... and make determinations” regarding the parties’ collateral. The agent for the Second Lien lenders countered that his objection was not interfering with the First Lien lenders’ exclusive enforcement rights, and that he was simply making an objection that ordinary unsecured creditors make, as permitted by the agreement.

The bankruptcy court made two determinations, each of which has important implications for the treatment of intercreditor agreements. The court first ruled that the Second Lien lenders could press their objection, despite the First Lien lenders’ exclusive right to exercise remedies. The court based this conclusion in part on a puzzling decision by the First Lien agent to stipulate that the First Lien lenders’ consent to (and other involvement in) the sale of assets did not constitute an “exercise of remedies” under the intercreditor agreement. But the court also emphasized the lack of clarity in the parties’ agreement. “If a secured lender seeks to waive its rights to object to a 363 sale,” the bankruptcy judge wrote, “it must be clear beyond peradventure that it has done so.” The judge contrasted the parties’ agreement with the American Bar Association’s model intercreditor agreement in this regard. Unlike the ABA model agreement, which explicitly states that the Second Lien agent is deemed to consent to a section 363 sale that the First Lien agent approves, the “language of the Intercreditor Agreement [in this case] falls short of such clarity.”

The court’s second ruling pointed in the opposite direction. Although she permitted the Second Lien lenders to object, the judge nevertheless permitted the sale to go through. She gave the Second Lien

primarily on cases addressing disputes over the scope of junior lenders’ obligation to remain silent in various contexts, which are the cases Morrison describes as “middle road” cases.

lenders their day in court, but did not allow the objections to derail the asset sale that Boston Generating had spent nearly two years arranging.

The ultimate outcome of the hearing makes the contrast between *Boston Generating* and two earlier cases that enforced the literal terms of intercreditor agreements less stark than it initially appears. In *Erickson* and *Ion Media*, bankruptcy courts relied on the explicit language of the intercreditor agreement to deny standing to second lien lenders. In distinguishing the two cases, Judge Chapman suggested that the intercreditor agreements in the earlier cases were much more clear. But the judges in each of the cases also seem to have been mindful of the effect their rulings would have on the outcome of the case. In *In re Erickson Retirement Communities, LLC* and *In re Ion Media Networks, Inc.*, the second lien lenders' actions threatened to bog down a case that was otherwise close to resolution. By denying standing to in *Erickson*, the court avoided statutory language that suggests an examiner must be appointed if a creditor requests one; and in *Ion Media*, denying standing silenced a second lien creditor that was far out of the money and appeared to be objecting in the hope of being bought off. In *Boston Generating*, the court allowed the objection but did not permit it to derail the debtor's proposed sale.

In sum, *Boston Generating* places a premium on careful drafting of intercreditor agreement, and also suggests that bankruptcy courts may be keeping one eye on the implications an existing deal of permitting second lien lenders to take action in the face of contractual language that appears to require their silence. Similar tendencies can be seen in two of the most recent and high profile intercreditor agreement disputes.

B. The Intercreditor Dispute in *Momentive*

The *Momentive* bankruptcy was hotly contested from the outset, and produced important decisions on difficult issues that might have been avoided if the parties had managed to settle, as the bankruptcy judge strongly hinted they should do. *Momentive*, a silicone and quartz manufacturer that had been acquired by Apollo in 2006, proposed a "deathtrap" reorganization plan that gave its senior (First and 1.5 Lien Noteholder) lenders a choice between accepting the plan, which promised payment in cash in full but required the lenders to waive a \$200 million make whole claim; or rejecting the plan, asserting their make-whole claim, and receiving replacement notes plus the cramdown rate of interest. Although the senior lenders rejected the plan, the bankruptcy court held that they were not entitled to a make-whole payment and confirmed the proposed plan under the cramdown provision. The senior lenders then sued the junior (Second Lien Noteholder) lenders under the parties' intercreditor agreement, arguing that the junior creditors' support for the reorganization plan violated the agreement, and that any distributions to the junior creditors needed to be turned over to the senior lenders.

Explicitly endorsing the *Boston Generating* standard that the waivers of junior creditors' rights must be "clear beyond peradventure," the bankruptcy court rejected each of the senior lenders' arguments. Much as the agreement in *Boston Generating* failed to specify that junior lenders could not object to a 363 sale that seniors approved, the agreement here focused on the parties' collateral and liens, rather than their right to payment. "The ICA is very clearly an intercreditor agreement pertaining to the parties' collateral rights," the court concluded. "That is the overall context of the agreement and it is in that context that the claims should be evaluated." Because the junior lenders' support for

Momentive's plan did not interfere with the senior lender's liens or collateral in any way, the junior lenders' actions were not barred by the intercreditor agreement. The court also ruled that the junior lenders were entitled to contest the amount of the senior lender's claims, since the agreement lacked the explicit "silent second lien" provisions often included in intercreditor agreements.

C. The Intercreditor Dispute in *Radio Shack*

In *Radio Shack*, the creditor coalitions have been more complex than in any of the cases discussed thus far.⁶ RadioShack has two main groups of secured lenders, the ABL lender group, which holds a first lien on RadioShack's liquid assets and a second lien on its intellectual property securing a \$585 million obligation; and SCP, which holds a second lien on the liquid assets and a first lien on the intellectual property securing a \$250 million loan. Each of the loans is divided into multiple tranches. The relationship between the ABL and SCP loans is coordinated by an intercreditor agreement, and relations with each loan by "agreements among lenders" (AALs).

The lightning rod for dispute was a proposal by Standard General, which holds a "second out" position in the ABL lien, to buy a large number of RadioShack's stores in partnership with Sprint. Under the proposal, Standard General would be permitted to credit bid its claim. Although it was clear to everyone that Radio Shack's assets needed to be sold, Salus, one of the lenders in the SCP lender group, asked the bankruptcy court to prohibit Standard General from credit bidding. If Standard General were able to credit bid, Salus argued, the credit bid would effectively cut off Salus's claim that the intercreditor agreement gave it priority over payments that the ABL group had received prior to bankruptcy. The ABL group's first out lenders sided with Salus in this dispute for somewhat analogous reasons, arguing that a credit bid by Salus would give Salus de facto priority in violation of the ABL group's agreement among lenders.

Yet another ABL group lender, Cerberus, took Salus's side in the dispute. Cerberus argued that the ABL group's agreement among lenders prohibited Salus from objecting to a sale that Cerberus had agreed to. Cerberus had initially consented to Salus's objection. But the bankruptcy court concluded that the earlier consent did not preclude Cerberus from revoking its consent. "The plain language of Section 14(c) [of the agreement among lenders] does not restrict Cerberus from settling or otherwise changing its position or mind," the court said; "and, indeed, to construe the document otherwise would be demonstrably contrary to Cerberus's presumed contractual expectations."⁷ Salus could not pursue its objection, the court concluded, because the agreement only permits Salus to "take positions consistent with what an unsecured creditor would take."⁸

The agreement in RadioShack arguably was clearer than the agreement in Momentive, and Salus's objective more obviously precluded by its terms. Perhaps these facts fully explain the court's ruling. But it does not seem coincidental that the ruling also had the effect of removing a potential obstacle to the best deal available for selling Radio Shack's assets.

