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# Debtor's Choice: A Menu Approach to Corporate Bankruptcy

Robert K. Rasmussen*

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* Associate Professor of Law, Vanderbilt Law School. B.A. 1982, Loyola University of Chicago; J.D. 1985, University of Chicago Law School. I am grateful to the Dean's Fund at Vanderbilt Law School for financial support. I would like to thank Barry Adler, Doug Baird, James Bowers, David Gray Carlson, Dick Craswell, Rob Gertner, Jason Johnston, Dan Keating, Alan Schwartz, David Skeel, Bob Thompson, George Triantis, and the participants at the George Mason Law and Economics Workshop, the Vanderbilt Legal Theory Workshop, and the Washington University Work in Progress Workshop for helpful comments on an earlier version of this paper. An earlier version of this paper was presented at the annual meeting of the American Law and Economics Association. None of the above parties has agreed to modify the general default rule absolving the commentator from any remaining errors.

The growing use of Chapter 11 by financially troubled firms has been accompanied by an increasing uneasiness in the academy over the normative desirability of such proceedings. Scholars have struggled to justify the law of corporate reorganizations, especially the existence and contours of Chapter 11. The conclusions that they have reached range across the spectrum. Some claim to justify Chapter 11 in its entirety,[1] others claim that they have shown that it is justified for certain types of firms but not others,[2] and still others believe they have demonstrated that Chapter 11 should not exist at all.[3] Even those who find some role for Chapter 11 do not universally approve of the current content of its provisions.[4]

This failure to reach a consensus stems from a basic flaw contained in all of the theories of corporate-reorganization law offered to date. In short, those propounding these various theories err not so much in the answers that they reach as in the question that they ask. All scholars seek to assess the desirability of Chapter 11 by asking what set of bankruptcy rules the government should create. They all proceed on the premise that either Congress via legislation or a bankruptcy court on a case-by-case basis should decide whether or not a particular type of firm should be allowed to file for corporate bankruptcy. Embracing this premise, each scholar then attempts to identify scenarios under which he or she asserts that corporate reorganization under Chapter 11 is justified. The debate among the scholars offering these scenarios turns on the scenarios' relative plausibility. The diversity in viewpoints results from differing assessments of the impact of the bankruptcy regime on the groups—creditors, shareholders, workers, or members of the community at large—in whom

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1. *See, e.g.*, Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411 (1990); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717 (1991); 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).

2. *See, e.g.*, Douglas G. Baird, *The Uneasy Case for Corporate Reorganization*, 15 J. LEGAL STUD. 127 (1986); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 U. VA. L. REV. 155 (1989); David A. Skeel, *The Uncertain State of an Unstated Rule: Bankruptcy's Contribution Rule Doctrine After* Ahlers, 63 AM. BANKR. L.J. 221 (1989); Robert Gertner & Randal C. Picker, Bankruptcy and the Allocation of Control (Feb. 16, 1992) (unpublished manuscript, on file with the *Texas Law Review*).

3. *See, e.g.*, Barry E. Adler, *A Political Theory of American Corporate Bankruptcy*, 45 STAN. L. REV. (forthcoming 1993) (on file with the *Texas Law Review*); 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).

4. For example, see David A. Skeel, Jr., *Markets, Courts and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. (forthcoming) (arguing "that chapter 11's 'one size fits all' approach should be replaced with separate chapters for close and nonclosely held corporations"); Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. (forthcoming) (arguing that the bankruptcy reorganization process has been disintegrating because cases proceed too slowly under the present system).

the scholar is interested.

The damning flaw shared by each of these theories is the assumption that Congress or the courts, rather than the investors in the firm, must control a firm's access to Chapter 11. Stated differently, all theorists assume that bankruptcy law is a mandatory rule; it is a rule set in place by the government that cannot be altered by those whom it affects. The mandatory nature of bankruptcy, however, is itself anomalous when viewed in the larger context of general contract law. Most rules governing the consensual relationship among various parties are default rules. In other words, they apply only if the parties do not provide otherwise.[5] Faced with this anomaly, it is time for bankruptcy scholarship to address the question of who should decide whether a firm is eligible for corporate reorganization under the auspices of the Bankruptcy Code.

The first Part of this Article argues that a firm's ability to file for bankruptcy reorganization should be determined by the firm's investors rather than by the government. This conclusion flows from the realization that a creditor's treatment in bankruptcy is nothing more than a term of the contract that a firm makes with that creditor. Bankruptcy law simply specifies the payoff that the creditor will receive if a given contingency arises; namely, that the firm files a bankruptcy petition. Bankruptcy law thus is part of the bargain between the investors of a firm and its creditors; it is not a bargain amongst the creditors themselves.

Before specifying what content this contract term should take, this Article examines whether this term should be a default rule or a mandatory rule. Contrary to the prevailing wisdom, this Article argues that bankruptcy law should be treated as a default rule. There is no reason to think that a single bankruptcy regime would be appropriate for all firms or that those affected by the bankruptcy term of the credit contract should not be able to select the term of their choosing. This does not mean, however, that the crafting of a bankruptcy regime should be left totally to private contract. The rights of nonconsensual creditors should be set by a mandatory rule. Moreover, to decrease transaction costs, Congress should create a menu bankruptcy system. Under this system, a firm upon formation would be required to select one of the alternatives from the

5. Classification of rules as either "mandatory" or "default" is common. *See, e.g.*, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87 (1989); Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL'Y 639, 641 (1989); Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489, 490 (1989); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 606 (1990); *see also* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261 (1985) (analyzing the costs and benefits of state-supplied contract terms that the parties are free to contract out of).

menu, thereby specifying the firm's available bankruptcy option. Such a commitment mechanism would assure all potential lenders that their rights would be governed by the same bankruptcy regime as the rights of all the firm's other creditors.

The second Part of this Article begins the enterprise of creating this menu. It first adumbrates the existing provisions of Chapter 7 and Chapter 11, and then examines the traditional justification for corporate reorganization, as well as those justifications put forward in recent years. In doing so, this Article critiques these explanations based on the insight that bankruptcy law should be thought of in terms of the contract between a firm and its creditors. Although the various explanations admittedly identify reasons a firm might want to include a particular type of bankruptcy proceeding in its various contracts with its lenders, they do not offer any justification for including in these contracts a governmentally mandated bankruptcy term. Taken as a whole, these theories suggest that, if given the choice, different firms might choose to be subject to different bankruptcy regimes. Thus, while the current literature erroneously treats bankruptcy law as a mandatory rule, it does provide evidence that there is diversity among firms. This heterogeneity implies that firms should be offered a choice of bankruptcy options.

This Article concludes by combining the insights from the first two parts of this Article to produce a menu scheme for corporate reorganization. The menu is designed with two goals in mind. First, the selections on the menu are crafted to allow parties to solve the maximization problem. In other words, the selections are ones that, in some situations, might be the efficient contract term. Selection of such terms increase the total expected gain to the parties. Second, this Article explores possible strategic impediments to selecting the optimal term. Contract scholarsbip has progressed past the blind faith that contracting parties, even without transaction costs, will always reach the optimal solution.[6] Drawing on insights from modern game theory, this Article

6. *See, e.g.*, Ayres & Gertner, *supra* note 5, at 92-93 (arguing that strategic bargaining could impede parties from bargaining around inefficient default rules); Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 732-33 (1992) [hereinafter Ayres & Gertner, *Strategic Contractual Inefficiency*] (noting the "growing consensus among contract scholars that . . . the hypothetical contract that parties whould choose in a world without transaction costs . . . fails to account for the inefficiencies that can be caused by strategic bargaining under conditions of asymmetric information"); Jason S. Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291, 296 (1992) [hereinafter Johnston, *Opting In and Opting Out*] ("There may be a number of ressons parties would not bargain to include broad fiduciary protection even if such protection would be efficient."); Jason S. Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615, 623-26 (1990) [hereinafter Johnston, *Strategic Bargaining*] (rejecting the theory that, absent transaction costs, initial legal rules are irrelevant to the outcome, and arguing that initial rules produce suboptimal outcomes because they impact the parties' incentives for information revelation necessary

shows that there are no impediments to firms selecting the optimal bankruptcy regime when they are first formed, but that later amendments of the corporate charter must be constrained so as to eliminate the potential for future expropriation of wealth from creditors to shareholders.

## I. A Default Rule Approach to Corporate Rcorganization

Too often those exploring the normative underpinnings of corporate-reorganization law begin their inquiry into such law at the end or in the middle of the problem rather than at the beginning. Currently, two competing theories of corporate reorganization dominate the literature. The "creditors' bargain" conception of bankruptcy, currently the most fully developed bankruptcy theory, contends that bankruptcy law should be viewed as the bargain that creditors of the firm would reach among themselves after they have lent money to the firm. The creditors, having bargained with the firm to receive their state-law collection remedies, then bargain amongst themselves, at least hypothetically, and devise bankruptcy proceedings.[7] Alternatively, the "value-based" account of bankruptcy law attempts to consider various values in determining the fate of the bankrupt firm.[8] The firm is in bankruptcy and it falls to either Congress or the bankruptcy judge to weigh the competing values at stake. This theory in essence assumes that insolvency is a problem whose solution must be addressed only once the condition manifests itself and the firm finds itself in a bankruptcy proceeding. The question then becomes what is the most equitable distribution of the remaining assets.[9] Or, to put the problem another way, how should the inevitable pain that is going to be caused by the firm's inability to pay its debts in full be parceled out?

Both theories ignore reality. A creditor's treatment in a bankruptcy

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for an efficient solution); Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215, 247 (1990) (noting that "one may lack confidence in the ability of [parties to a contract] to calculate their own optimal strategies").

7. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 10-19 (1986) [hereinafter JACKSON, LOGIC AND LIMITS]; Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain*, 91 YALE L.J. 857 (1982) [hereinafter Jackson, *Creditors' Bargain*]. Baird uses an approach closer to that offered here under which the equity holders are part of the hypothetical bargain. *See* Baird, *supra* note 2, at 129-35. While Baird thus purports to examine bankruptcy law from the perspective of potential lenders, he ultimately takes nonbankruptcy law as a baseline and views bankruptcy law as the parties' response to the inadequacies of this baseline. *See id.*

8. For examples of this theory, see Korobkin, *supra* note 1, at 762 (explaining that financial distress is understood by the value-based account of bankruptcy law "not only as an economic, but as a moral, political, personal, and social problem that affects its participants") and Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777 (1987) (presenting bankruptcy policy, not as mere economic collectivism, but as an effort to optimally protect competing and conflicting values).

9. *See, e.g.*, Warren, *supra* note 8, at 777 ("[B]ankruptcy policy [is] a composite of factors that bear on a better answer to the question, 'How shall the losses be distributed?'").

proceeding is not something that the creditor considers only after it has extended credit to the firm. Similarly, bankruptcy is not an unknown disease that the affected parties must confront only after the firm's financial difficulties have become apparent. The fact of the matter is that the possibility of bankruptcy hangs over every decision to lend money to a firm. It is a contingency of which both parties are aware. Asking how the law should sort out rights either after the firm finds itself in a bankruptcy proceeding or after the creditors' initial lending decisions have been made ignores the fact that firm failure is an event that the contracting parties take into account at the beginning of the contractual relationship.[10] The lawyer who structures a deal without examining what will happen if one of the parties ends up in a bankruptcy proceeding is simply not doing her job correctly.[11] Lawyers, and the clients whom they represent, are well aware of the existence of bankruptcy proceedings when making decisions about whether to enter into a relationship with a firm. To the extent that bankruptcy theory attempts to justify bankruptcy law from any point in time after a party becomes a creditor of a firm, it begins the inquiry in the wrong place.

Any attempt to justify bankruptcy law from a normative perspective should begin with the observation that bankruptcy law is a term of the contract between the firm and those who extend credit to it. To see why this is so, consider the position of a lender deciding whether to extend credit to the firm and, if so, at what price. The lender will compare the return that it can expect to receive from the firm to the return that it could expect to receive from its best alternate investment. This sets the minimum price the lender will agree to accept from the firm. The maximum price to which the firm will agree to pay is set by the firm's source of alternative financing. The price that the lender charges is the interest rate on the loan. This rate depends in large part on the lender's assessment of the probability that the firm will repay the loan. The lender considers the sum of the expected payments and discounts these payments to present value. If the

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10. *Cf.* Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 647 n.6 (1992) (suggesting that bankruptcy scholarship should focus on creating a set of optimal insolvency rules rather than treating state-law rights as a baseline).

11. A recent example of this planning in the shadow of bankruptcy law is the decision over whether a bank should insist on the personal guarantee of the firm's owner. Recent case law has held that banks which hold personal guarantees of an insider of the firm face a longer preference period than they would otherwise. *See* Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1194-1200 (7th Cir. 1989). One of the most discussed topics in recent corporate literature is whether attorneys should advise banks to insist that the guarantor waive his right of contribution from the firm, thus eliminating the problem of the extended preference period. *See, e.g.*, Peter L. Borowitz, *Waiving Subrogation Rights and Conjuring up Demons in Response to* Deprizio, 45 BUS. LAW. 2152, 2168 (1990) (arguing that rather than forcing lenders to restructure their guaranty forms, advocates should work on defining "sensible boundaries for *Deprizio*'s application").

lender faces no chance of default by the firm, the interest rate that the lender charges will be relatively low. As the risk of default rises, so does the interest rate. We are thus not surprised when we see healthy companies getting loans at lower rates than more risky companies receive.

Simply because a lender is not repaid in full, however, does not mean that it is not repaid at all. Firms do not, as a factual matter, either pay a loan off in full or pay nothing at all. Often a firm partially repays its loan. Thus, the lender in making its lending decision will consider its likelihood of repayment when the firm cannot satisfy all of its obligations. When making this calculation, the lender will take account of the existing bankruptcy regime. Bankruptcy law determines the payment that the lender will receive once the bankruptcy petition is filed. If the bankruptcy laws redistribute the remaining assets of the firm to other creditors or to shareholders, this distribution scheme lowers the amount of the payments that the lender would otherwise receive. The lender will compensate for this decrease in expected payments by raising the interest rate that it charges the firm. Correspondingly, the lender will lower its interest rate to the extent that it can expect a substantial payment if the firm files for bankruptcy.[12]

A creditor's treatment in a bankruptcy proceeding thus affects the creditor's initial lending decision. This is because the bankruptcy regime specifies a creditor's payoff when certain contingencies occur. The contingencies that determine the creditor's "bankruptcy payoff" are the firm encountering financial distress and filing a bankruptcy petition.[13] Once the relationship between a bankruptcy proceeding and the initial lending decision is recognized, it becomes clear that bankruptcy law cannot redistribute assets among the various parties viewed from an ex ante perspective. To the extent that bankruptcy law provides favorable treatment for one creditor, that creditor will accept a lower interest rate to do business with the firm; to the extent that bankruptcy decreases a creditor's return, that creditor will demand a higher promised return in the first instance.[14] So long as a creditor can anticipate its treatment in

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12. *See* William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS., Autumn 1977, at 13, 21 ("[T]he evidence and economic theory strongly support the proposition that any increase (or decrease) in lending costs brought about by changes in the bankruptcy law will in the long run be passed along to borrowers or potential borrowers as lenders make their adjustment.").

13. Not all financially distressed companies file for bankruptcy. Recent studies indicate that about half of the firms in financial distress file for bankruptcy. *See* Stuart C. Gilson, *Bankruptcy, Boards, Banks and Blockholders*, 27 J. FIN. ECON. 355, 360 (1990); Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 316 (1990).

14. *See* Easterbrook, *supra* note 1, at 414 ("[A]lthough [bankruptcy] law creates losers given that a firm becomes a debtor in bankruptcy, it does not create losers *ex ante*. . . . [C]reditors will charge

bankruptcy, it can ensure that it receives a market-based rate of return on its loan.[15]

Once the link between the extant bankruptcy regime and a creditor's initial lending decision is established, it becomes readily apparent that bankruptcy law is a term of the contract between a firm and each of its creditors. Contracts specify the rights and duties of the contracting parties in various states of the world. Stated differently, a contract specifies the returns to each party under certain contingencies. The ideal contract, which explicitly details each party's payoff under all possible contingencies, is called a fully contingent contract.[16] Of course, writing such a contract is impossible. Parties neither know every contingency nor wish to spend the time and effort drafting a provision handling every contingency of which they are aware. Nevertheless, some contractual terms are explicit. For example, a contract may include a clause that relieves a party from performing its obligations if such performance is prevented by an "Act of God"; it may also specify that certain actions by one party are to be treated as a breach of the contract. Other terms of the contract are implicit in that they are supplied by law. For example, the doctrine of impracticability relieves a party of the obligation of performing its part of the contract even though the contract itself appears to state the party's obligation without qualification.[17]

From this perspective, it is clear that bankruptcy law is an implied term of the contract between a creditor and the firm. It specifies the creditor's return in those situations where the financially beleaguered firm files a bankruptcy petition. Under current law, secured creditors receive the value of their collateral and general creditors share the remaining assets on a pro rata basis. Bankruptcy law is thus, at a fundamental level, no different from the myriad of rules that the law implies to flesh out the

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more for money, emerging no worse off across their portfolio of loans."); *cf.* MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 109 (1983) ("In general, then, whenever the parties to a dispute are in some kind of contractual or market relationship, it may be difficult, if not impossible, to use the legal system to redistribute income.").

15. This assumes, of course, that the lending market is competitive. If it is not, if one lender has significant market power, that lender can demand an above-market return. There is no reason to suggest, however, that the lending market is not competitive. Moreover, even if the market allowed a lender to command an above-market return, the amount of the premium should remain fixed regardless of the lender's treatment under bankruptcy law. There is thus no reason to believe that one type of bankruptcy law would produce a greater expected return to a lender than would a competing type of such law.

16. *See* GERARD DEBREU, THEORY OF VALUE 98-102 (1959); Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449, 1453-55 (1989); Lewis A. Kornhauser, *Reliance, Reputation, and Breach of Contract*, 26 J.L. & ECON. 691, 695 (1983).

17. *See* U.C.C. § 2-615 (1991); RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981). The classic case in this area of the law remains Taylor v. Caldwell, 122 Eng. Rep. 309 (K.B. 1863).

bargain between contracting parties.

This conception of bankruptcy law differs significantly from the existing theories of corporate bankruptcy law. Consider first the creditors' bargain theory propounded by Douglas Baird and Thomas Jackson.[18] As its name implies, the creditors' bargain theory seeks to explain existing bankruptcy law as the agreement the creditors would reach among themselves concerning the disposition of the insolvent firm. This theory assumes that the creditors first extend credit to the firm and thus obtain their nonbankruptcy-law collection rights, and then they craft a bankruptcy regime among themselves based on these rights.[19] The creditors in this hypothetical bargain agree to act as a group so as to prevent a destructive race to the firm's assets.[20]

This heuristic ignores the fact that the current bankruptcy regime is known by all parties when creditors extend credit to the firm in the first instance. To the extent that the bankruptcy process ensures the proper deployment of the firm's assets and thus creates additional funds that creditors receive, it is the firm that benefits in the first instance through a reduction in the interest rate that it is charged. Bankruptcy law is not the term that creditors would agree upon amongst themselves so as to increase their expected return; rather, it is the term that the firm would offer the creditors to maximize *its* expected return. The creditors' bargain conception of bankruptcy law with its hypothetical bargain thus flounders on the shoals of reality.[21]

The value-based approach to bankruptcy law fares no better. Its

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18. *See, e.g.*, 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) [hereinafter Baird & Jackson, *Bargaining After the Fall*]; 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*]; *see also* Robert E. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U. CHI. L. REV. 690, 692 (1986) (reviewing DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY (1985) and describing Baird and Jackson's creditors' bargain heuristic as "setting the terms of the scholarly debate for the next decade"). This theory, first proposed by Thomas Jackson, *Creditors' Bargain*, *supra* note 7, has been examined and employed in numerous articles. *See, e.g.*, Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Baird, *supra* note 2; Jochen Drukarczyk, *Secured Debt, Bankruptcy, and the Creditors' Bargain Model*, 11 INT'L REV. L. & ECON. 203 (1991).

19. *See* Jackson & Scott, *supra* note 2, at 160 ("A central premise underlying this creditors' bargain conceptualization is that a system of state law entitlements . . . is already in place and that parties know what their priority positions will be so long as state law continues to govern their rights.").

20. *See* JACKSON, LOGIC AND LIMITS, *supra* note 7, at 10-19; Jackson, *Creditors' Bargain*, *supra* note 7, at 860.

21. Thus, the flaw in the creditors' bargain theory is not that it fails to take a contractual approach to bankruptcy law; rather, the flaw is that it selects the wrong perspective for delineating the terms to which the parties would agree.

basic premise is that various values must be taken into account in the bankruptcy proceeding. The "values" that are to be considered are never identified with much precision.[22] The theory, however, suffers from a more fundamental problem. The parties whose values are to be taken into account have by and large dealt consensually with the firm.[23] Before asking how bankruptcy law should consider the values of these various parties, we should ask ourselves why the parties cannot consider the values themselves. It is hard to imagine that either the courts or Congress can better protect the values at issue than those immediately affected. It is only by focusing on the end of the relationship between the firm and those with whom it has dealt that the value-based theory has any currency.

By failing to begin the inquiry with the initial lending decision, bankruptcy scholars fundamentally misconstrue the law of corporate reorganizations. In particular, this error has caused them to assume that the law must mandate both the availability of bankruptcy as well as the content of its provisions. This assumption flows logically from the faulty premises of current theory. If bankruptcy law represents an agreement among creditors, as creditors' bargain theorists propose, it of course could never be reached in the real world. Creditors are a fluid group. Even if one were able to solve the logistical problem and get all current creditors of a firm to reach an agreement on the division of the firm upon insolvency, this agreement would be short-lived. New creditors of the firm emerge constantly; the sheer impossibility of constructing a lasting agreement among creditors leads directly to the proposition that bankruptcy law should be mandatory.[24] Conversely, if bankruptcy law is designed to sort out values once a petition is filed, it is clear that those with claims to the firm's assets must be forced to participate in the proceeding. Unless the bankruptcy court has jurisdiction over all of the parties, it cannot assess and weigh all of the competing values.

