

BANKRUPTCY AND THE FUTURE OF AGGREGATE LITIGATION: THE PAST AS PROLOGUE?

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TABLE OF CONTENTS

INTRODUCTION.....	840
I. THE RISE AND FALL OF THE EQUITY RECEIVERSHIP	846
A. <i>Railroads and the Problem of Group Resolution</i>	848
B. <i>The Equity Receivership</i>	852
1. <i>The Expansion of Receiverships</i>	852
2. <i>The “New-fashioned” Receivership</i>	854
C. <i>The End of the Equity Receivership</i>	856
1. <i>The First Wave of Statutory Reforms</i>	860
2. <i>The Chandler Act and the Turn to Administrative Supervision in Bankruptcy</i>	865
II. THE RETURN OF BANKRUPTCY	872
A. <i>Reorganization Practice After the Fall</i>	873
1. <i>The Chapter XI Loophole in Agency Supervision</i>	873
2. <i>Exploiting the Loophole</i>	877
B. <i>The Bankruptcy Bar and Reform</i>	882
III. LESSONS FOR THE FUTURE OF AGGREGATE LITIGATION.....	884
A. <i>The Cycles of an Aggregation Device</i>	884
1. <i>Stages of Innovation and Reform</i>	885
2. <i>Assessing Proposals for Class Action Reform</i>	886
B. <i>Lawyers, Aggregation, and Institutional Reform</i>	888
CONCLUSION	893

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INTRODUCTION

You have heard this story before. A promising new procedure for the aggregation and efficient resolution of dispersed claims develops from more rudimentary antecedents. The device rapidly evolves through experimentation and innovation on the part of lawyers and judges. At first, this new way of gathering together claimants is recognized as a necessary means to achieve socially useful ends, and those involved in its development are seen as public-minded advocates. Then, as the device matures, a different mood sets in. Courts become increasingly skeptical of its more adventurous expansions. Commentators—sometimes for ideological purposes—attack the procedure as the creature of parasitic lawyers preying on a helpless public. The bar that has grown up around the procedural device attempts to preserve the gains of two generations of lawyering. Eventually, however, Congress steps in and whittles away the space for further innovation. In the end, judicial, academic, and legislative criticisms diminish the usefulness of a once promising procedural advancement.

That is the story of bankruptcy, but it should sound familiar to those who follow the development of the class action. Any discussion of the future of the class action frequently involves looking to its past.¹ That tale is a familiar one, too. Although not wholly a creature of the modern age,² the class action in its current shape was formed by the hydraulic pressures of contemporary society. Mass production and communication, combined with the wide distribution of goods and services, exposes large numbers of people to common wrongdoing.³ At the same time, individual adjudication of mass claims presents high transaction costs for litigants and serious institutional concerns for courts fearing crowded dockets and inconsistent

1. See, e.g., Stephen B. Burbank, *The Class Action Fairness Act of 2005 in Historical Context: A Preliminary View*, 156 U. PA. L. REV. 1439, 1484–1509 (2008) (recounting the history of the “revolution” in class action practice and the later “counterrevolution” by the Supreme Court to discipline the use of the device); Robert H. Klonoff, *The Decline of Class Actions*, 90 WASH. U. L. REV. 729, 736–39 (2013) (providing historical context for the increasing skepticism by courts toward the class action); Judith Resnik, *Lessons in Federalism from the 1960s Class Action Rule and the 2005 Class Action Fairness Act: “The Political Safeguards” of Aggregate Translocal Actions*, 156 U. PA. L. REV. 1929, 1936–38 (2008) (drawing parallels between the historical development of Rule 23 of the Federal Rules of Civil Procedure and the Class Action Fairness Act of 2005).

2. See generally STEPHEN C. YEAZELL, *FROM MEDIEVAL GROUP LITIGATION TO THE MODERN CLASS ACTION* (1987).

3. See David L. Shapiro, *Class Actions: The Class as Party and Client*, 73 NOTRE DAME L. REV. 913, 923–34 (1998) (describing the limitations of individual litigation when a group has been exposed to wrongdoing by a defendant).

judgments.⁴ Together, these realities channel litigation, perhaps inevitably, toward aggregation.⁵ The class action—at least the version of the procedural device born in 1966 when Rule 23 was revamped—answered the drive toward aggregation with a form of representative litigation. From that origin story, the class action is then said to trace an Icarus-like arc from rise to ruin. Hubris, combined with the heat of political,⁶ judicial,⁷ and academic⁸ criticism, brought the class action back down to earth. The desire for aggregation now has to seek other outlets for relief.

Bankruptcy, when it gets mentioned in a discussion of the development of the class action, usually appears only as a digression from the main narrative. Bankruptcy became relevant over the last twenty-five years as a

4. *See id.* at 926–28.

5. *See generally* Samuel Issacharoff & John Fabian Witt, *The Inevitability of Aggregate Settlement: An Institutional Account of American Tort Law*, 57 VAND. L. REV. 1571 (2004).

6. *See generally* David Marcus, *The History of the Modern Class Action, Part I: Sturm Und Drang, 1953–1980*, 90 WASH. U. L. REV. 587 (recounting the political context of development and retrenchment of the class action from the 1970s through the 1980s).

7. Dissatisfaction with aspects of class action practice has been voiced by prominent judges over the years. *In re Rhone-Poulenc Rorer, Inc.*, 51 F.3d 1293, 1299 (7th Cir. 1995) (Posner, J.) (expressing concern that after certification of a class action, defendants would be forced “to stake their companies on the outcome of a single jury trial, or be forced by fear of the risk of bankruptcy to settle even if they have no legal liability”); *see also* HENRY J. FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 120 (1973) (suggesting that class certification induced defendants to enter into “blackmail settlements” of meritless claims). It is also fair to say that the Supreme Court has taken a cautious view of the legitimate use of the class action device. *See, e.g.*, *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2561 (2011) (reversing certification of a nationwide employment discrimination class action); *Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 864–65 (1999) (reversing certification of a limited fund mass tort class action); *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 628–29 (1997) (affirming decertification of an opt-out mass tort class action). And that caution is not of recent vintage. *See Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 178–79 (1974) (rejecting the allocation of class certification notice costs to the defendant); *Zahn v. Int’l Paper Co.*, 414 U.S. 291, 301–02 (1973) (holding that even if the claims of the named plaintiffs in a class action satisfy the amount in controversy requirement for federal jurisdiction, each individual class member’s claims must do so as well); *Snyder v. Harris*, 394 U.S. 332, 339–42 (1969) (holding that class members’ claims could not be aggregated to satisfy the amount in controversy requirement); Arthur R. Miller, *Of Frankenstein Monsters and Shining Knights: Myth, Reality, and the “Class Action Problem,”* 92 HARV. L. REV. 664, 679 (1979) (discussing a period of federal court “antipathy” to the class action from the late 1960s to the mid-1970s that was “made all the bleaker by the Supreme Court’s restrictive decisions” in *Snyder*, *Zahn*, and *Eisen*).

8. Academic criticism of class actions emerged shortly after the 1966 amendments to Rule 23. *See, e.g.*, Milton Handler, *The Shift from Substantive to Procedural Innovations in Antitrust Suits—The Twenty-Third Annual Antitrust Review*, 71 COLUM. L. REV. 1, 9 (1971) (labeling the antitrust class action “a form of legalized blackmail”); Jonathan M. Landers, *Of Legalized Blackmail and Legalized Theft: Consumer Class Actions and the Substance-Procedure Dilemma*, 47 S. CAL. L. REV. 842, 899–900 (1974) (describing Rule 23 as having “lost sight of its origins” and calling for legislative reform of the class action). That criticism has not abated. *See, e.g.*, MARTIN H. REDISH, WHOLESALE JUSTICE: CONSTITUTIONAL DEMOCRACY AND THE PROBLEM OF THE CLASS ACTION LAWSUIT 21–61 (2009) (arguing that class actions violate basic democratic and constitutional norms).

form of aggregation that could be a substitute for the class action.⁹ Although not able to serve as a complete substitute, bankruptcy came to play a key role in the resolution of some mass tort claims that could not be resolved through class actions. Asbestos litigation represents the prime example of bankruptcy's use as an aggregation device once attempts at global resolution through the class action had failed.¹⁰ Bankruptcy, it has been said, was transformed by the asbestos crisis in order to become a viable alternative to the class action.¹¹ Outside of the relatively confined niche of enterprise-threatening mass tort liability, however, bankruptcy does not figure prominently in the debate about the possible future course of aggregate litigation.

This view of the place of bankruptcy is too narrow. Bankruptcy is more than a limited substitute for the class action, and it holds broader lessons for those interested in the future of aggregate litigation. It can serve as a reference model for judging the proper shape of aggregation. But I do not tackle that broader claim in this Article. Instead, I wish to press a more limited line of argument. I will draw out parallels between the twin arcs of the development of bankruptcy law and the class action.

My goal is to demonstrate that bankruptcy serves as a rich source of historical guidance for those interested in the future path of aggregate litigation. Bankruptcy law—and, more specifically, the law governing the reorganization of firms—is the oldest, most enduring, and most far-reaching form of procedural aggregation in use in the United States.¹² To be sure, courts have resorted to other examples of collective litigation in

9. See Alan N. Resnick, *Bankruptcy as a Vehicle for Resolving Enterprise-Threatening Mass Tort Liability*, 148 U. PA. L. REV. 2045, 2045–49 (2000) (discussing the use of bankruptcy as an alternative form of aggregation “[w]hen other mechanisms fail or are likely to be ineffective”).

10. Although the Bankruptcy Code as enacted in 1978 did not contain any express provision that contemplated its use as a means to resolve mass litigation, bankruptcy law soon came to serve that role in asbestos cases. Beginning with the asbestos producer Johns-Manville in 1982, increasing numbers of companies facing liability from asbestos personal injury suits have chosen to use the Bankruptcy Code to aggregate and resolve that liability. See *In re Johns-Manville Corp.*, 36 B.R. 727, 737–40 (Bankr. S.D.N.Y. 1984) (finding that the company did not act in bad faith by filing a bankruptcy petition to resolve its asbestos liability). Bankruptcy did not become the dominant form of aggregate resolution of asbestos claims, however, until after the Supreme Court decertified the nationwide asbestos settlement class actions in *Amchem* and *Ortiz*. See RICHARD A. NAGAREDA, MASS TORTS IN A WORLD OF SETTLEMENT 167 (2007) (“Of the seventy-three asbestos-related bankruptcy filings from 1976 to 2004, more than half occurred after 1997—that is, in the period since *Amchem*.”).

11. NAGAREDA, *supra* note 10, at 161–82 (describing the transformation of bankruptcy practice to accommodate mass resolution of asbestos claims).

12. Although there was no enduring federal bankruptcy statute until 1898, American courts had long before employed forms of aggregate procedural devices to rearrange the debtor-creditor relationship. See *infra* Part I.B.

various forms throughout history.¹³ I do not argue that bankruptcy is *sui generis* in that sense. But bankruptcy law is unique in two respects. First, the Bankruptcy Code¹⁴ retains much of the basic working order of the procedural innovations that first debuted more than 150 years ago with the development of the equity receivership—the non-statutory form of reorganization that contains the antecedents of Chapter 11 of the modern Code. Second, like the rise of aggregation in civil litigation, the law of business reorganizations developed as a direct result of the pressing needs of a modern industrial economy in which mass resolution was required to address the claims of widely dispersed individual claimants. Thus, bankruptcy law has taken a long path that hints at the direction other forms of aggregate litigation may follow in the future.

What draws me to this comparison? When viewed in its broad sweep, the history of American bankruptcy law bears a close resemblance to the more recent history of the class action. The earliest form of court-centered business reorganization arose out of the realities created by the great corporations of the day—the railroads.¹⁵ An increasingly sophisticated reorganization practice in railroad cases drove the development of a large body of case law—and an influential body of lawyers specializing in the area. Beyond the railroads, other business enterprises made use of the nascent reorganization device as it was refined. Those developments spurred the formulation of procedural rules that embraced, expanded, and influenced the practice.¹⁶ But success bred serious attacks on reorganization law. Most prominently, commentators came to see the reorganization bar as corrupt. Rather than being viewed as public-spirited professionals providing a necessary service in the best traditions of the bar, reorganization lawyers were painted as deeply conflicted actors who

13. YEAZELL, *supra* note 2.

14. References to the Bankruptcy Code are to Title 11 of the United States Code.

15. See Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420, 1440–42 (2004) (describing the role of railroads in the development of the equity receivership).

16. Receivership practice helped to motivate procedural reform in the federal courts. Because receiverships were frequently brought on the equity side of the federal courts by a small handful of lawyers (concentrated in New York) who practiced around the country, there was longstanding pressure to bring national uniformity to federal practice. See Charles E. Clark & James Wm. Moore, *A New Federal Civil Procedure*, 44 YALE L.J. 1291, 1315 n.105 (1935) (noting that statutory reforms of corporate reorganizations decreased the pressure on federal equity procedure); see also Judith Resnik, *Failing Faith: Adjudicatory Procedure in Decline*, 53 U. CHI. L. REV. 494, 508 (1986) (noting that equity cases “were critical to the enterprise” of drafting the Federal Rules of Civil Procedure in years when receiverships were frequently used).

placed their own self-interest above those of claimants.¹⁷ A sustained legislative reform effort followed, then grew into an outright attack in the New Deal era that limited the freewheeling development of reorganization law. The mood of suspicion persisted, and reorganization practice continued at a diminished level. Yet, bankruptcy law returned in more vibrant form at the end of that period of exile.¹⁸ Only after a generation, however, did the cycle reverse when the modern Bankruptcy Code was adopted in 1978.¹⁹

Will the class action follow a similar arc? The answer to that question is, of course, unknowable. But the revival of bankruptcy after its dramatic fall²⁰ may offer some lessons for the future trajectory of the class action—and aggregate litigation more broadly.

First, the pressures that drove the development of a court-centered form of business reorganization did not dissipate in the years after the legislative attack in the 1930s on reorganization practice. Instead, other mechanisms served as an outlet for those pressures. The New Deal reforms sought to make a regime under the auspices of an administrative agency (the Securities and Exchange Commission (SEC)) the principal route through which reorganizations would be channeled. Nevertheless, a more flexible route to business reorganization did not disappear entirely. Instead, when the court-centered but SEC-supervised regime proved inadequate to handle the realities of resolving the financial distress of firms, lawyers and the courts took the lead in forging an alternative reorganization process.²¹ A small and limited form of court-centered and lawyer-driven reorganization returned to fill the gap.

17. The most detailed formulation of this view came from William O. Douglas. As chairman of the SEC, Douglas (together with Abe Fortas and their staff) produced an influential report on corporate reorganizations. SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1936–1940) [hereinafter SEC REPORT]. Douglas attacked the bar for its large fee awards (paid from the debtor’s assets). See 1 SEC Report, *supra*, at 866–68 (summarizing criticisms of reorganization lawyers). The report, issued in multiple volumes over several years, also accused lawyers of compromising their obligations to creditors due to the close relationships among the Wall Street law firms that dominated the practice, the managers of the businesses undergoing reorganization, and the bankers who orchestrated the process. See *infra* Part I.C.2.

18. See *infra* Part II.

19. Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2549 (codified in scattered sections of 11 U.S.C.).

20. See *infra* notes 208–10 and accompanying text (discussing disincentives that limited the number of bankruptcy filings after the New Deal era reforms).

21. See Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 534 n.22 (1983) (discussing the flexible “bargain” model of business reorganization that competed with the more rigid SEC-supervised process).

Second, the control and supervision of lawyers was an integral part of bankruptcy's revival story. While acknowledging that a court-centered and lawyer-driven process would remain crucial to business reorganizations, the later generation of reformers who led the way to the Bankruptcy Code in 1978 were particularly concerned about the role of lawyers in the bankruptcy process. They recognized that the tarnished reputation of bankruptcy lawyers had impeded efforts at bankruptcy reform.²² So, partly out of concern about actually deterring lawyer misconduct and partly out of concern about addressing the *perception* of lawyer misconduct, the bankruptcy system has built into it institutions that seek to check excessive influence by lawyers.²³

These lessons do not make for an entirely happy story. Bankruptcy law and bankruptcy practice continue to generate controversy. The most recent legislative efforts to amend the Bankruptcy Code were, at bottom, expressions of distrust about a process that seemed peculiarly within the control of courts and lawyers.²⁴ Commentators—both scholarly and popular—remain critical of the large fees garnered by lawyers in large bankruptcy cases.²⁵ But despite these concerns, few believe that the bankruptcy process will be dismantled.

Part I of this Article recounts the development of the law of business reorganizations and the sustained attack on bankruptcy practice that culminated in the hobbling of the reorganization bar during the New Deal. I provide a good deal of detail about these historical developments,

22. A common complaint before the adoption of the Bankruptcy Code was that bankruptcy practice was an overly complicated field controlled by an overly exclusive group of lawyers—a situation that tended to increase lawyer control and to lead “almost inevitably” to abuses by a few attorneys. Don J. Miner, Comment, *Business Reorganization Under the Bankruptcy Reform Act of 1978: An Analysis of Chapter 11*, 1979 BYU L. REV. 961, 984–85.

23. *See id.* at 985 (discussing Bankruptcy Code features that counter defects of the previous bankruptcy system); *see also infra* text accompanying notes 276–81 (discussing features of the modern bankruptcy system designed to check self-dealing and excessive control by lawyers).

24. Congress enacted significant changes to bankruptcy law as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C., 18 U.S.C., and 28 U.S.C.). The statute has been viewed, particularly by the bankruptcy bar and bench, as an expression of congressional distrust of the practices of bankruptcy lawyers and judges. *See, e.g.*, Keith M. Lundin, *Ten Principles of BAPCPA: Not What Was Advertised*, 24-SEP AM. BANKR. INST. J. 1, 69 (2005) (“Together with anti-debtor . . . and anti-lawyer . . . themes, BAPCPA arrived on a wave of anti-bankruptcy judge rhetoric.”).

