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AN ESSAY ON OPTIMAL BANKRUPTCY RULES AND SOCIAL JUSTICE

*Robert K. Rasmussen**

The economic approach to bankruptcy envisions bankruptcy law as a set of rules approximating the contractual terms to which, at the time credit is extended, a creditor and debtor would agree should govern in the event of the debtor's insolvency. Some traditional bankruptcy scholars criticize the economic approach for what they see as its failure to advance goals and values which they deem necessary for social justice, and contend that viewing bankruptcy law as a set of contractual terms ignores the impact of insolvency upon various groups affected by a firm which experiences financial difficulties.

In this article, Professor Robert K. Rasmussen challenges those critics, arguing that the economic approach to bankruptcy law is fully compatible with social justice as defined by philosopher John Rawls. Rawls's theory of justice requires that those in the original position must adequately advance the needs of society's least advantaged members in order to create a just political and legal system. In accordance with this requirement, Professor Rasmussen demonstrates that regardless of which class of creditors is found to be the least advantaged, the economic approach to bankruptcy law protects that class's interests better than more traditional theories. Thus, from a Rawlsian perspective, adopting a bankruptcy regime designed to promote efficiency would promote social justice.

What to do about Chapter 11? This question has become one of the more vigorously debated issues in corporate law. The debate itself has proceeded at two levels. At one level, discussion has focused on whether Chapter 11 should be abolished, amended, or retained. Proposals range from the most conservative—retaining Chapter 11 in its

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present form[1]—to the most extreme—abolishing Chapter 11 in its entirety.[2] Some scholars advocate modest amendments to cure what they perceive as the most pernicious problems with current law.[3] Other, more expansive proposals for reworking extant law include an auction regime under which firms that file for bankruptcy are sold to the highest bidder,[4] and a menu of optional bankruptcy regimes from which a firm can select when it is incorporated.[5]

At another level, however, the debate over Chapter 11 reflects a division over which policies bankruptcy law should embrace. Arrayed on one side of the debate are those who view bankruptcy law in solely economic terms. For these scholars, the goal of bankruptcy law is wealth maximization. To implement this goal, these scholars attempt to devise a bankruptcy system which mirrors the set of contractual rules that a firm would establish with its consensual creditors at the time these creditors initially decide to lend money to the firm.[6] To be sure, scholars beginning from this premise have reached different conclusions, but they all share one common thread—they attempt to replicate the optimal contract that would be reached between a firm and those who extend it credit.

Other participants in the ongoing bankruptcy debate condemn this conception of bankruptcy policy. They view the economic conception as impoverished and sterile, an approach to bankruptcy law which privileges economic arguments over all other considerations. Although not rejecting the law and economics goal of efficiency, these scholars contend that bankruptcy law should also be concerned with other matters, including the redistribution of a debtor firm's assets to those persons least able to protect themselves. To critics of a purely

1. Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717 (1991).

2. *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27 (1991); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992).

3. *See, e.g.*, Lynn M. LoPucki, *The Trouble With Chapter 11*, 1993 WIS. L. REV. 729, 749-52 (proposing modified reorganization proceedings for small firms); Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625 (1991) (advocating quick elimination of classes which clearly should receive no part of the reorganized firm under the absolute priority rule); Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11 (advocating limiting current venue choice under Chapter 11); David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 518-20 (proposing modified reorganization proceedings for small firms).

4. Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986).

5. Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992).

6. *See* Adler, *supra* note 2; Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 647 n.6 (1992); Rasmussen, *supra* note 5; Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. & ECON. 595 (1993).

economic approach, the choice is clear—efficiency must at times give way to the demands of social justice.[7]

In some respects, this traditional view of bankruptcy law resembles the nonutilitarian approach to law in general, particularly in its criticism of wealth maximization as an animating principle. The economic vision of bankruptcy law, the argument runs, inappropriately treats existing societal inequalities as a given, and in doing so perpetuates these inequalities.[8] Traditional bankruptcy theorists buttress their contentions by pointing to the plight of certain parties affected by the filing of a Chapter 11 petition, including workers, tort claimants, and members of the surrounding community in which the debtor is located. To traditional theorists, the needs of these parties justify existing law and thus refute the criticisms leveled by the economic approach.[9]

This essay responds to the nonutilitarian attack on the economic conception of bankruptcy law. I argue that the conception of bankruptcy law produced by the economic theorists better comports with a nonutilitarian perspective of social justice. In doing so, I rely heavily on John Rawls's seminal work, *A Theory of Justice.*[10] Rawls's celebrated work offers a comprehensive alternative to an economic vision of social justice. Indeed, Rawls conceived his work as an alternative to utilitarian thought in general.[11] Rather than viewing justice as maximization of utility, Rawls defined justice as fairness.

Those who endorse the traditional understanding of bankruptcy law appear to share this focus on fairness. Concerns with fairness run throughout their work. Despite this mutual emphasis on fairness, however, Rawls's compelling work does not lead to an endorsement of the ideas advanced by traditional bankruptcy theorists. Instead, a Rawlsian approach to bankruptcy law is much more attuned with the concerns of economic theorists. Rawls differs from traditional bank-

7. *See* Korobkin, *supra* note 1, at 766-68; Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 352-61 (1993) [hereinafter Warren, *Policymaking*]; Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777 (1987) [hereinafter Warren, *Bankruptcy Policy*]; Warren, *supra* note 1, at 467-68.

8. Those interested in the general issue of the normative role of efficiency in the law would do well to read *Symposium on Efficiency as a Legal Concern*, 8 HOFSTRA L. REV. 485 (1980).

9. *See* sources cited *supra* note 7.

10. JOHN RAWLS, A THEORY OF JUSTICE (1971) [hereinafter RAWLS, A THEORY OF JUSTICE]. Rawls has continued to refine the ideas presented in *A Theory of Justice*. Much of his subsequent work has been collected in a recent book. *See* JOHN RAWLS, POLITICAL LIBERALISM (1993) [hereinafter RAWLS, POLITICAL LIBERALISM]. Donald Korobkin has attempted to defend extant law from a normative perspective, drawing on the work interpreting Rawls. *See* Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541 (1993). Korobkin acknowledges that his effort departs from Rawls's work, *id.* at 544 n.16, but still asserts that Rawls's theory of justice supports his argument. For two reasons, however, discussed *infra* at note 42, Korobkin's defense of current bankruptcy law cannot be said to flow from a Rawlsian perspective.

11. *See* RAWLS, A THEORY OF JUSTICE, *supra* note 10, at viii.

ruptcy theorists, not so much in the goals sought to be achieved, but rather in the perspective that he takes. Rawls begins his inquiry from the "original position." This construct ensures that existing distributions of societal resources are not given *a priori* legitimacy and that the effects of any given legal system are measured across society as a whole. This emphasis on societal effects distinguishes Rawls's methodology from that of traditional bankruptcy scholars, who focus solely on the problems of a firm in financial distress and ignore the effects of bankruptcy law on those individuals not in bankruptcy. Rawls, on the other hand, demands that the welfare of these parties be considered as well.

Rawls proposes that those in the original position would attempt to maximize the position of the least advantaged members of society. This "difference principle," which has been the target of much scholarly criticism, contains a highly redistributive element: Inequalities are allowed only to the extent that they improve the lot of the least fortunate. When Rawls's difference principle is applied to the competing bankruptcy theories, the economic approach proves itself more capable of protecting the interests of the least advantaged. While it may be difficult to identify with certainty which members of society are the "least fortunate" for the purposes of bankruptcy law, all groups which might possibly qualify as the least fortunate fare better under the economic approach to bankruptcy law than under the traditional theory.

The importance of this conclusion cannot be overstated. John Rawls is the architect of modern social-justice theory, and the fact that his views of social justice comport with an economic approach to bankruptcy law completely undermines arguments which reject, solely on fairness grounds, the economic approach. Anyone who wishes to serve as an apologist for the existing form of bankruptcy law must base that position on something other than an instinctive sense that existing law is more likely to achieve social justice than the competing vision offered by law and economics scholars.

The structure of the article is as follows. Part I sets forth Rawls's theory of social justice and explains why it is an appropriate vehicle for examining bankruptcy law. Rawls's work suggests that a just bankruptcy regime would improve the situation for the least advantaged members of society. Part II then demonstrates that a bankruptcy regime designed to promote economic efficiency fulfills this criterion. Regardless of which group is considered the least advantaged, the economic approach to bankruptcy dominates the traditional one. The driving force behind this conclusion is that the economic approach considers the total social effects of bankruptcy law, whereas the traditional approach focuses only on firms which actually file for bankruptcy. The article concludes that it is untenable to

argue that any unjustness in society as a whole prevents the implementation of a just bankruptcy regime.

I. Bankruptcy from the Original Position

Economic analysis has generated many useful insights into the normative underpinnings of bankruptcy law.[12] Yet not all bankruptcy scholars embrace this mode of analysis. Too often, however, those rejecting economic analysis offer no comprehensive theory to take its place. Instead, these scholars enunciate various "policies" or "values" which bankruptcy law is supposed to serve, and implore bankruptcy judges to do as much as possible to effectuate these goals. Generally, these goals of bankruptcy law include saving jobs, assessing the needs of the surrounding community, treating creditors equitably, and assuring compensation for tort victims.[13]

The concerns articulated by traditional bankruptcy scholars cannot be dismissed lightly. Bankruptcy law affects people's lives. Those crafting any bankruptcy regime should be attuned to these effects. Yet merely being concerned with the effects of bankruptcy law, or for that matter any law, does not in and of itself provide a framework for addressing these concerns. Ad hoc attempts to alleviate perceived problems may be either ineffectual or counterproductive. Missing from the pleas for a bankruptcy law committed to fostering various values is an underlying theory of social justice that explains how, and why, these concerns should be addressed. Bankruptcy scholars who find economic analysis incomplete should articulate a competing theory that justifies the goals on which they seek to ground their vision of bankruptcy law.

A. *Why Rawls?*

A number of social justice theories have been proposed. An inevitable question which arises when arguing that the economic conception of bankruptcy law comports with social justice is: Why has this particular theory been selected? To be sure, one could choose Rawls's *A Theory of Justice*, and his subsequent works expanding on

12. *See, e.g.*, Thomas H. Jackson, The Logic and Limits of Bankruptcy Law (1986) (explaining, *inter alia*, the Bankruptcy Code's treatment of executory contracts, preference law, and the automatic stay); Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. Chi. L. Rev. 738 (1988) (examining the Bankruptcy Code's absolute priority rule); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97 (1984) [hereinafter Baird & Jackson, *Corporate Reorganizations*] (explaining conflicts between secured and unsecured creditors in bankruptcy).

13. *See* Warren, *Bankruptcy Policy*, *supra* note 7; Korobkin, *supra* note 1; *see also* H.R. Rep. No. 595, 95th Cong., 1st Sess. 220 (1977) ("The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.").

the propositions contained therein, on the ground that *A Theory of Justice* is one of the most widely acclaimed philosophical works written in this century. Moreover, Rawls's efforts speak directly to those who devise legal institutions, thus making his works fertile ground for legal scholars interested in social justice. Nevertheless, I do not select Rawls for these reasons. Rather, my criterion for picking Rawls is more pragmatic. Rawls's project shares the premises and values espoused by those who embrace the traditional approach to bankruptcy law. If Rawls's conception of social justice nevertheless supports the economic approach to bankruptcy law, the assertion that such an approach slights important values would be seriously undermined.

The assertion that Rawls's normative framework should be used to measure the traditionalists' attack on an economic approach to bankruptcy law rests on three propositions. First, the economic approach to law in general is traditionally linked with utilitarianism,[14] and Rawls's work is, in large part, a direct response to utilitarianism. Although Rawls views his theory as a general response to all forms of utilitarianism, he focuses particularly on classical utilitarianism, which he describes as holding that "society is rightly ordered, and therefore just, when its major institutions are arranged so as to achieve the greatest net balance of satisfaction summed over all the individuals belonging to it."[15] Stated differently, classical utilitarianism seeks to maximize the sum of all individuals' utility functions.[16] Rawls attempts to establish an alternative conception for determining the means by which a society should distribute its assets amongst its members.[17] This opposition to classical utilitariansim is exactly what traditional bankruptcy theory applauds.