This assumption of a mandated bankruptcy law has driven the scholarly agenda. To date, academics have attempted to justify the existence of Chapter 11 in two ways. Those employing the creditors' bargain have attempted to identify some situations in which the creditors of a firm would have agreed to such a reorganization.[25] Their efforts

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22. *See, e.g.*, Korobkin, *supra* note 1, at 721 ("[B]ankruptcy law is a response to the many aspects of financial distress—moral, political, personal, social, and economic—and, in particular, to the grievances of those who are affected by financial distress."); Warren, *supra* note 8, at 811 (describing bankruptcy as "a dirty, complex, elastic, interconnected [system] from which I can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision").

23. For the way in which bankruptcy law should treat nonconsensual creditors, see *infra* note 52 and accompanying text.

24. *See* Baird, *supra* note 2, at 135 ("Many different parties are involved, and they come on the scene at different times. They cannot readily reach an actual agreement among themselves.").

25. *See, e.g.*, Jackson, *Creditors' Bargain*, *supra* note 7, at 866 (evaluating the merit of a

have been only partially successful, and they have failed to reach any consensus on the issue. Although most acknowledge that in theory a Chapter 11-like proceeding may be appropriate for some types of debtors, by and large they do not embrace the law's current unlimited availability of Chapter 11.[26] They thus end up advocating either that Congress, through legislation, or bankruptcy courts, through case-by-case adjudication, limit access to Chapter 11. Those employing the value-based approach search for the values that should be taken into account once there are not sufficient assets to satisfy the claims of the creditors. According to these theorists, as long as the right values are counted, the system works.

The realization that bankruptcy is part of the initial contract a creditor makes with the firm calls into question the assumed mandatory availability of Chapter 11. Legal rules implicitly determine the content of much of the contract between two parties. Contract scholars identify two types of rules: mandatory rules and default rules. The former are rules that the government imposes and the parties cannot contract around; the latter are rules that the government imposes only if the parties do not specify otherwise.[27] Placing the debate over corporate bankruptcy into the larger contract context where it properly belongs, it is clear that the current option afforded to all firms to file for corporate reorganization under Chapter 11 is a mandatory rule. In other words, a firm cannot contract around its provisions; it cannot make a legally enforceable contract not to file for bankruptcy.[28] Those who advocate maintaining the current universal access to bankruptcy in essence suggest that access to bankruptcy should be fixed by a mandatory rule. All firms have the right to file for Chapter 11, and these advocates of the status quo do not recognize any reason for denying a firm the ability to file for Chapter 11. Indeed, these theorists generally advocate preventing a firm from waiving its right to file for bankruptcy.[29]

Despite the uniformity of bankruptcy scbolars' assumptions about the mandatory nature of Chapter 11, viewed in the broader context of contract theory, this assumption is an anomaly. Many, if not most, rules

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government reorganization scheme for unsecured creditors); Jackson & Scott, *supra* note 2, at 168 (arguing that for "repeat players" in the creditors' bargain, risk spreading as a form of prepaid insurance is more efficient than case-by-case analysis of risk); Scott, *supra* note 18, at 707 n.52 (describing situations involving business failures from unanticipated common disasters).

26. *See infra* Part II (explaining these theories).

27. *See supra* notes 5-6 (citing much of the literature on default rules).

28. *See* 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).

29. For example, see JACKSON, LOGIC AND LIMITS, *supra* note 7, at 17 ("To allow a debtor to contract with a creditor to avoid participating in the bankruptcy proceeding would destroy the advantages of a collective system.").

in contract law are default rules; they apply only if the parties fail to contract around them.[30] For example, if the parties' contract does not mention whether or not a contract is assignable, the law provides that, as a general matter, most contracts are assignable.[31] The parties, however, are free to contract around this rule by providing that the contract cannot be assigned. Another default rule limits damages recoverable by a party injured by contract breach to those damages that are foreseeable.[32] The parties are generally free to contract for greater liability if they so choose.

The standard justification for having default rules is that a default rule, by giving the parties freedom to specify what they actually want, leads to improved returns to the contracting parties.[33] If the default rule is the most efficient one for the parties, they will not, as a general matter, bargain to a different result.[34] Even if a different rule is more efficient in the sense that it increases the surplus for the contracting parties, they will not bargain to the superior rule if the increase in the contract is less than the bargaining costs. If, however, the gain from the switch to the more efficient rule exceeds the bargaining cost, the parties will bargain to the more efficient result.[35] This is the standard "Coasian contractual theory."[36]

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30. On the role of default rules in the law of contracts, see generally Ayres & Gertner, *supra* note 5, and Goetz & Scott, *supra* note 5.

31. *See* Fitzroy v. Cave, 2 K.B. 364, 372-73 (1905); RESTATEMENT (SECOND) OF CONTRACTS § 317(2) (1981).

32. *See* RESTATEMENT (SECOND) OF CONTRACTS § 351 (1981). The classic case on this point is Hadley v. Baxendale, 156 Eng. Rep. 145 (Ex. 1854). Literature on *Hadley* includes RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 114-15 (3d ed. 1986) (arguing that the *Hadley* principle "induces the party with knowledge of the risk either to take appropriate precautions himself or . . . pay [the other party] to assume it"); Ayres & Gertner, *supra* note 5, at 101-04 (describing *Hadley* as an "example of how a penalty default can restrict rent-seeking behavior"); Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105, 138 (1989) (arguing that the progeny of *Hadley*, which stresses "either the likelihood of damage on bresch or the defendant's knowledge of special circumstances, should be set aside in favor of . . . a theory of tacit assumption of risk"); Johnston, *Strategic Bargaining*, *supra* note 6, at 616 (analyzing the economic implications of *Hadley* as representative of a default contract rule).

33. For examples of this reasoning, see Johnston, *Strategic Bargaining*, *supra* note 6, at 624; Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351, 370 (1978); Randy E. Barnett, *Rational Bargaining Theory and Contract: Default Rules, Hypothetical Consent, the Duty to Disclose, and Frand*, 15 HARV. J.L. & PUB. POL'Y 783 (1992).

34. Such bargaining would occur only when there is asymmetrical information that would allow the party with the advantage to gain a bigger share of the surplus by contracting to a less efficient rule. *See* Ayres & Gertner, *Strategic Contractual Inefficiency*, *supra* note 6, at 762; Johnston, *Strategic Bargaining*, *supra* note 6, at 625-26.

35. POLINSKY, *supra* note 14, at 13; Johnston, *Strategic Bargaining*, *supra* note 6, at 624.

36. The term is Johnston's. *See* Johnston, *Strategic Bargaining*, *supra* note 6, at 618. The term recognizes that these insights derive from the Coase Theorem. *Id.* at 624. For an example of an article using such reasoning, see Robert E. Scott, *The Case for Market Damages: Revisiting the Lost Profits Puzzle*, 57 U. CHI. L. REV. 1155, 1172-73 (1990) ("In a world where Coasian assumptions of zero transactions hold, the damage rule is irrelevant because parties can and will negotiate around a

The case for default rules becomes stronger as the types of parties or situations covered by a given rule become more diverse. The greater the diversity of parties or situations covered by a rule, the less likely will it be that one size fits all. For example, a rule of no-specific-performance may work well when there is a well-functioning market, but it may work less well when replacements for the contracted performance are not readily available.[37] Given that current bankruptcy law provides only one standard bankruptcy term for all firms, and that firms vary greatly in size and complexity, it is hard to imagine that such law maximizes the contracting surplus for all parties. Indeed, it is hard to imagine that any one bankruptcy rule, whatever it may be, would be the optimal rule for all firms.[38] There thus is strong reason to suspect that treating bankruptcy as a default rule would increase the overall welfare of the contracting parties. Indeed, the next Part of this Article demonstrates that different types of shareholders would probably prefer different sets of bankruptcy rules. This strongly suggests that a default-rule approach is superior to the law's current prescription of a mandatory rule.

To be sure, mandatory contract rules do exist. For example, parties cannot contract for murder and minors cannot enter into binding obligations. However, mandatory rules are generally viewed as the exception rather than the norm.[39] As such, one must provide a justification for invoking mandatory rules. Contract theorists generally agree that mandatory rules can be justified either by society wanting to protect the contracting parties themselves (paternalism) or by society wanting to protect third parties (externalities).[40] In other words, the burden is on those advocating a mandatory rule to demonstrate the necessity for its existenee.

In light of these potential gains from shifting to some sort of default rule, the premise that the ability to file for bankruptcy should be a

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suboptimal legal rule.").

37. *See* Kronman, *supra* note 33, at 357-58. Much of the debate over the use of specific performance turns on whether or not there is an effective cover market. *See* Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 284-91 (1979) (arguing that expanding the availability of specific performance would not generate higher post-breach negotiation costs because buyers and sellers have similar cover costs); Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341, 385-89 (1984) (comparing different contract remedies in light of parties' "relative contract costs"). The debate over the availability of specific performance is nicely analyzed in Lewis A. Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 U. COLO. L. REV. 683, 711-17 (1986).

38. *Cf.* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 5 (1991) ("No set of promises is right for all firms at all times. No one thinks that the governance structure used for a neighborhood restaurant will work well for Exxon or Hydro Quebec.").

39. *See* Ayres & Gertner, *supra* note 5, at 87.

40. *Id.* at 88.

mandatory rule, while at times noted in passing,[41] cannot be justified.[42] To be sure, some have defended the mandatory nature of bankruptcy. Some of these arguments are simply the artifact of misconceiving the proper inquiry. For example, consider the argument propounded by creditors' bargain theorists that we need bankruptcy to solve a common-pool problem.[43] Common pools result where individuals are free to use assets, but cannot constrain their fellow citizens from using the same assets.[44] The creditors' bargain theorists have suggested that bankruptcy law must be mandatory in order to solve the common-pool problem that arises when individual creditors are left to their state-law remedies. In such a situation, these persons would engage in a race to the debtor's assets, which would lead to a lower return than if they acted as a group. The creditors' bargain theory attempts to solve this problem by replacing individual collection rights with a collective proceeding.[45]

But this race for the assets of the firm on which the creditors' bargain theory is predicated differs significantly from the traditional common-pool problem.[46] Creditors consensually enter into dealings with the firm. The cost of having an inefficient bankruptcy option is ultimately borne by the equity holders of the firm in the form of higher interest payments whereas the costs associated with common pools are borne by all. Consider a rule that security interests are not respected in bankruptcy. This rule, so long as it is known in advance, will not reduce the return to secured creditors. The effect of such a rule would be that secured creditors would demand a higher interest rate to offset the risk that they will not be

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41. *See, e.g.*, Baird, *supra* note 2, at 135 (explaining that "investors cannot easily substitute their own procedures in the place of bankruptcy rules"); Jackson & Scott, *supra* note 2, at 203 ("The benefits of standardized distributional rules suggest that the traditional contractual freedom to opt out of the creditors' bargain might sensibly be restricted in bankruptcy.").

42. Alan Schwartz has reached a similar conclusion, at least with respect to publicly held firms. *See* Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J. LEGAL EDUC. (forthcoming Apr. 1993). Schwartz argues that for publicly held firms, equity holders would offer bondholders contracts that committed the firm to a private reorganization upon default. The analysis in this Article is consistent with Schwartz's conclusion, but goes further in that it extends to all firms and, by offering a menu of bankruptcy options, attempts to reduce the costs of contracting, which may otherwise prevent the parties from agreeing to the optimal bankruptcy regime.

43. *See* JACKSON, LOGIC AND LIMITS, *supra* note 7, at 8-11.

44. Alan E. Friedman, *The Economics of the Common Pool: Property Rights in Exhaustible Resources*, 18 UCLA L. REV. 855, 855 (1971); Gary D. Libecap & Steven N. Wiggins, *Contractual Responses to the Common Pool: Prorationing of Crude Oil Production*, 74 AM. ECON. REV. 87, 88-89 (1984); Richard J. Sweeney et al., *Market Failure, The Common Pool Problem, and Ocean Resource Exploitation*, 17 J.L. & ECON. 179, 182 (1974).

45. *See* Jackson, *Creditors' Bargain*, *supra* note 7, at 861-64 (arguing that the collective proceeding eliminates strategic costs and reduces recovery variations associated with a creditor "race to the courthouse").

46. This difference is noted in Picker, *supra* note 10, at 647 (differentiating the common-pool problem, which typically arises among strangers, from the relationships between a debtor and its creditors, which are largely contractual and can be structured to minimize the common-pool problem).

able to recover the value of their collateral. To the extent that secured credit is beneficial, it is beneficial to the debtor. Any impediment to the optimal arrangement will ultimately be borne by the firm.

The same is true for all aspects of the bankruptcy term of the contract. Creditors will price their loans based on their treatment in a bankruptcy proceeding. The equity holders ultimately bear the cost. Thus, unlike the common-pool problem where the cost of suboptimal action is spread among all of the participants, in the case of bankruptcy the equity holders are best positioned to select the rule that provides for the largest expected return to the firm. Thus, the mandatory nature of bankruptcy cannot be justified by a hypothetical creditors' bargain designed to overcome a nonexistent common-pool problem.

A second argument raised in defense of the mandatory nature of bankruptcy is the need for standardization. In short, some argue that having a mandatory bankruptcy scheme makes it easy for all players to know the rules of the game.[47] This argument has two aspects. First, standardization saves the parties the cost of creating an entire bankruptcy regime from scratch. If each firm were required to draft its own set of bankruptcy procedures, it may very well be that for many firms the cost of drafting such procedures would outweigh the gain that the firm would realize through the introduction of the efficient bankruptcy term. Added to this drafting cost is the cost of communicating the bankruptcy term to all subsequent creditors. If the firm wishes to offer a custom-made bankruptcy term to all of its creditors, it must explain these provisions again and again.

A second aspect of the standardization argument is that the mandatory nature of bankruptcy guards against strategic behavior. If one creditor could contract out of bankruptcy, all creditors would have to be on guard and learn about such efforts.[48] The firm cannot contract with all creditors at once. The first creditor contracting with the firm, in light of the potential problem of the firm reaching a different contract with subsequent creditors, might adopt a maximin approach. In other words, a creditor would attempt to maximize its return assuming that the other creditors were attempting to minimize its return.[49] The motivation of the

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47. *See* Jackson & Scott, *supra* note 2, at 203 (noting the "extraordinary benefits" of limiting bankruptcy options to "a few model forms"); *see also* Goetz & Scott, *supra* note 5, at 261 (calling the state-supplied terms in an executory contract "an attempted interparty *communication*" (emphasis in original)).

48. *See* JACKSON, LOGIC AND LIMITS, *supra* note 7, at 17 ("To allow a debtor to contract with a creditor to avoid participating in the bankruptcy proceeding would destroy the advantages of a collective system.").

49. For a formal description of maximin and minimax strategies, see ERIC RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 103-04 (1989); DAVID M. KREPS, A COURSE IN MICROECONOMIC THEORY 508-09 (1990) (describing the Folk Theorem, which holds that

creditor would be as follows. If the firm cannot credibly commit itself to offering only one bankruptcy term, the creditors may not agree to the optimal bankruptcy term for fear that other creditors would not be bound to the same term. Instead, the creditor would agree only to a bankruptcy term that protected the creditor from future expropriation. In other words, while there might be potential gains from contracting out of Chapter 11, the costs of trying to implement such a regime would outweigh the potential benefits. According to its proponents, the benefits of standardization outweigh the benefits of customizing.[50]

The solution to both the transaction-cost problem and the strategic-action problem is to have a menu of bankruptcy options available. When a firm is formed, it would be required to select what courses of action it wishes to have available if it runs into financial difficulties down the road. The virtue of standardized options is that they reduce transactions costs and make communication to third parties easy. One can still allow parties to write their own contract if none of the options available suit their needs, though a well-crafted set of options should ensure that most firms prefer one of the options to the cost of creating a brand new bankruptcy procedure. The existence of a known menu of bankruptcy choices thus answers the transaction-cost argument for treating bankruptcy as a mandatory rule.

A menu approach can handle the strategic-manipulation problem as well. An approach that limits the firm's ability to change its selection after it has incurred debt ensures that the threat of the firm amending its bankruptcy choice so as to transfer wealth from the creditors to the equity holders is eliminated. A full discussion of such limitations is postponed until the choices on the menu have been delineated.[51] For now, the important point is that these limitations ensure that a firm can publicly announce what bankruptcy option it would choose, and all future creditors would be able to rely on the option that the firm specifies.

A menu approach to corporate bankruptcy law creates another benefit as well; it would aid the owners of a firm in deciding which option they should choose. By offering a discrete set of choices, the menu would enable banks and other creditors to anticipate the interest-rate adjustments that would be made for each option. They could then communicate to those establishing the firm the true cost of selecting one bankruptcy

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all possible outcomes above a player's minimax value are sustainable equilibria in an infinitely repeated game).

50. This statement applies the argument that Goetz and Scott have put forward for standardized terms in contract law. *See* Goetz & Scott, *supra* note 5, at 321 (concluding that standardized contract terms avoid the risks associated with "untested combinations").

51. *See infra* subpart III(B) (discussing the appropriate limitations on the debtor's ability to amend its available bankruptcy options after firm formstion).

provision over another. The benefit of this communication is increased by the fact that, as discussed in the next Part of this Article, choosing the optimal bankruptcy term may turn on the preferences of the firm's owners. Such owners, not Congress or the courts, are in the best position to assess these preferences, and the menu approach allows the owners to compare each option's benefits with its costs.

It is thus clear that as far as those who choose to deal with a firm are concerned, the law of corporate reorganization should be a default rule. However, involuntary creditors should be subject to a mandatory rule. Persons such as tort creditors have in no meaningful sense contracted with the firm. If their rights could be set by the investors of the firm, their rights would most likely be nonexistent. Since the firm does not need their consent, the equity holders have an incentive to foist on them the harshest terms possible. Stated differently, given the inability of nonconsensual creditors to contract with the firm ex ante, a default-rule approach would encourage consensual creditors to shift the costs of insolvency onto nonconsensual creditors. If the firm could assign the lowest possible priority to nonconsensual claimants, it could thus increase the return to consensual claimants, thereby lowering the firm's cost of credit.

This problem is easily remedied. It is beyond peradventure that mandatory rules can be justified as protecting third parties. It is clear that nonconsensual creditors need such protection. They do not, however, need the protection of a mandatory bankruptcy regime. The question of the appropriate treatment of nonconsensual claimants when a firm is insolvent is the subject of a rich literature.[52] This Article does not, and need not, enter this debate. Rather, once policymakers decide the optimal treatment of nonconsensual creditors, this treatment should be unalterable by any debt contract. In other words, the priority status of tort claimants should not depend on which bankruptcy option a firm selects. Thus, a bankruptcy regime consisting primarily of default rules can readily accommodate the existence of nonconsensual claimants.

52. The proposals for treating nonconsensual claimants involve both the question of whether the shareholders of the firm should receive limited liability and whether the nonconsensual claimants should receive a priority to the firm's assets. *See, e.g.*, Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporate Law*, 30 U. TORONTO L.J. 117, 148-49 (1980) (suggesting unlimited liability for closely held corporations and, in some cases, personal liability for directors of public corporations); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1902 (1991) (proposing unlimited liability for shareholders and the subrogation of 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 take priority over 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).

It is clear that there are potential efficiency gains from switching to a menu approach. The task that remains is to create an appropriate menu to ensure that such gains are realized. It is one thing to justify the use of some type of default rule; it is quite another to craft the rule itself. To undertake this task, this Article next examines existing law and the theories of corporate reorganization offered to date, and then crafts a menu based on plausible assumptions as to the kinds of proceedings that various types of equity holders may prefer.[53]

## II. The Theories of Corporate Reorganization: A Reappraisal

This Part of this Article first explores current bankruptcy law, including Chapter 11. It then surveys the debate that has arisen over the reorganization provision's normative justification, setting forth the various views offered to date and examining the plausibility of each in light of the discussion in Part I.

### *A. The Extant Provisions of Corporate Bankruptcy Law*

The Bankruptcy Code provides financially troubled firms with two means—Chapter 7 and Chapter 11—by which they may confront their difficulties. To understand the options that bankruptcy law provides, it is first necessary to examine the state of affairs that obtains in the absence of such law. In the absence of bankruptcy law, state law regulates the relationship between a debtor and its creditors. As a positive matter, bankruptcy is built upon state-law collection procedures. State law determines the way in which creditors may establish priority to the firm's assets as against other creditors.[54] Under state law, some creditors of a firm have contracted for priority over the firm's other creditors. These creditors have taken a security interest in the firm's assets, thus entitling them to be paid out of these assets before the other creditors.[55] If the

53. The argument for treating bankruptcy law as a default rule has been economic in nature. For an argument that such treatment comports with notions of social justice, see Robert K. Rasmussen, Bankruptcy, Default Rules, and Social Justice (unpublished manuscript, on file with the *Texas Law Review*).

54. *See* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 827 (1987) ("[E]xisting bankruptcy law does not set substantive rights and its procedural rights can be understood only against the backdrop of nonbankruptcy procedural rights."); Alfred Hill, *The* Erie *Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013, 1035 (1953) (observing that the "apparent purpose of the Bankruptcy Act" is "to provide a system for the effectuation of what are for the most part state-created rights"). *But see id.* at 1035 n.94 (giving examples in which creditors' substantive rights to priority among assignments, asserted under state law, were modified by equity courts sitting in bankruptcy). Whether this should be true as a normative matter is, of course, a different question.

55. The procedures for obtaining security interests are the province of Article 9 of the Uniform Commercial Code.

debtor is recalcitrant in giving the secured creditor the benefits of its collateral, the creditor may enlist the state to enforce its contractual rights.[56] The firm's remaining creditors establish their priority as against competing creditors by simply being the first to receive the unencumbered assets of the firm.[57] Such creditors can either be willingly paid by the debtor or, after they have established their right to collect from the debtor through a state-court judgment, they may enlist the aid of the state in procuring the debtor's assets.

