The Logic *and* Limits *of* Bankruptcy Law

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INTRODUCTION

The Two Roles of Bankruptcy Law

BANKRUPTCY LAW has been in existence, although intermittently, for almost as long as credit. Its origins can be traced back to the days of Roman law; indeed, its name is derived from statutes of Italian city-states, where it was called *banca rupta* after a medieval custom of breaking the bench of a banker or tradesman who absconded with property of his creditors.[1] After a spotty start in this country, it has been a fixed feature of our legal landscape since 1898.[2] But only with the 1980s has it grown in popular and legal prominence. As it becomes more visible, bankruptcy law has become more controversial and its perceived usefulness more widespread. It is fashionable, for example, to state that keeping firms in operation is a goal of bankruptcy law. It is likewise fashionable to see bankruptcy law as embodying substantive goals of its own that need to be "balanced" with (among others) labor law, with environmental law, or with the rights of secured creditors or other property claimants.[3]

1. Treiman, "Acts of Bankruptcy: A Medieval Concept in Modern Bankruptcy Law," 52 *Harv. L. Rev.* 189 (1938). Bankruptcy was transplanted to England in 1542, when Parliament enacted an "Act Against Such Persons As Do Make Bankrupt," 34 & 35 Henry VIII, ch. 4 (1542). See generally Treiman, "Escaping the Creditors in the Middle Ages," 43 *L.Q. Rev.* 230 (1927).

2. Congress passed the first bankruptcy act in 1800, 2 Stat. 19; it was repealed in 1803. It was next introduced in 1841, 5 Stat. 440, and was repealed eighteen months later. Congress passed another bankruptcy act in 1867, 14 Stat. 517; it was repealed in 1878. The Bankruptcy Act of 1898 was the first "permanent" bankruptcy statute in this country; it survived (with substantial amendments, particularly in 1938) until replaced by the current Bankruptcy Code in 1978. See generally C. Warren, *Bankruptcy Law in United States History* (1935).

3. For an example of a case that sees bankruptcy law's mission as that of keeping firms in operation and sees a corollary need to limit the protections accorded secured creditors,

All of these propositions are derived from an essential truth: bankruptcy law *can* be used to keep firms in operation, and bankruptcy law inevitably touches other bodies of law. But none reflects bankruptcy law's historical function, and insufficient attention has been devoted to how importing these other policies into bankruptcy will affect its long-standing role. Through this book I hope to establish the importance of bankruptcy law in meeting its historical goals—and the limits that notion implies for bankruptcy policy. My view of what bankruptcy law exists to do is, I believe, virtually unquestioned. But I believe that this widely accepted view of what bankruptcy law should be doing also carries with it certain limits, suggests certain things it should *not* be doing. Just as too many spices can spoil the soup, so, too, including too much in bankruptcy law can undermine what everyone agrees it should be doing in the first place.

Bankruptcy law can and should help a firm stay in business when it is worth more to its owners alive than dead. That is a far cry, however, from saying that it is an independent goal of bankruptcy law to keep firms in operation. Not all businesses are worth more to their owners—or to society—alive than dead, and once one recognizes that, one has to identify *which* firms bankruptcy law should assist and why. Saying that bankruptcy law "exists" to help keep firms in operation helps not at all in drawing that line. Instead, a theory of what bankruptcy law can and should do is necessary.

Bankruptcy law, moreover, because it affects all areas of the legal landscape in adjusting rights among creditors and other owners, must deal with labor law, environmental law, and tax law and with the rights of secured creditors and other property claimants. All of these people have contractual or statutory rights to assert claims against a debtor and its assets. As such, they are inevitably affected by bankruptcy law. But it is one thing to say that they are affected by bankruptcy law and quite another to see bankruptcy law as containing a set of substantive legal entitlements against which these other rights must be compromised. Before one jumps to the conclusion that bankruptcy policies need to be balanced with these other policies, one has to be clear what it is that bankruptcy law can and should do—and what it cannot and should not do.

In analyzing bankruptcy law, as with any other body of law, it helps to start by identifying first principles. Those principles can then be de-

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see *In re* South Village, Inc., 25 Bankr. 987 (Bankr. D. Utah 1982), an opinion written by Ralph Mabey, perhaps the most respected bankruptcy judge on the bench at that time.

veloped by defining their potential operation in the existing social, economic, and legal world to identify precisely what bankruptcy law should encompass, how it can accomplish its goals, and the constraints on its ability to do so.[4] That normative view of bankruptcy law can then be contrasted with the Bankruptcy Code as enacted to see whether and to what extent the existing regime follows the path the principles suggest is the proper one.

The point of this book is to suggest what the underpinnings of bankruptcy law should be and then to apply that learning to a variety of issues while testing the current provisions of the Bankruptcy Code against them. This approach is not unique. In fields as disparate and complex as antitrust, oil and gas, intellectual property, and corporate finance, analysis of discrete legal problems usually begins with a look at the theoretical framework that the law is built upon.[5] But this approach *is* almost unique to bankruptcy law. Much bankruptcy analysis is flawed precisely because it lacks rigor in identifying what is being addressed and why it is a proper concern of bankruptcy law. For that reason, when a new and urgent "problem" is discovered in the context of a bankruptcy proceeding, courts, legislators, and commentators all too often approach its resolution in an ad hoc manner, by viewing bankruptcy law as somehow conflicting with—and perhaps overriding—some other urgent social or economic goal.