To be sure, it is a mistake to equate economic analysis of law with utilitarianism. Much modern economic analysis of law is not utilitarian in the classic sense; instead, economic analysis seeks to maximize societal wealth rather than societal utility.[18] Goods should be awarded to those individuals who are willing to pay the most, not to those for whom the goods have the highest utility. The following ex-

14. *See, e.g.*, Richard A. Epstein, *The Next Generation of Legal Scholarship?*, 30 STAN. L. REV. 635, 645 n.35 (1978).

15. RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 22.

16. Utility is a direct measure of a person's happiness, and a person's "utility function" assigns the amount of happiness that she would gain from a certain event. By maximizing the sum of the utility functions of all members of society, one maximizes the total happiness of that society.

17. Whether Rawls accomplishes his goal of providing an account which is distinct from utilitarianism is, of course, another question. For arguments that he has not, see Kenneth J. Arrow, *Some Ordinalist-Utilitarian Notes on Rawls's Theory of Justice*, 9 J. PHIL. 245 (1973); John C. Harsanyi, *Can the Maximin Principle Serve as a Basis for Morality?: A Critique of John Rawls's Theory*, 69 AM. POL. SCI. REV. 594 (1975).

18. For a discussion of the difference between wealth maximization and utilitarianism, see RICHARD A. POSNER, THE ECONOMICS OF JUSTICE 48-115 (1981) [hereinafter POSNER, JUSTICE]; Richard A. Posner, *Wealth Maximization Revisited*, 2 NOTRE DAME J.L. ETHICS & PUB. POL'Y 85, 87-88 (1985).

ample illustrates the difference between maximizing wealth and utility. Assume that I own a spacious Tudor house. A neighbor of mine has been blessed with both a larger family and a greater sense of aesthetics than I possess. Thus, my neighbor would derive a greater utility from this house than I do—her family requires more space to live comfortably, and she sees a cherished architectural masterpiece where I see only four walls, a door, and a roof. I would gladly take $1,000,000 in exchange for my house, but she cannot meet this price because of her limited means. The classical utilitarian would require that the house be transferred to my neighbor because doing so would increase society's overall utility. The wealth maximizer, on the other hand, would not force the transfer because such a transfer would decrease society's wealth. This decrease in wealth comes about because prior to the transfer, I have an asset that I value at $1,000,000 and that my neighbor values at a lower amount. After the transaction my neighbor now has an asset that I value more than she does—at least in terms of willingness to pay for it. Society's overall wealth has thus been diminished.

Despite the ways in which economic analysis of law differs from classic utilitarianism, Rawls's objections to the latter extend to the former. Both theories seek to maximize some value, whether wealth or utility, in society as a whole. Neither theory is specifically concerned with the welfare of any particular individual, and thus neither theory addresses distributive questions. This failure to consider the basic entitlements of an individual leads Rawls to reject classical utilitarianism, and, by extension, economic analysis of law as well.[19] Instead, Rawls propounds a theory of social justice which places primary emphasis on the welfare of individual members of society rather than the overall welfare of society. This stance thus situates Rawls as a most distinguished opponent of economic analysis of law.

The second reason for choosing Rawls's work to evaluate whether bankruptcy law is just is Rawls's explicit placement of his theory of justice within a liberal democratic framework. Some philosophers who reject utilitarianism also reject classical liberal democracy. Using their work to evaluate this country's bankruptcy law would be of little practical value. The ongoing debate over the appropriate contours of bankruptcy law is concerned with legal reform. As such, it takes place against a backdrop of widely shared norms, one of which is that our country is committed to liberal democracy. From a practical standpoint, advocating a bankruptcy regime justified from premises which the vast majority of lawmakers reject makes little sense. Rawls, however, accepts the basic premise of a liberal democracy, and

19. *See* RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 27 ("Utilitarianism does not take seriously the distinction between persons.").

his work therefore generates a useful assessment of whether a particular conception of bankruptcy law comports with social justice.

Finally, Rawls's work contains a strong redistributive element. As described in greater detail below, Rawls considers existing assets and individual talents as societal assets. This means that no person by reason of his natural endowments or social situation has an *a priori* claim to a greater share of society's assets than does any other individual. Rawls's preference for redistribution tracks one of the main themes in traditional bankruptcy scholarship. Indeed, some scholars defend current bankruptcy law because of its redistributive element.[20] Thus, one might think that if any theory of social justice could supply a philosophical foundation for the traditional approach to bankruptcy, it would be that of Rawls.

B. Rawls's A Theory of Justice *and Bankruptcy Law*

Rawls's *A Theory of Justice* offers a theory which attempts to establish standards under which a society can be considered just. This theory focuses on what Rawls terms the *basic structure* of society, and the way in which this structure distributes *primary goods*. A brief explanation of terminology is in order. Rawls defines the *basic structure* as "the way in which the major social institutions fit together into one system, and how they assign fundamental rights and duties and shape the division of advantages that arises through social cooperation."[21] The *major social institutions* include "the political constitution and the principal economic and social arrangements."[22] *Primary goods* are those items which every rational person desires to have regardless of the goals which she sets for herself during her life.[23] Primary goods are thus a measure of the inputs of a person's happiness, rather than a measure of happiness itself. Rawls defines the primary goods which a society must distribute as individual rights and liberties, opportunities, authority, income and wealth, and self-respect.[24] In short, Rawls examines the fundamental structure by which society distributes its wealth, broadly defined, among its members.

Rawls justifies focusing on the basic structure of society on the grounds that if the basic structure of a society is not just, transactions

20. *See, e.g.*, Warren, *supra* note 1, at 467-71; Warren, *Policymaking, supra* note 7, at 352-61; Elizabeth Warren, *"Why Have a Federal Bankruptcy System?"*, 77 CORNELL L. REV. 1093 (1992).

21. John Rawls, *The Basic Structure as Subject*, 14 AM. PHIL. Q. 159, 159 (1977); RAWLS, POLITICAL LIBERALISM, *supra* note 10, at 258.

22. RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 7; *see also* RAWLS, POLITICAL LIBERALISM, *supra* note 10, at 258.

23. RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 62, 92; RAWLS, POLITICAL LIBERALISM, *supra* note 10, at 75-76.

24. RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 62, 92; RAWLS, POLITICAL LIBERALISM, *supra* note 10, at 76; John Rawls, *The Priority of Right and Ideas of the Good*, 17 PHIL. & PUB. AFF. 251, 255-58 (1988) [hereinafter Rawls, *Priority of Right*].

which take place within that society will not be just, regardless of how free and fair the transactions appear to be when viewed in isolation.[25] A voluntary exchange between two individuals is not in and of itself just; rather, the justness of the exchange turns upon the basic structure of the society in which the individuals making the trade are situated. Consequently, Rawls ignores the existing distribution of goods in society. This denial of presumptive validity for existing distributions of wealth aligns Rawls with those who, like traditional bankruptcy scholars, reject any equation between social justice and wealth maximization.[26]

If Rawls is to assist in evaluating the law of bankruptcy, then that law must be shown to fall within his definition of the basic structure. That is, we must consider whether bankruptcy law is the type of "major social institution" that assigns "fundamental rights and duties" in society with respect to primary goods. By *bankruptcy law* I refer only to corporate bankruptcy law and thus exclude individual bankruptcy law.[27] In addition, my use of *bankruptcy law* is somewhat more expansive than is customary; it encompasses all forms of debt collection, regardless of whether they have their genesis in federal or state enactments. Modern economic bankruptcy analysis attempts to craft an optimal set of rules which apply when a firm becomes insolvent.[28] Whether these rules originate in the state or national government has no import when considering the justness of such laws. In this essay *bankruptcy law* is synonymous with "the law which governs financial distress." It is the law on which prospective creditors base their decisions to lend or extend credit, and it is the law which determines the ultimate distribution of a debtor's assets.

Bankruptcy law thus defined is an appropriate subject for the application of Rawls's theory of justice. The operation of a private property, market-based economy, such as the current American system, directly implicates bankruptcy law. The hallmark of such an economy is that some firms inevitably fail. Some firms make products which the public no longer wants (or never wanted), while others cannot produce goods or provide services at a competitive price. The result, of course, absent some form of nonmarket subsidization, is eventual bankruptcy. Any economic system which often results in corporate insolvency needs a way to deal with these failures. There may, however, be other firms which in the long run are efficient (in the sense

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25. RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 160; RAWLS, POLITICAL LIBERALISM, *supra* note 10, at 265-69.

26. *Cf.* POSNER, JUSTICE, *supra* note 18, at 100 (rejecting Rawls's framework because it fails to give persons an entitlement to their natural endowments).

27. I have previously discussed why I distinguish between corporate and individual bankruptcy law. *See* Rasmussen, *supra* note 5, at 78 n.113 (arguing that the "fresh start" policies applicable to an individual's financial distress have no role to play in considering the financial distress of a corporation).

28. *See id.* at 55-68.

that their operating revenues exceed their operating expenses), but may in the short run be both unprofitable and unable to receive interim financing.[29] The fate of all these firms, as well as the fate of those persons affected by these firms' operations, is decided by the controlling bankruptcy regime. Failure is thus an inevitable component of a market-based economy, and therefore, one cannot fully assess the distributive effects of such an economic system without considering how that economy handles firms which experience financial distress. Bankruptcy law performs that function; it determines the fate of the financially troubled firm and allocates who gets what when there are not enough assets to go around. Bankruptcy law is thus part and parcel of the nation's economy.

The structure of the economy clearly falls within Rawls's definition of the basic structure of society.[30] The economic system is the central way by which a society creates wealth and decides which goods are to be created. Wealth and income, two of Rawls's primary goods, are created and distributed by a country's economic system. Rawls himself endorses a market economy as the economic system which would exist in a just society. Although agnostic between whether private parties or the government should own the means of production, he notes that competitive markets "select the goods to be produced and allocate resources to their production in such a manner that there is no way to improve upon either the choice of productive methods by firms, or the distribution of goods that arises from the purchases of households."[31]

A society's economic system is thus part of its basic structure. For the purposes of this essay, I explicitly assume that a market economy based on private property is in place. Not only does Rawls make this same assumption,[32] any other assumption is so divorced from extant conditions that determining the just bankruptcy system in such an

29. This is a standard justification for Chapter 11. *See, e.g.*, 124 CONG. REC. 32,392 (1978) (statement of Rep. Edwards); 124 CONG. REC. 33,990 (1978) (statement of Sen. DeConcini); Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 734 (1993). For a representative example of this viewpoint, see *The Experts Advise: How to Apply for a Judgeship*, 23 BANKR. CT. DEC. A1, A1-A6 (Sept. 10, 1992) (quoting Phil Handel, attorney at a Massachusetts law firm) ("I think you can get a lot of personal satisfaction out of preserving jobs in the community and a sense that you've added to a continuity of social justice."). Whether a significant number of firms with long-term earnings potential but short-term financial difficulties and inability to receive necessary interim financing exists is a debated question, on which there is little empirical evidence. *See* Michelle J. White, Corporate Bankruptcy as a Screening Device 15-16 (1993) (unpublished manuscript, on file with author).

30. Rawls, *Priority of Right*, *supra* note 24, at 255-58.

31. *Id.* at 271.

32. *Cf. id.* at 274 ("At the start I assume that the regime is a property-owning democracy since this case is likely to be better known."). For an empirical argument that American capitalism is more just than communism under a Rawlsian perspective, see Richard C. Bayer, *On John Rawls's* A Theory of Justice: *Empirical Application of Justice Theories: A Test Case*, 42 INT'L SOC. SCI. J. 565 (1990).

economy, assuming it even had a bankruptcy system, would provide little guidance to those concerned with the justness of bankruptcy law in our society. Bankruptcy law as it operates in a market-based economy is thus rightly considered part of society's basic structure.

Rawls posits that a society is just when the basic structure by which it distributes primary goods is "fair." Indeed, Rawls describes his entire project as "Justice as Fairness."[33] Fairness, for Rawls, is a procedural fairness. In other words, fairness occurs when the principles governing society have been selected according to the proper procedures; there is no external constraint on the *content* of these principles.[34]

The appropriate procedures, for Rawls, begin from the "original position," which asks what political system people would prospectively choose if they did not know what their place in society would be.[35] This approach prevents the status quo from serving as a justification for itself, and also prevents individual members of a society from denoting a system as "just" solely because it allows them to retain or obtain a favored place in that system. Under Rawls's approach, those in the original position are unaware of their current amount of societal wealth and the nature and extent of their natural abilities. Rawls thus treats wealth and natural abilities as societal, rather than individual, assets.[36]

Thus, persons in the original position evaluate competing societal institutions from behind a thick veil of ignorance. They do not know whether they are rich or poor, smart or dumb, female or male.[37] These individuals are, however, moral persons in the sense that they can understand and act according to the selected principles of justice and that they can form judgments and act according to their own sense of the good.[38]

33. *See* RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 3. Rawls himself states: "I . . . present the main idea of justice as fairness, a theory of justice that generalizes and carries to a higher level of abstraction the traditional conception of the social contract." *Id.*

34. *See* John Rawls, *Kantian Constructivism in Moral Theory: Rational and Full Autonomy*, 77 J. PHIL. 515, 522-24 (1980) [hereinafter Rawls, *Kantian Constructivism*]; RAWLS, POLITICAL LIBERALISM, *supra* note 10, at 102-07.