⁶ For an overview of the loans and the dispute discussed in the text that follows, see King & Spalding, *Client Alert: Recent Unitranche Issues in the RadioShack Bankruptcy Case* (June 1, 2015).

⁷ [CITE to transcript].

⁸ *Id.*

D. Implications

One obvious effect of the recent intercreditor disputes is to raise significant questions about the assumption that intercreditor agreements reduce transaction costs by keeping some parties silent. Perhaps intercreditor agreements will serve this function as they evolve, and as courts interpret them in more consistent fashion. But the agreements have prompted extensive litigation, as parties who agreed to be silent raise objections and enter into side deals that may violate these agreements. They appear to have magnified transaction costs, rather than reducing them.

Another key implication arises from courts' treatment of intercreditor disputes. In some cases, like *Erickson*, *Ion Media*, and *Radio Shack*, the court enforced the side agreements specifically by denying standing because the agreement required it; in some cases, such as *Momentive*, only damages were at stake, and in some cases, such as *203 N. LaSalle Street Partnership*, enforcement of the term is denied entirely. A common theme in the cases is that courts read the terms of an intercreditor agreement against the party who seeks to contract around the Bankruptcy Code, unless it is "clear beyond peradventure." This approach may reflect courts' belief that enforcement of intercreditor agreements may have deleterious effects on the bankruptcy process as a whole.

The "clear beyond peradventure" approach to interpreting side agreements can have unintended consequences going forward. To increase the likelihood of enforcement, lenders can be expected to make their future agreements broader and clearer. This in fact is precisely what bankruptcy professionals have begun to advise. "In the future," a prominent law firm wrote after summarizing the RadioShack dispute, "senior creditors would be well advised to demand specific and far-reaching protections that cover more than pure collateral enforcement."⁹ In response to the *Momentive* court's narrow reading of the lien subordination in the parties' intercreditor agreement, another prominent law firm recommended that senior lenders consider asking for, among other things, a broader provision requiring "[t]urnover of distributions received in respect of the junior lien creditor's secured claim, regardless of source or form, as opposed to only distributions of collateral or proceeds thereof."¹⁰

In short, the courts' current approach does not adequately balance the costs and benefits of enforcing side agreements. Our normative proposal has the potential to strike a better balance by targeting the remedies for breach, rather than the interpretation of the contract language. To understand the virtues of our approach, we first need to develop an understanding of the costs and benefits of enforcing side agreements, to which we now turn.

III. Theory

In this section, we provide a simple theoretical framework that will help to understand the costs and benefits of enforcing side agreements in the presence of side deals. The theory will help us understand the reasons parties write these agreements, and the sources of externalities that bankruptcy law may play a helpful role in solving.

⁹ King & Spalding, *supra* note __.

¹⁰ DavisPolk, [Overview of *Momentive*], p. 8.

A. Background Principles

Underlying all of our analysis is the foundational normative theory of bankruptcy known as the Creditors' Bargain theory. The Creditors' Bargain theory says that an ideal bankruptcy outcome is one that would be chosen by a sole owner—a hypothetical individual who owns all of the firm's assets on the bankruptcy petition date¹¹. The sole owner will choose to dispose of the company's assets—reorganization, liquidation, or sale of the assets as a going-concern, and the timing of this decision—in a way that maximizes the company's value. If the firm's creditors could collectively agree to an outcome once bankruptcy occurs, they would choose to act as a sole owner would act, because this would maximize the total recovery for all the creditors. Thus, when we refer to an outcome as *efficient* or *inefficient*, the sole owner's decision will be our efficiency benchmark.

Corporate bankruptcy law is built on the premise that a debtor's contracts with its creditors will not necessarily lead to an efficient outcome in bankruptcy, because the creditors are not coordinated either ex-ante, when they lend to the debtor, or ex-post, when bankruptcy occurs. Bankruptcy's automatic stay, which prevents creditors from seizing the debtor's assets upon bankruptcy, is one of bankruptcy law's mandatory (non-waivable) terms. It is based on the premise that a debtor and a creditor would not be expected to contract for a stay on their own, even if the collective creditor body would benefit from it. Nor will a creditor voluntarily postpone collection at bankruptcy: she may have the incentive to "race to the courthouse" to get a bigger share of the bankruptcy estate for herself. Though this negatively affects the other creditors, the debtor and the particular creditor will not, in general, be expected to internalize any impact their contract has on the other stakeholders.¹²

The Creditors' Bargain theory argues that, when the sole owner principle is at risk, the law is justified in altering the creditor's rights. The specific enforcement remedy the creditor would be entitled to pursue outside of bankruptcy is often replaced with compensation that approximates the value of that remedy. A secured creditor upon bankruptcy can no longer seize collateral, as she could do outside of bankruptcy, but the Code gives the secured creditor the right to receive *adequate protection* payments in lieu of the repossession right¹³.

B. Side Agreements and Side Deals

The background principles above are well-known, and the use of bankruptcy law to replace a specific performance remedy with damages when the contract is between the debtor and a creditor is well-accepted. But what, if anything, changes when the contract is between two creditors? It is less obvious that a side contract between creditors implicates the same issues. Because creditors compete in bankruptcy for the common pool of debtor assets, it is clear that a contract with the debtor that provides better treatment to one creditor can be to the detriment of the other creditors. But the effect of a side agreement between creditors on the non-party stakeholders is not as evident. If a side

¹¹ [Cite to Baird and Jackson here.]

¹² There are contractual devices to mitigate these externalities. An early creditor might include covenants that limit the rights a borrower can grant subsequent lenders so as to minimize these externalities. But these contractual devices are imperfect for both legal and practical reasons. [add citations here]

¹³ This is not to say that U.S. law provides the amount of compensation that the Creditors' Bargain theorist would advocate; in particular, a secured creditor is not entitled to compensation for the lost time value of money. See *Timbers*.

agreement merely reshuffles the value that these parties are entitled to receive from the debtor, it is hardly an issue for bankruptcy law to interfere with.

Moreover, these side agreements might be expected to help the non-party stakeholders. Parties to the side agreement should have incentive to structure a side deal to maximize the joint value of their claims. Put differently, side agreement parties would be expected to replicate a sole owner principle with respect to *their* claims. This means that we might see side agreements as a pure good in bankruptcy. To be sure, the side agreements will not be written in the interests of all creditors, but they might be expected to reduce the side agreement parties to the equivalent of a single party who owns the claims of the side contracting coalition. This could reduce fragmentation and increase the scope for value-creating bargains that bankruptcy law tries to create.