I believe that this approach is fundamentally mistaken. Bankruptcy law, at its core, is debt-collection law. This is what we all agree on. When firms or people borrow, things sometimes do not work out as hoped.

4. Bankruptcy law is federal law, not state law. See U.S. Constitution, Art. I, Sec. 8, cl. 4. Its placement there has to do with notions of limits on the territorial power of state courts in our federal system. In a typical credit transaction, for example, a debtor residing in Illinois may borrow money from credit companies located in North Carolina and may own property situated in California. Illinois' power to affect the right of a North Carolina credit company to levy on property located in California may be limited. See, e.g., International Shoe Co. v. Washington, 326 U.S. 310 (1945). This notion applies both to creditor remedies and to discharge. See Ogden v. Saunders, 25 U.S. (12 Wheat.) 212, 358–68 (1827) (discharge under one state's law is no defense to an action brought by citizens of another state in another state's courts). The same problems can be replicated internationally, where, for example, the automatic stay will not affect creditors without "contacts" in the United States from pursuing property outside its borders. Here, comity is necessary. See §304.

5. See, e.g., R. Bork, *The Antitrust Paradox* (1979); R. Posner, *Antitrust Law: An Economic Perspective* (1976); V. Brudney & M. Chirelstein, *Cases and Materials on Corporate Finance* (2d ed. 1979); Libecap & Wiggins, "Contractual Responses to the Common Pool: Prorationing Crude Oil Production," 74 *Am. Econ. Rev.* 87 (1984); S. McDonald, *Petroleum Conservation in the United States* (1970); Friedman, "The Economics of the Common Pool: Property Rights in Exhaustible Resources," 18 *UCLA L. Rev.* 855 (1971).

For any number of reasons—from bad luck, crop failure, unexpected tort liability, dishonesty, or whatever—it is inevitable that some who borrow will not be able to repay what they owe. In a world in which creditors can call on the state to take a debtor's assets from it, it is necessary to establish what to do when debts are greater than assets. Two questions arise: (1) do we place limits on what creditors can take from their debtors; and (2) how do we decide rights among creditors when there are not enough assets to go around?

Much debt-collection law addresses these questions. Bankruptcy law does too, but it does so against the backdrop of other debt-collection law. Indeed, bankruptcy law is an ancillary, parallel system of debt-collection law. That position both defines its usefulness and sets its limits. Bankruptcy law historically has done two things: allowed for some sort of a financial fresh start for individuals and provided creditors with a compulsory and collective forum to sort out their relative entitlements to a debtor's assets. The policy relating to discharge and notions of a fresh start does in fact represent an independent substantive policy that is enacted through bankruptcy law and that must be balanced with other concerns, most notably the notion of open access to the credit markets in the first place. It addresses the question of whether limits should be established on what creditors can get from their debtor.

This substantive policy of a financial fresh start, although important when dealing with debtors who are human beings, is, however, also limited in an important respect. When firms rather than individuals are involved, neither bankruptcy law nor other law places limits on what creditors can get from their "debtor" precisely because the debtor is a fictional legal being. To talk about the need of a corporation or other business entity to use bankruptcy in order to have a fresh start is to conflate a number of issues, none of which have anything to do with giving an honest but unlucky individual a second financial chance. We might care that the assets of a corporation be used effectively, but how assets are used is a question distinct from giving those individuals who "own" them a second chance. There is no need to give a corporate charter a fresh start. When the unit involved is a corporation, the "debtor" is always shorthand terminology for something else—shareholders, managers, workers, or whatever—and we should realize that this something else is what we are talking about. The question of why we give individuals the right to a financial fresh start—and one that they cannot waive by contract (although they can in fact waive it, and a number of other rights, in other ways—such as by commiting murder)—is, to be sure, important,

and its answer is somewhat uncertain and controversial. We will return to it in Chapter 10.

For the discussion in the first nine chapters of this book, I set aside the question of a financial fresh start for individuals. The statement that a corporation needs a fresh start reflects something very different—the view that the corporation should continue what it is doing. That issue is one of how assets should be used by those that own them, not one of giving a human being a right to renew his financial life.

The question of how assets are used is the focus of the other principal role of bankruptcy law, and working out its implications will consume our attention for the first nine chapters of this book. This role of bankruptcy law—historically its original function—is that of bankruptcy as a collective debt-collection device, and it deals with the rights of creditors (or owners) inter se. But it is first necessary to be precise what that means. Once one sets aside the question of the need of individuals for a financial fresh start, the remaining principal role of bankruptcy law has been and should be more procedural than substantive. That goal is to permit the owners of assets to use those assets in a way that is most productive to them *as a group* in the face of incentives by individual owners to maximize their own positions. Not all debt-collection rules are created equal. The rules governing debt collection can actually affect the total amount of the assets available to the creditors. When one is dealing with firms, the question is how to convert ownership of the assets from the debtor to its creditors, not how to leave assets with the debtor. But the process of conversion is costly. Bankruptcy law, at its core, is concerned with reducing the costs of conversion. This is the accepted starting point of bankruptcy law—and also the source of the limitations on what bankruptcy law should do. It is that goal, to which the bulk of bankruptcy law and the majority of the provisions of the Bankruptcy Code are devoted, and its associated limitations to which we turn first.[6]

