THE LOGIC AND LIMITS OF BANKRUPTCY LAW

Thomas Jackson

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Harvard Law School

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Note. The material in this Discussion Paper is excerpted from a draft of a book entitled THE LOGIC AND LIMITS OF BANKRUPTCY LAW: Applications of Collective Action and Discharge Policies; the author is Thomas Jackson. THe book will be published by the Harvard University Press. The material here is, in the following order, Abstract of Chapters, Table of Contents, Introduction, Ch. 1, Ch. 2, Ch. 9. Footnotes are not included.

Abstract of Chapters

Chapter 1 This chapter locates bankruptcy as a species of debt-collection law, and justifies its basic regime as a response to a common pool problem created when there are diverse "owners" (creditors and others) and too few assets.

Chapter 2 Building on the common pool model developed in the first Chapter, Chapter 2 discusses the limits inherent in viewing bankruptcy as a response to a common pool problem, particularly insofar as changing relative nonbankruptcy entitlements are concerned. These points are then applied to the determination of "claims" for purposes of bankruptcy, and the notion of resorting to nonbankruptcy law to determine relative values is developed. Examples such as loan acceleration in bankruptcy and the treatment of nonmanifested tort claims are explored.

Chapter 3 Basic trustee avoiding powers are examined in light of the notion of relative values developed in the prior chapter. The bankruptcy treatment of state-created priorities and statutory liens are also examined in light of the common pool model.

Chapter 4 The question of what is available to be distributed to the pool of claimants is the subject of Chapter 4. In this chapter, the view of bankruptcy developed in the first two chapters of the book is applied to look at the question of what are assets from the perspective of the residual class. The notion of resorting to nonbankruptcy law for an examination of relevant attributes that one then tries to mirror in the bankruptcy forum is developed in this chapter, and contrasted to the normative irrelevance of nonbankruptcy labels.

Chapter 5 The notion of executory contracts -- contracts that remain unperformed on both sides -- plays an important part in bankruptcy law and practice. In this chapter, executory contracts are explored as combinations of assets and liabilities, and the learning from the prior chapters are accordingly applied to examine executory contract problems. The role of rejection, assumption, cure, and assignment, are all explored through this lens.

Chapter 6 Prior to Chapter 6, the model of bankruptcy law used in the book rested on two assumptions: that bankruptcy (or insolvency) occurred suddenly and that bankruptcy proceedings were over in an instant. In Chapter 6, the first assumption is relaxed, and strategic planning in the pre-bankruptcy period is examined. In that context, preference law is seen as a response to the problems involved in making the transition from an individual to a collective regime in a world in which claimants may see the collective proceeding coming, which otherwise might replicate the common pool problems

/ law is designed to ameliorate. Details of the
e section are examined against this view of preference
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In Chapter 7, the second assumption -- that
/ proceedings are over in an instant -- is relaxed.
ıces two problems. One is making sure that the
f time does not work to change relative values of
claimants in a way that would lead individual self-
to work against the common good. The other problem is
aking sure that debtors in bankruptcy get no special
garding future operations. How to deal with both of
blems simultaneously is the subject of Chapter 7.
e points in mind, the question of the automatic stay,
pplicability to things such as toxic waste clean-up
ost-petition refusals to deal, and the rights of
reditors, are explored. Also explored are questions
ow to deal with claims that arise during the
/ proceeding.

This chapter examines the twin questions of how to
inefficient uses of the bankruptcy process and how to
uptcy cases to commence at the appropriate time --
f too early or too late. Standards for governing
the bankruptcy process and incentives such as bounties
red in light of the common pool model of bankruptcy

The details of the Chapter 11 "reorganization"
re explored in this chapter. In particular, this
ritically examines the justifications for the Chapter
ıtion procedures, and asks whether bankruptcy law
better served if corporations were forced to use
uation mechanisms instead of negotiations as a way of
whether a firm should be kept together, and as a way
ning how to split up the proceeds from any such

) At this point, the book substantially shifts its
l examines the related questions of why there is a
" policy for individuals, and why this right of
cannot be waived in advance. The chapter looks at
e explanations that have been posited, and advances a
t blends economic explanations with recent literature
ve and volitional psychology. It also discusses the
involved between access to credit in the first place
to the discharge right.

Drawing on the analysis of the previous chapter,
er looks at why bankruptcy law protects human capital
nbankruptcy law remains the principal source of other
exempt" property, and how nonbankruptcy attributes
important focus. The chapter closes by examining
of limits there should be on the right of discharge.

THE LOGIC AND LIMITS OF BANKRUPTCY LAW:
Implications of Collective Action and Discharge Policies

Thomas H. Jackson

INTRODUCTION

THE TWO ROLES OF BANKRUPTCY LAW

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

All these propositions are derived from an essential truth: bankruptcy law <u>can</u> be used to keep firms in operation, and bankruptcy law inevitably touches other bodies of law. But none reflect bankruptcy law's historical function or consider carefully how importing these other policies into bankruptcy will affect its longstanding role. Through this book, I hope to convince you of the importance of bankruptcy law in meeting its historical goals -- and the limits it implies on bankruptcy policy. My view of what bankruptcy law exists to do is, I believe, virtually unquestioned. But I believe this widely-accepted view of what bankruptcy law should be doing also carries with it certain limits -- suggests certain things it should not be doing. Just as too many spices can spoil the soup, so, too, can pushing too much into bankruptcy law undermine what everyone agrees it should be doing in the first place.

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

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

In analyzing bankruptcy law, as with any other body of law, it helps to start by identifying first principles. From there, those principles can be developed by locating them against the existing social, economic, and legal world, and identify precisely what, and how, bankruptcy law can accomplish its goals, and the constraints on its ability to do so.[4] That normative view of bankruptcy law can then be contrasted with the Bankruptcy Code as enacted, to see whether, and to what extent, the existing regime follows the path the principles suggest is the proper one.

The point of this book is to suggest what the underpinnings of bankruptcy law should be and then to apply that learning to a variety of issues while testing the current provisions of the Bankruptcy Code against them. This approach is not unique. In fields as disparate and complex as antitrust, oil and gas, intellectual property, and corporate finance, analysis of discrete legal problems usually begins with a look at the theoretical framework that the law is built upon.[5] But this approach <u>is</u> almost unique to bankruptcy law.

Much bankruptcy analysis is flawed precisely because it lacks rigor in identifying what is being addressed and why it is a proper concern of bankruptcy law. For that reason, when a new and urgent "problem" is discovered in the context of a bankruptcy proceeding, courts, legislators, and commentators all too often approach resolution of the problem in an ad hoc manner, by viewing bankruptcy law as somehow conflicting with and perhaps overriding some other urgent social or economic goal.

I believe that this approach is fundamentally mistaken. Bankruptcy law, at its core, is debt-collection law. This is what we all agree on. When firms or people borrow, things sometimes do not work out as hoped. For any number of reasons -- from bad luck, crop failure, unexpected tort liability, dishonesty, or whatever -- it is inevitable that some who borrow will not be able to repay what they owe. In a world in which creditors can call upon the state to take a debtor's assets from it, it is necessary to figure out what to do when debts are greater than assets. Two questions arise: (1) Do we place limits on what creditors can take from their debtors; and (2) How do we decide rights among creditors when there are not enough assets to go around?

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

This substantive policy of a financial fresh start, while important when dealing with debtors who are human beings, is, however, also limited in an important respect. When we are talking about firms rather than individuals, neither bankruptcy law nor other law places limits on what creditors can get from their "debtor" precisely because the debtor is a fictional, legal being. To talk about the need of a corporation or other business entity to use bankruptcy in order to have a fresh start is to conflate a number of issues, none of which have anything to do with giving an honest, but unlucky, individual a second financial chance. We might care that the assets of a corporation be used effectively. But how assets are used is a question distinct from giving those individuals who "own" them a second chance. We do not care about a corporate charter, and there is no need to give it a fresh start. When speaking of a corporation, the "debtor" is always going to be a shorthand for something else -- shareholders, managers, workers, or whatever -- and we should realize that that is what we are talking about. The question of why we give individuals the right to a financial fresh start -- and one that they cannot waive by contract (although they can in fact waive it, and a number of other rights, in other ways -- such as by commiting murder) -- is, to be sure, both important and its answer somewhat uncertain and controversial. We will return to it in Chapter 10.

For the discussion in the first nine chapters of this book, we are better off if we set the question of a financial fresh start for individuals aside. A statement that a corporation needs a "fresh start" must reflect something very different -- a view that the corporation should continue doing what it is doing. That issue, however, is one of how assets should be used by those that own them, not one of giving a human being a right to start his financial life over.

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

CHAPTER 1

THE ROLE OF BANKRUPTCY LAW AND COLLECTIVE ACTION IN DEBT COLLECTION

Bankruptcy law and policy reflect a longstanding debate. Importantly, it is not so much a debate over whether bankruptcy law should exist at all, but over how much it should do. All agree that it serves as a collective debt-collection device. Whether, when dealing with firms, it should do more is the crux of the debate. I plan to start by establishing in this chapter what accepted wisdom already acknowledges -- that bankruptcy's system of collectivized debt collection is, in principle, beneficial. Most of this book will then be concerned with exploring how that benefit can be realized and, as importantly, how viewing bankruptcy as a collectivized debt-collection device brings limits on what else bankruptcy can do well. It is in the latter part, perhaps, that the most conflict exists. It exists, however, because bankruptcy analysts have failed to follow through on the first principles of establishing a collectivized debt collection system. To show you why bankruptcy's principal role brings with it limits on what else can be carried around as baggage is the function of this book. To get there, however, we need to begin at the beginning. Let's start with why, in fact, bankruptcy law <u>should</u> be doing what everyone takes as a given.

Bankruptcy law is a response to credit. The essence of credit economies is people and firms -- who can be called debtors -- borrowing money. The reasons for this are varied. In the case of individuals, it may largely be a device to smooth out consumption patterns by borrowing against future income. In the case of corporations and other firms, it may be a part of a specialization of financing and investment decisions. And, just as the reasons for borrowing are varied, so, too, are the methods. The prototype creditor may be a bank or other financial institution that lends money, but that is only one of many ways in which credit is extended. An installment seller extends credit. So does a worker who receives a paycheck on the first of December for work performed in November. The government, in its role as tax collector, also extends credit to the extent taxes accrue over a year and are due at the end. Similarly, a tort victim who is injured today and must await payment until the end of a lawsuit extends credit of sorts, albeit involuntarily and (probably) unhappily. Finally, credit is not just extended by "creditors." Purchasers of common and preferred stock of a corporation in a financing are also lending money to the debtor. Their repayment rights are distinct (they are the residual claimants), but it is proper to view them, too, as having defined rights to call on the assets of the debtor for payment.

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

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

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

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

While the <u>methods</u> for establishing a place in line are varied, the fundamental ordering principle remains. Creditors are paid according to their place in line for particular assets. With a few exceptions, moreover, one's place in line is fixed by when one acquires an interest in the assets and takes the appropriate steps to publicize it.[7] A solvent debtor is like a show that isn't sold out and all seats are considered equally good. In that event, one's place in line is largely a matter of indifference. But when there is not enough to go around to satisfy all claimants in full, this method of ordering will define winners and losers based principally on when one gets in line.

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

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

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

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

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

What you want is some rule that will make all hundred fishermen act as a sole owner would. That is where bankruptcy law enters the picture in a world not of fish but of credit. A debtor's assets may be like the lake. The "grab" rules of nonbankruptcy law, and their decision to allocate assets on the basis of first-come, first-served, create an incentive on the part of individual creditors, when they sense a debtor may have more liabilities than assets, to get in line today (by, for example, getting a sheriff to execute on the debtor's equipment) because, if they do not, they run the risk of getting nothing. This decision by numerous individual creditors, however, may be the wrong decision for the creditors as a group. Even though the debtor is insolvent, they might be better off if they held the assets together. Bankruptcy provides a way to make these diverse individuals act as one, by imposing a collective and compulsory proceeding on them. Unlike a typical common pool solution, however, the compulsory solution of bankruptcy law does not apply in all places at all times. It, instead, runs parallel with a system of individual debt-collection rules, and is available to supplant them when and if needed.

This is the historically-recognized purpose of bankruptcy law and perhaps is none too controversial in itself. Because more controversial limits on bankruptcy policy derive from it, however, I should become a bit less allegorical and a bit more precise. Exactly how does bankruptcy law make creditors as a group better off? To get a handle on the answer to that question, consider a simple hypothetical involving credit, not fish. Debtor has a small printing business. Potential creditors estimate that there is a twenty percent chance that Debtor (who is virtuous and will not misbehave) will become insolvent, through bad luck, a general economic downturn, or whatever. (By insolvency, I mean a condition whereby Debtor will not have enough assets to pay back his creditors.)[15] At the point of insolvency -- I'll make this very simple -- the business is expected to be worth $50,000 if sold piecemeal. Creditors also know that each of them will need to spend $1,000 in pursuit of their individual collection efforts should Debtor become insolvent and fail to repay them. Under these circumstances, Debtor borrows $25,000 from each of four creditors, Creditor _1_, Creditor _2_, Creditor _3_, and Creditor _4_. Because these creditors know that there is this twenty percent chance, they can account for it -- and the associated collection costs -- in the interest rate they charge Debtor. (We might as well assume for now that each party can watch out for its own interest, to see, as in the example of fishing, whether there are reasons to think that these people would favor a set of restrictions on their own behavior without dipping into paternalism or other similar reasons.)

Given that these creditors can watch out for their own interests, the question we really need to think about is _how_ these creditors would want to go about protecting themselves. If the creditors have to protect themselves by means of a costly and inefficient system, Debtor is going to have to pay more to obtain credit.[16] Thus, when we consider them all together -- Creditors _1_ through _4_ _and_ Debtor -- the relevant question is: would having a bankruptcy system available reduce the costs of credit?

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

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

Thus, the most obvious reason for a collective system of creditor collection is to make sure that creditors, in pursuing their individual remedies, do not actually decrease the aggregate value of the assets that will be used to repay them.

In our example, it would occur when the printing press (for example) could be sold to a third party for $20,000, leaving $30,000 of other assets, but the business, as a unit, could generate sufficient cash so as to have a value of more than $50,000.[17] As such, it is directly analogous to the fish in the lake. Even in cases in which the assets should be sold and the business dismembered, the aggregate value of the assets may be increased by keeping groups of those assets together (the printing press with its custom dies, for example) to be sold as discrete units.

This advantage, however, is probably not the only one to having a collective system available for creditors. Consider what the creditors would get if there was no bankruptcy system, putting aside the ultimate collection costs. If there were no collective system, to return to our little example, all of Creditors 1 through 4 know that, in the case of Debtor's insolvency, the first two creditors to get to (and through) the courthouse (or to Debtor, to persuade Debtor to pay voluntarily), will get $25,000, leaving nothing for the third and fourth. And, unless the creditors think that one of them is systematically faster (or friendlier with Debtor), this leaves them with a 50% chance of gaining $25,000, and a 50% chance of getting nothing.[18] A collective system, however, would ensure them that they would each get $12,500.