The numerical examples below demonstrate that this intuition is only true in some, but not all cases. When bargaining frictions exist, a side agreement can create negative externalities. The side agreement parties have the incentive to strike agreements that maximize their collective payoff. This can create tension with overall efficiency when the attempt to keep more surplus for themselves makes it less likely that a value-creating side deal will occur through bargaining. The side contract parties do not take into account the benefits that other stakeholders receive from side deals; hence, side contracts foreclose side deals too often.

In this way, side agreements between creditors have similar effects to a contract between a debtor and a secured creditor. A secured creditor has the right to seize its collateral when the debtor defaults. In bankruptcy, the mandatory automatic stay prevents collateral seizure. This is justifiable because the debtor and the secured creditor do not internalize the effects of the other creditors when a bargain to prevent collateral seizure breaks down. Thus, the Bankruptcy Code replaces a specific performance right (to seize collateral) with damages (adequate protection payments). The side agreement may not threaten to remove a key *asset*, but it may remove a key *party* (the silent creditor) from negotiations. Our proposal is to honor the substance of the side agreement, but replace the contracted-for remedy with expectation damages, as the Code does with secured creditors.

1. Setup and Assumptions

Suppose that parties S and J write a side agreement before bankruptcy. The concrete example we have in mind is two creditors who agree to take a senior (S) and a junior (J) lien on the same collateral, but the example can apply to any two parties who are stakeholders in a company. S and J will be expected to choose the terms that maximize the expected value of their combined claims.

Party C is also a stakeholder in the company, but C is not a party to the ex-ante side agreement between S and J. This could occur because C comes along after the agreement is signed, or because C became a creditor before the transaction but not actively monitoring the debtor and is thus uninvolved with the

negotiation the side agreement when it occurs.¹⁴ C can be thought of as an unsecured creditor, whose interests are likely to be more aligned with J than with S.¹⁵

In order for our problem to be interesting and realistic, there must be some impediment to bargaining over outcomes at bankruptcy. The Coase Theorem tells us that if all interested stakeholders bargain perfectly, the sole owner principle will always hold, and the efficient outcome will always occur. Bargaining frictions in bankruptcy are common and can occur for many reasons. One reason is coordination problems caused by the fragmentation of claims. Large corporate loans are often broken into pieces and held by many holders; in such cases, coordinating these diverse holders can take time. We represent these frictions in our theory in a simple fashion by assuming that one of the parties is unable to bargain.

For the first part of our discussion, we consider examples in which S will not be able to bargain¹⁶, but C will be able to negotiate with J to strike a side deal if a mutually beneficial one is available. These assumptions will not be true in all cases, and we will relax them in subsequent examples. When analyzing the incentives of S and J to write the side agreement, we will assume that S and J fully anticipate the parties that will be available to bargain and the payoffs.

There will, however, be some uncertainty over payoffs at bankruptcy. We represent this through two possible “states of the world” that may occur at bankruptcy, each with equal probability. The states can be analogized to the future prospects of the company when the bankruptcy occurs, which may be more or less favorable depending on conditions that are hard to forecast in advance, when the debtor borrows. We will suppose that these conditions are known and observable to everyone on the bankruptcy date, but they are sufficiently hard to describe in advance that S and J cannot write a contract that is conditioned on the state of the world.

Whatever the state of the world, there will be two possible actions, action g and action b, that can be chosen. We can imagine these actions as two possible strategies that party J would be free to pursue absent a side agreement, which are payoff-relevant and may affect what happens to the bankrupt company’s assets. For example, suppose that a motion has been made to sell the company and J has the option to exercise its legal right to raise an objection to the sale, or be silent. Alternatively, C might express an interest in reorganizing the company by proposing a plan, and J can choose whether or not to collaborate with C¹⁷.

¹⁴ To keep the discussion simple, we do not explicitly involve the debtor in the negotiation of the side agreement, but we suspect that this would not affect our analysis significantly. The debtor will want to borrow at the lowest possible interest rate from S and J, so a side agreement between S and J that maximizes the joint payoff of S and J in bankruptcy would be preferred by the debtor as well.

¹⁵ Junior lienholders in bankruptcy are also unsecured creditors to the extent that their collateral value is less than what they are owed. Thus, an unsecured creditor is more likely to prefer the junior lienholder’s preferred action than the senior creditor’s preferred action when they both disagree.

¹⁶ For the time being, we do not endogenize the reason for this bargaining friction. One reason it occurs in practice is because S’s claim is tranching and held by many dispersed holders who would have trouble coordinating themselves to strike a bargain. Asymmetric information is also a well-known reason that bargaining can be imperfect.

¹⁷ The setup here is based on the framework of incomplete financial contracts from Aghion and Bolton, *An Incomplete Contracts Approach to Financial Contracting*, Review of Economic Studies 1992. To suit the issue at hand, we make important modifications to their setup, including the existence of the side party, and the

We make one final assumption concerning the bargaining process. Whenever a side deal between J and C is possible, they will reach an agreement that makes J and C collectively better off, and any surplus as a result of the deal will be split evenly between C and J. The 50/50 split of surplus is not essential to our result, but our results rely importantly on the idea that C captures at least some of the surplus in bargaining with J.

Example 1: The Good Side of Side Agreements

party	Good State (p=.5)		Bad State (1-p = .5)	
	g	b	g	b
S	120	200	120	200
J	20	0	20	0
C	70	0	10	0
S+J	140	200	140	200
S+J+C	210	200	150	200

To gain some intuition, we start with Example 1, which is intended to demonstrate the potential benefit of side agreements. The table shows the direct payoffs—the payoffs that would result absent any side agreements or side deals-- to parties S, J, and C, which depend upon on the state of the world and the chosen action. In this example, S and J have divergent interests in both states: S prefers action b and J prefers action g. Collectively, though, S and J’s total direct payoffs favor action b in both states, as their collective payoff is 200 under action b and 140 under action b. The good and bad state differ only in C’s payoff. C’s direct payoff favors action g, and thus C’s preferences are aligned with J.

To make an analogy from the example to the real world, party S might favor a fast sale of the company in bankruptcy (action b), rather than a long and protracted reorganization process (action g). J, the junior creditor, may be “out of the money” and would not stand to receive any payoff if the company is immediately sold. This might cause J to raise objections or employ delay tactics to slow the process down. This might benefit C, who represents unsecured or other lower priority creditors, who also favor delay. But, importantly, J’s preferred action will hurt S more than it helps J; thus, S and J have incentive to strike a side agreement that induces J to consider S’s payoff when it chooses an action.

a. Status quo actions

Under the status quo (no side agreements or side deals), **J would choose action g in both states**, in order to get 20 instead of 0. The S+J coalition would receive a total payoff of 140 in both states.

This choice would be efficient in the good state, since the total payoffs of all parties (S+J+C) are 210 under action g and 200 under action b. But it would be inefficient in the bad state, as action b generates a larger payoff for all parties (200) than action g (150). Since the good state and bad state occur with equal probability, the status quo would produce a total expected payoff to all parties of 180¹⁸.

assumption that S cannot bargain. On the other hand, because the bargaining parties are usually creditors, we do not assume that one of the two parties has no wealth, which is the key source of bargaining frictions in the Aghion and Bolton model.