6. One working assumption needs to be set forth. The lessons of the normative model I will be using in the first nine chapters are sometimes dismissed by people who believe that they are based on "unrealistic" assumptions and, particularly, that they assume a degree of rationality or calculation that simply is not present. In their present form, however, none of these criticisms is focused enough to justify dismissal of this normative model. Cognitive and volitional shortcomings are more relevant to an analysis of individual behavior—the sort of behavior that discharge deals with—than to an examination of institutional or market behavior. Investments by firms do have market constraints. Firms that systematically act impulsively or underestimate the risks of investments might, to be sure, be weeded out and replaced by firms that calculate risks more carefully. The result seems, however, to be welcome, not undesirable. Remember that the financial failure of

a corporation is distinct from the financial failure of the individuals who own it. When focusing on the latter question, we are in the realm of a financial fresh start for individuals, a topic we put aside for now. As for the former question, there is not much reason to think that the cognitive or volitional biases of individuals will lead to any systematic bias in the market's pricing mechanisms. If, for example, such behavior leads individual investors to react overly enthusiastically to a biotechnology firm's latest public offering, more skilled investors will be able to capitalize on that. Because of the likely presence of such skilled investors, aggregate (that is, marketplace) price levels at the end of the day should show no sign of any systematic underestimation of risks. It is that factor that allows us to defer an examination of individual factors until Chapter 10.

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The Role of Bankruptcy Law and Collective Action in Debt Collection

BANKRUPTCY LAW and policy have been subject to long-standing debate. This debate is not so much about whether bankruptcy law should exist at all but about how much it should do. All agree that it serves as a collective debt-collection device. Whether, when firms are involved, it should do more is the crux of the dispute. I plan to start by establishing in this chapter what accepted wisdom already acknowledges—that bankruptcy's system of collectivized debt collection is, in principle, beneficial. Most of this book will then be concerned with exploring how that benefit can be realized and, as importantly, how viewing bankruptcy as a collectivized debt-collection device imposes limits on what else bankruptcy can do well. It is in the latter area that the most conflict arises. It exists because bankruptcy analysts have failed to follow through on the first principles of establishing a collectivized debt-collection system. To show why bankruptcy's principal role limits what other functions it can usefully perform is the objective of this book. Toward that end we shall first examine why bankruptcy law *should* be doing what everyone takes as a given.

Bankruptcy law is a response to credit. The essence of credit economies is people and firms—that can be called *debtors*—borrowing money. The reasons for this are varied. In the case of individuals credit may serve as a device to smooth out consumption patterns by means of borrowing against future income. In the case of corporations and other firms it may be a part of a specialization of financing and investment decisions. And just as the reasons for borrowing are varied, so, too, are the methods. The prototype creditor may be a bank or other financial institution that lends money, but that is only one of many ways in which credit is extended. An installment seller extends credit. So does a worker

who receives a paycheck on the first of December for work performed in November. The government, in its role as tax collector, also extends credit to the extent that taxes accrue over a year and are due at the end. Similarly, a tort victim who is injured today and must await payment until the end of a lawsuit extends credit of sorts, although involuntarily and (probably) unhappily. Finally, credit is not extended just by "creditors." First-round purchasers of common and preferred stock of a corporation are also lending money to the debtor. Their repayment rights are distinct (they are the residual claimants), but it is proper to view them, too, as having defined rights to call on the assets of the debtor for payment.

Whatever the reasons for lending and whatever its form, the terms on which consensual credit is extended depend to a substantial extent on the likelihood of voluntary repayment and on the means for coercing repayment.[1] We are not concerned here with the means for getting paid when the debtor is solvent—when it has enough assets to satisfy all its obligations in full—but is simply mean-spirited or is genuinely disputing whether it has a duty of payment (as the debtor might be with our putative tort victim or with a supplier who the debtor believes sold it defective goods). The legal remedies for coercing payment when the debtor is solvent concern the rights of a creditor to use the power of the state in pursuit of its claim. This is a question of debtor-creditor law and one to which bankruptcy law historically has had nothing to add, directly at least.

Bankruptcy law can be thought of as growing out of a distinct aspect of debtor-creditor relations: the effect of the debtor's obligation to repay Creditor A on its remaining creditors. This question takes on particular bite only when the debtor does not have enough to repay everyone in full. Even then, however, a developed system exists for paying creditors without bankruptcy.[2] The relevant question is whether that existing system of creditor remedies has any shortcomings that might be ameliorated by an ancillary system known as bankruptcy law.

To explore that question, it is useful to start with the familiar. Creditor

1. The terms of involuntary credit, such as tort claims (and perhaps things such as tax claims, too), are not set by negotiation and thus are less likely to be affected by matters such as the likelihood of voluntary repayment or the means for coercing repayment. Other interests, such as the deterrent effect of tort rules, may, however, be affected. See Schwartz, "Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship," 14 *J. Legal Studies* 689 (1985); Halpern, Trebilcock, & Turnbull, "An Economic Analysis of Limited Liability in Corporation Law," 30 *U. Toronto L. Rev.* 117 (1980); Note, "Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times," 36 *Stan. L. Rev.* 1045 (1984).