35. For earlier works using similar conceptions of an original position, see John C. Harsanyi, *Cardinal Utility in Welfare Economics and in the Theory of Risk-taking*, 61 J. POL. ECON. 434 (1953); John C. Harsanyi, *Cardinal Welfare, Individualistic Ethics, and Interpersonal Comparisons of Utility*, 63 J. POL. ECON. 309 (1955); William Vickrey, *Utility, Strategy, and Social Decision Rules*, 74 Q.J. ECON. 507, 523 (1960). Unlike Rawls, these authors concluded that those in the original position would select utilitarianism as their guiding principle.

36. For a different conception on the ownership of natural abilities, see ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 213-31 (1974).

37. Rawls does not explicitly state in *A Theory of Justice* that the persons are ignorant of their sex. Indeed, Rawls continually uses the masculine pronoun to refer to those making the choice. *See* SUSAN M. OKIN, JUSTICE, GENDER, AND THE FAMILY 90 (1989). Rawls's later work clarifies that persons are indeed ignorant about their sex. *See* John Rawls, *Fairness to Goodness*, 84 PHIL. REV. 537 (1975); RAWLS, POLITICAL LIBERALISM, *supra* note 10, at 25.

38. Rawls, *Kantian Constructivism*, *supra* note 34, at 525; RAWLS, POLITICAL LIBERALISM, *supra* note 10, at 103-04.

In the original position, there are no differences between individuals. All differentiating aspects of individuals, whether stemming from social or genetic sources, are stripped away. Indeed, from such a position a discussion amongst the members of society is not necessary; because each individual shares an identical set of attributes, all members of society will agree on whether the basic institutions of their society are just.[39] The results reached in the original position are thus the same whether only one person or all members of society are placed in that position.

Persons behind the veil of ignorance are ignorant only of their individual characteristics. In other respects, each person has a good deal of knowledge, including a basic familiarity with economic theory, political affairs, and human psychology. "Indeed, the parties are presumed to know whatever general facts affect the choice of the principles of justice."[40] The parties are not altruistic, however, in using this knowledge to choose a just society. Rather, each person—or one person chosen at random—seeks to further her own ends as best she can determine them in the absence of complete self-knowledge.[41]

Applying Rawls's theory to bankruptcy involves evaluating the form of bankruptcy law from the original position, behind the veil of ignorance. Although such an approach is not the enterprise undertaken by traditional bankruptcy scholars, it is the only way to supply an underlying *theory* of social justice which these scholars have failed to offer in their quests for social justice through bankruptcy regulation. Use of the veil of ignorance is indeed a valuable approach to assessing bankruptcy law. Rather than artificially narrowing the inquiry solely to a particular firm in distress, or specific creditors of that firm, use of the veil of ignorance permits an examination of a bankruptcy regime's overall effects on the way in which the basic structure distributes society's primary goods.

Bankruptcy law affects firms both inside and outside of bankruptcy.[42] For example, bankruptcy law can affect a debtor's competitors. The filing of a bankruptcy petition stays all debt collection efforts,[43] allowing a firm to fund only those ongoing expenses necessary to remain in operation while the bankruptcy case is pending. This

39. RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 139 ("[W]e can view the choice in the original position from the standpoint of one person selected at random.").

40. *Id.* at 137.

41. *Id.* at 142-50.

42. Korobkin overlooks this point in his defense of the current regime. He views only those who have dealings with the firm itself as being affected by bankruptcy. *See* Korobkin, *supra* note 10, at 574. More specifically, Korobkin attempts to fashion a view of bankruptcy law from the standpoint of the financial distress of a particular firm, rather than assessing the overall effect of bankruptcy law on both those in and out of financial distress. It is this narrow focus which allows Korobkin to conclude that bankruptcy law should be concerned with the "most vulnerable" party before the bankruptcy judge. *See id.* at 581-89.

43. The Bankruptcy Code's automatic stay provisions are found at 11 U.S.C. § 362 (1988).

provides a debtor with the opportunity to unfairly price its products or services while in bankruptcy.

This potential to inflict substantial loss on other parties not in bankruptcy is more than idle speculation. Eastern Airlines filed for protection under Chapter 11 following a strike by its machinists, which was subsequently honored by its pilots,[44] but the results of the filing extended far beyond the participants in the labor dispute. Because of the Bankruptcy Code's automatic stay,[45] Eastern did not have to pay its prepetition debt; it merely had to meet current expenses. In economic terms, Eastern only had to pay the marginal costs of continued operations rather than the average cost. In an attempt to win back customers, Eastern lowered its fares, beginning a fare war which caused losses throughout the entire industry.[46] These losses arose only because of the protection afforded Eastern by the automatic stay. Thus, Eastern's competitors were adversely affected by the extant bankruptcy regime. Such consequences, however, go undocumented by any analysis that focuses solely on the participants in a bankruptcy proceeding.

Moreover, the consequences of bankruptcy law extend well beyond the firm's competitors. Bankruptcy law affects interest rates that all firms must pay, regardless of whether they eventually end up in bankruptcy.[47] To see why this is so, consider the position of those who lend money to a firm. In deciding whether to lend money to a firm, and at what interest rate, the putative creditor is concerned with its expected return. Part of this expectation includes the probability that the firm will end up insolvent, and the return that the creditor will receive upon such an occurrence. To the extent that a creditor is promised more by a given bankruptcy regime, that creditor will charge a lower rate of interest in the first instance. We are not surprised, for example, that secured creditors, who have been promised a priority right to the proceeds from the sale of specific assets of the debtor should the debtor default, charge lower interest rates than do general creditors who lack such assurance.

If a bankruptcy regime causes a rise in interest rates, fewer business ventures will be undertaken in the first instance, and existing businesses will have a harder time servicing debt payments, driving more firms into financial distress. Both of these effects will in turn reduce the number of jobs available in the economy. When a bankruptcy regime protects certain persons who have dealt with a bankrupt firm, this protection may come at the expense of others in society who

44. *See* AARON BERNSTEIN, GROUNDED: FRANK LORENZO AND THE DESTRUCTION OF EASTERN AIRLINES 146-68 (1990).

45. *See supra* note 43.

46. *See* Lawrence A. Weiss, Restructuring Complications in Bankruptcy: The Eastern Airlines Bankruptcy Case 37-38 (Apr. 15, 1993) (unpublished manuscript, on file with author).

47. *See* Rasmussen, *supra* note 5, at 55-68.

would have obtained jobs but for the rise in interest rates caused by the bankruptcy regime. In comparing competing bankruptcy regimes, it is important to use a scheme which will assess the effect on those firms which file for bankruptcy *and* those entities which, although they might not file for bankruptcy, are nonetheless affected by the governing bankruptcy law. Assessing bankruptcy law from the original position allows such a comparison; in contrast, the positions advocated by traditional bankruptcy scholars do not. Thus, it makes sense to assess the fairness of a bankruptcy system from the perspective of the original position. The remaining task is to examine the decision-making process of those in the original position.

Rawls argues that behind the veil of ignorance, parties would first select two principles of justice by which they evaluate competing societal structures. The first principle of justice[48] is that "each person is to have an equal right to the most extensive basic liberty compatible with a similar liberty for others."[49] This principle addresses the dispensation of society's basic rights and liberties. The second principle of justice is that "social and economic inequalities are to be arranged so that they are both . . . reasonably expected to be to everyone's advantage, and . . . attached to positions and offices open to all."[50] Rawls defines this second principle of justice as the *difference principle*. This principle governs the dispensation of the remainder of society's primary goods.

Application of the difference principle in assessing competing societal structures requires a lexical ordering of such structures. Such a process compares the position of the worst-off class of individuals under the competing regimes. If these individuals are treated better in one regime than the other, the former regime is chosen. If they are equally situated in both regimes, then the position of the second most worst-off class under each regime is compared. The process is repeated until we locate the class that is the least-advantaged class whose situation would be affected by the choice between institutions.[51] In other words, parties in the original position select among competing institutions based on the "maximin" principle. This principle, as its name implies, seeks to maximize the utility of the class in

48. Rawls later modified this first principle, stating that individuals have an equal right only to "a fully adequate scheme" instead of to "the most extensive total system" of basic liberties. *See* John Rawls, *The Basic Liberties and Their Priority*, *in* 3 THE TANNER LECTURES ON HUMAN VALUES 1, 5 (Sterling M. McMurrin ed., 1982). This change has no bearing on applying Rawls's work to bankruptcy law, however, because Rawls's first principle of justice has no impact on such law. *See infra* text accompanying notes 58-60.

49. RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 60; RAWLS, POLITICAL LIBERALISM, *supra* note 10, at 5. Although Rawls's later work modifies some of the arguments made in *A Theory of Justice*, his basic conclusion that his two principles of justice would emerge from the original position remains unchanged. *See id.* at 5-7.

50. RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 60.

51. *Id.* at 82-83; *see also* AMARTYA SEN, COLLECTIVE CHOICE AND SOCIAL WELFARE 138 (1970).

the minimum position, i.e., the class which has the smallest amount of primary goods. The baseline is thus equal distribution of the primary goods which remain after the first principle of justice has been implemented. Movements away from this baseline can only be justified to the extent that resulting inequality in distribution increases the overall societal amount of primary goods and is not at the expense of society's least-advantaged members.[52]

Not surprisingly, the difference principle has failed to garner universal support. For example, John Harsanyi has shown that if persons behind the veil of ignorance are risk neutral and assume that they have an equal chance of becoming any member of society, one ends up not with Rawls's difference principle, but rather with standard utilitarianism. This occurs because under these assumptions, those choosing the basic structure of society would be concerned with the average welfare of all members of society rather than merely the welfare of the worst-off members.[53] Indeed, the difference principle is the most controversial aspect of Rawls's work,[54] with many commentators doubting that it would emerge from the original position.[55]

I too seriously doubt whether the difference principle would in fact be selected from behind the veil of ignorance. Despite these misgivings, however, it seems prudent for the purpose of this essay to accept this integral part of Rawls's work because the difference principle embodies a strong redistributive element: Unequal distributions are allowed only to the extent that they improve the position of the least-advantaged members of society. Neither existing wealth nor natural abilities in and of themselves entitle a person to a greater share of primary goods. This concern with the affairs of the most-disadvantaged members of society coincides quite accurately with the concerns motivating traditional bankruptcy scholars. These scholars endorse redistribution of assets to the less well-off when a firm experiences financial distress. By accepting the difference principle as a criterion

52. *See* RAWLS, POLITICAL LIBERALISM, *supra* note 10, at 282 ("Because they start from equal shares, those who benefit least . . . have, so to speak, a veto."); Pat Shaw, *Rawls, The Lexical Difference Principle and Equality*, 42 PHIL. Q. 71, 76 (1992) ("A position of equality is the notional starting point; and equality is traded for benefits.").

53. *See* Harsanyi, *supra* note 17, at 598-99. For a formal proof of this point, see Ken Binmore, *Social Contract I: Harsanyi and Rawls*, 99 ECON. J.: Q. ROYAL ECON. SOC'Y 84, 85-88 (Supp. 1989).

54. *See* BRIAN BARRY, THEORIES OF JUSTICE 214 (1989) ("No other aspect of Rawls's theory has attracted more commentary than his effort to show that the difference principle can be derived from the original position as he specifies it, and it is, I think, safe to say that no other aspect of the theory has met with such uniform rejection."). For Rawls's defense of the difference principle, see John Rawls, *Some Reasons for the Maximin Criterion*, 64 AM. ECON. REV. 141 (1974). For another defense of the principle, see Joshua Cohen, *Democratic Equality*, 99 ETHICS 727 (1989).