The two alternatives that bankruptcy law provides to the strictures of state law stay the efforts of creditors to collect their debts through their state-law remedies, and channel the collection efforts into the bankruptcy forum.[58] The first of these alternatives is Chapter 7. Chapter 7 is the liquidation provision of the Code under which the assets of the firm are reduced to cash, and this cash is distributed to the firm's creditors. The mechanics of this process are relatively straightforward. Once a firm files a petition under Chapter 7, the firm's current management loses control over the firm.[59] An interim trustee is appointed by the United States Trustee,[60] and a permanent trustee is elected by the firm's creditors.[61] The primary obligation of the trustee is to "collect and reduce to money" the assets of the firm as "expeditiously" as feasible.[62] This money is then distributed to the firm's creditors. Chapter 7 sets forth the order in which the competing claimants are paid.[63] By and large, state-law priorities are respected. Those who have obtained a special priority to certain assets under the state-law collection system—either by perfecting a consensually granted security interest or obtaining a valid nonconsensual lien—retain their priority over other creditors.[64] Thus, secured creditors are given the property in which they have a security interest or are paid the proceeds

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56. Under Article 9 of the U.C.C., a debtor may choose between two options to obtain the benefit of his collateral:

> First, he can seize the goods subject to his security interest and either keep them in satisfaction of the debt or resell them and apply the proceeds to the debt. Often a resale will result in a deficiency for which the debtor is usually liable. Alternatively, the creditor can ignore his security interest and obtain a judgment on the underlying obligation and proceed by execution and levy.

JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 25-4, at 1195 (3d ed. 1988).

57. *See id.* § 24-4, at 1131 (discussing the doctrine of "first in time, first in right" which "runs like a gold thread through virtually all priority schemes").

58. *See* 11 U.S.C. § 362(a) (1988).

59. *See id.* §§ 701-704 (discussing the selection and duties of trustees).

60. *Id.* § 701(a).

61. *Id.* § 702(b).

62. *Id.* § 704(1).

63. *Id.* § 726(a).

64. *See id.*

from the sale of such property.[65]

The major deviation from state law is Chapter 7's treatment of general creditors. Chapter 7 replaces the race among creditors with pro rata sharing.[66] Once a bankruptcy petition is filed, the general creditors no longer compete against each other for the firm's unencumbered assets. To the extent that there are not sufficient assets to pay such creditors in full, the shortfall is borne by all general creditors in proportion to the amount that they have loaned the firm.[67]

Other deviations from state law currently exist as well. While bankruptcy law respects a secured creditor's state-law priority, such respect is not complete. State law entitles secured creditors not only to the proceeds of their collateral, but also to such proceeds at a certain time. Once a firm defaults on its obligations to a secured creditor, that creditor knows that it can institute court action and thereby ensure that it will receive the proceeds from the sale of its collateral within a specified time.[68] To the extent that a bankruptcy proceeding extends the time before the secured creditor is paid without compensating the creditor for that delay, it does not respect state law.[69] Whether a secured creditor will be compensated for any bankruptcy-imposed delay turns on whether the value of the creditor's collateral exceeds the amount that the creditor is owed. If the creditor is oversecured, it will accrue interest on its claim during the bankruptcy proceeding.[70] If, however, the creditor is undersecured, it will not be compensated for any bankruptcy delay. While the Code is not clear on this last point, the Supreme Court in *United Savings Ass'n v. Timbers of Inwood Forest Associates*[71] held that undersecured creditors receive only the value of their collateral regardless of whether bankruptcy has delayed receipt of such proceeds.[72]

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65. *Id.* § 724(b).

66. *See id.* § 726(b).

67. If there are sufficient assets to pay the general creditors, the remaining assets go first to pay interest to the general creditors, with any remaining funds going to the shareholders. *Id.* § 726(a)(5). Such cases where the debtor's assets exceed its liabilities arise infrequently.

68. The time between instituting legal action and receiving the proceeds of the foreclosure sale differs depending on the relevant state law and the type of asset involved. For example, as a general proposition, foreclosure on real property takes longer than foreclosure on personal property. *See* RAY D. HENSON, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 10-5, at 355 (2d ed. 1978) ("[C]ode remedies are more expeditious than the usual mortgage foreclosure laws . . . .").

69. Of course, a creditor has no right to complain if the delay caused by bankruptcy replicates the delay that the creditor would have had to bear under state law. *See* Sexton v. Dreyfus, 219 U.S. 339, 344-45 (1911).

70. *See* 11 U.S.C. § 506(b) (1988). An oversecured creditor is entitled to such interest even if it is a nonconsensual creditor. *See* United Ststes v. Ron Pair Enters., Inc., 489 U.S. 235, 241 (1989) (allowing the government to recover postpetition interest on a tax lien filed against property owned by the debtor).

71. 484 U.S. 365 (1988).

72. *Id.* at 382. However, one commentator argues that the Code is better interpreted as

Third, Chapter 7 deviates from state law by according special priority to what would otherwise have been general unsecured claims.[73] Employees receive a special priority for a portion of their unpaid wages; the firm's obligation to its pension plan also receives a limited priority. Grain operators, fishermen, and consumers also are accorded preferred treatment. Finally, the government's claim for unpaid taxes must be satisfied before general claimants are paid anything.

Thus, the defining attribute of a Chapter 7 proceeding is that the assets of the firm are reduced to cash, which is then distributed to those whom state law recognizes as having a claim for payment from the firm. During the period of reducing the assets to a pile of cash, the Code presumes that the firm will not be operating.[74] The trustee, however, may ask the bankruptcy court to let her operate the business while it is in Chapter 7. The court will grant such permission "for a limited period, if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate."[75] Regardless of whether a firm receives such permission, the net result of a Chapter 7 proceeding is that the assets of the firm are sold to third parties for cash, which is then turned over to the firm's creditors. Although the claims of the firm's creditors that are not paid in full are not technically discharged,[76] these remaining claims are worthless because the firm has no remaining assets. Chapter 7 is thus a day of reckoning—the current owners of the firm are cashed out, and the assets end up in the hands of new owners.

The Code gives the financially distressed firm a second option: that of filing for reorganization under Chapter 11. Whereas a Chapter 7 liquidation usually results in the discontinuation of the enterprise, the goal of a Chapter 11 proceeding is to revamp the capital structure of the firm so that the firm can continue as a going concern. This being the case, it is not surprising that the proceedings under Chapter 11 are much more complex than those under Chapter 7. One would expect that maintaining a business and negotiating a new capital structure takes more time and effort than closing shop, selling the firm's assets, and distributing the resulting proceeds.

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compensating undersecured creditors for bankruptcy-imposed delays. *See* Thomas O. Kelly III, Comment, *Compensation for Time Value as Part of Adequate Protection During the Automatic Stay in Bankruptcy*, 50 U. CHI. L. REV. 305, 309-22 (1983). Baird and Jackson argue that such delay should be compensable as a normative matter. *See* Baird & Jackson, *Corporate Reorganizations*, *supra* note 18, at 99-100. The flaw in the latter argument is that it assumes that creditors have contracted for their security interest with the debtor, and only then contract with other creditors over the content of a bankruptcy proceeding.

73. *See* 11 U.S.C. §§ 726(a)(1) & 507(a)(3)-(7) (1988).

74. *See id.* § 721 (requiring court authorization for a trustee to continue operating a business).

75. *Id.*

76. Chapter 7's discharge provision applies only to individuals. *See id.* § 727(a)(1).

One major difference between the two bankruptcy provisions is who controls the firm while it is in bankruptcy. In most Chapter 11 proceedings, unlike Chapter 7 proceedings, the current management retains control of the enterprise.[77] Such retention may be necessary to ensure that the firm continues to operate while in bankruptcy. A trustee may be able to come in and sell the assets of a firm to the highest bidder; she may, however, not be able to step in and run a business with which she has no familiarity. Retaining current management may be necessary; however, at least in the short run, this retention causes problems as well.[78] By ensuring that current management stays in place, Chapter 11 provides an inducement for the managers, who control the bankruptcy decision, to file a Chapter 11 rather than a Chapter 7. If they file a Chapter 7, they lose their jobs; if they file a Chapter 11, they get to retain them, at least in the short run.[79]

At the same time as the prebankruptcy managers run a firm in Chapter 11, those with claims to the assets of the firm, including the existing equity holders, attempt to create a new capital structure for the firm. This new structure will be set forth in a plan of reorganization. Such a plan is simply a blueprint for the future of the firm and its creditors. Plans of reorganization usually call for the continuation of the enterprise, although plans that provide for the liquidation of the business are not infrequent.[80] In a plan in which the firm remains as an operating business, the plan sets forth the terms under which existing creditors exchange their claims against the old firm for cash, notes, or a share of the

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77. *See id.* § 1107(a) (mandating that the debtor in possession shall exercise "all the rights . . . and powers, and shall perform all functions and duties . . . of a trustee," including the power to operate the debtor's business under 11 U.S.C. § 1108). To oust current management, a party in interest, normally a creditor, must request the appointment of a trustee to run the firm. The court is instructed to grant such a motion "for cause, including fraud, dishonesty, incompetence, or gross mismanagement." *Id.* § 1104(a)(1). LoPucki and Whitford report that in their study of the bankruptcies of 43 publicly traded companies, the current management was replaced by a trustee in only two cases. *See* Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies 35 (Dec. 13, 1991) (unpublished manuscript, on file with the *Texas Law Review*).

78. These problema are nicely examined in Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991).

79. Some managers even manage to retain their positions in the long run. In a study of publicly held companies in financial distress, Stuart Gilson reports that 46% of directors and 43% of CEOs retain their jobs for more than two years after such distress. *See* Gilson, *supra* note 13, at 356. LoPucki and Whitford, however, found that although management retained exclusive authority to propose a plan of reorganization in the majority of cases, in 91% of cases there was at least one change in CEO during the period starting eighteen months before filing and ending six months after confirmation, and in 70% of cases there was at lesst one change in CEO during the pendency of the Chapter 11 proceeding. *See* LoPucki & Whitford, *supra* note 77 (manuscript at 68-70).

80. *See* ED FLYNN, STATISTICAL ANALYSIS OF CHAPTER 11, at 12 (1989) (estimating that 20-30% of 2395 confirmed plans of reorganization in 15 districts called for the liquidation of the enterprise).

reorganized enterprise. The consummation of a plan of reorganization discharges all prebankruptcy claims against the firm.[81]

Chapter 11 sets forth the ground rules by which those with a stake in the firm develop a plan of reorganization. These ground rules are both procedural and substantive. On the procedural side, the Code gives the firm's equity holders the exclusive right to propose a plan of reorganization for the first 120 days after the petition is filed.[82] Bankruptcy courts have the power to extend this period of exclusivity,[83] and such extensions are common.[84] After the period of exclusivity expires, any creditor or shareholder may file a plan of reorganization.[85]

Once a plan of reorganization is proposed, approval of the plan in the first instance is done through voting by the firm's claimants. The proposed plan will divide the creditors and stockholders into various classes.[86] Creditors can only be grouped together in a class if their claims are "substantially similar" to the other claims in the class.[87] As a practical matter, this means that each secured creditor will usually be grouped in a class by itself. Classes that receive no distribution under the plan are deemed to have rejected the plan.[88] Classes for which the plan provides payment in full are deemed to have accepted the plan.[89] For the remaining classes, which are to receive partial satisfaction of their claims, a creditor class is deemed to accept a plan when more than one-half of the voting creditors in the class holding more than two-thirds of the amount of claims held by voting creditors in the class have accepted the plan.[90]

Chapter 11 also sets forth substantive ground rules for a plan of reorganization. It does this by specifying the minimum amount that a dissenting creditor must receive for the plan to be confirmed over that creditor's objection. The rights of individual creditors turn on whether or not they are secured and, if they are not, whether or not their class has accepted the plan. If a secured creditor objects to a plan, the plan can be confirmed by the bankruptcy court only if the plan either provides that the secured creditor retains its lien on its collateral and the plan promises the

81. 11 U.S.C. § 1141 (1988).

82. *Id.* § 1121(b).

83. *Id.* § 1121(d).

84. LoPucki and Whitford report that in their study of forty-three Chapter 11 cases, all involving publicly traded companies, the debtor retained the exclusive right to file a plan of reorganization in all but nine. This was true despite the fact that over half of the cases in their sample lasted over two years. *See* LoPucki & Whitford, *supra* note 1, at 128 n.6.

85. 11 U.S.C. § 1121(c) (1988).

86. *Id.* § 1123(a)(1).

87. *Id.* § 1122(a).

88. *Id.* § 1126(g).

89. *Id.* § 1126(f).

90. *Id.* § 1126(c).

creditor cash payments that have a present value equal to the amount of its claim, or if it provides that the secured creditor receives the "indubitable equivalent" of its claim.[91]

The rights of a dissenting unsecured creditor or a dissenting equity holder will turn on whether their class has accepted the plan. If it has, the only treatment that a creditor can demand is that it receives as much as it would have received in a Chapter 7 liquidation.[92] This hypothetical liquidation value is determined by a bankruptcy judge. If the creditor's class has rejected the plan, the plan may be confirmed only if it meets the additional requirement that it does not provide for any distributions to classes that are junior in priority to the objecting class.[93]

This last requirement is known as the "absolute priority rule."[94] It is this rule, which respects state-law priorities, that drives the bargaining over the plan of reorganization. When the firm is insolvent, the upshot of the absolute priority rule is that the creditors are entitled to the entire firm. This result conforms to state law, according to which shareholders are the residual claimants who receive the assets from the firm only after all other creditors have been paid in full. They are thus generally forbidden from taking assets from an insolvent firm.[95]

To be sure, the absolute priority rule does not mean that equity holders are cashed out in all plans of reorganization. Indeed, it is common that plans give some equity in the new firm to the shareholders of the old firm. Oftentimes creditor classes approve reorganization plans even though they are not being paid in full and equity holders walk away with a share of the reorganized enterprise. The equity holders' bargaining power arises from two sources. First, the equity holders' future contributions to the firm may be necessary to the survival of the enterprise. In many small corporations, the manager is also the owner of the firm. Her participation in the reorganization may be required for the firm to survive. For example, the manager may be the owner of a firm that manufactures

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91. *Id.* § 1129(b)(2)(A).

92. *Id.* § 1129(a)(7)(A)(ii).

93. *Id.* § 1129(b)(2)(B)(ii), (c)(ii).

94. *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988) (providing that "a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan"). Classic treatments of the absolute priority rule are contained in Walter J. Blum, *Full Priority and Full Compensation in Corporate Reorganizations—A Reappraisal*, 25 U. CHI. L. REV. 417, 417-28 (1958); Walter J. Blum, *The "New Directions" for Priority Rights in Bankruptcy Reorganizations*, 67 HARV. L. REV. 1367, 1368 (1954); and Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 581 (1950).

95. *See* UNIF. FRAUDULENT TRANSFER ACT § 5(a), 7A U.L.A. 648 (1985) (prohibiting transfers from an insolvent firm for less than reasonably equivalent value). For state laws that prohibit the payment of dividends while the firm is insolvent, see, for example, CAL. CORP. CODE § 501 (West 1990); COLO. REV. STAT. ANN. § 7-5-110(1) (1986); DEL. CODE ANN. tit. 8, § 170(a) (1974); GA. CODE ANN. § 7-1-460(a) (Michie 1989); N.Y. BUS. CORP. LAW § 510(a) (McKinney 1986).

furniture. The firm's reputation for quality arises from the manager's unrelenting insistence that every piece of furniture sold is of the utmost quality. Without this manager running the firm, few would buy the firm's furniture. Moreover, the manager's efforts are due in large part to the fact that it is her "name on the furniture." Thus, the firm-specific skills of the manager may be necessary if the business is to survive, and the manager may refuse to participate in the reorganized firm unless she is given an equity interest in the new firm. Under such circumstances, it does not seem objectionable for creditors to consent to equity's continued participation in the firm.[96]

The second source of equity's bargaining power is more problematic. Often it is the procedural protections that equity is granted under the Code that drive the negotiation process. For example, the firm's current management is given the exclusive right to propose a plan of reorganization for at least 120 days. If management can convince the bankruptcy judge to extend this right, creditors may eventually consent to management's demand that equity holders participate simply to ensure that a plan of reorganization is proposed.[97] Another source of equity holders' power is that they have control of the firm's management. While creditors may not have had any prior dealings amongst themselves, they all have dealt with the firm's management. A cooperative management could thus facilitate the rcorganization process. It may be necessary to "buy off" the equity holders for such facilitation to occur.[98] Moreover, if equity holders can make a plausible case that a firm is solvent, it can threaten to force a costly valuation hearing. Creditors faced with such a threat may find it more expeditious to provide for equity holders in the plan rather than litigate the issue of solvency before the bankruptcy judge.[99] Finally, it seems to be the case that the bankruptcy bar, perhaps because of its experience with these other factors, simply expects that equity holders will have to be provided for in a plan of reorganization.[100]

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96. For a more detailed analysis of this point, see Baird & Jackson, *Bargaining After the Fall*, *supra* note 18, at 747-60. One difficulty with the Code as it has been interpreted is that it prevents secured creditors, when they own all the assets of the firm, from reaching a deal with the manager that cuts out the general creditors. *Id.* at 760-87. This prohibition on "squeeze outs" of the junior creditors dates to Northern Pac. Ry. v. Boyd, 228 U.S. 482, 505 (1913) (holding that "[a]ny arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either [secured or unsecured creditors] comes within judicial denunciation" (citing Louisville Trust Co. v. Louisville, N.A. & C. Ry., 174 U.S. 674, 684 (1899))).

97. *See* Adler, *supra* note 18, at 451.

98. *Id.* at 449.

99. *Id.* at 451-52.

100. *See* LoPucki & Whitford, *supra* note 1, at 144. This expectation may result from the perceived need of creditors' attorneys, who want to maintain their relationship with debtor's counsel. *See id.* at 156 ("We concluded that the lawyers in the cases we studied had an incentive to be concerned not only with the welfare of their clients but also with their relationships to each other.").

Equity holders may thus participate in the reorganized firm either because they add needed skills to the enterprise, or because they need to be placated. One may argue over which reason explains equity's share in any given case. It is clear, however, that equity holders often participate in a reorganization even where there is little probability that they are contributing firm-specific skills to the reorganized enterprise. A recent study of reorganizations in large, publicly held companies showed that in twenty-one of the thirty cases studied, equity holders received distributions even though the creditors were not being paid in full.[101] A second study of publicly traded companies that filed for protection under Chapters 7 and 11 revealed that priority was violated in twenty-nine of the thirty-seven cases studied.[102] It is hard to imagine that in each of these cases the public shareholders' share of the new firm was in exchange for the firm-specific skill that they promised to bring to the reorganized entity.

Despite the seeming clarity of the Code on the contours of the absolute priority rule, one major issue remains unresolved. Under current law, it is unclear whether a bankruptcy court can confirm a plan of reorganization over the objection of a dissenting creditor when the plan provides that a junior interest is to be given a stake in the reorganized firm in exchange for a new contribution by such interest to the enterprise. Prior to the passage of the Code, the Bankruptcy Act allowed judicial confirmation over the objections of a single creditor so long as the plan was "fair and equitable."[103] The Supreme Court interpreted this language as allowing a confirmation of a plan granting an interest to a junior claimant if the plan called for such claimant to contribute "money or money's worth" to the reorganized firm, and where the value of the contribution matched the value that the interest was to receive.[104] The Code, however, defines the vague requirement of "fair and equitable" by setting forth detailed criteria for when a plan may be confirmed over creditor objection.[105] The "fresh contribution"[106] situation is not listed as a permis-

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101. *Id.* at 142.

102. Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority Claims*, 27 J. FIN. ECON. 285, 286 (1990). A third study that examined 27 cases, some of which were handled under the predecessor to Chapter 11, showed that 78% of the plans contained deviations from the absolute priority rule and that in most of the cases, 18 of the 27 studied, shareholders received distributions even though the senior claimanta were not paid in full. *See* Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 754 (1989).

103. *See* Act of Aug. 27, 1935, ch. 774, § 77(e)(1), 49 Stat. 911, 918 (1935). For the historical development of this language, see Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy*, 44 STAN. L. REV. 69, 74-90 (1991).

104. Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 122 (1939).

105. 11 U.S.C. § 1129(b) (1988).

106. The term "fresh contribution" has its origin in the language of *Case*, 308 U.S. at 121 ("Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonsbly equivalent to their contribution, no objection can be made.").

sible method of overcoming such objection. The Supreme Court in *Norwest Bank Worthington v. Ahlers*[107] noted that whether the Code allows confirmation when junior parties retain an interest in exchange for "money or money's worth" is an open question. Since *Ahlers*, lower courts have split on this issue.[108]

In courts that recognize the fresh contribution exception, equity holders have another arrow in their quiver in their negotiations with the firm's creditors. One might be tempted to say that this right is of little value because equity has to make a fresh contribution. Such an assertion, however, would fail for two independent reasons. The first arises from the process by which equity's attempt to participate in the reorganized firm is handled. If a creditor class dissents, the fresh contribution rule allows equity to argue that it is supplying a new contribution that justifies the share accorded to it under the plan.[109] The merits of this argument will have to be decided by a bankruptcy judge. Because the stake that equity holders usually receive in a plan of reorganization is equity in the new firm,[110] the judge will have to value the firm in order to value equity's proposed share.[111] The cost of such a judicial valuation may induce

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107. 485 U.S. 197 (1988).

108. Some courts have rejected the fresh contribution exception. *See In re* Drimmel, 108 B.R. 284, 288 (Bankr. D. Kan. 1989) ("This court does not believe any such exception to the [absolute priority] rule exists under the Code."), *aff'd*, 135 B.R. 410 (D. Kan. 1991); *In re* Winters, 99 B.R. 658, 663 (Bankr. W.D. Pa. 1989) (holding that no exception exists "('infusion of new capital' or otherwise)" to the absolute priority rule). Other courts have embraced the exception. *See In re* U.S. Truck Co., 800 F.2d 581, 588 (6th Cir. 1986) (saying that where the necessity of seeking new money from old stockholders exists, "and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made"); *In re* Greystone III Joint Venture, 102 B.R. 560, 574 (Bankr. W.D. Tex. 1989) (calling the exception a "logical expansion on the notion that an equity reorganization should, in all respects, be 'fair' and 'equitable'"), *aff'd*, 127 B.R. 138 (W.D. Tex. 1990), *rev'd*, 948 F.2d 134 (5th Cir. 1992), *cert. denied*, 1992 WL 171442 *and* 1992 WL 126985 (Oct. 5, 1992). Still other courts have expressed doubts about the exception's viability. *See* Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1361 (7th Cir. 1990); *In re* Stegall, 865 F.2d 140, 142 (7th Cir. 1989) (both questioning whether the fresh contribution exception survived the enactment of the 1978 Code, but emphasizing that the issue remains open in the Seventh Circuit). Academic opinion is also split on this issue. *See* John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963, 1011-12 (1989) (arguing that *Ahlers* implicitly overruled the fresh contribution exception, and that the exception had been without sufficient doctrinal basis); Markell, *supra* note 103, at 102 (concluding that "it is appropriate to dismiss the argument that the Code abolished *Case*'s dicta"); James J. White, *Absolute Priority and New Value*, 8 COOLEY L. REV. 1, 31 (1991) (rejecting the continued existence of the fresh contribution exception).