25. *See, e.g.*, Nelson D. Schwartz & Julie Creswell, *Who Knew Bankruptcy Cases Paid So Well?*, N.Y. TIMES, May 2, 2010, at BU1 (describing concerns about the significant fees charged by lawyers and other professionals in the Lehman Brothers bankruptcy case); Lynn M. LoPucki & Joseph W. Doherty, *Professional Overcharging in Large Bankruptcy Reorganization Cases*, 5 J. EMPIRICAL LEGAL STUD. 983, 985 (2008) (reporting that courts award higher fees in bankruptcy venues favored for large reorganization cases).

because they are largely unknown to those in the complex litigation field. Understanding the path of business reorganization law helps to situate the later lessons I draw from the parallels between bankruptcy and the class action. Part II recounts the movement to reform and revive bankruptcy practice, a movement that helped produce a new Bankruptcy Code in 1978. The Code reversed key policy decisions made in the New Deal era and, as a consequence, spurred a revival of corporate reorganizations in the late twentieth century. Part III draws from that background and attempts to sketch out briefly—more in the form of questions than definitive answers—possible routes for the future development of aggregate litigation.

I. THE RISE AND FALL OF THE EQUITY RECEIVERSHIP

It is common for those unfamiliar with bankruptcy to think of the field as human misery and failure wrapped in mind-numbing technical detail. The story of bankruptcy law in the United States, however, is a fascinating one. Charles Warren opened his classic account of the history of American bankruptcy law with the concession that bankruptcy is a “gloomy and depressing subject” and a “dry and discouraging topic.”²⁶ Nevertheless, Warren was quick to observe that bankruptcy had a colorful history, “for not only does it reflect the changes in viewpoints and in economic conditions in our [n]ational history, but it also reminds us of how frequently the views and conditions of today are mere repetitions of the past.”²⁷ Debtor-creditor relations were central to the life of the law from colonial times.²⁸ Debt cases were a prominent part of the business of the courts—both state and federal.²⁹ The development of the law governing debt, in other words, can tell much about the development of the law more

26. CHARLES WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* 3 (1935).

27. *Id.*

28. *See generally* BRUCE H. MANN, *REPUBLIC OF DEBTORS: BANKRUPTCY IN THE AGE OF AMERICAN INDEPENDENCE* (2002).

29. Cases involving debtor-creditor relations were a mainstay of litigation in the colonial courts. *See generally* WILLIAM E. NELSON, *THE COMMON LAW IN COLONIAL AMERICA VOL. 2: THE CAROLINAS AND THE MIDDLE COLONIES, 1660–1730* (2013) (describing the central place of debtor-creditor cases in the colonial American legal system). Following adoption of the Constitution, the newly created federal courts could not exercise general federal question jurisdiction (except for a brief period in 1801) until after the Civil War. *See* Alison L. LaCroix, *The New Wheel in the Federal Machine: From Sovereignty to Jurisdiction in the Early Republic*, 2007 SUP. CT. REV. 345, 360–62 (2008). Therefore diversity cases, including suits for the collection of debts, formed much of the docket of the federal courts. *See* Debra Lyn Bassett, *The Hidden Bias in Diversity Jurisdiction*, 81 WASH. U. L.Q. 119, 122–35 (2003).

broadly. Indeed, it lends support to Warren’s view of changes in the law as “mere repetitions of the past.”³⁰

Debtor-creditor law was a politically charged topic, with serious tension between state courts and legislatures,³¹ and between state and federal institutions,³² about debtor relief. Political debates about the role of the courts and the proper balance between the business of the federal and state courts played out in debates about the debtor-creditor laws.³³ Even as interstate commerce expanded in the early republican period, national legislation on the subject of bankruptcy proved to be a sensitive topic. Fear of overreach by the federal government as against the states and fear of overempowering the federal courts combined with competing ideologies about debtor relief to make a stable federal bankruptcy statute difficult to enact.³⁴

For those reasons, the Constitution’s grant of authority to Congress to enact “uniform Laws on the subject of Bankruptcies throughout the United States”³⁵ did not produce an effective bankruptcy law for much of the first century after the adoption of the Constitution. Three attempts at national bankruptcy legislation—in 1800, 1841, and 1867—proved short lived.³⁶ Each statute came after a serious economic downturn. And each one was repealed when the business cycle turned upward again.³⁷ Pro-debtor sentiment, creditor dissatisfaction, jealousy of federal power, or a mix of

30. WARREN, *supra* note 26, at 3.

31. See Theodore W. Ruger, “A Question Which Convulses a Nation”: *The Early Republic’s Greatest Debate About the Judicial Review Power*, 117 HARV. L. REV. 826 (2004) (recounting the divisive debate in 1820s in Kentucky after the state supreme court invalidated a debtor relief statute).

32. Henry Friendly provided an influential account of diversity jurisdiction’s origins as a response to fears that the state courts and legislatures would prove hostile to out-of-state creditors. See Henry J. Friendly, *The Historic Basis of Diversity Jurisdiction*, 41 HARV. L. REV. 483, 498 (1928) (“There was a vague feeling that the new [federal] courts would be strong courts, creditors’ courts, business men’s courts.”).

33. See, e.g., Ruger, *supra* note 31, at 836–55 (describing the political context of debtor-creditor disputes in early nineteenth century Kentucky).

34. See generally WARREN, *supra* note 26.

35. U.S. CONST. art. I, § 8, cl. 4. The meaning of “bankruptcies” in the Bankruptcy Clause was the subject of some debate. See DAVID A. SKEEL, JR., *DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 27 (2001). The text of the Constitution could be read narrowly to incorporate the distinction found in earlier English statutes between “insolvency” laws (designed for the relief of debtors) and “bankruptcy” laws (limited to merchants and traders). *Id.* A debtor could not initiate a voluntary bankruptcy under the English laws, which were designed to assist creditors in collecting and liquidating the debtor’s assets, rather than to give debtors relief. *Id.* The Supreme Court rejected that reading of the clause in favor of a broader interpretation that encompassed the subject of financial distress more generally. *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122, 192–97 (1819).

36. See Bankruptcy Act of 1800, ch. 19, 2 Stat. 19 (repealed 1803); Bankruptcy Act of 1841, ch. 9, 5 Stat. 440 (repealed 1843); Bankruptcy Act of 1867, ch. 176, 14 Stat. 517 (repealed 1878).

37. In total, the three laws were in force for about sixteen years. See SKEEL, *supra* note 35, at 25. The 1867 statute enjoyed the longest duration of the three. See *supra* note 36.

all three contributed to the demise of each federal law.³⁸ That left the regulation of debtor-creditor relations to state law.³⁹ A permanent, stable federal bankruptcy law did not come into force until 1898.⁴⁰

A. *Railroads and the Problem of Group Resolution*

The law, like nature, abhors a vacuum. The absence of a federal bankruptcy law did not diminish the pressures of financial distress in an increasingly complex national economy. The conflict over the creation of a federal bankruptcy law initially focused on individuals and small merchants in crisis.⁴¹ As business enterprises expanded in the nineteenth century, however, debtor-creditor relations began to move beyond that simple model. Rather than a morality tale of individual debtors or small businesses on the one hand and a few creditors on the other, financial distress became a more complicated drama involving capital-intensive firms interacting with large numbers of creditors and with the general public.⁴² Those creditors, in turn, might be sophisticated financiers, less sophisticated and more dispersed investors, trade creditors, employees, or others.

The railroads played the definitive role in spurring the creation of a body of law to meet the realities of financial distress in an industrial age. The railroads were the great engine of change in the American economy. Their influence extended beyond the increased speed and decreased cost of transportation that they inaugurated. They were, as one prominent study of their influence described them, the first “big business.”⁴³ And they

38. See generally WARREN, *supra* note 26.

39. See generally PETER J. COLEMAN, *DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY, 1607–1900* (1974).

40. See Bankruptcy Act of 1898, ch. 541, 30 Stat. 544. The 1898 Act was amended at various times in the twentieth century and then replaced by the Bankruptcy Reform Act of 1978, which introduced the Bankruptcy Code.

41. See COLEMAN, *supra* note 39, at 269–75.

42. The equity procedure later adapted to the needs of railroad financial distress—the receivership—developed as a device for preserving the assets of individuals or business partnerships from spoliation. Its use in railroad reorganizations required accommodation of more complex relations among the firm, its creditors, and the public. See Henry H. Swain, *Economic Aspects of Railroad Receiverships*, 3 *ECON. STUD.* 53, 55–56 (1898) (“When the law of receivers came to be applied to railroads, therefore, it speedily began to undergo various modifications, some of which were radical in the extreme.”).

43. The term was used by Alfred Chandler in his study of the influence railroads had on business management and finance. ALFRED D. CHANDLER, JR., *THE RAILROADS: THE NATION’S FIRST BIG BUSINESS* (1965). The literature on their effect on the law is also substantial. See generally JAMES W. ELY, JR., *RAILROADS AND AMERICAN LAW* (2001) (surveying the effect of railroads on American law from their emergence in the nineteenth century); Philip L. Merkel, *The Origins of an Expanded*

transformed American law as they expanded. Bankruptcy law did not escape their transformative effect.

Railroads in the nineteenth century generally shared a number of features that made their occasional bouts of financial distress particularly troubling and forced the development of the law. First, railroads tended to have complicated capital structures. Railroads were financed through multiple tiers of equity and debt.⁴⁴ Common stock, preferred stock, and various series of bonds were used to fund the construction of a typical railroad.⁴⁵ More importantly, American railroad bonds were often secured by mortgages on select portions of the enterprise's assets.⁴⁶ Bond mortgages covered discrete pieces of the railroad—such as trackage over a particular subdivision.⁴⁷ The Wabash railroad, for example, was encumbered by thirty-eight mortgages covering different portions of its operations.⁴⁸ The Philadelphia & Reading counted ten separate mortgages (one for each series of bonds issued) encumbering parts of its main line.⁴⁹ Should the underlying debt go unpaid, the bondholders had an absolute right under state law to seize and liquidate the property.⁵⁰ These pledges of the railroad's property as collateral, perversely, made it more difficult for creditors to assert their usual state law remedies to collect if the railroad defaulted on the bonds. Bondholders would have to foreclose on their collateral, which would bring a liquidation value far below the value of the

Federal Court Jurisdiction: Railroad Development and the Ascendancy of the Federal Court, 58 BUS. HIST. REV. 336 (1984) (discussing the influence of railroad cases on the development of federal court power in the nineteenth century).

44. See STUART DAGGETT, RAILROAD REORGANIZATION 334–36 (1908) (describing the complexity of a railroad's capital structure). The sometimes bewildering mix of securities issued by nineteenth century railroads can be attributed to the multiple mergers of smaller lines used to build up a rail network. *Id.* at 335.

45. See *id.*

46. See Albro Martin, *Railroads and the Equity Receivership: An Essay on Institutional Change*, 34 J. ECON. HIST. 685, 688 (1974).

47. Rather than a blanket security interest in favor of a creditor on all the firm's assets (as would be common today), railroads tended to have "a crazy quilt of security interests, made even more Byzantine by waves of mergers among the railroads." David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1323, 1356 (1998) [hereinafter Skeel, *Evolutionary Theory*]. Even when bondholders attempted to create a blanket, first-priority mortgage on all of a railroad's property, the terms were easily circumvented. See WILLIAM Z. RIPLEY, RAILROADS: FINANCE AND ORGANIZATION 124–25 (1915).

48. See FREDERICK A. CLEVELAND & FRED WILBUR POWELL, RAILROAD FINANCE 235 (1912).

49. See RIPLEY, *supra* note 47, at 122–23. The Reading's mortgages covered overlapping portions of track varying in length from 54 to 116 miles. *Id.* at 122.

50. The bondholders' right to possession and sale was sound in theory but often uncertain in practice. See CLEVELAND & POWELL, *supra* note 48, at 227–32 (describing obstacles to bondholders' seizure and sale of railroad property in satisfaction of debt, including the uncertainty of bondholders' rights under bond indentures, the opposition of state entities holding superior liens, and the complexity of competing interests in railroad property).

firm if the railroad were kept intact.⁵¹ Disconnected miles of track in the middle of the Great Plains would not likely generate sufficient value at an auction to repay the bondholders.⁵² The unsecured creditors faced a similar problem when attempting to collect from a financially distressed railroad. Because state law creditors' remedies operated on a first-in-time principle of priority, unsecured creditors needed to beat out other unsecured creditors in the race of diligence to reduce claims to judgment before the firm's assets were exhausted.⁵³ Remedies framed with individual actors in mind—a single creditor and a single debtor—were simply inadequate for the task of resolving the financial distress of firms with multiple claimants.⁵⁴

Second, the creditors of railroads were widely dispersed. Even a railroad that covered territory across only two states might have creditors in many more states.⁵⁵ Although the initial period of railroad growth in the 1840s was spurred by state governments (which subsidized railroads), the capital markets played an increasingly prominent role when the industry matured and competition increased.⁵⁶ Railroads were extraordinarily capital intensive, and bankers acting for the railroads had to cast a wide net

51. Railroads, perhaps more so than other businesses, had greater value as going concerns than in liquidation. See Skeel, *Evolutionary Theory*, *supra* note 47, at 1360.

52. See *id.* at 1356 (observing that “the value of [bondholders’] collateral—say, one hundred miles of track in the middle of nowhere—was essentially worthless unless the railroad remained intact”).

53. See John Fabian Witt, *Narrating Bankruptcy / Narrating Risk*, 98 NW. U. L. REV. 303, 311 (2003) (“[C]ommon law priority rules meant that the first creditor to sue had a significantly better chance of recovering his loan. The result was an unseemly race to the courthouse door.”).

54. See Skeel, *Evolutionary Theory*, *supra* note 47, at 1355–56. Sale of the entire railroad as a going concern was not a feasible option. As an initial matter, because a single railroad mortgage did not usually encumber the entire property, creditors holding mortgages on different pieces of the assets would have had to cooperate to achieve a sale. See *id.* This presented a significant coordination problem. See F.H. Buckley, *The American Stay*, 3 S. CAL. INTERDISC. L.J. 733, 742–43 (1994) (describing bondholders’ difficulty in uniting to seize control of a railroads’ assets). Moreover, there was no obvious party that could be expected to participate on the other side of such a sale. Almost no single buyer had the financial wherewithal—at least, not in the middle of the nineteenth century—to acquire entire multi-state railroads. See Jeffrey Stern, *Failed Markets and Failed Solutions, The Unwitting Formulation of the Corporate Reorganization Technique*, 90 COLUM. L. REV. 783, 790–91 (1990). Auctioning off the property as a whole, then, would be unlikely to generate a sale price close to the face value of the mortgages. *Id.* (“Under these circumstances, foreclosure, instead of offering relief to a legitimate creditor, threatened to devalue his collateral and minimize his chances of obtaining satisfaction.”).

55. From an early point, railroads exhausted local sources of capital and turned to bank-assisted financing from the sale of securities in “New York, Boston, Philadelphia, and the other financial centers” in the United States and ultimately Europe. See CLEVELAND & POWELL, *supra* note 48, at 14, 21.

56. See SKEEL, *supra* note 35, at 49; Schulz v. State of New York, 639 N.E.2d 1140, 1144–45 (1994) (discussing history of state subsidies for early railroads).

to raise sufficient private financing for their construction. The bonds that financed the growth of the railroads were sold to large numbers of investors in the United States and in Europe and were resold on secondary markets.⁵⁷ As a result, a typical railroad's bonds were "held in time by persons scattered by residence or travel over the universe."⁵⁸ Beyond their secured bondholders, railroads also had general creditors.⁵⁹ In order to rationalize a railroad's financial affairs, it was necessary to gather and bind all of its various counterparties and stakeholders. But that was not a simple task. The size, variety, and dispersion of creditors would block a successful negotiation of the matter.⁶⁰

Third, there was a shared sense that the resolution of financial distress was particularly crucial in the case of railroads. Railroads served a critical role in the economic and social life of the communities they touched.⁶¹ If they ceased operating, or if they were hobbled by a debt-overburdened capital structure, they affected interested parties far more numerous than bondholders and trade creditors. In other words, the public-regarding aspects of railroads justified measures to facilitate the necessary group resolution that would permit them to continue operating.⁶² The lack of

57. By the early years of the twentieth century, a significant portion of the secured debt of American railroads was held by European investors. See RIPLEY, *supra* note 47, at 4–8.

58. LOUIS HEFT, *HOLDERS OF RAILROAD BONDS AND NOTES: THEIR RIGHTS AND REMEDIES* 117 (1916). As Heft describes, most railroad creditors were not particularly sophisticated. *Id.* at Preface ("It is fairly safe to say that the great majority of the holders of railroad bonds and notes never read their securities nor the mortgage that secures them. It is only when the railroad company, whose securities they hold, becomes insolvent or defaults that they seek advice as to their rights.")

59. Although less common than mortgage bonds, unsecured debentures were also issued by railroads starting in the late nineteenth century. See RIPLEY, *supra* note 47, at 141–43.

60. See Witt, *supra* note 53, at 311 ("Far-flung credit networks exacerbated the kinds of collective action problems that plagued debt collection in situations of multiple creditors.")

61. See generally Bradley Hansen, *The People's Welfare and the Origins of Corporate Reorganization: The Wabash Receivership Reconsidered*, 74 *BUS. HIST. REV.* 377, 385–400 (2000) (discussing the common judicial view in the nineteenth century that railroads were quasi-public entities).

62. Courts explicitly relied on considerations of the public interest in cases involving the resolution of railroad financial distress. As the Supreme Court stated in an early decision concerning a railroad receivership:

[T]he cessation of business for a day would be a public injury. A railroad is authorized to be constructed more for the public good to be subserved, than for private gain. As a highway for public transportation it is a matter of public concern, and its construction and management belong primarily to the Commonwealth, and are only put into private hands to subserve the public convenience and economy. But the public retain rights of vast consequence in the road and its appendages, with which neither the company nor any creditor or mortgagee can interfere. They take their rights subject to the rights of the public, and must be content to enjoy them in subordination thereto.