55. Researchers have experimented with college students and claimed that the results show that those in the original position would choose to maximize average utility subject to a minimum income. *See* Norman Frohlich et al., *Laboratory Results on Rawls's Distributive Justice*, 17 BRIT. J. POL. SCI. 1 (1987).

of analysis, I endeavor to meet the traditionalists' objections on their own terms. I am thus willing to assume, for the purposes of this essay, that bankruptcy law should be primarily concerned with the status of the least-advantaged members of society. It remains to be determined, nevertheless, which conception of bankruptcy, the economic or the traditional approach, comports with the difference principle.

II. SELECTION OF A SOCIALLY JUST BANKRUPTCY REGIME

A. *Application of Rawls's First Principle*

After describing the principles which those in the original position would select, Rawls sets forth the procedure by which these principles would be implemented. Parties behind the veil of ignorance must first establish a just constitutional framework.[56] At this point, the parties are still unaware of their individual attributes, but they now know general facts about their society, such as its political culture and level of economic advancement. The constitution's primary task is to implement Rawls's first principle of justice, ensuring that all citizens share the same basic liberties. These liberties "are . . . political liberty . . . , liberty of conscience and freedom of thought, freedom of the person along with the right to hold (personal) property, and freedom from arbitrary arrest and seizure . . . ."[57]

This constitutional implementation of the first principle of justice has no effect on the contours of bankruptcy law. As it relates to a person's economic well-being, the constitution drafted in the original position may promise to all a basic level of material wealth in order to ensure that they may enjoy the basic liberties that the constitution parcels out.[58] Corporate bankruptcy law, however, would play no role in fulfilling this promise.[59] Bankruptcy law distributes the assets of a financially distressed firm to those who have a prior relationship with it; there is little reason to suggest why these assets should go to the government for a distribution to those whose income is below a certain level. Directly taxing the more affluent so as to generate sufficient funds to provide the basic wealth level needed by all members of society would be the most effective system of redistribution. Although a just constitution may require the redistribution of societal wealth, bankruptcy law has little to commend it as a mechanism for such redistribution. Thus, a Rawlsian constitution implementing the

56. RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 195-98.

57. *Id.* at 61.

58. *See* Frank I. Michelman, *Constitutional Welfare Rights and* A Theory of Justice, *in* READING RAWLS 345 (Norman Daniels ed., 1989) ("Enjoyment of basic liberties . . . has fairly straightforward and objective biological entailments. Thus the right to provision of these may rank with liberty among the social priorities established by the theory of justice as fairness.").

59. Of course, the same may not be true for individual bankruptcies.

first principle of justice imposes no constraints on those in the original position when adopting a corporate bankruptcy system.[60]

B. *Application of the Difference Principle*

After a just constitution is established, the legislature created by that constitution enacts laws to govern society. The legislators themselves are no different from the rest of the citizens behind the veil of ignorance; they do not know their personal characteristics. Whereas the just constitution embodies the commands of Rawls's first principle of justice (thereby guaranteeing these liberties against legislative encroachment), the laws established by the legislature implement the second principle of justice, the difference principle. Legislators thus seek to enact "social and economic policies . . . aimed at maximizing the long-term expectations of the least advantaged . . . ."[61]

Rawls does not pretend that this process of creating laws informed by the difference principle will yield a unique set of policies. He candidly admits that his process "is often indeterminate: it is not always clear which of several constitutions, or economic or social arrangements, would be chosen. . . . Often the best that we can say of a law or policy is that it is at least not clearly unjust."[62] Such indeterminacy should not be surprising; it exists in most philosophies of distributive justice.[63] This indeterminacy, however, does not mean that a Rawlsian inquiry is not worth the effort. Many potential laws may be shown to be unjust, and in some areas a consensus on what constitutes a just law may be obtainable. Moreover, to the extent that legal scholarship in the two decades since Rawls's work has focused on the consequences of particular legal rules,[64] this scholarship provides a basis for evaluating the effects of competing legal regimes on the least advantaged members of society. Using this learning in applying the difference principle, we *can* conclude that the Rawlsian legislature would select the economic vision of bankruptcy law over that proposed by the traditionalists.

Before applying Rawls's work to bankruptcy law, however, two caveats are in order. First, I doubt whether Rawls's work can reason-

60. Current constitutional law does impose constraints on the treatment of secured creditors. *See* Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589 (1935) ("The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment."); Wright v. Union Central Life Ins. Co., 311 U.S. 273, 278 (1940) (stating that secured creditors are constitutionally protected against having the value of their collateral taken away in bankruptcy proceedings). For reasons why this protection need not be an essential element of a Rawlsian constitution, *see infra* text accompanying notes 76-77.

61. RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 199.

62. *Id.* at 199, 201.

63. *See* RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE 335-36 (1990).

64. Judge Posner has discussed this change in the nature of legal scholarship. *See* Richard A. Posner, *The Decline of Law as an Autonomous Discipline: 1962-87*, 100 HARV. L. REV. 761, 767-69 (1987).

ably be read to speak to many of the specific questions which inevitably arise during a bankruptcy proceeding. Political philosophy offers little to the question of whether oversecured nonconsensual creditors should receive postpetition interest on their claims,[65] or the appropriate length of the preference period.[66] The Bankruptcy Code is filled with provisions that are akin to traffic lights. The fact that the rules exist and everyone knows their content is more important than the substance of that content. Thus, I seek only to examine the basic attributes of the economic vision of bankruptcy law; I do not pretend that Rawls fills in the details.

The second caveat is more in the nature of a clarification. I do not claim that the economic approach to bankruptcy law can be *derived* from Rawls's work. The difference principle enables us to compare competing institutional structures from a perspective of social justice. It is a principle of evaluation, not creation. Accordingly, my claim is that Rawls's vision of social justice supports the economic theory of bankruptcy law, not that such a theory devolves from Rawls's work.

C. *The Difference Principle and Modern Economic Bankruptcy Theories: General Considerations*

The modern economic account of bankruptcy law argues that bankruptcy law should be viewed as a term of the contract between a debtor and those who provide it with money or services.[67] This view rejects prior economic analysis which argued that the sole purpose of bankruptcy law was to solve a collective action problem among a debtor's creditors.[68] Scholars embracing this modern view of bankruptcy have proposed a variety of regimes. Central to these regimes is that they attempt to specify the optimal debt contract and that they allow parties to opt out of the state-supplied bankruptcy terms. These scholars agree, however, that there are limits on the ability to create contractual obligations which set forth the rules governing the firm's future in the event of bankruptcy. Most importantly, the agreement among the firm's consensual creditors cannot purport to affect the treatment of the firm's nonconsensual claimants. The rationale for this limitation is two-fold. Nonconsensual creditors (such as tort victims, for example), as the name implies, do not contract with the firm and cannot look after their individual interests through negotiation.

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65. This issue was resolved in United States v. Ron Pair Enterprises, Inc., 489 U.S. 235 (1989), where the Supreme Court held that such creditors are entitled to receive postpetition interest pursuant to 11 U.S.C. § 506(b) (1988).

66. The preference period is currently 90 days, although in limited circumstances the period may be extended to one year. *See* 11 U.S.C. § 547(b) (1988).

67. Picker, *supra* note 6, at 647; Rasmussen, *supra* note 5, at 55-68.

68. The leading proponents of this view are Douglas Baird and Thomas Jackson. For a summary of their views, see DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 39-43 (2d ed. 1990).

Moreover, consensual creditors have an incentive to accord nonconsensual claimants the lowest priority imaginable. Economic theories of bankruptcy thus require that the state establish the appropriate treatment of nonconsensual creditors and that this rule cannot be altered by contract.[69]

The modern economic conception of bankruptcy law comports with the goal of maximizing societal wealth.[70] The basic insight supporting this conclusion is that the payoff which debt collection law gives to a consensual creditor is part of the initial contract between a creditor and the firm. The more a creditor expects to receive upon default, the lower the interest rate it will charge. To the extent that a debtor prefers a set of bankruptcy rules which provides it with certain benefits—such as the opportunity for its shareholders to participate in the reorganized enterprise—it can select a regime which offers such protection if it is willing to pay for it. Letting debtors decide whether the benefits of a certain regime exceed its costs increases societal wealth because no debtor is forced to adopt a bankruptcy term which it views as decreasing its own wealth. Given that the market prevents consensual creditors from demanding an excessive interest rate, these creditors' wealth is unaffected by the bankruptcy regime in place. The economically derived bankruptcy regime thus increases societal wealth because one party is better off, and no party is worse off.

The question remains whether legislators behind the veil of ignorance would enact an economically-derived bankruptcy regime when faced with the choice between it and current law. In Rawlsian terms, the hypothetical legislature must choose which of the competing conceptions of bankruptcy better comports with the difference principle. One difficult problem in applying the difference principle is determining who counts as the least-advantaged members of society. Is it the single person who is actually the least-advantaged, the bottom five percent of persons as measured by primary goods, the bottom half, or some other group? Moreover, what is the relevant benchmark in making the necessary comparison? Is it income, wealth, or social position? Rawls acknowledges this problem[71] and suggests that practical sense be our guide.[72]

An additional problem arises specifically in the bankruptcy context. Bankruptcy law treats individuals based on their relationship with the firm; the Bankruptcy Code does not compare each individual's amount of primary goods with that of the other parties-in-interest. In other words, bankruptcy law's treatment of a particular individual depends on whether she is a creditor; not whether she is

69. *See* Rasmussen, *supra* note 5, at 67.

70. *Id.*

71. *See* RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 98 ("The serious difficulty [in applying the difference principle] is how to define the least fortunate group.").

72. *Id.* ("Yet we are entitled at some point to plead practical considerations . . . .").

more or less advantaged than other members of society. Certainly, one could imagine a bankruptcy scheme based on the relative positions of those dealing with the firm. Such a regime would mandate that a bankruptcy judge implement the difference principle on a case-by-case basis. In any particular bankruptcy case, it may be possible to ascertain with some degree of certainty which persons are the worst off.[73] A judge could hold a hearing to determine the relative wealth of the competing parties and then redirect the assets of the firm to those most in need.

Although such a regime may initially appear to comport with the difference principle, this appearance is specious. A general command to the bankruptcy judge to redistribute wealth to the worst-off persons appearing before her would have little to commend it to those in the original position. Such a demand would have the effect of discouraging lenders who do not think that they would be deemed the least-advantaged from lending money to a firm in the first instance. Consider, for example, a bank deciding whether to lend money to a firm. If this potential creditor knows that it will not be the least-advantaged party in the event of bankruptcy, it will expect to receive a reduced amount or even no payout at all if the firm files for bankruptcy. This knowledge will encourage lenders to either raise interest rates or refuse to lend money to risky prospects. Similarly, employers would have an incentive to hire those who were comparatively better off and to locate in more prosperous communities. A bankruptcy redistribution to the least advantaged results in nothing more than a tax on those individuals who choose to deal with persons worse off than themselves. The effect of such a tax would be an overall reduction in society's wealth in that there would be less economic activity.

To be sure, a generalized decrease in society's wealth, standing alone, is not a decisive consideration for those applying Rawls's difference principle. What does tip the decision against case-by-case application of the difference principle is that this decrease in wealth stems from a disincentive to engage in business with the least-advantaged members of society. It is precisely those whom the difference principle protects who would be disadvantaged by such an ad hoc system. Thus, bankruptcy law, in order to advance the interests of the least-advantaged members of society, must consist of a set of defined rules, rather than merely an exhortation to judges to apply the difference principle on a case-by-case basis.[74]

The problem of determining who counts as the least advantaged remains. In accordance with Rawls's admonition to let practical sense

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73. Such a system appears consistent in some respects with Warren's claim that the bankruptcy judge should consider the effects of financial distress.

74. *Cf.* RAWLS, POLITICAL LIBERALISM, *supra* note 10, at 283 ("The objection that the difference principle enjoins continuous corrections of particular distributions and is a capricious interference with private transactions is based on a misunderstanding.").

be our guide, I have selected groupings based on the standard distinctions found in the bankruptcy literature. These include employees, tort victims, shareholders, consensual creditors, and members of the firm's community.[75] These groupings have the advantage of being based on the relationship that the group has with the firm. Thus, they avoid the problems associated with a general instruction to aid the least-advantaged members of society. This benefit, however, is not without its price: Members of each group are not homogeneous in terms of their individual societal rank. Tort victims, for example, run the gamut from the very wealthy to the very poor. Nevertheless, it strikes me that this problem is unavoidable given that any party's relationship to the firm, and hence that party's relevant classification in bankruptcy, is not determined—and, as shown above, cannot be determined—by that party's relative place in society.