¹⁸ The expected value is calculated by multiplying the probability of each state times the payoff in that state and adding up. In this case, we have $.5*210 + .5*150 = 180$.

Side agreements

Now, let's suppose that S and J can write a side agreement that maximizes the expected payoff of the S and J coalition. We will first analyze the best agreement S and J could write, assuming that the parties provide that the agreement will be enforced via specific performance. We will then do the same analysis assuming the parties contract for stipulated damages, and we will compare the two possibilities to see which remedy S and J will choose. We will then examine whether the choice leads to an efficient outcome.

b. Side agreement enforced by specific performance (SP)

First, let's consider the side agreement S and J would write, supposing for the moment that any side agreement can be enforced specifically by S. Specific performance implies that S can require that J choose action b. Since the parties anticipate S's inability to negotiate, a decision to require action b will always lead to action b being chosen, even if C were willing to pay any amount to have the decision changed to g.

Under SP, S and J will write an agreement that requires that J choose action b. S+J will prefer this outcome to the status quo with no side agreement. J will agree to choose action b, and the S+J coalition will receive 200 in both states. This is preferred to the status quo, where the S+J coalition would receive only 140 in both states. But it leads to an inefficient outcome in the good state, because the S+J coalition do not take C's value into account.

If the choice were between the status quo and an SP contract, the SP contract is preferred from an efficiency perspective. The total expected value under SP is only 200, which is greater than the 180 expected payoff under the status quo. It is not always true, however, that an SP contract is preferred to the status quo from an efficiency standpoint whenever the parties choose it. If, for example, we increase C's payoff by more than 20 in both states when action g is chosen, then the status quo payoff will be larger than 200. Generally, SP contracts may increase or decrease efficiency relative to the status quo, because the parties do not internalize the effects of their contract on C.

c. Side agreement enforced by stipulated damages (SD)

Using the numbers in Example 1, S and J can improve upon specific performance by enforcing their side agreement through damages. Let d denote the stipulated damage payment in the side agreement between S and J. When the agreement is enforced through damages, J can choose to breach the side agreement and choose action g if it is willing to pay d . This opens the door for C to make a side deal with J to encourage the breach. Since S and J seek to maximize their joint payoff, they will take any anticipated payment from C to J into account when they decide on the right level of damages.

Here, S and J will write a contract that requires J to choose action b, and pay $d = 90$ to S if it chooses action g. They will choose damages of 90 because it elicits the maximum possible side payment from C to encourage the breach in the good state. Note that in Example 1, the J+C coalition prefers action g to action b by 90: J prefers action g by 20, and C prefers g by 70. Hence, C can only convince J to breach and choose action g if C pays J the entire 70 it would gain from action g. If C offers any payment lower than 70, J will perform under the side contract and choose action b. In the good state, then, J will breach the contract, and choose action g. C will make a side payment of 70 to J, and J will pay 90 in

damages to S. In the good state, taking side payments into account, the S+J coalition will get a total payoff of 210.

In the bad state, J will choose action b. In the bad state, C+J's direct payoffs would only increase by 30 if they chose action g, so it will not be in their joint interest to pay 90 in damages to S. Hence, in the bad state, the S+J coalition will get a total payoff of 200.

d. Takeaways from Example 1

There are several useful takeaways from our analysis in Example 1. First, a side agreement with a specific performance remedy improves upon the status quo for the S+J coalition, but it performs worse from an efficiency standpoint. This happens because the side deal creates negative externalities on the outside creditor (C) by inducing action b in the good state. In this case, however, the optimal S+J side contract will not include specific performance. S+J will prefer a contract with stipulated damages that results in action g being chosen in the good state and action b in the bad state, which is consistent with efficiency.

Second, the S+J coalition chooses damages that are larger than expectation damages (ED). S loses only 80 when action g is chosen, but S+J contract for $d = 90$ to divert more value from C. In this case, there are no efficiency consequences to this redistribution of value, so our normative theory is unconcerned with the difference between SD and ED. But as we will show in Example 2, the difference can also matter for efficiency.

Example 2. Stipulated damages can be too large, and lead to inefficient outcomes.

party	Good State ($p=.5$)		Bad State ($1-p = .5$)	
	g	b	g	b
S	120	200	120	200
J	20	0	20	0
C	100	0	70	0
S+J	140	200	140	200
S+J+C	240	200	210	200

Example 2 is similar to Example 1. S's and J's payoffs have not changed, but C has a stronger preference for action g in both states. In fact, C's preference is so strong that action g is now the efficient action in both the good and bad states.

Because S's and J's payoffs have not changed, the status quo, specific performance, and expectation damage calculations are the same as under Example 1. But the stipulated damages analysis is different in an important way: damages can be set too high and lead to inefficient outcomes.

a. Stipulated damages

Under SD, the S+J coalition will face a trade-off when they set the terms of the side agreement. If they want to divert the most surplus from C in the good state, they will choose $d = 120$, so that (following Example 1), C will pay J its entire surplus of 100 in order to induce a breach. But if they do this, the damages will be so high that J will prefer not to breach, and will choose action b in the bad state. S+J

will receive a total of 240 in the good state, and 200 in the bad state. Since the probability of each state is 50%, the S+J coalition would get an expected payoff of 220.

Alternatively, S and J could set $d = 90$. This damage payment will induce C to pay its full surplus of 70 in the bad state. In the good state, however, C will keep some of its surplus. When C and J bargain to a side deal in the good state, they will bargain to a 50/50 split of any surplus that arises in moving from action b to action g. A quick calculation will verify that C will pay a side payment of 85 to J, to induce J to breach.¹⁹

Taking the side payments from C into account, if S+J choose $d = 90$, they would get $120 + 20 + 85 = 225$ in the good state and 210 in the bad state. This has an expected value of 217.5. Since $217.5 < 220$, **S+J will set the damages high ($d = 120$). This leads to an inefficient choice of action b in the bad state.**

Example 2 illustrates that stipulated damages can lead to inefficient outcomes. In an attempt to divert more surplus from C, S+J set the stipulated damages so high that C chooses not to bargain with J in the bad state. As a result, action b is chosen in the bad state instead of the efficient action g. This result is an application of a classic result in the antitrust literature, which shows that exclusive dealing contracts between a buyer and a seller can have anticompetitive effects, by blocking a lower cost seller from entering a market²⁰. The application of this idea to the bankruptcy bargaining context, to our knowledge, is new.

b. Expectation damages

As in Example 1, if J were required to pay expectation damages to S, it would pay only $200 - 120 = 80$ to S upon breach. **As with Example 1, ED again yields an efficient outcome**, as J will breach in both states and choose action g. In fact, ED will always lead to efficiency whenever the outside party (C) can freely bargain with J. To see this, note that C+J will strike a side deal to induce J to breach whenever the net gains to C and J exceed the damages. But the damages, since they are calculated using ED, are the net losses to S. Hence, C and J will internalize the costs of their action on S, making the socially efficient choice.