109. *See Kham & Nate's*, 908 F.2d at 1360; *In re Stegall*, 865 F.2d at 142-43; *In re U.S. Truck*, 800 F.2d at 588.

110. *See, e.g., In re* Potter Material Serv., Inc., 781 F.2d 99, 100 (7th Cir. 1986); *In re Greystone III Joint Venture*, 102 B.R. at 578; *In re* Marston Enters., Inc., 13 B.R. 514, 517 (Bankr. E.D.N.Y. 1981).

111. *See* Adler, *supra* note 18, at 447 ("Because reorganization does not involve a public auction, a bankruptcy court does not know the value of the firm in which it must distribute interests. . . . [T]he court must oversee and, if necessary, resolve a negotiation among claimants who have different

creditors to vote for the plan rather than objecting to it.

A second reason to reject a benign view of the fresh contribution rule is that one has to explain why the firm's creditors voted against such contribution. If equity proposed to take only a portion of the reorganized firm equal to its contribution, there should not be any reason for the creditors to object. If the creditors, whose money is on the line, think that equity is receiving more than they are contributing, one must supply a reason why a bankruptcy judge is in a better position to decide the sufficiency of the contribution.[112] Stated differently, the fresh contribution rule, even if it were costless to implement, allows the shareholders to participate in the reorganized firm based on a third party's evaluation of the value of the firm and the proposed contribution. Even if the inevitable judicial errors in valuation were unbiased, the shareholders would still benefit. If the judge undervalues their contribution or overvalues their share of the new firm, the old shareholders simply do not participate in the new firm, just as they would not participate in the absence of the fresh contribution exception. If, however, the judge overvalues their contribution or undervalues their share of the reorganized firm, the fresh contribution exception to the absolute priority rule leads to shareholder participation that otherwise would not occur.

The contrast between Chapter 7 and Chapter 11 is thus quite stark. The former consists of a relatively quick procedure designed to cash out the creditors of the troubled firm. The latter is a more complex proceeding wherein the various claimants to the firm attempt to reach a consensual bargain under the watchful eye of the bankruptcy court.

### B. *The Traditional Explanation for Chapter 11*

Putting aside misplaced notions of giving a corporation a fresh start in life,[113] Chapter 11 and its historical antecedents traditionally have been justified on the grounds that it is at times better to keep a corporation together than to sell it off piecemeal. Stated differently, firms are sometimes worth more than the sum of their parts. Congress, when it passed Chapter 11, visualized the new law as a method by which this going-concern surplus could be preserved.[114] Congress believed that

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opinions about the debtor's value.").

112. One possible reason may be that the creditors think they can extract a greater payment from the shareholders. Whether one approves of such tactics may depend on whether one thinks that the shareholders are trying to capture the owner's subjective value.

113. The fallacy of implanting fresh-start notions into corporate bankruptcy is exposed in JACKSON, LOGIC AND LIMITS, *supra* note 7, at 190-92 (distinguishing the underlying concern in bankruptcy law of "ensuring that distributional conflicts do not result in poor deployment decisions" from a fresh-start policy for corporations). *See also* Meckling, *supra* note 12, at 13 ("The market for human capital is distinctly different from markets for other kinds of capital.").

114. *See* H.R. REP. NO. 595, 95th Cong., 2d Sess. 222 (1978), *reprinted in* 1978 U.S.C.C.A.N.

Chapter 7 liquidations resulted in the piecemeal dismemberment of the firm,[115] and thus the Chapter 11 alternative was necessary to ensure that those firms that should be kept together would in fact remain intact.[116]

Historically, this distinction between Chapter 7 and Chapter 11 has been true as a positive matter. Nearly all Chapter 7 cases involve the piecemeal liquidation of the debtor.[117] This should not be surprising. The management of a firm, once it decides that it should file for bankruptcy, controls in which Chapter the firm places itself. Management has a built-in incentive to file for Chapter 11. The management of a firm is treated much better under Chapter 11 than in a Chapter 7 proceeding. It remains in place, thereby receiving a salary, and any increase in the value of the firm inures to its benefit.[118] For management to relinquish these potential benefits voluntarily by filing a Chapter 7 petition, it must believe that there is no chance for the firm to survive as a going concern. Thus, while nothing in the Code prevents the sale of a firm as a going concern under Chapter 7, the realities of the situation dictate that only firms that are going to be liquidated end up in Chapter 7. Indeed, not even all liquidations end up in Chapter 7; many Chapter 11 plans call not for the continuation of the firm, but rather for its liquidation.[119]

The traditional conception of Chapter 11 has failed to withstand scrutiny.[120] The attack on this conception is not with the obvious notion

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5963, 6179 (justifying the enactment of Chapter 11 by saying that "[t]he 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"); *cf.* 124 CONG. REC. H32392 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards) ("The amendment also encourages business reorganizations by a streamlined new commercial reorganization chapter. . . . It will protect the investing public, protect jobs, and help save troubled businesses."); 123 CONG. REC. H35444 (daily ed. Oct. 27, 1977) (statement of Rep. Rodino) ("For businesses, the bill facilitates organization, protecting investments and jobs.").

115. *See* Bradley & Rosenzweig, *supra* note 3, at 1043-44 ("Congress was concerned that liquidations destroy valuable firm-specific assets and impose substantial costa on corporate stakeholders such as security holders, employees, suppliers, customers, and communities . . . .").

116. *See id.* at 1043 (noting that Congress, in the Bankruptcy Reform Act of 1978, was "determined to push managers of financially troubled firms toward reorganization rather than liquidation [because] Congress believed that assets would be more highly valued if utilized in the industry for which they were designed, rather than scrapped").

117. David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 504 (1992).

118. *Cf.* Rose-Ackerman, *supra* note 78, at 299-300 (saying that managers who stay on during reorganization have considerable leverage, are "dehtors-in-possession," and are charged with proposing the initial reorganization plan).

119. *See supra* note 80.

120. The seminal attack on this notion is found in Baird, *supra* note 2, at 129-35 (arguing that owners of a publicly held firm are likely to prefer the outright sale of the firm to the highest bidder to reorganization). *See also* JACKSON, LOGIC AND LIMITS, *supra* note 7, at 218-24 (endorsing Baird's suggestion for eliminating Chapter 11). More recent rejections of Chapter 11 include Bowers, *supra* note 3; Bradley & Rosenzweig, *supra* note 3; and Adler, *supra* note 3.

that at times it is in the claimants' interest to keep a firm intact even though the amount of their claims exceeds the value of the firm. Rather, the attack has been on the assumption that Chapter 11 is necessary to accomplish this objective.[121] The extant provisions of Chapter 11 are in effect a sale of the corporation to its creditors.[122] Before the bankruptcy proceeding, creditors are owed specific amounts of money and the shareholders hold the residual claims. After the proceeding, some of the old creditors are now the owners of the firm, having exchanged their debts for cash, new debt, or equity. The original claims of the various parties are extinguished. They are traded for claims on the new enterprise. If the old equity holders participate in the new organization, it is usually because the creditors have consented to such participation.

Such a sale to the existing claimants is by no means the only conceivable disposition of the firm. One could imagine a regime under which the firm is auctioned off to the highest bidder. The winner of the auction then decides whether or not to keep the business running and whether current management should remain in charge. Another possibility would be to have default on a loan obligation wipe out existing equity, and make the lowest class of creditors the firm's new equity holders.[123] Or it simply may be the case that the reorganization game is not worth the candle; firms left to state law may do a better job disposing of their assets than does a bankruptcy court.[124] Accepting any of these arguments would doom the traditional justification for the existence of Chapter 11. Rather than endorsing any of these proposals, this Article merely seeks to show that it is possible that some firms, given the choice, would not contract for unlimited access to Chapter 11. To this end, the Article compares Chapter 11 to the oldest proffered alternative, an auction regime. I choose this alternative because it is the one to which the defenders of Chapter 11 have had the most opportunity to respond.

To justify maintaining Chapter 11 as opposed to an auction regime, one must explain why the firm's shareholders would offer potential lenders a contract that provided for this hypothetical sale[125] rather than a real

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121. *See* Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 777 (1988) (taking as a given the existence of corporate reorganizations, but suggesting a new "method of dividing the reorganization pie" wherein the participants receive a percentage of the reorganized company); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 530 (1983) (arguing that Chapter 11 is "slow, costly, and often unpredictable" and suggesting replacing the current method of firm valuation with a valuation method that includes selling 10% of the firm on the market to get a valuation of the firm's price).

122. Tom Jackson first introduced the notion of Chapter 11 as a hypothetical sale. *See* Note, *Giving Substance to the Bonus Rule in Corporate Reorganizations: The Investment Value Doctrine Analogy*, 84 YALE L.J. 932, 943-46 (1975).

123. *See* Bradley & Rosenzweig, *supra* note 3; Adler, *supra* note 3.

124. *See* Bowers, *supra* note 3.

125. *See* Baird, *supra* note 2, at 139 ("The difference between a [Chapter 7] liquidation and a

one.[126] Chapter 11 cannot be justified in the abstract; it must be compared to the available alternatives. In a world where many firms, both large and small, are sold to the public, it is unclear that a sale to the firm's extant investors is necessary to ensure that the firm remains intact. Thus, the costs of the hypothetical sale must be compared with its benefits.

The costs in the hypothetical sale can be quite high. The first cost is that the equity holders are given procedural protections that they can use to "buy" a spot in the reorganized firm. For example, equity holders have the exclusive right to propose a plan of reorganization for the first 120 days after the petition is filed.[127] Moreover, this exclusivity period can be, and often is, extended by the bankruptcy court.[128] Equity holders also have the right to demand a valuation of the firm.[129] Such a procedure can be a costly undertaking. In addition, the price that ultimately is set is not a market price; rather, it is a price set by the bankruptcy court.[130] Given this potential to increase the costs of a reorganization proceeding, equity holders may be able to trade these protections for a stake in the reorganized enterprise even though the firm's creditors are not being paid in full. Thus, the Code skews the reorganization process toward a sale to existing creditors based upon a judicial guess of market prices and a buyout of procedural rights as opposed to a sale based on market prices themselves.

Chapter 11 is costly for another reason: in many cases, the decision whether to terminate a business or keep it going will be clear;[131] how-

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[Chapter 11] reorganization is that the first involves an actual sale of all the assets of a business to a third-party buyer and the second involves a hypothetical one.").

126. Baird cast his argument in terms of why all of the investors of the firm would agree to this term. *See id.* at 131 ("Bankruptcy law prevents a costly and destructive race to the firm's assets by offering a collective proceeding that freezes the rights of all investors in a firm, values them, and then distributes these assets according to the priority scheme that the parties agreed would be used in the event that such a day of reckoning should come about."). As shown in Part I, this misconceives the effect of the bankruptcy term. *See supra* Part I. I have recast Baird's argument to comport with the observations made in Part I.

127. 11 U.S.C. § 1121(b) (1988); *see supra* text accompanying note 82.

128. 11 U.S.C. § 1121(d) (1988); *see supra* notes 83-84 and accompanying text.

129. *See* 11 U.S.C. § 1129(b)(2)(C) (1988); Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133, 148-49 (1979).

130. Those in control of the firm often have the ability to file bankruptcy in a number of different bankruptcy courts, and their ultimate choice may be driven by the court's reputation as being a "debtors'" court. *See* 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, 30 ("We suspect that some cases were filed in New York in anticipation of rulings that would have been reached by the bankruptcy court in the city of the company's physical location if the case had been filed there.").

131. For example, despite the fact that Johns-Manville was insolvent, few people thought that the company should be liquidated in a piecemeal fashion. Rather, the main disagreement was whether or not Johns-Manville had filed its petition in "good faith." *See* Daniel J. Tyukody, Jr., Comment, *Good Faith Inquiries Under the Bankruptcy Code: Treating the Symptom, Not the Cause*, 52 U. CHI. L. REV.

ever, in other cases it may be unclear whether the business should continue. In an auction regime, the decision whether or not the business should continue depends on whether new investors are willing to pay more for the enterprise as a whole than they will pay for its assets separately. In a Chapter 11 proceeding, the decision is made by current investors, some of whom obviously have a bias in favor of continuation. The creditor who sells supplies to the company and the equity holders who would be cashed out if the assets were sold for cash undoubtedly favor continuation even if the firm should be closed. Faced with this state of affairs, those who would otherwise be cashed out may seek to prolong the bankruptcy proceeding.[132] Such delaying efforts not only ensure that if an upswing in the firm occurs, they can profit from it, but they also allow these claimants to threaten to keep the firm in bankruptcy court and waste the firm's assets. Faced with such a threat, the creditors may find it advantageous to agree to a reorganization even though a liquidation would maximize the value of the assets.

One may be tempted to think that such redistributions through reorganization proceedings favor equity holders. As we saw in Part I, they do not. Creditors are aware of bankruptcy law's procedures when they decide to extend credit. To the extent that bankruptcy law works a redistribution from creditors to shareholders, creditors will price the risk.[133] The less that creditors expect to receive in the event that a firm ends up in a bankruptcy proceeding, the more they will charge for the loan in the first instance by increasing the interest rate. Looked at in these terms, bankruptcy redistribution is a type of insurance:[134] equity holders

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795, 817-19 (1985); Note, *The Manville Bankruptcy: Treating Mass Tort Claims in Chapter 11 Proceedings*, 96 HARV. L. REV. 1121, 1122-28 (1983); Comment, *Relief from Tort Liability Through Reorganization*, 131 U. PA. L. REV. 1227, 1238 (1983). For a description and analysis of the events leading to the Johns-Manville bankruptcy, see KEVIN J. DELANEY, STRATEGIC BANKRUPTCY ch. 3 (1992).

132. *See* Baird & Jackson, *Corporate Reorganizations*, *supra* note 18, at 107.

133. At times creditors may not price the risk because as interest rates rise, it may be that only riskier persons find it in their interest to borrow. *See* Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 395-99 (1981) (discussing the role of interest rates as screening devices for distinguishing between good and bad risks). Moreover, higher interest rates give borrowers a greater incentive to engage in risky behavior. *Id.* In such a situation, creditors may increase their return by rationing credit. *Id.* Thus, bankruptcy allocations to equity holders may decrease the supply of loans available in the first instance.

134. This analogy is also drawn in Jackson & Scott, *supra* note 2, at 168. "Reorganization insurance" differs from most insurance, however, in the amount that the insured party receives when the contingency covered by the insurance occurs. LoPucki and Whitford's study of publicly held corporations indicates that the payouts to shareholders ranged from 1% to 57.7% of the total amount paid to equity and unsecured creditors. LoPucki & Whitford, *supra* note 1, at 142. Most of the payouts clustered around 5%; only two exceeded 10%. *Id.* Other studies suggest an average payment to equity of about 8%. *See* Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy*, 45 J. FIN. 1457, 1458 (1990); Weiss, *supra* note 102, at 299. Most

are allowed to participate in the reorganized enterprise, thus ensuring them that they will not see their investment completely wiped out when the firm becomes insolvent. But like all types of insurance, it has a price: giving shareholders additional rights in bankruptcy makes it quite likely that all firms will have to pay more for credit, thus reducing the value of all shares.[135]

Many of these costs may be reduced by an auction regime. Under such a system, shareholders would have no power to threaten to hold up debt holders. The corresponding reduction in interest rate on the debt may convince shareholders that they would be better off under such a system.

To be sure, an auction regime is no panacea. Outside bidders may have difficulty valuing the firm because information regarding the future potential of the firm may be in the sole possession of management, and they may have incentives to keep this information private.[136] Moreover, if current managers do add value to the firm, the new owners must reach agreement with them.[137] Such negotiations may be expensive. Finally, the existence of the auction regime may lead managers to invest in projects that require their future participation, even if such investments are not the most profitable ones available.[138] Thus, there are real costs to an auction system.[139]

Nevertheless, the costs of Chapter 11 are quite high. For example, the costs incurred in the failed reorganization effort of Eastern Airlines ran in the hundreds of millions of dollars.[140] The upshot of the auction proposal is that one cannot simply assume that Chapter 11 is necessary to ensure that firms that should remain intact do so. The congressional

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insurance contracts held by private individuals contemplate a much higher payout.

135. This transfer leads to a loss in efficiency. As Lucian Bebchuk has shown, the increase in interest payments leads to an increase in the incentive of management to undertake riskier projects. *See* Lucian A. Bebchuk, The Ex Ante Moral Hazard Effects of Chapter 11 and Debt Renegotiation 7-8 (Apr. 5, 1991) (unpublished manuscript, on file with the *Texas Law Review*). Barry Adler makes a similar point. *See* Adler, *supra* note 18, at 473 (arguing that for a substantially solvent debtor the prospect of bankruptcy reallocation increases management's equity incentive to invest the debtor's assets in a risky project).

136. *See* Gertner & Picker, *supra* note 2 (manuscript at 11). At times, firms in financial distress may wish to create the impression that their prospects are poor. *See* Robert Gertner, Capital Structure Signalling in Distressed Debt Restructurings 22 (Feb. 1991) (unpublished mansucript, on file with the *Texas Law Review*).

137. *See* Gertner & Picker, *supra* note 2 (manuscript at 21) (explaining that, even during post-auction negotiations, new owners and manager/shareholders will wrangle over the revelation of privately held information).

138. *See* Lucian A. Bebchuk & Randal C. Picker, Bankruptcy Rules, Entrenchment, and Human Capital 9 (Aug. 6, 1992) (unpublished manuscript, on file with the *Texas Law Review*).

139. Indeed, Baird, though still an advocate of an auction regime, is more cautious in his support than he once was. *See* Douglas G. Baird, Revisiting Auctions in Chapter 11 (unpublished manuscript, on file with the *Texas Law Review*).

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

assumption driving the enactment of Chapter 11 thus can no longer be unquestionably accepted.

### C. *Alternative Justifications for Corporate Reorganization*

The responses to the suggestion that the costs of Chapter 11 may exceed its benefits have been varied. Some have offered arguments that try to justify Chapter 11 in its entirety, others have attempted to justify the availability of Chapter 11 only for a subset of firms, and still others have argued for eliminating the provision in its entirety.[141] This subpart both sketches the various situations that the current literature has examined, and offers criticism of these positions based on the insight that bankruptcy law is a term of the contract that the equity holders of the firm offer potential lenders.

1. *The Arguments for Full Availability of Chapter 11.*—Many scholars have argued for the continued full availability of Chapter 11 for all firms. To evaluate these arguments, it is helpful to consider the reorganization of a publicly held firm. The case for an actual sale of the firm is strongest when the corporation is publicly held. This argument is hard to refute. A market already exists for the firm's equity. Morcover, it is hard to imagine that most of the existing claimants to the firm are necessary to the reorganization effort. Even if one group, such as the managers, did provide value to the firm that could not be replaced in the market, there is little reason to suggest that a third-party buyer could not negotiate with such management to ensure their retention.[142] There is little reason to think that investors in a publicly held corporation would contract for the right to have a hypothetical sale to themselves if the firm becomes insolvent. Thus, the case for Chapter 11 is most difficult where the firm is publicly held.

Nevertheless, some scholars do argue that the current mandatory rule of unlimited access to Chapter 11 should be maintained. One line of attack has been aimed at the premise that lawmakers should compare the costs of current law to an auction regime. These types of arguments have taken a number of forms. One argument holds that because equity is usually allowed to participate in a rcorganization, the parties' actual contract takes this possibility into account.[143] Thus, not allowing firms to file for Chapter 11 would work a redistribution from the shareholders to the creditors. The point is undoubtedly true, from an ex post perspective. To the extent that current law is inefficient, creditors have priced this

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141. *See supra* notes 1-3 and accompanying text.

142. *See* Baird, *supra* note 2, at 140-42.

143. *See* LoPucki & Whitford, *supra* note 1, at 180.

cost into their contracts by charging higher interest rates. That the parties contract based on extant law cannot justify such law as a normative matter. Otherwise, all current law—bankruptcy or otherwise—would be justified regardless of its content because the parties would have considered it in structuring their transactions. The thrust of the analysis offered in Part I is that parties will in fact base their contracts on current law, and that the relevant questions are first whether the law should supply mandatory or default rules and second what the content of those rules should be. The observation that parties will react based on the answers to these questions in no way helps to answer these questions.

It is true, however, that changing current law may upset the expectation of parties that have contracted based on the previous law. Some shareholders may have been forced by current law to pay higher interest rates than they otherwise would have, but this does not imply that they should now be forced to forgo what they paid for with these higher interest rates—namely, the ability to force their participation in the reorganized enterprise. The menu scheme proposed in this Article therefore recognizes that some firms have already been operating under a mandatory rule. The change to a default-rule regime should be implemented so as not to force existing shareholders to surrender what they have bought.[144] Nevertheless, the change should be made. Protecting the expectations of current equity holders provides no justification for denying future equity holders the ability to offer lenders contracts containing the bankruptcy term that maximizes the equity holders' expected return.

A second argument for the continued existenee of Chapter 11 is a rejection of the inquiry into which regime would best serve the interests of the parties. In this vein, it has been argued that economic analysis "cannot identify what the most efficient rule governing distributions in bankruptcy would be."[145] The support offered for this assertion is the fact that one noted bankruptcy-law scholar, Thomas Jackson, has over the course of time modified his view of the absolute priority rule.[146] Jackson once considered the "fresh contribution" exception to the absolute priority rule insupportable,[147] though he now suggests that it may be efficient in theory.[148] Thus, the argument goes, economic analysis is indeterminate,

144. This concern is addressed in subpart III(B) of this Article.

145. *See* LoPucki & Whitford, *supra* note 1, at 183.