2. See generally S. Riesenfeld, *Creditors' Remedies and Debtors' Protection* (3d ed. 1979).

remedies outside of bankruptcy (as well as outside other formal, non-bankruptcy collective systems) can be accurately described as a species of "grab law," represented by the key characteristic of first-come, first-served. The creditor first staking a claim to particular assets of the debtor generally is entitled to be paid first out of those assets.[3] It is like buying tickets for a popular rock event or opera: the people first in line get the best seats; those at the end of the line may get nothing at all.

When the issue is credit, the ways that one can stake a place in line are varied. Some involve "voluntary" actions of the debtor: the debtor can simply pay a creditor off or give the creditor a security interest in certain assets that the creditor "perfects" in the prescribed manner (usually by giving the requisite public notice of its claim).[4] In other cases a creditor's place in line is established notwithstanding the lack of the debtor's consent: the creditor can, following involvement of a court, get an "execution lien" or "garnishment" on the assets of the debtor.[5] Or, sometimes, a place in line may simply be given to a particular claimant by governmental fiat, in the form of a "statutory lien" or similar device.[6]

Although the *methods* for establishing a place in line are varied, the fundamental ordering principle is the same. Creditors are paid according to their place in line for particular assets. With a few exceptions, moreover, one's place in line is fixed by the time when one acquires an interest in the assets and takes the appropriate steps to publicize it.[7] A solvent debtor is like a show for which sufficient tickets are available to accom-

3. See generally Baird, "Notice Filing and the Problem of Ostensible Ownership," 12 *J. Legal Studies* 53 (1983).

4. In real estate this generally requires the recording of a deed of trust or mortgage with the applicable county recorder. With personal property, governed by Article 9 of the Uniform Commercial Code, it generally requires either the filing of a financing statement in the applicable office or offices or possession of the property by the secured party. See Uniform Commercial Code §§9-302 through 9-305; 9-401 (1978).

5. *Execution lien* generally refers to the lien that arises at or around the time the sheriff, following a judgment and the issuance of a writ of execution, seizes property. With respect to real property, the applicable lien is sometimes called a *judgment lien,* and it arises upon docketing of the judgment in the applicable files. With respect to many kinds of intangible personal property, such as an employer's obligation to pay wages to a debtor or a bank's obligation to pay money the debtor has on deposit with the bank, the applicable lien is called a *garnishment lien,* and it arises upon the serving of a writ of garnishment on the employer or bank, as the case may be. A brief survey of the details of creditor collection may be found in D. Baird & T. Jackson, *Cases, Problems, and Materials on Bankruptcy* ch. 1 (1985).

6. The most common label is *statutory lien,* although other terms (such as *statutory trust*) are commonly used. See Selby v. Ford Motor Co., 590 F.2d 642 (6th Cir. 1979). This point is discussed more fully in Chapter 4.

7. See, for example, the rules for New York, contained in N.Y. CPLR §§5202, 5203, 5232, 5234(b), 5236.

modate all prospective patrons and all seats are considered equally good. In that event one's place in line is largely a matter of indifference. But when there is not enough to go around to satisfy all claimants in full, this method of ordering will define winners and losers based principally on the time when one gets in line.

The question at the core of bankruptcy law is whether a *better* ordering system can be devised that would be worth the inevitable costs associated with implementing a new system. In the case of tickets to a popular rock event or opera, where there must be winners and losers, and putting aside price adjustments,[8] there may be no better way to allocate available seats than on a first-come, first-served basis. In the world of credit, however, there are powerful reasons to think that there *is* a superior way to allocate the assets of an insolvent debtor than first-come, first-served.

The basic problem that bankruptcy law is designed to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors *as a group* when there are not enough assets to go around. Because creditors have conflicting rights, there is a tendency in their debt-collection efforts to make a bad situation worse. Bankruptcy law responds to this problem. Debt-collection by means of individual creditor remedies produces a variant of a widespread problem. One way to characterize the problem is as a multiparty game—a type of "prisoner's dilemma."[9] As such, it has elements of what game theorists would describe as an *end period* game, where basic problems of cooperation are generally expected to lead to undesirable outcomes for the group of players as a whole.[10] Another

8. When a show is oversubscribed at a given price, and barring effective scalping laws, people who are first in line can resell the tickets at the market-clearing price. An upward price adjustment by the promoter in the ticket price may simply allow him (rather than those in line) to collect the difference. Although price adjustments arguably are superior to standing in line as a way of allocating tickets to a show, it is a solution that we can safely put aside for our purposes. The ultimate aim of creditor collection devices is collection of money. At the time of collection (as opposed to when the money is loaned, when it may make sense to take a lower interest rate in exchange for security—a place at the front of the line), paying money to improve one's place in line is simply a pointless swap of money for money.

9. A "prisoner's dilemma" rests (as does a common pool problem) on three essential premises. One, that the participants are unable (for one reason or another) to get together and make a collective decision. Two, that the participants are selfish (or cold and calculating) and not altruistic. Three, that the result reached by individual action is worse than a cooperative solution. See A. Rapoport & A. Chammah, *Prisoner's Dilemma* (1965).