c. Takeaways from Example 2

There are a few new takeaways from Example 2. First, we saw in Example 1 that specific performance contracts can be detrimental to efficiency, because they may inhibit a value-increasing bargain. But in that example, the S+J coalition would prefer a stipulated damage contract that is consistent with efficiency. Example 2, by contrast, shows that a stipulated damages contract can lead to the same inefficiencies as specific performance. Again, the reason for inefficient side agreements is externalities: S and J do not have incentive to consider the lost surplus that outside parties (C) sacrifice when the opportunity for a value-creating side deal is lost due to excessively high damages. Expectation damages always leads to an efficient outcome, provided that the parties outside the side agreement can bargain

¹⁹ Under action g, J+C together would get a direct payoff of 120, but pay damages of 90 to S. Under action b, they would get 0 and pay no damages. Thus, J+C would get a surplus of $120 - 90 = 30$ from choosing action g. Under a 50/50 split, C would keep a surplus of 15. Since C's direct payoff is 100 in state g, this means that C must pay $100 - 15 = 85$ to J. Notice that J's total payoff is the direct payoff plus the side payment minus the damages: $20 + 85 - 90 = 15$.

²⁰ See Phillippe Aghion and Patrick Bolton, *Contracts as a Barrier to Entry*, American Economic Review 1987.

with J. But the parties to the side agreement do not always have the incentive to write an agreement that leads to efficient outcomes, even if such an agreement exists.

Example 3. Bargaining with S to enforce the side agreement

party	Good State ($p=.5$)		Bad State ($1-p = .5$)	
	g	b	g	b
C1	0	50	0	50
S	210	200	120	200
J	20	0	20	0
C2	50	0	50	0
S+J	230	200	140	200
C1+S+J+C2	280	250	190	250

So far, we have seen that ED contracts lead to efficient outcomes in side agreements, but that the parties themselves do not necessarily have the incentive to write these contracts themselves. We have only shown the efficiency of ED, however, when all outside parties to the side agreement can bargain freely with J, the party who waived rights in the side agreement. We also have not shown that SP contracts may be optimal for the side agreement parties, as is common in practice. Why might parties prefer an SP contract, and is it efficient when it is chosen?

In Example 3, we address these issues by considering the possibility that the bargaining environment may change. In this case we suppose that S is able to strike a side deal but J is not. What effect will this have on the incentives of the S+J coalition with respect to the side agreement they write, and how will this impact the efficiency of ED as an alternative?

To make the case interesting, we introduce two outside parties (C1 and C2). C1’s interests are more aligned with S than with J, while C2’s interests are more aligned with J. We suppose that C1 has the ability to bargain with S, but C2 and J cannot bargain.

Status quo

The status quo outcome is similar to Examples 1 and 2. J will choose action g to improve her payoff by 20. This will be consistent with efficiency in the good state (a total payoff of 280 versus 250) but inefficient in the bad state (190 versus 250).

a. Specific performance and stipulated damages

Notice that in this example, S’s and J’s direct payoffs are aligned in the good state: they both prefer action g. This makes the analysis of SP contracts different from the earlier examples. If S+J can write a side deal that includes SP as a remedy, S will require that J choose action b. This will result in J choosing action b in the bad state. In the good state, however, S also prefers action g. Thus, S can choose not to

enforce the side agreement, allowing J to choose action g. Knowing this, C1 will offer a side deal to S to induce S to enforce the contract against J.²¹

Because C1 strongly prefers action b, C1 will be willing to pay S to invoke its right against J. Because C1 and S will split their total surplus of $250 - 210 = 40$ in half, C1 will pay 30 to S to induce S to invoke J's choice of action b. This is inefficient in the good state, because C2's payoff is not taken into account.

If S and J chose to write a contract with stipulated damages, the outcome would be equivalent to the SP outcome. S and J would set damages high enough that J will prefer not to breach the contract if S chooses to enforce it. J will choose action b in both states, and in the good state, SS will make the same side payment to induce S to enforce the contract against J.

b. Expectation damages

Under expectation damages, the outcome differs from the outcome that would occur under the S+J coalition's preferred contract. In Example 3, ED again results in a more efficient outcome. In the bad state, J will perform under the contract and choose action b. In the good state, J will breach, choose action g. J will not need to pay any damages for breach, because S's direct payoff also favors action g. This outcome is consistent with efficiency.

It is crucial to emphasize, however, that the efficiency consequences can be reversed, depending on C2's payoff. To see this most simply, consider Example 3 if C2's payoff in both states falls from 50 to below 20 under action g. None of the contracts or outcomes would change, but the efficiency consequences would be reversed and the SP contract the parties prefer would yield an efficient outcome, while ED would not.

c. Takeaways from Example 3

Example 3 highlights another potential source of inefficiency that can result from side contracting, but it also illustrates that replacing the parties' choice of remedies with ED is not a panacea for all efficiency problems. The inefficiency of the side agreement follows because the side agreement parties will take into account only themselves and the parties with whom they expect to be able to strike bargains. In the earlier examples, we showed the virtues of ED, which flow from the ability of J to strike side deals. But when J cannot bargain, a SP contract (or a SD contract with damages high enough to prevent breach) can be preferred.

Our theory points out the costs and benefits of side agreements, but it notes that no alternative will be a perfect solution to all sources of inefficiency that might arise. In the next section, we argue that while ED is not a perfect remedy, the Bankruptcy Code is better placed to handle the costs of ED than it is to handle the costs that arise from SP and SD.

IV. Normative Implications

We can apply the results of the above analysis, to develop a framework for how courts should approach these intercreditor disputes. To show how this framework plays out, we will examine the disputes that

²¹ Note that this does not require a bargain with J, which we have assumed is not possible here. S could simply communicate to J whether it intended to enforce its contract against J or not, and J will act accordingly.

faced courts in several recent high profile bankruptcy cases. We maintain our assumptions that bankruptcy law has a primary goal of maximizing the value of the estate. We also have assumed that there are, in some cases, limitations on the ability of parties to bargain around certain outcomes. The key, then, is for judges to enforce intercreditor agreements in the way most consistent with the model we have laid out above.

a. Basic Principles

We briefly state some of the lessons from the model before delving into the cases:

First, intercreditor agreements can reduce coordination problems between the parties to an agreement, and can thus maximize the joint value of their claims. This suggests that there is no reason for bankruptcy law to interfere when the intercreditor agreement has no risk of externalities. We define externalities as the potential to reduce the value of the estate for creditors who are not party to the intercreditor agreement (these creditors are the *C*'s in our examples above).