Once the groupings have been determined, the difference principle demands that those behind the veil of ignorance identify which of these groups is the least advantaged. In applying the difference principle to select between the economic vision of bankruptcy law and current law, I freely admit that I cannot *a priori* identify the group that is the least-advantaged. Depending on the circumstances, the least-advantaged group might be tort victims, employees of the financially distressed firm, or the owners of a small family business. There is no reason to suppose, however, that those in the original position are better able to make such a determination. To overcome this problem, this essay considers all types of parties which may be affected by a bankruptcy regime on the chance that any one of them may be considered the worst off. As each type of party is analyzed, I assume that party to be in fact the least advantaged. I then examine whether the treatment of that party under an economic account of bankruptcy law, as opposed to current law, violates the difference principle, and would thus cause those in the original position to reject the economic regime.

One final note about the above-listed groupings is in order. Grouping secured creditors with unsecured creditors under the heading of *consensual creditors* may strike some as odd. Most bankruptcy literature customarily divides consensual creditors into secured and unsecured creditors, and treats the two groups as having opposing interests.[76] This tension arises from the fact that as secured creditors receive more in a bankruptcy distribution, the unsecured creditors receive less. Much bankruptcy law and bankruptcy scholarship concerns

75. These groupings can be found in, among others, Korobkin, *supra* note 1, at 574; Warren, *Bankruptcy Policy*, *supra* note 7, at 785-89.

76. *E.g.*, Baird & Jackson, *Corporate Reorganizations*, *supra* note 12, at 106-07 (1984) (noting conflict in interest between secured and general creditors); Warren, *Bankruptcy Policy, supra* note 7, at 789 ("Enforcing the state law collection rights of secured creditors often comes at the cost of defeating the state law collection rights of unsecured creditors whose claims are discharged without payment.").

itself with mediating the dispute between these two groups of creditors. This perceived opposition results, however, from taking too narrow a temporal perspective. To understand why this is so, one must recognize that consensual creditors decide whether to extend credit to a firm, and on what terms. Thus, those who voluntarily extend credit, whether or not on a secured basis, can always raise the interest rates they charge in response to a regime which redistributes money away from them. To the extent that a creditor bargains for more protection in the form of collateral in which she has a priority, that creditor can offer a lower interest rate on the loan.

The ability of consensual creditors to adjust interest rates depending on their expected recovery if a firm experiences financial distress leads to the conclusion that the standard distinction between secured and unsecured creditors matters little in a Rawlsian analysis of bankruptcy law. During a bankruptcy proceeding, there may very well be a divergence of interests between these two types of creditors. But before a lender becomes either type of creditor, she cares little about the relative treatment of the creditors. Her main concern is knowing what her treatment would be if the debtor cannot pay all debts in full, so that she can price her loan accordingly. This ability to adjust interest rates implies that all consensual creditors can ensure that they receive a competitive rate of return. Market pressures prevent consensual creditors from receiving more than this. Thus, the existence of secured credit does not promise a greater expected return to secured creditors or a lesser expected return to unsecured creditors. *Ex ante*, all consensual creditors have the same expected return.

This being the case, the more interesting question is not what benefit creditors receive from secured credit, it is instead what benefit does the firm receive from being able to grant a priority position to certain creditors? To the extent that a secured creditor lowers her interest rate in exchange for a promise of certain collateral, the firm's unsecured creditors will raise their interest rates because they can no longer look to such collateral for the satisfaction of their debts.[77] Thus, to the extent that the institution of secured credit is a benefit, it is a benefit to the firm and not to those creditors who receive security for their loans. Those in the original position thus have little reason to favor either secured or unsecured creditors as a class. The relevant class for them is that of consensual creditors.

I am unable to say with certainty which group should be considered the least advantaged for the purposes of bankruptcy law. This inability does not doom the attempt to discern a just bankruptcy regime, however, because the following analysis shows that whichever

77. *See* Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1060 (1987) ("[Unsecured creditors] will raise their rates because the withdrawal of assets from the previously available asset pool increases the riskiness of their loans.").

group is assumed to be the worst off in society, the selection of a just bankruptcy regime using the difference principle will yield the same result: All groups will be better off under the economic approach to bankruptcy law.

III. Classes of Creditors Affected by Bankruptcy

A. *Consensual Creditors*

The group least likely to be composed of society's most-disadvantaged members is the firm's consensual creditors. Nevertheless, engaging in the contrary assumption, the economic vision of bankruptcy law clearly prevails over the traditional view when measured from the original position. Bankruptcy law, regardless of its content, affects consensual creditors only to a minor extent. These creditors voluntarily decide whether to lend money to the firm. The better off they expect to be in bankruptcy, the less they will charge for credit on the front end. Consensual creditors are not concerned with redistribution as such because they can adjust their interest rates. Bankruptcy law thus does not affect the expected return that consensual creditors anticipate at the time of the initial lending decision.

This inability to decrease the consensual creditors' expected return on any given loan does not imply, however, that consensual creditors are indifferent to which bankruptcy regime the Rawlsian legislature selects. To the extent that a bankruptcy regime raises interest rates, this will result in a smaller demand for loans. Projects which look attractive to a firm based on one interest rate may become unattractive if the interest rate rises. In a regime with higher interest rates, lenders make fewer loans. This decrease in demand translates to a lower overall profit to lenders. Consensual creditors would therefore prefer a regime which lowers interest rates, rather than one which has an *a priori* preference for either secured or unsecured debt.

When judged in these terms, a Rawlsian legislature would prefer the economic regime over existing law. Current law redistributes wealth from consensual creditors to shareholders.[78] This redistribution causes a rise in interest rates. Given that shareholders in many situations would probably agree to forgo their prospective bankruptcy protection in exchange for reduced interest rates,[79] current law raises

78. For empirical demonstration of this point, see Alann C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. Fin. 1457, 1458 (1990) (reporting results of a study in which shareholders received payment during reorganization in excess of amount they would receive under strict adherence to the absolute priority rule); Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. Pa. L. Rev. 125 (1990); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. Fin. Econ. 285, 299-300 (1990).

79. *See* Rasmussen, *supra* note 5, at 102 (arguing that, e.g., shareholders in a limited partnership with a single real estate asset would have incentives to select a "no-bankruptcy option").

interest rates above the level which both the consensual creditors and the shareholders prefer. The economic approach, on the other hand, avoids this problem. It generally allows shareholders to opt out of the current law which gives substantial protections to shareholders.[80] Under such an economic regime, creditors can announce the interest rates they will charge based on the amount of protection that the shareholders want in the event of a bankruptcy proceeding. If shareholders want more protection, they will have to pay for it in the form of increased interest charges. By ensuring that interest rates are raised only when the shareholders are paying for bankruptcy protection that they deem worth the cost, the economic bankruptcy regime would not unduly inhibit the debt market through higher interest rates.

This argument, of course, is premised on the proposition that redistribution away from consensual creditors in bankruptcy will cause such creditors to raise their interest rates when they lend money. A supporter of bankruptcy redistribution might assert that this proposition depends on an assumption of perfect markets with zero transaction costs.[81] This assertion is incorrect. Any bankruptcy regime is going to have to operate in the real world—a world of imperfect markets and positive transaction costs. In comparing two bankruptcy regimes, many identical deviations from a hypothetical perfect market will exist under both regimes. Simply saying "markets are not perfect" or "transaction costs exist" does little to defeat the proposition regarding interest rates. What is required to do so is a showing why the nonexistence of a perfect market without transaction costs will make creditors indifferent to the way in which bankruptcy law treats their claims.

This is a task the traditional bankruptcy scholars cannot accomplish. Common sense suggests that if a creditor knows she will get no return if her debtor files for bankruptcy, she will charge more than if she expected to receive some payment should bankruptcy occur. Indeed, few should be surprised to learn that secured creditors, who are promised the value of their collateral (up to the amount of the debt) upon default, charge lower rates of interest than do unsecured creditors who have no such promise. The same is true in the bond market. Bonds containing covenants which protect the bondholders pay less interest than similar bonds without such covenants. Existing credit markets thus seem to care greatly about the treatment of creditors' claims when a firm encounters financial distress.

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80. *See generally id.* at 100-11.

81. Professors LoPucki and Warren have attacked economically based arguments on this ground. *See* Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79, 97-110 (1992); Warren, *Policymaking*, *supra* note 7, at 380-82.

Faced with this state of affairs, the traditionalists might suggest that consensual creditors would not react by increasing interest rates if bankruptcy law engaged in only a little redistribution. This suggestion could be supported by two arguments. The first is that the redistribution would be so small and so far in the future that the consensual creditors would not be affected enough to raise their interest rates. This may in fact be true for some consensual creditors. Many creditors set their interest rates incrementally rather than continuously. In other words, they charge rates which jump by certain fractions of a point—say, an eighth—and have no rates between those increments. For such creditors, being treated a little worse in bankruptcy might not cause them to move their rates to the next increment because the loss of bankruptcy protection may not justify such a rise. For other creditors, however, bankruptcy redistribution may be the deciding factor in moving their interest rates. Although bankruptcy redistribution may not in and of itself justify such a jump, the redistribution may make a difference to a creditor who simply needed a little added possibility of loss in order to increase its rates. Thus, some creditors may not raise interest rates at all, while others may raise them more than bankruptcy redistribution standing alone would justify. On balance, it seems reasonable to suspect that these two effects lead to a general rise in interest rates sufficient to offset the losses imposed by bankruptcy redistribution.

The second argument that traditionalists might offer for the proposition that a little redistribution in bankruptcy will not raise interest rates is that creditors are simply not sophisticated enough to assess the impact bankruptcy law has on them. The response to this argument is two-fold. First, this proposition is simply false for many creditors. There are sophisticated creditors who know the ways in which the law affects their expected return on a loan. Second, for "unsophisticated" creditors, competitive pressures penalize those who consistently underprice their loans. In the end, such creditors cannot routinely ignore the effect of bankruptcy law on the monies they actually received.

It is thus reasonable to conclude that redistribution away from consensual creditors will cause them to raise their interest rates. Given this situation, those in the original position would, to the extent they considered relevant the treatment of consensual creditors under the difference principle, select the economic approach to bankruptcy law over the current system.

B. *Shareholders*

A second group of individuals that bankruptcy law affects is the firm's shareholders. As with consensual creditors, it is unlikely that this class of persons would be the least advantaged in a bankruptcy

proceeding. As a general matter, those with shares of stock tend to be financially better off than those without such shares, although this general rule is probably less true for some owners of small businesses. Nevertheless, if shareholders are the least advantaged, the difference principle requires that those behind the veil of ignorance reject the current form of Chapter 11 in favor of the economic approach to corporate bankruptcy law. A significant amount of current bankruptcy law focuses on the treatment of shareholders.[82] Shareholders receive procedural protections which they can use to extract payments from creditors despite the fact that creditors are nominally entitled to be paid in full before shareholders receive any distribution from the firm.[83] Indeed, empirical analysis reveals that shareholders consistently receive distributions from a firm under federal bankruptcy law despite the fact that the firm's unsecured creditors are not paid in full.[84]

This end run around the Bankruptcy Code's absolute priority rule might lead some to suggest that potential shareholders in the original position would prefer current law because of its redistributive aspect. They would not. Shareholder protection, to the extent that it does not come at the expense of nonconsensual creditors,[85] must come at the expense of consensual creditors. As an empirical matter, studies indicate that such payouts are funded by paying unsecured creditors—who, outside the mass tort situation, are predominantly consensual creditors—less than they would otherwise receive.[86] Consensual creditors, however, will charge shareholders higher interest rates for the protection provided. Viewed in this light, to the extent that bankruptcy law protects shareholder interests, it acts as a form of financial distress insurance.[87] If disaster strikes, shareholders do not lose everything. Current law essentially requires that all shareholders buy such insurance because firms have a nonwaivable right to file for

82. Professor Adler provides an excellent discussion of the way in which current bankruptcy law reallocates wealth to shareholders from the firm's creditors. *See* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 446-55 (1992).

83. *See id.*

84. *See* sources cited *supra* note 78.

85. I am unaware of any evidence which indicates that payouts made to shareholders come at the expense of tort creditors rather than the larger group of all unsecured creditors. If such an appropriation is in fact occurring, shareholders might in fact prefer existing law to a regime derived from the economic view of bankruptcy law. Nevertheless, behind the veil of ignorance, tort creditors are probably more disadvantaged than shareholders. This being the case, the difference principle requires selection of the economically inspired proposal over current law. *See infra* text accompanying notes 101-09.

