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## ESSAY

# BANKRUPTCY POLICYMAKING IN AN IMPERFECT WORLD

*Elizabeth Warren\**

### INTRODUCTION

Conclusions about the bankruptcy system are not in short supply. A cursory review of both the academic literature and the popular press coverage of bankruptcy in just the past year suggests alternatively that the system is excessively costly, has failed miserably, requires substantial amendment, should be repealed, operates effectively in most cases, is internally inconsistent, provides an important opportunity to save failing businesses, and is manipulated for inappropriate purposes. Some charges may be true, and some may not. Embedded within each claim, however, are presumptions about the policy objectives of the bankruptcy system — presumptions that commentators neither fully articulate nor defend. If some of those presumed policy objectives are problematic, then any evaluation based on them is necessarily problematic as well.

Why have a bankruptcy system? What function is it designed to serve? To argue whether it is costly, whether it is failing, or whether it should be reshaped, amended, or scrapped, some joinder over what the system is designed to do is essential. A success by one normative measure may be a failure by another. As a result, many of the current debates are not about proposed recommendations so much as they are debates by proxy over the premises imbedded within those recommendations about whether to have a bankruptcy system at all.

Notwithstanding an avalanche of writing about bankruptcy and the intensity of feelings bankruptcy laws evoke, a thoughtful articulation of bankruptcy policy has fallen on somewhat hard times. Douglas Baird and Thomas Jackson have led a skilled, but narrow law-and-economics challenge to the bankruptcy laws, arguing for greater effi-

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\* William A. Schnader Professor of Commercial Law, University of Pennsylvania. B.S. 1970, Houston; J.D. 1976, Rutgers, Newark.—Ed. I am grateful for the detailed comments I received from Lucian Bebchuk, Duncan Kennedy, and Kenneth Klee on earlier drafts of this essay, and the helpful discussion with the Law and Economics Workshop at Harvard Law School. I also appreciate the research assistance of Mark Hageman, Harvard Law School Class of 1993. This essay is better for all their efforts.

ciency here and there in their relentless march through the various sections of the Bankruptcy Code.<sup>1</sup> They employ a theoretical approach that values enhanced allocative efficiency, as measured by certain factors they identify.<sup>2</sup> Others, such as Lucian Bebchuk and Mark Roe, have specified particular inefficiencies with greater clarity and proposed innovative alternative approaches.<sup>3</sup> A number of scholars have resisted the Baird and Jackson effort to define the bankruptcy debate with passing disapproval of the Bebchuk and Roe positions,<sup>4</sup>

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1. E.g., THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986) (describing a systematic treatment of multiple provisions of the Code); Douglas G. Baird, *The Uneasy Case for Corporate Reorganization*, 15 J. LEGAL STUD. 127 (1986) (questioning the usefulness of chapter 11); Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988) (analyzing absolute priority rules in chapter 11); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984) [hereinafter Baird & Jackson, *Corporate Reorganizations*] (analyzing adequate protection in chapter 11); Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985) (analyzing fraudulent conveyance rule in leveraged buyouts); Douglas G. Baird & Thomas H. Jackson, *Kovacs and Toxic Wastes in Bankruptcy*, 36 STAN. L. REV. 1199 (1984) (analyzing claims in chapter 11); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989) (discussing salvage and the common-pool problem in chapter 11).

2. Baird and Jackson are primarily interested in the "creditors' bargain heuristic," an analytic device that focuses on the liquidation and reorganization rights for which creditors would have negotiated *ex ante* in a no-transactions bargaining environment. Robert E. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U. CHI. L. REV. 690 (1986) (reviewing DOUGLAS G. BAIRD & THOMAS H. JACKSON, *CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY* (1985)); see Baird & Jackson, *Corporate Reorganizations*, *supra* note 1, at 97, 110-11. They believe business failures create conditions under which the self-interested impulses of individual creditors, if left uncontrolled, would place the creditors in costly competition with one another for limited resources. *Id.* at 105-09. Bankruptcy is a device to channel these creditors by force into a coordinated and orderly liquidation of the debtor's assets. Baird and Jackson concede that such a value-enhancing liquidation is a defensible goal of bankruptcy, with the corollary that there is little excuse for a bankruptcy system to reorganize debtors to avoid such a sale. *Id.* The business of bankruptcy is limited to efficient debt collection, not to the rehabilitation of the business debtor or to control over the distribution of the debtor's assets. See, e.g., Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987).

3. See, e.g., Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988) (proposing the issuance of corporate securities to distribute ownership of bankrupt company); Mark Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983) (proposal to issue warrants to distribute value of bankrupt company).

4. See, e.g., Charles W. Adams, *An Economic Justification for Corporate Reorganizations*, 20 HOFSTRA L. REV. 117, 117 (1991) (challenging the conclusions of Baird, Jackson, Roe, and Bebchuk for not attaching "sufficient significance to the transaction costs involved in using the market to raise the capital necessary to reorganize a corporation's capital structure"); David G. Carlson, *Game Theory and Bankruptcy Reorganizations*, 9 BANKR. DEV. J. 219, 220 (1992) (criticizing Baird and Picker game theory for "serious blunders in legal research and a priori reasoning"); David G. Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341 (1987) (criticizing Jackson's assumptions and methodology); Theodore Eisenberg, *A Bankruptcy Machine that Would Go of Itself*, 39 STAN. L. REV. 1519, 1522, 1529 (1987) (observing that Jackson's approach downplays the complexity of state law and fails to place bankruptcy law in the proper social context); Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1216 (1991) (concluding that issues in chapter 11 are more

but the articulation of alternative points of view has not been nearly so coherent and well focused.

The policies we embrace and the models we use to describe the system animate our vision of how the system operates and our conclusions about its successes and failures. If the inquiry over bankruptcy policy becomes nothing more than a debate over allocative efficiency, it will pass over crucial elements of the policy scheme that cannot be so neatly tied up in economic models. An approach that eschews any role for efficiency analysis suffers a similar fate, creating an economic versus noneconomic dichotomy that negates a realistic appraisal of the bankruptcy system.

This essay is about bankruptcy policy. It attempts to articulate a comprehensive statement about the various and competing goals that underlie the bankruptcy system. The essay offers both a positive observation, drawn from the Code and its operation, and a normative evaluation, designed to outline the difficult value judgments that comprise the bankruptcy system. It also serves warning: before commentators propose any sweeping changes or policymakers take seriously any suggestions to scrap the system, they must consider the impact of such proposals on a number of competing normative goals.

My decision to make this piece an essay — short on footnotes and written in moderately plain English — is a deliberate strategic, as well as stylistic, choice. No doubt many of the propositions put forth here could be restated in a fashionable economic lingo, mathematical formulations, or game-theory hypotheses. Such approaches might yield gains in precision that would test the outer reaches of the ideas. It is also possible that much of what I say here could be restated in other ways: with reference to philosophy, political economy, or other scholarly fields from which the ideas might be borrowed, re-formed, and applied by more or less successful analogy. Such approaches might prove my own erudition, and they might add other insights to the discussions as well. But I leave those formulations for another day.

Bankruptcy policy debates suffer enough from communication problems. Not only do some academics seem more interested in discourse-as-war-take-no-prisoners than in the expansion of the collective

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complex than Baird, Jackson, and Roe suggest); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 721 (1991) (arguing that the "economic account [of bankruptcy] is deeply flawed" and the view of what makes it "'distinct' is misguided"); Donald R. Korobkin, *Value and Rationality in Bankruptcy Decisionmaking*, 33 WM. & MARY L. REV. 333 (1992) (making the same argument); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEXAS L. REV. 51, 55, 59 (1992) (arguing creditor's bargain theory ignores reality).

understanding of the bankruptcy system's operation,<sup>5</sup> they also seem to care less and less about any readership outside a handful of other academics.<sup>6</sup> While the latter point might be dismissed as simply a poke at academic snobbery, it has fundamental ramifications for a debate about policy proscriptions. Thoughtful, useful policy debates are informed by a number of perspectives, including those that do not originate within the academic community. The identification of problems and the development of solutions depend on a clear understanding of how the system functions. The role of the academic to provide an abstract model to explain the system or to offer new insights based on deductive reasoning can be enormously valuable. If, however, the academic contribution to the policy debates is deliberately insulated from give-and-take with those who participate in the development and implementation of these laws, such contribution will necessarily be stunted and uninformed.<sup>7</sup>

A robust debate should include a variety of approaches to the questions at hand and a number of different proposals for consideration. Ideas from other disciplines and new generations of contrary thinkers invigorate us. When we talk about bankruptcy policy, however, we also need a center, some sense of shared ideas about the system's purpose. I believe this approach requires an articulation of the normative goals of the system that scholars, practitioners, judges, and legislators can share. Some may shade their description of the system in one direction, and others may explore subset issues in greater detail. In either case, there is little to gain by loud arguments with no joinder

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5. Perhaps my own scholarship, which has been sharply critical of deceptive empirical work, fits within this description. See Teresa A. Sullivan et al., *Limiting Access to Bankruptcy Discharge: An Analysis of the Creditors' Data*, 1983 WIS. L. REV. 1091; Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992) [hereinafter Warren, *Untenable Case for Repeal*]. I like to think those critiques are designed to preserve the marketplace of ideas rather than to destroy it, but I am certain my targets would see that differently. My debates with Professor Baird have been vigorous affairs as well, but our shared aspiration was that the form of point-counterpoint would sharpen the issues — not drive a discussant from the field. See Baird, *supra* note 2; Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 776 (1987). I recognize that I may only flatter myself with my supposed good intentions. I intend here only to express my fear that some of the attacks and counterattacks on the issue of bankruptcy do not seem to advance an understanding of the bankruptcy system so much as they attract attention for the proponent at the expense of thoughtful exchange. I believe the observation is worthy of consideration, even if some readers would characterize me as a miscreant.

6. One scholar working in the commercial law area has repeatedly claimed that he writes only for "seven important people." While I remain amazed that someone would deliberately write for an audience that would fit comfortably into a minivan, I speculate from reading a number of law review articles that they are also written to impress equally small audiences.

7. See John D. Ayer, *So Near to Cleveland, So Far from God: An Essay on the Ethnography of Bankruptcy*, 61 U. CIN. L. REV. 407 (1992) (discussing the tradition in bankruptcy law of prominent academics influencing the bankruptcy system while they maintain close interest in practice).

of issue or by refusals to acknowledge substantial commonality. If we have some shared vision of the enterprise, the odds are greater that we can build on each other's insights and bring our collective intellectual energies to greater fruition — and that we can reduce the energy required to separate out work with little merit.

I am mindful of the discomfort that accompanies normative discussions about policymaking. As Duncan Kennedy has pointed out with some force, our attraction to an efficiency analysis stems from its apparent value-neutral base. It offers us the opportunity to avoid much more uncomfortable discussions about values and politics that inhere in discussions about redistribution and paternalism.<sup>8</sup> But, as Kennedy also demonstrates, the insulation from value judgments that economic analysis offers is illusory, providing only indeterminate solutions.<sup>9</sup> Economic analysis plays a significant role in describing the operation of the bankruptcy system and identifies important normative objectives in the system.<sup>10</sup> Nevertheless, neither the discomfort in articulating the alternative values at stake nor the impossibility of defining an overarching moral theory of behavior excuses those who work with policy questions from dealing with the distributive issues that bankruptcy policy implicates.

The list of policy goals I offer is deliberately open textured. Another reader might divide the list more finely from four items to six or eight or recombine them to two or three. It is also possible that this essay omits aspects of the system such that one could usefully rearticulate it by refining and adding to what is here. The reader, however, should not mistake this flexibility as a suggestion that "anything goes." Such an approach yields little that is useful. The statement of goals this essay presents is intended to be a direct challenge to everyone who worries about the bankruptcy system: Can we live with this definition of the core issues? Will the law-and-economics crowd admit that more than allocative efficiency is at stake? Will everyone else admit to the importance of efficiency analysis? Can we find ways to deal with conflicting goals that will, for example, account for increased inefficiency while meeting important distributive goals? Will a clearer articulation of the spectrum of issues at stake stop the judgments about the effectiveness of the system that conclude so many law review

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8. Duncan Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387 (1981) [hereinafter Kennedy, *Entitlement Problems*]; Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563 (1982).

9. See Kennedy, *Entitlement Problems*, *supra* note 8.

10. Even Kennedy did not argue that all economic analysis should stop. Instead he stated that the notion of efficiency in law and economics "has a limited heuristic usefulness." *Id.* at 444.

articles but that are based only upon a single policy consideration? I hope for some agreement, but, if such a consensus does not come to pass, I hope at least for joinder of issue in our continuing debates.

## I. SETTING THE STAGE FOR A POLICY DISCUSSION: BUSINESS FAILURES AND CONSUMER FAILURES

I begin this essay with the same limitation that Professor Baird and I imposed on our earlier debates: this piece explores the policy aspects of business bankruptcies.<sup>11</sup> The justification for doing so now is the same as it was then: the financial collapse of individuals raises social and economic questions that are far beyond the scope of the issues addressed in this essay. A single bankruptcy code encompasses both business and consumer bankruptcies, and both types of cases employ a common language. Nevertheless, they are in fact two distinct systems operating under very different constraints and moving toward different objectives.<sup>12</sup>

The differences between the two systems are many. Financially troubled individuals cannot be dissolved the way insolvent corporations can, and individual debtors continue to consume and produce while their corporate counterparts may disappear once their assets are disbursed among their creditors. Consumer bankruptcy policy rightly concerns itself with the fresh start in ways that are not nearly so pressing for corporate debtors. Moreover, the incentive effects of bankruptcy laws on families struggling with large mortgages, job layoffs, or overwhelming medical debts are not the same as the incentive effects on companies making investment and asset-deployment decisions that will affect how they meet their environmental cleanup obligations, whether they can fund their pension plans, and how many jobs they will continue to support. Analogies between the two may sometimes be apt, but the circumstances differ sufficiently to justify discrete policy discussions.<sup>13</sup>

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11. This essay is an extension of earlier conversations with Douglas Baird. See Baird, *supra* note 2; Warren, *Bankruptcy Policy*, *supra* note 5.

12. ELIZABETH WARREN & JAY L. WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* (2d ed. 1991), defends, in greater detail, the view that the two systems differ in sufficiently important ways to be treated as two distinct systems. Others have followed that position elsewhere; for example, an increasing number of casebooks distinguish the treatment of consumer cases from that of business cases. See, e.g., JAMES J. WHITE & RAYMOND T. NIMMER, *BANKRUPTCY* (1992) (concentrating almost exclusively on "business bankruptcy").

13. Notwithstanding these obvious differences, the scholarly analysis of bankruptcy frequently blurs this distinction. In the most recent summary of the bankruptcy field, for example, Professors Epstein, Nickles, and White have written a three-volume treatise, DAVID G. EPSTEIN ET AL., *BANKRUPTCY* (1992), that makes the technical aspects of the statute the uniting feature with scant attention to the differences between the bankruptcy of Johns-Manville and Jane Jones. The authors have special sections on the differences between chapter 7, chapter 11, chapter 12,

I reserve questions about individual bankruptcy for my work on individual debtors, which I continue to pursue. A note of reservation is appropriate, however, in identifying the scope of this inquiry. While the consumer-business distinction is critical to understanding the operation of the bankruptcy system, it breaks down at the margins. The line between a small business debtor and an individual debtor is often only a formal distinction. Individuals in bankruptcy are disproportionately the owners of small businesses,<sup>14</sup> and businesses in bankruptcy are overwhelmingly smaller businesses that are not publicly traded.<sup>15</sup> Individual bankruptcy petitions often accompany the smallest business bankruptcies as well, suggesting a significant crossover of policy considerations. Questions about how to deal with the smallest business bankruptcies appropriately also invoke issues about how to deal with their bankrupt owners.