10. When one expects that the game will be played an infinite number of times, cooperation may be the best strategy—which contradicts one of the premises necessary to

way of considering it is as a species of what is called a *common pool* problem, which is well known to lawyers in other fields, such as oil and gas.[11]

This role of bankruptcy law is largely unquestioned. But because this role carries limits on what *else* bankruptcy law can do, it is worth considering the basics of the problem so that we understand its essential features before examining whether and why credit may present that problem. The vehicle will be a typical, albeit simple, common pool example. Imagine that you own a lake. There are fish in the lake. You are the only one who has the right to fish in that lake, and no one constrains your decision as to how much fishing to do. You have it in your power to catch all the fish this year and sell them for, say, $100,000.[12] If you did that, however, there would be no fish in the lake next year. It might be better for you—you might maximize your total return from fishing—if you caught and sold some fish this year but left other fish in the lake so that they could multiply and you would have fish in subsequent years. Assume that, by taking this approach, you could earn (adjusting for inflation) $50,000 each year. Having this outcome is like having a perpetual annuity paying $50,000 a year. It has a present value of perhaps $500,000. Since (obviously, I hope) when all other things are equal, $500,000 is better than $100,000, you, as sole owner, would limit your fishing this year unless some other factor influenced you.[13]

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create a prisoner's dilemma. See R. Axelrod, *The Evolution of Cooperation* (1984); Hirshleifer, "Evolutionary Models in Economics and Law: Cooperation Versus Conflict Strategies," in 4 *Research in Law and Economics* 1 (1982). This is not true, however, when the number of times the game will be played has a known finite horizon. It then takes on the attributes of an end period game, where the dominant strategy is selfish behavior. See R. Axelrod, supra. Although insolvency may signal an end to relationships with one debtor, many creditors will still favor cooperation because of repeat dealings with each other. But not all will expect such repeat dealings, and destructive races to assets can be caused by a few "bad apples." I analyzed bankruptcy as a prisoner's dilemma in Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain," 91 *Yale L.J.* 857 (1982).

11. See Hardin, "The Tragedy of the Commons," 162 *Science* 1243 (1968); Libecap & Wiggins, "Contractual Responses to the Common Pool: Prorationing Crude Oil Production," 74 *Am. Econ. Rev.* 87 (1984); Friedman, "The Economics of the Common Pool: Property Rights in Exhaustible Resources," 18 *UCLA L. Rev.* 855 (1971).

12. This discussion assumes no costs—or, more precisely, nets them out; nothing in the example, however, turns on that. It also assumes that you are interested in fish only for the money they bring you; as we will see later, nothing really turns on that assumption either.

13. These other factors are likely to be few in number. If you thought you would die next year, you could still transmit your fishing rights to your children or sell them for $500,000, buying $100,000 of fish from other sources, and giving $400,000 to some other charity. Only if you (and anyone who might buy your rights) were convinced that the

But what if you are not the only one who can fish in this lake? What if a hundred people can do so? The optimal solution has not changed: it would be preferable to leave some fish in the lake to multiply because doing so has a present value of $500,000. But in this case, unlike that where you have to control only yourself, an obstacle exists in achieving that result. If there are a hundred fishermen, you cannot be sure, by limiting *your* fishing, that there will be any more fish next year, unless you can also control the others. You may, then, have an incentive to catch as many fish as you can today because maximizing your take this year (catching, on average, $1,000 worth of fish) is better for you than holding off (catching, say, only $500 worth of fish this year) while others scramble and deplete the stock entirely.[14] If you hold off, your aggregate return is only $500, since nothing will be left for next year or the year after. But that sort of reasoning by each of the hundred fishermen will mean that the stock of fish will be gone by the end of the first season. The fishermen will split $100,000 this year, but there will be no fish—and no money—in future years. Self-interest results in their splitting $100,000, not $500,000.

What is required is some rule that will make all hundred fishermen act as a sole owner would. That is where bankruptcy law enters the picture in a world not of fish but of credit. The grab rules of nonbankruptcy law and their allocation of assets on the basis of first-come, first-served create an incentive on the part of the individual creditors, when they sense that a debtor may have more liabilities than assets, to get in line today (by, for example, getting a sheriff to execute on the debtor's equipment), because if they do not, they run the risk of getting nothing. This decision by numerous individual creditors, however, may be the wrong decision for the creditors as a group. Even though the debtor is insolvent, they might be better off if they held the assets together. Bank-

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world would end next year or that the government would confiscate your rights next year without compensation might your optimal strategy be to catch all the fish you could this year. In calculating how much fishing to do this year, you would need to weigh numerous factors and would undoubtedly face a number of uncertainties. You would, for example, be estimating reproduction and death rates of the fish, the likelihood of factors such as acid rain affecting future crops of fish, and the like. Thus, in assessing how much to fish, you would face a probability distribution, and one with some degree of uncertainty. You would also face a problem of controlling yourself once you made this decision. None of this, however, undercuts the point in text: you would try to take the course that you thought would bring you the greatest return, in present value terms.