146. *Id.* at 182.

147. *See* Baird & Jackson, *Bargaining After the Fall, supra* note 18, at 754-58 (arguing that the fresh contribution rule is inconsistent with the parties' initial bargain and that the parties ought to be able to renegotiate a new bargain).

148. *See* Jackson & Scott, *supra* note 2, at 194-97. In the end, Jackson and Scott do not endorse the fresh contribution rule in practice because of the difficulty in implementing the rule. *See id.* at 200-02.

and cannot be used as a basis for jettisoning current law. There are two flaws with this argument. The first is that the example does not support the conclusion. Jackson's earlier work assumed that a firm's creditors would not agree to share common business risks with the debtor;[149] his more recent effort relaxed that assumption.[150] Such progression from models with many restrictive assumptions to more complex models is common. It is not evidence that the mode of analysis is somehow flawed, or that it is not possible to determine whether one rule may be more efficient than another. If one wants to dispute a conclusion reached through the aid of economics, one should be forced to offer some reason for believing that the conclusion is wrong rather than simply disparaging its evolution.

The second problem with the rejection of economic analysis is that it falls into the error of assuming that bankruptcy law is a mandatory rule. It may be the case that no one rule exists that all shareholders would find optimal in every situation; specifically, we may not be able to conclude on an a priori basis whether shareholders would decide to pay a higher rate of interest in exchange for the ability to receive a piece of the reorganized firm. It may be that there is some reason why some shareholders would prefer the current regime. Thus, economic analysis might not tell us what the optimal rule is for every firm. This is not an indictment of economic analysis. Rather, this heterogeneity of preferences is the standard justification for default rules. If in fact the optimal bankruptcy term is different for different types of firms, this is a condemnation, not an endorsement, of current law.

A third argument offered to justify extant law is the belief that the market incorrectly values reorganized enterprises. For example, LoPucki and Whitford assert that "[a]ny valuation of a corporation undergoing reorganization . . . is only approximate."[151] It is unclear what they mean by this statement. They may mean that the price the market assigns to a company is wrong. Such an assertion would make little sense. It is hard to see what is meant by the "value" of a company apart from what someone is willing to pay for it. Alternatively, they may mean that at times companies that have low market values while in bankruptcy later have higher market values. To be sure, stock prices often go up. But by the same token, stock prices often go down. The price of a firm that the

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149. *See* JACKSON, LOGIC AND LIMITS, *supra* note 7, at 11-17; *see also* Jackson, *Creditors' Bargain*, *supra* note 7, at 864-68 (arguing that creditor agreements capable of preserving the debtor's value as a going concern, while possible, would not be very likely in many cases).

150. *See* Jackson & Scott, *supra* note 2, at 164 (arguing that when precautionary actions are cost-beneficial, all parties will gain from an agreed upon risk-control strategy that would assign the entire risk of contingencies to the group that is best able to influence the amount of risk).

151. LoPucki & Whitford, *supra* note 1, at 189.

market sets is only a guess at the firm's future value. To the extent that market errors are not systematically biased one way or the other, equity holders should be indifferent to such variations.

Perhaps LoPucki and Whitford's claim regarding the market's valuation asserts that the market is systematically biased against financially distressed firms.[152] One could question whether this is so. Not only are no studies or explanations offered for this proposition, but is hard to imagine that such underpricing would be a constant feature of the market. Once the fact that the market undervalued financially distressed firms was publicized, one would think that savvy investors would bid up the shares of these companies to competitive levels. Moreover, even assuming that the market undervalues distressed companies, this fact in and of itself cannot justify a rejection of market valuations. The question is not whether the market is perfect; the question is whether the market is better at pricing companies than a bankruptcy judge. No reason is offered to assume that the judge is the better of the two.[153]

When arguing for Chapter 11's nonmarket valuation of the firm, one might be tempted to contend that Chapter 11 is akin to the appraisal remedy commonly found in corporate law. Corporate law at times allows a shareholder dissenting from a takeover to reject the offered price—which is in essence the market price—and insist instead on a judicially determined "fair" price.[154] There are two problems with this analogy. First, many states do not allow appraisal where the firm is publicly traded,[155] presumably on the theory that the market is a superior indicator of the value of the firm than a judge. Thus, the analogy to Chapter 11 may not be persuasive. Second, and more importantly, if the appraisal remedy is to serve as a justification for Chapter 11, one must validate it in the first instance, but many commentators have attacked the appraisal remedy as a method of valuation.[156] However, it has been argued that the appraisal

152. Such an assertion ignores the fact that the firm as sold would not be financially distressed. The point of a Chapter 7 sale is to sell the firm free of its existing debt. Thus, the claim really should be that the market cannot value a debt-free firm.

153. LoPucki and Whitford also note that often no market exists for shares of a publicly held company immediately before bankruptcy. LoPucki & Whitford, *supra* note 1, at 189 n.166. This should not be surprising; if in fact the firm is insolvent, the stock may well be worthless. However, when the firm is offered on the market without its current liabilities, there is no reason to expect that the shares will not trade.

154. REVISED MODEL BUSINESS CORP. ACT §§ 13.28, 13.30 (1984).

155. *See* Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 844 (1984) ("Implicitly, the wisdom of relying exclusively on market value to determine fair value has been recognized by . . . the . . . ststes that currently exclude from an appraisal those dissenters whose shares are listed on a national securities exchange . . . .").

156. *See* ROBERT C. CLARK, CORPORATE LAW 447-48 (1986); David Cohen, Comment, *Valuation in the Context of Share Appraisal*, 34 EMORY L.J. 117, 145-46 (1985) (attacking the appraisal remedy as a method of valuation because the true goal of modern valuation techniques is to ascertain the market

remedy can be justified by a downward-sloping demand curve.[157] In such a situation, the market price does not reflect the value that all the investors place on the stock; rather, it only indicates the value of the stock to the marginal investor. While such a situation means that the market price may not reflect the value that all investors place on their stock, this raises a problem; namely, what the "value" of the firm is.[158] Given these problems, the existence of an appraisal remedy in corporate law cannot justify the existence of Chapter 11.

Another argument that has been raised in favor of current law accepts the proposition that the comparison must be made between a hypothetical and a real sale, but instead rejects the accepted wisdom. Namely, it is suggested that, despite one's intuitions, it may be the case that a hypothetical sale is cheaper than an actual one.[159] This argument has two aspects. The first component is a reliance on empirical research that suggests that the costs of bankruptcy may be less than the costs of auctioning off the firm.[160] Buttressing this empirical argument is the additional argument that if creditors did not prefer the hypothetical sale, they should be able to secure legislation eliminating it.[161] The continued existence of Chapter 11 is thus invoked as an argument for its normative desirability.

Both parts of the argument fail. The reliance on current studies cannot withstand scrutiny. These studies undoubtedly understate the true costs of Chapter 11. They make no attempt to measure such bankruptcy costs as the business opportunities that the firm must forgo because its managers' attention is focused on the bankruptcy proceeding and the loss of customers that the firm incurs because of the uncertainty about its future.[162] Also, the argument compares the costs of a Chapter 11 proceeding of a publicly held company in terms of its value to the percentage of the value an investment bank requires to take a company public.[163] This argument compares apples and oranges. The pereentage used for the cost of bankruptcy involves large firms whereas the percentage used for the cost

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value of the asset).

157. *See* Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1286-95 (1990) (citing the downward-sloping demand curve as a justification for appraisal valuation while, at the same time, discussing the problems of arriving at a proper valuation).

158. *Id.* at 1289.

159. *See* Easterbrook, *supra* note 1, at 413.

160. *Id.* at 415 (citing Weiss, *supra* note 102).

161. *See id.* at 413 (noting that the Bankruptcy Code is what creditors wished it to be, and that there is not great demand for more auctions).

162. *See* Weiss, *supra* note 102, at 289. For a discussion of the indirect costs of bankruptcy, see Karen H. Wruck, *Financial Distress, Reorganization, and Organizational Efficiency*, 27 J. FIN. ECON. 419, 437-38 (1990).

163. *See* Easterbrook, *supra* note 1, at 415.

of an auction involves smaller firms.[164] Simply because an investment bank charges twenty percent of the deal to take a small company public does not imply that it would charge twenty percent to sell Johns-Manville. Conversely, one would think that if it cost Johns-Manville ten percent of its assets to go through Chapter 11, this does not mean that it would cost all companies ten percent. Thus, the comparison must be between how much it would cost to sell a company with how much it would cost to have the same company go through Chapter 11. To be sure, this does not yield a definite solution because the available data does not allow this comparison to be made. The empirical evidence thus fails to resolve the question of whether conducting a reorganization under Chapter 11 is cheaper than selling the firm on the market.

The second prong of the argument is just as problematic. The assertion that passing legislation would be easy is questionable. The inefficiency of the bankruptcy contract term is passed along to the equity holders. Equity holders, however, have an incentive only to seek a change in the legal rule before they invest in a firm. Once a firm has paid for the inefficiency in current law through a higher interest rate, the firm's equity holders have little incentive to change the law. Such a change would simply deprive the equity holders of the benefits they received in exchange for the higher rate. Any pressure for change would thus have to come from potential equity holders. It is highly unlikely, however, that such a diffuse and amorphous group would be able to act together to lobby for new legislation.[165] Indeed, the legislative process in corporate law is often thought to promote the interests of managers, who are a well-defined and concentrated group.[166] As discussed above, managers benefit from the current universal availability of Chapter 11.[167] Thus, the continued existence of Chapter 11 should not be treated as a signal of its efficiency.

There is a more important point to be made about all of these

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164. *See id.*

165. The problem of diffuse groups organizing to influence lawmakers is well known. *See* KAY L. SCHLOZMAN & JOHN T. TIERNEY, ORGANIZED INTERESTS AND AMERICAN DEMOCRACY 82-85 (1986) (discussing the fact that the interests of narrowly focussed groups with narrowly concentrated benefits and costs are more likely to be given representation than the interests of diffuse groups with distributed costs and benefits); Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371, 391 (1983) (mentioning that the special problems of heterogeneous groups in organizing to influence lawmskers include increased cost due to the difficulty of controlling free riding, the tendency of one group member to shirk his duties and impose the cost of producing pressure on the other group members). In the administrative-agency context, this same problem leads to agency capture. *See* Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1669, 1684-87 (1975).

166. *See* Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89, 90-92 (1990) (noting that recent trends in corporate law, including antitakeover statutes, tend to favor managers over other constituencies).

167. *See supra* text accompanying notes 77-79.

arguments in favor of retaining Chapter 11. None of them offers any reason why bankruptcy law should be a mandatory rather than a default rule. To the extent that one accepts any of the arguments offered, at most they show that the current version of Chapter 11 should be an option on the menu. Perhaps judges are more accurate than a market at valuing a firm; perhaps hypothetical sales are cheaper than real sales. If so, then equity holders would be willing to select the ability to file for Chapter 11 from the bankruptcy menu. The decision would be up to those whom the choice affects rather than academics or legislators.

There is, however, one argument which—if credited—might be taken as a justification for treating bankruptcy as a mandatory contractual term. This argument is that there is a public value to reorganizations. The crux of the argument is that Chapter 11 is a forum in which the various participants in the firm can express their diverse values. Bankruptcy proceedings in this view are a type of "group therapy."[168] Placing this argument in the context of the mandatory/default-rule choice, one could assert that bankruptcy law should be a mandatory rule because letting a firm select an option that did not allow for such "therapy" might impose a cost on persons not doing business with the firm.

There are at least three problems with this argument.[169] The first is its assumption that bankruptcy allows affected parties to express themselves. I have yet to meet a creditor or a worker who thinks that she is a better person because her firm went through Chapter 11. Indeed, to the extent that a Chapter 11 proceeding takes a long time to complete,[170] it probably increases the anxiety of those involved. Workers do not know if they will lose their jobs; creditors do not know whether they will be repaid. Uncertainty is normally viewed as a cost, not a benefit.

The second problem with the public-values approach is that even if one takes the argument at face value, if in fact the therapy is worth more than its cost, the firm would select that option in the first instance. If expression of values in a reorganization mattered, workers and creditors would prefer to deal with firms that, upon insolvency, would let them express themselves. To the extent that this expression is valuable, parties would pay for it. For example, I have known persons who are more than willing to pay higher premiums for health insurance that covers the cost of therapy. Similarly, the equity holders of a firm, having to compete for

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168. Korobkin, *supra* note 1, at 722.

169. For other criticisms of Korobkin's therapeutic notion of bankruptcy law, see Bowers, *supra* note 3, at 72-76.

170. In one study of 37 bankruptcy cases, the average length of a bankruptcy proceeding was 2.5 years, with a range from 8 months to over 8 years and a standard deviation of 1.4 years. Lawrence A. Weiss, *The Bankruptcy Code and Violations of Absolute Priority*, 4 CONTINENTAL BANK J. APPLIED CORP. FIN., Summer 1991, at 71, 72.

workers and for credit, would select the Chapter 11 option if these parties were in fact willing to reduce their payment demands in exchange for the possibility of expression when the firm encounters financial distress.

The final problem with the public-values argument is the most fundamental. The linchpin of the group-therapy analysis is the assertion that a corporation "has personality. . . . [I]t is, like an individual debtor, a moral, political, and social actor."[171] By attributing such characteristics to a corporation, it becomes easy to import values associated more frequently with individual persons into the process of corporate reorganization. The unsupported assertion that corporations are like individuals in the ways noted is difficult to accept. Most, if not all, of the corporate literature rejects analogizing a corporation to an actual human being.[172] Rather, corporations are viewed as a set of contracts among the various investors to the corporation.[173] Even those scholars who reject the contractual conception of the corporation do not argue that corporations are people too. To impart concerns normally associated with giving individual debtors a fresh start in life into the corporate reorganization context requires more than an *ipse dixit.*[174]

Much disagreement thus exists about the propriety of Chapter 11 for publicly held corporations. Two crucial points emerge. First, none of the arguments that have been offered for retaining extant law supply any basis for concluding that bankruptcy law should be a mandatory term of the

171. Korobkin, *supra* note 1, at 745.

172. *See, e.g.*, JACKSON, LOGIC AND LIMITS, *supra* note 7, at 4 ("To talk about the need of a corporation or other business entity to use bankruptcy in order to have a fresh start is to conflate a number of issues, none of which have anything to do with giving an honest but unlucky individual a second financial chance.").

173. The classic piece on this score is Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937). More recent work includes Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organizations*, 62 AM. ECON. REV. 777 (1972); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982); Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197 (1984). For an overview of the development of this theory, see Henry Butler, *The Contractual Theory of the Corporation*, GEO. MASON U. L. REV., Summer 1989, at 99, 101-06. For an excellent general discussion of the "corporate contract," see EASTERBROOK & FISCHEL, *supra* note 38, at 1-39.

174. Korobkin could have attempted to draw support from the corporate-law literature that attacks the contractual view of the corporation. *See, e.g.*, William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1526 (1989) (conceding the "legitimacy of the [contractual view's] approach to corporations" while at the same time arguing that this theory "becomes hard to accept either as an evolutionary climax or as an objectively correct edifice standing outside of time"); William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 464 (1989) (asserting that this "theory has mischaracterized these corporate contracts, making what amount to political assertions"). To do so, he would have to show that these alternate theories comport with his assertion that a corporation has human attributes.

contract between the firm and its creditors. At most, these arguments offer reasons suggesting that current law should be a selection on the menu. Second, none of the arguments suggest any impediment to the equity holders of the firm selecting the optimal bankruptcy term from among those offered.

2. *The Argument for Limited Availability of Chapter 11.*—The argument for a one-size-fits-all reorganization provision seems weak. At a minimum, it would appear that the equity holders of some public firms would, given the opportunity, offer debt contracts that provided for an auction of the firm upon insolvency rather than the laborious provisions of current law. Some bankruptcy scholars have argued that Chapter 11, or something like it, might be optimal for certain subsets of firms. While they thus might reject Chapter 11 as an across-the-board reorganization proceeding, they endorse its more limited availability.

Such availability, however, does not extend to all firms that are not publicly held. In some closely held firms, the equity holders may share many of the same attributes as equity holders in large, publicly held companies. Such persons may be risk-neutral and have no firm-specific assets.[175] In comparing the costs of a Chapter 11 proceeding to an auction regime, the main difference in this case from the case of the publicly held company is the lack of an established market for the firm's shares. This difference has a direct impact on the question of whether the investors, ex ante, would offer debt contracts providing for an auction or a hypothetical sale. The lack of an existing market increases the price of the auction. Markets create incentives both for firms to disclose and investors to discover information.[176] Taking a previously privately held company public requires a good deal of information dissemination; without an existing market, much of the necessary information regarding the firm's prospects is not known.

There is another cost to auctioning privately held firms as well. It may well be the case that the firm's current management would seek to join one of the groups seeking to buy the firm at the auction. In this situation, the managers would have an incentive to make the company appear to be worth as little as possible. Communicating the true value of the company would decrease their chance of becoming the successful bidders.[177]

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175. For example, an investment bank that finances a leveraged buyout may also receive some equity in the new firm. *See* Laurie P. Cohen, *Merrill Lynch Leads Wall Street's Buy-Out Business: Using Its Financial Clout, Firm Acts as a Principal in Transactions*, WALL ST. J., Aug. 5, 1987, at 6.

176. *See* EASTERBROOK & FISCHEL, *supra* note 38, at 288-90 (arguing that "worthwhile" projects will be fully disclosed to encourage investment and information about less attractive projects will be divulged so investors will not assume the worst).

177. The role of management in an auction regime is problematic. Allowing management to join

Whether investors prefer a market valuation as opposed to one established by a bankruptcy judge in this situation again depends on the relative costs. Here the question becomes whether it is costlier for outsiders to gain the information necessary to price the firm versus the cost of a hypothetical sale. In both situations, a third party will have to make a judgment as to the value of the firm. The difference is that of experience and cost. On the one hand, investment bankers such as Goldman, Sachs specialize in pricing firms; bankruptcy judges do not. Indeed, a bankruptcy judge is ultimately going to rely on the advice of experts. Moreover, the judge is going to rely on experts who, rather than having an incentive to get top dollar for the firm in real capital markets, are being paid by one side or another. On the other hand, a bankruptcy judge does not charge the parties for her services.[178] Even if investment bankers are called in as experts, one suspects that their fees would be lower than if they actually had to sell the company. Thus, the case for a judicial sale seems stronger, but by no means compelling, in the case of a privately held company than it is in the case of a publicly held company.

One argument that scholars use to justify the availability of Chapter 11 for this subset of firms is that of risk sharing.[179] The key to this line of analysis is the assumption that in a small, closely held firm, the owner/manager and perhaps some of the creditors may be risk-averse.[180] In such a situation the owner/manager and the firm's creditors may agree to

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one of the bidding groups raises the problem of "winner's curse." "Winner's curse" refers to a situation where a potential bidder might fear winning the auction. Such a potential bidder would ask herself wby she should be willing to pay more than the bidding group with current management, which presumably has the best information as to the firm's value. Thus, allowing management to join in a bid might reduce the number of bidders in auctions where no bidder has a reason for valuing the firm higher than other bidders. In other words, winner's curse is a problem in "common-value" auctions as opposed to "private-value" auctions. For a general discussion of the winner's-curse problem, see Nikhil P. Varaiya, *The "Winner's Curse" Hypothesis and Corporate Takeovers*, 9 MANAGERIAL & DECISION ECON. 209 (1988) (outlining the theory of the winner's curse and providing empirical results to support it); *cf.* James C. Cox & R. Mark Isaac, *In Search of the Winner's Curse*, 22 ECON. INQUIRY 579 (1984) (arguing that optimal *ex ante* bidders will never suffer from a winner's curse in an auction where only the winning bid is announced).

178. This is a point Baird overlooks in his analysis. While it may be socially optimal for investment bankers to sell the firm, the partiea do not besr the cost when the judge conducts the sale. Of course, nothing precludes the law from requiring that the parties pay for the judge's services.

179. *See* Jackson & Scott, *supra* note 2, at 164-69 (analyzing bankruptcy as one way to share the risks of a "common disaster"). For criticisms of the use of risk sharing as justifying current law, sce Adler, *supra* note 18, at 463-88 (arguing that the costs of reallocating risk through bankruptcy outweigh the benefits); Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319, 329-31 (1991) (identifying flaws inherent in the Jackson & Scott thesis and concluding that its "exploration of risk aversion fails to give any justification for existing law"); Mark J. Roe, *Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics*, 75 VA. L. REV. 219, 239 (1989) (arguing that creditors may not want to share certain risks even if they could overcome coordination problems).

180. *See* Jackson & Scott, *supra* note 2, at 164-69.

share common risks among themselves, rather than having the residual claimant bear all of these risks in the first instance. Under the analysis of the first Part of this Article, the owner/manager would agree to pay a higher interest rate in exchange for an assurance that she would not be cashed out if the firm experienced financial difficulties that were not of her own making.

The risk-sharing argument begins with the recognition that, as a general matter, there are two different types of risks. There are endogenous risks over which a certain party will have control, and there are exogenous risks over which neither the equity holders nor any of the creditors will have control.[181] In economic terms, these latter risks are really economic conditions that, while affecting the payoff of certain actions, are not within the control of the parties. In a world where all risks could be identified and classified, the parties would contract that an endogenous risk would be borne by the party who controls that risk. For example, the risk that an employee will steal company funds is an endogenous risk—the hiring manager can control this risk by screening her employees carefully and by establishing accounting systems. It is therefore likely that the parties would contract for the manager to bear the risk of such defalcations. Other risks, however, such as an economic downturn, are out of the control of any of the parties. Here the efficient contract may share the risk of failure due to such a downturn.[182]

The motivation for sharing common risks runs as follows. Risk-averse investors, by definition, will at some point be willing to take a lower expected return in exchange for less variance in the possible return.[183] In a bankruptcy regime that has an absolute priority rule mandating that equity holders may be paid only after all other investors have been paid in full, exogenous risks increase the variance in the returns that the equity holders can expect. Equity holders bear the full risk, up to the value of their investment. If the investors cannot diversify risk by investing in a number of firms, they are better off by paying creditors to share some of the risk. While such payments may decrease the equity holders' expected return (the creditors are of course going to charge for bearing this added risk), they reduce the variance in the expected return. Such a contract is a form of insurance. The equity holder makes a payment to the senior creditor in the form of a higher interest rate, and the equity holder in exchange receives assurances that she will not be cashed out if the firm becomes insolvent because of an exogenous risk.