Would the creditors agree, ahead of time, to a system that "guaranteed" them (in the event of Debtor's insolvency), $12,500, in lieu of a system that gave them a 50% shot at

$25,000 -- payment in full -- and a 50% shot at nothing? Resolution of this question really turns on whether the creditors are better off with the one than the other. There are two reasons to think they are, even without looking to the question of a "going concern surplus" and without considering the costs of an individual collection system (which we will examine next). First of all, if these creditors are risk averse, assurance of receiving $12,500 is a better deal than a 50% shot at $25,000 and a 50% shot at nothing. Even if they can diversify the risk -- by loaning money to a lot of people -- it is probably preferable to eliminate it in the first place.[19] This, then, represents a net advantage to having a collective proceeding.

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

These various costs to using an individual system of creditor remedies suggests that there are, indeed, occasions when a collective system of debt-collection law might be preferable. Bankruptcy provides that system. It is the single most fruitful way to think about bankruptcy to see it as ameliorating a common pool problem created by a system of individual creditor remedies. Bankruptcy provides a way to override the creditors' pursuit of their own remedies and to make them work together.[22]

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

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

These problems with optimal uses of bankruptcy are the subject of Chapter 8. It is possible that the rules specifying when a bankruptcy petition may be filed prevent a collective proceeding from arriving until it is too late to save the debtor's assets from the self-interested actions of various creditors. Another possibility, however, is that the collective proceeding will begin too soon. Forcing all the creditors to refrain from individual actions (many of which have the effect of monitoring the debtor and preventing it from misbehaving) brings its own costs. Thus, to say that bankruptcy is designed to solve a common pool problem is not to tell us how to design the rules that do that well. We will need to return to these questions later in the book. These concerns do not, however, undermine the basic insight of what bankruptcy law is all about.

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

Nor can we be confident that the bankruptcy rules themselves don't create problems. They do, and we will examine later how they should be dealt with. Because these complications play out against a backdrop of basic bankruptcy principles, however, it is preferable for now to make two simplifying assumptions. The first assumption is that insolvency occurs without warning. By this assumption, we eliminate consideration of strategic behavior that is likely to exist when some creditors sense the imminent likelihood of bankruptcy's collective proceeding and attempt to avoid it. This assumption will be relaxed in Chapter 6. The second assumption is that bankruptcy proceedings take no time. By this assumption, we can set aside problems that occur through the passage of time, and the fact that this passage of time affects various claimants in different ways. We can also set aside the complications that result from a debtor's need to encourage people to deal with it while in bankruptcy and the fact that some of these people may wear both pre-petition and post-petition hats. This assumption will be relaxed in Chapter 7.

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

CHAPTER 2

DETERMINING LIABILITIES AND THE BASIC ROLE OF NONBANKRUPTCY LAW

Bankruptcy provides a collective forum for sorting out the rights of "owners" (creditors and others with rights against a debtor's assets), and can be justified, as we have seen, in providing protections against the destructive effects of an individual remedies system when there are not enough assets to go around. This makes the basic process one of determining who gets what, in what order. "Who" is fundamentally a question of "claims," or what shall often be referred to as "liabilities." "What" is fundamentally a question of "property of the estate," or what shall often be referred to as "assets." At one level, there is nothing magical about these basic building blocks. A "liability" is something that makes you less valuable -- that you would pay to get rid of. An "asset," on the other hand, is something that makes you more valuable -- that someone would pay you for.

In looking at all of this, it is helpful to think of bankruptcy as follows. What bankruptcy should be doing, in the abstract, is asking how much someone would pay for the assets of a debtor, assuming they could be sold free of liabilities. The resulting money is then taken and distributed to the holders of the liabilities according to their nonbankruptcy entitlements. Essentially, this and the next three chapters simply flesh out this idea against the basic role of bankruptcy law we explored last chapter. The question addressed in this chapter and the next is exactly what this means in considering how claimants should be treated in bankruptcy. And the basic answer to be developed involves seeing the bankruptcy process as protecting, at a minimum, the relative value of particular nonbankruptcy entitlements, instead of the rights themselves. This is the subject of determining "liabilities" in bankruptcy, and involves the question of how to divide up the assets. The question of what the assets are that are divided up is the subject of the fourth chapter. There we will see that the question of assets is integrally related to the question of liabilities.

A. The Destructive Effect of Changes of Relative Entitlements in Bankruptcy

Bankruptcy's basic procedures are designed to ameliorate a common pool problem. The key to effective implementation of this goal is to trigger bankruptcy when, and only when, it is in the interests of the creditors as a group. In Chapter 8, we will explore how hard it may be to fashion rules designed to accomplish that. But this notion of what bankruptcy law can do tells us one thing immediately. Insolvency may be an occasion to collectivize what hitherto had been an individual remedies system. It does not call, however, for implementing a different set of relative entitlements, unless doing so can be justified as a part of the move from the individual remedies system. Indeed, it is not just that the need for a collective proceeding does not go hand in hand with new entitlements. It is that the establishment of new entitlements in bankruptcy conflicts with the collectivization goal. Such changes create incentives for particular holders of rights in assets to resort to bankruptcy in order to gain, for themselves, the advantages of those changes, even though a bankruptcy proceeding was not in the collective interest of the investor group. These incentives are predictable and counterproductive, for they reintroduce the fundamental problem bankruptcy law is designed to solve: individual self-interest undermining the interests of the group. These changes, it is easy to show -- and this chapter will show -- are better off made _generally_, instead of in bankruptcy only.

The problem of changing relative entitlements in bankruptcy is the focus of much of what appears in the next several chapters. It not only underlies this book's normative view of bankruptcy law, but it also forms the basis of the bankruptcy system that has been enacted. The Supreme Court made this point in a case that is as important for recognizing it as the actual issue decided is unimportant. The case is _Butner v. United States_, decided in 1979.[1] _Butner_ involved a secured creditor's claim to rents that accrued on the property serving as collateral after the filing of the bankruptcy petition, relative to the claims of the unsecured creditors generally. Under relevant state law, as the Supreme Court described it, the debtor was entitled to the rents as long as it remained in possession or until a state court, on request, ordered the rents to be paid over to the secured creditor. In bankruptcy, the unsecured creditors of an insolvent debtor can be viewed as the new equity "owners" of the debtor, and hence entitled to what the "debtor" was entitled to outside of bankruptcy. This gave rise to the conflict between the secured creditor and the trustee, as representative of the unsecured creditors. The issue the Supreme Court took Butner to decide was: What should the source of law be (state or federal) in defining how the secured creditor may realize on the post-bankruptcy rents? The Court saw the source of law as nonbankruptcy, and observed that "the federal bankruptcy court should take whatever steps are necessary to ensure that the [secured creditor] is afforded in federal bankruptcy court the same protections he would have under state law if no bankruptcy had ensued."[2] It justified this result as follows:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy."[3]

In the notion of "forum shopping," the Supreme Court expressed the fundamental point.

Yet to say that Butner denounced changing relative entitlements only in bankruptcy, does not end the matter. It is important to understand why such rule changes cut against bankruptcy's recognized goal. This requires separation of two issues that arise when a debtor is in bankruptcy. First, it is necessary to decide what to do with the debtor's assets, and, second, it is necessary to decide who gets them. The principal proposition to be established here is that only by treating the answer to the second question as a nonbankruptcy issue can it be kept from unfavorably altering the answer to the first. To put this another way, in playing out the notion of bankruptcy as collective debt-collection law, bankruptcy law should not create rights. Instead, it should try to see that what rights exist are vindicated to the extent possible. It is only by doing this that bankruptcy law can in fact minimize the conversion costs of transferring an insolvent debtor's assets to its creditors.

This is easiest to see by starting with a case where there is no occasion to use bankruptcy as a response to a common pool problem. This is the case where only one person has rights to the debtor's assets. Such a person, the sole owner of the assets, would have no creditors. Irrespective of any thought of bankruptcy, this sole owner would continually reevaluate his use of the assets. If he were manufacturing buggy whips, at every moment (in theory at least) he could reassess whether this was the best thing for him to be doing with those assets. If it was, he could continue doing that. But if it was not, he could stop, and either use the assets for some other purpose or sell them, piecemeal or as a unit, to others. This decision would be his alone. And he presumably would make it in light of what would bring him the most from the assets.[4]

Now this is, of course, an oversimplification. No person has full ownership of assets in the sense that he has absolutely unfettered control over their use. I do not have the right to sell cocaine even if I could make lots of money doing it. Similarly, a person making buggy whips may be subject to regulations governing the types of materials he can use, or the minimum wages he must pay, or the environmental controls he must observe. These regulations will constrain his decisions and may lead him to choose a different use than he would choose in their absence.

This, however, does not fundamentally undercut the basic point -- given an existing array of legal rules, our "sole" owner would presumably decide to use the assets in the way that would bring him the most. He has, by definition, no need to use bankruptcy to ameliorate a common pool problem because a common pool exists only when there is more than one person with rights. He, accordingly, would be utterly indifferent to bankruptcy policy, unless the debtor's use of it benefitted him (by permitting the debtor, for example, to escape an undesirable nonbankruptcy charge). If a charge were placed upon assets only in bankruptcy law (such as that a debtor could not go out of business without first protecting employees), this owner would remain free to ignore it by going out of business without using bankruptcy. He could only be obligated to take account of such a charge if it were imposed by nonbankruptcy law.

When rights to assets[5] are spread among a number of people, however, as they almost always are, things change. Now it is necessary to decide not only how best to deploy the assets, but also how to split up the returns from those assets.[6] Because of the diversity of the owners, the deployment question creates a common pool problem. Bankruptcy law exists to solve that problem. But the lessons from the common pool show that the answer to the distributional question should not affect the determination of how to deploy the assets.[7] As a group, these diverse owners -- bondholders, tort victims, trade creditors, shareholders, and others -- would want to follow the same course as a sole owner. The owners as a group, in other words, would want to keep the distributional question from spilling over into the deployment question.

Bankruptcy law is best approached by separating these two questions -- the question of how the process can maximize the value of a given pool of assets and the question of how the law should allocate entitlements to whatever pool exists -- and limiting bankruptcy law to the first. This distinction makes clear the relationship between bankruptcy rules and nonbankruptcy rules and provides a principle of bankruptcy policy capable of identifying which nonbankruptcy rules may need to be supplanted.

Because there is perhaps no point in bankruptcy policy that is more easily misunderstood, it is worth proceeding carefully. Let's consider one of the most common views of what bankruptcy law should do. This view, it seems fair to state, is that bankruptcy law exists, in part, to help firms stay in business because of an increased social value and/or the jobs that are saved. In one guise, this could simply restate the common pool problem: diverse owners, if unconstrained, will pull apart assets when they would be worth more to the group of owners kept together. Usually, however, the notion of keeping firms in business seems to be meant as an independent policy. Examine what that means. It would mean that, irrespective of the wishes of the owners, a firm's assets should be kept in their current form because somebody -- society or workers -- is better off.[8]

To view this as properly located in a _bankruptcy_ statute, however, is to mix apples and oranges, if one accepts the view (as everyone seems to) that bankruptcy law also exists as a response to a common pool problem. The question is really one of defining substantive rights. If the group in question -- society, or workers, or whatnot -- deserve such rights, it is counterproductive to locate them only in a bankruptcy statute. Consider workers. Under existing nonbankruptcy law, workers have no substantive entitlements to keep assets in their current form. Put another way, they are not "owners" with substantive rights against the assets. For that reason, the owners are free to close up the business without considering the interests of the workers if doing so brings the owners more money. The fact that those owners have a common pool problem and need to use a collective proceeding to ameliorate it, is not, however, a reason to suddenly give a new group -- workers -- rights they would not otherwise have and that could be ignored if the bankruptcy process were avoided. The decision whether they should have such rights should not be bankruptcy-specific. It addresses a distributional question as well as a deployment question.[9]

Another way to put this is to say that there is a distinction between saying that something is a problem that Congress should address and saying that something is a problem that Congress should address through bankruptcy law. The first addresses a federalism question, perhaps. The second should address a collective debt-collection question. Whether giving workers substantive rights over how assets are used is a good thing or not, just as whether secured creditors should come ahead of unsecured creditors, addresses a question of underlying entitlements. While protecting the victims of economic misfortune who have not been given rights against assets may be an important social and legal question, it is not a question specific to bankruptcy law. However the question is answered, there would still need to be a bankruptcy statute, because answering these substantive questions one way instead of the other does not eliminate the common pool problem. Because the issues of who should have entitlements and how to address a common pool problem are distinct, they should be kept separate in the legal response.[10]

Nor is this simply an academic point. Bankruptcy law cannot both give new groups rights and continue effectively to solve a common pool problem. Treating both as bankruptcy questions interferes with bankruptcy's historic function as a superior debt-collection system against insolvent debtors. Fashioning a distinct bankruptcy rule -- such as one that gives workers rights they do not hold under nonbankruptcy law -- creates incentives for the group advantaged by the distinct bankruptcy rule to use the bankruptcy process even though it is not in the interest of the owners as a group. The consequences can be seen frequently. Many cases are begun where the reason for filing for bankruptcy quite clearly is nothing more than the fact that the entity bringing the case is advantaged because of a bankruptcy rule change.[11] Bankruptcy proceedings inevitably carry costs of their own.[12] When bankruptcy is activated for a rule change that benefits one particular class, the net effect may be harmful to the owners as a group. It is this problem that makes such rule changes undesirable as a matter of bankruptcy law.

Even though a nonbankruptcy rule may suffer from infirmities such as unfairness or inefficiency, if the nonbankruptcy rule does not undermine the advantages of a collective proceeding relative to the individual remedies that exist given those entitlements, imposing a different bankruptcy rule is a second best, and perhaps a counterproductive, solution. At bottom, bankruptcy is justified in overriding nonbankruptcy rights *because* those rights interfere with the group advantages associated with creditors acting in concert. If the nonbankruptcy rule -- for example, a rule permitting owners to close down a business without considering the plight of workers -- is thought undesirable for reasons other than its interference with a collective proceeding, the proper approach for Congress would be to face that issue squarely and to overturn the rule in general, not just to undermine or reverse it in bankruptcy.[13] The latter course is undesirable because, as *Butner* recognized, it creates incentives for strategic "shopping" between the nonbankruptcy and bankruptcy forums.[14]

B. *Determining Liabilities by Focusing on Relative Values*

To this point, the discussion has been abstract. What are these nonbankruptcy entitlements? Exactly how are they to be "respected" in bankruptcy, given that the nature of bankruptcy is to change things from an individual to a collective regime? Under what circumstances should these nonbankruptcy entitlements *not* be respected? It is these more concrete questions that we can turn to now, and examine how the model of bankruptcy just developed can be used to resolve them. We will first look at how bankruptcy law should determine those who are entitled to participate in its division of assets and then at the issue of how to rank-order those who are so entitled.