Barton v. Barbour, 104 U.S. 126, 135 (1881).

likely legislative remedies, however, left the courts to craft procedural devices to do so.⁶³

These features of railroad financial distress should be readily familiar to class action scholars. Claims held by widely dispersed claimants seemed to call out for group resolution as a matter of equity, efficiency, and exigency. Whether the courts had the necessary procedural devices on hand to resolve those claims, however, was a separate matter.

B. The Equity Receivership

Although the courts did not have ready-made tools designed for the problem of railroads in financial distress, they developed those tools over a generation of experimentation.⁶⁴ The procedural device adapted for the task was the receivership—derived from the equitable power of a court to protect a debtor’s property, at a creditor’s request, pending litigation.⁶⁵ As a form of provisional remedy, a receivership allowed a court to appoint someone to take control of the debtor’s assets, thereby rendering the assets immune from execution or other process issued by another court.⁶⁶ The effect was two-fold. A receivership centralized disputes concerning the assets in one forum. It also prevented piecemeal dissipation of the assets by multiple judgment creditors, each racing to execute against the debtor’s property.⁶⁷

1. The Expansion of Receiverships

By the second half of the nineteenth century, receiverships had taken on a standard form. A creditor of a financially distressed railroad would file a “creditor’s bill” seeking the appointment of a receiver of the railroad’s property.⁶⁸ This effectively halted other creditors’ attempts to

63. See Martin, *supra* note 46, at 687–88 (explaining that the lack of an enduring federal bankruptcy law “forced the American judicial system to innovate a procedure for dealing with railroad insolvencies”); see also Abram Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281, 1303 & n.92 (1976) (citing railroad reorganizations as “functions that the courts assumed (or were given)”).

64. See Stern, *supra* note 54, at 791–98 (detailing the development and operation of equitable schemes for resolving financial distress).

65. See *id.* at 787–88 (describing the origins of the receivership).

66. See *id.*

67. A receiver could, for example, obtain an injunction to prevent a creditor from executing on the debtor’s property. See *id.* at 793–94.

68. See James Byrne, *Foreclosure of Railroad Mortgages*, in SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION, AND REGULATION 77–79 (1917) [hereinafter SOME LEGAL PHASES]. Reorganization professionals developed a preference for proceeding in federal court,

collect against the debtor.⁶⁹ Later, the creditor would file a “foreclosure bill” to arrange for the sale of the debtor’s property.⁷⁰ The foreclosure sale, however, was typically delayed while the parties negotiated a reorganization of the railroad’s financial affairs.⁷¹ Depending on the number of classes of bonds issued by the railroad, representative committees—called “protective” committees—were organized to carry out the negotiation.⁷² Equity holders and general unsecured creditors would form similar committees.⁷³ The various committees served as representatives of the scattered stakeholders in the company during the negotiations.⁷⁴

The use of committees permitted widely dispersed persons with claims or interests in the debtor to play an effective role in the reorganization of the debtor’s financial affairs. Bondholders authorized their respective committees to proceed by depositing their bonds with the committee.⁷⁵ If, however, the eventual plan of reorganization produced by the negotiation was not satisfactory, bondholders could withdraw their bonds as a form of disapproval.⁷⁶ Once a plan had been finalized, the combined committees—referred to as a single “reorganization committee”—would proceed with

and a creditor’s bill filed by a creditor whose citizenship would create diversity jurisdiction was common. *Id.* at 82; Paul D. Cravath, *Reorganization of Corporations*, in *SOME LEGAL PHASES*, *supra*, at 157–58.

69. The appointment of a receiver was akin to the attachment of the debtor’s property. *See* LEONARD A. JONES, *A TREATISE ON THE LAW OF RAILROAD AND OTHER CORPORATE SECURITIES, INCLUDING MUNICIPAL AID BONDS* § 458 (1879). The receiver—treated as an impartial officer of the court—protected the property during the pendency of litigation. CHARLES FISK BEACH, JR., *COMMENTARIES ON THE LAW OF RECEIVERS* § 1 (1887). A receivership was originally viewed as “merely ancillary or auxiliary to the main action” and intended solely to secure the payment of a final judgment by the debtor. JONES, *supra*, § 458. The exigencies of railroads in financial distress, however, prompted courts to permit receivers to act beyond those narrow bounds and to manage the business during its reorganization. *See* *Davis v. Gray*, 83 U.S. (16 Wall.) 203, 219–20 (1872) (recognizing that it was no longer unusual for courts to put receivers in charge of railroads “which have fallen into financial embarrassment, and to require them to operate such roads, until the difficulties are removed, or such arrangements are made that the roads can be sold with the least sacrifice of the interests of those concerned”).

70. *See* Cravath, *supra* note 68, at 161–62.

71. *See* SKEEL, *supra* note 35, at 58.

72. *See* Cravath, *supra* note 68, at 162–74 (describing the formation of protective committees).

73. Each protective committee represented a single class of security. *See id.* at 172 (noting “the formation of . . . protective committees to represent other classes of securities, whether bonds or stock or unsecured claims, as the case may be”).

74. *See* David A. Skeel, Jr., *Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship*, 113 HARV. L. REV. 1075, 1083 (2000) [hereinafter Skeel, *Vern Countryman*] (describing the role of protective committees “to negotiate on behalf of the widely scattered investors who held that class of securities”).

75. *See* Cravath, *supra* note 68, at 163.

76. *See id.* at 168 (noting that depositors dissatisfied with the plan of reorganization could withdraw their securities within a specified window of time after receiving notice of the plan).

the sale of the debtor's property.⁷⁷ Because the reorganization committee held all the securities deposited with the individual committees, it could use these securities to bid at a foreclosure sale. The "sale" to the firm's creditors, of course, was often a formality, because no competing bidder would usually show up to contest.⁷⁸ The purchased assets were then transferred to a new corporation, and the securities in the old railroad were exchanged according to the terms provided for in the reorganization plan.⁷⁹

Courts also developed a response to the problem of holdouts who refused to deposit their bonds with the committee. These dissenting creditors might, in theory, seek to pursue a real foreclosure sale in order to satisfy their bonds. They were entitled to be paid, in cash, their pro rata share of any proceeds of the sale.⁸⁰ This procedure would have the effect of requiring a payout to the dissenters in order to proceed with the plan of reorganization. By the 1880s, however, it became common practice for courts to impose an "upset price" at receivership foreclosure sales.⁸¹ Essentially, the upset price set a minimum acceptable bid at a foreclosure sale.⁸² Courts often set low upset prices, which, perversely, punished holdouts.⁸³ With a low cash payout as the alternative, dissenters were more likely to participate in the reorganization.⁸⁴

2. *The "New-fashioned" Receivership*

Perhaps inevitably, the receivership process shifted from solely a creditor's remedy to a device that could be initiated by a debtor seeking to reorganize itself. A receiver in equity practice was originally understood as someone, independent from the debtor, who acted for the benefit of creditors.⁸⁵ In traditional receiverships, creditors sought the appointment of a receiver to prevent the dissipation of assets by the debtor or other creditors in the race of diligence.⁸⁶ But within a generation, it became commonplace for the *debtor* in railroad reorganizations to seek appointment of a receiver in order to resolve the debtor's financial distress. Credit for the shift may lie with Jay Gould, the robber baron, who in 1884

77. See Byrne, *supra* note 68, at 142.

78. See SKEEL, *supra* note 35, at 59.

79. See Cravath, *supra* note 68, at 206-07.

80. See Stern, *supra* note 54, at 797.

81. See SKEEL, *supra* note 35, at 60.

82. *Id.*

83. *Id.*

84. See *id.*

85. See Hansen, *supra* note 61, at 378-79.

86. See *supra* notes 65-67 and accompanying text.

initiated the receivership of the Wabash, St. Louis & Pacific Railway—a receivership that was accused of breaking “nearly every important precept of this old branch of equity law.”⁸⁷ The Wabash case, contemporary critics charged, had turned the creditor’s remedy of a receivership into a form of voluntary bankruptcy, even though no federal bankruptcy law existed at the time.⁸⁸ After the Wabash, these “new-fashioned receiverships”⁸⁹ became more common, particularly as the railroad industry reorganized in the late nineteenth and early twentieth centuries.⁹⁰ Criticism of the shift came not only in scholarly circles but also in the popular and financial press.⁹¹

Anyone who has studied the history of the class action—in particular, the settlement class—should find the criticisms of these receiverships to be familiar. Critics of the debtor-initiated receivership saw two key defects in the practice. First, the receiver, supposedly there to protect the interests of creditors, was the handmaiden of the debtor. Like the concern about “reverse auctions” in settlement classes,⁹² this criticism centered on the lack of assurance that the receiver would act in the interest of the absent claimants rather than the interest of their adversary.⁹³ Second, critics objected to the expanded power this form of receivership gave the courts. Just as later criticism of the class action focused on the legitimacy of using a procedural device to engage in quasi-legislative resolution of societal

87. Martin, *supra* note 46, at 685. The Wabash case has generated an impressive quantity of scholarship, both among contemporary commentators and among more recent scholars of corporate and bankruptcy law. See Hansen, *supra* note 61, at 379 n.8 (citing works on the Wabash receivership).

88. D.H. Chamberlain, *New-Fashioned Receiverships*, 10 HARV. L. REV. 139, 142 (1896) (“The proceeding, so far as it resembled any former proceeding or type of legal proceedings, resembled most an application in voluntary bankruptcy. It could not have been this, because no bankrupt law was then in existence.”).

89. Chamberlain coined the term in his classic article attacking the Wabash proceedings. See *id.* Recent scholarship has questioned the view that the Wabash case represented a sharp break from prior receivership practice. See Hansen, *supra* note 61, at 379–80 (“The Wabash receivership should be viewed as an example of continuity rather than of change.”).

90. Between 1870 and 1933, more than 1000 railroads were reorganized through equity receiverships. See Churchill Rodgers & Littleton Groom, *Reorganization of Railroad Corporations Under Section 77 of the Bankruptcy Act*, 33 COLUM. L. REV. 571, 571 (1933).

91. See Hansen, *supra* note 61, at 382 (describing critical news coverage of the Wabash case).

92. The “reverse auction” problem in class actions arises out of the concern that plaintiffs’ lawyers will compete against each other by offering the lowest price the defendant must pay to achieve litigation peace through a class settlement. See John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 COLUM. L. REV. 1343, 1354 (1995) (“At its worst, this process can develop into a reverse auction, with the low bidder among the plaintiffs’ attorneys winning the right to settle with the defendant.”).

93. See Chamberlain, *supra* note 88, at 143 (“The interests of creditors could not have been made the primary consideration in the appointment of receivers, because . . . the persons appointed were not representative of the wishes or interests of the lien creditors of the [rail]road, but the friends and choice of those who had managed the [rail]road.”).

problems,⁹⁴ criticism of the receivership process denounced the seemingly expansive powers arrogated by the courts handling reorganization cases. Even if a court believed that it was protecting creditors who were better off in a voluntary receivership, it was said, the new process allowed the courts to stray beyond the confines of adversarial litigation and into the realm of legislative policymaking.⁹⁵ There followed a slight retreat from the more aggressive use of receiverships. Rather than having the debtor initiate a receivership, the common practice by the early twentieth century called for a friendly creditor to do so.⁹⁶ This way of going about receiverships was in substance no different, but respected the formal requirements of an adversarial legal process.

C. *The End of the Equity Receivership*

By the early years of the twentieth century, the equity receivership had become commonplace in American law. It appeared to have achieved its purposes—continuity of railroads and the rationalization of their overly complex capital structures. The American railroad industry, given to boom and bust, survived the severe economic downturn of the 1890s without disrupting the economic life of the country.⁹⁷ Railroads had reorganized their capital structures and avoided being dismantled. The process had become so entrenched that, when Congress enacted the Bankruptcy Act of 1898, the statute largely left the equity receivership alone.⁹⁸ Oddly, the first enduring bankruptcy legislation in American history did not alter the

94. This concern is a central theme of the Supreme Court's decisions curtailing the use of the settlement class to resolve asbestos litigation. *See Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 845–46 (1999) (invoking the limitations of the Rules Enabling Act as a reason to avoid “adventurous application” of Rule 23); *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 597 (1997) (“This case concerns the *legitimacy* under Rule 23 of the Federal Rules of Civil Procedure of a class-action certification sought to achieve global settlement of current and future asbestos-related claims.” (emphasis added)).

95. *See Chamberlain*, *supra* note 88, at 144–45 (“If a court may of its own motion assume to represent and act for parties not before it, it is not easy to fix any limits to its activities or powers.”). Later commentators, however, came to see the equity receivership as a form of expansive, though legitimate, judicial policymaking. *See Chayes*, *supra* note 63, at 1303; Warner Fuller, *The Background and Techniques of Equity and Bankruptcy Railroad Reorganizations—A Survey*, 3 LAW & CONTEMP. PROBS. 377, 392 (1940).

96. *See Fuller*, *supra* note 95, at 379.

97. “In 1894, 20 percent of all railroad mileage in the United States was in the hands of receivers.” Hansen, *supra* note 61, at 378.

98. *See Bankruptcy Act of 1898*, ch. 541, 30 Stat. 544.

judge- and lawyer-made procedural innovations that had matured into the equity receivership.⁹⁹

But far greater scrutiny of receiverships followed shortly thereafter. The skepticism of the merits of receivership practice spread from commentators to courts.¹⁰⁰ In a key decision in 1913, the Supreme Court ratcheted back the more expansive innovations in equity receiverships. *Northern Pacific Railway v. Boyd*, well known to bankruptcy lawyers for its formulation of the “absolute priority” rule (still an important concept in the confirmation of a Chapter 11 plan under the modern Bankruptcy Code), held that an unsecured creditor could challenge a reorganization long after the proceeding had ended in a reorganized railroad.¹⁰¹ The unsecured creditors had been cut out of the reorganization plan, while shareholders had received valuable distributions, including interests in the reorganized railroad.¹⁰²

Although it is not usually described this way in the bankruptcy literature, *Boyd* can be seen as a case about a failure of representation. Unsecured creditors had not been at the negotiating table during the reorganization process that produced the plan.¹⁰³ In the years leading up to *Boyd*, the equity receivership process, which had begun as a way to protect creditors, had turned into a way for the debtor, by striking a deal with a favored group of creditors, to achieve a resolution of its financial distress that was binding on all creditors. By forcing equity receiverships to accommodate the interests of unsecured creditors, *Boyd* complicated matters. The decision “was something of a shock to many lawyers,” in the words of Robert Swaine, a leading reorganization lawyer.¹⁰⁴ But the reorganization bar adapted to the decision by altering receivership practice

99. See *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434, 448 (1940) (noting that the 1898 Act “afforded no facilities for corporate reorganization which, in consequence, could be effected only through resort to the equity receivership”).

100. The most important early critic was Chamberlain. See Chamberlain, *supra* note 88. But there were other prominent critics. William Howard Taft, then a United States Circuit Judge, provides a summary of contemporary skepticism about the development of equity receiverships and the federal courts’ role in entertaining them. See William H. Taft, *Recent Criticism of the Federal Judiciary*, 18 ANN. REP. A.B.A. 239, 257–64 (1895) (discussing political and practical criticisms of receiverships).

101. 228 U.S. 482, 502–05 (1913).

102. See *id.*

103. See *id.* at 488–90. Reorganization lawyers understood *Boyd* to require greater attention to the interests of unsecured creditors during the reorganization process. See Cravath, *supra* note 68, at 193, 195.

104. Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 COLUM. L. REV. 901, 902 (1927) [hereinafter Swaine, *Certain Developments*].

to include provisions for unsecured creditors to be paid in the form of cash or (more typically) the right to participate in the reorganized railroad.¹⁰⁵

Criticism of the equity receivership mounted in academic circles as well. Jerome Frank, who had practiced in Chicago as a reorganization lawyer, led the charge.¹⁰⁶ As two prominent commentators have aptly described Frank's view, receiverships had become "a vehicle by which the old shareholders and professionals could extract value at the expense of unsophisticated investors."¹⁰⁷ Those unsophisticated creditors did not have sufficient interest or expertise to monitor the process. Lacking a champion in reorganizations, they were at the mercy of the managers, bankers, and lawyers who orchestrated the receiverships.¹⁰⁸

By the 1930s, academic attacks on the equity receivership had become New Deal orthodoxy.¹⁰⁹ Reorganization lawyers bore much of the criticism. They were portrayed as completely subservient to Wall Street bankers and indifferent to the interests of the mass of creditors who required protection.¹¹⁰ Fee awards in reorganization cases, Thurman Arnold wrote, amounted to "high-class boondoggling."¹¹¹ Max Lowenthal similarly criticized the Wall Street reorganization bar, particularly the Cravath firm.¹¹² In a detailed study of the bankruptcy of the Chicago, Milwaukee, St. Paul & Pacific Railroad, which had collapsed in spectacular fashion, Lowenthal painted a dark picture of a process that favored insiders—managers, bankers, and their lawyers—to the detriment of small-time investors. Lowenthal's lurid account of the descent of the railroad (commonly called the Milwaukee Road) placed blame on the bankers who directed the reorganization.¹¹³ But he also criticized the conflicts of interest of the lawyers who represented the receiver. Although

105. This response to *Boyd* was apparently the creation of Swaine, then a young lawyer with Paul Cravath's firm. See Douglas G. Baird & Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393, 405–08.

106. *Id.* at 408–09.

107. *Id.* at 410–11.

108. See generally Jerome Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 VA. L. REV. 541 (1933) [hereinafter Frank, *Realistic Reflections*].

109. See Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 934–35 (2001) (observing that young academics critical of receivership practice became influential during the New Deal).

110. See *id.* at 934–35.

111. THURMAN W. ARNOLD, *THE FOLKLORE OF CAPITALISM* 258–59 (1937).

112. See MAX LOWENTHAL, *THE INVESTOR PAYS* (1933). Lowenthal, an acolyte of Felix Frankfurter, was a politically active attorney.