86. *See* sources cited *supra* note 78.

87. This analogy is drawn from Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 168 (1989).

Chapter 11.[88] Thus, these corporations cannot credibly commit to not take advantage of Chapter 11 and thereby garner the benefits of its proshareholder provisions.

Some shareholders might very well want such insolvency insurance if given the choice.[89] It is unlikely, however, that *all* shareholders would find the protections offered by current bankruptcy law worth the price of higher interest rates. The economic vision of bankruptcy permits shareholders to decide whether such insurance is desirable. Equity owners must weigh the cost of such insurance, in the form of higher interest rates, against the added protections the Bankruptcy Code provides upon financial distress. The ability to make this choice represents an improvement over current law where all shareholders receive, and pay for, the same level of protection regardless of whether they believe that such protection is in their interest. Treating bankruptcy as an integral part of the original contract between a firm and its creditors allows shareholders who find bankruptcy insurance desirable to purchase it, while those who would rather forgo such protections can also do so. Thus, if shareholders are the persons least advantaged in bankruptcy, the difference principle's concern with maximizing their welfare would ensure that the economic view of bankruptcy prevails over the traditional approach.

C. *The Surrounding Community*

The third group of persons affected when a firm enters bankruptcy is those individuals who live in the surrounding community. Supporters of the present form of Chapter 11 often invoke community interests in justifying the pro-reorganization bias of current law.[90] When a firm fails, especially a large one, those in the community are made worse off. The community may collectively feel a loss in self-esteem. Also, many members of the community may have had their livelihoods indirectly supported by the existence of the firm. Fewer people with good jobs translates into fewer shops. Many traditional bankruptcy scholars suggest that Chapter 11, with its pro-reorganization bias, ameliorates these adverse effects. The strength of this argument depends on how many firms are saved under the current law that would otherwise be lost under a bankruptcy regime based on the economic theory of bankruptcy law. The consequences of a bankruptcy regime for any given community will never be completely positive or negative. Some communities will suffer greatly when a firm located in that community files for bankruptcy. Protecting these com-

88. *E.g.*, United States v. Royal Business Funds Corp., 724 F.2d 12, 15 (2d Cir. 1983); *In re* Tru Block Concrete Prods., Inc., 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983); *In re* Southern Land Title Corp., 301 F. Supp. 379, 395-96 (E.D. La. 1968).

89. *See* Jackson & Scott, *supra* note 87, at 158-59.

90. *E.g., see* Korobkin, *supra* note 10, at 554; Warren, *Bankruptcy Policy, supra* note 7, at 788.

munities by encouraging reorganization at all costs, however, will harm other communities. This happens, for example, in communities where firms fail because the emphasis on protecting communities raises interest rates, or communities in which businesses do not locate or start up due to the higher interest rates caused by the bankruptcy regime.[91]

To illustrate, assume that we extended the pro-reorganization bias of current law to its logical extreme and enacted a bankruptcy law which forbade firms from shutting down their operations until all assets had been exhausted in an attempt to be competitive. Such a law may indeed maximize the number of firms able to reorganize after a bankruptcy petition has been filed. Some firms which would otherwise have been terminated by their creditors may very well rebound if insulated from creditor-initiated attempts to close the business. This rule, however, would create great disincentives for anyone considering investing in a business which may not be able to succeed in the market. The "operate until you drop" rule tells a potential investor, whether she is deciding to lend money to the firm or to buy its stock, that if the firm turns out to be noncompetitive, she will lose her investment. This will inevitably lead to fewer investments. Thus, many businesses which otherwise would have been formed will never be started. Other businesses will fail because when they encounter financial trouble, no creditor will be willing to loan additional money. These failures of businesses which might otherwise exist and thrive undoubtedly have an impact on the community in which the businesses would otherwise have been located.

Faced with this state of affairs, those in the original position would have to make an educated guess about the competing effects of the economic and traditional approaches to bankruptcy law. Behind the veil of ignorance, legislators do not know the type of community in which they live. The first matter the legislature must decide is the relevant benchmark by which to measure these effects. To the extent that by encouraging reorganization, bankruptcy law raises interest rates, and this increase causes another firm to fail, the comparison is straightforward. The legislators in the original position simply compare the number of firms which are saved to the number which are lost.

The calculation becomes more complex, however, when the possibility of new firms forming in an environment of lower interest rates is thrown into the mix. In certain instances, it may well be the case

91. It may well be the case that such communities are in poor areas. Those individuals contemplating starting a business often perceive the costs of operation in poor areas to be higher than those necessary to operate in more wealthy areas. One example would be the perceived risk of increased crime. If starting a business in a poor community, where presumably many of the inhabitants are financially worse off, is thought to be more expensive, any rise in interest rates may disproportionately stifle corporate formation in poor communities.

that the cost to a community of losing a firm is greater than the benefits to a corresponding community of gaining a similar firm. Consider, for example, a large firm in a small town. The demise of the firm may have a disastrous impact on the lives of those who, although having no direct connection with the firm, are nevertheless intimately bound up with its fate. One example among many is the grocer who has to shut down because the closure of the firm deprives him of his customers. Losing one's life's work intuitively seems like a greater cost than the cost another person suffers when she does not become a grocer because a firm did not start up in her community, but nevertheless pursues a gainful career.[92] The losses inflicted upon a community when one firm shuts down thus may not be entirely offset by the gains in another community where a new firm forms.

It is easy, however, to overstate the point. As an empirical matter, it is doubtful whether many firms are so extensively connected with the surrounding community that the firm's failure inflicts substantial losses on the community in general. The losses inflicted on a small community by the failure of a large firm are readily apparent. When the focus turns to the failure of large firms in a large community, or the failure of small firms generally, imagining that these failures impose substantial costs on those in the surrounding community becomes more difficult. The fact that in some instances a firm's failure imposes communal losses that exceed the communal benefits created by another firm's formation does not imply that this relationship holds in every case.

In the end, it is necessary to compare the effects of the competing bankruptcy approaches on corporate formation and survival. The question is not whether Chapter 11 saves some firms—there is no question that it does. Rather, the inquiry for those in the original position is whether, as a comparative matter, the traditional approach saves more firms than does the economic approach, and if so, whether there are sufficient benefits from the economic approach in terms of encouraging new firms, and allowing existing firms to service their debt, which offset the advantage that the current form of Chapter 11 has in terms of maintaining existing firms.

It is difficult to imagine that Chapter 11 saves significantly more firms than would the economic approach to bankruptcy law. Chapter 11 has been perhaps most successful in allowing large, publicly held firms to reorganize. One study of publicly-traded firms with more than $100 millon in assets which had completed Chapter 11 proceedings[93] found that of the forty-three firms meeting this criteria, twenty-

92. It seems to me a much more difficult question if the choice is between losing a career in which one is already employed and not ever having the opportunity to start any career at all. *See infra* text accompanying notes 111-12..

93. *See* Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 602-04 (1993).

two had their core business survive the conclusion of the case.[94] As of 1993, five of these businesses had refiled under Chapter 11.[95] These are precisely the types of firms most likely to have a major impact on the surrounding community if they go out of business. There is no reason to suggest, however, that these firms would not survive under an economic approach to bankruptcy. Most scholars who have considered the problem suggest that for publicly-traded firms, the economic vision of bankruptcy would have the firm auctioned off to the highest bidder.[96] It is difficult to imagine a situation where the buyer of the firm would have the firm cease its operations if in fact the firm was worth more as a going concern. It is thus inaccurate to point to Chapter 11's success in cases of large, publicly-traded firms as a justification for its retention.

Even were the interests of the surrounding community significantly affected by the survival of small firms, it would still be the case that the community would be better served by an economic approach to bankruptcy law. Chapter 11 does not save a significant portion of the small firms that file for bankruptcy. Roughly ninety percent of small businesses that file for Chapter 11 fail.[97] Thus, any community interest served by the retention of small firms is minimally advanced by current law. Indeed, many small firms arrange their capital structures so that Chapter 11 is not an available alternative.[98] Chapter 11 thus offers little solace for small firms, and there is little reason to believe that a regime driven by efficiency would do worse. Indeed, an economic approach would be an improvement for small businesses to the extent that such businesses could select a set of bankruptcy rules attuned to their needs.[99]

Moreover, to the extent that an efficient bankruptcy regime would lower the interest rate that all firms pay for credit, one would expect that fewer firms would face financial distress in the first instance. This is particularly the case given the fact that companies filing for bankruptcy in the 1980s were more highly leveraged than companies filing for bankruptcy in earlier periods.[100] The higher the leverage of a firm, the more that firm will be affected by an increase in

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94. In 7 of these 22 cases, the business was sold to a third party. *Id.* at 603.

95. *Id.* at 604.

96. *See* Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523 (1992); Baird, *supra* note 4; Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633 (1993); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 785-88 (1988); William H. Meckling, *Financial Markets, Default and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS. 13, 13-16 (1977); Rasmussen, *supra* note 5, at 100-03; Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983).

97. *See* Warren, *Policymaking*, *supra* note 7, at 373-74.

98. *See* Douglas G. Baird, *The Costs of Corporate Reorganization*, 72 WASH. U. L.Q. (forthcoming 1994).

99. *See* Rasmussen, *supra* note 5, at 100-07.

100. *See* Bradley & Rosenzweig, *supra* note 2, at 1094-95.

interest rates. Thus, an economic conception of bankruptcy law promises to have a beneficial indirect effect of decreasing the number of firms facing financial distress. This conclusion, coupled with that regarding firm formation, implies that those in the original position would, if they viewed members of the surrounding community as the least advantaged, select an economic conception of bankruptcy over the traditional one.

D. *Tort Creditors*

Tort creditors are the fourth group of persons affected by a bankruptcy regime. The group for which perhaps most traditional bankruptcy scholars express the greatest sympathy consists of those persons injured in some fashion by the operations of the firm. Such sympathy is hardly surprising. Existing nonbankruptcy law contains two features which disadvantage these individuals. These features are limited shareholder liability and according tort claimants priority status equal to that of general unsecured creditors. Taken together, these rules tend to result in tort creditors receiving minimal payouts from insolvent firms. This shabby treatment of tort creditors has prompted traditional bankruptcy scholars to advocate an increased ability for such persons to recover on their claims.[101]

By viewing the situation of tort victims from the perspective of an on-going bankruptcy proceeding, however, traditional bankruptcy scholars have failed to identify the ills caused by the current regime. Undercompensation of tort creditors constitutes only one problem caused by extant law; analysis from the original position exposes the other, perhaps more important effect. For those in the original position, the chance of becoming a tort victim impacts the deliberative process in two ways. The first of these is the problem which motivates traditional bankruptcy law scholars, the issue of compensation. Firms in financial distress do not possess sufficient assets to pay all competing claimants. Inevitably, therefore, some of these claimants will not be paid in full, and many may not be paid at all.[102] A second effect which those in the original position would consider is minimizing the number of accidents in the first instance. All things being equal, lia-

101. For examples of the traditional scholars' concern for tort victims, see Korobkin, *supra* note 10, at 569 (bankruptcy law should show more solicitude to nonconsensual creditors than to trade creditors); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. (forthcoming 1994) (arguing that trade creditors should be paid before secured creditors); Warren, *Policymaking*, *supra* note 7, at 354 (bankruptcy law is desirable to the extent that it negates problems faced by nonconsensual creditors under state law).

102. Bankruptcy law only affects tort law to the extent that the tort-feasor cannot pay all of its claimants; bankruptcy law has nothing to say about which actions should trigger tort liability. An economic analysis of these issues can be found in WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW (1987). A different analysis, ostensibly based on the work of Kant, can be found in Ernest J. Weinrib, *Toward a Moral Theory of Negligence Law*, 2 L. & PHIL. 37 (1983).

bility laws which reduce the size of the class which counts as the least advantaged are to be favored over laws which expand that class.