A successful transition from the nonbankruptcy to the bankruptcy forum does not require the preservation of each detail of any given nonbankruptcy right. To be sure, the fewest dislocations are achieved when the bankruptcy system respects the right just as it exists in the nonbankruptcy world, so that the right remains in full force not only against the debtor but also against rival creditors. Here, dislocations are minimized because bankruptcy law would then not defeat the creditor's right to specific performance of its original entitlement, and its value would accordingly be fixed at exactly what it was in the nonbankruptcy world. Inevitable problems introduced by the valuation process are, thereby, avoided.

Respecting these rights in full, however, can conflict with the core role of bankruptcy to maximize the value of assets in the face of pressures to ignore the collective weal for individual gain. Thus, it is necessary to weigh the damage recognizing a particular nonbankruptcy right would cause to collective action against the costs of any incentives potentially created by upsetting that right. Because the collective damage to adhering to a right may sometimes exceed any benefit, a bankruptcy statute sometimes must replace nonbankruptcy rights with something else.

While this might appear to be a difficult principle to apply, in many cases it is not. Consider the simple example of unsecured creditors that we were using in the last chapter. It is impossible to follow the nonbankruptcy rights of these creditors precisely, for if all their rights could be specifically enforced, there would be no cause for a bankruptcy proceeding at all. To respect all rights specifically is necessarily to overvalue some of them in comparison with the rights held by competing claimants. For example, if all rights were specifically respected, this would mean that "grab" remedies would be replicated in bankruptcy. Bankruptcy's collectivization goal, for this reason, requires bankruptcy rules to override individual creditor grab remedies -- a result accomplished by the automatic stay we will examine in Chapter 7.

To say that the exercise of a particular right interferes with bankruptcy's collectivizing function, does not generally mean, however, that its nonbankruptcy value relative to the value of other creditors' rights cannot be adhered to.[15] Although the question of determining what will be called "relative values" is itself complex, and will demand our attention shortly, the basic focus should be clearly kept in mind: we are in a world where one needs to think of measuring relative values, not in terms of abstract rights. The basic point to be explored in this chapter is that where the entitlements themselves should not be fully protected, such as is the case with individual creditor grab remedies, sound bankruptcy policy still calls for the preservation of relative values. Doing so minimizes the strategic gamesmanship that otherwise would hamper the smooth replacement of individual-based remedies with a collective proceeding.

Nonetheless, it is far easier to state than to implement a

(putting aside issues we deal with in Chapter 7 arising out of the fact that bankruptcy proceedings themselves take time)

policy that preserves the relative value among competing rights while abandoning the effort to preserve all entitlements absolutely within the bankruptcy framework. Indeed, this program demands an understanding of large bodies of substantive legal rules -- for the purpose of valuing their attributes -- as a precondition of implementing bankruptcy law. The substantive analysis is further complicated because the translation from one system to the other may not be precise. Bankruptcy's procedures may not be directly analogous to nonbankruptcy procedures, and creditors' rights outside of bankruptcy may depend on specific contexts that cannot be replicated, but only approximated, within the bankruptcy system.

Notwithstanding these conceptual "translation" problems, bankruptcy's objective is easy to express, even if hard to implement. The bankruptcy process should duplicate the relative standing among claimants that would exist outside of bankruptcy's collective framework. This is the concept of "relative value." The relevant inquiry might be conceived this way: Who would be entitled to what under nonbankruptcy law, if the debtor were to go out of business on the date of the bankruptcy petition and if there was not self-interested grabbing of assets at that point?

Consider this approach as applied to perhaps the most common, and uncontroversial, of bankruptcy's policies -- the pro rata treatment of general, unsecured creditors. To the extent this treatment is justified at all, it is justified by a legal homily such as "bankruptcy courts are courts of equity, and equality is equity."[16] With the benefit of a notion of what bankruptcy law should be doing, however, we can be more precise as to <u>why</u> pro rata treatment of unsecured creditors is proper bankruptcy policy.

Imagine that I, together with a professor from Harvard, were each going to lend $10,000 to a common debtor. And imagine that we met with each other and with the debtor before making the loans. The debtor (in a very virtuous moment) asked us: "Assume that you wake up some day, and discover that I have only $15,000 in assets, even if they are used in their most productive fashion. We have already agreed that a 'grab' system in this event will function poorly, because the assets might then fetch only $12,000. How do you want to divide the assets that do exist?"

As we saw in Chapter 1, it would be in our joint interest to agree to a collective proceeding (or some other device) allowing the Harvard professor and me to get a total of $15,000, instead of $12,000. If we were forced, in this pre-loan meeting, to reach a decision on how we would split the assets in the event of insolvency, what would we decide? While the agreement we would reach on splitting depends on a number of factors (such as our relative savvy and bargaining skills), I doubt the two of us could do any better than agree to split them pro-rata.[17]

More to the point: What if, now, you were a legal decision-maker, required to <u>fashion</u> a rule to allocate assets in a collective proceeding, because of the realization that the relevant creditors will not be able to meet together before the fact and reach a consensual bargain? You need a rule that applies not only to the Harvard professor and me, but to innumerable other combinations of creditors, from two to thousands.[18] Assuming you only were concerned with unsecured creditors, isn't the rule that you would devise quite clearly a pro rata rule, that (as applied to our little example) would result in the other professor and I splitting the assets 50-50? This represents our odds of getting the money if there was no collective proceeding (fifty percent of the time, I'd get there first and get paid in full; fifty percent of the time, the Harvard professor would get there first and get paid in full).

Nor would anything change if I lent $5,000, and the other professor lent $15,000. The best rule that could be devised for splitting the assets would still reflect our odds of getting the money if there was no collective proceeding, and that would be a split in the ratio of one to three. Given that the debtor has $15,000 of assets, this means, in a collective proceeding, that I would collect $3,750 and the Harvard professor would collect $11,250.

This, then, seems to provide our basic apportioning rule, because it mimics the value of our expected positions right before bankruptcy, at least given that the rule must be fashioned without knowing anything in particular about the creditors it will be dealing with. No other single apportioning rule works as well across a range of cases. It is also the apportioning rule that the Bankruptcy Code uses, and that perhaps fuels the shop-worn phrase that "equality is equity." At bottom, it is perhaps best to see this as meaning that those in a similarly situated group -- such as general creditors -- should split the assets available to their group pro rata, and nothing more.

This point is an offspring of the notion of bankruptcy as a collective debt-collection device. It is, unfortunately, also all to easy to lose sight of it. When the creditors are Citibank and Bank of America, we may all be happy to see them treated pro rata. This, however, might not be the case if one of the creditors is a worker who is owed a week's wages or a tort victim whose lungs were destroyed by a product the debtor built, and the other is Bank of America. Bank of America is a creditor with (one hopes) a diversified portfolio. It knows that a certain number of loans are going to be bad and it can make adjustments in the interest rate it charges if it turns out that a bankruptcy rule gives it less than perfect prorationing. The worker or tort victim, on the other hand, is unlikely to be a creditor with a diversified portfolio or with an ability to make adjustments quite as easily.

Do circumstances such as these affect our basic conclusion about a pro rata division of assets? I would argue that the answer is clearly "no," at least when we are speaking of <u>bankruptcy</u> policy. The question we have started to address is whether tort claimants should fare better than general creditors with a diversified portfolio. That question, however, is a general question about the status of tort claims relative to other kinds of claims. We are no longer simply solving a common pool type problem -- discussing how to collectivize debt-collection without making things worse than they already are.

The focus, in other words, has shifted from one that is related to bankruptcy to one that is broader. If nonbankruptcy law treats tort victims and the Bank of America as general, unsecured creditors, with similar rights and collection remedies, that is a conclusion that bankruptcy law should take as a given, so as to most effectively implement <u>its</u> unique social and economic role of providing a collective forum to deal with common pool problems in the credit world. Whether the underlying assignment of entitlements is correct is irrelevant when the issue is one of implementing bankruptcy's collectivization policy.

Bankruptcy law's existence can be justified on the ground that oftentimes it is the case that the decision of what to do with assets (subject to baseline legal entitlements) is not lodged in a single person, but is, instead, lodged in a number of different entities and in a number of different ways. Take the case of a corporation that has shareholders, unsecured creditors, secured creditors, employees, and managers. Under much modern corporate law, it is most useful to view the shareholders, unsecured creditors, and the secured creditors as the "owners" of the firm.[19] They have different packages of rights to the assets at different times, but they all have the right to call upon the firm's assets under one set of circumstances or another. As commonly referred to, secured creditors have first dibs to certain assets; shareholders have residual dibs to all the assets; and the unsecured creditors come in between. Now it may be that the decision as to what to do with the assets is usually lodged in the shareholders, as long as they do not default on their obligations to the creditors. This point, however, only serves to identify that the rights of the various groups to the assets come in different packages. It is still useful to think of them -- secured creditors, unsecured creditors, and shareholders alike -- as "owners."

It is, at least as a first approximation, less useful to think of the employees or managers as species of owners. Workers may have an entitlement to a certain wage level, but as nonbankruptcy law is currently set up, they have no draw <u>as workers</u> on the assets. They have no say as to whether the assets should remain doing what they are doing or not. They may have claims to the assets to secure their wages or the future terms of their collective bargaining agreement, but, to the extent they do, they are creditors, and it is better to think of them as creditors than as workers. Managers, moreover, may have a lot of day-to-day control, and leverage that comes from controlling the operating machinery, but, when push comes to shove, they have no <u>legal</u> rights to use the assets (other than the assets represented by their own services) in opposition to the wishes of the shareholders and creditors. Thus, they have no "rights" that need to be accounted for in a collective proceeding (again, other than insofar as their future services are needed).

Once one identifies those with rights against the assets, one has identified the pool of "owners." These people are determined by rules outside the bankruptcy process. Some of these people have rights "superior" to (or at least different from) others: consider (for example) secured creditors, unsecured creditors, and shareholders. How their rights are identified vis-a-vis one another is a question of their nonbankruptcy entitlements.

A collective insolvency proceeding is directed toward reducing the costs associated with diverse ownership interests. Other problems should be addressed as general problems, not as bankruptcy problems. And, just as the filing of a petition in bankruptcy provides little justification for altering the relative rights of owners and non-owners of the firm, so should it have little effect on the rights of owners inter se. Changes in nonbankruptcy rights should be made only if they benefit all those with interests in the firm as a group. A rule change unrelated to the goals of bankruptcy creates incentives for particular holders of rights in assets to resort to bankruptcy in order to gain, for themselves, the advantages of that rule change, even though a bankruptcy proceeding was not in the collective interest of the investor group.[20] It is this concept that underlies bankruptcy law's concern with relative values.

1. Determining **Whether** a Person Participates in the Bankruptcy Process

From this brief discussion of the valuation of the claims of general creditors in bankruptcy, we can see that the first rule of a collective proceeding designed to serve bankruptcy law's historic role is that it should take the value of entitlements as it finds them. The difficult substantive issue of whether those entitlements are right is an important question, perhaps, but it is not a bankruptcy question.

To say that bankruptcy law should take the value of entitlements as it finds them means, in turn, that, as a very general approximation, bankruptcy should freeze the rights of all the creditors the way they were the moment before the collective proceeding starts and then value them, so frozen, relative to one another. This requires a determination of what the rights would be worth in the abstract -- how much, in other words, a particular claimant would be entitled to were the debtor not insolvent. This may be considered the question of establishing a "nominal" value. Since the debtor is presumably insolvent, however, all those with claims will not be paid their nominal values in full. Thus, bankruptcy must also concern itself with the question of who gets what, in what order. This is the question of "relative value." The important lesson from thinking of bankruptcy law as a species of debt-collection law is that the source of both nominal and relative values is nonbankruptcy law. Demonstrating why this is so, and what it means for bankruptcy law, is the focus of the remainder of this chapter.

The relevant time to determine whether someone is a secured creditor or a judgment creditor (or even a creditor at all), is, generally speaking, as of the filing of the petition. That this is so, comes from the nature of the common pool. Bankruptcy is used as a way of implementing a decision as to what to do with assets of a debtor. Its owners are those with rights of some sort or another against the debtor's assets at the moment that implementing decision is made. It is perhaps useful to analogize it to a start-up business, with capital coming in at that moment. Once the business is up and running, it needs to make its way in the world, subject to the legal and economic restraints of our society. So, too, should it be in bankruptcy. This means that bankruptcy law should determine who are "owners" of the assets, in the sense of having rights against them, at the moment the bankruptcy petition is filed.[21]

Consider, first, what types of rights might be considered to be claims cognizable in bankruptcy -- the question addressed, in the statute, by section 101(4). The principle behind looking to nonbankruptcy law to determine, in the first instance, who the claimants are should be obvious, and directly associated with the notion of preserving relative values. Bankruptcy law would be an odd place to generate new federal causes of action. Each time it does, strategic incentives are created to use the bankruptcy process for individual gain, even if it comes at the expense of the collective weal.[22]

Accordingly, nonbankruptcy law should identify whether a particular claimant has a right to reach the debtor's assets.

If, for example, a competitor claims that the debtor caused it injury by advertising that the debtor's product was superior, nonbankruptcy law determines whether there is a right to resort to the debtor's asets to redress that injury -- whether there is, in other words, a cognizable cause of action for trade losses. If the debtor is liable because, for example, the relevant state recognizes the tort of commercial disparagement, the competitor should hold a "claim" cognizable in bankruptcy. If, however, nonbankruptcy law does not provide for a cause of action because, for example, the state does not recognize the tort of commercial disparagement or because such product comparisons are protected by the First Amendment, the competitor should have no higher rights in bankruptcy than outside it and, accordingly, should not participate in the division of the debtor's assets either in or out of bankruptcy.

In all contexts, the basic program is the same. The central difficulty lies in identifying the structure of the nonbankruptcy claims to be vindicated in the bankruptcy setting, where the focus is always on the substance of the claims and not the labels attached to them under state law. A state, for example, may choose (for any number of reasons) not to call something a "claim." Whatever its label, however, if the holder has rights against assets of the debtor, it has the attributes of a claim for purposes of bankruptcy.[23]

2. Determining Nominal Values from Nonbankruptcy Attributes

The kinds of questions concerning claimants bankruptcy law must address involve more than deciding who has rights against assets. Assuming that nonbankruptcy law defines the asserted right as a cause of action, how does one place a nominal value on the resulting claim? Sometimes this inquiry is tied to possible nonbankruptcy procedural defenses that reduce to zero the value of a claim. Such would be the position, for example, of a cause of action barred by an ordinary statute of limitations prior to the date of the filing of the bankruptcy petition. Applying that statutory bar in bankruptcy properly mirrors the zero value of the claim outside bankruptcy.

a. The Propriety of Loan Acceleration in Bankruptcy

A slightly more difficult issue is raised by an assertion that a cause of action, although it conceivably could be brought later, could not be brought at the time of the commencement of the bankruptcy proceeding. Because these causes of action might be allowed in the future, they have some existing value under nonbankruptcy law at the time of bankruptcy. These "unmatured" causes of action, whose existence is not tied to the debtor's future course of operation, should be recognized in bankruptcy as "claims." The difficult question is how to give them a nominal value.