The manager/equity holder may have another incentive to share the

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181. *See id.* at 164.

182. *Id.* at 165-66.

183. Indeed, it is difficult to explain the notion of insurance without the concept of risk aversion.

exogenous risks of business failure. Such persons often make nonpecuniary investments in the firm. The stock example here is the owner who says, "My business is my life." Those who make such nonpecuniary investments would be willing to pay a higher rate of interest in exchange for assurance that they would not be cashed out if the firm failed. Only by such payments can they protect their investments. Viewed in this light, the ability to participate in the reorganization is a form of prepaid insurance. The reason we do not see actual contracts agreeing to share risks, according to those who advocate risk sharing, is that no creditor would agree to such insurance unless all other creditors were bound. Yet the creditor would have no guarantee that the debtor would force all other creditors to include such a term. In other words, there is a collective-action problem.[184]

While risk aversion thus suggests that investors may wish to share risks, it is difficult to justify the contours of current law based on risk sharing.[185] The proponents of risk sharing argue, however, that the *Timbers* rule, which denies compensation to undersecured creditors for the delay of payment that bankruptcy imposes on them,[186] may be justified as a type of risk sharing.[187] As a practical matter, it would be difficult for a court to decide whether a business failure was caused by an endogenous or exogenous risk.[188] Thus, denying protection against delay in all cases may be an appropriate response to the problem of risk aversion.[189]

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184. Jackson & Scott, *supra* note 2, at 176.

185. *See id.* at 199-202 (arguing that the uncertainty in the current law and the inability to screen cases properly causes claimants to share more risks than they would have in the original creditors' bargain). Such caution is not surprising. As Barry Adler has stated, "[b]ankruptcy's reallocative provisions would generate beneficial risk[]sharing . . . only by mere chance." Adler, *supra* note 18, at 483.

186. *See supra* text accompanying notes 71-72.

187. Jackson & Scott, *supra* note 2, at 188-89.

188. *Id.* at 189. Kahn and Huberman have shown that a clause that places all the risk initially on the borrower, with the possibility of later renegotiation, may be an optimal response to this problem. Gur Huberman & Charles Kahn, *Limited Contract Enforcement and Strategic Renegotiation*, 78 AM. ECON. REV. 471, 473-75 (1988) [hereinafter Huberman & Kahn, *Limited Contract Enforcement*]; *see also* Charles Kahn & Gur Huberman, *Default, Foreclosure, and Strategic Renegotiation*, LAW & CONTEMP. PROBS., Winter 1989, at 49, 54-57. If the reason for the firm's default is observable by the lender, but not verifiable to a court, the borrower would have the incentive to use appropriate efforts in running the firm. This being the case, all defaults would be renegotiated because they were caused by economic conditions over which the management had no control rather than by shirking on the part of management. One could justify a limited version of Chapter 11 that stayed only general creditors as a way to ensure that general creditors did not impede the renegotiation process. Indeed, a recent study suggests that the less general creditors are owed, the more likely it is that a firm faced with financial difficulties will restructure its debt without filing a bankruptcy petition. *See* Gilson et al., *supra* note 13, at 316. For an analysis of the effects of such a selective stay, see Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311, 348 (1991).

189. Jackson & Scott, *supra* note 2, at 189-90.

One may question justifying the *Timbers* rule through risk sharing on a number of points. For example, it is unclear whether the money denied the secured creditor flows to the risk-averse equity holder. Often it may go to junior creditors who are not necessarily risk-averse.[190] Even if it does go to the risk-averse equity holders, because the transfer is made regardless of the type of risk involved, equity holders now have too little of an incentive to guard against endogenous risks.[191] This is the standard moral-hazard problem: when people do not bear the full eonsequences of their actions, they have an incentive to use less than the appropriate level of precaution.[192] Whether the gains from sharing exogenous risks exceed the loss from lessening the incentives of the equity holders to guard against endogenous risks is a question that simply cannot be answered in the abstract.[193]

The advocates of the risk-sharing explanation for Chapter 11 also suggest that the willingness of some eourts to find an unwritten fresh contribution exception to the absolute priority rule may be a result of risk sharing.[194] The difficulty with justifying the fresh contribution exception on the basis of risk sharing, according to the theory's proponents, is the problem of implementation. One implementation problem, already alluded to, is determining whether the insolvency resulted from unfavorable economic conditions or from shirking on the part of the owner/manager. This is a problem of screening.[195] Courts cannot readily identify the cause of the firm's financial distress. This being the case, they would sometimes deny participaton by the managers even though their efforts did not contribute to the firm's financial problems, and they would sometimes allow participation even though the managers in fact were responsible for the firm's decline. In addition to this problem, the inroads on the absolute priority rule, unlike the *Timbers* rule, are ad hoc and thus vary greatly even in those cases where it is invoked. Parties simply do not know what percentage of the reorganized firm the court will allow the equity holders to retain, or the price the court will approve for the new stake in the enterprise. This added uncertainty makes it unlikely that the parties would contract around the absolute priority rule for the nebulous fresh contribu-

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190. Rasmussen, *supra* note 179, at 329.

191. *Cf.* Adler, *supra* note 18, at 473-74 (noting that bankruptcy rules can create "perverse risk incentives" for management).

192. For a lucid discussion of the moral-hazard problem, see KREPS, *supra* note 49, at 577.

193. For other criticisms of this risk-sharing justification, see Adler, *supra* note 18, at 463-88 (arguing that bankruptcy reallocation costs exceed its benefits); Rasmussen, *supra* note 179, at 329-31 (concluding that Jackson and Scott's explanation of risk aversion "fails to give any justification for existing law"); Roe, *supra* note 179, at 220-28 (arguing that risks resulting from creditor misfeasance should not be shared).

194. Jackson & Scott, *supra* note 2, at 196.

195. *See id.* at 200-02 (discussing the "screening costs of bankruptcy rules").

tion exception that currently exists.[196]

Risk sharing thus does not justify the contours of current reorganization law even for those firms in which the owners might be risk-averse and have made nonpecuniary investments. Indeed, it has been argued that risk sharing cannot justify current law at all.[197] Nevertheless, the general insight offered by risk sharing—that certain equity holders may wish to pay a higher rate of interest for an agreement on the part of creditors to share certain risks—does have an intuitive appeal. Many persons are risk-averse, and they do make nonpecuniary investments. The benefit to them of being assured of a place in the reorganized firm may be worth its cost. For such persons, it may be optimal to select some modified form of Chapter 11 from the bankruptcy menu.

A final argument suggesting that some type of reorganization proceeding may be appropriate in certain instances revolves around the need to capture firm-specific skills. By and large, those who challenge the existence of Chapter 11 agree that the case for Chapter 11 is the strongest where the equity holders provide unique contributions to the enterprise. In a large corporation it is unlikely that the equity holders contribute any special value to the enterprise: IBM is worth the same whether I own some of its stock or whether I sell the stock and it is bought by someone else. In the case of a small, closely held corporation, however, it is quite conceivable that various equity holders provide value to the firm. For example, consider the case of a small furniture maker that runs into financial difficulties because of a recession in the local economy. Much of the value of the firm may lie in the designing ability of the owner/manager. In other words, the manager has firm-specific skills.[198]

The other claimants do not have a right to insist on the manager's continued presence in the reorganized firm.[199] Thus, if the firm becomes insolvent, the creditors of the firm must convince the manager to remain in charge. They cannot force her to stay with the firm over her objections. However, to say that one claimant provides firm-specific skills does not mandate a hypothetical sale to the existing creditors; rather, it simply means that the buyers of the firm have to reach a deal with that manager. The question that must be addressed is whether it is any harder for a third

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196. *See* Mark J. Roe, *Bankruptcy and Mass Tort*, 84 COLUM. L. REV. 846, 852 n.17 (1984).

197. *See* Adler, *supra* note 18, at 489 (characterizing compulsory risk sharing as "crude and costly").

198. *See* Ronald J. Gilson & Robert H. Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 STAN. L. REV. 313, 354-55 (1985) (distinguishing between human capital that can be readily transferred to a new firm and human capital that is firm-specific).

199. *See* Baird & Jackson, *Bargaining After the Fall*, *supra* note 18, at 751 (noting that the manager has the power, if not the right, to refuse to work for the firm).

party to reach such a deal than it is for existing creditors. Such a party must negotiate with the manager for her to stay. There is no reason to think that such negotiations would be ineffective. Thus, the presence of firm-specific skills on the part of one party cannot in and of itself justify the continued existence of Chapter 11.

However, it may be the case that there are a number of parties, such as a manager and various creditors, who provide unique value to the firm. If there were an actual sale of the firm, potential buyers would have to negotiate individually with these providers of firm-specific skills to continue their contributions to the firm. Such bargaining would be costly and might also end in failure. Thus, in this situation, the investors ex ante may have contracted for a judicial sale rather than an actual one.[200] As with many of the situations described thus far, the ultimate answer depends on the relative costs and benefits of such proceedings, and these costs and benefits are difficult, if not impossible, to measure in the abstract.

3. *The Argument for Eliminating Chapter 11.*—It has recently been suggested that Chapter 11 should be repealed and replaeed with a regime of contingent equity.[201] In a world of "contingent equity," all debt contracts contain a promise that if the firm defaults on its payment obligations, the current equity class is eliminated and the most junior debt holders become the new equity class.[202] If the debtor defaulted on an obligation to a class more senior than the new equity class, the new equity class must itself cure the default or it will also be eliminated and replaced by the next junior debt holders. The process is repeated until there is no longer either an outstanding default or an existing debt.[203]

The motivation for moving to a contingent-equity regime is the high cost of current rcorganization law.[204] Bradley and Rosenzweig, examining the evidence generated since the enactment of the current Chapter 11, conclude that, at least in the case of publicly traded corporations, the current law results in a transfer of value from bondholders and shareholders to the firm's management.[205] Thus, they conclude that

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200. Jackson and Scott also endorse the use of Chapter 11 in this situation. *See* Jackson & Scott, *supra* note 2, at 191.

201. *See* Bradley & Rosenzweig, *supra* note 3, at 1079-86. Barry Adler has made essentially the same proposal, labelling it "chameleon equity" as opposed to "contingent equity." *See* Adler, *supra* note 3 (manuscript at 18-28).

202. *See* Bradley & Rosenzweig, *supra* note 3, at 1082.

203. *Id.* at 1083-84.

204. *Id.* at 1088-89.

205. *Id.* at 1076-77 ("Filing a Chapter 11 petition . . . permit[s] management to extract wealth from the firm's various security holders."). The conclusion that the Code transfers wealth from stockholders to managers is based on a comparison to the pre-Code law. *See id.* at 1077 n.80. It does not imply that the stockholders should be entitled to any of the value of the firm.

the costs of Chapter 11 are quite high, and that contingent equity should be substituted in its place.[206] This new system would be cheaper than current law in that it would remove all costs associated with court-supervised reorganization.

To be sure, contingent equity is not without costs. There are three costs under such a system. First, there is the cost of writing debt contracts, which define default as an event that results in the transfer of ownership of the firm. In a contingent-equity regime, default cashes out the current equity holders. One would thus expect that equity holders would be more careful in defining events of default than they are under current law. Second, there is the cost to the new equity class of negotiating with managers to stay on board. Each time a change in ownership occurs, the new owners have to decide whether they want to keep the old management, and, if they do, reach an agreement with them to remain. Third, there is the cost of reducing some of the benefit that is associated with secured credit. Current explanations for sccured credit focus on the secured creditor's ability to monitor the spccific assets in which it holds a security interest.[207] Contingent equity is tantamount to giving the secured creditor a security interest in the entire firm rather than in the specific assets that it intends to monitor. Despite these nontrivial eosts, it may well be that contingent equity is on the whole a more efficient system than current law.

Even if it is more efficient, it does not mean that it should be imposed by Congress. The fiaw in this proposal is the same as in other arguments concerning reorganization law: it assumes that bankruptcy must be a mandatory rule. The argument is that, on balance, the costs of Chapter 11 outweigh those associated with contingent equity. While this may be true for some firms, it might not be true for all. Indeed, the proponents of contingent equity do not even claim that it is so. They only assert that, as a general matter, contingent equity is superior to current law. If this is true, then some firms would, if given the chance, prefer to be contingent-equity firms.

Finally, it has been argued that federal bankruptcy law should be eliminated, leaving only state law to handle the problem of a firm in financial distress.[208] Such a change would increase efficiency because it would force the firm to dispose of its assets, and the firm is the most efficient disposer of these assets. While this may or may not be true as a general matter, it at most suggests that a firm should be able to opt for no

206. *See id.* at 1088-89.

207. *See generally* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986).

208. *See* Bowers, *supra* note 3, at 51-57 (arguing that state-law systems of distribution maximize the gains from collecting debt in bankruptcy).

federal bankruptcy law if it so chooses.

At most, the current theories of reorganization offer scenarios under which the equity holders of some firms might find it preferable to opt for a reorganization proceeding akin to Chapter 11. The heterogeneity in firms confirms the wisdom of treating bankruptcy law as a default rule. Because the current scholars have failed to appreciate the fact that bankruptcy law is nothing more than a contract term, they have been hesitant to suggest a way to handle the problems inherent in having different types of firms.[209] The next Part of this Article, which creates a menu of bankruptcy-law selections, overcomes this problem and allows those in the best position to make the decision to select which bankruptcy term maximizes their expected value.

## III. The Menu

The existing theories of corporate reorganization do not offer any persuasive arguments for treating bankruptcy law as a mandatory rule. At most, they offer some reasons why certain types of debtors would prefer some version of Chapter 11 over a sale of the firm under a modified version of Chapter 7, and why some might prefer no eourt-supervised bankruptcy proceedings at all. This Part of the Article draws on this and other work to craft the selections that should be on a congressionally enacted menu. This Part also considers limitations on selection, which are necessary to guard against strategic behavior.

### A. *The Selections on the Menu*

Drafting a menu of bankruptcy options requires a balance between specifying the optimal rule for each different type of firm and the information costs associated with learning the contours of a number of different bankruptcy terms.[210] At some point the marginal gain of another option is outweighed by the cost of learning the details of that option. Sensitive to this concern, the menu devised below incorporates large parts of existing law, thereby reducing the costs of learning an entirely new set of rules, and provides only those options that a reasonable number of firms are likely to select.

The first alternative on the bankruptcy menu would enable the firm

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209. For example, although Baird recognizes that Chapter 11 may not be optimal in certain instances, he suggests that the need to interpret Chapter 11 provisions sensibly is more pressing than the need to undertake reform. *See* Baird, *supra* note 2, at 147.

210. This is the same problem that often arises in the consumer context. *See* Howard Beales et al., *The Efficient Regulation of Consumer Information*, 24 J.L. & ECON. 491, 524-26 (1981) (discussing the balance between increasing the amount of information provided to a consumer and the comprehensibility and cost of providing such information).

to commit to never filing a petition under federal bankruptcy law. This would be the "no-bankruptcy" option. Under this option the firm could choose either to rely solely on the state-law debt-collection system or to become a contingent-equity firm. However, no federal bankruptcy-law proceeding would be available.

Equity holders may find it in their interest to select this no-bankruptcy option where the firm is comprised of a single asset, the equity holders contribute no firm-specific value, and there is a financing secured creditor whose claim exceeds the asset's value.[211] In this situation, creditors might offer the firm a lower interest rate than they would if the firm could choose to file either Chapter 11 or Chapter 7. A lower interest rate might be available because none of the potential gains from a bankruptcy proceeding exist under these facts: there is no going-concern value to be preserved in these single-asset cases because the only issue involved is the proper deployment of that asset. There is no reason to think that this deployment decision will be affected by whether the asset is held by the current equity holders of the firm, or by a third party that receives the asset at a foreclosure sale. Additionally, given that upon insolvency the financing creditor receives the proceeds of the collateral, there is no need to worry about pro rata sharing. Thus, federal bankruptcy law would in no way improve the return to creditors relative to state law.[212]

Moreover, it may be the case that adding the ability to file for federal bankruptcy decreases the return to creditors in this situation, thus increasing the interest rate that the lender charges the firm. Federal bankruptcy law stays all nonbankruptcy collection efforts.[213] The practical effect of this stay is that equity holders can stall foreclosure actions by filing for bankruptcy.[214] This delay gives the equity holders the opportunity to hope that the market value of the asset will rise. The cost of this potential delaying tactic will be reflected in the interest rate the lender charges the firm. Moreover, under current law, it is impossible for the borrower to credibly commit that it will not file for bankruptcy. Even

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211. Such firms often find themselves in bankruptcy, usually to delay state foreclosure proceedings. *See, e.g.*, North Cent. Dev. Co. v. Landmark Capital Co. (*In re* Landmark Capital Co.), 27 B.R. 273 (Bankr. D. Ariz. 1983); Yaffe v. Andrews (*In re* Andrews), 17 B.R. 515 (Bankr. C.D. Cal. 1982); Ketchickan Lodge No. 1429, Benevolent & Protective Order of Elks v. Hewitt (*In re* Hewitt), 16 B.R. 973 (Bankr. D. Alaska 1982); Provident Bank v. BBT (*In re* BBT), 11 B.R. 224 (Bankr. D. Nev. 1981).

212. It may be the case that many firms would choose this option. *See* Bowers, *supra* note 3, at 61 (arguing that as a general matter nonbankruptcy collection law is more efficient than bankruptcy collection law).

213. 11 U.S.C. § 362 (1988 & Supp. II 1990).

214. Filings shortly before foreclosure are common. *See, e.g.*, Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 200 (1988).

though forgoing the future opportunity to file a bankruptcy petition might be efficient at the time of the loan, once the foreclosure proceeding begins, it is in the interest of the borrower to delay the foreclosure through the institution of a bankruptcy proceeding. Because current law voids contracts promising not to file for bankruptcy, the borrower can file a petition regardless of its previous commitment.[215] Switching to a menu system solves the problem. Allowing the firm to select a no-bankruptcy option allows the firm to credibly commit to its lender that it will not impede the lender's access to the collateral beyond the time required for foreclosure under state law.

A limited partnership whose sole asset is an apartment building, the construction of which is financed by a loan from a bank, might be the type of firm that would select the no-bankruptcy option.[216] The investors will take no part in the running of the apartment building. Their sole concern is receiving the lowest interest rate possible. The lower the interest rate, the greater the likelihood that the owners of the building will be able to service the debt load and have profits left over. State law promises the financing bank that if the partnership is not able to make its payments on the loan, the bank can foreclose on the property. The bank can then either let a third party buy the building at the foreclosure sale, or it can buy the property itself. In either event, state law assures the bank that it can obtain the value of its collateral within a certain period of time after the loan goes into default. There seems little role for any form of federal bankruptcy law to play in such a situation. At most, such law would simply increase the maximum time that it would take the bank to gain control of the building, thereby increasing the interest rate that the lender would charge in the first instance. Selecting the no-bankruptcy option from the menu in this situation would guarantee the equity holders the lowest interest rate.

The no-bankruptcy option would also allow a firm to decide to be a contingent-equity firm. The adoption of such a corporate structure would eliminate both the individual collection remedies of state law, and court-supervised federal bankruptcy. To this end, Congress should enact a law, in addition to the menu proposed here, that would allow for the creation of contingent-equity firms.[217]

A second option on the menu would enable the firm to file a

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215. *In re* Weitzen, 3 F. Supp. 698 (S.D.N.Y. 1933).

216. These facts are similar to the facts in the *Timbers* case. *See* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 368 (1988).

217. Adler points out that many obstacles stand in the way of enacting legislation allowing for the creation of contingent equity. *See* Adler, *supra* note 3 (manuscript at 37-40). Some of these barriers, such as the need to eliminate the double taxation of corporate profits, seem insurmountable. Thus, while a contingent-equity option appears desirable in principle, it is unlikely that it will ever materialize.

Chapter 7 petition only.[218] The current version of Chapter 7 would be modified to provide expressly that firms filing under its provisions are to be auctioned off to the highest bidder.[219] Such an option would be preferable for those equity holders who would prefer the possibility of an actual sale to a hypothetical sale provided by Chapter 11. Equity holders in public companies would probably prefer such an option[220] because if assured that an actual sale would take place in the event of insolvency, creditors would offer lower interest rates. Under this modified Chapter 7 option the creditors would be assured that bankruptcy would be relatively short, thus promising a quicker payout than under most Chapter 11 proceedings,[221] and that all proceeds from the firm's assets would go to them rather than to equity holders. Creditors in such a situation would thus offer lower interest rates to a firm whose only option is a Chapter 7 auction as opposed to a firm that could file for Chapter 11 protection.

The availability of the revised Chapter 7 in this situation improves upon state-law collection procedures in two respects. First, the proposed Chapter 7 assures the creditors that the firm will remain intact if that is the best configuration for the firm's assets. State law, under which individual creditors have an incentive to seize assets of the firm, requires a careful use of security interests so as to prevent a destructive race to the firm's assets. Errors in crafting the optimal capital structure could well lead to the piecemeal liquidation of the firm. This disbursement may not be the appropriate deployment of the firm's assets. Given the possiblity under state law of an inefficient disposition of the firm's assets, creditors will charge a higher rate of interest in the first instance. Selecting the revised Chapter 7-only option from the menu solves this problem. There is no reason to suggest that a firm whose core operations are healthy, but which is burdened by excessive debt, will not be bought as an entire entity.

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218. One issue that I do not address here is the extent to which the options on the menu should change the current practice of letting management decide when a bankruptcy proceeding should begin. For an examination of this issue, see Robert K. Rasmussen, Pulling the Trigger: Control of the Bankruptcy Decision Under a Menu Approach to Bankruptcy (unpublished manuscript, on file with the *Texas Law Review*).

219. As Baird points out, there is nothing in Chapter 7 that prohibits the auctioning of the firm as a whole. *See* Baird, *supra* note 2, at 145 ("A going-concern sale of assets is possible under the existing structure of Chapter 7 . . . ."). Nevertheless, there is no mechanism that compels such an auction. *See id.* (arguing that going-concern sales of assets "run counter to the thinking of most bankruptcy judges and practitioners"). The revised Chapter 7 proposed in the text would be such an option.