14. Note that this, like the prisoner's dilemma, assumes that you are selfish, not altruistic. Where there are a hundred fishermen, it only takes one selfish one to upset the altruism of the others. Thus, the assumption seems quite reasonable.

ruptcy provides a way to make these diverse individuals act as one, by imposing a *collective* and *compulsory* proceeding on them. Unlike a typical common pool solution, however, the compulsory solution of bankruptcy law does not apply in all places at all times. Instead, it runs parallel with a system of individual debt-collection rules and is available to supplant them when and if needed.

This is the historically recognized purpose of bankruptcy law and perhaps is none too controversial in itself. Because more controversial limits on bankruptcy policy derive from it, however, less allegorical and more precise analysis is necessary. Exactly *how* does bankruptcy law make creditors as a group better off? To find the answer to that question, consider a simple hypothetical example involving credit, not fish. Debtor has a small printing business. Potential creditors estimate that there is a 20 percent chance that Debtor (who is virtuous and will not misbehave) will become insolvent through bad luck, general economic downturn, or whatever. (By insolvency, I mean a condition whereby Debtor will not have enough assets to satisfy his creditors.[15]) At the point of insolvency—I shall make this very simple—the business is expected to be worth $50,000 if sold piecemeal. Creditors also know that each of them will have to spend $1,000 in pursuit of their individual collection efforts should Debtor become insolvent and fail to repay them. Under these circumstances Debtor borrows $25,000 from each of four creditors, Creditors 1 through 4. Because these creditors know that there is this 20 percent chance, they can account for it—and the associated collection costs—in the interest rate they charge Debtor. Assume that each party can watch out for its own interest, and let us see whether, as in the example of fishing, there are reasons to think that these people would favor a set of restrictions on their own behaior (apart from paternalism or other similar considerations).

Given that these creditors can watch out for their own interests, the question to be addressed is *how* these creditors should go about protecting themselves. If the creditors have to protect themselves by means of a costly and inefficient system, Debtor is going to have to pay more to obtain credit.[16] Thus, when we consider them all together—Creditors 1

15. This is, by the way, almost precisely the definition of insolvency in the Bankruptcy Code. Section 101(29) defines insolvent as "with reference to an entity other than a partnership, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—(i) property tranferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and (ii) property that may be exempted from property of the estate under section 522 of this title."

16. The extent to which this adjustment will result in the costs being fully transferred

through 4 *and* Debtor—the relevant question is: would the availability of a bankruptcy system reduce the costs of credit?

This requires us to try to identify what bankruptcy's advantages might plausibly be. Identification of abstract advantages is not, however, the end of the issue. One must also compare those possible advantages with the costs of having a bankruptcy system. Determining whether a bankruptcy system would reduce the cost of credit requires a net assessment of charges.

But first the case for bankruptcy's advantages. The common pool example of fish in a lake suggests that one of the advantages to a collective system is a larger aggregate pie. Does that advantage exist in the case of credit? When dealing with businesses, the answer, at least some of the time, would seem to be "yes." The use of individual creditor remedies may lead to a piecemeal dismantling of a debtor's business by the untimely removal of necessary operating assets. To the extent that a nonpiecemeal collective process (whether in the form of a liquidation or reorganization) is likely to increase the aggregate value of the pool of assets, its substitution for individual remedies would be advantageous to the creditors as a group. This is derived from a commonplace notion: that a collection of assets is sometimes more valuable together than the same assets would be if spread to the winds. It is often referred to as the surplus of a going-concern value over a liquidation value.

Thus, the most obvious reason for a collective system of creditor collection is to make sure that creditors, in pursuing their individual remedies, do not actually decrease the aggregate value of the assets that will be used to repay them. In our example this situation would occur when a printing press, for example, could be sold to a third party for $20,000, leaving $30,000 of other assets, but the business as a unit could generate sufficient cash so as to have a value of more than $50,000.[17] As such it

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back to the debtor depends on the elasticities of supply of and demand for credit. See Meckling, "Financial Markets, Default, and Bankruptcy: The Role of the State," 41 *Law & Contemp. Probs.* 13 (Autumn 1977); Weston, "Some Economic Fundamentals for an Analysis of Bankruptcy," 41 *Law & Contemp. Probs.* 47 (Autumn 1977).

17. The reasons for this result are complex. The assumption is that the printing press is worth only $20,000 in the hands of a third party but more in the hands of Debtor. If this is so, however, one might think that the third party could then turn and sell the press to Debtor for more than $20,000 (making its value in the hands of the third party more than $20,000). Indeed, pursuing this path leaves one with the question of why there would have been a default in the first place. See Klein, Crawford, & Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," 21 *J. L. & Econ.* 297, 298–299 (1978). Suffice it to say, for our purposes, that informational and transactional barriers are often sufficient to permit this discrepancy to exist.

is directly analogous to the case of the fish in the lake. Even in cases in which the assets should be sold and the business dismembered, the aggregate value of the assets may be increased by keeping groups of those assets together (the printing press with its custom dies, for example) to be sold as discrete units.

This advantage, however, is not the only one to be derived from a collective system for creditors. Consider what the creditors would get if there were no bankruptcy system (putting aside the ultimate collection costs). Without a collective system all of the creditors in our example know that in the case of Debtor's insolvency the first two creditors to get to (and through) the courthouse (or to Debtor, to persuade Debtor to pay voluntarily), will get $25,000, leaving nothing for the third and fourth. And unless the creditors think that one of them is systematically faster (or friendlier with Debtor), this leaves them with a 50 percent chance of gaining $25,000, and a 50 percent chance of getting nothing.[18] A collective system, however, would ensure that they would each get $12,500.