These two problems are related. To the extent that a firm knows that it will not have to fully compensate its future tort victims, it has too little incentive to take care to prevent accidents in the first instance.[103] The firm will not bear the full cost of its actions and thus has an incentive to engage in unduly risky behavior. In other words, undercompensation for tort victims is positively correlated with the number of tort victims. Existing law, with its low priority status for tort victims and its rules of limited liability for tort-feasors inevitably leads to undercompensation. This problem has been well documented in the academic literature, and three basic proposals have been offered as a solution.[104] One such proposal is to retain limited shareholder liability but give nonconsensual creditors priority status in the event of bankruptcy over the firm's consensual creditors.[105] This proposal decreases the probability of accidents and increases the level of compensation for those accidents which do occur by forcing the firm to internalize all risk, at least up to the amount of its assets. Admittedly, to the extent that a firm's assets are insufficient to cover the costs of accidents, some externalization of risk remains. On the other hand, because debt holders now are faced with the risk of having their claims extinguished through tort claims, these creditors have an incentive to insist that the firm obtain adequate insurance to compensate potential tort victims.

Two other proposals have been offered which further reduce the risk of accidents. One proposal couples priority status for tort creditors with unlimited liability for shareholders.[106] This proposal increases the compensation to actual tort creditors by making available more assets (of both the debtor and its shareholders), and decreases

103. *See* GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 58-59 (1970); John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 389-93 (1981); William Vickrey, *Automobile Accidents, Tort Law, Externalities, and Insurance: An Economist's Critique*, 33 LAW & CONTEMP. PROBS. 464, 477 (1968).

104. *See* Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporate Law*, 30 U. TORONTO L.J. 117, 148-49 (1980) (arguing for unlimited liability for closely held corporations and personal liability for directors of public corporations); Henry Hansmann & Reineir Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1891-92 (1991) (proposing unlimited liability for shareholders and subrogating tort debts to contract debts); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1643-49 (1991) (proposing that tort claims prime all consensual claims, including those of secured creditors); Alan Schwartz, *Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship*, 14 J. LEGAL STUD. 689 (1985) (suggesting unlimited shareholder liability for certain torts but retaining limited liability for other torts); Christopher M.E. Painter, Note, *Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045, 1080-83 (1984) (proposing priority status for tort claims).

105. *See* F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1417 (1986); Adler, *supra* note 2, at 340; Painter, *supra* note 104, at 1080-83.

106. *See* Leebron, *supra* note 104, at 1643-49.

the number of torts by providing shareholders with additional incentive to monitor the firm's activities. The final proposal advocates moving to a system of unlimited liability, but giving consensual debt claims a priority in a distribution of the firm's assets. The argument for prioritizing contract claims is two-fold. First, shareholders are better monitors of the firm than are debt holders and thus should bear the primary monitoring responsibility. Second, firms that want to put tort creditors first can easily opt out of the rule of debt-holder priority, whereas firms that want to privilege contractual creditors would find it nearly impossible to opt out of a rule which gave priority to tort victims.[107]

The difference principle suggests that the Rawlsian legislature would adopt the second approach—priority for tort creditors coupled with unlimited liability. From the perspective of the original position, this proposal better serves the interest of the least advantaged than the competing proposals. It performs better than a system coupling priority with limited liability because it increases the expected compensation to those injured by corporate activity, while at the same time reducing the likelihood of such injurious activity occurring. It is also better than the third approach. Under the third approach, it is more likely that there will be insufficient assets to satisfy tort claimants, and debt holders have no incentive to monitor the firm's activities. To be sure, not all debt holders will have the means or the incentives to monitor firm activity. Where monitoring is not efficient, however, debt holders will not engage in such activity and will simply raise the cost of credit. In situations where efficient monitoring is possible, some creditors undoubtedly do oversee corporate conduct. This being the case, those in the original position would select the bankruptcy regime which encouraged monitoring.

Various objections to this scheme might be raised. One criticism might be that tort-creditor priority coupled with unlimited liability will raise both the cost of debt and the cost of capital when compared to other potential regimes, and thus lead to less business activity. This objection is undoubtedly correct, but it does not adequately focus on why the cost of business activity is being raised. The second approach does no more than ensure that firms and their owners are forced to bear the full cost of corporate actions. Moreover, this argument against the second approach has no logical stopping point; it would seem to imply that there should be no tort liability at all. To the extent that creditors or shareholders have to share the returns from firm activity with tort victims, they will raise, respectively, the cost of credit or capital. Thus, those in the original position would reject a simple focus on whether a particular tort regime increases the costs of credit and capital.

107. Hansmann & Kraakman, *supra* note 104, at 1902 n.66.

This is not to say, however, that a tort system's effects on business activity are irrelevant. Consider, for example, the issue of whether shareholder liability for corporate torts should be pro rata or joint and several. Joint and several liability would increase compensation for tort victims. Under a pro rata system, some shareholders might not have sufficient funds to cover their share of the liability. Without an action against the other shareholders, tort victims could be undercompensated for their claims. However, there is a cost to joint and several liability. It creates a disincentive for wealthy capital providers to combine with those who are less wealthy. Moreover, because every investor is potentially liable for the full amount of excess tort liability, there may additionally be excessive monitoring of the firm's activities.[108]

On balance, I think that those in the original position would opt for the pro rata rule, although the matter is not free from doubt. Just as we cannot assess with certainty who will be the least advantaged group in every case, neither can those in the original position. At some point, concern for tort victims must give way to concerns about other groups. Focusing on tort victims to the exclusion of all others would eventually harm the least-advantaged members of society. For example, society could eliminate many torts if cars were outlawed. But those in the original position would surely value the economic gains that cars make possible over the costs of the inevitable accidents. It seems fair to say that the least advantaged are better off in a society with cars than they would be in a society without cars. Knowing the point at which some torts should be allowed to occur in the course of activity which benefits the least-advantaged members of society is not an easy matter. Ideally, we would like to know the amount of primary goods which both tort victims and the least-advantaged members of society possess and how protecting tort victims in particular would affect the least-advantaged in general. In the absence of such information, we simply have to use the evidence that we have and make an educated guess. Doing this, it seems to me that the costs of joint liability will simply be too great for those in the original position to accept.

In sum, if those in the original position considered tort victims to be the least-advantaged members of society affected by the bankruptcy regime, they would, applying the difference principle, adopt the economic approach to bankruptcy law over current law.[109] Moreover, a Rawlsian legislature would probably select a tort system which gives

108. *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89 (1985); Leebron, *supra* note 104, at 1581-82.

109. That current law remains intact despite its obvious inefficiency and unfairness is no surprise to the students of public choice. Although all members of society are potential tort victims, the chance that any one person might become a tort creditor is small enough that persons will not form a coalition to change existing law. Indeed, one reason for legislating behind the veil of ignorance is to avoid all the forces which comprise the domain of the public choice literature.

tort creditors a priority to the firm's assets, and makes the firm's shareholders individually liable on a pro rata basis if the firm's assets are insufficient to fully compensate all tort victims.

E. Employees

The final class of individuals affected by bankruptcy law is the firm's employees. Bankruptcy courts and academics often justify Chapter 11 by invoking the need to save jobs.[110] Indeed, my sense is that workers are most likely to be the least-advantaged group in any given bankruptcy proceeding. This intuition seems especially true for those proceedings which do not involve tort claimants. But, does the prospect of being an employee, who may be the least advantaged of those affected by financial distress, suggest that those in the original position would endorse current law? Again, the focus must not be on whether current law or the economic theory of bankruptcy increases the welfare of employees of firms that have already filed for bankruptcy, but instead on which vision of bankruptcy law increases the welfare of workers as a group.

One problem that arises in assessing employee welfare is determining the yardstick for that measurement. The benefits to workers should be measured in primary goods. Such goods include not only money, but also self-respect.[111] Having a job not only provides financial well-being for an individual, but also increases her self-respect. One can argue, for example, that a person who loses a job is in a worse position than a person who was already jobless. An employee may have incurred debts based on her expectation of keeping her job, and, equally as important, may have invested much of her personal self-esteem into the job which she had. If this is true, those in the original position might place greater weight on maintaining a person's employment rather than creating a new job for someone else. In other words, one may not be able to simply total the aggregate number of jobs under competing bankruptcy regimes and from this total alone decide which of these regimes would be selected by those in the original position.

Of course, one could argue that it is better to have had a job and lost it than never to have had a job at all. Having a job gives a person the ability to plan and save for the future, as well as the chance to develop skills which may be useful in finding a different job if the current job is lost. Moreover, it also seems plausible to assume that a person's self-respect stemming from employment increases with time. Yet, the longer one holds a job, the more one can prepare for the dislocations which occur if the job is lost. It is thus far from certain

110. *See, e.g.*, Korobkin, *supra* note 1, at 764-65; Warren, *Bankruptcy Policy, supra* note 7, at 788.

111. RAWLS, A THEORY OF JUSTICE, *supra* note 10, at 440.

that those in the initial position would privilege job retention over job creation.

Rather than choosing between these two arguments on their merits (and I find the choice to be rather difficult), for the purposes of this essay I want to credit the proposition that losing a job entails a greater loss than never having a job at all. I do so because this proposition better comports with the traditionalists' emphasis on the need to save jobs. Accepting the proposition that the cost of losing a job exceeds the benefit of getting one, however, does *not* imply that those employing the difference principle would in every instance prefer saving jobs to creating jobs. Not having a job has real costs, measured both in terms of money and self-respect. Individuals unable to find a job are often burdened with financial constraints or a loss of the self-respect which our society associates with earning a living. Thus, although it may be difficult to say that a bankruptcy regime which has the effect of simply transferring jobs between persons is superior to one which does not, at some point the cost of foregoing additional jobs in the economy exceeds the cost of saving existing jobs. Of course, it is impossible to specify the exact amount of new jobs needed to justify the loss of an existing job. As Rawls suggests, our intuition must be our guide in this area.[112]

In assessing the impact of a bankruptcy regime on workers, one must realize that workers as a group are not homogeneous. For one subgroup of workers, those with many job prospects upon entering the job market, the difference principle certainly does not require the rejection of the economic conception of bankruptcy. Employees who are able to select among competing firms because they have highly sought-after skills are able to decide whether they want to join a firm that has committed itself to reorganization at all costs. Such persons routinely select among competing offers based, at least in part, on job security. These employees, of course, are unlikely to be the least-advantaged members of society. Even should highly skilled employees join a firm which ends up being liquidated, they presumably can land another job without too much trouble. The cost associated with the loss of a job for more talented people is quickly ameliorated by finding new employment. Those who have had the good fortune to be endowed with highly desirable skills are of little concern to those in the original position.[113]

112. *Id.* at 94.

113. To be sure, workers who at one time have highly desirable skills may, at the time of financial distress, find that the market no longer values their skills. Thus, these workers are worse off than workers who continue to have many options, but better off than workers who never had options in that, at the time they had options, they had the opportunity to take steps to guard against the day when these options might disappear. In any event, I do not consider these workers as a separate group because they seem to fall between the two extreme categories of workers. If those in the original position would select an efficient set of bankruptcy laws if it

Not all workers, however, have the option of choosing among competing employers. Employees who have little opportunity to meaningfully choose an employer may well be the least-advantaged members of society, at least in a bankruptcy proceeding. Thus, their status under the competing bankruptcy regimes would determine which regime would be selected. Under the economic approach to bankruptcy law, firms do not necessarily ignore the needs of these unskilled workers. The economic approach attempts to mirror the optimal contract that firms would offer investors. Corporations are aware that they have to compete with other firms for all employees, not just the highly-skilled workers. If employees value the protection that Chapter 11 provides, firms would prefer a bankruptcy scheme which enticed employees with the promise of such protection. Whether firms would conclude that the savings attributable to inducing workers with Chapter 11 protections outweighs the cost to the firm of higher interest rates is an issue that cannot be answered in the abstract. For present purposes, I assume that under the economic approach some employees will end up working for firms that do not offer Chapter 11 protection, and that these employees, because they have few non-firm-specific skills, have little opportunity to secure other employment.

The present form of bankruptcy law may very well be superior to a regime based on economic theory for those less-skilled employees able to actually secure employment under current conditions. These employees receive benefits under the present form of Chapter 11 from two potential sources: redistributions from firms which ultimately fail, and the ability to keep their jobs in those firms which successfully reorganize under Chapter 11. As to the first type of benefit, were the economic approach adopted, some firms would be liquidated more quickly than under the present regime.[114] Thus, it may be the case that some employees would lose their jobs sooner under the economic approach than they do under current law and thus receive less of the benefits of employment than they otherwise would. Consider in this respect the bankruptcy of Eastern Airlines. Through asset sales, Eastern accumulated hundreds of millions of dollars in cash.[115] Over the objections of Eastern's creditors, the bankruptcy court allowed Eastern to spend over $600 million in its efforts to reorganize.[116] During the entire course of the bankruptcy proceeding, Eastern lost over $1.6

considered either of the extreme groups of workers to be the least advantaged, it follows that they would reach the same result if their focus were on this intermediate group.