220. There remains the problem of how equity holders actually select such an option. Few firms begin life as publicly held corporations. The problem of firm evolution is discussed in the next section.

221. Chapter 11 can be a lengthy process. *See supra* note 170. For example, LTV has been in bankruptcy since 1986. *Judge Sets Hearing on Sale of LTV Unit to Martin Marietta*, WALL ST. J., Aug. 6, 1992, at C16. Federated Department Stores, however, emerged from bankruptcy after two years, a period of time that most analysts viewed as short. *See* Ellen J. Pollock, *Federated, Allied Bankruptcy Lawyer Gets Much Credit for Speedy Resolution*, WALL ST. J., Jan. 13, 1992, at A4.

Indeed, just as the 1980s brought firms that specialized in taking companies private, enacting the menu approach advocated here might lead to the formation of firms that specialize in buying firms in bankruptcy proceedings.

The second benefit to creditors in choosing the revised Chapter 7-only option is the requirement of pro rata sharing. This benefit does not, of course, apply to secured creditors who are promised the value of their collateral. General creditors, however, may benefit from pro rata sharing, and pass these benefits along to the equity holders in the form of lower interest rates. Many theories of secured credit posit that secured creditors are the ones charged with monitoring a firm,[222] and general creditors are inferior monitors. Nevertheless, in a world where the first creditors to get paid keep the money, general creditors will have an incentive to monitor the firm to ensure that they are not left behind in a race to the firm's assets.[223] Assuring general creditors a pro rata share of the firm's assets, however, will reduce their incentive to monitor, thus leaving such monitoring to the more capable monitors, the secured creditors.[224]

Creditors are thus able to offer lower interest rates if they know that a firm's bankruptcy option is to precipitate an auction under Chapter 7.[225] The equity holders in a publicly held company would most likely take such a lower rate. The risk that the company files a bankruptcy petition and they are cashed out is a risk that they can diversify by purchasing the shares of a number of companies.[226] To be sure, managers cannot

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222. Robert Scott wrote the leading article on the monitoring theory of secured credit. *See generally* Scott, *supra* note 207. Other works discussing monitoring include Barry E. Adler, *A New Perspective on the Bankruptcy Priority Puzzle*, 22 J. LEGAL STUD. 17-27 (forthcoming 1992) (on file with the *Texas Law Review*); Picker, *supra* note 10. Other scholars argue that general creditors, rather than secured creditors, are charged with monitoring the firm. *See* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1158-61 (1979) (arguing that general creditors usually extend credit for a longer time period and in larger quantitiea and therefore must assume more monitoring costs); *cf.* Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 59 (1982) (arguing that in certain situations "talented monitors will prefer to serve as unsecured creditors").

223. *See* Jackson, *Creditors' Bargain*, *supra* note 7, at 861-64.

224. One might be tempted to argue that general creditors would monitor the firm to ensure that the secured creditor does not repossess its collateral and thus terminate the firm's operations. Such an argument is unpersuasive. When the secured creditor discovers that there is a threat that general creditors might race to the firm's assets, it has an incentive to protect its collateral. If the secured creditor removes its collateral, the firm may file bankruptcy in order to reclaim the collateral. *See* 11 U.S.C. § 542(a) (1988). This being the case, it would be more profitable to the secured creditor simply to force the firm into bankruptcy itself.

225. It is unclear, however, whether all creditors will offer a lower rate. Certainly creditors making substantial loans will have an incentive to learn which bankruptcy selection a firm has chosen, and adjust its interest rate accordingly. For creditors making small, short-term loans, however, the cost of discovering the type of bankruptcy a firm has selected may exceed the benefit of being able to offer a lower interest rate. To the extent that firms as a group will have superior bankruptcy terms under a menu approach, the rate of interest that such creditors charge all firms may be lower.

226. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE

diversify their risk that the company will become insolvent, but this inability is beneficial to the equity holders. The traditional tension between debt and equity in an insolvent firm is well understood. Managers, to the extent that they represent shareholders, have an incentive to engage in risky ventures, which may have an expected negative present value.[227] This incentive makes debt more costly. The Chapter 7 regime reduces this incentive. The new owner of the company will continue to employ the managers only if the owner believes they are capable. To the extent that the managers engage in transactions that decrease the expected value of the firm, they decrease the probability that they will be retained by the new owners. Thus, the choice of the Chapter 7-only option will give managers an incentive to act in the best interests of the firm, which will again reduce the initial cost of credit. This is another gain over the current system.

Whether equity holders of a closely held corporation would select the Chapter 7-only option is a question that cannot be answered in the abstract. Indeed, much of the confusion in the current literature results from the fact that some types of equity holders might prefer a Chapter 7-type proceeding, but others would find it in their interests to offer a contract allowing the firm to reorganize under a Chapter 11-type proceeding. A number of plausible reasons have been suggested explaining why the equity holders of a closely held firm might want the firm to be eligible for Chapter 11. The equity holders may be risk-averse, and unable to diversify their risk. They thus would be willing to pay for assurance that they will not be cashed out.[228] The equity holders may also be willing to pay a higher rate of interest to protect their nonpecuniary investment in the firm.[229] In an actual sale, the negotiations required to ensure that existing managers and suppliers stay on may be too complex for actual purchasers to undertake and complete successfully.[230] Finally, a hypothetical sale may on the whole be cheaper than an actual sale.[231] In

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136-39 (4th ed. 1991); Franco Modigliani & Gerald A. Pogue, *An Introduction to Risk and Return*, FIN. ANALYSTS J., Mar.-Apr. 1974, at 68, 73-76.

227. *See* Jensen & Meckling, *supra* note 173, at 334 (arguing that when large firms are financed almost entirely with debt-type claims, owner/managers have an incentive to make high-risk and high-payoff investments). Managers also have an incentive to not engage in projects with a positive net present value where the potential gains flow to the debt holders. *Cf.* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 155 (1977) (arguing that "the existence of corporate debt *can* reduce the present market value of the firm by weakening the corporation's incentive to undertake good future investments" (emphasis in original)).

228. *See supra* notes 133-35 and accompanying text; *cf.* Jackson & Scott, *supra* note 2, at 158-59 (noting that equity owners' interests are worthless in the case of liquidation and that they will realize more from their claims if the insolvent debtor is allowed to reorganize).

229. *Id.* at 174-75.

230. *See* Baird, *supra* note 2, at 140; Jackson & Scott, *supra* note 2, at 191.

231. *See* Easterbrook, *supra* note 1, at 416-17 (comparing valuations made by the market to those estimated by the judicial system).

any or all of these situations, it may be the case that the equity holders at the time of contracting would prefer a bankruptcy term that provides for some sort of Chapter 11 proceeding. To accommodate these diverging preferences, the menu also needs a version of the current Chapter 11. With the competing selections of a real and a hypothetical sale available, the menu approach will allow banks to tell the equity holders the exact cost of their choice. Whether or not the cost of Chapter 11 is worth its benefits will be a decision that each firm will have to make on its own.

The next selection on the menu would be one for a type of bankruptcy proceeding that does not yet exist. It would stay all creditors except for the financing creditor. The motivation for this type of bankruptcy provision is as follows: There are two types of risk—those over which the firm has control and those over which it does not.[232] Lenders know that courts may have trouble distinguishing between these two types of risk. In situations where the financier can distinguish which type of risk is responsible for a particular business failure (in other words, the risks are observable but not verifiable), the efficient solution may be to give the bank the power to call the loan on demand.[233] When such a provision is in place, the manager has the incentive to work hard because she bears all the downside risk. If she shirks her responsibilities, the bank will detect her actions and call the loan. Alternatively, if the manager works hard, but the firm nevertheless defaults because of an economic downturn, the bank would renegotiate the loan. In this situation, a bankruptcy proceeding may be needed to stay the efforts of third-party creditors while the firm negotiates with the bank.[234] However, the bank cannot be stayed; if it is, the manager does not bear all the downside risk of shirking. This selective-stay model of bankruptcy may leave the bank with the liquidation value of its collateral while giving the manager the full value of her human capital.[235]

The final choice on the menu is to allow the firm to create its own bankruptcy regime, subject to the restraint that it must treat nonconsensual

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232. *See supra* notes 181-82 and accompanying text.

233. *See* Kahn & Huberman, *supra* note 188, at 59-60 (describing nonjudicial foreclosure or "the inclusion of terms in the loan contract specifying the circumstances and procedures by which the lender will obtain assets from the borrower in the event of default"). This option may disappear when there are multiple levels of debt. *See* Paul Asquith et al., Anatomy of Financial Distress: An Examination of Junk-Bond Issuers 8-11 (Oct. 1991) (unpublished manuscript, on file with the *Texas Law Review*) (reporting the results of an empirical study showing that banks are generally unwilling to forgive principal in nonbankruptcy workouts where firms have multiple layers of debt).

234. *See* Baird and Picker, *supra* note 188, at 311-12.

235. This result always obtains if the manager can buy out the bank for the liquidation value of the collateral. *See id.* at 344-47. If the manager does not have this option, whether or not she enjoys the full value of her human capital turns on the relationship between the bank's liquidation value and the division that the parties would agree to if they were forced to bargain.

creditors according to the rule that the state selects.[236] Much of our thinking about the appropriate bankruptcy regime has been colored by the existence of current law. It may be that those in control of the firm would desire a system bearing little resemblance to current law. To be sure, the gain over any of the choices on the menu would have to exceed the drafting and communication costs that a custom-designed system would entail. If the gain does exceed the cost, however, there is no reason to forbid the firm from crafting its own set of rules. Indeed, if it turns out that a large number of firms end up drawing a similar set of rules, these rules could eventually be added to the menu.

One potential argument against allowing firms to draft their own bankruptcy regime is that the standard forms constitute a "public good."[237] In other words, allowing individual firms to opt out of a standard form eventually leads to a disintegration of the form. Thus, much of the benefit of having standard forms, such as eertainty and ease of communication, would be lost. Despite this potential problem, the customized option should remain. The menu as crafted incorporates all existing theories for what constitutes an efficient bankruptcy regime. If a great number of firms in fact choose to deviate from the standard form, this is evidence that our current understanding of corporate reorganization is inadequate. Given the existing prohibition on innovation, we should welcome evidence that we know little about optimal insolvency rules rather than trying to suppress it.

### B. *The Treatment of Secured Creditors and Equity Holders Under the Menu*

There are thus five basic options on the menu: no-bankruptcy, a revised Chapter 7-only, Chapter 11,[238] the selective stay, and a custom-designed system. There remains the question of specifying the contours of the two "traditional" bankruptcy selections that appear on the menu, Chapter 7 and Chapter 11. The most controversial issue surrounding the current design of bankruptcy law is perhaps its treatment of secured

236. For a discussion of the rights of nonconsensual creditors, see *supra* note 52 and accompanying text.

237. The public-good argument for mandatory contract terms is found in Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1567-69 (1989). A response to this argument is contained in Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1603-04 (1989).

238. Firms with a Chapter 11 option do not necessarily have to be reorganized; they can be liquidated. Thus, under the proposed regime there seems little role to play for the current Chapter 7. *But see* Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. & ECON. 223 (1991) (arguing that Chapter 7 serves to assure all the creditors that the assets of the debtor have been distributed).

creditors. Specifically, there is disagreement over the *Timbers*[239] issue: whether undersecured creditors should be compensated for the bankruptcy-imposed delay in receiving the proceeds of their collateral.[240] In addressing this question, it is important to recognize the impact on this debate of the conclusion that bankruptcy law is simply a contract term. This means that bankruptcy law's treatment of undersecured creditors depends on which rule is most efficient. The price of the inefficient rule is simply a deadweight loss to the equity holders. Because they bear the cost of the inefficient rule, they would, absent strategic impediments, offer a contract that contains the optimal rule. Thus, the concern about whether bankruptcy law should respect state-law rights, which is at the heart of the current debate over *Timbers*,[241] is to a large extent irrelevant.

The proper resolution of the *Timbers* issue turns in large part on the benefits secured credit brings to the firm. If there were no benefit to secured credit from the firm's point of view—in other words, if any reduction in the interest rate that the firm receives from the secured creditor is offset by an increase in the interest rate for unsecured credit[242]—then a firm would opt for the current *Timbers* rule. Giving the secured creditor the time value of its collateral has two costs. The first would be a payment of the interest itself. This cost would be offset by having a lower interest rate initially, and thus does not weigh in favor of adopting one rule or the other. Second, however, the bankruptcy court would have to determine the time at which the secured creditor would have received the proceeds of its collateral under state law, and then assign an appropriate rate of return. This cost includes the cost of litigating the issue as well as the cost of uncertainty as to the bankruptcy judge's decision. The firm would have to bear this cost, and would not recoive any corresponding benefit. Not granting time value to the undersecured creditor pretermits all of these calculations. If there is no benefit to secured credit, a firm would choose the *Timbers* rule.

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239. United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988).

240. *Compare* Baird & Jackson, *Corporate Reorganizations*, *supra* note 18, at 121-25 (arguing that undersecured creditors should be compensated for delay in foreclosing on their collateral) *with* Warren, *supra* note 8, at 801-04 (arguing that there should be no compensation).

241. *See* Baird & Jackson, *Corporate Reorganizations*, *supra* note 18, at 110 (arguing that limiting secured creditors' state-law rights runs counter to the important bankruptcy-law goal of "preserv[ing] the value of assets for the benefit of those who own them"); *see also* Baird, *supra* note 54, at 832 n.14 (citing *Timbers* as support for the proposition that valuation of secured claims should be based on the value of state-law rights).

242. *See* Thomas H. Jackson & Alan Schwartz, *Vacuum of Fact or Vacuous Theory: A Reply to Professor Kripke*, 133 U. PA. L. REV. 987, 997 (1985) ("[F]uture creditors will be disadvantaged by the security and so will charge higher interest rates to offset any possible earlier gains."); *see also* Jackson & Kronman, *supra* note 207, at 1154 (explaining that the reduction in rates charged by secured creditors might exceed the increase in unsecured credit rates if the arrangement reduces overall monitoring costs).

Yet if there were no benefit from secured credit, firms would probably not take on secured debt at all. There is a cost to taking on such debt: contract provisions must be negotiated and forms must be filed.[243] The fact that we see secured credit used by a large number of firms is some evidence that it has some benefit. Explaining what this benefit is, however, has not proven to be an easy task.[244] Perhaps the most persuasive explanation is that secured credit allows the lender to specialize in monitoring the firm.[245] If this is true, the choice on the *Timbers* issue is whether compensating the undersecured creditor for bankruptcy-imposed delay would affect the lender's monitoring of the firm. If refusing to give the secured creditor the time value of its interest in the collateral reduces that creditor's incentive to monitor, this would decrease the value of secured credit. Thus, firms might choose a bankruptcy regime that compensates secured creditors for their opportunity costs.

The question of whether a secured creditor would reduce its monitoring because it will not receive compensation for being deprived of the opportunity to foreclose on its collateral is difficult to answer in the abstract. The secured creditor's primary incentive to monitor is to ensure the preservation of its collateral. Even absent the promise of payments during the bankruptcy proceeding, the creditor will have the incentive to ensure that its collateral is not impaired. Yet, at the margin, the promise not to receive payments makes the collateral worth less than it otherwise would be. This may lead to a marginal decrease in the secured creditor's incentive to monitor. Moreover, not compensating the undersecured creditor for the delay caused by bankruptcy may give the general creditors an incentive to delay the conclusion of the bankruptcy proceedings simply because such delay transfers value from the undersecured creditor to them.[246] Yet there may be sufficient incentives to conclude the bankruptcy proceeding as quickly as possible (such as the desire to save on

243. *See* Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 222 (1989).

244. Many scholars have tried to identify the benefits of secured credit. *See, e.g.*, David Besanko & Anjan V. Thakor, *Collateral and Rationing: Sorting Equilibria in Monopolistic and Competitive Credit Markets*, 28 INT'L ECON. REV. 671 (1987); Helmut Bester, *The Role of Collateral in Credit Markets with Imperfect Information*, 31 EUR. ECON. REV. 887 (1987); F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986); Jackson & Schwartz, *supra* note 242; Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985); Arie Melnik & Steven Plau, *Loan Commitment Contracts, Terms of Lending, and Credit Allocation*, 41 J. FIN. 425 (1986); Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984); Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981); Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984).

245. *See* Picker, *supra* note 10, at 658; Scott, *supra* note 207, at 910; Adler, *supra* note 222 (manuscript at 7).

246. Baird & Jackson, *Corporate Reorganizations*, *supra* note 18, at 121-25.

attorneys' fees) which reduce the threat of delay.

The uncertain rationale for secured credit, coupled with the uncertain effect of the *Timbers* rule on the benefits of secured credit (assuming that the monitoring explanation for secured credit is correct), suggests caution before mandating one rule or the other. The most sensible solution is to have the menu allow for the choice of either rule. The firm could select payments to undersecured creditors during bankruptcy, or it could opt for the *Timbers* rule. This choice is available for firms that select either the Chapter 7-only option or the Chapter 11 option.

The remaining issue to be resolved is the existence *vel non* of the fresh contribution exception to the absolute priority rule.[247] This issue turns on whether shareholders would be willing to pay a higher rate of interest for the possibility of not being cashed out in a reorganization. The equity holders, even in a Chapter 7 proceeding where the firm is sold as a going concern, would always have the opportunity to participate in the new firm regardless of the existence of the fresh contribution exception. First, they could either buy the firm themselves or join in a group that buys the firm.[248] Second, if the equity holders provide firm-specific value, any buyer of the firm would negotiate with the equity holders to remain on board.[249] The fresh contribution issue is thus not about whether the equity holders can participate in the reorganized firm; it is whether they should be able to force their participation over the objections of the firm's creditors.

A lender trying to price the fresh contribution option currently faces two difficulties. The first, which would be eliminated by the menu approach, is simply determining whether the option exists. The current unsettled state of the law leaves potential creditors unsure about whether the equity holders can force their way into the reorganized firm over the creditors' objection. The second difficulty that the fresh contribution exception presents is predicting the way the exception will be applied. Even in those jurisdictions where the fresh contribution exception is recognized, the lender does not know whether the judge will value the actual contribution to the firm at anything close to the portion of the firm that the equity holders seek to retain.[250]

This uneertainty can be reduced by having the firm select the amount of the firm that the equity holder has the option to retain, and the

247. *See supra* notes 94-112 and accompanying text.

248. If the current equity holders are likely to have private information regarding the value of the firm, it may be efficient to prevent them from participating in the auction. *See supra* note 177.

249. This point is made in Baird & Jackson, *Bargaining After the Fall*, *supra* note 18, at 753-54.

250. *See generally* Raymond T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009, 1043-47 (1987) (discussing valuation risks in bankruptcy).

price the equity holder will have to pay if it exercises the option. This would make the fresh contribution exception more certain in its application, thus making it easier for lenders to price.[251] This proposal simply recognizes the fact that the fresh contribution exception, if it exists, is really nothing more than an option for the existing equity holders to purchase part of the reorganized firm. The proposed menu clarifies the contours of the option by specifying the amount of equity covered by the option, and the price at which the option can be exercised.

There are many advantages to this menu scheme in addition to letting the parties decide for themselves what type of arrangement they want. By having a number of possible selections, parties can choose the option that best fits their needs while at the same time avoiding the necessity of drafting the provisions themselves. Moreover, employing standard provisions makes it easy to communicate the terms of the deal to new parties who deal with the firm. Thus, the menu as detailed offers a substantial improvement over current law.

### C. *Strategic Considerations*

Modern game theory has advanced law-and-economic analysis past the Coasian notion that parties, if they are well informed and transaction costs are low enough, will always reach the correct result.[252] Any proposal for the creation of a default rule now has to be concerned with strategic obstacles that will impede a party from making the optimal choice.[253] Problems of incomplete information, asymmetric information, and adverse selection can often lead to suboptimal results. This subpart examines some of the strategic problems that may arise if the law were to allow a firm to choose its bankruptcy scheme. These problems can arise at two different times—at firm formation and when the firm wants to change its choice of the bankruptcy term. As the corporate-law literature

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251. This modified version of the fresh contribution exception has other benefits as well. *See infra* text following note 266.

252. The Coase Theorem, although not named as such, is found in Ronald H. Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960). Notable applications of the Coase Theorem in the academic literature include POSNER, *supra* note 32, at 12-16; Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449 (1987); David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987); Stewart Schwab, *A Coasean Experiment on Contract Presumptions*, 17 J. LEGAL STUD. 237 (1988); Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 YALE L.J. 353 (1988).

253. *See* Ayres & Gertner, *supra* note 5; Johnston, *Strategic Bargaining*, *supra* note 6; Katz, *supra* note 6; Schwartz, *supra* note 243.

has recognized, the case for unfettered choice is strongest when the firm is first incorporating, but is lessened when the firm seeks to amend its existing charter.[254] The menu system thus has to be sensitive both to the fact that the needs of the firm might change over time and that unfettered ability to amend the corporate charter would allow shareholders to shift value from the creditors to themselves, thus robbing the menu system of much of its appeal.

As to the problems that may arise when the firm is first selecting an option from the menu, the problem of moral hazard must be addressed. A moral hazard exists where an actor does not bear the full consequences of her action.[255] For example, a person with medical insurance may be more likely to go to the doctor when it is not cost-justified than would a person without such insurance. This state of affairs arises because those with insurance do not bear the full cost of their actions while those without insurance do. To the extent that some of the selections on the menu present a form of "rcorganization insurance" whereby equity holders know that they will not bear the full cost of a bad decision, there is a potential moral-hazard problem.

This problem does not loom large in the menu as crafted. To be sure, there is always a moral-hazard problem in a corporation.[256] The

254. *Cf.* Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1399 (1989) ("The questions of contractual freedom in the initial charter and in midstream . . . are different and require separate examination."); Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1822-29 (1989) (arguing that the case for limiting the freedom to opt out of corporate rules is strongest with midcourse charter amendments); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1674-76 (1989) (arguing that managerial control over the agenda, information, and deal enhancements creates coercion and shareholder apathy over opt-out charter amendments); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1443-44 (1989) (noting that investor apathy toward charter-amendment decisions allows corporate managers to pursue self-interested goals); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1473-74 (1989) (observing that self-interested corporate managers might use charter amendments to shore up their own power at the expense of shareholders); Gordon, *supra* note 237, at 1574-75 (arguing that corporate insiders have an incentive to use charter amendments to their own advantage). *See generally* Ronald J. Gilson, *The Case Against Shark Repellant Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982).