113. See *id.* at 76–107 (describing the control exercised by the company's bankers upon entering receivership).

those lawyers were supposed to serve the receiver, who in turn was appointed to protect the interests of dispersed constituents, Lowenthal demonstrated that the lawyers actually answered to the managers and bankers who controlled the receivership process.¹¹⁴ Rather than protecting the interests of small creditors and shareholders, those who controlled the receivership process stood accused of serving their own interests (and paying themselves handsomely in the process).¹¹⁵

Lowenthal's exposé garnered widespread attention. Favorable book reviews appeared in the *Columbia Law Review*,¹¹⁶ the *Harvard Law Review*,¹¹⁷ and the *Yale Law Journal*.¹¹⁸ The criticism of self-dealing and conflicted practices in receiverships reached beyond academic circles. The *New York Times* published a laudatory review by Professor Gardiner Means of Columbia Law School, who described Lowenthal as having thrown "a brilliant light . . . on an important phase of investment bank practice—that of corporate reorganization."¹¹⁹

William O. Douglas (who had worked as a lawyer at Cravath for two very unhappy years)¹²⁰ proved to be the most ardent critic of the reorganization process. Although generally neutral about the wisdom of receiverships in an initial study of small and medium-sized business cases,¹²¹ Douglas became scathing when he turned his attention to the large receiverships that were the specialty of the elite bar. In his later report for the SEC (SEC Report), Douglas recounted case studies in which reorganization lawyers, acting in concert with managers and bankers, appeared to run roughshod over the interests of creditors.¹²²

114. *See id.* at 131–45 (describing steps taken by lawyers for the railroad's bankers to institute the receivership).

115. *See id.* at 120–30 (describing the connections among the receivers, bankers, and lawyers—and their fees).

116. John T. Flynn, *The Investor Pays*, 33 COLUM. L. REV. 1080 (1933).

117. Joseph L. Weiner, *The Investor Pays*, 47 HARV. L. REV. 419 (1933).

118. Roger S. Foster, *The Investor Pays*, 43 YALE L.J. 352 (1933).

119. Gardiner C. Means, *A Significant Case Study of Big Business and the Bankers: Mr. Lowenthal's Illuminating Account of the Chicago, Milwaukee & St. Paul Receivership*, N.Y. TIMES, June 23, 1933, at BR3. The newspaper separately noted the book and its revelations in another review. *Book Traces Fall of St. Paul Road*, N.Y. TIMES, June 5, 1933, at 18.

120. Douglas suffered psychosomatic illnesses triggered by the stress he experienced while at the firm. *See* NOAH FELDMAN, SCORPIONS: THE BATTLES AND TRIUMPHS OF FDR'S GREAT SUPREME COURT JUSTICES 64–65 (2010). Douglas had worked on reorganization cases while at Cravath, including extensive work on the receivership of the Milwaukee Road. *See* SKEEL, *supra* note 35, at 102–03.

121. William O. Douglas & John H. Weir, *Equity Receiverships in the United States District Court for Connecticut: 1920–1929*, 4 CONN. BAR J. 1 (1930).

122. 1 SEC REPORT, *supra* note 17, at 866–68.

The apparent self-dealing of those handling the richest reorganization work generated much of the hostility of reformers. Attorneys' fees, the SEC Report stated, "frequently constitute the largest single item" on the list of reorganization expenses.¹²³ The bar, which should expect only "modest" fees, stood accused of having "forsaken the tradition that its members are officers of the court."¹²⁴ Creditors—particularly, widely dispersed junior bondholders—were said to suffer as a result of the distortions of the reorganization process at the hands of the lawyers.¹²⁵ The incendiary nature of Douglas's report ensured its influence, which culminated in legislative reform of the reorganization process.

The political dimension of these attacks was plain. The reorganization bar was the elite bar. Its grandees practiced on Wall Street and were close to the bankers and business executives who opposed the New Deal.¹²⁶ An attack on reorganization lawyers resonated with a public incensed at revelations of greed and self-dealing.¹²⁷ The politically ambitious Douglas used the investigation of receivership practices to bring himself to public prominence and to garner favor in New Deal circles.¹²⁸

1. *The First Wave of Statutory Reforms*

In 1933 and 1934, Congress enacted significant changes to the receivership process. These legislative reforms predated the SEC Report and were spurred by the economic crisis of the Great Depression. With a wave of railroad failures, Congress first enacted a codification and reform of railroad receiverships.¹²⁹ A year later, it enacted section 77B of the Bankruptcy Act of 1898,¹³⁰ which attempted, in the words of a contemporary commentator, to "remedy the substantive and procedural

123. *Id.* at 867.

124. *Id.*

125. In the view of the New Deal reformers, junior bondholders were small, unsophisticated investors at the mercy of the insiders who controlled the firm, its equity, and the receivership process. See Baird & Rasmussen, *supra* note 105, at 409–11 (explaining Jerome Frank's concern for protecting junior creditors).

126. See SKEEL, *supra* note 35, at 63–69 (describing the dominance of the elite bar in receivership practice).

127. See Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 168 (2004).

128. SKEEL, *supra* note 35, at 123. Douglas was initially seen as too accommodating to the interests of Wall Street. His attack on receivership practice largely quieted those criticisms. *Id.*

129. The statute was codified as section 77 of the Bankruptcy Act of 1898, 47 Stat. 1474 (1933). It did not, however, include provisions for non-railroad corporations. *Id.*

130. Act of June 7, 1934, ch. 424, 48 Stat. 911, 912.

difficulties inherent in reorganization through equity receiverships.”¹³¹ Although providing for the reorganization of corporations beyond the railroads, Section 77B was a relatively modest development.¹³² The statute displaced the prior practice of an equity receivership followed by foreclosure through judicial sale, but it was in most respects an incremental reform.¹³³ It responded to dissatisfaction with receivership practice that transcended critics and supporters of the receivership system. While equity receiverships had been criticized by advocates for small creditors and investors on the ground that the practice gave too much control to those who ran “the reorganization machinery,”¹³⁴ criticism mounted from within that machinery as well.

The elite reorganization bar objected to some of the inefficiencies in the jury-rigged procedures of receivership practice. Their principal objection was the difficulty of binding dissenters.¹³⁵ Because the closing out of a receivership through a judicial sale came with the requirement of paying off dissenting creditors, a receivership could founder if the court set a high upset price.¹³⁶ Particularly after the *Boyd* decision, courts were licensed to hear out those dissenters who complained about the fairness of the reorganization process and the details of the proposed sale.¹³⁷ To be sure, reorganization lawyers could minimize these difficulties by forum shopping—instituting proceedings before a friendly judge who was unlikely to be sympathetic to dissenters.¹³⁸ But the interests of the reorganization bar lay in the adoption of a stable statutory scheme that would clarify procedures for binding dissenters without resorting to the use of a judicial sale and upset price. It so happened, then, that those who

131. Alfred B. Teton, *Reorganization Revised*, 48 YALE L.J. 573, 573 (1939).

132. *See id.*

133. *See* E. Merrick Dodd, Jr., *Reorganization Through Bankruptcy: A Remedy for What?*, 48 HARV. L. REV. 1100, 1135–37 (1935) (summarizing the changes enacted by the statute and describing it as “a step, but only a step, on the road to reform”).

134. *Id.* at 1100.

135. *See id.* at 1100–01.

136. *See supra* Part I.B (describing the judicial sale process in equity receiverships).

137. *See* Swaine, *Certain Developments*, *supra* note 104, at 907–08.

138. When a corporation, such as a railroad, operated in more than one state, a wide choice of forums for receivership proceedings was available. The receivership case could then be brought before the sort of judge whose tendency to view the minority as obstructionists would lead him to fix a low upset price for the property and to approve any plan consented to by a substantial majority of the security holders or creditors which did not too palpably violate the “fixed principle” of the *Boyd* case.

Dodd, *supra* note 133, at 1101.

criticized reorganization practice and those who controlled reorganization practice wished to abolish the judicial sale procedure.¹³⁹

Reorganization professionals also sought statutory reform in order to place the receivership process on a firm footing that would withstand increasing signs of hostility from the courts. By the late 1920s, the equity receivership was the well-established method for reorganizing the affairs of corporations. But dicta in Supreme Court opinions suggested growing skepticism about the device and caused alarm among reorganization lawyers. In *Harkin v. Brundage*, a 1928 decision, the Court found that the appointment of a receiver in a non-railroad case had been procured fraudulently and took the occasion to cast doubt on the common practice of a creditor's collusively instituting a receivership without first reducing his claim to judgment.¹⁴⁰ The Court's apparent suspicion of abuses in receivership practices was amplified in a later decision, *Shapiro v. Wilgus*, which warned that the receivership device was a remedy "not to be granted loosely, but . . . to be watched with jealous eyes."¹⁴¹ Although perhaps not nearly as severe a rebuke as *Amchem* and *Ortiz* were taken to be in the class action world in the 1990s,¹⁴² *Harkin* and *Wilgus* were viewed as a bad omen by reorganization professionals.¹⁴³

The Court's apparent mood of skepticism about the freewheeling use of the receivership raised concern by suggesting that increased scrutiny would be placed on the consensual or "friendly" receivership to which reorganizers had become accustomed,¹⁴⁴ and which reorganization lawyers viewed as crucial to the efficient resolution of a firm's financial distress. Indeed, it appeared that the Court had questioned the very legitimacy of the consensual receivership itself. Robert Swaine criticized the Court's dicta in the cases on the ground that they "would seem to raise questions embarrassing to counsel seeking to preserve for the benefit of creditors the integrity of temporarily embarrassed corporate ventures."¹⁴⁵ The lower

139. *Id.* at 1105–06.

140. 276 U.S. 36, 52 (1928).

141. 287 U.S. 348, 356 (1932) (citing *Michigan v. Michigan Trust Co.*, 286 U.S. 334, 335 (1932)). The striking language of the opinion came, of course, from Justice Cardozo's pen. *Id.* at 351.

142. The Court's decisions in *Amchem* and *Ortiz* have been treated by commentators as putting significant limits on the use of the class action as a device for resolving mass litigation. See, e.g., Elizabeth J. Cabraser, *The Class Action Counterreformation*, 57 STAN. L. REV. 1475, 1475–76 (2005).

143. See Henry J. Friendly, *Some Comments on the Corporate Reorganizations Act*, 48 HARV. L. REV. 39, 43–45 (1934) (observing that the Court's cautionary language in *Harkin*, *Wilgus*, and a subsequent case had made the equity receivership "a vehicle of dubious utility" for reorganizing corporations in many cases).

144. See *id.* at 43.

145. Robert T. Swaine, *Corporate Reorganization Under the Federal Bankruptcy Power*, 19 VA. L. REV. 317, 322 (1933) [hereinafter Swaine, *Corporate Reorganization*].

courts appeared to sense the change in mood, as Swaine and other leading reorganization lawyers were aware, and that was not a positive development from their perspective. To show how precarious matters had become, Swaine discussed a case that he considered to involve “conventional receivership proceedings” and then quoted the opinion of the court, which condemned the receivership as “collusive, sham, fictitious, in bad faith, of ulterior motive for the benefit of the defendant alone.”¹⁴⁶

These suggestions sparked theoretical doubts about the continued validity of receivership practice—at least for non-railroad corporations¹⁴⁷—at the same time that reorganization lawyers expressed increasing displeasure with features of the receivership process at the onset of the Great Depression. Those who ran the process believed that its basic machinery was not well suited to resolving the financial distress of large, modern industrial corporations.¹⁴⁸ The chief complaint in this respect was that receivership practice had relied on the use of ancillary proceedings—that is, equity suits brought wherever the debtor’s property was located—in multiple courts to span the territorial limitations of a single court’s jurisdiction.¹⁴⁹ But this stitching together of proceedings had grown cumbersome. In an age of nationwide commerce and transportation, the ancillary receivership process was more “adapted to the era of the localized factory, the butcher shop with the proprietor at the block, and the

146. *Id.* (quoting *May Hosiery Mills, Inc. v. F. & W. Grand 5-10-25 Cent Stores, Inc.*, 59 F.2d 218, 220 (D. Mont. 1932), *rev’d sub nom.* *May Hosiery Mills v. U.S. Dist. Court*, 64 F.2d 450 (9th Cir. 1933)). The district court in *May Hosiery Mills* relied on the Supreme Court’s *Harkin* decision. *May Hosiery Mills, Inc.*, 59 F.2d at 220 (“Plaintiff is a dummy or mere ‘tool’ of defendant, and the proceedings are ‘collusive,’ to adopt the characterization of Chief Justice Taft in the . . . *Harkin* Case . . .”). Although the district court’s decision was reversed on appeal, that gave limited comfort to reorganization lawyers.

147. There were suggestions in *Wilgus* that greater scrutiny was appropriate in receiverships involving non-railroad corporations (because railroads were considered public interest corporations for which the necessity of a receivership could be more readily presumed). See 287 U.S. at 356; Skeel, *Evolutionary Theory*, *supra* note 47, at 1360–61.

148. See Swaine, *Corporate Reorganization*, *supra* note 145, at 317–18 (describing “the inefficiency and waste involved in the present judicial machinery for corporate reorganizations”).

149. Federal courts traditionally have respected the territorial limits of the jurisdiction of the state in which they sit, a restriction that remains today (albeit with exceptions allowing the courts to reach beyond those limits in certain circumstances). See FED. R. CIV. P. 4(k). At the time of the first legislative reforms of the receivership system, a more expansive provision assured that a receivership brought in a federal judicial district was sufficient to control the debtor’s property throughout the circuit in which the district was located. Judicial Code of 1911, ch. 231, § 56, 36 Stat. 1087, 1102 (codified at 28 U.S.C. § 117 (1926)) (repealed 1948). There was serious doubt, however, whether that provision applied to receiverships of non-railroad corporations, and therefore the reorganization of other large businesses had to rely on ancillary receiverships in multiple districts. See Swaine, *Corporate Reorganization*, *supra* note 145, at 319.

railroad venturing into but one or two states beyond the borders of that of its incorporation.”¹⁵⁰ The resort to ancillary proceedings was inefficient and wasteful—requiring separate counsel and the costs of maintaining multiple suits—and therefore some provision for broader jurisdictional reach of a single court was needed in the view of the reorganizers.¹⁵¹

The initial statutory reforms decidedly favored the vision of a more secure equity receivership process advocated by the reorganization bar. Section 77B provided for the institution of a reorganization proceeding by the corporate debtor itself, without the need for a friendly creditor.¹⁵² It also bestowed on the judge before whom reorganization proceedings were commenced extensive powers to enjoin competing proceedings in other courts.¹⁵³ With those powers came greater concentration of control in a single forum. Section 77B eliminated the need for ancillary proceedings, in keeping with one of the principal goals of reorganization professionals.¹⁵⁴ A single court would have the ability to bring together the scattered parties in interest and resolve the affairs of the reorganizing company.

Section 77B’s central feature contained what the bar had sought—a provision for a reorganization plan to have binding effect on dissenters if there was sufficient support for the plan. Confirmation of the plan would require an affirmative vote of two-thirds of creditors by amount of claims in each class (and, in some cases, of a majority of shareholders).¹⁵⁵ The statute also decreased the blocking power of those opposed to the plan by providing that dissenters did not need to be paid in cash for their claims.¹⁵⁶ Building on the practice that had developed after *Boyd*, the statute required a court to make a finding of fairness after the plan had been accepted by a sufficient number of creditors and shareholders.¹⁵⁷ Although the

150. Swaine, *Corporate Reorganization*, *supra* note 145, at 317.

151. *Id.* at 317–18.

152. Act of June 7, 1934, ch. 424, 48 Stat. 911, 912 (adding § 77B to the Bankruptcy Act of 1898). Three or more creditors with claims, in the aggregate, over \$1000 could also institute a proceeding. 48 Stat. at 913.

153. § 77B(c), 47 Stat. at 917. The chief benefit of the new provision over older practices was the addition of an unambiguous power to enjoin judicial proceedings instituted before the filing of a petition (there was a recognized power in equity to bar actions instituted after the receivership petition was filed). *See* Friendly, *supra* note 143, at 54.

154. Friendly, *supra* note 143, at 56. The statute also granted the reorganization court broader powers to issue injunctions *in personam*. *Id.*

155. § 77B(e)(1), 48 Stat. at 918.

156. The plan could alter the rights of creditors “either through the issuance of new securities of any character or otherwise.” § 77B(b)(1), 48 Stat. at 913.

157. The statute required the court to confirm the plan upon finding that it was “fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible.”

reorganization court was not supposed to be a rubber stamp, commentators such as Henry Friendly (then a lawyer with a significant reorganization practice) recognized that in reality the court would “not attempt to work out a plan itself or to substitute its business judgment for that of the persons whose money is actually at stake.”¹⁵⁸ The philosophy behind the statutory reform favored by the reorganization bar placed receivership practice on a secure statutory foundation, eliminated its key inefficiencies, and yet retained authority over the process in the hands of the professionals who had long controlled it.

2. *The Chandler Act and the Turn to Administrative Supervision in Bankruptcy*

A very different philosophy would guide the next major statutory reform of bankruptcy practice in the New Deal era. Rather than build on the section 77B process, which remained court-centered and lawyer driven, Congress tacked toward an administrative regime to superintend corporate reorganizations. Barely four years after reorganization professionals had succeeded in establishing statutory grounding for receiverships, the entire process was largely eradicated in large corporate cases. The story of the turn from the limited reforms of the early 1930s to a more extensive administrative regime in bankruptcy reorganizations has been told at length elsewhere.¹⁵⁹ But the key steps in the transformation of bankruptcy practice deserve attention by those pondering the future course of aggregate litigation, because the complaints about the reorganization process, and the menu of options available to reformers, echo current debates about the class action and its alternatives.