114. This may occur if there is an auction regime in place, *see* Baird, *supra* note 4; if Chapter 11 were repealed in its entirety, *see* Bradley & Rosenzweig, *supra* note 2; if firms could opt out of Chapter 11, *see* Schwartz, *supra* note 6; or if firms were required to select their bankruptcy regimes from a menu of options, *see* Rasmussen, *supra* note 5.

115. *See* Weiss, *supra* note 46; Agis Salpukas, *Court Gives Eastern Air $135 Million*, N.Y. TIMES, Nov. 28, 1990, at D1.

116. *See* Seth Lubove, *A Bankrupt's Best Friend*, FORBES, Apr. 1, 1991, at 99.

billion.[117] Some of this money went to Eastern's employees because the airline was kept in business longer than it would have been had the money not been spent. Had a different bankruptcy regime been in place which required Eastern to auction off its assets upon financial distress, it would more quickly have gone out of business, and its employees would have received less money than they otherwise did.

The present form of bankruptcy law thus benefits some employees, but those in the original position would ascribe little weight to such a gain. At most, this type of bankruptcy redistribution provides a short-term increase in employee income. It does not lessen the psychological costs which often accompany job loss. Indeed, a prolonged bankruptcy proceeding which leaves workers in doubt about their future may in fact cause more psychological problems than a relatively quick termination of the enterprise. The gains from such redistributions thus seem marginal at best, fleeting attempts to stem off, for a brief time, the inevitable job loss.

Supporters of Chapter 11 argue that the present form of bankruptcy law not only saves jobs in the short term, as in the Eastern Airlines case, but in the long term as well. They contend that Chapter 11 permits the rehabilitation of firms in financial distress who may only be experiencing short-term difficulties in paying outstanding obligations.[118] Restructuring the firm's capital structure will allow it to operate profitably in the future. Evaluating this claim from the original position turns on the number of jobs current law is likely to save as compared to the economic approach. If current law does save a more significant number of jobs than the economic approach would, this fact would be a strong argument in favor of its adoption by those in the original position. Indeed, it would probably be compelling.

There is little evidence, however, that these savings exist. First, the number of successful reorganizations tends to be small. As an empirical matter, most reorganization attempts under Chapter 11 fail to produce a viable entity. For example, one study found that for Chapter 11 petitions filed before 1987, only seventeen percent of the debtors had confirmed plans of reorganization by July 1989, with one-third of those plans calling for liquidation of the firm's assets.[119] The conventional wisdom is that ninety percent of Chapter 11 cases fail in that they do not lead to a successful reorganization of the company.[120]

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117. *See* Weiss, *supra* note 46.

118. Congress embraced this view when it enacted the Bankruptcy Code. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 220 (1977) ("It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets."); 124 Cong. Rec. H32,392 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards) (explaining that passage of the Code "will protect the investing public, protect jobs, and help save troubled businesses").

119. *See* Edward Flynn, Administrative Office of the U.S. Courts, Statistical Analysis of Chapter 11, at 10-11 (Oct. 1989) (unpublished manuscript, on file with the *University of Illinois Law Review*).

120. *See* Warren, *Policymaking*, *supra* note 7, at 373-74.

Moreover, many successful reorganizations which do result in job retention, such as those of large publicly-held companies like Texaco and Johns-Manville, would not end up as piecemeal liquidations under the economic approach. It is not in any party's interest for firms to operate under a bankruptcy regime which would encourage the liquidation of a company which was worth more as a going concern. For example, it may be true that under the economic approach many larger firms are likely to be auctioned off after encountering serious financial distress.[121] There is no reason to think, however, that the new owners of the debt-free company would liquidate an efficient enterprise. Indeed, even under current law, a firm's assets are at times sold to a third party who then operates the debtor's former business.[122] Thus, there is little reason to suggest that the economic approach would result in fewer jobs being saved than are saved under current law.

Nevertheless, I am willing to assume for the sake of argument that present bankruptcy law saves some jobs in firms which experience financial distress that would be lost under an economic approach. This does not mean, however, that legislators behind the veil of ignorance would reject the economic approach in favor of current law based on the possibility that each legislator might end up being an employee who has little choice in selecting her employer. The choice of bankruptcy regimes affects not only those who work for firms in financial distress, but also other actual and potential workers. In particular, if a bankruptcy regime redistributes wealth to workers, this redistribution will result in increased interest rates which consensual creditors charge the firm. This increase in interest rates in turn causes additional firms to fail—thus losing those jobs—and other firms not to form in the first instance—causing a loss of potential jobs. Behind the veil of ignorance, the legislators do not know whether they will be workers favored by a bankruptcy redistribution, or instead an employee whose job prospects are lessened by bankruptcy's redistributive element.

Faced with this uncertainty, a Rawlsian legislature would attempt to compare the number of jobs saved and lost under the competing bankruptcy regimes. Thus, the inquiry boils down to whether the economic account of bankruptcy law would create significantly many more jobs than it destroys. All available evidence suggests that it favors job creation. First, as the foregoing argument demonstrates, there is no reason to suspect that current bankruptcy law saves a significant number of jobs compared to the modern economic conception of bankruptcy law. There is evidence, however, that the traditional

121. I previously discussed this point in Rasmussen, *supra* note 5, at 102-05.

122. *See* LoPucki & Whitford, *supra* note 93, at 603 (in 7 of the 22 cases where a firm's core business survived the Chapter 11 proceeding, the core business was sold to a third party).

approach costs a substantial number of jobs by causing a rise in interest rates which all firms must pay. Second, there is a great deal of "dead-weight" cost associated with the present form of Chapter 11. The redistribution of the debtor's assets to workers costs money. Bankruptcy is an expensive proceeding. The fees of the bevy of lawyers, accountants, and other professionals who are employed during a Chapter 11 proceeding reduce the return which creditors as a group ultimately receive. The cost bankruptcy imposes on lenders is greater than the benefits received by the workers. This is because much of these costs go to parties who are not the firm's workers. Thus, the subsequent increase in interest rates will ultimately exceed the benefits to employees. For these reasons, bankruptcy redistributions favoring employees do not maximize the position of the worst off. Instead, workers are, as an overall group, negatively impacted under a traditional approach. The chance of being a worker would thus lead those in the original position to select an economic bankruptcy regime.

F. Further Considerations

The Rawlsian analysis does not conclude with the application of the difference principle. After the principles of justice are implemented, the resulting institutions are compared with our intuition. Rawls terms this comparison "reflective equilibrium." The notion behind comparing intuition with actual results is intended to provide stability in the system which is created. Any political system, regardless of how attractive it may appear from the perspective of the original position, will not achieve long-term stability if it fails to comport in practice with the general intuitions of the members of society.

The economic theory of bankruptcy easily passes this test. American society is by no means wedded to the current form of reorganization law. For over half of the country's history, there was no federal bankruptcy law.[123] Major substantive changes in reorganization law, once established, have taken place on a fairly routine basis.[124] Moreover, the major potential objection to the economic vision is that an economic approach accords too little weight to the concerns of workers, an objection which assumes that our political system is somehow committed to saving jobs at all costs. At a time when this country's major corporations are laying off tens of thousands of people, this argument rings hollow.

In summary, the conclusions from applying Rawls's analysis to the ongoing bankruptcy debate is that those in the original position would enact an economically-derived bankruptcy regime rather than current law. Furthermore, the economic approach also meets Rawls's requirement of reflective equilibrium. Thus, *A Theory of Justice*,

123. *See* LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 269-75 (2d ed. 1975).
124. *See* BAIRD & JACKSON, *supra* note 68, at 31-37.

fairly considered, endorses the justness of a social institution which handles the problems of financial distress from an economic perspective.

IV. From the Original Position to Contemporary America

Defenders of the traditional order may object that this use of Rawls is deceptively simple. These defenders might agree that a bankruptcy regime based on economics may achieve a type of formal justness when viewed in isolation or as part of an overall societal structure which is itself fundamentally just. The basic structure in place in this country today, they would argue, is a far cry from a system comporting with the Rawlsian vision of social justice. Thus, the application of Rawls's work to bankruptcy law in this essay does not justify implementing a bankruptcy system derived from economics under real-world conditions. Essentially, the objection is that a just bankruptcy law in an unjust economy may produce unjust results. By *unjust results* I mean a distribution of primary goods in a manner which does not accord with the difference principle. Bankruptcy law, the argument goes, should not seek justness in its own right, but rather should aim to achieve results contrived to counteract the existing inequitable distribution of societal assets, and thus contribute to greater overall social justice.

This argument fails for three reasons. First, rather than skewing the optimal approach to bankruptcy law, we should instead focus our attention on the unjust aspects of society and work to change them. Attempting to imperfectly compensate through bankruptcy law is at most a second-best, suboptimum response that hampers the pursuit of integrity in the nation's bankruptcy scheme.

Moreover, any effort to counteract perceived social injustices through bankruptcy law will necessarily be ad hoc, and grossly imprecise in attaining its goals. Many firms that fail never file a bankruptcy petition. Other firms emerge from financial distress without filing a bankruptcy petition, avoiding bankruptcy only at the cost of laying off a substantial portion of their work force. Even healthy companies lay off employees when the economy is in recession. All of this conduct imposes costs on the affected parties, but these effects cannot be dealt with in a world in which all redistribution concerns begin only at the time a bankruptcy petition is filed. Moreover, ad hoc approaches to bankruptcy law inevitably result in protecting some people at the expense of others who themselves might be worse off. In the end, an efficient bankruptcy regime, by promoting business activity, will more likely help the worst-off members of society than will a bankruptcy system geared toward redistribution, even in a world of imperfect social justice.

Perhaps the most important objection to those who would reject the economic conception of bankruptcy based on what they perceive as general social injustice is that the argument fails in any significant way to link its predicate—the existence of injustice—to its conclusion—the rejection of what is otherwise a just bankruptcy regime. Incumbent on those who would reject the Rawlsian outcome is that they show how the injustices they perceive affect the evaluation of any bankruptcy regime. Some scholars, for example, may argue that current society unjustly treats workers. Yet, the economic vision of bankruptcy treats these persons as a group better than the traditional vision. In other words, the economic approach ameliorates rather than aggravates the posited injustice. Thus, it may be the case that we live in what some would call an unjust society, but this condemnation of the extant state of affairs fails to provide a sufficient basis from which the economic account of bankruptcy law can be rejected.

Indeed, given the nature of bankruptcy law, it is hard to see how it can work as a mechanism to remedy any existing unjustified inequality in the distribution of primary goods. I argued earlier in this essay that a general command to bankruptcy judges to distribute assets to the least advantaged would not achieve its intended effect. Moreover, any set of rules aimed at advancing the interest of a particular class would raise interest rates if such advantage comes at the expense of consensual creditors. Such a rise is justified in the case of tort victims. But, moving beyond those who have not chosen to enter into a relationship with the debtor firm, a rise in interest rates will harm other members of the least-advantaged class. For example, helping employees of a bankrupt firm hurts employees at other firms. This being the case, it is difficult to imagine how current law ameliorates any of the unjustness one may find in our society's current distribution of primary goods. Thus, the traditionalists cannot save current bankruptcy law by asserting that it is designed to remedy certain unjust aspects of society. Therefore, those who ascribe to Rawls's vision of social justice should endorse a bankruptcy regime designed to maximize societal wealth.

V. Conclusion

Law and economics has provided legal scholars with powerful tools to assess which laws increase the overall wealth of society. The work of John Rawls has provided a method by which to measure whether legal institutions comport with at least one conception of social justice. In considering bankruptcy law, arguments for wealth-maximization and justice-enhancement actually coincide to support the adoption of an economic approach to such law. A bankruptcy regime designed to promote efficiency ensures that the least-fortunate members of society, whoever they may be, are treated better than

they are under current bankruptcy law. The preferential treatment of the least advantaged is the hallmark of Rawlsian justice.

This overlap between the demands of efficiency and the requirements of social justice should not be surprising. Rawls, unlike some bankruptcy law scholars, is not hostile to efficiency. Indeed, he recognizes that efficient markets combined with equal opportunity for all members of society offer more hope for the least-favored group in society than does a centrally-planned economy. To be sure, social justice at times demands redistribution from the more affluent to those who are less well off. There is little reason to suggest, however, that bankruptcy law, broadly defined, should be the vehicle for this reallocation.