This question actually invites examination of a broader topic: how to treat unmatured claims in bankruptcy. This includes the most common liability of all: an obligation to repay a loan. Consider, for example, an asserted claim based on a thirty-year loan of $10,000, made fifteen years ago at five percent interest. This is clearly a "claim," because nonbankruptcy law gives the creditor recourse to the debtor's assets in the event repayment were not forthcoming. The claim "arose" before the filing of the bankruptcy petition, because even if the debtor were to cease doing business today, it would be obligated to repay the loan, or to make provisions for its future repayment. How, then, should the loan be treated in bankruptcy? Should it be treated as due and payable on the occurrence of bankruptcy and, if so, in its face amount (of $10,000) or in some smaller amount reflecting its present value?

This question may best be approached by separating out three distinct issues. First, and perhaps most important, how should an unmatured loan be treated when, at the moment of bankruptcy, the debtor is not otherwise in default? Second, if loans are not accelerated by the commencement of bankruptcy itself, can the lender provide, by means of an "ipso facto" clause, for such acceleration? Third, should the fact of default prior to the time of bankruptcy matter, and, if so, how? We shall examine the first two issues in this chapter. While we will also discuss briefly an answer to the third issue, full analysis of it must await Chapter 6, where we relax one of our current assumptions: that bankruptcy's collective proceeding occurs suddenly and there are no pre-bankruptcy strategic actions.

First, then: What should the general rule be for unmatured loans when a bankruptcy proceeding is commenced? As a positive matter, the Bankruptcy Code gives one answer, and then provides the debtor with an option to give a different answer in a reorganization proceeding. The general answer, announced by the legislative history to section 502, is to treat bankruptcy as an event of default and acceleration. In our example, this would mean that the nominal value of the claim is its face amount of $10,000.[24] While this automatic acceleration rule also applies in a reorganization under Chapter 11, the debtor is given in that case the opportunity to gain back the original maturity date of the loan, by reinstating the terms of the contract -- a right that is likely to be exercised principally against secured creditors with below-market loans.[25]

These positive features of bankruptcy law can be analyzed against bankruptcy law's collective debt-collection function. Consider, first, the case of the presumptive rule where a debtor is liquidating in bankruptcy. In that event, even though the present value of the loan, apart from its acceleration feature, is substantially less than $10,000, accelerating the $10,000 principal is almost surely the correct way of mirroring the nonbankruptcy nominal value of that claim. The reason for this, however, is <u>not</u> that bankruptcy itself should constitute an event of acceleration. The advent of a collective proceeding itself suggests no nonbankruptcy attribute that should automatically give a right of acceleration. It is, instead, the nonbankruptcy attributes of a liquidating debtor that justify the presumptive acceleration rule of section 502.

This comes from trying to mirror as closely as possible what occurs in bankruptcy with relevant nonbankruptcy attributes. If an insolvent debtor were being dismembered by creditors outside of bankruptcy, any loan agreement worth its salt would have default and acceleration provisions that would afford the lender its opportunity to share in the spoils without having to wait until the maturing date 15 years hence, at which time, under a system of individualistic grab remedies, the debtor's assets would be long gone. The decision of a debtor (or its creditors) to liquidate in bankruptcy should change nothing: it represents the kind of event that would trigger such default and acceleration.

This would be true even where the assets are being sold as a unit in a Chapter 7 proceeding. In that case, the nominal "debtor" is changing. The buyer of the assets becomes the new debtor on the loan, and the original debtor ultimately disappears, because it is in the process of liquidating. Outside of bankruptcy, the general rule, from basic contract law, is that repayment obligations on loans can be assigned to a new entity without permission of the lender only if the original entity remains on the hook.[26] In the case of an asset sale in Chapter 7, however, the debtor -- the original entity bankruptcy.

Thus, the general reinstatement rule of section 1124 that is applicable, in a bankruptcy reorganization, may be viewed as reflecting, in rough fashion, the nonbankruptcy rules underlying the treatment of non-delegable duties. Since reinstatement under section 1124 is optional, the debtor is, of course, free to have the loan accelerated when it is in its interest to do so (as it would, outside of bankruptcy, generally be able to accelerate repayment by defaulting). Such a rule most accurately mirrors its nonbankruptcy attributes. But pushing a debtor into bankruptcy provides no greater opportunity for strategic behavior by a lender with a below market loan.

We have just examined the general rule for treating unmatured loans in bankruptcy. The next question is whether it should be possible to contract around this general rule. Should a lender, through a clause in the loan agreement, be able to specify that the filing of bankruptcy itself occasions a default and acceleration? (This kind of clause is commonly called an "ipso facto" clause.) The current Bankruptcy Code refuses to recognize this kind of ipso facto clause, in the case of a reorganizing debtor[32] (and, as we will see in the next two chapters, in the case of assets and executory contracts as well). In justifying this, the Senate Report explains that this result should cause no consternation: "The holder of a claim or interest who under the plan is restored to his original position, when others receive less or get nothing at all, is fortunate indeed and has no cause to complain."[33] This comment is apparently premised on the unstated view that bankruptcy is a fortuitous event allowing the lender to achieve a "windfall" by accelerating a debt that has a below-market interest rate.[34]

This justification, however, is unsatisfying. It is inaccurate to say that reinstatement of the maturity of a loan is all that a lender is "entitled to" since it was but a "fortuity" (for the lender) that its debtor went into bankruptcy. For, this is a fortuitous event that the lender seems to have bargained for. In essence, one can view the lender as having contracted for an option to call in its respective loan and to reloan the resulting money at the then-market rate.[35] One can also view the lender, moreover, as having already paid for this option (just as a secured lender, for example, has paid for other entitlements that are recognized in bankruptcy). Dismissing the potential rights of a lender by referring to them as "windfalls," then, obscures analysis. The relevant question is whether the presence of an ipso facto clause can be justified, and, if justified, whether such a clause is worth the inevitable strategic costs it creates.

Why might a lender desire an ipso facto clause? The most promising justification seems to be one that views such clauses as serving a role akin to a range of other contractual covenants.[36] The usefulness of such covenants (often called "financial covenant" or "restrictive covenant" clauses) in loans or other contracts, is commonly perceived as one of policing.[37] After entering into a loan or a contract at a certain interest rate, a debtor has an incentive to engage in activities that unilaterally increase the riskiness of the loan -- by, for example, changing investment decisions to include riskier choices.[38] Financial covenant clauses may be designed to allow a creditor to police this species of misbehavior by giving the lender the option of calling in the loan upon the occurrence of such opportunistic behavior.[39]

An ipso facto clause might be present in a given contract precisely because it serves such a policing role. To be sure, it does not allow a creditor to say "because you have misbehaved, I am terminating the loan," for it identifies no misbehavior. The contract or loan may be terminated only <u>after</u> the debtor has gone into bankruptcy. As such, it may serve as a broad-brush <u>in terrorem</u> clause designed to deter misbehavior in general by imposing a cost on the debtor who resorts to bankruptcy, and hence imposing a cost on engaging in activites that increase the likelihood of bankruptcy.

The problem with this analysis, however, is that it assumes that the debtor bears the costs of this clause. An aspect of the problem of diverse ownership, however, exists here. These clauses would have an effect on a reorganization (where acceleration is not the order of the day), and might harm the remaining unsecured creditors by requiring them to pay for a (secured) claim at its face amount instead of its unaccelerated present value worth. The group that is likely to bear the costs of this clause in bankruptcy, accordingly, is not the "debtor" (or its shareholders), but the other creditors.[40] Thus, the debtor may have no particular incentive in negotiating loans to exclude such clauses, and other creditors may have no effective way of forcing the debtor to exclude them.[41] It may be preferable, therefore, to refuse to recognize clauses negotiated by the debtor whose impact will be felt almost exclusively by other creditors, notwithstanding their possible prophylactic role, because they have effect only upon insolvency (or similar occurrence). In that case, other monitoring clauses, the effects of which might be felt by the debtor, could be used instead.[42]

Ipso facto clauses, in other words, may reflect the type of rights that bankruptcy law is justified in ignoring <u>because</u> they may be destructive of the collective weal in bankruptcy. That rationale, however, extends only to a ban on ipso facto clauses. In addition to the general rule for unmatured loans and the problem of contracting around the general rule, we still have to consider a third aspect of acceleration. If the debtor has defaulted on the loan prior to bankruptcy, is reinstatement of that loan proper? Again, the inquiry is fueled, as a positive matter, by section 1124, which provides that reinstatement is permissible if the defaults are cured. The normative question, however, is whether this outcome is proper.

Viewed from the perspective of nonbankruptcy attributes, the answer would appear at first to be "no." Absent some grace period in the loan contract or applicable law itself, a lender, following a material breach, usually has the power of acceleration, and is free to ignore "cure" offers by the debtor. Mirroring this nonbankruptcy attribute in bankruptcy, accordingly, would seem to call for loss of the power of reinstatement under section 1124 if there was a pre-bankruptcy default, unless the contract or applicable law provided for a cure period that had not yet expired on the date of bankruptcy.

We are not fully ready to analyze the question of the effect of pre-bankruptcy defaults, however. In a world in which neither the debtor nor its creditors saw bankruptcy (or insolvency) coming -- our current operating assumption -- we could rely on the nonbankruptcy attributes just identified. But, relaxing that assumption, we will see that a debtor might default for two (related) reasons that bankruptcy law may properly be concerned with: a default occasioned so as to favor the creditor (by permitting it to accelerate a loan before the occurrence of bankruptcy), or a default occasioned by a debtor's realization that it was insolvent and did not care who received its carcass. For this reason, a full examination of the question of what effect a pre-bankruptcy default should have on the ability of reinstatement in section 1124 must be deferred until Chapter 6, where planning in the immediate pre-bankruptcy period is examined.

b. Special Aspects of Claims that Are not "Fixed" at the Time of Bankruptcy

Another important aspect of the translation problem surrounding liabilities concerns the question of fixing nominal values, where the values of claims are not already fixed in the nonbankruptcy forum. Setting the value of these unliquidated claims[43] may be both costly and time-consuming. To determine whether someone has a successful antitrust claim against the debtor, for example, may take several years as a matter of nonbankruptcy law, and even more time may then be needed to place a nominal value on that claim. The whole procedure, moreover, may cost hundreds of thousands of dollars.

Does the principle that bankruptcy law derives valuations from nonbankruptcy law require adherence to these nonbankruptcy valuation procedures? Consider the case of a debtor that is liquidating in bankruptcy. It would, of course, be possible to follow nonbankruptcy procedures by deferring disposition of the debtor's assets (or their proceeds) to any group that would share at or below the level of priority accorded the entity with the unliquidated claim. The claim could then be liquidated in ordinary ways. Such a procedure would be workable, although cumbersome, as some mechanism must be introduced to keep track of the various other claimants so that they, finally, could be paid whenever all prior or equal claims had been liquidated.[44]

This process could even be formalized, to make it easier for liquidated claimants to cash out at any time. All liquidated claimants (other than those, such as secured creditors, who could safely be cashed out today) could, for example, be given "shares" against the pool of assets (or their proceeds). These shares, together with those issued to other claimants as their claims became liquidated, would be cashed out after all unliquidated claims had been determined. How much each claimant would ultimately get would depend (1) on the nominal size of its claim (as determined by the number of shares) versus the other claims in the pool, and (2) on the relative priority of those shares vis-a-vis the shares held by other claimants. If any claimant wished to cash out before that ultimate distribution, it could sell its shares in a secondary market for a price that reflected the expected payout in the ultimate distribution.

This solution, however, may give undue deference to nonbankruptcy valuation procedures. These procedures, even if they make sense when claims will be paid in full, may make little sense when the resulting claim will receive only ten cents on the dollar, as will often be the case in bankruptcy. The relatively fixed costs (such as attorney's fees) associated with nonbankruptcy claim liquidation procedures may loom unduly large when translated into the bankruptcy forum. It may be in the interests of all the claimants to expedite the process, thereby scaling down its costs. For that reason, a bankruptcy system might legitimately adopt its own procedures for estimating the expected value of a claim if successful and the probability of its success. While the normal nonbankruptcy trial procedures are watered down or eliminated, as long as there is no bias in the direction of estimation, then there is no particular reason to think that the value of those nonbankruptcy procedural rights has been interfered with.[45]

This point is perhaps clearest in the case of unmatured claims, where the only needed adjustment (if any) is discounting to present value. In principle, however, the process is no different, or normatively less desirable, with respect to claims that are contingent, unliquidated, or disputed. As such, these estimation procedures would be another instance where a nonbankruptcy right was supplanted in bankruptcy, but where the value of that right would be protected. Putting aside problems with commencement of a bankruptcy case simply to gain access to these valuation procedures, which will be discussed in Chapter 8, the problems with this procedure stem less from the theoretical nature of the valuation process than from the practical (and perhaps constitutional) problems that arise from having such determinations made by a judge in the absence of full-blown trial procedures. Estimating values does not improperly extend bankruptcy law to nonbankruptcy areas as long as there is no reason to think that the estimation process is systematically skewed in one direction or another.[46]

What is improper, however, is what was done in Bittner v. Borne Chemical Co.[47] In Bittner, the shareholders of The Roflite Company had brought a tortious interference counterclaim against the debtor, Borne Chemical Co. Borne Chemical then filed for bankruptcy. The bankruptcy judge valued the claim at zero for purposes of the bankruptcy proceeding. In part, the consequences of this decision were ameliorated by his requirement that the claim be reconsidered if a state court ever decided in favor of the Roflite shareholders on the counterclaim. In this way, their ultimate payment probably would not be seriously jeopardized.[48] There are other consequences to valuing claims, however, such as voting on a plan of reorganization, and the decision clearly affected them. The Third Circuit affirmed, noting that, according to the bankruptcy judge's finding of fact, the Roflite shareholders' "chances of ultimately succeeding in the state court action are uncertain at best." The Third Circuit went on to say:

> Yet, if the court had valued the Roflite stockholders' claims according to the present probability of success, the Roflite stockholders might well have acquired a significant, if not controlling, voice in the reorganization proceedings. . . . By valuing the ultimate merits of the Roflite stockholders' claims at zero, and temporarily disallowing them until the final resolution of the state action, the bankruptcy court avoided the possibility of a protracted and inequitable reorganization proceeding while ensuring that Borne will be responsible to pay a dividend on the claims in the event that the state court decides in the Roflite stockholders' favor.[49]

This reasoning, however, does skew nonbankruptcy values. It is based on valuing a disputed and unliquidated claim below the "present probability of success" to make sure too much voice is not given to a claimant who indeed might be found later to never have a claim at all. The present probability of success, however, already discounts that voice. After all, there is another side to the story. If the claim is later established, a claim estimated today at its present probability of success is undervalued.[50] The only solution that ensures that, on average, the vote of such claimants is neither too large nor too small, is estimating the nominal value of the claim, taking into account the chance of success. If it is not willing to wait until all events run their natural course (and there are costs to doing so), bankruptcy law must establish estimation procedures. But nothing in bankruptcy law justifies a deliberate attempt to ignore proper valuations in these procedures.