The discussion in this essay takes as its prototype the somewhat larger business, one that operates as more than a single-person unit. Nonetheless, it is important to bear in mind that a small-business, big-business distinction may also be in order. The circumstances of owner-operated businesses may differ from those of larger companies in ways that influence important policy considerations. In small businesses, for example, identity between equity and management is often perfect. Consequently, rules about equity participation in closely held businesses have a very different impact than they would in big businesses, in which professional management teams are not necessarily interested in protecting the interests of equity owners. Similarly, in small businesses the ability to produce value may depend much more critically on the presence of a particular manager, whereas the management teams of larger businesses are more fungible.

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and chapter 13, *id.* §§ 1-8 to 1-10, but they cover most materials without reference to the underlying context in which they arise. While this treatise — intended for practitioners, teachers, and students — makes few policy evaluations, it nonetheless represents the system as a single, unified abstraction. Similarly, a number of casebooks about bankruptcy take the same abstract approach, combining mastery of consumer bankruptcy with mastery of business bankruptcies in a largely seamless web. The exception, in most books, is the identification of the chapter 13 wage-earner plan, which, as a matter of law, is available only to individuals. While authors necessarily get this provision in some context, other provisions mix consumer and business cases at will. See, e.g., ARNOLD B. COHEN & LEON S. FORMAN, *BANKRUPTCY, ARTICLE 9 AND CREDITORS' REMEDIES* (2d ed. 1989).

14. About 20% of the individual debtors in bankruptcy are either currently self-employed or were formerly self-employed at the time they file for bankruptcy. This shows an overrepresentation of failed entrepreneurs in bankruptcy, because only about seven percent of the working population generally is self-employed. TERESA A. SULLIVAN ET AL., *AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA* 111 (1989).

15. Less than one-tenth of one percent of the debtors filing for chapter 11 are publicly traded companies. Warren, *Untenable Case for Repeal*, *supra* note 5, at 441. For a discussion of the differences between the ways in which large and small companies may experience bankruptcy, see *id.* at 442-43.



It may be that the distinctions between small and big businesses are sufficiently important that at some junctures bankruptcy policies would appropriately diverge for different kinds of business debtors.<sup>16</sup> While I do not sustain that distinction throughout these materials, I recognize that, to move from abstraction to application, such a distinction might become increasingly important.

## II. THE FUNCTIONS OF THE BUSINESS BANKRUPTCY SYSTEM

This description of the functions of the business bankruptcy system begins with a factual observation: when a business fails, there is a substantial risk that it will not have sufficient resources to meet all its outstanding obligations. To complicate this problem, businesses rarely fail after neatly wrapping up all their outstanding obligations. Instead, they tend to falter during active, sometimes frantic, operations, leaving contracts in various states of performance and nonperformance; owing past-due bills along with contingent future obligations; and disappointing legions of suppliers, employees, customers, creditors, and others who fear that they will not get all they had expected from their dealings with the debtor. Some entity or group of entities will likely bear the losses of the business' inability to meet its obligations.

It is possible to have a legal regime with no formal bankruptcy system, but it is not possible to avoid legal rules that deal with the consequences of business failure. Some rules must determine the rights of the contract claimants and tort victims, banks and employees, or suppliers and customers when the pool of the debtor's assets rapidly diminishes and the claimants clamor for satisfaction. We might integrate such rules into a single system or scatter them throughout the collection system. We may construct them deliberately or inadvertently. We may also call them "bankruptcy" or "rutabaga" or any other fanciful word. Regardless of these elements, the rules will create a collection system that determines the value of a failing business, how to distribute that value among parties whom the failure affects, and the extent to which affected parties can externalize the costs of failure to others who did not deal with the debtor.

In bankruptcy a single federal system that supersedes state law collection priority rules brings together the collection rules. This system

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16. Professors Baird and Picker and I defend, for example, different rationales for the absolute priority rule in the case of small, closely held businesses and large, publicly held businesses. We disagree on what that policy should be, but we all recognize the different kinds of value a rule should protect in small and large business cases. Compare Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9, 11-19 with Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311 (1991).

aims, with greater or lesser efficacy, toward four principal goals: (1) to enhance the value of the failing debtor; (2) to distribute value according to multiple normative principles; (3) to internalize the costs of the business failure to the parties dealing with the debtor; and (4) to create reliance on private monitoring. In this section, I consider each of these functions in turn, exploring both the normative values at stake and the ways in which the current bankruptcy system implements these goals.

### A. *A System To Enhance Value*

The rules that govern the management of a failing business affect the value of the business. Congress recognized that, if legal rules make it difficult for a troubled firm to survive or if they increase the costs of operation, value will necessarily decline sharply when a firm is in trouble. Conversely, if the rules give the business opportunities to reorganize its debt and offer protection from collecting creditors, the rules will prop up the value of the troubled business.

One of the principal functions of bankruptcy law is to enhance the value of a failing firm. The normative analysis is fairly straightforward: if the rule can increase the value of the failing firm, it will reduce the total costs imposed on the parties dealing with the failing debtor. If the cost of producing the increase in value is less than the value obtained, then the rule has increased net values, which is the desired result.<sup>17</sup>

This goal, which focuses on the allocative efficiency of the bankruptcy system, is implemented through reduction in collection costs and retention of value that a state collection action would otherwise dissipate. The positive analysis is equally straightforward: key elements of the bankruptcy system were created to accomplish this cost savings and value conservation. Congress used four principle devices: (1) development of specialized collection rules; (2) implementation of collective creditor action; (3) reduction in the strategic behavior of debtors and creditors; and (4) preservation of the business' going-concern value.

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17. The business' competitors, however, do not view the survival of a troubled business positively. In the airline industry, for example, more successful airlines want less successful airlines to be put out of business immediately in order to reduce the number of carriers and to increase their own market share. The successful airlines' public relations campaign serves as a reminder that our economic system is deeply interrelated; no disaster is bad for everyone, and no success is good for everyone. In this case, however, decreasing competition so that the survivors can become more profitable is not in line with widely accepted economic or normative principles.

### 1. *Creating Specialized Collection Rules*

Because legal obligations are rarely self-executing, collection rules emerge that define the rights of parties to extract payment when others fail to meet their obligations. These rules define how one party forces another to pay, as they also — deliberately or inadvertently — order the priority of repayment among different creditors who have collection rights. Both federal bankruptcy law and state debtor-creditor law define the rules of debt collection, but the goals of the two systems differ markedly, resulting in very different applicable rules in each system.

The principal objective of state collection law is to provide a single creditor with an avenue to pursue the collection of an unpaid obligation. Some creditors bring collection suits because a debtor denies liability on a debt, while others do so when the debtor is slow to pay. State collection law is routinized, depending heavily on legal rights determined elsewhere in the trial court system. It embodies a series of formalistic rules with a narrow factual inquiry leading to the eventual liquidation of the debtor's assets. While its effectiveness in dealing with a recalcitrant debtor may be questionable, the routine work of the state system is to provide a relatively low-cost, minimal-inquiry system to collect legal obligations.

The issues at stake in a typical business failure, however, are substantively different from those in routine state law collection suits. When a debtor faces failure, the possibility of default on a number of outstanding obligations or of a complete cessation of business activities transforms collection issues. Any single collection effort against a failing debtor necessarily affects the likelihood of collection by all other creditors. If one creditor were able to collect a large judgment in full, for example, the debtor might have too few assets to pay what it owes to other, similarly situated creditors. Moreover, since the debtor may cease doing business altogether if one creditor enforces its rights, the exercise of collection rights implicates larger social and economic issues as well: workers may lose jobs, taxing authorities may lose ratables, trade creditors may lose customers, and so on.

While state law deals with routine single-debt collections, bankruptcy laws deal specifically with the more complex issues raised in the context of impending multiple default. When the debtor faces failure, questions of the priority of repayment and discharge from debt become central to the collection process. Bankruptcy laws are developed explicitly to order priority of repayment, providing a far more complex scheme to establish deliberate priority rules among hundreds of possible competing claimants. Moreover, the bankruptcy court may

conduct wide-ranging factual inquiries and give all interested creditors an opportunity to discuss a broad range of matters that might affect the likelihood of their repayment.

To be sure, bankruptcy law is not the only source of collection priority rules. State collection laws also create some collection priorities. In giving some creditors an exclusive right to reach certain property, or in allowing some creditors speedier access to the collection system, the state law system necessarily creates a repayment priority that will affect the creditors of a failing debtor. I develop this point in greater detail in section II.B, which deals with distributional issues, but the relevant point in this section focuses only on system specialization. The state system does not require, nor even provide, an opportunity for the searching inquiry about the implications of debtor default that inhere in the development of a bankruptcy scheme.

In the current scheme, state collection law and federal bankruptcy law together form a specialized, yet flexible collection system. State law delineates a circumscribed set of procedures for balancing the interests of a nonpaying debtor and a collecting creditor, creating a system that accommodates a limited factual inquiry and that is readily accessible for resolving routine collection disputes. Federal law creates a multifaceted, integrated system to cope with the competing concerns of a wider range of interested parties in more complicated relationships and more distressed circumstances. It incorporates and overrides the state priority system. The national system thus addresses a number of normative concerns that arise in connection with the potential demise of an ongoing business, which need not be raised in every collection action. These different collection systems offer a measure of flexibility by providing fora that are reasonably calculated to resolve the disputed issues in different kinds of cases. At the same time, they minimize total collection costs by invoking a complex system only when more complex issues are at stake. In addition, they provide a law that is deliberately distributional, based on a collection of principles discussed later in this paper.

## 2. *Enhancing Collective Action*

The Bankruptcy Code reduces the costs of collection from a troubled debtor by collectivizing creditor activities. By replacing the competitive state law collection systems, in which each creditor engages in separate monitoring and collection activities, with a collective-action system, the bankruptcy mechanism attempts to achieve significant cost savings. The primary collective device in the Bankruptcy Code is the creditors' committee, an elective group that hires a single counsel and

its own team of experts to monitor the progress of the bankruptcy case and to protect the rights of the creditors generally.<sup>18</sup> The creditors' committee is designed to accomplish effective creditor involvement at the lowest possible costs. Committee expenses are paid from assets of the estate, resulting in a cost spreading that may also enhance the effectiveness of the monitoring and creditor participation.<sup>19</sup>

In addition, the interests of the creditors are represented by officials paid by the debtor's estate but who are responsible to the creditors as a group. In chapter 7 cases, a trustee is appointed to act on behalf of all the creditors.<sup>20</sup> The U.S. Trustee, a representative of the Justice Department, has both general supervisory responsibility for these appointed trustees and the power to enter a case if there is reason to believe that they are not adequately representing the creditors' interests.<sup>21</sup> In a chapter 11 case, the debtor's management team is left in place unless a party makes an affirmative showing that a trustee is needed to protect creditors' interests.<sup>22</sup> As a result, the U.S. Trustee exercises somewhat more aggressive supervisory powers in reorganization cases. The U.S. Trustee monitors the activities of the debtor in possession, reviews the progress of the chapter 11 case, supervises creditors' committees in the exercise of their functions, and intervenes if it believes creditors' interests are not adequately represented.<sup>23</sup>

Savings are also realized by imposing stiff requirements on debtors to cooperate with creditors' efforts to monitor a troubled business. A few examples illustrate the point. Following a bankruptcy filing, the debtor must reveal detailed information about the past operation of the business and its projected business activities.<sup>24</sup> This requirement makes it easier to determine what has happened to the business and to scrutinize the future disposition of its assets. The debtor is restricted to activities undertaken in the ordinary course of its business, which prevents the debtor from concealing or otherwise moving assets to

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18. 11 U.S.C. §§ 705, 1102 (1988).

19. 11 U.S.C. §§ 503(b), 1103(a) (1988). The chapter 11 system is premised on the active participation of creditors who will be most affected by the outcome. If such creditors do not in fact participate, there is no one to implement many of the benefits available to creditors. For example, if creditors do not supervise, lawyers may serve as counsel to the creditors' committee, running up fees and producing little benefit. There are both empirical questions about the operation of creditors' committees and policy questions about designing systems that do not realistically reflect the circumstances of most parties who use it, but I must reserve both questions for another day. For now, it is important to note the design structure that permits creditors to act collectively to reduce their costs.

20. 11 U.S.C. §§ 701, 702 (1988).

21. 28 U.S.C. § 586(a)(1)-(3) (1988).

22. 11 U.S.C. §§ 1104, 1107 (1988).

23. 28 U.S.C. § 586 (1988).

24. 11 U.S.C. § 1106(a) (1988).

make collection difficult.<sup>25</sup> If the debtor wishes to engage in out-of-the-ordinary transactions, it must notify its creditors and seek court approval.<sup>26</sup> Debtors who violate such rules may find their management replaced by a trustee who reports directly to the court and the creditors.<sup>27</sup>

To further the collective interests of the creditors, the Bankruptcy Code operates directly to reduce the costs of coping with a business failure. A number of provisions are designed to increase collection efficiency in a bankruptcy action; quick decisions, abbreviated trials, estimation of claims, elimination of duplicate efforts, restricted notification requirements, reduced waiting periods, minimal paperwork, automatic stays from collection, stipulated valuations, and emergency orders are all bankruptcy devices intended to capture value for the estate under the adverse conditions that multiparty litigation and a failing business present.<sup>28</sup> Perhaps no part of the legal system is more cognizant of the transaction costs of collection and dispute resolution than the bankruptcy system, and surely no system is so conspicuously directed toward cost reduction.

### 3. *Reducing Strategic Behavior*

Strategic, and often wasteful, action is a persistent problem in collection systems. Under any system, both debtors and creditors can be counted on to press whatever advantages they may have. Exploitation of superior information or greater bargaining power, for example, is an expected — and, according to most commentators, beneficial — aspect of the contract-bargaining process.<sup>29</sup> But some advantages arise because of differences among legal systems or because ineffectual laws permit parties to avoid the enforcement of rights they long ago bargained away. Such advantages create a wasteful, *ex ante* exploitation

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25. 11 U.S.C. §§ 363(c), 1106(a) (1988).

26. *See, e.g.*, 11 U.S.C. § 363 (1988).

27. 11 U.S.C. § 1104 (1988).

28. One of the most cost-effective uses of bankruptcy may be to bring a number of similar lawsuits against a debtor — such as those from the tort claimants in *A.H. Robins* or *Johns-Manville* — into a single forum for much less costly resolution than the case-by-case adjudication that would have taken place at state law. For a discussion of similar proposals for mass joinder and resolution of toxic exposure cases outside the bankruptcy system, see David Rosenberg, *The Causal Connection in Mass Exposure Cases: A "Public Law" Vision of the Tort System*, 97 HARV. L. REV. 849 (1984).

29. The Uniform Commercial Code, for example, denies enforcement of unconscionable contract clauses, which it defines in U.C.C. § 2-302(1) (1992). The Code drafters made clear, however, that the principle does not include "disturbance of allocation of risks because of superior bargaining power." U.C.C. § 2-302(1) cmt. 1. Parties are expected to take advantage of superior information and strength in the marketplace in the statute that is most central to the regulation of commercial contracts.

that drives up collection costs. Attempts to take advantage of opportunities that the collection system creates dissipate both debtors' and creditors' resources while producing little identifiable benefit.

Disparate collection systems, such as those in the fifty states, often provide fertile ground for nonproductive strategic behavior.<sup>30</sup> While state law systems do not sanction debtor misbehavior, they nonetheless hinder the creditor's preemptive and remedial strikes.<sup>31</sup> If the debtor is sophisticated, the opportunities to play this game, both before and after judgments are rendered and collection efforts have begun, are almost limitless.