255. *See* KREPS, *supra* note 49, at 577-79; Richard S. Higgins, *Products Liability Insurance, Moral Hazard, and Contributory Negligence*, 10 J. LEGAL STUD. 111 (1981); Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 WIS. L. REV. 65, 67-68; Donald R. Decre, Note, *On the Potential for Private Insurers to Reduce the Inefficiencies of Moral Hazard*, 9 INT'L REV. L. & ECON. 219, 219-22 (1989).

256. *See* BREALEY & MYERS, *supra* note 226, at 428-29; Jeremy I. Bulow & John B. Shoven, *The Bankruptcy Decision*, 9 BELL J. ECON. 437, 454-55 (1978); Devra L. Golbe, *The Effects of Imminent Bankruptcy on Stockholder Risk Preferences and Behavior*, 12 BELL J. ECON. 321, 321-28 (1981); Joseph E. Stiglitz, *Some Aspects of the Pure Theory of Corporate Finance: Bankruptcies and Take-Overs*, 3 BELL J. ECON. & MGMT. SCI. 458, 461-62 (1972); Michelle J. White, *Public Policy Toward Bankruptcy: Me-First and Other Priority Rules*, 11 BELL J. ECON. 550, 556-57 (1980). Susan Rose-

existence of debt means that, even in a solvent firm, the equity holders do not bear the full risk of failure; much of this risk is borne by the debt holders. The equity holders, however, capture the full benefits of a successful venture. Thus, the equity holders have an incentive to engage in riskier behavior than they would if they bore the full costs and benefits of their decisions. This is the standard conflict between debt and equity; equity holders prefer riskier investments than do debt holders.[257]

If anything, the menu proposed here, rather than exacerbating this problem, reduces it. The first point is that many of the bankruptcy options on the proposed menu do not affect the moral-hazard problem incumbent in the division of ownership between debt and equity. The problem does not increase under those options where the equity holders stand to lose their entire investment in the venture if the firm ends up in bankruptcy. Thus, as to those options that do not give the equity holders an automatic right to retain an interest in the firm after bankruptcy, there is no increase in the moral-hazard problem.

In those situations where the firm makes a selection that contains a form of reorganization insurance, the moral-hazard problem is reduced. This result seems counterintuitive at first blush; insurance is normally thought to increase, not decrease, moral-hazard problems.[258] The key insight as to the potential benefit of insurance in this context is that the insurance payoff, as contained in the menu, is not a set amount. Rather, it is a set percentage of the reorganized firm. This retention of an interest in the reorganized firm insures that the equity holders still bear a cost if a decision decreases the value of the firm. Recall that it is the threat of being cashed out on insolvency that creates the moral-hazard problem in the first instance.[259] By retaining the participation option, equity holders still have something to lose by engaging in projects that are too risky. The standard moral-hazard problem inherent in the division of ownership between debt and equity increases as the firm's financial condition deteriorates. The worse the firm's condition, the less the equity holders have at stake, and the more they have an incentive to take a risky gamble to reverse the firm's fortunes.[260] To the extent that the participation option ensures equity a place in the new firm, equity holders now bear

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Ackerman couples the traditional moral-hazard problem with manager's incentives. *See* Rose-Ackerman, *supra* note 78, at 286-92.

257. *See* BREALEY & MYERS, *supra* note 226, at 434-37.

258. *See* George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1547-48 (1987).

259. *See* Baird & Jackson, *Corporate Reorganizations*, *supra* note 18, at 104-09.

260. *See* BREALEY & MYERS, *supra* note 226, at 428-29; Bulow & Shoven, *supra* note 256, at 454-55; Golbe, *supra* note 256, at 321-28; Stiglitz, *supra* note 256, at 462; White, *supra* note 256, at 556-57.

some of the cost associated with failure. This selection links the interests of equity holders with those of the debt holders. It thus reduces the moral-hazard problem that arises when the firm's financial condition becomes critical.

Another problem that could arise by treating bankruptcy law as a default rule is the problem of adverse selection.[261] This problem, like the moral-hazard problem, is prevalent in the insurance context. Adverse selection occurs when the party making a choice has private information as to its type. For example, in the health insurance market, we can assume that a person deciding whether or not to buy insurance knows whether or not she, as a general matter, is in good health or poor health. If insurers could not determine the health of those who applied for insurance, eventually only sick types would buy insurance. Those with bad health would eventually drive out those with good health. The healthy person would not want to join an insurance pool with the unhealthy person because she would be subsidizing the insurance of the unhealthy person. In the language of game theory, we would have a separating equilibrium with unhealthy persons buying insurance, assuming that insurance companies would still offer it, and with healthy persons going without insurance.[262] This is true even though it may be optimal for the healthy persons to buy insurance.

The adverse-selection problem does not loom large in the bankruptcy-menu context. This potential problem exists only for those selections that provide equity with some reorganization insurance. Yet there is little reason to suspect that only high-risk firms will select such insurance. The reason is that there is in effect a very large copayment required with reorganization insurance. Copayments are payments that the insured must make before collecting on the insurance. The copayments in the bankruptcy context are the initial investment in the firm, minus the value of the participation option. If an equity holder knew that a firm she was considering forming had a high probability of failure, she simply would not form the venture in the first instance rather than selecting reorganization insurance.

Another concern that should be addressed when crafting default rules is the problem of private information. In some contractual situations,

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261. The classic paper in this regard is George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). A lucid discussion of the adverse-selection problem can be found in KREPS, *supra* note 49, at 625-29.

262. The classic article on this point is Michael Rothschild & Joseph Stiglitz, *Equilibrium In Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629 (1976). *See also* Priest, *supra* note 258, at 1540-46 (discussing the need for insurers to collect within their risk pools enough individuals with low exposure to risk so that insurance costs remain financially attractive to all members).

the existence of private information can lead to suboptimal results: the disclosure of private information, while increasing the overall value of the deal, would decrease the value to the party making the disclosure.[263] The party with the private information thus makes an inefficient selection so as not to reveal its private information.[264] Whether or not this is a problem in the bankruptcy context depends on what sort of private information would be revealed by selecting one of the options on the menu. One piece of information that could be revealed would be whether the equity holders of the firm are risk-averse or risk-neutral. One would imagine that those firms selecting the Chapter 7 option are comprised of risk-neutral equity holders, while those firms that select a type of bankruptcy law with a participation option have more risk-averse owners.[265] The effect of revealing to the lender this information as to the equity holders' taste for risk is unclear. On the one hand, lenders may prefer risk-averse borrowers. Risk aversion may reduce the tension caused by the separation of debt and equity because risk-averse decisionmakers are less likely to undertake risky ventures that imperil the debt holder's investment. Thus, lenders may be willing to offer risk-averse borrowers a lower interest rate. The extent to which this rate will be lower turns on the ability of the investor to use other contractual provisions to constrain decisions that place its investment at risk.[266]

On the other hand, the way to reveal oneself as risk-averse is to select a participation option. This option reduces the lender's return in bankruptcy, thus leading it to raise its initial interest rate. The overall effect of revealing risk aversion is thus unclear. This being the case, there does not seem to be a strong incentive for either a risk-averse or a risk-neutral investor to conceal its type. The cost to the risk-averse investor of mimicking the risk-neutral investor is that it loses its reorganization insurance. Yet if the eost of the insurance—which in this case is the higher interest rate—exceeds the expected benefit—which is the ability to participate after the firm is in bankruptcy—then the risk-averse investor should not buy the insurance. Conversely, the cost to the risk-neutral investor of mimicking the risk-averse investor is paying for insurance. The only tine that the risk-neutral investor would have an incentive to buy such

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263. *See* Johnston, *Opting In and Opting Out*, *supra* note 6, at 325-28; Johnston, *Strategic Bargaining*, *supra* note 6, at 626-39.

264. For example, in debt restructuring workouts, basically healthy firms may not wish to reveal that they have bright prospects. They therefore have an incentive to mimic bad firms, thereby keeping their future prospects private. *See* Gertner, *supra* note 136 (manuscript at 1-2).

265. *See supra* notes 175-97 and accompanying text.

266. For examples of common loan covenants, see Avner Kalay, *Stockholder-Bondholder Conflict and Dividend Constraints*, 10 J. FIN. ECON. 211, 211-33 (1982); Schwartz, *supra* note 243, at 216-18; Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 122-26 (1979).

insurance is if it had a negative cost; in other words, if the cost of borrowing with the participation option was less than the cost of borrowing with the Chapter 7-only selection. Such a state of affairs seems unlikely.

Another piece of information that may be revealed by the selection the equity holders make from the menu is whether the investors in a closely held firm plan on shirking. To understand this problem, assume that there are two types of investors: shirkers and hard workers. Shirkers want to borrow money, but they do not want to invest any firm-specific capital; they plan on walking away from the business if it runs into trouble and starting life anew. At the margin, they are more likely to be at the golf course than the office. Hard workers, in contrast, plan on making firm-specific investments. The shirkers do not want to reveal their type, but the hard workers do. Asking for the selective stay may reveal the investor to be a hard worker. The investor is willing to trust the financing lender to decide upon insolvency whether or not she has performed her tasks. Selecting this option thus signals to the potential lender that the investor is a hard worker. Choosing a different option, however, does not reveal that the investor is a shirker. Rather, the investor may be a hard worker, but believe that the bank will not accurately distinguish between losses due to shirking and those due to unfavorable economic conditions. Thus, hard workers may select a participation option to ensure that they will have the opportunity to remain with the firm. While a lender does want to distinguish between hard workers and shirkers, there is nothing in the bankruptcy menu that suggests that the choice selected will necessarily lead to one type of party making an inefficient choice so as not to reveal its type.

Allowing firms unfettered choice from the bankruptcy menu at the time of capital formation thus makes sense. There is little reason to believe that strategic impediments will preclude those forming the firm from making the optimal choice.

This leaves the problem of changes in the firm's original choice. Firms evolve. Most companies do not start out as publicly held entities; most of today's large corporations were yesterday's start-up companies. Any scheme that seeks to optimize the value of the firm based on the nature of the firm's investors has to recognize that the type of investor in any given firm may change over time. The risk-averse owner/manager of the small corporation will, if the firm prospers, be replaced by the risk-neutral public investor. Thus, firms need a mechanism by which they can change the type of rcorganization for which they are eligible. Just as one bankruptcy procedure is not optimal for all firms, one bankruptcy procedure may not be optimal for the same firm throughout all of its existence. Locking firms into their original choice will undoubtedly lead

to inefficient results.[267]

The obvious answer to the problem of firm evolution, letting firms change their bankruptcy option as their needs change, cannot be adopted. Firms cannot be allowed unlimited freedom to amend their chosen menu option. Such freedom to change the corporate charter would rob the menu regime of many of its benefits. The benefit that a firm receives from committing to a bankruptcy option that gives the equity holders less ex post than does the current Chapter 11 would evaporate because the commitment would not be credible. For example, a firm selecting the revised Chapter 7-only option could not be assured of getting a lower interest rate. The lender would know that if the firm ran into financial difficulty, it would be in the interest of the equity holders—and especially the managers who fear that they would not be retained if the firm were sold to outsiders—to switch to some version of Chapter 11. By doing so the equity holders would be able to ensure that they would not be cashed out as they would be in a Chapter 7 proceeding, and the managers would avoid having their performance scrutinized by the new owners. The lender, anticipating this behavior, would thus charge what it would had the firm selected Chapter 11 originally. The gains from the menu system would be lost.

The problem, however, is not insolvable. What is needed are sensible restraints on the amendment process to ensure that a firm cannot reallocate its value from the debt holders to the equity holders. There should thus be no prohibition on a firm that had originally contracted for Chapter 11 amending its charter to allow for Chapter 7. Such a move gives up equity-holder protection in exchange for lower interest rates on future borrowing. Such an option would take care of most of the problems caused by firm evolution. The case for forgoing Chapter 11 is strongest in the case of a publicly held firm.[268] As a general matter, small closely held firms tend to evolve into large publicly held firms rather than vice versa. Thus, most firms that wanted to change their bankruptcy options would probably want to forgo protections for the owner/manager that they had previously chosen. Since the change from a Chapter 11 selection to a Chapter 7-only selection cannot transfer wealth from the debt holders to the shareholders, such amendments should be allowed without legal constraints.

Other changes in the bankruptcy term would be more problematic. As described above, a firm should not have complete freedom to change from a Chapter 7-only selection to a Chapter 11 selection. Yet at times such a change may be necessary given the change in the nature of the firm.

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267. *Cf.* Gordon, *supra* note 237, at 1575 (noting that mandatory and rigid rules create efficiency costs that are avoidable with more flexible regulations).

268. *See* discussion *supra* section III(C)(1).

For example, a publicly held firm going private in a leveraged buyout might find a Chapter 11 proceeding to be the optimal bankruptcy term. In this situation, change in the corporate charter should be allowed only with the consent of all of the creditors.[269] Such consent would allow creditors to protect themselves from reallocation of the value of the firm from themselves to the equity holders. This protection would allow these creditors to give a preferable interest rate to those firms that select Chapter 7. The limitation on midterm amendments allows the firm to credibly commit to a Chapter 7-only regime.

One more amendment problem remains, and that is how to handle a firm's desire to move either to or away from the no-bankruptcy option. Here it does not matter whether the no-bankruptcy option involves existing state-collection remedies or the proposed contingent-equity structure. Consider first amendments that involve either a switch to or a switch away from traditional state-law remedies. Both such moves must be constrained in the same manner as the move to Chapter 11. The main difference that would be caused by a move from any bankruptcy selection to the no-bankruptcy selection would be a change from the pro rata sharing among general creditors mandated by bankruptcy to the nonbankruptcy rule of first come, first served. The potential danger of allowing unrestrained moves to the latter regime is that the change in bankruptcy option may be done simply to give a particular creditor a preference. For example, consider the situation in which a firm has a large financing creditor that has not taken a security interest in the assets of the firm.[270] The creditor also holds the personal guarantee of the firm's manager. If the firm is insolvent, the manager has an incentive to prefer the holder of the personal guarantee to the detriment of the other unsecured creditors.[271] Preference law currently would recapture direct payments made to such creditor

269. One might argue that this requirement of unanimity creates a holdout problem. Such problems arise, however, only where an individual deciding what action to take has an incentive to prefer her private interest to that of the group. For example, bondholders have an incentive to vote against an exchange offer so as to force full payment of a bond even if such offer is beneficial to bondholders as a group because the offer would allow the firm to avoid filing for bankruptcy. *See* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 236 (1987). Such a problem does not manifest itself here because there is no reason to think that the change to a Chapter 11 regime is in the interest of the bondholders as a group.

270. *See* Schwartz, *supra* note 243, at 217 (noting that unsecured financing lenders sometimes constrain the debtor's ability to borrow additional funds).

271. *See* Ray v. City Bank & Trust Co. (*In re* C-L Cartage Co.), 899 F.2d 1490, 1494 (6th Cir. 1990) (discussing the validity of transfers that benefit inside creditors); Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1198 (7th Cir. 1989) (noting that some payments to creditors "may have been favored only because payment reduced insiders' exposure (recall that the insiders select which debts to pay first)"); Andrew J. Nussbaum, Comment, *Insider Preferences and the Problem of Self-Dealing Under the Bankruptcy Code*, 57 U. CHI. L. REV. 603, 614 (1990) (stating that a creditor's procurement of an insider's guarantee is often no more than a "thinly cloaked pursuit of preference" for payment and a way to obtain indirect control over a debtor).

during the year before the filing for bankruptcy.[272] Were the firm able simply to switch to a no-bankruptcy option, the manager could ensure that the financing creditor would receive the bulk of the firm's assets. Immediately after changing the bankruptcy option, the manager would transfer all the assets of the firm to the financing lender.

There are two ways in which this opportunistic switch could be prevented. The first, as in the case of the switch to a Chapter 11 selection, would be to require creditor approval of the change. Indeed, merely asking for creditor approval might be a signal to the creditors that the firm is in financial distress, given that the situation where a no-bankruptcy solution is efilcient tends to be relatively rare.[273] The second way to handle the problem of opportunistic switching would be that, absent creditor approval, the firm could change its charter, but would have to wait a set period of time, say one year,[274] before the change became effective. In other words, the implementation of the amendment would be delayed to ensure that the purpose of the amendment was not to prefer one creditor at the expense of other creditors.

Equity holders might strategically amend away from the no-bankruptcy option, when that rule is the traditional state-law remedy, in two other ways. The first is simply to stay the collection efforts of its creditor. Consider, for example, the situation of the single asset/single creditor case discussed earlier. At the time the firm was formed, it was efilcient for the firm to include in its lending contract a term forgoing federal bankruptcy law to assure the financing creditor that it could quickly recover its collateral upon default. Such assurances would not be credible if the firm, faced with foreclosure, could amend its charter, file for bankruptcy, and thus gain the use of the automatic stay. For this reason, changes from no-bankruptcy to bankruptcy should require creditor consent.

Allowing the firm simply to wait a set period of time before the amendment would take effect would not eliminate this problem. It would simply delay the time of the redistribution. Indeed, the equity holders, if they were allowed to make a delayed change, would have an incentive to make such a change immediately after securing their financing. The lender, recognizing this incentive, would thus base its interest rate on the cost that would be imposed by a Chapter 7-only term rather than the cost of the more efficient no-bankruptcy term. Thus, the problem of making

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272. 11 U.S.C. § 550(a) (1988); *Ray*, 899 F.2d at 1493-95; *Levit*, 874 F.2d at 1194-96. *But see* Nussbaum, *supra* note 271, at 610 (noting that most courts have denied recovery from creditors and have required trustees to pursue the insiders).

273. The situations in which a no-bankruptcy selection may be efficient are discussed *supra* notes 211-17 and accompanying text.

274. The one-year period is selected because that is currently the reach-back period for insider preferences. 11 U.S.C. § 547(b)(4)(B) (1988).

a credible commitment can be solved only by requiring creditor approval of switching from a no-bankruptcy to a bankruptcy regime.

The second possible manipulation by the managers may be to reallocate assets to themselves, just as in the case of the potential switch from Chapter 7 to Chapter 11. Thus, for the same reasons that the switch from Chapter 7 to Chapter 11 must be conditioned on creditor consent, so must the switch from no-bankruptcy to Chapter 11.

Consider now the situation where the firm wants to change either to or from a contingent-equity structure. Changes to a contingent-equity structure should be limited as are changes to traditional state law because the problem of preferences, which limits the change from a bankruptcy regime to traditional debt-collection measures, is still present when the change is to contingent-equity. The change from contingent-equity to a bankruptcy regime is also problematic. Once again, it could be the occasion for a transfer from the debt holders to the equity holders. Thus, creditor assent should be required for such a change.

The final amendment problem that should be considered is one involving the selective stay. The move from a selective stay to another form of bankruptcy law should require the consent of the financing lender. It is the party that could potentially lose out if such an amendment is made opportunistically. The lender, which bargained for the opportunity to be able to decide that the firm should discontinue its operations, would have this power removed by the imposition of the automatic stay. Similarly, a move from a selective stay to the no-bankruptcy option should require the approval of all creditors. The financing creditor could be hurt by such a move in that it loses the opportunity to decide unilaterally whether or not the firm should continue. The other creditors are injured by the potential preference problems that arise by removing the selective stay.

Potential amendment to the selective-stay option also requires legal constraints. Allowing freedom of movement from a bankruptcy option to the selective-stay situation creates the possibility of using the change to prefer the financing lender. Thus, such a change would require creditor approval. The same is true for a change from the no-bankruptcy option to the selective stay. The fear here is that the change, by removing the collection remedies of the other creditors, might work a preference to the financing lender.

Of course, it is impossible to specify in advance what limitations should be applicable when a firm drafts its own set of insolvency provisions. This lack of an established amendment system, however, is not problematic. The firm itself would have to include sensible restrictions on its power to amend the charter in order to make its original commitments credible.

These restrictions on midterm amendments will ensure that the

potential gains from the menu system are realized. By preventing opportunistic amendments, the system assures the lenders that the provisions on which they are basing their interest rates will not be changed. As with the options themselves, these restrictions are simply terms that the equity holders would offer at the initial contracting stage. Equity holders seeking to gain the benefit of a rate reduction by selecting a certain type of bankruptcy law would prefer a mechanism by which their commitment is credible. At the same time, they would also desire the freedom to amend the contract term when such amendment is efficient. The scheme sketched above answers both of these concerns.

The above analysis also answers a practical problem with the proposed menu approach; namely, what we should do about firms that already exist. While a menu approach may be superior for firms formed after the menu has been put into place, one may ask what should be done with the many firms that never had the choice to select their bankruptcy term because of the law's current insistence on treating bankruptcy law as a mandatory rule. The answer to this problem is simple: all current firms have contracted based on the assumption that the firm could file for Chapter 11. In other words, all firms have been paying premiums for reorganization insurance. Any legislation barring access to Chapter 11 would be, in the short run, simply a wealth transfer to the firm's creditors. Thus, all existing firms should be presumed to have selected the Chapter 11 option. Specifically, they should be deemed to have selected the current *Timbers* rule denying delay costs to undersecured creditors. Moreover, they should be deemed also to have rejected the modified fresh contribution option suggested by this Article. Since it did not exist, and since it is highly uncertain that there is any fresh contribution exception today, the practical solution is to deem current firms to have selected the no-contribution version of Chapter 11. If a firm desires a different option, it should have to follow the amendment procedures detailed above.

## IV. Conclusion

For too long bankruptcy scholars have failed to realize that bankruptcy law is really part of contract law. The reorganization proceeding offered by federal bankruptcy law is simply a term in the fully contingent contract between a firm and each of its creditors. When the focus shifts from a firm in trouble to the contract that the firm would offer those deciding whether or not to extend credit to the firm in the first instance, many of our previously held conceptions about the nature of bankruptcy shift as well. One prominent shift is the assumption that the availability of Chapter 11 is a mandatory rule. A world with a menu of bankruptcy options is certainly no worse, and indeed may be quite better, than the world as it exists today.