The point can be extended in considering the bankruptcy petitions of such asbestos manufacturers as Manville Corp. and UNR Industries, whose legal position has been the source of much academic and public interest since the early 1980s.[51] At the core of the debate is the status of the "future" asbestos victims. From the perspective of nominal values, they are best understood as "creditors" holding existing "claims" because their future causes of action under state law have a present value today under the applicable nonbankruptcy law.[52] These tort claims, moreover, "arose" before the filing of the bankruptcy petition because they are based on the past, completed actions of the debtor. If the debtor were to cease doing business on the filing of the bankruptcy petition, it would not influence the likelihood that the claimants would eventually exhibit the signs of an asbestos-related disease attributable to the debtor's product. The company's future survival is irrelevant to whether or not the disease or injury manifests itself; it is relevant only to the issue of payment.

That there has been a debate, however, is largely due to a confusion in the role of nonbankruptcy law. In giving content to words in the Bankruptcy Code such as "claim" or "arose" that describe who participates in bankruptcy's collective proceeding, there is no particular reason to think that one should resort to nonbankruptcy law to define those words.[53] To be sure, courts must resort to nonbankruptcy law to determine who is entitled to participate in the distribution of assets, but nothing in this process suggests that one also must look at what state law _calls_ some asserted claim. Doing so would confuse attributes (where nonbankruptcy rules play a crucial role) with labels (where nonbankruptcy rules should play no role). In the contested issue in the bankruptcies of Manville and UNR, for example, the attributes are (1) whether the right being asserted, based on an asbestos-related tort, is cognizable under state law (it is); (2) whether such a cause of action has some value at the time of the bankruptcy proceeding (it does, if it is not barred by the statute of limitations);[54] and (3) whether such a cause of action arises out of the "past" of the debtor (it does). If those attributes are present, then the person is -- and should be -- a "creditor" holding a "claim" within the meaning of the Bankruptcy Code. How state law chooses to label those attributes (for any number of a variety of nonbankruptcy reasons) is of no moment.[55]

This is not, however, simply a fight over semantics. The failure to include the nonmanifested tort victims as "creditors" holding "claims" would almost certainly disrupt the nonbankruptcy relative values of those with rights against a debtor's assets. This, in turn, may result in the wrong decision being made as to what to do with the assets. Since it is worth running with this for a moment, consider the following scenario. You are the president and major shareholder of a company that, according to a recent report you have just received, has claims (used in the broadest sense) outstanding (i.e., based on the company's past activities) against it with a present value of $4 billion. Included in this are these future tort claims. They have a present value of approximately $2 billion, for, although you do not know who will bring them, an actuarial estimate has been made as to the number of suits that will be brought, along with an estimate as to the average recovery per suit. Also included in this are present tort claimants -- who have already filed suit -- and trade creditors, banks, and so forth. For present purposes, to keep it simple (and because it ultimately does not make any difference), assume that your company has no secured debt.

You also have a report that the company has assets that are worth something like $1.5 billion if sold off piece by piece and something like $2 billion if kept together in the current business. The figure of $1.5 billion reflects what buyers would pay for individual assets of your company, and represents their valuation of what those individual assets would bring to them over time. The $2 billion figure is calculated the same way. The only difference is it is calculated asking what it is worth to keep those assets together, doing what they are now doing.[56] It represents, for example, the buyer's (or the market's) prediction that the assets can generate $250 million of income (adjusted for inflation) in perpetuity. The $250 million is net after future operating expenses, like wages, supplies, and taxes. It is like an annuity, except it is, of course, riskier, which means it will be valued for less than a riskless annuity that generated $250 million a year. This $2 billion figure, then, means that people would not pay more than $2 billion for the right to capture your company's future income stream -- this $250 million a year -- even if there were <u>no</u> claims against the assets at the time they were bought.

There <u>are</u> claims against your company, however. In fact, there are so many claims that the company is insolvent in the following sense. It might be able to generate the cash to pay off claims as they arise for the present, but ultimately the company's assets are not expected to generate more than $2 billion in present-day cash. Its liabilities, moreover, have a present-day value of $4 billion. Any way this is sliced, then, your company is expected to eventually run out of money (and out of business).

You have been shown the report today showing $2 billion in nonmanifested, but statistically likely, tort claims. Tomorrow, your accountants will require you to disclose that fact on your company's financial reports.[57] Even though you, as a principal shareholder, might like to drag things out,[58] the result of this disclosure may be to accelerate things. Here, the concept of individual grab remedies is likely to come home to roost. Creditors, such as banks, that have the option to call in their money, are likely to do so now, when they still can be paid in full. The release of the information, in other words, may make your company a prime candidate for a bankruptcy proceeding (although who is going to file the petition that starts the case is a problem).

What are your options? You can try to dissolve the company under state law, and sell off its assets piece by piece. This will bring $1.5 billion. Your company's claimants will satisfy themselves against this, and they will have no one else to go after (as the tort doctrine of successor liability almost certainly will not apply to the person who buys one drill press from your company). Your company will, in essence, get rid of $4 billion of claims for $1.5 billion in assets. That is a fundamental attribute of the concept of corporations as entities with liabilities limited by their assets. As for who gets the money, it is a question of nonbankruptcy law (as no bankruptcy proceeding has been commenced). Oftentimes, as a matter of state law, a dissolving corporation needs to make reserves for nonaccrued claims -- at least if they must be shown on its balance sheet.[59] These claims probably would. So, the $4 billion in claimants share the $1.5 billion in assets.

There is, however, a better outcome for the group. If some way can be found to keep the company's assets together, as a going concern, freed of these existing liabilities, the creditors can then receive $2 billion in cash. This could be accomplished by a sale of the company to a conglomerate like Allied Chemical or to Victor Posner or to the public for $2 billion, <u>if</u> it could be sold free of claims arising out of its past. (The company could also be reorganized -- which, as Chapter 9 will explore, means, in essence, to sell the company to the claimants.)

This, however, assumes that your company can get rid of the tort claims arising out of its past, but that haven't yet manifested themselves in anyone. If you cannot, and given that such "future" claims have a present value of $2 billion, no one will pay anything for your assets, except to the extent that they can milk them first (using the ubiquitous "grab" law) or to the extent they can jump priority over the tort claimants by imposing a capital structure with senior debt in it. Perhaps the buyers figure that, through devices such as these, they can preserve $1 billion (present value) out of the assets for themselves. Putting aside losses in value due to the milking, this means that they figure $1 billion will go to the "future" tort claimants.[60]

Under this scenerio, things sound fairly good for the group of creditors: we have garnered for them $2 billion dollars -- $1 billion from the sale and $1 billion that they will be expected to get from the company that has been sold.[61] But it is here where the question of whether unmanifested tort victims have "claims" cognizable in bankruptcy cuts in. If one cannot get rid of these nonmanifested claims either by dissolving under state law (because other creditors must share with them in the assets) or by a going concern sale outside of bankruptcy (because of successor liability), a holding that says the unmanifested tort victims do not hold "claims" in bankruptcy gives the other creditors a golden opportunity. The other creditors can run the company through bankruptcy before dissolving it under state law. Under section 726, only holders of claims get to participate in the bankruptcy distribution.[62] Thus, when the company is sold for scrap in bankruptcy, the "existing" creditors get $1.5 billion to split among their $2 billion in claims. The company then leaves bankruptcy. Nothing is discharged (because liquidating corporations don't receive discharges in bankruptcy).[63] The nonmanifested tort claimants are still around and, as their claims mature, they can still sue your company. But it has no assets, having been stripped of them in bankruptcy. The company now dissolves under state law. Now the tort claimants are finished. There is no one to sue. They, in essence, have been sold down the river with zero.

The problem with this is not simply a distributional one. For our purposes, the problem is that of a common pool. This is a bad outcome for all the creditors taken as a group because they get $1.5 billion instead of $2 billion. The present creditors have an incentive to fight for it anyway, because they get the entire $1.5 billion themselves.[64] This represents individual greed subverting the common welfare, and that is *precisely* the problem that bankruptcy law is designed to ameliorate.

Can the existing creditors in this hypothetical do even better and capture the entire $2 billion for themselves, by selling the company as a going concern for $2 billion *and* excluding the nonmanifested tort claimants from distribution (so the existing creditors get the whole $2 billion in proceeds)? If so, we would return to having simply a distributional problem, not a common pool problem. But it is hard to see how the existing creditors can do this. They cannot as a matter of tort law, because of the doctrine of successor liability.[65] As for using bankruptcy, if the nonmanifested tort claimants are not included in the bankruptcy process, because they are determined not to be "creditors" holding "claims," their rights will not be discharged in bankruptcy either. This means that any buyer will take the assets subject to their claims (either in a reorganization or through the tort doctrine of successor liability).

This means, however, that the buyer will not pay $2 billion for the assets, but (under our assumed facts), only $1 billion. And, having excluded the future claimants from bankruptcy, the existing creditors won't want to divide up the $1 billion they can get by selling the company as a unit. They, after all, can get $1.5 billion by selling the company, in bankruptcy, piecemeal. This means that the best the existing creditors can do is to sell the company for scrap. As we have seen, however, that is the wrong solution. By excluding nonmanifested tort victims from the category of "creditors" holding "claims," we have created an incentive for the known group to reach for the wrong size pie. It is the group, moreover, that presumably decides what to do with the assets.[66]

The preferable solution here is to include the nonmanifested tort victims in the bankruptcy process as holders of claims, so they get to share in the assets, but then to sell the assets free of all such claims for $2 billion.[67] We want, again, to make the asset "pie" as large as possible and not have fights over how to divide it up lead to wrong "size" questions. This is done by respecting the nonbankruptcy valuations, not changing them because of a nonbankruptcy label of "no claim."[68]

Analytically, exactly the same issue was involved in a case involving toxic waste clean-up orders in bankruptcy. In Ohio v. Kovacs,[69] the issue was whether a toxic waste clean-up order was dischargeable in bankruptcy. The issue had bite, because the debtor was an individual, and a finding of nondischargeability would mean that the state could pursue the debtor's future income following bankruptcy. But the way the State of Ohio argued for that result was by asserting that the clean-up order was not a "claim" (as only liabilities on claims are discharged in bankruptcy). Its technical argument was that this was an "equitable right of performance," and not within the definition of claim in section 101(4).[70]

Focusing, however, on labels, not attributes, is hardly the way to get a bankruptcy issue decided correctly. The Supreme Court, in holding that under the particular facts of Kovacs, the clean-up order was a claim,[71] saved Ohio from itself. As Justice O'Connor sketched in her concurrence,[72] Ohio's argument was perverse. If Ohio were right, when it faced enforcing a clean-up order against a corporate polluter in bankruptcy, it might have talked itself out of any share of the assets at all. In a Chapter 7 liquidation proceeding, after the assets are sold, the proceeds are distributed first to recognized property claimants and then as specified in section 726 of the Bankruptcy Code. Section 726, however, speaks only of payments on "claims" and makes no distinction based on whether the debtor is an individual or a corporation. If the assertion were correct that Kovacs' obligation to Ohio was not a claim, the general creditors of a corporate polluter would share in the proceeds in a bankruptcy liquidation. Ohio would receive nothing, as it, under its own argument, did not hold a claim. Corporations receive no discharge in Chapter 7, but it makes no difference whether they do or not. After the bankruptcy distribution, the obligation of a corporate debtor to clean up a toxic waste site would not be enforceable as a practical matter because the debtor would have no assets. In any event, the obligation will disappear when the corporation dissolves under state law, after the bankruptcy proceeding.

This clearly upsets the relative nonbankruptcy entitlements of the various parties in interest. Had the corporate debtor dissolved under state law without resorting to bankruptcy, Ohio would have received its share of the debtor's assets on account of the debtor's obligation to clean up the toxic waste site. Bankruptcy law should not be interpreted to upset such state entitlements. But, lacking a firm focus of the normative implications of bankruptcy theory, Ohio lost sight of the fact that what was in question was the relative entitlements of the various parties, and painted itself into a legal corner from which the Supreme Court had to extricate it.

What, then, does one do with the argument that an obligation to clean up toxic wastes is neither "a right to payment" nor "an equitable remedy for breach of performance," breach of which gives rise to a right to payment? In interpreting these phrases, there is a distinction that makes sense, and that can be used to infuse the meaning of the somewhat inartful definition of "claim." Excluding some forms of equitable relief from the definition of "claim" makes sense if one considers its role as one of distinguishing two kinds of obligations: those obligations of a debtor that result from activities engaged in before the filing of the petition and whose consequences <u>continue</u> to exist even if the debtor were to go out of business or die the moment that the bankruptcy petition is filed, and those obligations that arise because of the debtor's continued existence and that would never arise if the debtor were to cease operations or die.

So viewed, an order to clean up toxic wastes that already have been deposited would be a "claim" because the remedy arises out of a pre-petition action by the debtor the consequences of which do not depend upon the debtor's continued existence. By contrast, an injunction to cease polluting would not be a claim within the meaning of the Bankruptcy Code because it is directed at the debtor's future operations. If the debtor ceases to exist, the injunction has no meaning because there will be no further pollution by the debtor. Measured as of the date of bankruptcy, its value depends on something entirely within the debtor's control: having future operations. It, accordingly, should have a zero value as of the date of bankruptcy. Concluding that it is not a "claim" accomplishes that.

The Bankruptcy Code, to be sure, does not <u>always</u> adhere to the collectivization norm. Indeed, the failure of an articulated normative theory of bankruptcy law perhaps makes remarkable the extent to which the "is" corresponds to the "ought" in the field of liabilities in bankruptcy. But the collectivization norm also provides a basis to criticize the statute that exists. The Bankruptcy Code's treatment of claims for damages arising out of long-term leases of real property or long-term employment contracts provides a fruitful example.