The debtor most likely to engage in wasteful strategic behavior is the one facing business failure. This debtor has the least to lose and the most to gain from such strategies. Developing a uniform federal bankruptcy law that stretches across the nation — and has some international reach — can better control the circumstances most fraught with the potential for waste. A single bankruptcy filing creates an estate that nets all the debtor's property, wherever located, and covers all the debtor's economic relationships, in whatever stage of performance or breach.<sup>32</sup> To resolve their claims, all creditors must come to a single forum where they are assured of notice and an opportunity to be heard before the debtor's assets are distributed. The sweep of bankruptcy law and the applicable rules are essentially the same regardless of where the business files or which bankruptcy court issues the orders. The reach and uniformity of bankruptcy law sharply reduce the opportunities for strategic behavior.

Bankruptcy law does not eliminate strategic behavior, however, and sometimes it fosters new stratagems and delays. Opportunities for strategic delay are in some instances the result of poorly considered Code provisions; in others, they are the unavoidable consequence of a careful balance between debtor and creditor power. Some debtors forum shop, looking for marginal advantages in different courts.<sup>33</sup>

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30. The debtor facing coercive state collection actions can sometimes avoid them by moving property to another location. For example, simply by driving its equipment across a state line, a debtor can force its creditor to begin the collection process anew in a different state forum — assuming, of course, that the creditor is able to find the equipment in its new home.

31. State law allows creditors to make certain countermoves — such as sequestering property before judgment — but the laws make such moves expensive. Moreover, because these laws trigger constitutional concerns about deprivation of property without due process, a number of procedural and substantive safeguards hem in creditors' remedies. When applied against a wily debtor, these remedies are of doubtful effectiveness. See *infra* notes 132-33 and accompanying text.

32. See 11 U.S.C. § 541 (1988).

33. Evidence suggests that some large debtors considering chapter 11 forum shop, looking for judges who will interpret the flexible rules on plan exclusivity and attorneys' fees most favorably to debtors and their counsel. Lynn M. LoPucki & William C. Whitford, *Venue Choice and*

Nonetheless, a national bankruptcy system can minimize strategic behavior in ways that the disparate state collection systems could never accomplish. Opportunities for debtors' strategic behavior in bankruptcy should always be compared with the opportunities for strategic behavior that exist within the state collection scheme.

#### 4. *Retaining Value in the Failing Business*

The rationale commentators most often cite for a bankruptcy system is its ability to capture the going-concern value of a business; for many analysts, the function of bankruptcy — and hence the measure of its viability — begins and ends here.<sup>34</sup> This feature is undoubtedly a significant part of the bankruptcy scheme, but the opportunity to preserve the full value of the business has broader implications than simply the capture of going-concern rather than liquidation valuations.

Two empirically based economic assumptions underlie the attempt to preserve the value of a failing company: (1) orderly liquidation is likely to produce more value — or to avoid more loss — than piecemeal liquidation; and (2) going-concern value is likely to be higher than liquidation value. Chapter 7 implements the first premise by requiring an organized liquidation, monitored by all the creditors and supervised by the bankruptcy court, that presumably produces greater value than the chaotic mix of self-help repossession and judicial execution available at state law. The chapter 11 reorganization alternative implements the second premise, explicitly attempting to capture the going-concern value of a business that would likely be lost in any liquidation. The sale of an intact business might occur in either chapter 7 or chapter 11, retaining the excess value for the bankruptcy estate.

Like any other empirical observation, these factual presumptions underlying the bankruptcy system are subject to challenge. It may be that orderly liquidation yields no premium for the creditors, or that a going-concern value differs from liquidation value only in an irrational market that does not exist. There is ample evidence of the persistent belief in a going-concern differential in liquidation.<sup>35</sup> In addition, the

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*Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 Wis. L. REV. 11, 12.

34. See, e.g., Baird & Jackson, *Corporate Reorganizations*, *supra* note 1, at 100-01 (asserting that bankruptcy policy rests on a premise of enhancing the value of the failing company); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992) (same).

35. See, e.g., *In re Wine Boutique, Inc.*, 117 B.R. 506 (Bankr. W.D. Mo. 1990) (bankruptcy sale of going-concern business yields more than sale of assets individually); Kenneth N. Klee, *Chapter 11: The Commercial Creditor's Best Friend*, COM. LENDING REV., Winter 1992-93, at 44, 48 (citing examples of companies that were sold intact in bankruptcy to yield the highest possible prices).



price premium paid outside bankruptcy for intact businesses<sup>36</sup> supports the conclusion that both orderly liquidations and reorganizations of operating businesses enhance the value of the bankrupt estate, but it certainly does not prove this claim.

To make liquidations orderly and to attempt to capture a going-concern premium, the bankruptcy system embodies overtly utilitarian principles. A creditor with a state law right to repossess collateral, for example, may be forced to relinquish that right in bankruptcy if the debtor business is more valuable when the property remains in place.<sup>37</sup> The individual creditor loses something by forgoing immediate liquidation and waiting for continuing payments. Yet, the business — and all those who rely on the business — gains from the opportunity to liquidate in a more orderly fashion, to sell itself as a going-concern, or to reorganize itself into a viable enterprise.

Bankruptcy laws also enhance the value of the failing company by reducing creditors' incentives to dismantle it. Under state law, unsecured creditors who are quickest to act against a failing debtor may suffer no losses, while those who work with the debtor and hesitate to seize critical property bear the entire burden if the debtor's assets are depleted before they collect. State law rewards creditors for racing to grab assets and thereby encourages behavior that dismantles debtors in distress and precipitates business failures that might have been averted if the creditors had been more patient. The state system distributes benefits to aggressive creditors rather than cooperative ones; it thus tends to raise business failure rates generally. The bankruptcy system denies creditors access to more aggressive collection methods, such as immediate foreclosure, and ends the race to dismantle the debtor. Moreover, because the collection rules of bankruptcy have some retroactive application — for example, the return of preferential payments received within three months of a bankruptcy filing<sup>38</sup> — bankruptcy laws may serve not only to enhance the value of a business that has filed bankruptcy, but also to improve the value of a business that is foundering on the brink of a bankruptcy filing.

Bankruptcy courts also directly influence efforts to enhance the value of the bankruptcy estate. These courts enjoy enormous discre-

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36. Some describe the price differential as the "good will" of the company, a somewhat ephemeral term that may encompass more than just the going-concern value. *E.g.*, BLACK'S LAW DICTIONARY 625 (5th ed. 1979) (defining goodwill as "excess of cost of an acquired firm or operating unit over the current or fair market value of net assets of the acquired unit. Informally used to indicate the value of good customer relations, high employee morale, a well-respected business name, etc., which are expected to result in greater than normal earning power").

37. 11 U.S.C. § 362(d)(2) (1988).

38. 11 U.S.C. § 547(b) (1988).

tionary power that they can use to enhance the value of a failing business. Judges must make countless decisions — whether to permit the assumption of an executory contract, to appoint an examiner, or to approve the terms of a postpetition financing agreement — based on their assessment of what will yield the largest returns for the estate.<sup>39</sup> In addition, a number of statutory provisions specifically require the court to exercise commercial judgment. For example, the judge must choose between competing valuations to decide whether a debtor may substitute collateral, or to evaluate business projections to determine if a reorganization plan is reasonably calculated to support its proposed payout.<sup>40</sup> These fact-specific inquiries demand that judges make careful business decisions, as well as thoughtfully apply legal principles.

The most frequently discussed policy rationale for the bankruptcy system is its stated goal to enhance the value of the failing business, thereby reducing the collective losses suffered by the parties who have dealt with the debtor. The bankruptcy laws create a specialized collection system that uses a number of different devices to maintain the value of the failing firm. The Code actively promotes collective action for the creditors while it hems in the strategic behavior of the debtor that can dissipate the estate assets. By giving the business an opportunity for organized liquidation or for reorganization as a going concern, the laws also help retain the value of the debtor business.

### B. *A System To Distribute Value*

Any collection system necessarily has significant distributional implications because it fixes legal rights and creates priorities of repayment that represent the basis for participation in any renegotiation effort. Imbedded within state collection law is a straightforward scheme of distribution: secured creditors get cash or take their collateral; the first judgment creditor collects in full from what remains; the next judgment creditor takes in full from what still remains; and so on, until all the assets are gone.<sup>41</sup> This payment scheme is augmented by statutory lien and trust fund laws that give certain creditors automatic priorities, without reference to their contractual rights. So long as the debtor pays the remainder of its obligations as they mature, seizure of property by one creditor creates no inequality among creditors; the others can still expect to be paid in full. When there are insufficient assets to satisfy all claims against the debtor, however, the state collec-

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39. 11 U.S.C. §§ 365, 1104, 363 (1988).

40. 11 U.S.C. §§ 363, 1129(a)(11) (1988).

41. U.C.C. § 9-301(4) (1988).

tion scheme permits some creditors to receive payment in full while other creditors bear all the costs of a debtor's failure. Whether such distributional schemes are advertent or are merely the result of providing better protection for some interest groups — such as the preference for contract-based claimants over tort-based claimants or landlords over tenants — is an interesting point for political speculation. Whether or not the system is advertent, however, the state law system has a powerful distributional impact when the debtor fails.

The bankruptcy system reflects a deliberate decision to pursue different distributional objectives from those that the de facto scheme of general collection law embodies. Rejecting the “race of the diligent” that characterizes state law, the bankruptcy system substitutes a different normative principle: “equity is equality.” The Bankruptcy Code begins with the premise that all similarly situated creditors should be treated alike. The fact that general creditors — the last residual class of creditors, for whom much of the bankruptcy operation is run — share assets or participate in payments on a pro rata basis most directly embodies this premise.

Not surprisingly, implementing such a simple approach in a thoroughgoing fashion is neither economically nor politically feasible. The bankruptcy system lays down a normative principle of equality as a baseline around which it builds numerous exceptions. The Code promotes some creditors ahead of others, providing enhanced collection rights for taxing authorities, lessees of residential leases, and the employees of a failing business, among others.<sup>42</sup> This procedure does not mean that the Code's commitment to equality is halfhearted. It is more accurate — and perhaps more telling — to note that when bankruptcy law deviates from a strict equality principle, it does so for self-consciously redistributive ends. Every distribution that benefits a particular creditor at the expense of the collective estate represents a considered judgment to depart from the norm in a particular instance. Equality — and deliberate deviations from equality — stand at the center of bankruptcy policy.

### 1. *Parties with Different Legal Rights*

The framework of the bankruptcy system embodies the principle of equality. Within a single bankruptcy case, the consequences of debtor default can be determined for a large number of diverse parties, far more than could be heard in any state collection suit. Secured creditors and unsecured creditors, creditors with present claims and credi-

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42. 11 U.S.C. § 507(a) (1988).

tors with contingent claims, creditors with liquidated claims and creditors with unliquidated claims all face very different collection options outside bankruptcy. If the debtor survives to pay everyone, those differences may be of little consequence. When the debtor's business failure is imminent, however, the disparate classes of creditors all want a share of its assets. They recognize that what they cannot get now they will likely never get, so they exercise whatever collection rights they have as quickly and as vigorously as possible.

The differences in legal rights among the various creditors listed above, however, are quite significant. If these parties had to battle for assets under the state law scheme, the distribution of assets would heavily favor creditors with security interests, creditors with matured obligations currently in breach, and creditors with liquidated claims. Contract creditors would enjoy advantages over those whose claims are not founded in contract. Creditors who had either too little foresight or too little leverage would find themselves unsecured and at a significant disadvantage relative to their secured counterparts. Because involuntary creditors, such as tort victims and environmental cleanup funds, were unable to negotiate in advance for the kind of superior treatment at state law that secured creditors demanded, they would likely come into the claims process only after others had taken the most valuable assets.<sup>43</sup> Moreover, because their claims often take years to resolve, the period during which the business may fail and leave them with nothing to collect is far longer for these creditors than for their contract-based, secured counterparts.

Bankruptcy law avoids this priority scheme by bringing all the competing creditors into a single forum, where their competing claims can be resolved. Claimants with matured claims and those with contingent claims, those with liquidated claims and those with unliquidated claims, and those with negotiated rights and those with rights found elsewhere in law are all heard in a single bankruptcy case.<sup>44</sup> Assets and losses can be distributed among them on a principled basis, replacing the differing treatment they would have received under state law.

## 2. *Parties with No Formal Legal Rights*

Bankruptcy policy also takes into account the distributional im-

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43. Some states have recently begun to recognize these implications of their state law collection schemes and have enacted state environmental cleanup laws that take precedence over secured debt. *See, e.g.*, Environmental Cleanup Responsibility Act, N.J. STAT. ANN. § 13:1K-9.3 (West 1991).

44. 11 U.S.C. § 101(4) (1988).

pact of a business failure on parties who are not creditors and who have no formal legal rights to the assets of the business. Business closings affect employees who will lose jobs, taxing authorities that will lose ratable property, suppliers that will lose customers, nearby property owners who will lose beneficial neighbors, and current customers who must go elsewhere. Congress was acutely aware of the wider effect of a business failure on the surrounding community, and it adopted the 1978 Bankruptcy Code specifically to ameliorate those harmful effects<sup>45</sup> — that is, to redistribute the benefits that would stem from some creditors' collection rights to other parties who did not enjoy those rights.

The Code accounts for the rights of other parties that a business failure affects by giving a failing company an opportunity to sell itself as a going concern in chapter 7 or to reorganize in chapter 11. To the extent that it reallocates assets from a particular party to the group as a whole, thereby enabling the sale of an intact business or a reorganization effort, the Code carries out a deliberate distributional policy in favor of all those whom a business failure would have hurt. The choice to make bankruptcy "rehabilitative" represents a desire to protect these parties along with the debtor and creditors who are more directly affected.

To be sure, the protection the Code gives to parties without formal legal rights is derivative in nature and limited in scope. These groups have no specific right to be heard in the bankruptcy case, nor can they exercise any rights either to support or to oppose a proposal for the disposition of the failing business.<sup>46</sup> The Code leaves those decisions to the parties more immediately affected — the debtor and the parties with formal rights against the debtor. Those directly affected bear the most identifiable costs, and collectively they presumably make the most rational decisions regarding the long-term survival of the business. The Code protects the interests of parties without formal legal

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45. Congressional intent is always a slippery concept, but the comments surrounding the adoption of the 1978 Bankruptcy Code leave no doubt that Congress understood the deliberately broader impact of the bankruptcy system. HOUSE COMM. ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. NO. 595, 95th Cong., 2d Sess. 53-62 (1977), *reprinted in* 1978 U.S.C.A.N. 5963, 6014-23 (letter from Judge Conrad Cyr explaining the community impact of several pending bankruptcy cases, in response to a congressional request); REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, PT. 1, H.R. DOC. NO. 137, 93d Cong., 1st Sess. 85 (1973) (discussing the "overriding community goals and values" of bankruptcy); 124 CONG. REC. 33,990 (1978) (statement of Sen. DeConcini) (discussing "the public interest" beyond the interests of the disputing parties); 124 CONG. REC. 32,392 (1978) (statement of Rep. Edwards) (discussing efforts to "protect the investing public, protect jobs, and help save troubled businesses").

46. The state attorney general may appear and be heard on behalf of consumer creditors if the court determines the appearance is in the public interest. FED. R. BANKR. P. 2018(b).

rights only indirectly, largely through provisions that forestall liquidation to permit the business to remain in operation and to reorganize, instead of being shut down by a few anxious creditors.<sup>47</sup>

The rationale for protecting parties without formal legal rights may simply be political in nature; such protection encompasses a wider range of voters than the particular creditors who would profit from the immediate enforcement of their rights. Moreover, some of the parties without formal legal rights have well-organized political clout. The presence of a few clear giveaways to successful lobbying groups<sup>48</sup> makes it clear that the Bankruptcy Code is no more immune to political influence than any other legislation Congress passes. On the other hand, many of the beneficiaries of the indirect protection for parties without legal rights are, at best, only loosely organized groups that have shown little interest in the bankruptcy laws.