Disagreement about the reforms of the early 1930s centered on control of the reorganization process.¹⁶⁰ While section 77B may largely have satisfied the bankers and lawyers involved in corporate reorganizations, critics focused on the failure of the statutory changes to alter control of the

§ 77B(f), 48 Stat. at 919. Similar language has remained in Chapter 11 of the current Bankruptcy Code, which provides for the “cramdown” of a plan of reorganization over the objection of a dissenting class of creditors. See 11 U.S.C. § 1129(b)(1) (Supp. 2007–2011) (“[T]he court . . . shall confirm the plan . . . if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.”).

158. Friendly, *supra* note 143, at 74–75.

159. Professor Skeel gives a detailed account of the New Deal-era reforms in his history of American bankruptcy law. See generally SKEEL, *supra* note 35, at 109–27.

160. See Roger S. Foster, *Conflicting Ideals for Reorganization*, 44 YALE L.J. 923, 923 (1935) (observing that the “general tenor of [the] reform objective has been to shift control over reorganization from investment bankers to the security holders themselves or to public authority”).

process, which remained in the hands of corporate managers, their bankers, and their lawyers.¹⁶¹ Control of the reorganization process, the critics alleged, benefited professionals but harmed the unsophisticated, scattered claimants whose interests needed protection.¹⁶² Even though investors were given the opportunity to vote on a plan of reorganization, critics dismissed the value of that vote.¹⁶³ With incumbent managers and their professional agents in charge of the process, it was alleged, the statutory reforms of the early 1930s simply perpetuated many of the defects in friendly receiverships, including the “foisting of unfair plans upon masses of innocent investors, helplessly unorganized, or hopelessly uninformed.”¹⁶⁴ Individual claimants, in other words, were described as being at the mercy of those running the reorganization process—the professionals who proposed the plan to be accepted by claimants and who solicited their consent.¹⁶⁵ The monopoly on control of the process came with blatant conflicts of interest, and the reformers sought further measures to take the process out of the hands of the professionals who controlled it.

Douglas’s SEC Report provided the chief source of fuel for the critics of reorganization practice. The mammoth report recounted supposed abuses of the process that persisted even after the enactment of section 77B.¹⁶⁶ The SEC Report contained a series of reorganization case studies and made sweeping pronouncements about the defects in, and potential reforms of, the process.¹⁶⁷

161. See, e.g., Dodd, *supra* note 133, at 1135–36; Teton, *supra* note 131, at 573–74.

162. Jerome Frank in particular advocated greater judicial or administrative control in the reorganization process to benefit small investors. He described the situation of the average investor in acidic terms:

There is every reason why [the Supreme Court] should approve and foster active supervision by the lower courts of reorganizations so as to protect the average security holder who is otherwise helpless. Courts of equity have a tradition of aiding the helpless, such as infants, idiots and drunkards. The average security holder in a corporate reorganization is of like kind.

Frank, *Realistic Reflections*, *supra* note 108, at 569.

163. See Teton, *supra* note 131, at 573.

164. *Id.*

165. See *id.* (“Control of the distressed corporation permitted the old management not only to insulate itself from potential prosecution for its previous practices but to maintain a position of prestige and power, from which it could influence security holders to support its plan and projects.”); Skeel, *Evolutionary Theory*, *supra* note 47, at 1369 (describing the depiction of reorganization professionals as “more concerned with fees and keeping managers happy than with the investors they ostensibly represented”).

166. See 1 SEC REPORT, *supra* note 17, at 869–72 (asserting that section 77B enhanced the power of insiders in reorganizations).

167. *Id.* at 897–907 (summarizing conclusions and recommendations for reform).

At bottom, the report told a betrayal story. While investors deserved reorganizations that were “expeditious, economical, fair, and honest,” those who controlled the process had “self-serving objectives,” deployed “mechanisms incompatible with the needs and requirements of investors,” and “too often caused perversion of the functions of reorganization.”¹⁶⁸ The reorganizers, the report alleged, enriched themselves at the expense of the mass of claimants in the firms they were entrusted to set right.¹⁶⁹ Control came with patronage, and therefore bankers, managers, and lawyers sought to perpetuate control. The lawyers were held up for particular condemnation.¹⁷⁰ The report alleged that they had served two masters. Counsel were supposed to be fiduciaries of the mass of claimants connected to the reorganization but instead served the managers and bankers whose interests were taken to be opposed to those of the dispersed claimants.¹⁷¹

The release of the SEC Report was followed by legislative proposals for more far-reaching reform than section 77B. One proposal would have created a bankruptcy “conservator” to police the reorganization process.¹⁷² Rather than allow the parties to select the key officers in a reorganization, the conservator would intervene to break the cycle of patronage.¹⁷³ The bill that eventually became law, the Chandler Act, adopted an administrative supervision model.¹⁷⁴ Although the Chandler Act retained a court-based process for reorganizing firms, it introduced a sharp break from practices that had originated in the era of the equity receivership and had persisted through the enactment of section 77B.

168. *Id.* at 863.

169. *See id.* at 4–6 (asserting that the desire for “reorganization patronage” would often “redound to the great detriment of investors and cause security holders irreparable damage”).

170. Attorneys’ fees were among the chief expenses of the reorganization process, and the report charged that the elite bar involved in reorganization practice had abandoned the best traditions of the profession in order to enrich themselves. In the words of the report, the bar had “forsaken the tradition that its members are officers of the court and should request and expect only modest fees.” *Id.* at 867.

171. The report described the conflicted position of lawyers in the reorganization process:

To receive the benefits of both direct and indirect rewards, counsel for the dominant group, either the management or bankers or the two working in harmony, are frequently found in the key positions in the reorganization. In the selection of attorneys to represent protective committees and to serve in other capacities, counsel for the controlling group exerts considerable influence. Such attorneys are frequently found in the position which will probably wield the greatest influence and accordingly carry the largest rewards.

Id.

172. *See SKEEL, supra* note 35, at 113–14.

173. *Id.*

174. Chandler Act, 52 Stat. 840 (1938) (repealed 1978).

The principal object of the Chandler Act was the removal of those who had previously controlled the reorganization process.¹⁷⁵ The “keystone of the reform program” was Chapter X, which provided for mandatory appointment of a disinterested trustee in all reorganizations involving liabilities of \$250,000 or more.¹⁷⁶ Incumbent managers in Chapter X cases would no longer be able to call forth bankers and lawyers of their choosing to run the process. Rather than permit those forces to formulate a plan of reorganization and solicit support from the firm’s dispersed claimants and equity holders, the statute provided that those duties would fall to the trustee.¹⁷⁷ In order to prevent a reproduction of the status quo ante, the statute took a firm view of the “disinterested” trustee requirement. Bankers and lawyers who previously had been connected with the firm (such as involvement in underwriting outstanding securities) fell within the prohibition.¹⁷⁸

Sitting atop this new regime and exercising extensive influence over the reorganization process was the SEC. In keeping with the view of a reorganization as “an administrative problem,”¹⁷⁹ and “primarily an exercise in corporate finance and management,”¹⁸⁰ the Chandler Act contemplated resort to the expertise of the SEC. The Chandler Act gave the Commission the right to appear, with approval of the court, in any case.¹⁸¹ Of even greater significance, the SEC could render an advisory opinion on the merits of any plan of reorganization.¹⁸² Rather than allowing private ordering within the bounds of a loosely defined scheme, Chapter X contemplated a greater degree of influence by the agency in the basic process of reorganizing the affairs of the debtor. Although justified as an effort to introduce more transparency and public participation in the reorganization of firms, the trustee and SEC provisions of the Chandler Act left little room for claimants themselves to have a voice in the process.

175. The SEC proposals that formed the operative parts of the Chandler Act were intended “to usher the central players under existing law—managers, Wall Street bankers, and Wall Street lawyers—out of the reorganization process altogether.” Skeel, *Vern Countryman*, *supra* note 74, at 1089–90.

176. Teton, *supra* note 131, at 574; *see* Chandler Act § 156, 52 Stat. at 888.

177. Chandler Act §§ 167, 169, 52 Stat. at 890.

178. *See id.* §§ 157–158, 52 Stat. at 888; SKEEL, *supra* note 35, at 120.

179. Jerome Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U. L.Q. REV. 317, 321–22 (1941) [hereinafter Frank, *Epithetical Jurisprudence*].

180. 8 SEC Report, *supra* note 17, at 1.

181. Chandler Act § 208, 52 Stat. at 894. Oddly, however, the agency had no right to appeal. *Id.*

182. *Id.* § 172, 52 Stat. at 890. In cases involving more than \$3,000,000 of debt, the court was required to give the SEC an opportunity to opine on the plan of reorganization. *Id.* The court could also (but was not required to) do so in cases involving smaller amounts of liabilities. *Id.*

Remarkably, Chapter X did not require or encourage the formation of groups, such as official committees of creditors, to represent various constituencies during a negotiated resolution of the firm's financial distress.¹⁸³

To be sure, the agency's role was described as advisory.¹⁸⁴ The SEC could not directly control the formulation of a plan of reorganization in Chapter X, and it could not directly run the affairs of the business. But the combination of the mandatory independent trustee and the SEC's advisory role fundamentally altered the process of negotiating a plan. Even if other parties in interest wished to advocate for a particular resolution of the reorganization and could force consideration of their preferred plan, they could not solicit the support of creditors for the plan until it had been approved by the judge.¹⁸⁵ And the judge could not approve the plan before the SEC had an opportunity to review its provisions.¹⁸⁶ When the plan was sent to creditors for purposes of voting, the trustee was required to provide a copy of the SEC's report.¹⁸⁷ Even when the SEC did not file a formal report, it could involve itself in other ways. The agency could provide assistance in preparation of the plan, scrutinize the qualifications of fiduciaries involved in the case, challenge the trustee's administration of the estate, and advise the court of its views.¹⁸⁸ In effect, the SEC's role would quash the ability to organize of those who had served the principal role in corporate reorganizations—the managers, bankers, and elite lawyers in control of the process before the Chandler Act.

183. This feature of the Chandler Act represented a significant shift from Douglas's earlier views on the reform of business reorganizations. In the early years of the New Deal, Douglas had taken the view that reorganizations worked best when the process was channeled into negotiations among representative committees, with the government playing a limited watchdog role. See William O. Douglas, *Protective Committees in Railroad Reorganizations*, 47 HARV. L. REV. 565, 566 (1934) (“[T]here is great utility and virtue in having independent, well organized, aggressive, powerful protective committees.”). By the time the Chandler Act provisions were drafted, however, he had come to view the committee system as ineffectual at preventing the exercise of overbearing control by reorganization professionals. See SKEEL, *supra* note 35, at 122–23. The shift in his views can be attributed to the intervening SEC Report, his friendship with New Dealers who advocated a more interventionist government role in reorganizations, and Douglas's political ambitions. See *id.*

184. Chandler Act § 172, 52 Stat. at 891. The advisory nature of the SEC's opinion was a concession to the organized bar, which had objected to Douglas's preferred proposal of giving the agency more sweeping control over the reorganization process. See SKEEL, *supra* note 35, at 118.

185. Chandler Act § 176, 52 Stat. at 891.

186. *Id.* § 173, 52 Stat. at 891.

187. *Id.* § 175, 52 Stat. at 891.

188. Michael E. Hooton, *The Role of the Securities and Exchange Commission Under Chapter X, Chapter XI and Proposed Amendments to the Bankruptcy Act*, 18 B.C. INDUS. & COM. L. REV. 427, 431–47 (1977).

The effect of the SEC's supervisory role did not escape sophisticated observers. They feared the agency would not be sympathetic to the view that the formulation of a plan of reorganization "is in essence a bargain between the various classes of security holders and creditors and that the parties should be free to agree upon the terms of the bargain, subject only to a judicial review of limited scope."¹⁸⁹ An American Bar Association special committee on developments in administrative law that was chaired by Dean Roscoe Pound of the Harvard Law School denounced the Chandler Act's provisions as an example of a trend toward "administrative absolutism," which tended "to subject the management of all individual property and enterprise to an unchecked administrative control."¹⁹⁰ Less hyperbolic commentators expressed theoretical and pragmatic concerns about the new role of the SEC. Robert Swaine, for example, thought agency control of corporate reorganizations to be incompatible with "private litigation between private parties."¹⁹¹ But he presciently foresaw the resource limitations that would make agency involvement cumbersome as a practical matter. The SEC, he observed, did not have the ability to resolve the vast number of potential reorganization cases for which they would become responsible.¹⁹²

There were, of course, prominent defenders of the experiment in agency supervision. Jerome Frank (who had been chairman of the SEC before his appointment to the Second Circuit in 1941) criticized positions in Pound's ABA report for lacking "logical, as distinguished from

189. E. Merrick Dodd, *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations*, 38 COLUM. L. REV. 223, 232 (1938).

190. *Report of the Special Committee on Administrative Law*, 63 ANN. REP. A.B.A. 331, 344-45 (1938). The ABA Special Committee was part of an attempted "counter-reformation" by the organized bar against the proliferation of administrative agencies during the New Deal. William E. Forbath, *The Long Life of Liberal America: Law and State-Building in the U.S. and England*, 24 LAW & HIST. REV. 179, 190 (2006).

191. Robert T. Swaine, "Democratization" of Corporate Reorganizations, 38 COLUM. L. REV. 256, 265-66 (1938).

192. Swaine predicted that the responsibilities given to the SEC would inevitably outstrip its resources. As he wrote in a contemporary law review article that was highly critical of Chapter X:

The multiplicity of problems arising daily in the scores of reorganization cases in the various Federal courts throughout the country are beyond the capacities of any five man commission, however expert, able and well-intentioned its membership may be. What a host of lawyers will have to be added to the SEC staff to enable it to perform the functions which this provision contemplates! These problems will have to be met on the spot by the local lawyers employed by the SEC and what little past experience there is with respect to attempted intervention of government attorneys in private litigation gives no basis for confidence that their judgments will be particularly well considered or expert.

Id.

emotional,” support.¹⁹³ In Frank’s view, reorganization of financially distressed firms was “something more than a brawl” among private parties and was instead “an administrative problem in the solution of which the public, as well as the litigants, has an interest.”¹⁹⁴ He also doubted that the SEC’s role would cause serious practical difficulties.¹⁹⁵ He gave assurances that the agency’s Reorganization Division, which would be tasked with carrying out the duties assigned by the Chandler Act, would be adequately staffed with lawyers carrying expertise in business reorganizations.¹⁹⁶ As he saw it, the SEC would also improve the outcome in reorganizations by making “an intensive study of the debtor, its background, its financial structure, prospects, earning power and management, and the situation of the industry as a whole.”¹⁹⁷ Using its powers under the Chandler Act to examine witnesses and hold hearings in connection with a plan of reorganization, the agency would be able to inform the trustee and the court as to the running of the enterprise and its value.¹⁹⁸ The agency’s expertise, he believed, had been positively received by attorneys and judges after an initial period.¹⁹⁹

Frank may have had the more perceptive view on the quasi-public nature of the reorganization process, but his predictions about the capacity of the SEC and the practical effect of its supervisory role proved misguided. Resort to Chapter X, while initially robust, dropped off rapidly through the 1940s.²⁰⁰ The decline did not come about because lawyers and bankers had perfected a way to resolve firms’ financial distress without actually filing for bankruptcy. Coordinating large numbers of claimants without a bankruptcy filing would be quite difficult.²⁰¹ And one nonbankruptcy route for doing so quickly became unavailable. Underwriters tried to include group voting procedures in bond indentures so that a majority of a class of bondholders could vote to restructure a firm’s debt outside of a bankruptcy filing.²⁰² But, in response to pressure

193. Frank, *Epithetical Jurisprudence*, *supra* note 179, at 321.

194. *Id.* at 321–22. Frank bolstered his position on this point by reciting the extensive role played by courts in shepherding the reorganization process to completion in the old equity receiverships and under section 77B. *See id.*

195. *Id.* at 333–34.

196. *Id.*

197. *Id.* at 335.

198. *Id.* at 335–38. Frank also reported that the initial operation of Chapter X showed that independent trustees frequently relied on the expertise and resources of the SEC in completing their reports to the court on the debtor’s affairs. *Id.* at 336.

199. *Id.* at 349.

200. *See infra* notes 208–10 and accompanying text.

201. *See SKEEL*, *supra* note 35, at 121.

202. *Id.*

from the SEC, Congress enacted the Trust Indenture Act in 1939, which restricts the inclusion of voting provisions of that sort in bond indentures.²⁰³ Each bondholder must consent individually to the modification of any core term in the bond—including the amount of the principal, the interest rate, and the maturity date.²⁰⁴ The Chandler Act and the Trust Indenture Act combined to limit the space for any private workout without resort to bankruptcy.²⁰⁵

II. THE RETURN OF BANKRUPTCY

The New Deal reforms essentially closed out the era of large corporate reorganizations. Railroad reorganizations—which had been codified in the early New Deal but were not included in the Chandler Act—remained,²⁰⁶ but beyond those cases, bankruptcy lost much of its allure for large companies. In particular, the Wall Street reorganization lawyers who had been at the center of the practice exited it.²⁰⁷ The imposition of an independent trustee meant that managers who sought to reorganize would lose control over a firm and, perhaps, their jobs as well.²⁰⁸ The reforms also limited the participation of lawyers in the reorganization process. Corporate reorganizations, under the supervision of the SEC, became far less attractive for firms to pursue or for lawyers to organize. The Chandler Act had made the reorganization process rigid and cumbersome. The

203. Trust Indenture Act of 1939, ch. 411, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa–77bbb).

204. *Id.* § 316(b) (“Notwithstanding any other provision of the indenture . . . , the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder . . .”). For a detailed discussion of the origins of the voting prohibition, see generally Mark Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987).

205. Like the Chandler Act, the Trust Indenture Act was justified on the grounds of investor protection. Impeding private workouts outside the judicial and regulatory oversight of the bankruptcy process was a goal of the legislation. See Roe, *supra* note 204, at 251.

206. Receiverships for railroads had been codified in 1933, shortly before Douglas’s SEC study. See *supra* note 129 and accompanying text. The Interstate Commerce Commission (ICC) served as the agency that superintended railroad reorganizations, although the ICC enjoyed much broader authority than the SEC. See Max Lowenthal, *The Railroad Reorganization Act*, 47 HARV. L. REV. 18, 18–19 (1933) (describing the role of the ICC in section 77 cases, including the power to nominate a trustee and to withhold approval of a plan of reorganization).