Here, the crux of the problem is in determining how to set the nominal value of the claim. In both these cases, the Bankruptcy Code places a maximum on the claim's nominal value.[73] The rationales for such limitations, however, not only are unsatisfying on their own terms but, more importantly, have nothing to do with the role of bankruptcy as a collective debt collection device. Consider the claim of a landlord. Bankruptcy law limits a claim for damages resulting from breach of a lease. In cases where nominal damages, as calculated according to nonbankruptcy rules, exceed one year's reserved rent, the Bankruptcy Code sets a maximum on the landlord's nominal claim to 15 percent of the rent reserved for the remainder of the term or three years' reserved rent, whichever is less.[74] The justifications for this limitation appear to be twofold. First, it is asserted that otherwise the claim of a landlord might be "too large," with the consequence that full recognition would "prevent other general unsecured creditors from recovering a dividend."[75] Second, it is argued that permitting a landlord to assert its full claim would make the landlord the undeserving beneficiary of a speculative guess about the future course of real estate.[76]

Neither justification is satisfactory on its own terms. The claims of landlords are determined according to standard contract expectancy formulas. If the nominal claim is large, it is only because the damages, calculated in ordinary ways, are large. Uncertainty about the future, moreover, says nothing about a bias favoring a landlord. The nature of uncertainty is that things may end up better or worse than today's best guess.[77]

Thinking about claims determination in the light of the role of bankruptcy, moreover, reveals a second flaw in the reasoning that resulted in a limitation on a landlord's recovery. Even if either justification for limiting such claims were correct as a matter of abstract inquiry, bankruptcy is not the correct place to implement them. Claimants that are treated better outside of bankruptcy (because they are accorded larger nominal claims) are simply not equals in bankruptcy. They are like the holders of property rights that, as we will see next, bankruptcy law generally recognizes without independently reexamining their abstract worthiness. For that reason, even though a state law (assuming it existed) that generally treated landlords relatively better than other claimants might be an inappropriate nonbankruptcy policy, recognition of that differential treatment nonetheless remains appropriate bankruptcy policy. Bankruptcy moves from the individual to the collective. If landlords do better in the nonbankruptcy regime, then they should do better in bankruptcy as well. Casting the issue as one of bankruptcy policy misstates what is at issue and creates incentives to use bankruptcy for reasons that may not be collectively optimal.

3. Determining How a Claimant Participates in Bankruptcy: The Question of Relative Values

We have already looked at how the principle of taking entitlements from nonbankruptcy law accounts for the pro rata treatment in bankruptcy of those in a similar class. The principle also applies to respecting the relative values of those in different nonbankruptcy classes. Consider the example of fish in the lake. In returning to the example of 100 fishermen, the optimal rule to deal with the common pool problem would be one that decided on a maximum catch of $50,000 of fish a year, and that, assuming no relevant differences in the fishermen, divided up that catch into 100 equal piles of $500 each this year, and each and every subsequent year. (This would be enforced, for example, by assigning to each fisherman a license to catch only a certain number of fish.)

Now suppose that, in assigning entitlements initially to the 100 fishermen, one fisherman was permitted to catch two times as many fish as any other fisherman. Or the initial entitlement was allocated in a way that one fisherman was entitled to catch $20,000 of fish before the others were entitled to catch anything.[78] One may question whether this initial assignment of entitlements is wise. But that is a question of the original assignment of entitlements, not a response to a common pool problem. Whatever the initial assignment of entitlements, there is still likely to be a common pool problem.

That this is so, comes from the fact that the optimal solution for the group has not changed. The deployment question is distinct from the distributional question. The fishermen are still better off, as a group, if they catch $50,000 of fish this year, leaving fish to be fruitful and multiply, so that there would be $50,000 of fish each and every year in the future. The fact that some fishermen come ahead of others as a matter of initial entitlements is irrelevant to this deployment outcome. (Indeed, if one fisherman came absolutely ahead of the others, with respect to the entire catch, we would have our prototype of a "sole owner," from where we started.) If one fisherman is given an initial entitlement of catching twice as many fish as others, a person given the responsibility of solving the common pool problem could solve it by issuing a permit to that fisherman to catch $1,000 of fish, while all others could catch $500. Similarly, if the initial entitlement to one fisherman was the ability to catch $20,000 of fish in priority to the others, the common pool problem could still be solved without upsetting the relative value of the initial entitlement, by giving that fisherman the right to catch $20,000 of fish each year first, and splitting the remaining $30,000 of permitted catch each year pro rata among the other 99 fisherman.

Thus, the common pool problem -- a deployment problem -- can be solved without upsetting the relative values of the initial entitlements -- a distributional problem. When considering credit, moreover, a collective rule that respected the relative values of the initial entitlements is preferable to any other rule. No other rule in bankruptcy could solve the resulting common pool problem without inviting use of bankruptcy simply for purposes of effecting rule changes.[79]

Consider the question of security interests in bankruptcy. Assume, for purposes of this discussion, that the holder of a security interest has taken the applicable steps required by nonbankruptcy law, and, accordingly, has the right to use assets to satisfy the debtor's duty to repay it ahead not only of subsequent secured creditors, but also ahead of subsequent lien creditors or general unsecured creditors. (This secured creditor is like our fisherman with a right to catch the first $20,000 of fish.) Assuming we have made a societal decision to permit creditors to take security interests, the question before us is how to treat this interest in bankruptcy.

On the one hand, reaching the right deployment outcome may require that the specific nonbankruptcy <u>rights</u> of the secured creditor -- specifically, the right to remove the assets and sell them on default -- should not be respected in full. As we have seen, unsecured creditors have several reasons for desiring a collective proceeding. One of the most important is that the assets might be worth more together as a group. If the right of a secured creditor to remove collateral from the debtor's estate and remain outside of any collective proceeding were respected in kind, this advantage would be diminished or lost. To say this, however, is not to say that the value of the secured creditor's entitlement cannot be respected.[80] The benefit from collectivization exists be restraining the right; reallocating values is simply a distributional matter. Deciding on entitlements is independent of needing to solve a common pool problem. In a world in which secured creditors come first, there is going to be a common pool problem that bankruptcy law can address. And in a world in which all creditors share pro rata, there is still going to be a common pool problem that bankruptcy law can address. Resolving the entitlement question one way or the other is, therefore, irrelevant to addressing a common pool concern. They are not independent, however, in the sense that it is counterproductive for the common pool system to use different entitlements from the individual grab remedies system. Like all distributional matters, changing the rules in bankruptcy may reintroduce the "grab" problem bankruptcy law is supposed to be avoiding.

This point can be sharpened by considering the hypothetical examined earlier, except now assume that Creditor 1 is a creditor with a security interest in Debtor's printing press, the principal piece of Debtor's business equipment. The press could be sold for $50,000 on the open market. By virtue of this security interest, Creditor 1, outside of bankruptcy, is "assured" of receiving $50,000, the amount of its loan. If Creditor 1 is able to proceed independently of the other creditors when Debtor is insolvent, Creditor 1 might force a piecemeal liquidation when it removes the printing press. If the business, however, is worth $80,000 as a going concern and only $60,000 if sold piecemeal, the removal of the printing press by Creditor <u>1</u> would mean that the remaining creditors would receive only $10,000 on account of their claims. If, however, the collective proceeding allowed the assets to be sold as a unit for $80,000, it would be possible to pay Creditor <u>1</u> its $50,000, and still have $30,000 left over for the remaining creditors. This is an application of the fact that, as with fish, the optimal group outcome is independent of the way the assets are split.

We will see more on this later, in Chapter 7, when examining the question of how a secured creditor should be compensated for loss of its specific right to repossess and sell collateral. For now, it is important to see the distinction between respecting the right and respecting the relative value of that right, and how bankruptcy law should be concerned primarily with the latter. It is, moreover, important to see the other side of this coin: the consequences of respecting neither the right nor the value of the right.

What would happen? Assume the rule in bankruptcy was <u>all</u> creditors shared alike, whether or not they had a security interest enforceable outside of bankruptcy. One consequence is obvious. A secured creditor with knowledge of this at the time of making a loan will be expected to charge the debtor for this increase in its risk. This will lead to an increase in the cost of secured credit (because it is more risky), and to a decrease in the cost of unsecured credit (because it is less risky). Whether or not <u>this</u> result is desirable depends on whether the decision to allow secured credit or not was a good thing.[81] If one thinks secured creditors get too much (i.e., that secured credit is not fundamentally a good thing), one can always change the nonbankruptcy rule, and do away with secured credit.

The relevant question is whether there is anything wrong with expressing this dislike for secured credit by leaving the nonbankruptcy entitlement (secured creditors come first), but refusing to respect the value of it in bankruptcy. And the answer is "yes," because of the second consequence. When there are two parallel systems of debt collection, different substantive entitlements in the two systems invite messing up the deployment decision by tinkering with the distributional outcomes. Making a rule change such as this in bankruptcy only will lead the unsecured creditors to opt for a bankruptcy proceeding in order to gain access to this distributional rule change (which is favorable to them and unfavorable to the secured creditor), even when bankruptcy is a poor forum from the perspective of the creditors as a group. Bankruptcy proceedings have costs of their own. It may be the case that permitting the nonbankruptcy world to run its course is the best available option. This might occur, for example, if Debtor's business was worth $60,000 broken up piecemeal, and <u>less</u> than that as a going concern. It might cost the creditors as a group less to allow Creditor <u>1</u> to repossess the printing press and to sell it for $50,000, and to have Debtor sell the remaining assets for $10,000, than it would be to invoke bankruptcy, where the costs of the bankruptcy proceeding might reduce the net value of the assets from $60,000 to, say, $50,000.[82] In that event, Creditors 2 through 4 do much better, as each gets $12,500 instead of $2,500. But it is not just Creditor 1 who is worse off (getting $12,500 instead of $50,000), it is the group as a whole, for they have split $50,000 among themselves instead of $60,000.[83]

For this reason, the relative ranking of entitlements -- that is, the ordering of claims -- is also an integral part of their bankruptcy valuation. A secured creditor with a nominal claim of $10,000 may actually receive $10,000, whereas an unsecured creditor with a nominal claim of $10,000 may actually receive only $1,000. As their nominal claims are the same, the higher priority rights of the secured creditor account for the different amount that each receives in the bankruptcy process.

The concept of relative value is not exhausted by considering creditors alone. Shareholders of a corporation, for example, have a right under nonbankruptcy law to the assets of that corporation; the unique nonbankruptcy attribute of that right, however, is its residual nature. That attribute (as well as the right to any up-side potential) is reflected in valuing the shareholders' "claims" against those of competing claimants in the bankruptcy setting.[84] Shareholders get paid if, but only if, the claims of all others have been paid in full first. This is the way the world operates outside of bankruptcy, and it therefore is the way it should operate in bankruptcy.

More generally, whether the issue is one of ordering secured creditors vis-a-vis unsecured creditors, unsecured creditors vis-a-vis shareholders, or, even, unsecured creditors inter se, bankruptcy law has -- or should have -- little to say about the relative ordering of claims. That issue is a quintessential nonbankruptcy one of attributes. Bankruptcy law can do no better in fulfilling its accepted role than to adhere to the valuations that derive from that external ordering scheme.

However simple this point seems in the abstract, bankruptcy law occasionally loses sight of it. Secured credit is sometimes a notable example, although here the statutory response has been largely in line with the normative theory.[85] In other cases, the point has simply been missed entirely. Consider, for example, the question of the subordination of securities law claims in bankruptcy.[86] Section 510(b) requires the subordination of any claim either for rescission of the purchase or sale of a security of the debtor or for a damage claim arising from the purchase or sale of such a security. Such claims are to be subordinated "to all claims or interests that are senior to or equal the claim or interest represented by such security." The intellectual basis for this section is a 1973 article by John Slain and Homer Kripke.[87] The crux of their argument was that allowing a person to assert a claim in bankruptcy as an unsecured creditor based on the purchase of an equity interest impermissibly permitted the buyer of a risky security to bootstrap himself into a less risky class. They viewed the problem as one of risk allocation and saw the relevant risks as two: "(1) the risk of business insolvency from whatever cause; and (2) the risk of illegality in securities issuance."[88] The first risk they saw as a basic part of accepting equity instead of debt; the second risk they characterized as a risk that the enterprise was making an illegal stock offering to the equity shareholder. In either case, Professors Slain and Kripke argued that there was no basis to reallocate that risk in a bankruptcy proceeding to the general creditors, which treating any resulting damage claims as general unsecured claims would do.

In a 1983 article, Kenneth Davis challenged this rationale and its implementation in section 510(b), arguing that it is difficult to distinguish the risk to unsecured creditors caused by fraud in the issuance of securities from other risks (such as antitrust violations by the debtor) that they also bear.[89] Professor Davis's solution is to separate out the loss in value of the security caused by business risks (where the purchaser of equity securities, in his view, bears greater risk in return for the possibility of greater return) and the loss in value of the security caused by fraud (or the like) in the issuance (where the purchaser of equity securities, in Professor Davis's view, does not agree to bear that risk).[90]

Whatever the merits of any particular resolution to this debate, it is odd to see it discussed as a matter of bankruptcy policy. If state law treats the holders of security law claims as general creditors, these people enjoy attributes -- such as rights of levy -- that ordinary shareholders do not enjoy. The issue of what the status of securities law claims should be vis-a-vis other claims against a debtor ultimately comes down to whether certain shareholders (those holding fraud claims) should be allowed to assume the attributes of creditors. That issue is inherently one of nonbankruptcy law. Once nonbankruptcy law has decided on the ordering, it is improper to insist on a different result in bankruptcy based on whether a particular party agreed or did not agree to bear a particular risk. In all cases, what risks any party in fact bears has been set by nonbankruptcy law. There is no reason to reorder priorities -- to reallocate the relative value of such claims -- simply because the process of disbursement has been collectivized. For that reason, whether or not section 510(b) is good policy, it is not good bankruptcy policy.

To be sure, the issue of resolving relative attributes is not always easy, particularly when the focus is on rights <u>among</u> creditors, as opposed to the more common (contract-based) focus of rights of a creditor against a debtor. Nonbankruptcy law sometimes provides a particular claimant with a prior right to some or all of the assets of the debtor. These claimants may be holders of consensual security interests, execution liens, statutory liens, or any one of a number of other interests that have the effect of permitting the holder to assert a prior claim to some or all of the debtor's assets. Because nonbankruptcy law raising this issue comes in myriad forms, however, determining how to characterize the priority of a particular claim in bankruptcy may require sensitive understanding of the nature of the nonbankruptcy right and how it should be recognized in bankruptcy. How, for example, should a contract that gives the nonbankrupt party a right of specific performance be treated in bankruptcy? Suppose that a debtor has contracted to sell his Chagall painting to Creditor A for $10,000, and his computer to Creditor B for $10,000. Under applicable state law, Creditor A has a right of specific performance in conjunction with its contract, while Creditor B's rights on breach are limited, as with ordinary contract creditors, to monetary damages only. Creditor A and Creditor B have both paid the entire sums called for in the contract, and the debtor then files for bankruptcy. Creditor B's claim is that of an unsecured creditor, either in restitution (for his $10,000 back) or in expectancy, for breach of contract (which, for purposes of simplicity, will be presumed to be zero, apart from the claim to recover the $10,000). If, in the debtor's bankruptcy, the unsecured creditors are getting paid ten cents on the dollar, Creditor B will receive $1,000.