Notwithstanding whatever cynicism is appropriate about congressional motives, it remains the case that the protection of parties without legal rights also reflects a more profound economic reality: the parties with formal legal rights never completely internalize the full costs of a business failure. Any attempt to avoid haphazard liquidation helps offset the losses imposed on parties to whom the costs have been externalized as well. Moreover, the attempt to protect these parties reflects a judgment that it is beneficial to protect more than the goods that are traded by private contract. For example, much value is to be gained by encouraging parties to establish continuing relationships that contracts have not formalized. To presume either that only contract-based relationships convey value or that only the value of such relationships should be relevant to the policy goals of a legal system ignores this reality. The protection offered to parties without formal rights may be indirect and incomplete, but that does not mean that such factors are — or should be — irrelevant to policymaking.

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47. This observation leads to a question of application: Should a judge base a decision specifically on the interests of these parties without formal legal rights? Some judges believe they can discern and protect the public interest. I would argue that they should not go beyond the statutory mandate to permit a reorganization effort bounded by enumerated legal constraints. To enlarge those rights beyond the estate's opportunity to reorganize risks upsetting the balance of interests established by the legislature. This reasoning is, of course, only a process argument. It is noteworthy, however, that the 1978 Code eliminated language from the Bankruptcy Act of 1898 that permitted the court either to confirm or reject plans in large reorganization cases based on whether they were "consistent with public policy" or to prohibit rejection of contracts "in the public authority." 11 U.S.C. §§ 516(1), 616(4), 621(5) (1976) (repealed 1979). A different normative question arises when the legislature considers enlarging the rights of these parties.

48. *E.g.*, 11 U.S.C. § 507(a)(5)(B) (1988) (priority repayment for U.S. fishermen from fish storage and processing facilities).

### 3. *Other Distributional Principles*

Bankruptcy enlarges the scope of distributional issues by resolving in a single setting the interests of parties with competing legal claims, parties with different kinds of legal claims, and parties with no legal claims at all. A number of principles are applied to justify deviations from the baseline equity-is-equality principle and to implement a preference for orderly sale and reorganization. These principles isolate competing values with which the bankruptcy system is concerned, particularly those associated with preserving the estate and minimizing the costs of default. The following list may not be exclusive, but it identifies a number of the key factors:

*a. Relative ability to spread the risks of default.* Some creditors and parties affected by business failure are unlikely to have anticipated the risk that a business will cease to function, while others may face especially acute difficulties in spreading the risks of a debtor's default. Employees, for example, may be particularly ill-suited for the task of assessing and spreading risk in order to shield themselves from the effects of their employer's misfortunes. In theory, an employee might work for a hundred different employers, scattered among different industries and different geographic regions, thereby spreading the risks of default as bank lenders do. Markets, however, are sufficiently imperfect that any such scheme could exist only in an academic paper. Priority of repayment for past due wages gives employees preferential treatment,<sup>49</sup> reducing their costs when a business fails and permitting some correction for costs that market imperfections imposed on them. The Code provides a second, indirect protection for employees. By giving businesses the opportunity to reorganize, the Bankruptcy Code may permit employees to keep their jobs. This provision creates an alternative method to reallocate the risks of business failure away from the employees toward other lenders who can better diversify their investment portfolios.

*b. Encourage investment risk taking.* If investors perceived that businesses in some financial trouble faced immediate liquidation, they would likely have two responses: they would not invest their money to start businesses, or they would direct their business investments toward less risky enterprises.<sup>50</sup> To the extent that reorganization alter-

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49. 11 U.S.C. § 507(a)(3) (1988).

50. A number of commentators have speculated that high management turnover rates when businesses fail may already cause management to pursue risk-averse strategies that result in below-optimum rates of return. See, e.g., Irwin Friend & Larry H.P. Lang, *An Empirical Test of the Impact of Managerial Self-Interest on Corporate Capital Structure*, 43 J. FIN. 271, 271 (1988) (discussing problem of management's "maintaining a low debt ratio to avoid bankruptcy possibility" even when higher debt would be in shareholder's interest); Susan Rose-Ackerman, *Risk*

natives exist, companies that pursue risky alternatives have an opportunity to survive some short-term dislocations and a greater chance to see their risk-taking strategies pay off.<sup>51</sup> At the margins, any law permitting reorganization of a business increases the likelihood of survival of companies through troubled times, which makes risk-taking behavior more attractive.<sup>52</sup>

*c. Incentive effects on prebankruptcy debtor-creditor transactions.* A number of Code provisions are created with a view toward their ex ante incentive effects, with a particular focus on the period that precedes the business' collapse. To encourage creditors to work with a failing debtor and to avoid the state law asset grab that wastes assets and pushes many debtors into bankruptcy, bankruptcy laws are designed to negate the benefits a creditor gains by dismantling a troubled debtor. The Code voids prebankruptcy collection actions that diminish the estate and hasten its demise, while it sanctions transactions that tend to benefit the estate. For example, collection on an undersecured debt shortly before bankruptcy may be undone, and the creditor who moved ahead of its cohorts will have to repay its gain to the general pool.<sup>53</sup> Meanwhile, a security interest given to secure a new extension of credit will survive a bankruptcy filing.<sup>54</sup>

*d. Similarity over time.* The bankruptcy system equalizes the treatment of creditors and parties affected by business failure when

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*Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991) (noting that managers are more risk averse than the company's investors).

51. If the phrase "risk-taking strategies" conjures up visions of people in checked suits, selling swampland with great potential, it is somewhat misleading. "Risk-taking" stretches across a range of activities from start-up businesses, which are subject to statistically high failure rates, to farming activities, which depend on unpredictable weather.

52. For those who recall my criticism of Bradley and Rosenzweig's assertion that managers were misbehaving by taking on too much risk because of the possibility that bankruptcy would save them, I should highlight the distinction. Warren, *Untenable Case for Repeal*, *supra* note 5. Bradley and Rosenzweig argued that changes in the 1978 Code that left managers in control of their bankrupt companies created incentives for them to take on high-risk projects. Bradley & Rosenzweig, *supra* note 34, at 1047. Consequently, business failure was made "endogenous" in ways that had not existed previously. *Id.* I argued that the available empirical evidence contradicted such a conclusion. First, it showed very high managerial turnover rates post-Code that made their inference of inappropriate managerial incentives counterfactual. Warren, *Untenable Case for Repeal*, *supra* note 5, at 449-52. Second, management turnover rates rose rather than dropped after adoption of the Code, which directly negates their hypothesis that changes in the Code prompted inappropriate managerial strategies. *Id.* at 452-54. I did not argue, nor would I, that the presence of a workable bankruptcy system has no effect on the investment strategies a business should pursue or that their investors should demand. Here, I argue that businesses may pursue optimal investment strategies — including higher-risk strategies — if bankruptcy laws offer the business some protection in case of misstep.

53. 11 U.S.C. § 547(b) (1988) (making payment to an undersecured creditor within 90 days of filing a voidable preference).

54. 11 U.S.C. § 547(c)(3) (1988) (insulating a security interest, given within 90 days of filing, from voidable preference attack if the debtor used the new extension of credit to purchase assets for the estate).



timing variations leave them with very different formal rights. For example, those who have been injured by a debtor's product, such as workers who have been exposed to asbestos, can bring state law actions only after their injuries are manifest. In the case of a failing company, this rule leaves early claimants paid in full, while later claimants with the same rights discover there is nothing left to collect. Bankruptcy law, however, may resolve both present and future claims at once, giving comparable outcomes to those with similar legal rights, but different timetables for reaching the courthouse. The bankruptcy court may approve a plan to pay victims over time using similar procedures and providing similar payouts regardless of when their injuries appeared.<sup>55</sup> The Code generally minimizes the consequences of timing differences among the debtor's prepetition creditors as it reorders claims based on an underlying similarity of rights.

*e. Owners bear the primary costs of business failure.* Residual owners of the business have the least protected status in bankruptcy. This situation mirrors the principle outside bankruptcy that those who take the largest gains if the business succeeds also assume the risk of loss if the business fails. Accordingly, the Code permits the owner to retain ownership of the postbankruptcy business only if the creditors collectively consent or the business is able to pay all the creditors in full.<sup>56</sup>

*f. Minimize disruption of established economic patterns.* While bankruptcy necessarily reorders the rights of all parties with claims against the estate, the Code gives powerful residual protection to the most established forms of transactions, thereby reducing the impact of a bankruptcy filing on ordinary commercial expectations. Secured creditors provide a case in point. The Code might have provided that they receive nothing more in bankruptcy than their unsecured counterparts, thereby giving greater force to other normative principles identified here. Nonetheless, the secured creditors are the most overtly protected parties in the bankruptcy process.<sup>57</sup> While presumptions about ex ante incentives might justify the decision to extend such protection to secured creditors, it also seems that Congress feared that equalization of creditor status in bankruptcy would disrupt commercial expectations.<sup>58</sup>

This list is not exhaustive. Other elements in the distributional

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55. 11 U.S.C. §§ 101(9), 502 (1988).

56. 11 U.S.C. § 1129(b)(2)(B)(ii) (1988). Owners may participate in the postreorganization business only if they pay their creditors in full, their creditors consent, or they purchase new equitable ownership. 11 U.S.C. § 1129(a), (b) (1988).

57. Compare 11 U.S.C. § 506 (1988) (describing the calculation of a secured claim) with 11 U.S.C. § 502 (1988) (describing calculation of an unsecured claim).

58. See, e.g., Klee, *supra* note 35, at 46-49.

scheme clearly represent the kind of special interest legislation that lacks any principled support.<sup>59</sup> The list, however, provides a sense of the key normative objectives and illustrates how distributional norms are important in delineating the rights of each party in bankruptcy.

The development of a list only begins the policy inquiry. It does not explain how far to pursue a goal — should we reallocate all the resources of a business to parties who are poor risk spreaders? — nor does it resolve what to do when goals conflict — for example, owners should bear the losses a business failure imposes, but if they are unable to participate in a reorganization they may not see bankruptcy as a viable alternative, and they may make investment decisions that are too risk averse.<sup>60</sup> The failure to yield consistently predictable answers, however, does not undercut the progress made by identifying normative goals that the establishment of a bankruptcy system implicates.

The equities of equality should not be lightly accepted. For every party helped by recognition of a claim that a debtor would have delayed long enough under state law to escape payment entirely, and for every noncontract claimant who is able to collect a pro rata share that would have been otherwise practically impossible to collect, there is some other party who lost the benefits it enjoyed in the hierarchical system of state law. The communitarian quality of bankruptcy prompts appropriate howls from the parties who did better on their own. Equalizing the treatment of various parties dealing with a failing creditor, however, is not a redistributive idea that a bunch of post-New Deal liberals invented. More than a hundred years ago, the Supreme Court listened to the complaints of bondholders whose collection rights were curtailed in a railroad reorganization. It responded:

Bankrupt laws have been in force in England for more than three centuries, and they had their origin in the Roman law. The Constitution expressly empowers the Congress of the United States to establish such

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59. The special rights enjoyed by shopping centers against their bankrupt tenants, 11 U.S.C. § 365(b)(3) (1988), and the repayment priorities for U.S. fishermen and grain growers against their bankrupt elevator storage facilities, 11 U.S.C. § 507(a)(5) (1988), are hard to explain by any principled analysis.

60. It might be worth noting that similar questions of degree and balance exist in efficiency analysis as well. Sometimes the questions are posed as indeterminacy questions — for example, what to do when we cannot know how costs are externalized — and sometimes as empirical questions — for example, what to do when we do not know which party can pass along costs most effectively. Efficiency-based analysis may not highlight its inability to answer all questions. When one pushes much beyond the first-level analysis, however, as is required for policy implementation questions, it quickly becomes clear that one must make difficult choices with incomplete information. See Kennedy, *Entitlement Problems*, *supra* note 8, at 388-89 (arguing that efficiency arguments are political and all policy choices involve value judgments); Warren, *Bankruptcy Policy*, *supra* note 5, at 803-04 (claiming that economic analysis in bankruptcy encompasses distributional consequences even when the author denies any distributional intent).

laws. Every member of a political community must necessarily part with some of the rights which, as an individual, not affected by his relation to others, he might have retained. Such concessions make up the consideration he gives for the obligation of the body politic to protect him in life, liberty, and property. Bankrupt laws, whatever may be the form they assume, are of that character.<sup>61</sup>

That secured creditors, for example, lose some collection rights in bankruptcy is neither new nor remarkable. Indeed, some observers note that such creditors participated actively in shaping the 1978 Bankruptcy Reform Act so that their interests would be well protected.<sup>62</sup> The kinds of redistribution this analysis contemplated are bound to provoke controversy and dissent, with all sides invoking "fairness" arguments. The point of this analysis is that bankruptcy is a forum in which everyone parts with some rights in order to participate in a process that works for the collective good.

### C. *A System To Internalize the Costs of Failure to the Parties Dealing with the Debtor*

The third normative function the bankruptcy system serves is to constrain externalization of business losses to parties not dealing with the debtor. Like the other two principles, this one is followed in general direction only, and some counterexamples clearly appear in the Code. Nonetheless, the bankruptcy laws are organized to minimize losses to the general public when a business fails and to force parties dealing with the failing debtor to bear the burden of the failure.

The benefits of such a policy are obvious. Creditors' ability to externalize losses significantly blunts their incentives to make carefully considered lending decisions or to monitor the debtor to assure repayment. If a lender knows it must bear the bulk of the losses, the lender is more likely to develop appropriate levels of investigation and monitoring *ex ante*. With greater certainty of riskbearing and a reduced load on the public fisc, incentives are higher to achieve appropriate diligence and caution in debtor-creditor relations.

Bankruptcy restricts externalization of costs in three key ways: (1) it provides priority repayment of debt to the public fisc ahead of most other creditors; (2) it maintains a largely self-supporting implementation system; and (3) it insulates Congress from pressure to fund bailouts for individual business failures.

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61. *Canada S. Ry. v. Gebhard*, 109 U.S. 527, 536 (1883).

62. See Klee, *supra* note 35, at 46.

### 1. *Priority Repayments to the Public Fisc*

Bankruptcy policy minimizes losses to the public fisc in an obvious way: it requires payment first and in full to government taxing authorities. A number of different provisions governing the repayment of tax debt implement this requirement. Outside bankruptcy, the government has fairly strong collection powers that it exercises primarily through its power to enforce liens against property. A taxing authority can secure a lien against a debtor's property if the debtor is delinquent on its tax obligations. Bankruptcy law gives force to these liens after filing, exempting them from the ordinary provisions on avoidable preferences during the ninety-day period before filing.<sup>63</sup>

In addition to lien protection, taxing authorities enjoy a repayment priority in bankruptcy. While most unsecured creditors can do little more than participate in a pro rata distribution of assets and see their remaining debt discharged, a court cannot confirm a chapter 11 plan unless the tax debts are scheduled for repayment in full.<sup>64</sup> Taxing authorities need not even take the risk that the debtor will promise to repay its taxes and later default during the reorganization process. A debtor must pay priority taxes at the time of confirmation or within six years of the claim's assessment,<sup>65</sup> even though nearly every other creditor can be forced to wait for payment for longer periods during the course of the reorganization. In addition, the Code provides an independent ground for objecting to a plan that meets all the other requirements of plan confirmation if the court determines that "the principal purpose of the plan is the avoidance of taxes."<sup>66</sup>

Finally, if the debtor's property is insufficient to satisfy a tax lien or if the taxing authority did not move quickly enough to get a lien before filing, discharge cannot extinguish priority tax debt, unlike nearly all other debts.<sup>67</sup> The obliteration of nearly every other claim — the bankruptcy discharge — is powerless against priority tax debt.