Second, side agreements, written to maximize the bankruptcy payoff of the parties to the agreement, can lead to inefficient outcomes when the party with the right to enforce (the promisee, or *S*) cannot bargain costlessly. Inefficiency can occur whether the parties contract for specific performance or stipulated damages. The inefficiency arises because the agreement between promisor (*J*) and promisee (*S*) do not take into account the benefits that non-parties would realize if a beneficial side deal is struck. Thus, they may ex ante choose a remedy that puts a side deal at risk in order to capture more surplus for themselves. Replacing stipulated damages or specific performance rights with expectation damages lead to efficient outcomes when non-parties and the promisor can bargain, as long as they are calculated properly.

Third, expectation damages are not a panacea: they can lead to inefficient outcomes when the promisee and not the promisor can negotiate with non-parties. With expectation damages, the promisor only considers the direct interests of the parties to the agreement and not the surplus-enhancing side deal with the non-party.²² With specific performance or stipulated damages, however, the non-party may offer the promisee an efficient side deal to exercise its rights and force the promisor into a bargain.

While our theory helps us understand the costs and benefits of side agreements and the various remedies in a qualitative way, it does not tell us which costs and benefits are quantitatively more important. In the bankruptcy context, the errors introduced by specific performance and excessive stipulated damages and the errors introduced by expectation damages are different in kind. Specific performance and excessive stipulated damages cause the promisor to *under-assert* its interests and rights. In some cases, the promisor is forced to go along with the promisee even when it is in its interest (either directly or because of a side deal) to do otherwise. In those cases, the court is never exposed to information about the promisor's interests in the estate. More importantly, the bankruptcy process relies crucially on self-interested parties taking affirmative steps—such as providing new financing, or collaborating on a plan of

²² We have assumed that the value of the side deal is not included in a measure of expectation damages.

reorganization—that can benefit the other stakeholders. If those parties are silenced by a side agreement, there is little a court can do to compensate for their absence²³.

Expectation damages, on the other hand, allow the promisor to *over-assert* its interests and rights. Sometimes the promisor will assert its interests even when those interests cut against the overall interest of the estate. In these cases the promisee will object to a sale or vote in favor of a plan even when doing so destroys value for the estate. In those cases, the court will have to weigh the asserted interests of the promisor against the asserted interests of the promisee and the non-party stakeholders. The difference, then, is essentially one of false negatives (not enough assertion of rights) and false positives (too much assertion of rights).

These costs are different in kind, because the false negatives destroy value enhancing agreements or deprive the court and the parties of the information necessary to assess the impact that of decisions on the value of the estate. A side agreement might prohibit a junior lien creditor from providing DIP financing. If specifically enforced, the value of such a deal is never tested by the market or the bankruptcy court. And that value may have been such that it would have run to all stakeholders in the estate. Or a side agreement may prevent a junior lien creditor from objecting to a sale or voting in favor of a plan. Again specific performance deprives the court of the information that would have been contained in the objection or the favorable vote. That lack of information may be detrimental to other creditors who are disperse and disorganized and cannot, therefore, bring the objections (or support) on their own behalf.

The costs of over-asserting rights are much more readily mitigated by the Bankruptcy Code.

The main cost is merely that the court has to sift through extra information, which may impose a delay. But that is not a major cost. Indeed, weighing the merits of self-interested arguments of stakeholders is precisely what bankruptcy courts and the Bankruptcy Code are set up to do. It is their primary function. Moreover, the entire Bankruptcy Code envisions a process whereby the court and stakeholders together resolve conflicting self-interests through a process of structured negotiation and litigation. Thus, the cost of false negatives imposed by expectation damages is relatively small. When expectation damages are inefficient, they merely require the court or the parties to do a little more information filtering. But specific performance and excessive stipulated damages deprive the court of valuable information and opportunities that could meaningfully enhance the value of the estate.

b. Proposed Framework

The practical implication of our analysis is that when potential externalities have a non-trivial likelihood, courts should enforce intercreditor agreements with ED. To be clear, the agreements should always be enforceable for *at least* ED. Courts that have held even damages enforcement to a higher standard of contract interpretation have done so without justification. But SP or stipulated damages (SD) should only

²³ The Code provides DIP financiers with seniority but does not mandate that anyone provide the new money; Committee members are charged with representing the other unsecureds, investigating the debtor's books and participating in plan formation; A plan must be proposed by someone—and the silence of a party who has significant skin in the game makes this less likely to occur; 1129(a)(10) requires that there be one impaired class that approves a plan. These code provisions are weakened if one of the major parties is bound to predetermined course of action. An agreement of a junior creditor to vote either way (for or against) on a plan at a senior creditor's bidding can massively distort the way that 1129(10) functions.

be available in the case where it is plain that there is no externality on the estate – that the dispute truly is contained in its impact to the creditors who were parties to the agreement.

A court should, thus, first determine whether an intercreditor agreement poses externalities. And because our analysis suggests that the costs of limiting SP are small (essentially just marginal decisions costs on the court) relative to the costs of allowing it (depriving the court of information and estate enhancing opportunities) we do suggest that courts should err on the side of assuming there is an externality and limiting SP. SP should only be allowable where the risk of externality is *de minimis*. When that is true, the agreement should be enforced as written.

When, on the other hand, externalities are plausible, and a party is seeking specific performance, we might first consider how our proposal would work in an idealized environment. If it were feasible, a perfect court would first assess whether there are bargaining hurdles between non-parties and either the promisee or the promisor. If there are bargaining hurdles between the non-parties and the promisor, then ED are always preferable (assuming they can be calculated). If there are bargaining hurdles between non-parties and the promisee, then the right remedy is ambiguous and the court would have to assess the actual level of externalities and only enforce agreements where doing so minimized externalities.

This ideal-world prescription is unlikely to work in practice. It would require a court to 1) identify the relative bargaining hurdles and determine which parties can effectively enter into side deals and 2) identify the magnitude of externalities that would arise from enforcing a side agreement and those that would arise from not enforcing it. It may be easy enough for a court to assess whether externalities are plausible. But to ask a court to dig into the precise nature and magnitude of bargaining hurdles as well as externalities, is essentially to ask the court to litigate out the value of the estate. Once the court has determined which parties can bargain with each other and the full effects that those bargains will have on all other stakeholders in the estate, the court will have essentially determined which paths are best for the estate and which are worst. It is meaningless at that point to talk about specifically enforcing an agreement not allow a junior creditor to assert a right. If the right is beneficial to the estate the court will say that the prohibition has externalities. If it is costly to the estate, the court will say it has no externalities. The right will have been asserted and fully adjudicated. Moreover, such an inquiry, to the extent it looks at bargaining hurdles, may incentivize parties to create those hurdles where they do not otherwise exist.

Thus, the first best world of judicial inquiry in to the precise bargaining hurdles and externalities involved with every side agreement is not possible. Instead, we suggest, as a second best solution, a blanket rule favoring ED in the presence of externalities. This solution dominates the other alternatives (all SP, all SD, or some combination) because, as noted above, the costs introduced by SP (and SD) – namely a reduction in information about the estate and other valuable opportunities that may arise from asserted rights -- are of a kind that the Bankruptcy Code and the courts are not equipped to deal with. The errors introduced by ED, on the other hand, are easily mitigated by the core provisions of the Code and the core expertise of the bankruptcy court. As a result, the costs of an all-ED rule are much lower than the costs of an all-SP or SD rule. SP and excessive SD can lead to inefficient outcomes in a whole subset of cases. ED merely requires the court to entertain self-interested arguments that run against the interest of the estate.