207. In addition to the requirement of disinterested trustees and trustees’ counsel, the Chandler Act also restricted the solicitation of creditors, which combined to force Wall Street bankers out of their prominent role in bankruptcy reorganizations. See SKEEL, *supra* note 35, at 125. The fate of the elite reorganization bar, of course, followed the fate of the banking firms they served. *Id.*

208. This feature of Chapter X gave managers “an enormous disincentive” to file for bankruptcy. *Id.* at 171.

effect was obvious. Immediately after the Chandler Act's enactment, more than 500 firms filed for bankruptcy under Chapter X.²⁰⁹ That number rapidly dropped to fewer than 100 firms after six years and remained at about 100 per year during the 1950s and 1960s.²¹⁰

A. *Reorganization Practice After the Fall*

That did not, however, end the need to deal with the financial distress of firms. The railroads, which could continue to use a receivership process outside Chapter X (although one that was not as flexible as the old equity receivership), generated large cases as they collapsed and reorganized in the 1950s and 1960s.²¹¹ Most of this work remained in the hands of the few elite firms still practicing in the area, but the work dwindled.²¹² Beyond the railroad cases, limited signs of life in reorganization practice remained. Yet, the business cycle did not dissipate. Companies in financial distress remained a fact of a modern industrial economy. In order to resolve that financial distress, it was still necessary to bring together, and bind, a firm's dispersed claimants.

1. *The Chapter XI Loophole in Agency Supervision*

Although the Chandler Act was intended to end the era of lawyer-run business reorganizations for large companies, it contained a gap in its design that maintained an opening for firms seeking reorganization without the heavy hand of SEC oversight. While Chapter X of the Act had been designed for companies that had issued securities to the public, another provision, Chapter XI, was intended to provide for "arrangements" of other companies.²¹³ Unlike Chapter X, which required the appointment of a disinterested trustee and strong SEC oversight, Chapter XI allowed incumbent managers to remain in place and in possession during the rehabilitation process.²¹⁴ The debtor in a Chapter XI case was given the latitude to propose a plan, classify creditors, and then put the plan to a

209. *See id.*

210. *Id.* at 125–26 tbl. 4.1 (giving numbers of Chapter X filings between 1939 and 1970). Some of the decrease in the number of firms filing Chapter X petitions owed to the combined effects of the Great Depression, which had winnowed out many of the most precarious firms, and the long postwar economic expansion. *See id.* at 125.

211. *Id.*

212. *See id.* at 125.

213. Chandler Act §§ 301–399, 52 Stat. at 905–16, codified at 11 U.S.C. §§ 701–799 (1938 Supp.) (repealed 1978).

214. *Id.* § 342, 52 Stat. at 909.

vote.²¹⁵ Chapter XI, it had been thought, would be available for small firms with trade creditors and not for large companies that had issued publicly held securities. But the statute did not explicitly limit particular firms' entry to Chapter XI.²¹⁶ Indeed, the Chandler Act gave no clear guidance on how to determine which of the two "violently inconsistent" forms of reorganization would be appropriate in a given case.²¹⁷ This drafting error would lead to decades of litigation as the SEC and bankruptcy lawyers engaged in an extended tug-of-war over the form of reorganization in large business bankruptcy cases.

The failure to clarify the dividing line between Chapter X and Chapter XI cases becomes more understandable in light of the basic assumptions behind each provision. The SEC Report had alleged widespread abuses and self-dealing in reorganization cases before and after the early New Deal reforms.²¹⁸ More than an abstract concern about procedural corruption, these allegations suggested that small, widely scattered investors were systematically disadvantaged by those who supposedly represented them. Although we now think of shareholders as the group at the center of the securities laws, bondholders were the investors seen as most vulnerable in the eyes of New Deal reformers.²¹⁹ Recall that Chapter X had no provision for official committees or other formal structures of group representation.²²⁰ It was assumed that investors were less able to monitor the developments of the debtor's case and, because they were "generally widely scattered," would not be able to organize themselves into effective committees.²²¹ Thus, the SEC would step in as surrogate to serve the role of pervasive monitor. Smaller businesses, which typically

215. Jerome B. Weinstein, *The Debtor Relief Chapters of the Chandler Act*, 5 U. PITT. L. REV. 1, 16–17 (1938).

216. The main limitation on the use of Chapter XI was that the debtor was permitted to restructure only its unsecured debt. It was thought that this would bar most large companies with significant secured debt. SKEEL, *supra* note 35, at 162.

217. Eugene V. Rostow & Lloyd N. Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334, 1334–35 (1939). The lack of a formula for determining when a firm could use one but not the other form of reorganization was noted shortly after enactment of the statute. *See id.* at 1334 ("[T]he forty-odd experts who worked eight years revising the Act omitted from it any formula for determining which corporate debtors should be rehabilitated under Chapter X and which under Chapter XI.").

218. *See supra* notes 166–71 and accompanying text.

219. *See* SKEEL, *supra* note 35, at 112 (explaining that bondholders were "the investors that Douglas and the SEC feared were especially vulnerable").

220. *See supra* note 183 and accompanying text. The statute did permit the formation of *ad hoc* creditor groups that could receive compensation for costs and expenses from the debtor's estate. *See* Chandler Act § 242, 52 Stat. at 900.

221. SEC v. Am. Trailer Rentals Co., 379 U.S. 594, 613–14 (1965) (discussing operative assumptions of Chapter X and Chapter XI).

did not issue publicly traded securities, however, did not present the same concern. With smaller businesses, trade creditors could be expected to organize themselves and monitor the debtor's affairs.²²² As such, the SEC had no need to serve its special protective role. As the Supreme Court explained matters in a case about the proper division between the two chapters, investors were "far less likely than trade creditors to be aware of the financial condition and cause of the collapse of the debtor" and "less commonly organized in groups or committees capable of protecting their interests."²²³ It seemed natural that companies with publicly held securities should reorganize in Chapter X, while companies with trade creditors but no publicly held securities would benefit from the less elaborate Chapter XI process.

Because there was no bright-line test for when a firm could use the more hospitable reorganization provisions of Chapter XI, however, there was a gradual testing of boundaries.²²⁴ Firms (and the lawyers advising them) began filing Chapter XI cases that probably should have been brought as Chapter X cases.²²⁵ The role of lawyers in this transformation was evident. As Professor Lawrence King said, a debtor filing under Chapter XI could remain in control, and "the lawyer also remains in control."²²⁶ What followed was a steady increase in the number of firms—mostly medium-sized companies—pursuing reorganizations under the alternative form of Chapter XI.²²⁷

The SEC pushed back on this development by moving to transfer cases to Chapter X when, in the agency's view, a Chapter XI filing was not appropriate. At first, the agency litigated vigorously to define a categorical boundary between the two chapters. In the SEC's view, the two chapters were "mutually exclusive as to the types of corporation with which they [were] intended to deal."²²⁸ The SEC's position was that Chapter X was

222. *Id.* at 613; see Douglas G. Baird, *Bankruptcy from Olympus*, 77 U. CHI. L. REV. 959, 961–62 (2010) (describing the role played by trade creditors in small business bankruptcy cases).

223. *Am. Trailer Rentals*, 379 U.S. at 613–14.

224. The Supreme Court declined the SEC's invitation to lay down a bright-line rule that all companies that issued public securities were required to use Chapter X. Instead, the Court endorsed a case-by-case inquiry that invited further evasion. See *Gen. Stores Corp. v. Shlensky*, 350 U.S. 462, 466 (1956).

225. SKEEL, *supra* note 35, at 162–63.

226. *Id.* at 163 (quoting Professor King).

227. See Benjamin Weintraub et al., *Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation*, 24 FORDHAM L. REV. 616, 633–34 (1956) (noting the growth of Chapter XI cases among middle-sized firms).

228. Samuel O. Clark, Jr., Director of the Reorganization Division of the Securities and Exchange Commission, Address on the Securities and Exchange Commission and the Chandler Act, 3 (Jan. 5,

designed to protect holders of publicly held securities—bondholders and shareholders—and that the statute’s protection “would be rendered abortive” if companies with publicly held securities could reorganize under Chapter XI without the supervision of the SEC.²²⁹ The oversight responsibility given to the agency by the Chandler Act naturally fit that dividing line, in the SEC’s view. Because most large corporations at the time had issued at least some publicly held securities, the SEC tried to block attempts by those companies that sought to avoid the strictures of Chapter X by filing under Chapter XI.

In an early case involving such a challenge to a Chapter XI filing, *SEC v. United States Realty & Improvement Co.*, the Supreme Court ruled in the SEC’s favor.²³⁰ Although a majority of affected creditors had assented to the company’s plan to restructure its debt obligations, the SEC objected on the ground that Chapter XI was “inadequate” for a company with publicly held securities.²³¹ But while the Court ruled in the SEC’s favor, the decision did not provide the clear boundary line between the two chapters that the SEC advocated. Instead, the Court relied on a somewhat diffuse argument from equity to find that Chapter XI was inadequate on the facts of the particular case to the task of reorganizing the company.²³² The SEC’s victory in the case proved to be double-edged. Although it had succeeded in pushing back against an attempt at circumventing Chapter X, it had not gotten the Court to embrace a categorical test that would make Chapter XI off limits to large companies. At the same time, the court’s opinion in *United States Realty* sidelined SEC-championed legislation that would have amended the Chandler Act to close the Chapter XI loophole.²³³

When the Court next spoke on the appropriate boundary between Chapter X and Chapter XI, its decision, although again a victory as to the result for the SEC, arguably widened the loophole. The facts of *General*

1939), available at <http://www.sec.gov/news/speech/1939/010539clark.pdf>. As Director of the Reorganization Division, Clark was responsible for superintending Chapter X cases. *Id.*

229. *Id.* at 4.

230. 310 U.S. 434, 456–58 (1940).

231. *Id.* at 441–43.

232. *Id.* at 455–56.

233. The SEC promoted legislation that would have amended the Chandler Act to require firms whose securities were held by 100 or more investors to file under Chapter X. See David A. Skeel, Jr., *The Rise and Fall of the SEC in Bankruptcy* 11 n.31 (Univ. Penn. Law Sch., Inst for Law & Econ., Working Paper No. 267), available at http://papers.ssrn.com/paper.taf7.abstract_id=172030. Although the proposal received favorable attention, a House report concluded that *United States Realty* had eliminated the need for legislation. *Id.* (citing H.R. REP. No. 2372 (1940)). Congress later amended the statute to codify *United States Realty*. See *SEC v. Am. Trailer Rentals Co.*, 379 U.S. 594, 612 (1965) (describing the legislative acceptance of the Court’s holding in *United States Realty*).

*Stores Corp. v. Shlensky*²³⁴ were mundane—a company operating a chain of tobacco stores had fallen into financial difficulties and decided to restructure itself under Chapter XI as a more diversified retailer.²³⁵ A shareholder and the SEC objected on the ground that the company, which had outstanding publicly held securities, could reorganize only under Chapter X.²³⁶ The Court upheld the transfer of the case to Chapter X, but its reasoning did not embrace the SEC’s position.²³⁷ Expanding on its decision in *United States Realty*, the Court rejected the SEC’s arguments in favor of a Chapter X filing.²³⁸ Indeed, the Court explicitly held that the “the character of the debtor is not the controlling consideration in a choice between [Chapter] X and [Chapter] XI,” because even a large company with publicly held securities might benefit from the relief granted by a Chapter XI filing.²³⁹ Justice Douglas’s opinion for the Court suggested that the dividing line between the two forms of reorganization was the need to be served—particularly if there was reason for an independent trustee in cases where management had engaged in fraud or wrongdoing.²⁴⁰ The “honest” corporate debtor, however, did not necessarily have to resort to Chapter X when it sought to organize and bind scattered claimants and interest holders.²⁴¹ Shortly after *General Stores*, the SEC again proposed an amendment to the statute to make Chapter XI unavailable in cases in which the debtor had issued outstanding publicly held securities, but that proposal failed in committee.²⁴²

2. *Exploiting the Loophole*

If there is a central lesson to draw from corporate reorganization practice in the post-New Deal era, it is the difficulty of closing off routes to the felt necessity of group resolution. The rejection of any categorical test in *General Stores* opened the door for companies with publicly held

234. 350 U.S. 462 (1956).

235. *Id.* at 464.

236. *Id.* at 463.

237. *Id.* at 467–68.

238. *See id.* at 465–68.

239. *Id.* at 466.

240. *Id.* at 466–68 (“The essential difference is not between the small company and the large company but between the needs to be served.”).

241. *Id.* Ultimately, the Court ruled in the SEC’s favor based on deference to the lower courts’ conclusion that the business needed more pervasive restructuring than could be accomplished through Chapter XI. *Id.* at 468.

242. Aaron Levy, Assistant Chief Counsel, Division of Corporate Regulation of the Securities and Exchange Commission, Address at the Judicial Conference of the Fifth Circuit, 5–6 (May 11, 1961) [hereinafter Aaron Levy Address at the Judicial Conference of the Fifth Circuit].

securities seeking to skirt Chapter X while reorganizing. In the late 1950s and early 1960s, there was a marked increase in the number of publicly held companies filing for bankruptcy under Chapter XI.²⁴³ To be sure, *General Stores* did not completely hobble the SEC. The agency maintained a case-by-case litigation strategy of urging conversion to Chapter X when a debtor's rehabilitation required a substantial adjustment of widely held public debt.²⁴⁴ The SEC continued to object successfully to perceived inappropriate uses of Chapter XI,²⁴⁵ and even the prospect of an SEC challenge could derail a reorganization.²⁴⁶ But when the agency did succeed in moving to transfer a case to Chapter X, it was often in the face of judicial reluctance to undo what appeared to be sensible, simplified rationalization of a company's affairs through private ordering.²⁴⁷

A related lesson is the difficulty of centralized agency regulation of the resource-intensive process of negotiating and securing group resolution. The SEC did not oppose the use of Chapter XI in every case. A prominent reason for its reluctance to intervene in every case was the agency's lack of resources. As Robert Swaine had predicted, the SEC's Reorganization Division simply did not have the ability to superintend every reorganization of a large firm.²⁴⁸ The agency did not even seek to play an active role in all Chapter X cases, because "[o]therwise the limited staff of accountants, attorneys and financial analysts in Washington and in [the agency's] Regional Offices specially assigned to Chapter X cases could not work effectively and efficiently."²⁴⁹ Its staffers could not realistically delve into every case filed by a large company under Chapter XI and push for transfer to Chapter X. During the 1950s, the agency faced a chronic shortage of resources that disproportionately affected the Reorganization

243. SKEEL, *supra* note 35, at 165.

244. *See, e.g., In re Manufacturers Credit Corp. v. SEC*, 395 F.2d 833, 843 (3d Cir. 1968).

245. In a notable example, the SEC engaged in a vigorous campaign to limit or overturn the Second Circuit's opinion in *Grayson-Robinson Stores v. SEC*, in which the court of appeals rejected the agency's attempt to force a Chapter XI debtor to refile under Chapter X. 320 F.2d 940 (2d Cir. 1963). The agency largely succeeded when Judge Friendly, the author of the *Grayson* opinion, later ruled in the SEC's favor in *SEC v. Canandaigua*, a similar case. 339 F.2d 14, 21 (2d Cir. 1964); *see also* Peter J. Rooney, Comment, *Nonacquiescence by the Securities and Exchange Commission: Its Relevance to the Nonacquiescence Debate*, 140 U. PA. L. REV. 1111, 1122-30 (1992) (describing the SEC's successful efforts to limit the reach of *Grayson*).

246. *See* SKEEL, *supra* note 35, at 165.

247. Remarkably, in *Canandaigua*, the Second Circuit agreed with the SEC that the case should be transferred from Chapter XI to Chapter X but noted great displeasure with the outcome. 339 F.2d at 21 ("We repeat our dislike at having to insist on a course which scarcely a creditor or stockholder has sought and which may lead to disaster.").

248. *See supra* note 192 and accompanying text.

249. Aaron Levy Address at the Judicial Conference of the Fifth Circuit, *supra* note 242, at 2.

Division.²⁵⁰ The budgetary woes exacerbated the cumbersome nature of Chapter X, because the overburdened reorganization staff took longer to perform its tasks—such as producing the agency’s reports on plans of reorganization—in bankruptcy cases.²⁵¹ This led to a feedback loop: As the Chapter X process became more unattractive, debtors increasingly sought to avoid it, which in turn led to relatively few Chapter X filings, which in turn led to more budget restrictions on the Reorganization Division.²⁵² In the face of these obstacles, the agency retreated to a kind of passive resistance to the increase in Chapter XI filings by companies that, by rights, should have reorganized under agency supervision in Chapter X.

What caused the continued attempts to reorganize in a more flexible process? One explanation might be that self-interested lawyers were seeking to drum up reorganization business for themselves, and Chapter XI made bankruptcy a more attractive option for businesses than did Chapter X.²⁵³ Another is that managers of financially distressed businesses obviously preferred a process that did not require the appointment of an independent trustee.²⁵⁴ But these explanations do not capture the full picture. Those supposedly protected by the intervention of the SEC often supported attempts to evade the rigid regime of Chapter X in favor of a more permissive Chapter XI arrangement. To give one prominent example, the creditors in *SEC v. Canandaigua*—a key victory for the SEC in which the Second Circuit blocked the case from proceeding under Chapter XI—had not insisted on a Chapter X filing.²⁵⁵ Judge Friendly agreed with the SEC’s position but noted the court’s “dislike at having to insist on a course which scarcely a creditor or stockholder has sought and which might lead to disaster.”²⁵⁶ That sentiment against the straightjacket of Chapter X was echoed by important creditor interests in the legislative hearings leading to the adoption of the Bankruptcy Code in 1978.²⁵⁷ They, too, preferred the flexibility of Chapter XI. Chapter X was perceived as discouraging reorganization—sometimes until a firm’s value was

250. See SKEEL, *supra* note 35, at 170–71 (observing that “[t]he SEC’s reorganization division was particularly hard hit” by budget cuts beginning in the Eisenhower administration); David A. Skeel, Jr., *Welcome Back, SEC?*, 18 AM. BANKR. INST. L. REV. 573, 575–76 (2010).