Would the creditors agree in advance to a system that, in the event of Debtor's insolvency, guaranteed them $12,500, in lieu of a system that gave them a 50 percent chance of $25,000—payment in full—and a 50 percent chance of nothing? Resolution of this question really turns on whether the creditors are better off with the one than the other. There are two reasons to think that they are, even without looking to the question of a going-concern surplus and without considering the costs of an individual collection system. First of all, if these creditors are risk averse, assurance of receiving $12,500 is better than a 50 percent chance of $25,000 and a 50 percent chance of nothing. Even if they can diversify the risk—by lending money to many people—it is probably preferable to eliminate it in the first place.[19] This, then, represents a net advantage to having a collective proceeding.

18. These assumptions may not matter to the actual conclusion. Because of the "race," many of the special advantages one creditor holds may be worthless. Participation in or monitoring against the race will be costly for *all* creditors. In any event there will be residual elements of uncertainty of relative rankings that could be eliminated to the benefit of all creditors. Finally, there would be distinct advantages to a legal rule that presumed equality in the position of all creditors with similar legal entitlements, instead of delving into a case-by-case examination of factors such as "knowledge" or "friendliness." See Chapter 2.

19. Not all creditors, moreover, can achieve the requisite degree of diversification in a cost-effective way. The amount of diversification required to minimize the uncertainty cost may be quite large. See Langbein & Posner, "Market Funds and Trust Investment Law," 1976 *Am. B. Found. Research J.* 1.

One other possible advantage of a collective proceeding should also be noted: there may be costs to the individualized approach to collecting (in addition to the $1,000 collection costs).[20] For example, since each creditor knows that it must "beat out" the others if it wants to be paid in full, it will spend time monitoring Debtor and the other creditors—perhaps frequently checking the courthouse records—to make sure that it will be no worse than second in the race (and therefore still be paid in full). Although some of these activities may be beneficial, many may not be; they will simply be costs of racing against other creditors, and they will cancel each other out. It is like running on a treadmill: you expend a lot of energy but get nowhere. If every creditor is doing this, each one *still* does not know if there is more than a fifty-fifty chance that it will get paid in full. But in one sense, unless the creditors can negotiate a deal with each other, the creditors have no choice. Each creditor has to spend this money just to stay in the race because if it does not, it is a virtual certainty that the others will beat it to the payment punch. Of course, a creditor could decide that it did not want to stay in the race, and just charge Debtor at the time of lending the money for coming in last should Debtor become insolvent. Debtor is not likely, however, to agree to pay a creditor that extra charge for having a lower priority provision, because, once paid that extra amount, the creditor may have an incentive to take steps to remain in the race and make money that way.[21] For that reason it may be hard for a creditor to opt out of the race and get compensated for doing so.

These various costs to using an individual system of creditor remedies suggest that there are, indeed, occasions when a collective system of debt-collection law might be preferable. Bankruptcy provides that system. The single most fruitful way to think about bankruptcy is to see it as ameliorating a common pool problem created by a system of individual

20. The costs of individual creditor remedies, as posited in the example, is $4,000 for the creditors (and presumably some additional costs for the debtor). Bankruptcy costs may (but need not necessarily) be less. The most likely case for cost savings would be where the creditors would attempt to collect their claims at roughly the same time, as one would expect to occur when it was learned that Debtor was insolvent. A single inquiry into recurring collection questions is likely to be less expensive (both for the creditors and for the debtor) than the multiple inquiries necessary in an individualistic remedies system. See Weistart, "The Costs of Bankruptcy," 41 *Law & Contemp. Probs.* 107 (Autumn 1977). Other costs to the bankruptcy process are examined in Chapter 8.

21. The creditor could covenant to subordinate this loan, and the others might be viewed as third-party beneficiaries of that contract, thereby making it enforceable. But the solution has costs of its own, unless the creditor can control Debtor's intake of credit.

creditor remedies. Bankruptcy provides a way to override the creditors' pursuit of their own remedies and to make them work together.[22]

This approach immediately suggests several features of bankruptcy law. First, such a law must usurp individual creditor remedies in order to make the claimants act in an altruistic and cooperative way. Thus, the proceeding is inherently *collective*. Moreover, this system works only if all the creditors are bound to it. To allow a debtor to contract with a creditor to avoid participating in the bankruptcy proceeding would destroy the advantages of a collective system. So the proceeding must be *compulsory* as well. But unlike common pool solutions in oil and gas or fishing, it is not the exclusive system for dividing up assets. It, instead, supplants an existing system of individual creditor remedies, and as we shall see, it is this feature that makes crucial an awareness of its limitations.

Note that the presence of a bankruptcy system does not mandate its use whenever there is a common pool problem. Bankruptcy law stipulates a minimum set of entitlements for claimants. That, in turn, permits them to "bargain in the shadow of the law" and to implement a consensual collective proceeding outside of the bankruptcy process.[23] Because use of the bankruptcy process has costs of its own (as we shall see in Chapter 8), if creditors can consensually gain the sorts of advantages of acting collectively that bankruptcy brings, they could avoid those costs. Accordingly, one would expect that consensual deals among creditors outside the bankruptcy process would often be attempted first. The formal bankruptcy process would presumably be used only when individual advantage-taking in the setting of multiparty negotiations made a consensual deal too costly to strike—which may, however, occur frequently as the number of creditors increases.