Again, weighing and assessing the merits of such arguments is one of the core functions of a bankruptcy court. Indeed, modern bankruptcy procedure is modeled on our civil adversary system and assumes the constant flow of information (good and bad) to the judge. Judges are well equipped to deal with over

zealous parties. We should expect motions and objections that destroy value to be denied—and enforcing side agreements with an ED remedy will provide a deterrent to these motions and objections being raised. We cannot make a parallel comment about value-creating motions or objections or financing arrangements that are never raised. If a party is forced to be silent and no one asserts a position, the adversary system does not do a good job of identifying that efficiency loss. An efficient DIP financing arrangement that is never proposed cannot be created by the court. But an efficient DIP financing arrangement that is proposed can be rejected by the court. The same is true of plan support or objections. The asymmetry in how a judge deals with a bad objection (or assertion of a right) and a bad non-objection (or non-assertion of a right) creates the difference in kind between costs of ED and costs of SP that forms the foundation for our framework.

c. Forum and Venue

A final implication of our analysis relates to forum and venue and which courts should be deciding these cases.

There are two relevant groups of cases: 1) cases where the plaintiff only asks for ED; and 2) cases where the plaintiff asks SP or stipulated damages (SD).

ED only contracts: There is no theoretical reason to think that a bankruptcy court has any special knowledge in determining ED or that ED must be determined before a plan is confirmed.

Rather our analysis simply suggests that ED works better when a court gets the calculation right. In the absence of evidence that bankruptcy courts are better at measuring damages, there is no reason that we would favor a bankruptcy court and we should defer the parties' contractual choices.

The takeaway, then, is that for ED only cases we enforce forum selection clauses as written. If there is no forum selection clause we go to our standard default that the plaintiff chooses forum. There is really no bankruptcy reason to ignore these defaults and drag the case into the bankruptcy court.

In the doctrinal language: the case is simply not core because the key issues are sufficiently independent of the issues in the reorganization. The ICA does not affect the total claims on the estate. It only affects the ex post redistribution of payouts among sub groups of creditors. The bankruptcy court can ignore the ICA, award payments to the group of creditors as if the ICA did not exist, and allow them to litigate the distribution later.

One might argue that the ICA claims are non-core claims that are nonetheless related to the bankruptcy and should be brought into the proceedings. But that has no strong logic behind it. As starting point, non-core claims cannot be resolved with finality by the bankruptcy court. So the bankruptcy court's power to coordinate is weak. And more importantly, these ED claims are state law claims between non-debtors with little impact on the claims against the estate. The only issue is the amount of damages and that has nothing to do with the size of the estate. All of these factors weigh against ignoring the forum selection clauses or ignoring plaintiffs' presumed ability to choose forum (in the absence of a selection clause).

SP and SD cases: Considerations are much different for these cases. Our model shows that in many cases, the enforcement of SP (or SD) will have direct externalities on the bankruptcy estate. Rights whose benefits run to other creditors may not be asserted. Bankruptcy is a collective process that assumes that

certain parties rely on the arguments and actions of other parties. Its very premise is to prevent behavior that will benefit some stakeholders at the expense of the collective estate.

Specifically, our model has suggested that courts should refrain from enforcing SP and SD when there is a chance of externality. Those externalities are directly related to the reorganization: An inefficient plan of reorganization or sale might be chosen. For example, as we have shown, when J is specifically prohibited from objecting, C may be adversely affected because the value of the estate will be reduced.

So for every case where an SP (or SD) claim is made, the presiding court must first decide whether externalities are a risk.

A bankruptcy court that is in the middle of reorganizing a company has a unique expertise in determining whether SP (or SD) of a particular agreement will have externalities within that reorganization. And so it should be that particular bankruptcy court deciding the initial question of whether there are potential externalities. And once the court has undertaken to make that initial determination it should continue with the case.

Thus, in doctrinal terms, any time that a plaintiff in one of these cases seeks to get SP (or SD), then the case becomes core because it is not independent of the reorganization. This easily fits within both the statutory definition of core under 28 USC 157 and under the Constitutional definition in the Stern line of cases.

As a final note: This does allow the plaintiff (S in our model) some freedom to choose which court has power over the case. If S never asks for SP, then the case never becomes core. This is consistent with most of the US system that allows the plaintiff as master of the complaint to craft a case consistent with its desired forum.

d. Applying our theory to cases

Boston Generating

The Boston Generating bankruptcy involved an intercreditor agreement that set the priority of the parties to the agreement. It also included provisions preventing the second liens from bringing any objections or asserting certain rights. During the case these provisions raised the question of whether the second liens had standing to object to a sale. Despite terms providing that the second liens had no rights other than holding the lien, voting on a plan, and asserting the interests of unsecured creditors, the court allowed them standing to object to bid procedures.

To get there the Court introduced the “beyond peradventure” standard to allow the second liens to object to a sale despite the agreement. It basically said that provisions of an ICA that limited the ability of a party to assert bankruptcy rights should be held to a higher standard of interpretation. The contract had to be clear beyond peradventure. This is a strange mode of contract interpretation and suggests the courts may be playing fast and loose with the cannons of contract law to get to the pragmatic outcome.²⁴

²⁴ This is consistent with a common observation that bankruptcy courts often take some doctrinal license when working toward the right pragmatic outcome.

It also suggests that courts will be in a tough spot when the parties have drafted an ironclad agreement that nonetheless destroys value.

To be sure, though, the primary outcome – denying specific enforcement of the agreement – is exactly what our proposal calls for, provided that there is at least some chance that non-parties to the agreement stood to be affected by the objection²⁵. The posture of the case was such that the externalities were *potentially* high, and the court would not have known that they were zero until after it considered the objection. The sale, if it was not optimal, could have drained value from the remaining unsecured creditors (an externality). And until the court heard the objection from the second lien creditors, it would not have known whether the sale was optimal or not. And if no organized and powerful creditor group had brought the objections, then the issue would have gone unreviewed. The potential externality from leaving important issues unreviewed is the precise problem that requires specific performance be denied.

The path by which the court got to that outcome, however, is problematic. The “beyond peradventure” standard makes it less likely that the promisor would be forced to pay damages if the side agreement is breached in fact. To be sure, the damages in Boston Generating would have been small, because the objection that the second lien holders brought was denied and the sale went through. The damages running to the first liens should have been, at most, the costs of responding to the objection. But if the objection had succeeded and value for the firsts had been lost, then the damages might have been more significant.