The pursuit of repayment of government debts is not single-minded. The Internal Revenue Code contains a number of provisions that offer some tax relief for failing companies, particularly if the com-

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63. 11 U.S.C. § 547(c)(6) (1988).

64. 11 U.S.C. § 1129(a)(9)(C) (1988). Even in chapter 7, the Code requires that priority tax debts be paid ahead of most other unsecured debts. *See* 11 U.S.C. § 507(a)(7) (1988).

65. 11 U.S.C. § 1129(a)(9)(C) (1988). Preferential treatment extends only to tax debts that fit within the technical requirements of 11 U.S.C. § 507(a)(7). Such priority tax debts comprise most outstanding tax claims, but they do impose some timing requirements that require the taxing agency to move within prescribed time limits. *See* 11 U.S.C. § 507(a)(7) (1988).

66. 11 U.S.C. § 1129(d) (1988).

67. 11 U.S.C. §§ 523(a)(7), 1129(a)(9)(C) (1988).

panies reorganize their debts in bankruptcy.<sup>68</sup> Obviously, such assistance externalizes the costs of a business failure. Moreover, most nontax obligations owed to the government do not receive similar priority. For example, bankruptcy law treats damages stemming from the debtor's breach of a contract with the government the same as unsecured debt held by nongovernment parties. Nonetheless, the government's biggest revenue source — taxes — receives aggressive protection in bankruptcy.

The issue of protecting the public purse continues to evolve. As more businesses fail while owing the government huge sums for the cleanup of their environmental messes, and as more troubled companies try to subsidize the costs of operating their underfunded pension plans with money from federal insurance programs, the possibility of shifting costs from the private to the public domain moves beyond the issues dealt with in current tax laws. Courts are struggling over questions about the discharge of cleanup liabilities and the priority repayment of pension obligations.<sup>69</sup> The Code was written at a time when the possibility of shifting the costs of such huge liabilities was not yet an obvious threat to the public fisc — or an attractive strategy for troubled companies. Not surprisingly, Congress is considering action in both areas to force the companies and their creditors to bear such costs, rather than permitting the parties to shift those costs to the taxpayers.<sup>70</sup>

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68. For a more complete discussion of the rules on loss carry forward and carry back, NOLs, and other tax exoticia, and how these rules affect taxes actually paid by failing companies, see Jack Salomon, *Part XVI: Bankruptcy and Taxes*, in 2 BANKRUPTCY: TEXT, STATUTES, RULES (Robert E. Ginsberg & Robert D. Martin eds., 3d ed. 1992). Note, however, that Congress seems less inclined to support such subsidies. In July 1993, it repealed a stock-for-debt exception in bankruptcy that will eliminate some tax advantages enjoyed by reorganizing companies. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226(a), 107 Stat. 312, 487.

69. See, e.g., WARREN & WESTBROOK, *supra* note 12, at 783-85 (discussing the current difficulties with pension plan funding); Katherine Heidt, *The Automatic Stay in Environmental Bankruptcies*, 67 AM. BANKR. L.J. 69 (1993) (discussing current problems with halting government enforcement of environmental cleanup obligations).

70. For a discussion of proposals to deal with environmental claims, see, for example, Daniel Klerman, *Earth First? CERCLA Reimbursement Claims and Bankruptcy*, 58 U. CHI. L. REV. 795 (1991); James N. Lawlor, Comment, *Toxic Tug-of-War: Environmental Cleanup Costs, Bankruptcy and the Administrative Expense Priority — Is It a Collision of Conflicting Policies or Just Plain Confusion?*, 21 SETON HALL L. REV. 832 (1991); Lynn T. Manolopoulos, Note, *A Congressional Choice: The Question of Environmental Priority in Bankrupt Estates*, 9 UCLA J. ENVTL. L. & POLY. 73 (1990). For a proposal to deal with retiree claims, see S. 540, 103d Cong., 1st Sess. § 115(a) (1993) (treating pension plan contributions as administrative priority expenses in bankruptcy, thereby reducing government subsidization); *Retiree Benefits in Bankruptcy: Oversight Hearing on H.R. 5283 and Related Bills Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 99th Cong., 2d Sess. 1 (1986); *Retiree Health Benefits: The Fair-Weather Promise: Hearings Before the Senate Special Comm. on Aging*, 99th Cong., 2d Sess. 65 (1986); Dan Keating, *Good Intentions, Bad Economics: Retiree Insurance Benefits in Bankruptcy*, 43 VAND. L. REV. 161 (1990).

## 2. *A Self-Supporting System*

The bankruptcy system offers significant services to the parties involved with a failing company: it provides courts and associated personnel to hear parties' disputes, but it also requires those courts to deal with an extensive list of uncontested matters that arise in the course of a liquidation or reorganization. In addition, a filing office maintains significant public information about the debtors' financial circumstances; court-appointed officials monitor all chapter 7, chapter 12, and chapter 13 cases; court-appointed trustees run some chapter 11 cases; and a designated officer of the Justice Department — the U.S. Trustee — supervises trustees, provides additional monitoring of chapter 11 debtors, and intervenes in appropriate cases. Notwithstanding the far greater expenditure of resources than most civil actions require, these special bankruptcy features are largely self-supporting.

The U.S. Trustee system is particularly notable because, unlike most systems associated with court processes, it actually turns a profit for the government. Currently, every bankruptcy case yields a fee for the Trustee system.<sup>71</sup> These fees generated \$115.7 million during fiscal year 1992, compared with the program's estimated expenses of \$81.2 million.<sup>72</sup> Although the system is relatively new, the fees exceeded the costs of running the offices of the U.S. Trustee by a large enough margin so that the government took \$24.5 million out of the U.S. Trustee fund and transferred it to the general treasury on November 1, 1992.<sup>73</sup> Cross-subsidization clearly occurs in all governmental functions, but the U.S. Trustee system illustrates a startling anomaly: bankrupt debtors subsidize taxpayers generally.

Private trustees, appointed in all chapter 7 and chapter 13 cases, receive a fee from the receipts of the case. A large proportion of chapter 7 cases yields no fees,<sup>74</sup> so that the trustee collects only a portion of the filing fee as compensation. An informal compensation system exists, nonetheless, in which trustees can count on occasional big cases that will yield substantial fees, in part to make up for carrying a

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71. There is no *in forma pauperis* in bankruptcy. If a debtor cannot pay the filing fee, the debtor cannot file. The fees are substantial. The U.S. Trustee collects from the filing fees of each debtor: chapter 7 (\$30), chapter 13 (\$30), chapter 11 (\$300), and chapter 12 (\$100). In addition, the government requires quarterly fees based on the debtor's disbursements from every debtor with a pending chapter 11 case. OFFICE OF THE U.S. TRUSTEE, UNITED STATES TRUSTEE SYSTEM FUND 2 (Oct. 27, 1992) (report on file with author).

72. *Id.* at 4.

73. *Id.* at 1.

74. A study of bankruptcy petitions for individual debtors in the Eastern District of Virginia revealed that 95.6% of the chapter 7 petitions filed involved no-asset cases. Michael I. Herbert & Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed During 1984-1987*, 22 U. RICH. L. REV. 303 (1988).

number of small cases which are not cost effective. This process creates yet another cross-subsidization in bankruptcy: trustees' fees for administering and monitoring the bankruptcy system are paid in part by the parties in the instant case and are subsidized in part by parties to other bankruptcies who make the overall operation of the private trustees' practices profitable. In no case, however, does the public at large bear these fees.

Some bankruptcy courts, particularly those in high volume areas, have shifted even more of the costs of operating the system to the parties. In large cases, the court sometimes requires the parties to pay a portion of the cost of the court's staff directly. In the mid-1980s, Congress passed legislation permitting the bankruptcy court to use assets of the bankruptcy estate to pay for facilities or services necessary for case administration. The court administrator might hire clerks or lease space, for example, and charge the expenses directly to a debtor's estate.<sup>75</sup> The use of this provision varies, but the costs that the parties bear in the largest chapter 11 cases have been substantial.

Bankruptcy laws even make the operation of the bankruptcy courts partially self-supporting. The total cost for the bankruptcy system for fiscal year 1992 is estimated at \$375 to \$400 million,<sup>76</sup> including personnel costs, real estate costs, security, and so on. During the same period, the bankruptcy courts took in nearly \$129 million, a substantial portion of their overall costs. In addition to the filing fees, a portion of which the bankruptcy system keeps, debtors and their creditors using the system pay copy fees, bankruptcy-notice fees, fines, penalties, forfeitures, interest on deposits, registry fees, fees for judicial services, and a number of miscellaneous fees.<sup>77</sup> While the general taxpayer obviously contributes to the costs of keeping a bankruptcy court open, the fees imposed on those who use the system minimize the taxpayer costs.

### 3. *Political Insulation*

The bankruptcy system also forces greater internalization of costs by providing a mechanism to deal with failing companies and the enormous claims against them in a manner that discourages the parties from demanding a public bailout. The Chrysler story illustrates

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75. 28 U.S.C. § 156(c) (1988).

76. Letter from Mark J. Silver, Program Manager, Bankruptcy Administrator Program, Division of Bankruptcy, Administrative Office of the United States Courts, to Elizabeth Warren (Mar. 23, 1993) (on file with author).

77. *Id.* The numbers listed here do not include \$32 million in deposit funds held by the court at the end of the fiscal year. *Id.*

why Congress needs help in resisting such demands.<sup>78</sup>

In the late 1970s, Chrysler Automotive faced increasing financial troubles. Years of mismanagement, combined with declining sales and pressure from foreign car manufacturers, left Chrysler facing default on its massive loan obligations. As the crisis deepened, management devised a strategy to renegotiate Chrysler's debt, but its financial condition was too shaky to warrant extensions of the credit it required. Chrysler responded with a public relations campaign intended to demonstrate the impact of its impending failure. Spokespersons talked about jobs that would be lost, suppliers that would be put out of business, and banks that would go down with Chrysler if it failed. The campaign was not directed at their lenders, however. Instead, Chrysler focused its efforts on the federal government, asking for loan guarantees to help it overcome its cash-flow difficulties. Chrysler's creditors — joined by Chrysler employees and suppliers — actively took up the lobbying effort. They held rallies and participated in organized letter-writing campaigns. Ultimately, Congress acquiesced. After considering the views of the Secretary of the Treasury, the president of the United Auto Workers, the governor of Michigan, the mayor of Detroit, the vice president of the National Automobile Dealers Association, the executive director of the National Association for the Advancement of Colored People, and the United States Conference of Mayors, among others, Congress passed, by a comfortable margin, a loan guarantee bill that permitted Chrysler to restructure its outstanding debt.<sup>79</sup> Leading economists of different ideological and philosophical persuasions — including Milton Friedman, Alan Greenspan, James Tobin, John K. Galbraith, and Robert Eisner — vigorously opposed the rescue mission, a fact of little consequence to a Congress facing huge political pressure.<sup>80</sup>

The Chrysler story had a mostly happy ending, at least in the intermediate term. Chrysler weathered the crisis, the workers gave up some benefits but kept their jobs, Lee Iacocca and his management team took fat bonuses, and the company paid back the government guarantees in full. Nevertheless, Congress had set a worrisome precedent for federal bailouts. It had agreed to the Chrysler guarantee in part because it arose in the transition period between the Bankruptcy Act of 1898 and the replacement Bankruptcy Code of 1978. Most

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78. See generally MICHAEL MORITZ & BARRETT SEAMAN, *GOING FOR BROKE: THE CHRYSLER STORY* (1981) (describing the details of Chrysler's financial debacle and government rescue).

79. WALTER ADAMS & JAMES W. BROCK, *THE BIGNESS COMPLEX* 298-303 (1986).

80. *Id.* at 302.



observers regarded the old laws as inadequate for the reorganization of large, public companies like Chrysler, and the new Code remained untested.

As the Chrysler saga was unfolding, another highly visible financial crisis was in the making. The number of people beginning to show symptoms of asbestosis were multiplying rapidly. A mounting number of successful lawsuits had established that manufacturers using asbestos in their products had injured their workers for decades, and that the likely bill to compensate these victims would run into the billions of dollars. Recognizing their financial plight, the asbestos manufacturers decided to emulate a proven strategy: go public and ask for government help. Their chances of success looked even better than Chrysler's. Their victims were more sympathetic, the government arguably bore some responsibility because the Department of Defense had contracted for much of the asbestos work in the 1940s, and the odds of the business surviving and repaying the victims without government help seemed nonexistent.<sup>81</sup> Within twenty months of the Chrysler bailout, another industrial giant appeared in Washington asking for help.

This time, however, Congress issued a strongly worded refusal for the parties seeking its help: work it out yourselves. Congress reminded the asbestos lobby that the federal government was facing its own budget crisis, and it recommended a "private solution." The solution of choice was the new bankruptcy code. When Johns-Manville filed for bankruptcy — followed by other companies confronting significant asbestos liability — it became clear that, at a minimum, companies would have to exhaust their private resources before the government would step in with relief.

Thus, bankruptcy laws give large companies the opportunity to reorganize. Along with this opportunity come the hopes that creditors will eventually be repaid, tort victims will be compensated, and employees will be able to keep their jobs — all without subsidization from the taxpayer. Even if the reorganization effort fails, liquidation in bankruptcy involves delay, which gives those who depend on the failing business a chance for final collection and some time to adjust to the losses they will face. The opportunity for the business to reorganize and its accompanying hope of success allow Congress greater lee-

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81. Moreover, the companies could point to the government's earlier development of a national insurance fund for black lung victims as precedent for help with this specific work-related injury. See Black Lung Benefits Act, Pub. L. No. 91-173, 83 Stat. 792 (codified as amended at 30 U.S.C. §§ 901-945 (1988 & Supp. III 1991)); see generally Allen R. Prunty & Mark E. Solomons, *The Federal Black Lung Program: Its Evolution and Current Issues*, 91 W. VA. L. REV. 665 (1989).

way to withstand the pleading of all those who will be injured by the failure of the business. This process, in turn, tends to block the development of an ever-growing number of specialized government programs that externalize the costs of business failure to the taxpaying public.<sup>82</sup>

#### D. *A Privately Monitored System*

As a mechanism to deal with failing businesses, the bankruptcy system offers a number of potential benefits. The preceding sections suggest that it fosters substantial enhancement of the value of the debtor, so that parties receive more than they would under alternative collection systems. It also distributes those assets according to a deliberate scheme, offering protection to a number of deserving parties who would otherwise receive little. Further, the system forces parties who deal with the debtor to bear the burden of their losses without externalizing them to others. Yet the system can have no practical effect on commercial life unless we use it. A crucial feature of the bankruptcy system — and one that is essential to implement the other normative goals of the system — is that an effective means exists to bring the system into play at the appropriate time.