How should Creditor A's claim be treated, given its state-law right of specific performance? In recent contract scholarship, the right of specific performance has been illuminatingly analyzed as a property right.[91] If one were to attempt to apply that analysis to bankruptcy, it might seem at first glance that Creditor A should receive the painting, effectively satisfying Creditor A's claim at one hundred cents on the dollar, a far cry from the ten cents on the dollar payable to general unsecured claimants, such as Creditor B.

This is the result that seems to be reached in bankruptcy when the issue is raised.[92] But it focuses on the wrong attribute. To award specific performance is to respect Creditor A's right in full, when it is unlikely that a decision to award specific performance is intended, as a matter of nonbankruptcy law, to alter the relative ordering of claims between Creditor A and Creditor B (not to mention the other creditors) dramatically. In discussing rights among creditors, Douglas Baird and I have noted the importance of distinguishing between what we call a "property" right and a "priority" right[93] -- a distinction that is central to the present context. This is so because it is necessary to focus not on the state-law label, but on the attributes of that label and, most importantly here, on the value of those attributes vis-a-vis other claimants of the debtor.

The right of specific performance for certain contracts is most often justified on the ground that it secures the party enjoying that right against the undercompensation that would otherwise result from treating the claim as one that could be satisfied by monetary damages. That rationale, however, essentially describes a two-party relationship between the contracting parties. It does not mandate giving Creditor A $10,000 (in cash or in kind) while leaving Creditor B only $1,000. Instead, the relevant focus in bankruptcy (and one that makes the issue sometimes hard) is the question of attributes considered from the perspective of creditor versus creditor, not the attributes of a right a creditor has against the debtor. It is a question of priority, not property.

Taking that focus, a further examination of state law is likely to reveal that, considered vis-a-vis the claims of other creditors, the value of a right of specific performance in a contract for a unique good, on the eve of bankruptcy, was nothing close to 100 cents on the dollar. In our example, the relevant question for fixing relative values is how state law would treat Creditor A versus an execution creditor on the Chagall at the time of the bankruptcy proceeding. It is not how state law would treat Creditor A against the debtor. The nonbankruptcy solution is almost surely to favor the execution creditor because of the ostensible ownership created when the buyer (Creditor A) left the Chagall in the debtor's hands following the sale.[94] So, for that reason, allowing specific performance to justify payment in full to Creditor A in bankruptcy erroneously promotes a property right against the debtor -- specific performance -- into a priority right against other creditors. Specific performance in its normal contractual context, accordingly, should not be respected at its nominal value, because at bottom the relevant questions are nonbankruptcy ones that are not answerable by looking at labels (such as calling a specific performance right a property right). Instead, the focus must be on examining the value of that right, under nonbankruptcy law, vis-a-vis the debtor's other claimants at the moment of bankruptcy. It is this focus that needs to be kept in mind in translating liabilities to the bankruptcy forum.

CHAPTER 9

RECONSIDERING REORGANIZATIONS

The reorganization provisions of the Bankruptcy Code reflect a stage in the historical evolution of creditors' remedies against business debtors, from common law receiverships, to the formal process governing corporate reorganizations now embodied in Chapter 11 of the Bankruptcy Code.[1] Because of this long history, much conventional wisdom has been generated and reflexively accepted about the usefulness of the corporate reorganization process. As a result, here, perhaps more than elsewhere in the provisions of the Bankruptcy Code dealing with rights among claimants, it is necessary to return to first principles, to ask what a reorganization process should be doing, and how it should go about doing it.

As we have seen -- although it probably cannot be said too many times -- there is a distinction between business failure and the problems bankruptcy law is designed to solve. A firm can "fail" -- in the sense that its assets are better used elsewhere -- whether it is owned by thousands of creditors and shareholders or whether it is owned by one person. The problems of business failure themselves are not bankruptcy problems. The resolution of them should not be thought of as bankruptcy-specific.

Bankruptcy law does have a role when there are numerous creditors, and a potential common pool problem. But just as business failures can occur when there is no common pool problem, so, too, can a common pool problem exist when there is not a business "failure." To put this point another way, the fact that a business may have liabilities in excess of assets iteself says nothing about whether the assets should be doing what they are doing, or something else. In the case of Manville, for example, it is entirely possible that the current use of its assets (as a construction supply company) is the best use of those assets, and that it would be worth assembling them for that purpose if Manville did not already exist. It is not inconsistent with that observation to further note that Manville may in fact be insolvent, because of torts committed in its past.

There is, in other words, no correlation between whether firms should stay in business and solving a common pool problem.[2] Instead, we still have our original principle: the best way to solve the common pool problem created by diverse ownership is to take the relative value of entitlements as they exist outside of bankruptcy. If it is important for firms to stay in business because of the jobs they save, or because of their importance to their communities, that policy should be implemented as a matter of general law. It should not turn on whether ownership of the business is diverse, as it will if the policy is located in bankruptcy law. As we saw in the second chapter, it is wrong to think that there should be an independent substantive policy of reorganization law to give firms "breathing space" or to reorganize them because it "preserves jobs." These policies should not be bankruptcy policies. If a sole owner or unanimous group of owners could ignore these policies by avoiding bankruptcy, the fact that a common pool problem exists is no reason to import them into bankruptcy, where they will interfere with bankruptcy's core role as a collective debt-collection device. Instead, nonbankruptcy law decides who has rights to a firm's assets. The only question of relevance is whether these parties are better off as a group if the firm's assets stay doing what they are doing.

Thus, Chapter 11's reorganization provisions should be tested against the standard of whether they facilitate reaching the asset deployment question that the claimants as a group would want. It is this question that a focus on the common pool problem suggests is the proper one for bankruptcy law. The justification for Chapter 11, in other words -- and the measure against which its provisions should be examined -- is whether the "reorganized" firm is better for its owners as a group than alternative uses of the assets.

A. Reorganizations as a Form of Asset Sale

From this perspective, it is possible to set out a conceptual understanding of what a "reorganization" is. A reorganization, at least as a start, may be viewed as simply a *form* of the kind of decision about what to do with assets of a firm that is made in any bankruptcy proceeding.[3] In a prototypical liquidation proceeding, for example, the firm's assets are sold to third parties for cash or securities. They might be sold piecemeal, they might be sold in blocks, or they might be sold as a unit. In all cases, the decisionmaker in a liquidation proceeding should decide on the course of action that gets the most out of the assets for the claimants.

The only key conceptual difference between a reorganization and a liquidation is that in a reorganization the firm's assets (or most of them) are sold to the creditors themselves rather than to third parties. The principal distinction then, is <u>not</u> that the assets are kept together in a reorganization, for they also can be kept together perfectly well in a Chapter 7 liquidation proceeding, by having them sold as a unit to a third-party buyer. Indeed, the policies of bankruptcy law -- to gain the most for the claimants as possible -- would demand that such a "going concern" sale be made in a Chapter 7 proceeding if doing so brings more for the firm's assets than does another course. Instead, the key distinction between a "reorganization" and a "liquidation" is in who ends up owning the assets: third parties, at one pole, or the former claimants themselves, at the other pole.[4]

Seen this way, reorganization proceedings provide nothing more than a method by which the sale of a firm as a going concern may be made to the claimants themselves. This process, like any liquidation procedure, involves two steps. First, the assets of the firm are sold. Second, the claims against the debtor are paid out of the proceeds of this sale.[5]

What differs in the situation in which the firm is sold to its own claimants in a reorganization is that the valuation of the proceeds out of which the claims against the debtor are to be paid is more difficult. In a straight piecemeal liquidation, either the assets are distributed in kind to secured claimants (thus mimicking their nonbankruptcy rights) or the assets are sold (usually for cash) and the cash is distributed to the parties, principally in the order of their relative nonbankruptcy entitlements. In a going concern liquidation, the business is sold to a third party, usually for cash and/or marketable securities. In either of these cases, the valuation procedures are far from intractible.[6] The "claims" are measured (in the way we discussed in Chapter 2), their relative priority is determined, and then the proceeds, which because they are cash or marketable securities are easily valued, are distributed to the claimholders in the order of their relative nonbankruptcy entitlements. In a reorganization, however, the proceeds from the "sale" out of which claims against the debtor will be paid will consist principally of new claims against the "same" firm. This makes the valuation of the payment to the claimants substantially more difficult because the value of the reorganized firm's securities will depend on its value as a going concern.[7] Determining these values without using a market-pricing mechanism is one of the hallmarks of a bankruptcy reorganization proceeding.[8] It is principally these valuation issues that lie at the core of the reorganization chapter's provisions.[9]

The critical question to be asked in examining the reorganization provisions, then, is whether there is a net gain to the common pool from proceeding with a reorganization instead of a liquidation. The difficulties associated with a reorganization proceeding are in the valuation of the proceeds "received" -- the reorganized firm's securities -- upon the fictional "sale" of the firm back to its pre-bankruptcy claimants. Whether the process be a piecemeal liquidation, a going-concern liquidation (i.e., a sale of the entity to a third party), or a reorganization (i.e., a sale of the entity back to the claimants), nothing in the form of the process itself seems to call for a different standard of allocation among claims (the second step) in one type of proceeding than in another.[10] Because distributional questions should not affect the deployment of assets, this suggests that the relevant inquiry in choosing a Chapter 7 liquidation (piecemeal or going concern) or a Chapter 11 reorganization should be made at the first step when the decision is made as to which of these three routes should be taken. This decision should be made on the basis of which path provides the greatest aggregate dollar-equivalent return from the assets -- a detemination that should be made without considering the claims outstanding against those assets (this consideration becomes relevant at the payout, but not at the sale, stage).

The rationale behind the original absolute priority rule can be seen in light of this reasoning. That rule, as announced by Justice Douglas in Case v. Los Angeles Lumber Products Co.,[11] seems designed to mimic relative nonbankruptcy entitlements. Under the absolute priority rule as articulated in Case, claimants were entitled to have their relative values respected in full, according exactly to their nonbankruptcy entitlements. The fact that there was a going concern surplus to the assets as a whole was irrelevant.[12] This represented part of the value of the debtor's assets that the creditors had a right to over shareholders outside of bankruptcy, and the absolute priority rule respected that right inside of bankruptcy. Because the rigors of the absolute priority rule in practice turn on the accuracy with which valuations are made, the absolute priority rule was frequently circumvented in practice.[13] But the theory was one of respecting the value of nonbankruptcy entitlements.

B. Negotiations and Valuations in the Reorganization Process

The question remained, however, whether that expression of the absolute priority rule accurately captured the value of the nonbankruptcy entitlements of junior classes. In Case itself, Justice Douglas refused to consider "intangible" factors in applying the absolute priority rule.[14] Arguments of the shareholders that the firm was worth more with them than without them -- and that this was an asset that the creditors did not have a right to outside of bankruptcy -- were characterized by Justice Douglas as representative of a host of intangibles that would work to undermine the absolute priority rule. Yet in those arguments were the seeds of the present version of the absolute priority rule, embodied in section 1129 of the Bankruptcy Code. It provides a two-part test. First, individual creditors have a right, waivable only by their own individual consent, to receive as much as they would have in a liquidation under Chapter 7 (the "best interests of creditors" test).[15] Second, a "class" of creditors has a right to insist on payment in full before any junior class can receive anything on account of its claims or interests (the original absolute priority rule), but this right can be waived by a vote of the members of the class that hold 50% in number and two-thirds in amount of the claims in the class.[16]

The justification for permitting waiver of the absolute priority rule by class vote is that, notwithstanding nonbankruptcy entitlements, the allocation of the "going concern" surplus is properly the subject of negotiations among classes of creditors.[17] This kind of reasoning, however, should be examined with care. Exactly what is being negotiated over, and why is it a proper subject of negotiations in the bankruptcy framework?

The underlying justification for a reorganization process, seen in terms of bankruptcy as a collective debt-collection device, must be that the assets are worth more to the claimants themselves than they would be to third parties. Professor Robert Clark, for example, has suggested that the reorganization process

> made economic sense whenever there were no or few potential outside buyers with accurate and timely information about the true state of affairs and future prospects of the business or when the process of searching for and educating outside buyers would itself be very expensive.[18]

We will examine shortly the circumstances under which this justification might hold true. Suppose, for the moment, that it holds true some of the time. This justification suggests that the "extra" value attributable to selling the business back to the pre-bankruptcy claimants is the difference in the value of the firm owned by them and what a third party would be willing to pay for it. This means that the baseline protection for an individual claimant should be what the assets could be sold for in a liquidation, assuming they were sold for their highest and best use. It is improper, even accepting this rational for the reorganization process, to establish the baseline protection for an individual claimant as that of a piecemeal liquidation standard.

Thus, it is likely that what is the proper subject for negotiation, even accepting the premise that reorganizations are justified, is smaller than commonly recognized.[19] One should be negotiating only over the difference in value of the assets, put to their highest and best use, in the hands of a third party and the value of those assets in the hands of the pre-bankruptcy claimants. There is, however, a more troublesome question lurking in this justification for the reorganization process. This justification for Chapter 11's negotiation rules ultimately rests on the ground that having it permits the claimants as a group to enjoy a larger asset pie than otherwise. Any other justification simply masks an inquiry into the wisdom of initial entitlements and is not an expression of bankruptcy policy.

When one focuses on this, however, one realizes that negotiations for their own sake are not desirable. The question is whether the benefits of negotiating over how to split the surplus obtained by selling the assets back to the claimants instead of to third parties is worth the costs of those negotiations. This requires both making some assessment of the costs of negotiation, and some assessment of the benefits from the negotiation.[20]

Many of the costs of negotiation are clear. In any process that avoids marketplace pricing mechanisms, there will be innumerable disputes over the value of the assets, and over the value of the claims given against those assets.[21] There will also be disputes over the relative values the various classes are adding to the future well-being of the enterprise.[22] In addition, because the process of voting over the surplus is determined by class-wide vote, it becomes important to structure the classes properly, in a world in which there may be no absolute answer to the question of "proper" classification.[23] (Should, for example, a creditor that is contractually subordinated to another be placed in the same or a separate class? I have seen no answer to this that, under various valuation assumptions, would not invite strategic placement.) Thus, new procedural rules must be formed -- such as classification rules[24] -- and these new procedural rules inevitably bring costs when compared with a world (sale of assets to third parties) where similar rules would not be necessary.[25] The groups, moreover, are negotiating over distributional issues in a bilateral monopoly context, and any time this is done, there is some danger that the distributional fights will interfere with the optimal deployment result.

There is another, less obvious, cost. For firms that are insolvent, as we have seen, diverse ownership creates vastly different incentives for different groups of owners. Specifically, it is in the interests of shareholders to delay. Any event that fixes values today, such as a sale of assets or even a consummation of a plan of reorganization, leaves them with nothing as <u>their</u> baseline entitlement. When a group starts with nothing to lose by delay, that group will in fact favor delay. Much of the law of bankruptcy must concern itself with that incentive. It drives, for example, the notion of adequate protection for secured creditors, so as to require a group that might benefit from delay to pay for it. No similar device, however, exists (or is readily devised),[26] to require shareholders to compensate unsecured creditors for the costs of delay. Accordingly, if things turn out worse, the creditors pay for it. If things, on the other hand, turn out better, while the unsecured creditors may get some of those benefits, ultimately, they do not get them all.[27] Thus, the process of negotiation itself can be used as a vehicle to implement this delay.