251. See SKEEL, *supra* note 35 at 171.

252. *Id.* (describing complaints in the legislative history of the 1978 Bankruptcy Code that the SEC had “starved” its reorganization branch).

253. See *supra* notes 208–10 and accompanying text.

254. See *supra* note 208 and accompanying text.

255. 339 F.2d 14, 15–17 (1964).

256. *Id.* at 21.

257. See SKEEL, *supra* note 35, at 179–80.

irretrievably damaged.²⁵⁸ It was expensive, and it was slow.²⁵⁹ It also left little room for claimants to organize on their own to participate in the resolution of the debtor's affairs.²⁶⁰ A more accommodating process that permitted firms and claimants leeway to negotiate a resolution of financial distress would, in the end, benefit creditors as well.

The continued pressure to squeeze cases into Chapter XI also came from the realities of a changing economy. The credit markets expanded dramatically and, by the mid-1960s, leverage among businesses had increased.²⁶¹ In the United States—unlike in most other developed countries—debt instruments outpaced stocks in corporate finance.²⁶² An inevitable result was that the capital structures of firms became more complicated and debt laden. Chapter XI, with its speed and flexibility, provided an outlet for the need to restructure firms in financial distress. This had the effect of “transforming Chapter XI from a debtor-relief proceeding intended for small mom and pop businesses with small amounts of unsecured liabilities to a chapter used by Fortune 500 corporations.”²⁶³ The trend continued through the economic downturn of the early 1970s, culminating in the 1975 Chapter XI filing of W.T. Grant, a large retailer.²⁶⁴ The W.T. Grant case demonstrated how adept counsel had become at pushing the boundary between Chapter X and Chapter XI. The company was listed on the New York Stock Exchange and had more

258. The study commission's report that greatly influenced the 1978 Code criticized Chapter X for delaying debtors' resort to bankruptcy relief and thereby damaging the prospects for a successful reorganization. See COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. No. 93-137, pt. I, at 190–91.

259. See Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 109 (1997) (“Creditors believed that the formal requirements of Chapter X and SEC participation produced delay, during which costs mounted and assets dwindled, without creating any offsetting benefits.”). The budgetary constraints on the SEC's reorganization division also slowed the pace of Chapter X. See *supra* text accompanying notes 249–52.

260. One reason that creditors often did not object to the use of Chapter XI over Chapter X is that participating creditors could exercise greater control in Chapter XI in the absence of SEC supervision. Accordingly, Chapter XI tended to favor those parties in interest who participated actively in the case. See Posner, *supra* note 259, at 110–11.

261. See Harvey R. Miller, *Chapter 11 in Transition—From Boom to Bust and Into the Future*, 81 AM. BANKR. L.J. 375, 376 (2007).

262. See OXFORD HANDBOOK OF BUSINESS HISTORY 327 (Geoffrey Jones & Jonathan Zeitlin eds., 2008).

263. Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 171 (2004).

264. See Constantine N. Katsoris, Paul A. Soden & Stuart M. Bernstein, Lecture, *Is Chapter 11 Dead?*, 15 FORDHAM J. CORP. & FIN. L. 1, 12 (2009) (giving the W.T. Grant bankruptcy as an example of the transformation of Chapter XI).

than \$1 billion in debt.²⁶⁵ If any firm fell within the contemplation of Chapter X, it was W.T. Grant. Yet counsel were able to persuade the court that the case should remain in Chapter XI.

The expansion of Chapter XI involved much of the same sort of ingenuity and imagination seen in the development of the railroad receivership a century before.²⁶⁶ Chapter XI, although speedier and more flexible than Chapter X, was also more limited in some ways. An arrangement under Chapter XI, for example, could not force the alteration of a secured creditor's rights.²⁶⁷ But "a clever court and debtor might conspire to make it worthwhile for a secured creditor to agree to a reorganization," even if they could not require it.²⁶⁸ To accommodate comprehensive reorganization of larger firms, bankruptcy courts were urged to invoke the full extent of their equitable powers. Bankruptcy professionals recognized that bankruptcy courts might liberally construe the law, for example, to enjoin a secured creditor from pursuing its remedial rights in another forum.²⁶⁹ Just as the equity receivership grew to accomplish global resolution, Chapter XI expanded to accommodate similar pressures that could not be met through the cumbersome procedures of Chapter X.

In light of these developments, it is not surprising that when Congress revamped the bankruptcy laws in the 1970s, it blended Chapter X and Chapter XI in a way that selected the key features of Chapter XI. As part of the transformation that came with the Bankruptcy Code, the SEC lost its special role. The legislative climate in 1978 was very different from that in 1938 when the Chandler Act had hobbled corporate reorganization practice, and the reputation of the SEC—and administrative agency

265. Clifford J. White III & Walter W. Theus, Jr., *Chapter 11 Trustees and Examiners After BAPCPA*, 80 AM. BANKR. L.J. 289, 293 (2006).

266. Miller & Waisman, *supra* note 263, at 171.

267. Chandler Act § 356, 52 Stat. at 910 (providing that a Chapter XI arrangement "shall include provisions modifying or altering the rights of *unsecured* creditors generally or of some class of them" (emphasis added)); *see also* James J. White, *Death and Resurrection of Secured Credit*, 12 AM. BANKR. INST. L. REV. 139, 142 (2004) (discussing limitations of Chapter XI with respect to the treatment of secured creditors).

268. *See* White, *supra* note 267, at 143.

269. *See* Harvey R. Miller, *Bankruptcy and Reorganization Through the Looking Glass of 50 Years (1960–2010)*, 19 J. BANKR. L. & PRAC. 193, 196 (2010) (describing a "growing appreciation by professionals that bankruptcy courts in Chapter XI cases might liberally construe the bankruptcy law beyond its original intent"). Blocking a secured creditor from repossessing and selling its collateral gave the debtor leverage to force the creditor to cooperate in the case. *See* Posner, *supra* note 259, at 66. A stay of other proceedings against the debtor was automatic in Chapter X cases but not in Chapter XI cases. *See* 11 U.S.C. § 548 (1964) (repealed 1978); 11 U.S.C. § 714 (1964) (repealed 1978).

control in general—had been tarnished.²⁷⁰ At the same time, the expansion of Chapter XI (and the alignment of creditor interests behind the more flexible approach of that antecedent) suggested that corporate reorganization would be most useful if it took a form that was accommodating and accessible. A generation of experience with rigid administrative agency supervision had given way to reality.

B. The Bankruptcy Bar and Reform

Although various interests aligned to enact the Bankruptcy Code in 1978, the bankruptcy bar played a key role, and one significant motivation of the bankruptcy bar was to raise the general perception of bankruptcy practice. As David Skeel has explained, the various groups of bankruptcy professionals—practitioners, bar groups and reform organizations, consumer advocates, and academics—did not always agree on the optimal shape of bankruptcy reform.²⁷¹ The one thing they did agree on, however, was that reform of the bankruptcy process should “improve the reputation and status of bankruptcy law.”²⁷² The concern about the reputation of bankruptcy and bankruptcy lawyers was far different from the negative perception that had been harnessed to justify the Chandler Act in 1938. Rather than being perceived as elite moneymen in league with big business, the bankruptcy bar of the post-Chandler Act era had a more humble reputation.²⁷³ But the problem of perception remained.²⁷⁴

The post-New Deal bankruptcy bar may have lost its connection with the elite bar, but echoes of the charge against the old practices persisted. Too often, it was said, bankruptcy cases devolved into a “ring” of closely knit lawyers who wielded excessive control at the expense of creditors.²⁷⁵ Creditors were supposed to have the power, outside Chapter X, to exercise

270. See SKEEL, *supra* note 35, at 170–71 (describing the SEC’s weakened state and lack of sympathetic interest groups).

271. See *id.* at 136.

272. *Id.*

273. Very few “white shoe” law firms persisted in bankruptcy practice after the Chandler Act. That left the field to lawyers (often at predominately Jewish firms) who were not welcome in elite law firms at the time. See Eli Wald, *The Rise and Fall of the WASP and Jewish Law Firms*, 60 STAN. L. REV. 1803, 1833–35 (2008) (describing bankruptcy as an “undignified” practice area that “white shoe” firms avoided).

274. As Harvey Miller recounts, bankruptcy practice was shunned by prominent law firms due to its reputation “as a small, arcane, undesirable practice area inhabited, allegedly, by somewhat shady groups accused of feeding off the carcasses of failures.” Miller, *supra* note 269, at 194.

275. See Susan Block-Lieb, *What Congress Had to Say: Legislative History as a Rehearsal of Congressional Responses to Stern v. Marshall*, 86 AM. BANKR. L.J. 55, 62–63 (2012) (discussing responses to allegations that “bankruptcy rings” corrupted the bankruptcy process).

control in bankruptcy cases—for example, the ability to form a creditors’ committee or select a trustee in appropriate circumstances. In reality, dispersed creditors often had little interest in organizing themselves to do so. Instead, bankruptcy lawyers were said to solicit creditors to appoint the lawyers’ favored committees or trustees. Of course, those selected would then appoint the bankruptcy lawyer as counsel, with the prospect of generous fees paid from the debtor’s estate.²⁷⁶ So, the same charge of self-dealing and excessive lawyer control—although now in different form—haunted bankruptcy practice in the years after the New Deal crackdown.²⁷⁷

In order to cleanse the practice and elevate its public image, bankruptcy lawyers acquiesced in incorporating safeguards into the process. The general approach chosen by Congress involved incorporating participants to serve as a check against distortions in the running of bankruptcy cases. In reorganization cases, the new Code provided for an active role for creditors’ committees. To counter the charge that bankruptcy lawyers routinely took advantage of “creditors’ generally passive role”²⁷⁸ in bankruptcy cases, Congress authorized a new watchdog in bankruptcy cases. In place of the SEC, a new agency, the U.S. Trustee, took over the role of proposing trustees in liquidation cases and appointing creditors’ committees in reorganizations.²⁷⁹ The U.S. Trustee was also given standing to intervene and object to attorneys’ fees.²⁸⁰ The legislative design served to separate judicial functions from administrative functions in the bankruptcy system. Bankruptcy judges would be partially shielded from taking too active a role in the administrative tasks of a bankruptcy case.

Why did the bankruptcy bar agree to the entry of another administrative agency watching over the shoulders of judges and lawyers? One reason is that the role of the U.S. Trustee was less comprehensive than the overbearing and ineffectual SEC. The U.S. Trustee may have an important role in key parts of a case—helping to structure creditors’ committees and retaining the power to object to attorneys’ fees—but those tasks are supposed to be relatively limited ones. Another reason that the bar approved of the creation of the U.S. Trustee program is that it largely put to rest the charges of a “bankruptcy ring.” To be sure, bankruptcy

276. SKEEL, *supra* note 35, at 132–34.

277. *Id.*

278. *Id.* at 146.

279. See Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 35 (1995) (describing the role of the U.S. Trustee); 28 U.S.C. § 586 (listing the duties of the U.S. Trustee).

280. See 11 U.S.C. § 307.

lawyers contested that there ever had been such widespread underhanded practices.²⁸¹ But they acknowledged that the perception of self-dealing by lawyers in the field was an impediment to reform of the bankruptcy system. As Professor Frank Kennedy observed, “The members of the bar who do not practice before the bankruptcy courts and laymen regard bankruptcy administration, at least in the sizable business centers, as controlled by bankruptcy rings or cliques.”²⁸² Much of the resistance to expanding the reach of bankruptcy law stemmed from the hint of corruption that attached to the process. Removing that cloud would allow greater access to, and greater flexibility in, the bankruptcy process. In other words, the price of an expanded and modernized bankruptcy system was the inclusion of structural safeguards to curb the potential for lawyer self-dealing and excessive control.

III. LESSONS FOR THE FUTURE OF AGGREGATE LITIGATION

From this retelling of the rise, fall, and return of bankruptcy, I extract two potential lessons for the future of aggregate litigation. The first is that the move away from the class action may be a cyclical and not a secular trend. The second is that any form of aggregation that relies on the active hand of lawyers or other professionals (who stand to gain substantial compensation for their role) is likely to generate resentment and scrutiny. For that reason, introducing institutional structures that check the conduct of lawyers in an aggregation device is compatible with preserving the viability of the device.

A. *The Cycles of an Aggregation Device*

When courts resolve a problem that demands aggregation, they cannot do so without the close participation of lawyers. In the absence of another regime that could provide needed relief for a problem that required

281. Conrad Cyr, a bankruptcy judge who later served on the U.S. Court of Appeals for the First Circuit, vigorously contested that there was any evidence that bankruptcy rings operated in widespread fashion. See Conrad K. Cyr, *Setting the Record Straight for a Comprehensive Revision of the Bankruptcy Act of 1898*, 49 AM. BANKR. L.J. 99, 118 (1975). He testified before the Commission on the Bankruptcy Laws of the United States, which had been charged by Congress with evaluating the bankruptcy system, that allegations of corrupt rings in bankruptcy practice were based on rumors and anecdotes. *Id.* The most serious charges about the excessive influence of bankruptcy lawyers came from a report on bankruptcy administration by researchers at the Brookings Institution, a report that Cyr attacked as biased. See DAVID T. STANLEY & MARJORIE GIRTH, *BANKRUPTCY: PROBLEM, PROCESS, REFORM* (1971); Cyr, *supra*, at 118.

282. Frank Kennedy, *Restructuring Bankruptcy Administration: The Proposals of the Commission on Bankruptcy Laws*, 30 BUS. LAW. 399, 399 (1975).

aggregate resolution, the courts became the focal point for business reorganization in the United States. The equity receivership of the nineteenth century was not solely the product of lawyerly imagination—judges and financiers played a crucial part as well—but it was lawyers whose efforts were decisive. The lawyers of the day took rudimentary procedures and refined them to achieve the desired ends of global resolution of financial distress.

1. Stages of Innovation and Reform

As with any process built on foundations designed to carry far less weight, the law of business reorganizations grew in stages. In the first stage, new applications for older procedural forms were tested. Then, in time, a standard way of operating the device emerged. During this part of the cycle, the great public benefits that came from mass resolution of claims were championed. It is difficult to appreciate now, but observers in the late nineteenth century were awestruck at what had been achieved through court-centered receiverships. Without the direct intervention of the government, and without explicit statutory direction, a small group of lawyers had brought together creditors, managers, and bankers to rationalize the American railway system. Edward Sherwood Meade, a noted economist of the day, praised the flexibility of the receivership process and the ability of those handling receiverships to reorganize the morass of railway finances in a way that ultimately benefited the public by producing fiscally sound railroads.²⁸³

But the use of court-centered procedures to accomplish wide reaching—even legislative—aims will draw criticism. By the close of the nineteenth century, unfavorable academic attention was cast on the receivership system on grounds that should be familiar to those who study the class action today: the courts, it was said, had let lawyers overextend a procedure intended for resolution of ordinary disputes.²⁸⁴ Because that process criticism came from other lawyers, it resonated at first within the legal academy and the courts. It had limited reach outside those circles. But the effect was clear. The courts began to rein in the use of receiverships, although inconsistently, in the early twentieth century.²⁸⁵

283. Edward Sherwood Meade, *The Reorganization of Railroads*, 17 ANNALS AM. ACAD. POL. & SOC. SCI. 205, 205–09 (1901).

284. See *supra* note 95 and accompanying text.

285. See, e.g., *Shapiro v. Wilgus*, 287 U.S. 348 (1932); *Harkin v. Brundage*, 276 U.S. 36 (1928); *N. Pac Ry. v. Boyd*, 228 U.S. 482 (1913); see also *supra* Part I.C.

Process criticisms will have their greatest public impact when they merge with broader ideological trends. The mere fact that an in-the-courthouse procedure is overextended is meaningless to any non-lawyer observer. In the case of aggregation devices, however, the prospect of procedural abuse carries with it consequences that can garner broader public attention—lawyer enrichment at the expense of dispersed claimants. No one cares about procedure as much as lawyers do, but everyone understands money and control. What made William O. Douglas’s investigation of equity receiverships compelling was that it told a classic betrayal story—those with power had exercised it unchecked and had done so to enrich themselves at the expense of the public they purported to serve.²⁸⁶

The final stage of the bankruptcy cycle, however, is also instructive. The underlying reason for aggregation in the equity receivership cases—the need to bring together and bind claimants to resolve a firm’s financial distress—did not go away when the device was hobbled. Instead, the need to pursue that relief found other channels before being recognized forthrightly in later legislative reforms.²⁸⁷ For those who study the class action, perhaps the lesson is that the trajectory of that device should not be seen as a long, downward slide from Eden. Instead, if the underlying reasons for the rise of the class action do not disappear, then the needs the device has been used to address will be met—if only partly—some other way. And, if the right conditions are present, those needs may be acknowledged openly and reconciled in the future.

2. *Assessing Proposals for Class Action Reform*

The bankruptcy story also suggests that some versions of aggregate litigation reform are more enduring than others. The equity receivership began as an entirely judge- and lawyer-made procedure. The first efforts at overhauling the receivership system took the form of codification of practices that had developed in the common law way.²⁸⁸ Critics of receivership practice did not singlehandedly impose those reforms—instead, reorganization professionals themselves joined the efforts to rationalize a process that had developed practical and theoretical flaws.²⁸⁹ From their perspective, reform brought the promise of greater certainty

286. See *supra* notes 122–25 and accompanying text.

287. See *supra* Part II.A.

288. See *supra* Part I.C.1.

289. See *supra* Part I.C.1.

and efficiency in the process.²⁹⁰ Recall that section 77B of the Bankruptcy Act of 1898, enacted in 1934, strengthened the jurisdictional reach of the court in which a reorganization was pending, made it easier to bind dissenters, and eliminated the need to engage in a fictitious judicial sale to conclude the process.²⁹¹ Because these changes were deemed inadequate responses to the perceived abuses of the receivership process, however, far more radical reforms were imposed.²⁹² For those who seek to increase the flexibility and power of aggregate litigation, that outcome should be instructive. The improvements in the reorganization process enacted in the early 1930s were lost shortly thereafter, due in large part to the failure to include measures that countered perceived abuses by those who controlled the process. Those who propose reforms in aggregate litigation would do well to remember that.