Both privately and publicly initiated systems are used throughout the world to deal with failing businesses. In countries throughout Asia and Europe, government or regulatory intervention is the standard means to cope with insolvent corporations. The American bankruptcy system relies on a different mechanism: recourse to the bankruptcy courts is a private affair, available only when the parties more directly affected by its operation initiate it. No public resources are allocated to monitor debtors' financial conditions or to bring debtors in danger of collapse under court supervision. There are no "debt police" to scrutinize the likelihood that a debtor will not pay, nor are there state-authorized trustees to impose bankruptcy protection upon those at risk. The law leaves debt-collection and asset-distribution costs to the private parties who stand to lose or gain as the debtor

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82. The banking crisis makes an interesting counterpoint to the example of business bankruptcy. Banks may not file for bankruptcy relief; instead, when they fail a government agency reorganizes them and a government insurance fund pays off their creditors — typically, their depositors. The costs of such a system and the perverse risk-taking incentives it creates have become evident in recent years. At the same time, it is extraordinarily difficult for the government to consider any banking system that would result in less than payment in full for all creditors. See generally *Speeches from the Federalist Society Fifth Annual Lawyers Convention: Individual Responsibility and the Law*, 77 CORNELL L. REV. 955, 1078-1114 (1992) (speeches and discussion of Frank H. Easterbrook, Edith H. Jones, Elizabeth Warren, and Harris Weinstein).

suffers or prospers. The state merely provides the forum and the procedures to regulate the parties' efforts.

The normative preference for private over public initiation has many justifications. A private decision to use the bankruptcy process is likely to be better than a public decision. Private initiation lets the parties with the best information determine whether to use bankruptcy. The parties can assess the degree of risk involved in a transaction and how much debt enforcement they need. If they perceive little risk of loss, if the losses are sufficiently small, or if there is little hope for greater repayment in bankruptcy, the parties can simply decide not to invoke the system. This mechanism not only allocates the costs to those most affected by its use, but it also imposes no bankruptcy expense on parties who perceive no benefit in its use.<sup>83</sup>

A voluntary system also avoids the difficulties that arise when an official determination that a party is bankrupt sets the machinery in motion. Regulators' mistakes can force a complex bankruptcy scheme upon a debtor that could have resolved its problems more simply outside bankruptcy. Alternatively, they can cause a struggling business that otherwise might have eventually succeeded to fail at once. Reliance on regulators invites both overly aggressive and insufficiently attentive enforcement, imposing error costs on the parties in either case.<sup>84</sup>

Even if the bankruptcy decision is appropriately made, parties resistant to bankruptcy, either through misinformation or in response to competing incentives, may elect to spend a great deal of time and money litigating the threshold issue of filing. In that case, they dissipate value that could have been put to productive use in liquidation or reorganization. A properly constructed bankruptcy system places the bankruptcy decision in the hands of the parties who have superior information about the finances and the likely future of the business, and who will not expend resources to dispute the appropriateness of the filing.<sup>85</sup>

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83. Professor Randal Picker explains this point in greater detail when he argues that the benefits of private monitoring justify such debtor incentives as deviations from the absolute priority rule. Randal C. Picker, *Voluntary Petitions and the Creditors' Bargain*, 61 U. CIN. L. REV. 519 (1992). Picker justifies this analysis exclusively on allocative efficiency grounds as seen through a creditors' bargain model. *Id.* at 525-26.

84. Once again, the banking system provides an instructive counterpoint. It has had enormous problems establishing an effective monitoring mechanism to close down failing operations in just one, highly regulated industry. Problems of ineffective monitoring and high monitoring costs, as well as under- and overenforcement problems, have plagued the system. See, e.g., JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 573-77 (1992); Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153 (1988).

85. One exception has been the recent flurry of litigation, initiated by creditors, over the

In most businesses, the debtor best fits the description of the well-informed decisionmaker.<sup>86</sup> The debtor is typically the only party with access to full information about its outstanding obligations, future business plans, and income projections. While no one is a perfect decisionmaker, the debtor is usually best able to assess how successful the business is likely to be in meeting its continuing obligations, and to determine whether bankruptcy provides an opportunity to enhance the value of the business.

The system could, of course, have been structured so that bankruptcy would typically be creditor-, rather than debtor-, initiated. Such an approach, however, presents a number of problems. Creditors are not as likely as debtors to have immediate access to the detailed information necessary to make the filing decision. They would also face significant hurdles in securing current information even if they required such information in their initial loan documents. Moreover, creditors with the best information are likely to be sufficiently sophisticated and alert to have protected themselves thoroughly at state law. As a result, the creditors best able to act are the ones least likely to want to move toward the collective process of bankruptcy. To the extent that bankruptcy operates to redistribute value to less-active creditors, it requires some mechanism to initiate a bankruptcy proceeding that does not depend on creditor activity. Finally, creditor-initiated petitions, like those that government regulators initiate, would likely trigger disputes over the appropriateness of the filing, which would consume assets and cause delay. It may be entirely appropriate to permit creditors to initiate bankruptcy petitions when they are so motivated, but a system that relies on creditor initiation will likely be costly and underutilized.<sup>87</sup>

While a debtor may have the information to make the best decision about entering bankruptcy, there are substantial reasons for a debtor to resist a bankruptcy filing. The normative rationalization for bankruptcy often favors the interests of the creditors at the expense of either the shareholders or the managers of the business. The Code

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appropriateness of providing bankruptcy relief for a debtor with a single asset and a single creditor. Typically, these cases involve real estate deals — for example, involving apartment houses or office buildings — that have gone sour, and a creditor who plans a simple foreclosure at state law that is thwarted by a bankruptcy filing. The court litigation focuses on whether such a filing is in “good faith.”

86. Both Professors Baird and Picker see the informational advantages that current management has in making the bankruptcy decision. Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INTL. REV. L. & ECON. 223, 228 (1991); Picker, *supra* note 83, at 535.

87. In fact, creditors initiate only a tiny proportion of bankruptcy filings, less than one-tenth of one percent of the filings. The bankruptcy system is de facto a voluntary, debtor-initiated system. See *infra* note 106.

puts an end to much of the strategic maneuvering to avoid creditor collection that state collection law would permit. The bankruptcy laws give the court and the creditors much greater say in the operation of the business than they would have in a state forum. To enhance the value of the estate, bankruptcy laws may require selling off the business, a move that could leave current management without jobs and freeze out old equity altogether. Even if the business survives, the distributive norms of the Bankruptcy Code are nearly always contrary to the interests of the business owners, whom it places at the end of the payment line that forms outside the debtor's door in bankruptcy. Moreover, at every turn, the Bankruptcy Code makes it clear that the debtor has far greater disclosure obligations and is subject to much more extensive court supervision than would exist outside bankruptcy. Ultimately, managers and owners of a business must face the fact that, in filing for bankruptcy, they run a substantial risk of losing control of their business entirely and losing whatever value they might otherwise have been able to extract from the business.

In order to stimulate the debtor to initiate bankruptcy proceedings at an appropriate point when the business risks economic failure, there must be some incentive to attract the business into the bankruptcy process. The Bankruptcy Code offers one powerful incentive: the opportunity to save a failing business. Bankruptcy halts, at least temporarily, the debtor's downward slide, providing breathing space within which it can try to turn things around.<sup>88</sup> If the debtor wants to attempt to save its business, bankruptcy — with all its attendant restrictions and constraints — often offers the only practical opportunity to do so. Of course, if the owner of the business prefers to loot it and run, sees no hope of recovery, or is intent on turning it over to a particular creditor, the business will not file for bankruptcy voluntarily. In that case, the creditors will either step in and push the debtor into bankruptcy, or they will lose whatever protection bankruptcy can offer them. In the overwhelming proportion of bankruptcy cases, however, the owner or manager wants to stay and work with the failing business. As a result, the owner or manager may put the business in bankruptcy or negotiate a consensual agreement in the shadow of the bankruptcy laws.

One of the key reasons for the adoption of the 1978 Code was the widespread perception that the old Code was unworkable.<sup>89</sup> Debtors perceived that they could not save a business in bankruptcy, and their

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88. See 11 U.S.C. § 362 (1988).

89. See, e.g., WARREN & WESTBROOK, *supra* note 12, at 190.

creditors largely believed that the system dissipated assets and delayed payouts unnecessarily. The new Code — chapter 11 in particular — was designed with an avowed intention to make bankruptcy more attractive to businesses in trouble.<sup>90</sup> The Code gives debtors management control over the business after filing,<sup>91</sup> permission to continue the business in ordinary operations,<sup>92</sup> the exclusive right to propose a plan of reorganization,<sup>93</sup> exemption from securities laws when a plan is proposed,<sup>94</sup> and a number of other options that make it possible to operate a business successfully after filing.<sup>95</sup> By creating an opportunity for a business to survive its immediate financial crisis, the system serves several normative goals, including the objective goal of encouraging voluntary submission.

Here, as in many other instances under the Code, bankruptcy policies overlap. Value-enhancement norms coincide with voluntary-filing norms. For example, Code provisions permit the debtor to preserve going-concern value and at the same time give debtors a reason to file. Similarly, bankruptcy distribution rules supplant inadequately considered state law rules while constraining externalization of costs to the public fisc. In some cases, however, values may conflict. To the extent that the Code bribes management to bring a failing business into bankruptcy, some value presumably transfers, directly or indirectly, from the creditors to the managers. It is a legitimate subject of inquiry to explore whether the Code uses appropriate incentives to encourage optimal use of the system at the lowest cost.<sup>96</sup>

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90. See, e.g., HOUSE COMM. ON THE JUDICIARY, BANKRUPTCY LAW REVISION REPORT, H.R. REP. NO. 595, 95th Cong., 1st Sess. 231 (1977) ("Proposed chapter 11 recognizes the need for the debtor to remain in control to some degree, or else debtors will avoid the reorganization provisions in the bill until it would be too late for them to be an effective remedy."); H.R. REP. NO. 595, at 233-34 (recognizing debtors' concerns that a standard leading to frequent appointments of trustees would prevent debtors from seeking relief under chapter 11).

91. 11 U.S.C. § 1107 (1988). The debtor-in-possession may be replaced for cause at any time after commencement of the case and before confirmation of a plan. 11 U.S.C. § 1104 (1988).

92. 11 U.S.C. § 363(c) (1988); see also 11 U.S.C. § 1106(a) (1988) (authorizing the trustee to investigate the desirability of continuing the business).

93. 11 U.S.C. § 1121 (1988) (stating that the time of exclusivity for plan proposal is limited to 120 days, unless extended by the court).

94. 11 U.S.C. § 1145 (1988).

95. Picker focuses on the ability to violate the absolute priority rule as a key attraction for managers and shareholders to file for chapter 11. Picker, *supra* note 83, at 538-39. He may be correct that it is good policy to permit such deviations in order to attract debtor filing. Nevertheless, it does not follow that allowing the violations was an intentional incentive device, nor does Picker claim that it is. The absolute priority rule is still in force in the Code, although participation of prefling equity through a so-called new value exception reduces one of the shareholders' most significant disincentives for seeking a bankruptcy reorganization. This distinction is nothing more than a footnote to Picker's broader point that it might be good to permit such deviations in order to encourage voluntary filing.

96. Small businesses with managers and equity who are the same person or have close identity raise different issues about equity participation than do large businesses run by a professional

Identifying the normative principles does not conclude the policy exploration. This discussion articulates interwoven rationales for a mechanism in which the benefits and burdens combine to create a workable system for dealing with the debts of a failing company. It offers a framework for evaluating success and failure and the possibility of determining the empirical questions any substantive evaluation of the Code should address.

### III. EVALUATING POLICIES WITH MULTIPLE, ARTICULATED OBJECTIVES

A more careful elaboration of the elements of bankruptcy policy serves many functions. In some cases, it may simply reinforce an already widely accepted norm. For example, the value-enhancement principle is sufficiently well accepted that most policymakers need little encouragement to adopt procedures they perceive will result in net savings. Its inclusion here does little more than add fancy icing to a sturdy cake.<sup>97</sup> In some cases, however, a more complete elaboration of a bankruptcy policy may change how a problem is framed or what solutions are proposed.

The high rate of failure of chapter 11 cases provides an interesting case in point. Most observers estimate that about four out of five chapter 11 bankruptcy cases fail before a plan of reorganization can be confirmed.<sup>98</sup> Among these confirmed cases, approximately thirty percent of the plans provide for liquidation of the business.<sup>99</sup> By these

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management team with little equitable ownership. This distinction may be an important area in which the two kinds of cases should prompt two kinds of rules. See Warren, *supra* note 16.

97. Much of the current enthusiasm over development of a "fast-track chapter 10" stems from the desire to cut the costs of small business reorganization by implementing the well-accepted goals of value enhancement and cost reduction. See, e.g., *Judge Small Looks at Small Business Reorganizations*, 24 Bankr. Ct. Dec. (CRR) A4 (Apr. 15, 1993); *New Chapter for Small 11s Proposed*, *Weekly News & Comment*, 22 Bankr. Ct. Dec. (CRR), at A1 (Oct. 24, 1991).

98. Estimates of success vary somewhat, depending on the sample collected and the definitions used. Compare Edward Flynn, Administrative Office of the U.S. Courts, Statistical Analysis of Chapter 11, at 10-11 (Oct. 1989) (unpublished report on file with author) (study of 2400 confirmed chapter 11 cases 1979/1980-1986, estimating 17% confirmation rate); Susan Jensen-Conklin, *Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law*, 97 COM. L.J. 297 (1992) (study of 260 chapter 11 cases filed in Poughkeepsie, New York, 1980-1989, reporting a confirmation rate of 17%) and Lynn M. LoPucki, *The Debtor in Full Control — Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 99, 107 (1983) (study of 57 chapter 11 cases from Western District of Missouri in 1980, reporting a 27% confirmation rate) with LoPucki & Whitford, *supra* note 33, at 41 n.105 (study of 46 largest cases filed during 1979-1988, reporting 89 to 96% confirmation rate) and Flynn, *supra*, at 34 (finding a correlation between high asset size and high confirmation rates). Professor LoPucki also concluded that size is highly correlated with confirmation success. LoPucki, *supra*, at 109.

99. Flynn, *supra* note 98, at 12. Because one-third of the confirmed plans are liquidating plans, Flynn estimates that only 10 to 12% of the chapter 11 filings result in successful reorganizations. *Id.* at 13.

estimates, only about one in ten chapter 11 cases result in a reorganized, surviving business.<sup>100</sup>

Many commentators use this ninety percent liquidation rate as evidence that the chapter 11 system is failing miserably.<sup>101</sup> The initial proposition of this essay was that whether a system is failing or succeeding depends on the boundaries of its original mission. If the goal of chapter 11 is simply to keep lots of companies in business, the data are indeed damning.<sup>102</sup> If the system has other goals, however, the same data may support an inference that the system is successful.

There is little systematic information about the businesses that fail to confirm plans in chapter 11. We might hypothesize, however, that these businesses were in such grim financial shape that they were likely to liquidate in or out of bankruptcy.<sup>103</sup> These may be the businesses that should be shaken out of the economy — the restaurants that serve poor food in inconvenient locations, the manufacturers that produce inferior products at high prices, and the plumbers who do not fix leaks. If that is so, the bankruptcy system works as it should: these companies should not — and do not — survive their bankruptcy filings.

The bankruptcy process nonetheless had a significant impact on the businesses that filed for chapter 11 but never confirmed a reorganization plan. The distributional objectives of the Code were clearly in

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100. Publicly traded companies have much higher survival rates in bankruptcy. About 90% of the publicly traded companies in bankruptcy confirm a plan of reorganization. There is also evidence to suggest that success rates are positively correlated with size. LoPucki & Whitford, *supra* note 33, at 41 n.105 (finding confirmation rate of 89 to 96% among biggest cases filed during 1979-1988); Flynn, *supra* note 98, at 10-11 (estimating a 17% confirmation rate for all chapter 11 filings). LoPucki and Whitford as well as Flynn specifically identify size as a critical variable in the chapter 11 experience. Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 601 (1993); Flynn, *supra* note 98, at 33-35. For a discussion of the ways in which large and small companies may experience bankruptcy differently, see Warren, *Untenable Case for Repeal*, *supra* note 5, at 441-43. These differences have little statistical importance in evaluating the system because large, publicly traded companies comprise less than one percent of the chapter 11 filings. *Id.* at 441.