These problems with optimal uses of bankruptcy are the subject of Chapter 8. It is possible that the rules specifying when a bankruptcy

22. As such, it reflects the kind of contract that creditors would agree to if they were able to negotiate with each other before extending credit. This is an application of the famous Rawlsian notion of bargaining in the "original position" behind a "veil of ignorance." See J. Rawls, *A Theory of Justice* 136–42 (1971).

23. See Mnookin & Kornhauser, "Bargaining in the Shadow of the Law: The Case of Divorce," 88 *Yale L.J.* 950 (1979). Nonbankruptcy "workouts" are in fact commonly observed. See "The Business in Trouble—A Workout without Bankruptcy," 39 *Bus. Law.* 1041 (1984); Coogan, Broude, & Glatt, "Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills," 30 *Bus. Law.* 1149, 1154–60 (1975); Krause, "Insolvent Debtor Adjustments under Relevant State Court Statutes as against Proceedings under the Bankruptcy Act," 12 *Bus. Law.* 184, 185 (1957).

petition may be filed prevent the commencement of a collective proceeding until it is too late to save the debtor's assets from the self-interested actions of various creditors. Another possibility, however, is that the collective proceeding will begin too soon. Forcing all the creditors to refrain from individual actions (many of which have the effect of monitoring the debtor and preventing it from misbehaving) brings its own costs. Thus, to say that bankruptcy is designed to solve a common pool problem is not to tell us how to design the rules that do that well. These concerns do not, however, undermine the basic insight of what bankruptcy law is all about.

Like all justifications, moreover, this one is subject to a number of qualifications. To say that a common pool problem exists is not to say that individual behavior is entirely self-interested or that legal rules can solve all collective action problems. We often observe people behaving in a cooperative fashion over time even if it appears contrary to their short-run interest.[24] In the credit world, for example, creditors do not always rush to seize a debtor's assets whenever it seems to be in financial trouble. Yet despite this qualification the underlying point remains: sometimes people behave in a self-interested way and would be better off as a group if required to work together. The tragedy of the Texas oil fields in the first half of this century is a notable example of how self-interest led to the depletion of oil that otherwise could have been enjoyed by the group of oil field owners.[25] Creditor relations almost certainly are another area where this essential truth has validity, especially given the fact that creditors may have fewer incentives to cooperate when a debtor is failing than they do when there are greater prospects of repeat dealings with a debtor.

Nor can we be confident that the bankruptcy rules themselves do not create problems. They do, and we will examine later how they should be dealt with. Because these complications play out against a backdrop of basic bankruptcy principles, however, it is preferable for now to make two simplifying assumptions. The first assumption is that insolvency occurs without warning. By this assumption, we eliminate consideration of strategic behavior that is likely to exist when some creditors sense the imminent likelihood of bankruptcy's collective proceeding and attempt to avoid it. This assumption will be relaxed in Chapter 6. The second assumption is that bankruptcy proceedings take no time. By this assumption, we can set aside problems that occur through the passage of

24. Some of the reasons for this are explored in R. Axelrod, supra note 10.

25. See D. Glasner, *Politics, Prices and Petroleum* 32, 143–43 (1985); S. McDonald, *Petroleum Conservation in the United States: an Economic Analysis* 31–42 (1971).

time and the fact that this passage of time affects various claimants in different ways. We can also set aside the complications that result from a debtor's need to encourage people to deal with it while in bankruptcy and the fact that some of these people may wear both prepetition and postpetition hats. This assumption will be relaxed in Chapter 7.

Although imposing these two assumptions is, of course, somewhat unrealistic, doing so clarifies several key features of bankruptcy law. We can later extend our examination by making the inquiry somewhat more realistic. For now, however, it is sufficient to ask whether there is in fact a common pool problem that cannot be solved by creditors contracting among themselves. If the number of creditors is sufficiently small and sufficiently determinate, it may be possible for them to negotiate a solution at the time of insolvency that would avoid many, if not most, of the costs of an individual remedies system,[26] even if they were not bargaining in the shadow of the law. But in cases in which there are large numbers of creditors or the creditors are not immediately known at a particular time (perhaps because they hold contingent or nonmanifested claims), the ability of the creditors to solve the problem of an individual remedies system by an actual agreement may be lost. Bankruptcy provides the desired result by making available a collective system after insolvency has occurred.[27] It is the implications of that view of bankruptcy law that we can now begin to explore.

26. See Hoffman & Spitzer, "Experimental Tests of the Coase Theorem with Large Bargaining Groups," 15 *J. Legal Studies* 149 (1986); Libecap & Wiggins, supra note 11.

27. Bankruptcy is not the only possible legal response. One might imagine a less intrusive one to be a system whereby a debtor could decide whether to agree to allow its assets to be subject to a collective remedies system (such as bankruptcy law) by choice, made public by a nonretractable public filing. If such an election were virtually universal, a legal system such as our current bankruptcy law might be easier to administer.