At the same time, the bankruptcy story shows the inevitable dissatisfaction with rigid limitations on aggregation devices that hinder private resolution among claimants and other parties in interest. Legislative attempts to channel aggregation into an inflexible form run the risk of failing on their own terms. The Chandler Act's Chapter X had many admirable features and promised the benefit of agency expertise and monitoring. But it was far too rigid, too slow, and too costly. Moreover, the basic premise that undergirded Chapter X—that dispersed claimants *could* not, and therefore *should* not, play a meaningful role in the debtor's reorganization—proved to be flawed. Stifling an outlet for those claimants in reorganization cases put increasing pressure on the barrier between Chapter X and Chapter XI.²⁹³

Parties and their counsel will gravitate toward available aggregate procedures that allow flexibility and private ordering. The Chandler Act's imposition of administrative supervision in reorganization cases was well intentioned—only the close involvement of a public-minded agency, the New Deal reformers believed, could prevent self-dealing by those who had controlled receiverships to the detriment of dispersed claimants. Nevertheless, the Chapter X approach proved misguided. That approach understood business reorganization as essentially a matter of administrative expertise in the realm of corporate governance and finance.²⁹⁴ The increasingly sophisticated attempts by bankruptcy

290. See *supra* text accompanying notes 135–39.

291. See *supra* notes 151–58 and accompanying text.

292. See *supra* text accompanying notes 160–67.

293. See *supra* note 260 and accompanying text.

294. See *supra* notes 179–80 and accompanying text.

professionals to circumvent Chapter X and reorganize firms in Chapter XI, however, were driven by the very different realities of financial distress. When Chapter X was abolished with the enactment of the Bankruptcy Code in 1978, Congress approached business reorganizations with a view reflecting those realities—“that a reorganization is based on a bargain among creditors of a distressed company.”²⁹⁵ The “bargain” view, of course, fits more closely with the real world of bankruptcy, and with the real world of aggregate litigation more generally. Reforms of aggregate litigation devices that do not allow sufficient room for contesting parties to work out their own plan for resolution of the dispute are unlikely to prove satisfactory for very long.

This is not to say that aggregate litigation devices must encourage a free-for-all to be useful. To the contrary, it is possible to counter perceived abuses in aggregate litigation practice without eliminating its useful features. Before the demise of the New Deal approach to reorganizations, there was a general consensus that some aspects of the SEC’s role had been beneficial.²⁹⁶ It provided useful service as an outsider that “monitor[ed] the performance and qualification of other parties in interest.”²⁹⁷ That part of the agency’s role, although certainly in more limited form, was retained in the guise of the U.S. Trustee Program—housed in the Department of Justice—when the Bankruptcy Code was enacted in 1978.²⁹⁸

B. Lawyers, Aggregation, and Institutional Reform

The second major lesson the history of bankruptcy teaches concerns the role of lawyers. The fact that a process relies heavily on lawyers who may generate large compensation for themselves is not enough to generate

295. See SKEEL, *supra* note 35, at 181 (quoting SEC official Aaron Levy’s criticism of the effort to abolish Chapter X during the drafting of the Code) (internal quotation marks omitted).

296. See Hooton, *supra* note 188, at 465.

297. *Id.*

298. As the House Report on the proposed Bankruptcy Reform Act phrased it, the U.S. Trustee would serve the role as “watch-dogs to prevent fraud, dishonesty, and overreaching in the bankruptcy arena.” H.R. REP. NO. 95-959, at 88 (1977). The U.S. Trustee Program began as a pilot project in 18 judicial districts after the Code’s enactment in 1978. See Frank R. Kennedy, *Foreword: A Brief History of the Bankruptcy Reform Act*, 58 N.C. L. REV. 667, 677 n.56 (1980); U.S. DEPT. OF JUSTICE, EXECUTIVE OFFICE FOR U.S. TRUSTEES, AN EVALUATION OF THE U.S. TRUSTEE PILOT PROGRAM FOR BANKRUPTCY ADMINISTRATION: FINDINGS AND RECOMMENDATIONS 26–27 (1983) [hereinafter U.S. TRUSTEE REPORT]. After a five-year observation period, the interim program was implemented nationwide, with the exception of two states (Alabama and North Carolina). *Id.* at 9; Tabb, *supra* note 279, at 35.

scrutiny. It is instead the reality that the lawyers' compensation comes from the recoveries of many scattered claimants that raises alarm.

Criticism of lawyer conduct played a significant role in the New Deal attack on the receivership system.²⁹⁹ A similar sentiment plays a significant role in contemporary criticism of class actions.³⁰⁰ The scrutiny of lawyers in the two eras, however, is ideologically very different. In the New Deal, those on the left attacked the conduct of elite lawyers with business clients. In the class action world, the ideological configuration in large part has been reversed. But the criticism of class actions echoes the charge that a select group of elites have enriched themselves at the expense of the public. The enactment of the recent statutory curbs on the class action was expressly justified by the specter of "jackpot justice" in which class action lawyers profited but class members received little or no recovery.³⁰¹ In particular, critics of the class action pointed to the phenomenon of "coupon" settlements that provided large fee recoveries for class counsel but little monetary compensation for the class.³⁰²

Those who sought to undo the hobbling of the receivership system understood that they could not achieve their goals without elevating the perception of the bankruptcy system. Getting rid of the hint of underhanded practices became more than an ethical matter. It was central to the revival of an entire practice.³⁰³ In order to quiet the concerns about self-dealing by lawyers, they were willing to impose institutional structures to monitor bankruptcy cases—and the lawyers running those

299. See *supra* notes 166–71 and accompanying text.

300. The criticism amounts to more than mere anti-lawyers bias. Rather, it focuses on the perceived high agency costs in class action litigation, which "permit opportunistic behavior by attorneys." John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 882–83 (1987). But see Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103, 104 (2006).

301. See John F. Harris & Jim VandeHei, *Senate Nears Revision of Class Actions*, WASH. POST, Feb. 10, 2005, at A4 (describing criticism of class action lawyers by Senator Orrin G. Hatch).

302. In the years leading up to the enactment of the Class Action Fairness Act of 2005 (CAFA), the recovery of large attorneys' fees in connection with coupon settlements provided a constant subject of criticism in Congress. See David Marcus, *Attorneys' Fees and the Social Legitimacy of Class Actions*, 159 U. PA. L. REV. PENNUMBRA 157, 164–65 (2010) (discussing the "significant criticism due to the great imbalance between the often worthless coupons that class members received and the sizeable fees their attorneys reaped"). Although coupon settlements were not the sole reason for CAFA's passage, criticism of them appeared throughout the statute's legislative history. See *id.* at 165 ("From the very first congressional hearing on the bill to the last days of debate in the Senate and the House eight years later, the statute's supporters invoked the large fees that accompanied worthless coupons as evidence of a 'broken' system that produced 'outrageous decisions.'" (internal citations omitted)).

303. See *supra* Part II.B.

cases.³⁰⁴ Will that type of institutional reform be necessary to alter perceptions about aggregate litigation?

The importance of perception is perhaps more significant than lawyers embedded in the process care to admit. Judges do not typically invoke concerns about appearances when deciding contested issues in aggregate litigation.³⁰⁵ They may harbor those concerns without expressing them. But perhaps they should do so more openly. When Judge Weinstein deployed the term “quasi-class action”³⁰⁶ to justify altering the fee agreements that lawyers had entered into with their individual clients in the Zyprexa litigation, he admitted that serious concerns about perception formed part of his reasoning.³⁰⁷ I confess I once took a jaundiced view of that part of his Zyprexa decision. But I have come to realize that Judge Weinstein identified an important and undervalued point. “Litigations like the present one,” he maintained, “are an important tool for the protection of consumers in our modern corporate society, and they must be conducted so that they will not be viewed as abusive by the public; they are in fact highly beneficial to the public when adequately controlled.”³⁰⁸

304. When the Department of Justice evaluated the success of the U.S. Trustee pilot program after five years, its report included favorable comments from bankruptcy judges and lawyers about the improved perception of the bankruptcy process caused by the program’s presence. One judge approvingly noted that the “trustee program has helped remove, once and for all, any perceptions of judge impropriety,” while another noted that “[t]he U.S. trustee is an outsider in reality and perception—and this is very important.” U.S. TRUSTEE REPORT, *supra* note 298, at 199.

305. I do not mean, of course, that arguments based on “the sake of appearance” are unusual elsewhere in law or policy debates. *See generally* Adam M. Samaha, *Regulation for the Sake of Appearance*, 125 HARV. L. REV. 1563 (2012) (discussing and analyzing examples of legal and political decisions that are justified based on the sake of appearance). But those arguments tend to be expressed with reluctance by courts in aggregate litigation. *See* Susan P. Koniak, *Feasting While the Widow Weeps: Georgine v. Amchem Products, Inc.*, 80 CORNELL L. REV. 1045, 1120–22 (1995) (advocating for prophylactic rules to eliminate both the appearance and the reality of impropriety by lawyers in class actions and noting the courts’ reluctance “to say anything negative about the lawyers before them”). There are, however, notable exceptions. *See, e.g.*, *Kramer v. Scientific Control Corp.*, 534 F.2d 1085, 1088–1091 (3d Cir. 1976) (observing that “a class action is a special type of legal proceeding” in which “the appearance, not the fact, of impropriety” must be eliminated).

306. The term “quasi-class action” has been applied to aggregate litigation resolved outside a formal class action, typically through federal multi-district litigation proceedings, in which the court plays a significant role in controlling, among other things, the appointment and compensation of counsel. *See* Jeremy Hays, *The Quasi-Class Action Model for Limiting Attorneys’ Fees in Multidistrict Litigation*, 67 N.Y.U. ANN. SURV. AM. L. 589, 603–17 (2012) (describing the development of the quasi-class action).

307. *In re Zyprexa Prods. Liab. Litig.*, 424 F. Supp. 2d 488, 494 (E.D.N.Y. 2006).

308. *Id.*

Curbing the perceived self-dealing of lawyers is part of the bargain that allows aggregation devices to survive.³⁰⁹

But control should not be overbearing—nor does it need to be. The failed experiment with SEC oversight of business reorganizations was replaced by a more dynamic form of monitoring. Instead of mandatory review by an agency that created strong disincentives to using the device it was supposed to supervise, the reformed bankruptcy system put in place softer and more limited controls. One was a standing monitor—the U.S. Trustee—that could raise objections to potential abuses.³¹⁰ The second was the separation of some of the administrative functions in the case in a way that routinized them.³¹¹ The formation of committees of creditors, for example, no longer held the same potential for intrigue and lawyer self-dealing when it was removed from the hands of judges who could not easily monitor the process.

This is not to say that the balance struck in bankruptcy is ideal. Criticisms of the costs and fairness of the bankruptcy process persist. The prospect of large fee awards for bankruptcy lawyers in major reorganization cases still garners negative attention.³¹² On the other side of the equation, bankruptcy lawyers grumble about the performance of the U.S. Trustee as a neutral monitor in bankruptcy cases.³¹³ One criticism is that the program is on occasion too aggressive in asserting its prerogatives in the process. And business reorganizations have not entirely escaped the ideological firing line since the last major reform of the bankruptcy process in 1978.³¹⁴ Nevertheless, bankruptcy remains a palimpsest on which the failed experiments of the past are visible.

Those interested in the future of class actions and alternatives to the class action should appreciate a related point. Sometimes, legitimate concerns about curbing the excessive power of lawyers may inadvertently undermine useful features in an aggregation scheme. In the name of

309. One may be sensitive to perception without accepting that class action lawyers are routinely overcompensated for their work. Indeed, recent scholarship suggests otherwise. *See generally* Brian T. Fitzpatrick, *Do Class Action Lawyers Make Too Little?*, 158 U. PA. L. REV. 2043 (2010).

310. *See supra* note 298 and accompanying text.

311. *See, e.g.*, 11 U.S.C. § 1102(a) (providing that the United States trustee shall appoint a committee of unsecured creditors).

312. *See supra* note 25 and accompanying text.

313. For example, the U.S. Trustee program has drawn recent criticism from bankruptcy lawyers over attempts to promulgate new guidelines with the purpose of increasing transparency in attorneys' fee awards. *See* Jacqueline Palank, *\$1,000/Hour Bankruptcies: Attorneys Justify Their Fees*, WALL ST. J., June 4, 2012, at B6 (discussing bankruptcy lawyers' criticisms of new fee disclosure requirements proposed by the program).

314. *See* Melissa B. Jacoby, *The Bankruptcy Code at Twenty-Five and the Next Generation of Lawmaking*, 78 AM. BANKR. L.J. 221 (2004).

protecting claimants from the predatory power of those who controlled the reorganization process, the New Deal reformers removed the system of representative committees that had existed from the time of the equity receivership.³¹⁵ The reformers assumed that the committees were not truly representative, because the committees were dominated by the lawyers, bankers, and managers who ran the reorganization process.³¹⁶ But, instead of strengthening the committee system to bolster the protection of those claimants—to ensure their participation and representation—the reformers abolished the system altogether in Chapter X cases.³¹⁷ In its place, an agency—the SEC—was tasked with oversight of the process. That oversight role proved to hamper and not help the usefulness of the post-New Deal reorganization process.³¹⁸ At the same time, the reformers insisted on individualized bondholder consent to modifications of a company’s debt instruments in order to “protect” the bondholders from group voting provisions in private workouts and force the use of the agency-supervised bankruptcy process instead.³¹⁹ Rather than improving the reorganization process, however, the loss of the committee system and the possibility of private workouts made Chapter X less flexible and less representative of the claimants whose interests were at stake.³²⁰ In other words, legal reforms aimed at protecting individual claimants proved misguided in assessing the role claimants could play in the process.

Similar debates about the role of individual claimants are ongoing in the world of aggregate litigation. Should claimants be allowed to pre-commit to be bound by a group vote on a settlement agreement in non-class aggregations? The American Law Institute has made such a proposal,³²¹ but it has drawn criticism on the ground that it overempowers lawyers at the expense of the individual consent of each claimant.³²² The

315. See *supra* Part I.C.2.

316. See *supra* notes 109–22, and 183 and accompanying text.

317. See *supra* note 183 and accompanying text.

318. See *supra* Part II.A.2.

319. See *supra* notes 202–05 and accompanying text.

320. See *supra* Part II.A.2.

321. PRINCIPLES OF THE LAW OF AGGREGATE LITIG. § 3.17 (2010). The proposal provides in pertinent part:

[I]ndividual claimants may, before the receipt of a proposed settlement offer, enter into an agreement in writing through shared counsel allowing each participating claimant to be bound by a substantial-majority vote of all claimants concerning an aggregate-settlement proposal (or, if the settlement significantly distinguishes among different categories of claimants, a separate substantial-majority vote of each category of claimants).

Id. § 3.17(b).

322. See, e.g., Howard M. Erichson & Benjamin C. Zipursky, *Consent Versus Closure*, 96 CORNELL L. REV. 265 (2011); Nancy J. Moore, *The American Law Institute’s Draft Proposal to*

loss of the potential benefits to claimants from the ability to enter those kinds of arrangements³²³ is justified as the price of protecting against overbearing lawyers.

I do not want to suggest that bankruptcy contains all answers to all problems in aggregate litigation. Nor do I want to suggest that there are easy lessons to be drawn from the path of reform and counterreform in the reorganization process. But the concerns that motivated the assault on bankruptcy reorganizations in a previous generation are, on closer inspection, the concerns that class action observers debate today. The bankruptcy story is one that should speak to those beyond the community of bankruptcy specialists.

CONCLUSION

1938 was a transformative year for the federal courts. Proceduralists think of the promulgation of the Federal Rules of Civil Procedure, which included an early version of today's class action rule, as the key transformative reform of that year. But 1938 also marked radical reforms of another procedural system, as the Chandler Act took control of business reorganizations from the professionals who had dominated the field. In the following generations, both forms of aggregation have undergone continued change.

Bankruptcy, however, has followed a more tortuous path toward its present state. That journey should be studied by those pondering the fate of the class action and alternatives to the class action. It reveals the difficulty of suppressing the desire for aggregation in a flexible form. Indeed, so long as there is a more flexible alternative that leaves room for private ordering, it suggests that aggregation will move away from an overly rigid procedure that does not accommodate the need for interested parties (and their representatives) to bargain. The path taken by bankruptcy law reform also provides some guidance for those considering reforms of the class action and other aggregation devices. Any reform must protect the perception of the device as socially useful and not susceptible to lawyer self-dealing. Ill-considered reforms of aggregation

Bypass the Aggregate Settlement Rule: Do Mass Tort Clients Need (or Want) Group Decisionmaking?, 57 DEPAUL L. REV. 395 (2008); Thomas D. Morgan, *Client Representation vs. Case Administration: The ALI Looks at Legal Ethics Issues in Aggregate Settlements*, 79 GEO. WASH. L. REV. 734 (2011).

323. See D. Theodore Rave, *Governing the Anticommons in Aggregate Litigation*, 66 VAND. L. REV. 1183 (2013) (discussing the "peace premium" claimants receive from a precommitment to settle as a group).

devices cannot be resisted without countering the perception of betrayal by the professionals who practice in the field. Institutional structures that monitor and check that kind of self-dealing are a necessary price for the kind of flexibility that aggregate litigation requires. Both lessons are significant ones in light of the ongoing debates about the future of the class action. For class action lawyers and scholars who study complex litigation, turning to the “gloomy and depressing subject” of bankruptcy provides guidance—and, perhaps, even cheerful inspiration—at a time of uncertainty.