Generally, the “beyond peradventure” standard might lead to frivolous breach of intercreditor agreements that involve some ambiguity. Imagine that the second lien objection could have disrupted things just enough to stop the sale, and the first lien creditors bear a large loss as a result. If the second liens do not bear any costs for that move, then they will bring the objection even when it destroys estate value. The only way to correct this is through expectation damages, which cause them to bear the costs of the failed sale (and measure them against the benefits that same cause of action). But those damages are not awarded under the “beyond peradventure” standard that the court used.

Another potential unintended consequence of the “beyond peradventure” approach is that parties will skew the substance of future agreements so as to delineate the promisee’s rights more clearly. This may lead to promisors waiving more bankruptcy rights and creating greater negative externalities. One common reason that intercreditor agreements are ambiguous is that promisors often waive rights that accrue to secured creditors, but preserve their rights to object as unsecured creditors. If second liens waive these additional rights, agreements may look clearer, but actions that have the potential to benefit unsecured creditors become less likely.

Boston Generating highlights the risks of both specific performance on one hand, and a “beyond peradventure” standard on the other hand, in which damages for breach are not available. Our proposal suggests that it is better to alter the contractual remedies for breach (from SP or SD to ED) rather than the interpretive standard for determining breach. Interpreting the language of the contract faithfully

²⁵ A court might reasonably decide that the other creditors are so far out of the money that the outcome of the hearing would only affect the payoffs of the first and second lien creditors. Specific performance would be justifiable under those circumstances.

ensures that the parties to the side agreement can tailor their agreement to prevent holdout behavior when it is most likely to occur. The mandatory ED remedy does the work of limiting negative externalities.

Momentive

Momentive was ultimately a damages case. Though the intercreditor agreement specifically gave the senior lenders the option to ask for a specific performance remedy, senior lien holders did not press arguments to enjoin the junior lien holders from asserting their rights. A move to enjoin the junior lenders would have been problematic. The plan proposal process involves a system where the debtor proposes a resolution of the bankruptcy. In that process the debtor can choose the particulars of the plan. In practice, this is achieved through complicated negotiations with various stakeholders that result in a plan that favors some and disfavors others. The code then provides baseline protections such as absolute priority and the best-interest test to ensure that alliances do not overly favor or disfavor groups of creditors. There is still, however, a wide range of discretion in which the debtor may operate.²⁶ Lots of side deals are negotiated to ensure the debtor has necessary support for a plan. Within the limits of APR and the best interest test, value moves from one group of stakeholders to another in an attempt to lock in a feasible plan that creates value for the estate as whole. In Momentive these deals took the form, as they increasingly do in large bankruptcies, of a restructuring support agreement (RSA). The RSA locked in the side deals and provided the details of the plan that would result.

Only when parties assert their interests does the court receive information and arguments about whether 1) the proposed plan complies with APR, the best interest test, and the general provisions of the code; 2) whether the plan provides value to the estate; and 3) whether the side deals are problematic. By voting and arguing in favor of a plan, a creditor provides information to the court on where the plan creates value and complies with the code. Indeed, for this very reason, the code explicitly requires that a plan be approved by one impaired class of creditors. By objecting, the creditor provides information about where the plan destroys value and fails to comply.

If the senior lien holders in Momentive could force the junior lien holders to vote against a plan, the court loses information about the value of the estate and the claims. Imagine a reorganization with three classes of creditors where we have silenced the class in the middle. Now imagine there are two possible plans that could be confirmed. The best plan maximizes value and benefits the junior two classes. The other plan shifts value from the middle class to the senior creditors and leaves the third class completely out of the money. Without hearing from the middle class, the court is faced simply with a two party disagreement about the value of the two plans. Now imagine, quite realistically, that the third class is a fractured and dispersed group of unsecured creditors. If we let the middle class vote and assert their interest we are likely to get a plan that maximizes the estate and benefits the two junior classes. Much information can thus be gained by allowing the middle class to assert its interest and express its independent view of the options.

As we said, the junior lien holders in Momentive were allowed to assert their interests. In that sense, the case is consistent with our model. Yet, the court -- applying the beyond peradventure standard -- found no damages for the senior lien holders. As suggested above, the beyond peradventure standard as used

²⁶ Cite to Baird's RSA paper here.

in Boston Generating can be a rough doctrinal move to get to the pragmatic outcome of not specifically enforcing the terms of these agreements. But when it is applied to damages cases, it introduces unnecessary costs on independent contracting because it makes it harder to design an agreement that is targeted at preventing holdout behavior.

Once the junior lien holders were allowed to assert their interests, there was no longer a bankruptcy purpose to justify not awarding damages on the contract. Instead, the court simply failed to enforce an ICA and reduced the ability of the non-debtors to privately order their respective payments from the bankruptcy estate. Our model suggests instead that Momentive should have been an ED case – and one that never belonged in the bankruptcy court in the first place.

Radio Shack

The disputes in Radio Shack were quite complicated. Salus was trying to assert the rights of the SCP lender group under an intercreditor agreement to stop Standard General from crediting bidding under the ABL loan. Cerberus then tried to assert its rights under an AAL to prohibit Salus from asserting its rights. Finally, the first out lenders tried to assert their rights under an AAL to stop SG from moving forward with its sale and credit bid.

In the end, the court formally held that Cerberus could stop Salus from asserting its rights. The FOLs were pressured by the court to settle and give up their objections to the sale. And then in the end, the court let the sale go forward.

On a realist view of the whole case, the court was fully aware of all the various parties' reasoning and arguments and let the sale go forward. It refused to allow anyone to assert rights that would prohibit the sale. The court heard all the arguments, decided the sale was the appropriate outcome, and then ruled on the various agreements in a way that allowed the sale to go through. In that sense, the denial of Salus's ability to object did not deprive the court of the necessary information to rule on the sale.

From a more formalistic view point, it declined to specifically enforce FOL's asserted right to prohibit SG from bidding. It then specifically enforced Cerberus right to stop Salus from specifically enforcing its right to prohibit the bidding.

Our model suggests that the court got to the right outcome, but the formalistic path was not quite right. Salus's attempt to stop the sale under the ICA was fraught with the risk of imposing externalities on the estate (the unsecured creditors in particular). [More on their settlement] The court should have denied that outright, rather than denying it as a result of granting Cerberus's SP request. Finally, a damages suit should have been the remedy for all of the various parties.

V. Conclusion

In this paper, we have analyzed intercreditor and other side agreements, and what bankruptcy law should do about them. Courts' current approach to the topic varies, but courts clearly recognize a tension in enforcing them, and respond by reading the contract language in favor of preserving the rights the

Bankruptcy Code provides. We model the costs and benefits of enforcing side agreements and show that side agreements can create externalities that bankruptcy law is justified in limiting. We propose that side agreements should be enforceable, but a remedy in a side contract should be replaced by expectation damages if there is a potential for value-destroying externalities. Though our proposal is not a panacea for all problems that might arise in bankruptcy, on balance it honors the purpose of the side agreement while preserving open space for value-increasing actions that can benefit outside stakeholders.