Outside of bankruptcy, the event of insolvency permits general creditors to withdraw their contributions to the firm and stop the delay. It is a right to freeze the value of assets at a particular time and take away from the shareholders the possibility of future gain.[28] Bankruptcy law should respect the relative values of these rights, just as it respects the relative values of innumerable other rights. When bankruptcy procedures are used to delay this cash-out, absent a corrective cost imposed on the group that benefits from the delay, these procedures skew nonbankruptcy relative values and interfere with the common pool solution bankruptcy is clearly designed to achieve.

To minimize these costs, Professor Mark Roe has suggested, in an astute analysis that is sensitive to the types of concerns expressed here, that firms in a Chapter 11 reorganization be required to make a stock issuance to the public of ten percent of the total stock the firm will ultimately issue.[29] In this way, Professor Roe suggests, a value of the the enterprise as a whole can be obtained. He then would require the remainder of the claims against the enterprise to be issued as common stock, and distributed (along with the proceeds from the ten percent sale to the public) to the pre-bankruptcy claimants in accordance with their relative entitlements. In short, Professor Roe's proposal would solve many of the costs associated with Chapter 11 negotiations by reliance on market pricing mechanisms and avoidance of the negotiations themselves.

This proposal, however, while promising, would seem to be responsive to no particular normative view about what Chapter 11 should be doing. It solves the negotiation problems, to be sure, but only by doing away with the negotiation process. To justify eliminating negotiations, one must assume that there was nothing to negotiate over. It solves the valuation process by having the marketplace do the valuations. The justifications for a Chapter 11 process, however, assume that it is valuable either <u>because</u> its claimants have better knowledge about the value of the firm or <u>because</u> there are in fact valuable contributions being made to the future well-being of the firm by the various claimants. Professor Roe's solution "solves" the negotiation and valuation problems currently existing in Chapter 11 by assuming that neither of these justifications holds any force. But, as we will see, once one reaches that conclusion, there is no longer any need for a Chapter 11 process at all.

C. <u>Why Not Eliminate Chapter 11?</u>

It is to that -- the $64,000 question in the field of corporate reorganizations -- that we now can turn. Why have a separate reorganization process at all?[30] Consider, first, the justifications for negotiating over the "surplus" gained by using Chapter 11 instead of Chapter 7. One justification is that buyers will not pay as much as is the assets are worth, because they lack information that the current owners have as to exactly what the assets are worth.[31] This justification seems suspect. The question must be: "Better valuations compared to what"? To say that the market might undervalue because it lacks access to adequate information might be true in the abstract.[32] But if market-pricing mechanisms are not used, the alternative seems to be not the claimants themselves but the bankruptcy judge. To be sure, if the claimants can reach an agreement unanimously among themselves, they will decide valuation issues themselves. In those cases, however, they may not have needed bankruptcy's reorganization procedures at all. Moreoever, it is one thing to say that "insiders" have superior information. It is quite another thing to say that all "owners" asked to negotiate or approve a plan have such information. Owners include trade creditors, taxing authorities, and tort victims. They vote on plans of reorganization. In order to vote sensibly, they need to be given the information of the insiders as to why the business is worth more than the market thinks. If they can be given the information necessary to vote intelligently, however, one must then face the difficult question of why the market could not be given the information as well.

Thus it involves a nonsequitor to say negotiations are appropriate because of superior information held by insiders; such a statement makes sense only when all share that information. Moreover, there is a second problem. Such agreements are unlikely to be unanimous. Once they are not unanimous, it is no longer the case that we can say the claimants are doing the valuations. For although the claimants may negotiate among themselves to split the surplus, still the bankruptcy judge needs to determine valuations for two purposes. One, the bankruptcy judge needs to determine what third parties would pay for the assets, in order to determine the baseline protection for any particular dissenting creditor in applying the "best interests of creditors" test of section 1129(a)(7). Second, in any case where the creditors are getting paid not in cash but in new pieces of paper against the reorganized enterprise, the bankruptcy judge must also value those pieces of paper to see whether they are adequate under the standard of section 1129(a)(7) to protect the dissenting claimant.[33] But one cannot determine the value of this paper in the abstract, or by focusing on its nominal (or face) value. Instead, the value of these pieces of paper depend on the value of the firm itself.

There is no escaping the fact, then, that the bankruptcy judge must value both the firm in the hands of third parties and the value of the firm in the hands of its former claimants. This, however, suggests that the justification for Chapter 11 based on undervaluations by third-parties is suspect, at least in a society such as our current one, with well-developed capital markets.[34] In order to make these valuations, the bankruptcy judge must be provided information about the operations of the firm in the hands of its pre-bankruptcy claimants. If the bankruptcy judge can be given such information, in order to enable him to make an intelligent valuation determination, however, the question again is starkly posed: Why cannot this information be given equally as well to marketplace buyers?

There seems to be no easy "because" answer. To be sure, it might be thought to be more costly to provide information to the "world," or more time-consuming to find buyers and have them put together deals.[35] But it is by no means certain, even putting aside the costs of consensual negotiations among claimants, that providing suitable information (for purposes of voting) to claimants without special inside information and then litigating disputed valuation questions before a bankruptcy judge (who also has to be provided with that information) are <u>less</u> costly than finding suitable third-party buyers.

Moreover, there is likely to be a <u>cost</u> to valuations by a bankruptcy judge that are not present in marketplace valuations. Substantial evidence suggests that valuations by bankruptcy judges are systematically too high.[36] Most firms that exit from a reorganization fail shortly thereafter,[37] notwithstanding the fact that a bankruptcy judge should make a finding of "feasibility." There are no reasons to believe that bankruptcy judges are particularly good valuators. And there are, moreover, some reasons to think that even good-intentioned bankruptcy judges will be overly optimistic about a firm's chances of success -- and hence its value.[38] Cognitive processing errors may lead judges, like most individuals, to underestimate risks and to overestimate chances of success.[39] There are, moreover, few corrective constraints on such cognitive biases. Whereas market participants lose money when they guess wrong, no similar consequence befalls a bankruptcy judge. Nor are there likely to be effective constraints analogous to the discipline a market imposes on buyers who make systematic errors.[40]

For all these reasons, it is unlikely that an argument, based on market undervaluations provides a strong justification for having negotiations among both informed and uninformed claimants followed by valuation decisions by bankruptcy judges. If that is so, then undervaluation arguments also fail as a justification for the existence of the special reorganization rules of Chapter 11.

The remaining justification for these special procedures is not one that depends on more accurate valuation mechanisms. It, instead, is over the point first raised, and rejected, before Justice Douglas in _Case v. Los Angeles Lumber Co._[41] It may be that the firm is actually more valuable in the hands of its current claimants than it would be in the hands of third parties. The existing shareholders, for example, might be thought to have special knowledge or expertise, and, without their participation, the firm would be worth less. This knowledge and expertise, moreover, is _not_ an asset that the pre-bankruptcy creditors are entitled to (because they have no way of requiring shareholders to remain in the enterprise). Since, as a result of this fact, pre-bankruptcy shareholders also have a relative value, this justification would suggest that it, too, should be respected in a way that the absolute priority rule fails to. The way to respect it is to permit the parties to negotiate over how much these "assets" being contributed by the shareholders are worth to the firm's future operations. Thus, in order to maximize the value of the firm, this justification would suggest, it is necessary to keep the shareholders in place, and this requires that the creditors reach a consensual deal with these shareholders over how much of the value of the firm they are entitled to keep.

This justification, however, rests on dubious assumptions. In many firms, there is substantial separation of ownership and "control."[42] The people that work at the firm, and its officers and directors, are oftentimes likely to be insignificant shareholders of the enterprise. Usually, when one is talking about future value being added by having existing people stay on board, one is talking about employees and officers, not shareholders. Any group that takes over the business, be it a third party or the existing claimants, will have to reach a deal with these people (if they do not have existing employment contracts) in order to get them to continue with the firm. These negotiations are as necessary in bankruptcy as they are outside of bankruptcy. But they do not justify the current structure of Chapter 11, where the negotiations are over what portion of the going concern surplus should be passed on to the shareholders. In publically-held companies, it is odd to justify compensating the shareholders because the managers have firm-specific skills that give it greater value.

In other words, the ultimate issue is one of negotiations to acquire valuable post-bankruptcy assets for a firm. There is nothing unique about these negotiations to bankruptcy, and they would not seem to justify the existence of Chapter 11's special negotiation rules. One might think, however, that these rules have some value where the firm is "closely held," in the sense of having a substantial overlap between its shareholders and its managers. In those cases, whoever acquires the assets, if it wishes to keep them as a going concern, may have to reach negotiations with the current managers/shareholders. Given that these bargains are going to have to take place anyway, it might seem perfectly appropriate to have them take place in the context of a Chapter 11 proceeding.

This, however, is not an independent justification for the Chapter 11 process. The assets could still be sold to third parties in a Chapter 7 proceeding who, in deciding how much to pay for the assets, would have to reach (or factor in the costs of) a deal with the existing managers/shareholders to turn over a certain percentage of the firm to them. Those negotiations may be difficult, but they are not constrained by the artificiality of the setting of a Chapter 11 reorganization process. In the latter case, the parties on both sides of the table are fixed, and there is an aspect of a bilateral monopoly. In the case of bargaining in the Chapter 7 context, however, the buyer is not stuck. It is always free to walk, and other buyers are always free to negotiate as well (including, if they so desire, a coalition of existing claimants).

For these reasons, the premises for negotiation in a Chapter 11 process seem unproven and unpromising. Professor Roe is therefore probably correct in suggesting that they should be eliminated.[43] Once that point is reached, however, there seems to be no remaining justification for Chapter 11 at all. Professor Roe envisions a solution of an all common capital stock structure and a ten percent "float." But once the justifications for negotiation have been dismissed, and once one wants to rely on market-pricing mechanisms anyway, there is no particular reason to think that these artificial constraints on capital structures are necessary or appropriate.[44] There is no reason Chapter 7 could not be used as the vehicle to sell the firm as a going concern, in the same way that companies go public. The assets of the firm could be transferred to a new corporation. This new corporation could have a capital structure placed on it. A public offering of the shares in the various classes of that corporation could then be made. Such a solution avoids the inter-class conflicts over distribution that pervade Chapter 11 (because it is in the interest of no class to opposed selling the assets for more rather than less),[45] and avoids the artificiality of an imposed capital structure designed to solve that problem within the current confines of Chapter 11.

To be sure, this solution would require changes in other legal rules. The powers of the trustee, as well as the rules concerning the continuation of the business by the debtor in possession, would have to be modified so as to permit what occurs in the operation of the business in Chapter 11 to occur with equal ease in Chapter 7.[46] It would also be necessary to eliminate existing laws that give investors different rights if a firm is "liquidating" rather than "reorganizing," for these are bankruptcy-specific rules that get in the way of the asset deployment question. The trustee should be able to transfer to a third-party buyer not merely all the tangible assets of the firm, but also the intangible ones, including such things as the lawsuits the firm has against others.[47] Some tax rules provide additional examples. Under existing law, a tax-loss carryforward disappears when there is a sale of a the firm for cash, but it survives a sale of the firm for securities (even if they be readily converted into cash) and it survives when a firm is reorganized under Chapter 11.[48] The rule governing tax-loss carryforwards should be independent of what kind of bankruptcy proceeding is involved.

None of this, however, should obscure the underlying point. It would be letting the tail wag the dog to suggest Chapter 11 should be preserved (with or without its special bargaining rules) because, for example, existing rules permit certain assets -- such as tax attributes -- to survive only in the case of a reorganization. The preferable inquiry is to see if there is anything in Chapter 11's procedures that provide claimants with a better opportunity to achieve a correct distributional result. If there are not, then there are no reasons to preserve rules, in or out of Chapter 11, that force its use.

PREFACE

This book is the culmination of my efforts over the past five years to make sense out of bankruptcy law in my teaching and writings. In doing that thinking, I have become increasingly impressed with the intellectual coherence that underlies bankruptcy law. Its first principles, as I hope to demonstrate, are few and elegant. At the same time, however, I have become convinced that this coherence is frequently obscured by the fact that bankruptcy law affects and requires one to grapple with virtually every other major substantive area in the legal arena. That fact often causes bankruptcy analysts to ignore its first principles in ad hoc responses to particular interactions. This book will serve its goal if it nudges analysts to think about first principles in analyzing bankruptcy problems.

I am more confident of the usefulness of the principles I will outline in these pages in approaching problems than I am of any particular solution I advocate. One of the true advantages to writing this book is that I have returned to the scene of my former writings, in an attempt to integrate them. In doing so, and in responding to the work of others, I sometimes have found my views changing in subtle ways, and, indeed, on a few occasions, in rather dramatic ways. I have little doubt but that my views will continue to evolve. In any discipline that hopes to remain intellectually alive, that is as it should be. I have also found, however, that my views of the first principles of bankruptcy analysis have simply strengthened with time.

This book reflects my current thinking on bankruptcy law. Nonetheless, portions draw heavily on some previously published work. Portions of Chapters 1, 3, and 5 reflect Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain," 91 Yale L.J. 857 (1982); portions of Chapters 2, 4, and 5 reflect Jackson, "Translating Assets and Liabilities to the Bankruptcy Forum," 14 J. Legal Studies 73 (1985); portions of Chapters 3 and 6 reflect Jackson, "Avoiding Powers in Bankruptcy," 36 Stan. L. Rev. 725 (1984); portions of Chapter 7 reflect Baird & 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); finally, portions of Chapters 10 and 11 reflect Jackson, "The Fresh-Start Policy in Bankruptcy Law," 98 Harv. L. Rev. 1393 (1985).

A book such as this owes much to the input of many people, not the least of whom have been students who have forced me to think through (and modify) the implications of some of my tentative -- and not so tentative -- views. In addition, as one learns much from his colleagues, I have been blessed by being on the faculty at the Stanford Law School, where there is intellectual diversity, intensity, and cooperation. Useful comments on various portions of the manuscript were provided by Robert Clark, Vern Countryman, Theodore Eisenberg, Ronald

Gilson, Louis Kaplow, Anthony Kronman, and Steven Shavell. My greatest intellectual debt, however, goes to a frequent collaborator, Douglas Baird, who has grappled with me in approaching much of bankruptcy law and whose intellectual stimulus has fueled countless hours of thought on my part. This book is better in many ways than it would have been without his input. Finally, I owe much to Bonnie, who has sustained and endured with me through the long intense stretches while I was trying to write my thoughts on paper, and whose critical eye has made this book easier to read. I fondly dedicate this book, however, to Richard, whose gestation coincided with it.

T.H.J.

December 1985

For Richard