101. See, e.g., Thomas E. Ray, *Chapter 13, A Little Surgery Could Go a Long Way*, AM. BANKR. INST. J., Mar. 1993, at 31.

102. A 90% failure rate by itself, of course, proves nothing. If the failure rate for the same businesses outside bankruptcy would have been 100%, for example, then it would strengthen the inference that chapter 11 is effective in saving failing businesses. Notwithstanding this distinction, most observers believe a 10% success rate is something less than a ringing endorsement for the current system.

103. If the data suggested that businesses in similar condition fail more often when they choose chapter 11 than when they try to solve their problems outside bankruptcy, then, of course, they would provide grounds for a serious indictment of the chapter 11 system. This point, of course, would be true whether the failure rate were 90% or 10%. The comparison that makes any inference valid is what happens to similarly situated businesses outside bankruptcy. No one has gathered those data, however, so we are left to speculate based only on the little we know about the firms in bankruptcy.



play. For the cases that were converted to chapter 7 or liquidated in chapter 11, the court distributed assets pro rata to the unsecured creditors. Both present and future claimants had the opportunity to be heard and to share in any distribution of assets. Creditors could reclaim assets that had been paid to preferred creditors on the eve of filing. Payments that otherwise would have gone elsewhere were made to employees, tort claimants, taxing authorities, and pensioners. The court and a trustee supervised distribution of the assets to insure that it adhered to the federal scheme.<sup>104</sup> Perhaps most critically, those who could have killed off the business were kept at bay while the business received one last chance to survive and to repay more people and companies that depended on the business. Whether the estate produced sufficient assets to pay any of these creditors is unknown, but whatever assets the estate generated were distributed to the parties who dealt with the debtor according to policies embodied in the Bankruptcy Code.<sup>105</sup>

The debtor's trip through bankruptcy may also have increased the total value of the assets available to all the parties. The creditors had the benefit of collective action, a creditors' committee, and the supervision of the U.S. Trustee. The debtor was obligated to make a full accounting of its operations — explaining lost assets, revealing valuation information, and offering projections of future business. With more complete information, the debtors had the chance to seek buyers for the business or contemplate cashing in their unpaid obligations to buy the business for themselves. State law maneuvers were no longer available to the debtor to resist loss of control over the business or to fight, asset by asset, over the remaining business. Management could no longer sell off assets at bargain rates or divert the assets to favored

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104. If a case is converted to chapter 7, the court appoints a trustee to supervise the liquidation and distribution of the estate. 11 U.S.C. § 701 (1988). If the liquidation occurs in chapter 11, the court may or may not appoint a trustee, but both the U.S. Trustee and the bankruptcy court indirectly will supervise the liquidation. 11 U.S.C. §§ 1104, 1106, 1107 (1988).

105. Chapter 11 may serve other functions as well. Even if the case is dismissed rather than liquidated in chapter 7, the filing often serves to make the parties understand the seriousness of the circumstances and to bring them to the table for a settlement of their differences. Obviously, such bargaining takes place in the shadow of the bankruptcy laws, and the outcomes are heavily influenced by what each party could get — and lose — if the debtor reorganized or liquidated. Even in those dismissed cases, the bankruptcy laws are deeply influential.

The chapter 11 filing may serve yet another important function: it permits the board of directors to show that it has done everything possible to save the business. A very knowledgeable practitioner explains why some collapsing businesses file a chapter 11 reorganization rather than choosing liquidation: management fears shareholder derivative suits if they liquidate the business and their shareholders later decide that the business might have been saved in chapter 11. Telephone Conversation with Kenneth Klee of Stutman, Treister, and Glatt, Los Angeles (Apr. 1, 1993). This rationale would prompt filings that no one thought had much chance of survival, thereby contributing to a high failure rate in chapter 11. In such cases, chapter 11 functions a little like a funeral: a chance to declare the body dead and say a few prayers of farewell.

creditors. Finally, the parties got their last, best chance to preserve the going-concern value of the business through sale or confirmation of a plan.

While the possible benefits from the liquidation of these companies are many, it is not clear whether bankruptcy actually accomplished any of them. The bankruptcy filing may not, in fact, have enhanced the value of the failing business. The debtor may have exhausted the assets of the business with strategic delays long before filing, so that chapter 11 was just one more maneuver to postpone the day of reckoning. The creditors may have gained little from their collective action. In addition, the expedited procedures of bankruptcy may have meant little, as the debtor dragged its feet and prolonged its stay in chapter 11 so long as there were assets to continue paying management salaries and attorneys' fees. Moreover, debtors may have thwarted the distributional objectives of bankruptcy by concealing assets more effectively than either the trustee or their creditors could discern, or by planning their demise long enough in advance to avoid the application of various bankruptcy-avoidance provisions. Debtors may even have injured the public purse by using bankruptcy to avoid repaying environmental cleanup liabilities or to abandon underfunded pension plans that it otherwise might have paid.

An analysis of actual outcomes depends on empirical evidence, which is currently missing from the bankruptcy debates. Without that evidence we can only speak in terms of opportunities — opportunities to preserve value, to distribute it according to a deliberate federal scheme, and to reduce the externalization of costs to the public. The fact that the empirical evidence is missing, however, does not lead to a conclusion that the system has failed. Indeed, the single piece of evidence — ninety percent of the chapter 11 cases are liquidated — supports an inference that the system works well to liquidate businesses in line with bankruptcy objectives.

We know one more thing about the businesses that were liquidated after a chapter 11 filing: the owners of these businesses voluntarily brought them into the bankruptcy system, subjecting the business to increased monitoring, shared control, and, perhaps, liquidation.<sup>106</sup> It is entirely possible that the debtor filed these bankruptcy petitions af-

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106. The number of chapter 11 petitions that creditors bring is statistically insignificant. See Susan Block-Leib, *Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small*, 57 BROOK. L. REV. 803, 805 n.14 (1991). In 1988, for example, there were 260 involuntary petitions, *id.*, at 863 app. A, from a total of 18,889 chapter 11 petitions. L. RALPH MECHAM, ADMIN. OFFICE OF U.S. COURTS, ANNUAL REPORT OF THE DIRECTOR OF THE ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS 364 (1988). Later editions of the report have not tabulated more recent data on involuntary filings.

ter a creditor found enough informal leverage or brought a state court action that made it impossible to continue to operate the business outside bankruptcy. Nonetheless the debtor filed the petitions, which eliminated any need to litigate the issue of whether the debtor appropriately belonged in the chapter 11 system to resolve its financial problems. The government spent no public dollars to force the bankruptcy filing, and any benefits that flowed from the bankruptcy action were shared among all those affected by the business' failure. If bankruptcy offers any other benefits, these data suggest that those benefits were accomplished with minimal cost through private decisionmaking.

None of this discussion is intended to suggest, of course, that somehow a chapter 11 failure is better than a chapter 11 success. Many commentators analyze various aspects of the bankruptcy system to explore how it might operate with greater efficiency to reorganize more companies.<sup>107</sup> I only suggest that, while the system might be made better, one cannot conclude that it is failing simply because a high proportion of chapter 11 cases liquidate.

The bankruptcy system is intended to enhance value and to distribute that value according to a deliberate scheme. Whether it functions effectively to accomplish these aims is a topic of legitimate debate — and an appropriate subject for continued empirical study. A ninety percent liquidation rate in chapter 11 tells us only that the system is processing businesses' failures. That many of these cases began in chapter 11 with the hope of a reorganization suggests that the Code incentive — the opportunity to reorganize — effectively attracts some managers and shareholders to subject their company to the rules of chapter 11. A clearer articulation of bankruptcy policy does not tell us if the policy has been effectively implemented, but it does identify the normative goals that are critical in deeming the system a success or a failure.

#### IV. CONSTRAINTS ON BANKRUPTCY POLICYMAKING

It is possible to discuss policy objectives on a number of levels of abstraction, but too much abstraction may wash out significant details that should have an impact on any policy decision. Obviously some level of generality is critical. Without it, there would be little more

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107. One commentator, for example, has focused on poorly conceived tax laws that make it more difficult for companies to reorganize. Michelle M. Arnopol, *Why Have Chapter 11 Bankruptcies Failed So Miserably? A Reappraisal of Congressional Attempts To Protect a Corporation's Net Operating Losses After Bankruptcy*, 68 NOTRE DAME L. REV. 133, 136 (1992). She proposes solutions that she argues will permit more successful reorganizations while maintaining revenues and rationalizing the integrity of the tax structure. *Id.* at 194-97.

than a series of *sui generis* stories with no theme to unite them and no guidance for future decisionmaking. On the other hand, discussions about bankruptcy policy take place in an area of active political and economic debate; if the theorizing removes the policy analysis too far from reality, the exercise risks becoming meaningless in helping to inform the debates.

Ultimately, bankruptcy policymaking is not an academic exercise. Bankruptcy laws are now in a state of almost-constant revision. Both Congress and the courts struggle for a clearly defined bankruptcy policy to guide them as conflicts among competing considerations become sharper, as novel applications of bankruptcy law multiply, and as concern increases over the effects of bankruptcy law on the economy. The effort to derive coherence from — and to impose coherence on — the bankruptcy system compels ever greater attention to the theories that lie at the root of this system. Academics writing about the bankruptcy system do not have the luxury of assuming that what they say is not important in forming policies. Consequently, they cannot ignore the constraints of reality — except as they choose to make themselves irrelevant. This policy debate is about real provisions in real laws that have a real impact on millions of debtors, creditors, and others who are affected by economic failure.<sup>108</sup>

Before I end this essay, I want to touch on two elements that limit a meaningful policy debate about bankruptcy: bankruptcy laws operate in imperfect markets, and bankruptcy operates against a background of state collection laws that create strategic opportunities for resistant debtors. These circumstances shape both the actual forms bankruptcy laws can take as well as the aspirational goals bankruptcy may embody. To relax these constraints temporarily to explore one or another aspect of a hypothetical system may be a useful heuristic device, but to ignore them in making serious policy proposals presumes a counterfactual world that yields little meaningful insight. In this sense, the policy discussion of this essay takes its cue from the tradition of legal realism, asserting that real-world constraints necessarily — and properly — bind bankruptcy policy, and that only in a specified factual context does a policy discussion become meaningful.

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108. In the late 1970s and early 1980s, for example, every academic debate about debtors as rational actors who respond to statutory incentives was rapidly translated into law in the 1984 Amendments to the Bankruptcy Code. State and federal legislatures amended statutes to reduce debtor protection in the belief that such moves would reduce bankruptcy filing rates and encourage debtors who did file to try repayment in chapter 13. They adopted laws based explicitly on the economic analysis prevailing in the scholarly literature. For a discussion of this event and the empirical evidence showing the inapplicability of economic principles to guide legislative decision making, see Teresa A. Sullivan et al., *Laws, Models, and Real People: Choice of Chapter in Personal Bankruptcy*, 13 *LAW & SOC. INQUIRY* 661 (1988).

### A. *An Imperfect World*

We must consider bankruptcy policies in light of their application to cases that arise in the real world. It is therefore critical to note that the markets bankruptcy affects are not perfect and that they contain substantial transaction costs, information asymmetries, and ambiguities about the property rights of the parties. While one might make this blanket warning to constrain any policy debate, it is a particularly pertinent limitation in the bankruptcy area for two reasons: bankruptcy policy is itself grounded in market imperfections, and critics have ignored market imperfections in constructing a hypothetical system that is superior to the current bankruptcy system.

The basis for bankruptcy policy is so deeply rooted in market imperfections that any attempt to discuss such policy in a perfect market is a zenlike exercise, much like imagining one hand clapping. Bankruptcy laws are created to deal with the problems of market imperfections. If, in fact, markets were perfect — if debtors and their creditors had perfect information about the market generally and each party's position within it, if debtors and creditors could costlessly monitor, renegotiate, and enforce their agreements, if the legal rights of parties were always unambiguous and clear to all actors — then bankruptcy laws undoubtedly would take a different form. Many features of the bankruptcy system, for example, are intended to deal with creditors' inadequate information and the high costs of gathering the information they need to make collection decisions. Debtors must disclose substantial information about their business operations so that all creditors will have low-cost, accurate information to inform their oversight and strategic decisionmaking during the bankruptcy process.<sup>109</sup> If creditors had perfect, costless information, these provisions would be superfluous. Like other laws, bankruptcy laws take their shape from the problems with which they were created to cope.

Market imperfections are a critical element in the elaboration of any bankruptcy policy because such imperfections undoubtedly play an important part in causing the business failures that become the subject of bankruptcy laws. Some businesses may fail even in a perfect market environment. Nevertheless, the stories of distressed businesses that end up in bankruptcy are typically stories about high transaction costs, information asymmetries, and uncertainty over property rights. When Wang Laboratories failed to anticipate the importance of producing computers that were compatible with other equipment in the

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109. See *supra* notes 18-28 and accompanying text for examples of cost sharing and cost reduction from various Code provisions.

marketplace, or when Johns-Manville could not finance its current operations because of the widespread uncertainty about the future tort claims it faced, these companies demonstrated the high costs of dealing in markets in which neither they nor their creditors had full and perfect information to be able to transact without cost. The stories of failure may be depressingly routine or wildly colorful, but they almost always repeat the same elements of market imperfection that nearly every economic model proposing to analyze solutions to business failures carefully deletes.<sup>110</sup>

Not surprisingly, to test the vitality of a number of economic principles, researchers often begin their analysis with the familiar incantation of a perfect market: a world without those transaction costs, information asymmetries, or ambiguous property rights to muddy the analytic waters.<sup>111</sup> The assumptions of efficient markets may or may not be relaxed later in the argument — which obviously affects the effectiveness of any conclusions based on the hypothesis. This approach is a perfectly sensible way to begin to test the allocative efficiency of a rule of law. Without it, analysts would be mired forever in a swamp of conflicting and contaminating factors that would prevent them from identifying the incentives that various legal provisions create. Nonetheless, any policy conclusions derived under such artificial conditions are highly suspect. Unless we subject them to more rigorous testing, including some empirical analysis in those very real and very complex markets, they are worth little.

Such an abstract literature flourishes nonetheless. Articles abound in which authors begin with a “simple model of workouts and investment” that is laden with huge assumptions.<sup>112</sup> Some of the assumptions are explicit — “bank renegotiation is assumed to be costless”<sup>113</sup> and “the automatic stay is the only feature of Chapter 11” that makes a firm willing to invest<sup>114</sup> — while some are not — such as the as-

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110. This is not to say that all business failures stem from incomplete information, transaction costs, or ambiguities about property rights. It is possible for a business to suffer some unanticipated event, such as a lightning strike that destroys the business. A committed economist might argue that such losses, if uninsured, were the results of incomplete information about the likelihood of such a catastrophe or of high transaction costs to obtain such insurance. Nevertheless, that debate is not necessary to make the point raised here.

111. Some of the most interesting analyses of allocative efficiency build on models of bankruptcy that explore market imperfections directly and analyze likely outcomes under such conditions. See, e.g., Lucian A. Bebchuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J.L. ECON. & ORG. 253 (1992) (analyzing bargaining between equity holders and debtholders when property rights are ambiguous and transaction costs are substantial).

112. See, e.g., Gertner & Scharfstein, *supra* note 4.

113. *Id.* at 1196.

114. *Cf. id.* at 1029.

sumption that markets perfectly reflect all information.<sup>115</sup> Some authors offer proposals to reduce costs, improve efficiency, and correct management incentive problems in chapter 11 by having the bankruptcy court auction off the business by selling "riskless securities."<sup>116</sup> Evidently this device will yield the perfect price for the company without significant transaction costs, freeing the courts to spend time only to evaluate claims and distribute assets in accord with the rules of absolute priority.<sup>117</sup> Some identify their perfect markets premise but defend their proposals because they would operate "*immediately*" and save the costs currently expended.<sup>118</sup> Others propose sweeping reforms that put the chapter 11 company up for auction, assuming that such a move causes no apparent transaction costs and will perfectly yield the value of the company.<sup>119</sup> Others simply deliver the company into the hands of its creditors, assuming that such a move will avoid collection costs.<sup>120</sup> Evidently managers and owners will be infinitely compliant in these new systems, handing up their businesses in chapter 11 at the same rates as they now do, then quietly disappearing. Values will also be clear, as new buyers emerge ready to pay in full.

To be fair, some commentators propose models that ignore transaction costs but that propose no special solutions; they simply use the models to explore an element of the system and to develop insights that might add to an overall understanding of the system.<sup>121</sup> Others make clear the role of transaction costs and how one must deal with them separately,<sup>122</sup> while still other commentators conclude that the

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115. This assumption underlies the analysis of Gertner and Scharfstein. *Id.*

116. Cf. Michael C. Jensen, *Corporate Control and the Politics of Finance*, 4 J. APPLIED CORP. FIN. 13, 32 (1991).

117. *Id.*

118. See Bradley & Rosenzweig, *supra* note 34, at 1054, 1085-86 (emphasis in original).

119. See Phillippe Aghion et al., *The Economics of Bankruptcy Reform* (May 1992), (MIT Working Paper No. 92-11, on file with author). A variant on this proposal is in Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323-33 (1993) (proposing "Chameleon Equity" to solve bankruptcy problems through market sale of differently structured rights).

120. Cf. Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 300 (1990).

121. Professors Baird and Picker, for example, use a highly abstract game theory model to explore the incentives of parties in a bankruptcy negotiation, but they propose no sweeping changes of the bankruptcy laws based on their insights. Baird & Picker, *supra* note 16. The authors base their analysis on strong assumptions about the absence of transaction costs, and they explicitly disavow any claim that their analysis necessarily prevails in a more realistic setting. *Id.* at 347.

122. Bebchuk, *supra* note 3. Professor Bebchuk proposes that the debts of a bankrupt company be canceled, and the stock be divided among senior creditors in proportion to their debt. *Id.* at 784. Junior creditors would have options to buy the stock from senior creditors at the price of the debt, and shareholders could buy from junior debt. *Id.* at 786-87. The stated goal is to divide the reorganization pie to reduce inefficiencies that are grounded in valuation problems

system is far too complex to fit simple bargaining models.<sup>123</sup>

It is interesting to imagine what kind of market would produce enough failure to stimulate an interest in a bankruptcy system but would be so perfect that a hypothetical bankruptcy system could operate without concern for market imperfections. While some tests of allocative efficiency may reasonably begin with the presumption of a perfectly functioning market, a policy discussion should not begin in such a state of grace. To do so limits the sweep of the policy inquiry to questions of allocative efficiency and precludes alternate avenues of exploration at the inception of the journey. Bankruptcy policy discussions should provide ample opportunity to test allocative efficiency hypotheses, but they should provide a framework for considering a number of other functions of the bankruptcy system as well.

### B. *A Dual Collection System*

Another restraint on bankruptcy policymaking is that bankruptcy necessarily displaces an alternative collection system. There exists an intricate, well-developed collection system, based primarily on state laws that govern the collection of debt.<sup>124</sup> The unspoken assumption of many commentators that the collection alternatives are either bankruptcy or payment is not true. Nor is it the case that, absent bankruptcy, defaulting debtors would be forced immediately and costlessly to hand the business over to their creditors. Instead, the state collection system and the bankruptcy system provide alternative, formal rules for dealing with the collection of debt. Each creates the bases for informal leverage and negotiated settlements. Whenever commentators explore either the direct or indirect costs of bankruptcy, it is im-

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in bankruptcy. *Id.* at 777. Others criticize the work, however, for its failure to deal with transaction costs and argue that the proposed application is highly problematic notwithstanding Professor Bebchuk's disclaimer. Adams, *supra* note 4, at 152-57. Professor Adams includes Professors Baird and Roe and Provost Jackson in his critique of scholars who ignore the important role of transaction costs in their proposed alternatives to reorganization. *Id.* at 142-52.

123. See, e.g., Gertner & Scharfstein, *supra* note 4, at 1216-17. They employ such models to argue for their vision of bankruptcy. Yet they are quite critical of the abstract models of Professors Baird and Roe and Provost Jackson, dismissing the latter's analysis as too simplistic. *Id.*

124. The nonbankruptcy collection system comprises both state and federal elements. State law determines the formal collection rights of most contract and tort claimants, while nonbankruptcy federal law determines collection rights of certain other parties. The IRS, for example, has special collection rights controlled largely by federal collection laws. See, e.g., I.R.C. § 6322 (1988) (giving the IRS a tax lien when a tax assessment is made); I.R.C. § 6323(a) (Supp. III 1991) (establishing the priority of the IRS tax lien over all other creditors except purchasers and creditors with security interests, mechanic's liens, or judgment liens that were previously recorded). Notwithstanding a number of federal collection provisions, for ease of discussion the nonbankruptcy collection system is frequently referred to as the "state collection system." This term emphasizes the variability of the system, which is the key ingredient whether the origin of the laws is state or federal.



portant to consider the concomitant costs of resolution through the state collection system.

The most salient feature of the state collection system for the purposes of this discussion is its complexity. A creditor attempting to use state collection law to obtain and enforce a judgment must follow a series of intricate laws that raise substantial barriers to forced collection. These laws require steps that frequently tip off the debtor about impending collection efforts, permitting debtors to move assets to keep them out of their creditors' hands.<sup>125</sup> While it is possible to collect from the unsophisticated or the cooperative, the laws make it difficult to collect from a resistant debtor. A case such as *Vitale v. Hotel California, Inc.*<sup>126</sup> illustrates the practical and legal complexity involved in collecting an employee's claim for \$6317 against a New Jersey restaurant. More than two years *after* he had obtained a default judgment against the debtor and *after* countless collection efforts, Mr. Vitale was still struggling for his money — and he was collecting against a currently operating, apparently solvent business that remained in a single location. The *Vitale* case is remarkable only because it resulted in a published opinion; the difficulties the creditor faced were all too routine.

The laws are complex, but the multijurisdictional problems involved in debt collection multiply the complexity. Collection laws vary from state to state and, in some cases, from county to county. Even if the creditor surmounts the technical hurdles of proving the obligation and initiating the formal collection process in one jurisdiction, it faces the possibility that the debtor or the assets will move to another jurisdiction.<sup>127</sup> The creditor will not have to reestablish the underlying debt, but the creditor must initiate the collection process anew in the subsequent jurisdiction, making it both more expensive to collect and less likely that the creditor will be fully satisfied.

Debtors have a number of other informal means to resist their creditors' collection efforts. They may sell assets at below-market values to yield quick cash, distribute assets to favored creditors to reduce the assets available to complaining creditors, or redeploy assets into

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125. See, e.g., LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: TEXT, CASES AND PROBLEMS (forthcoming 1994).

126. 446 A.2d 880 (N.J. Super. Ct. Law Div.), *affid.*, 455 A.2d 508 (N.J. Super. Ct. App. Div. 1982).

127. Of course, not all assets can be moved. Real estate, for example, stays put, which makes it more valuable to attempt to seize. On the other hand, the procedures involved in seizing real estate can be highly technical. It can also take a substantial amount of time to terminate the interests of the debtor in the property and free it for resale. See, e.g., LOPUCKI & WARREN, *supra* note 125.

high-risk ventures that will increase the creditors' losses if the venture fails. Depending on the precise details, some of these activities may violate state collection laws or the creditors' contracts with the debtor. That does not mean, however, that such behavior will not occur. Creditors can spend substantial assets monitoring their debtors and still lose out if the debtor refuses to pay.

To be sure, not all collection actions end up in a multistate chase or a game of hide-and-seek with the debtor's assets. Most collection actions are routine affairs in which the biggest impediment to the creditor's successful collection is the debtor's lack of assets. To the extent that creditors complain about clever, slippery debtors who elude them through bankruptcy, however, it is important to remember that those debtors have more than a few opportunities to do the same in the state law system.

The uniform provisions of Article 9 of the U.C.C. lend some consistency to the collection area, but the provisions are more useful in creating substantive rights than in streamlining judicial enforcement.<sup>128</sup> Nonetheless, creditors with mortgages in real estate or security interests in other property frequently prefer the state collection system to its bankruptcy counterpart. Their preference is not for the convenience of collection at state law. Even creditors with enhanced interests, such as mortgagees and secured creditors, face complex and sometimes costly collection procedures, albeit procedures that are generally less expensive than those that unsecured creditors must pursue. Their primary benefit is their priority, which permits them to collect ahead of all other creditors.<sup>129</sup> Such benefits, however, apply only to a small subset of those to whom the debtor may owe significant obligations. Among the creditors with no practical access to state law collection priorities are nearly all tort victims, trade creditors, employees, pensioners, and literally hundreds of other classes of possible claimants against the debtor. Preference for a nonbankruptcy system is more often a distributional question rather than a question of efficiency of collection, as is so often posited.<sup>130</sup> Creditors who see the state collection system as accessible and superior to the bankruptcy

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128. If the debtor is unwilling to stand by while the creditor uses self-help remedies to repossess property, the Article 9 creditor is also thrown into the vagaries of state collection law. Article 9 sets forth uniform provisions for the creation of an enforceable security interest and provides for creditor self-help if the debtor cooperates. It does not, however, replace the state court collection system if the debtor resists repossession.

129. Kenneth Klee makes the important point that the Bankruptcy Code enhances collection for creditors with such security interests by reducing certain risks and costs of collection. See Klee, *supra* note 35.

130. Warren, *Untenable Case for Repeal*, *supra* note 5, at 467-74.

system tend to be a small, but powerful subset of all those to whom a debtor may owe obligations.

Notwithstanding the axiomatic element of the observation that bankruptcy laws play out against a complex state collection scheme, the number of observers who fail to acknowledge that fact as they criticize the bankruptcy system or compare it with a "costless" nonbankruptcy collection system is legion. One author proposes replacing the collective process of bankruptcy with a system of debtor distribution of assets<sup>131</sup> — a scheme which can evidently force the debtor to participate at no cost. Another proposes to take away the courts' control over the company's assets and put it back into the hands of investors.<sup>132</sup> He proposes to use contractual agreements to accomplish this goal — agreements that parties evidently could costlessly and perfectly enforce without resort to the courts. Other authors give similar primacy to the contractual arrangements between debtor and creditor, charging that the bankruptcy laws impose significant costs — and evidently assuming that parties would encounter no costs in trying to enforce rights granted under these perfectly negotiated contracts.<sup>133</sup> Anyone who routinely reads reports of contract litigation recognizes that such assumptions are not just unrealistic, they are demonstrably counterfactual. If the authors of these proposals believe that debtors who behaved strategically in chapter 11 could not or would not examine their contractual obligations for evidence of ambiguity, overreaching, and a dozen other litigable issues that would precede court enforcement, they have an asymmetric view of human behavior that is useful only in its ability to reinforce a wholly unrealistic economic model.

Once again, it is worth noting that much of the affection for contract-based alternatives to bankruptcy may not be due to cost-based preferences — although that is the language of the argument — so much as they are due to distribution-based objectives. Commentators who laud the ability of creditors to decide *ex ante* by contract what will happen to the debtor's assets if the debtor begins to fail demonstrate a *de facto* preference for contract-based claimants. All other claimants — those who have no opportunity to contract with the debtor, or who have little power in their contract negotiations — sim-

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131. James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097 (1990).

132. Rasmussen, *supra* note 4.

133. Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Bradley & Rosenzweig, *supra* note 34. The two proposals differ in form, but both rely on a seemingly costless enforcement of some costlessly negotiated contractual arrangements.

ply lose out as one group of creditors secures all the assets for themselves. Perhaps collection laws should prefer contract-based claimants over all other parties, but that is a debate we should have directly by focusing on the distributive implications of contract-based preferences, not a result that should be smuggled into the system through an analysis of allocative efficiency.

The presence of an alternative collection system based on a variety of state collection laws is integral to the development of the bankruptcy system. Bankruptcy exists in part to federalize and standardize a variety of collection rules and laws. If a single uniform collection system replaced the current state law collection system, if all creditors had easy access to the current state system, if there were not variability among the collection rules of the states, if debtors and creditors could not use state law variability as an opportunity for strategic behavior, and if the debtors did not have a number of devices to thwart creditor collection attempts, then, once again, the shape of the bankruptcy laws would undoubtedly differ from those extant today.

It is good to criticize any system; constant vigilance in the form of vigorous debate is useful to maintain or improve the efficacy of a legal regime. The criticism is more meaningful, however, if it takes account of the circumstances that constrain the operation of the system. Some of the criticism of the bankruptcy system is solidly grounded in the circumstances of the system, but a significant portion of the critique is not. To model improved systems that operate only in perfect markets, or to ignore the high costs of collection outside the bankruptcy system when critiquing the high costs of collection in bankruptcy, is to design an airplane that carries no payload, flies only in a gravity-free environment, and consumes no fuel. The exercise may be great fun, but it yields little that is useful for those who need to build planes that fly. It is important to separate debates about bankruptcy fancy from debates about bankruptcy policy.

### CONCLUSION

The debates over bankruptcy laws are not likely to subside soon. As bankruptcy policy continues to impinge on a number of other fields — such as tort, environmental liability, labor law, pension rights, banking regulation, class actions, director and officer liability, merger and acquisition rules, and SEC disclosure regulations — it is likely that the volume of the disputes about the bankruptcy system will increase rather than decrease. Bankruptcy policymaking no longer suffers from inattention; the question now is whether it can survive the spotlight.

Ink has spilled freely in the past few years as a number of critics have called for the reform or outright abolition of the bankruptcy system, claiming that it has failed and offering some other method for dealing with business failures. The critics reassert the theoretical justifications for the bankruptcy system by implication, focusing on how the system has failed to meet some thinly articulated goals.

It is important to expose the inefficiencies, inadequacies, incentives, and errors of the bankruptcy system. Its shortcomings may be many, and its operation is sufficiently important to both debtors and creditors to warrant thorough academic study and strong public debate. The chapter 11s of large, publicly traded cases that have fueled much of the debate are important, particularly as these cases become the fora for the resolution of a multitude of critical social issues. No one should sit back comfortably, assured that we have a well-functioning business bankruptcy system.

In the march through the details of the rules and the attention to the megacase, however, it is essential that the larger impact of the system not be lost. The bankruptcy system is designed to serve critical functions to preserve the value of failing businesses, to distribute that value according to deliberately defined policies, and to internalize the costs of business failure. The system assists a variety of businesses, more than ninety-nine percent of which are not publicly traded. It also serves literally millions of different creditors and other interested parties affected by the bankruptcy laws. Because the functions of the bankruptcy system are deeply intertwined, a single change has the potential to create multiple effects throughout the system. Moreover, changes pursued for one end may simultaneously move the system further away from a number of other objectives.

It is appropriate to end this essay by repeating the initial call for caution. Debates about bankruptcy policy must be more carefully framed to expose their policy presumptions, and any proposal for reform should be accompanied by a thoughtful evaluation of its impact on the competing policy concerns. It is also appropriate, however, to end with a call for a wider exploration of the problems of the system — particularly the kinds of problems that do not fit neatly within established paradigms. We remain woefully short on reliable empirical data about the operation of the system, particularly with respect to the routine cases. Our theoretical grasp of the incentives at work for competing parties is primitive at best, and it certainly deserves elaboration. In short, there is much to learn. In learning, however, there is much known that we should not forget.