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CLAIMS
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OPINIONS

AN EXCHANGE OF VIEWS

THE EFFICIENCY OF CHAPTER 11

by
*Robert K. Rasmussen**

One need only read the newspaper (and not even the financial pages) to get a suspicion that something may be wrong with the Bankruptcy Code's[1] reorganization provision, chapter 11. Recent events raise the specter that this provision may not be operating efficiently. The most striking of these events is the Eastern Airlines reorganization fiasco. At one time during its bankruptcy proceeding, Eastern, through the sale of its more

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[1] Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-1330), *as amended by* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3114 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); and, Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (codified as amended in various sections of 11 U.S.C.) [hereinafter Bankruptcy Code or Code].

valuable assets, had hundreds of millions of dollars in cash.[2] Despite this apparent wealth, Eastern was insolvent because the claims of Eastern's creditors exceeded this figure. Nevertheless, a pot of hundreds of millions of dollars offered the creditors some solace. Yet, at the end of the process, the solace was much less than expected. During Eastern's bankruptcy, the bankruptcy court allowed the distressed airline to spend over $600 million in an unsuccessful attempt to keep the airline in business.[3] Much of the money was spent despite the vociferous objections of Eastern's creditors.[4] This dissipation of Eastern's creditors' money leads to speculation whether the effort to reorganize a company under chapter 11 is worth the costs that an unsuccessful reorganization will entail.

In the Eastern case, the parties whose money was at stake objected to the continuation of Eastern's attempt to remain an operating airline. Such objections are understandable. Despite a proud history as one of this country's premier airlines, Eastern's recent history revealed that the only thing at which it excelled was losing money. In 1988, Eastern lost $209 million.[5] Filing for bankruptcy did nothing to stem the hemorrhaging of money. In the last three quarters of 1989, the year in which Eastern filed for bankruptcy, the carrier managed to lose $869 million.[6] Despite this history of losses, the bankruptcy court relied on its concerns for public policy and insisted that Eastern remain in the air. The court "articulated . . . time and time again [that] the flying public's interest must at all times be taken into account."[7] The result of this insistence seems to be the loss of a significant portion of the money that the creditors would have otherwise received.

These losses do not tell the whole story of the cost of Eastern's unsuccessful attempt to reorganize under chapter 11. In a desperate attempt to win back lost customers, Eastern offered a number of discount fares. Eastern was quite possibly pricing its services below cost. Such a strategy made sense for the insolvent airline because getting passengers back was Eastern's only hope to emerge from bankruptcy as a viable entity. Unfortunately, these low fares induced other airlines to reduce their fares, thus generating losses at these other airlines as well. The slow death of Eastern thus compounded the losses of both Eastern's creditors and its competitors.

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[2] Salpukas, *Court Gives Eastern Air $135 Million*, N.Y. Times, Nov. 28, 1990, at D1, col. 6.

[3] *A Bankrupt's Best Friend*, Forbes, April 1, 1991, at 99.

[4] *Id.*

[5] Galen, *It May Be Time to Pull the Plug on Eastern*, BUS. WK., Dec. 17, 1990, at 29.

[6] *In re* Ionosphere Clubs, 113 Bankr. 164, 168 (Bankr. S.D.N.Y. 1990).

[7] *Id.*

The competition's losses were particularly ironic given that the public policy on which the bankruptcy court relied was preserving competition in the industry.

To be sure, the money which Eastern consumed did not vanish. Rather, it was redistributed to those who did business with the bankrupt airline after it filed for bankruptcy. Employees were paid for their services, suppliers for their supplies, attorneys for their efforts, and the flying public was able to travel for a good deal less. While I, like every other consumer, have no objections to paying less for a seat on a plane, such a redistribution from Eastern's prepetition creditors to passengers like myself can hardly be seen as a vindication of bankruptcy policy, or indeed of any coherent policy.

Nevertheless, one cannot indict the current bankruptcy system based solely on one case. Supporters of chapter 11 will no doubt point to the many corporations which have emerged from its provisions as viable entities. Johns-Manville, which has reported record earnings since its emergence from chapter 11, and Texaco, which used chapter 11 as a weapon in its litigation battle with Pennzoil, are two examples of successful reorganizations. All that these examples show, however, is that pointing to isolated cases may stimulate inquiry but cannot end it. The value of any law simply cannot be judged by a few isolated examples. For instance, the Medicare system should not be scrapped because a few medical providers attempt to defraud the system; nor should the first amendment be repealed because the Supreme Court in *Dennis v. United States*[8] decided that members of the Communist Party were not entitled to its protections. In any legal system, cases will exist which are unrepresentative of how the system works as a whole. Judging the merits of a law based on such impressionistic evidence is at best foolhardy.

The problem of ensuring a representative sample is acute in the chapter 11 context. The debtors which garner most of the headlines in both the popular and financial press — Eastern, Johns-Manville, Texaco, Campeau, Drexel, MCorp, AH Robbins, Pan Am, LTV Steel — are not typical of most businesses in chapter 11. The more common debtors seeking reorganization under the auspices of the bankruptcy court are small closely-held corporations.[9] This divergence between the high visibility cases and the typical cases increases the risk that when lawmakers and the

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[8] 341 U.S. 494, 516-17 (1951).

[9] Furthermore, a recent study of chapter 11 cases revealed that over half of the debtors had debts of less than $1 million. *See* E. FLYNN, STATISTICAL ANALYSIS OF CHAPTER 11, at 18 (1989).

general public think about the efficacy of chapter 11, they are more likely to base their judgments on cases which are unrepresentative of the majority of chapter 11 cases.

Turning from isolated examples to systemic evidence suggests that the experience of Eastern is the rule rather than the exception. A recent study conducted by the Administrative Office of the United States Courts estimated that for chapter 11 cases filed after 1987, at most 30% will result in confirmed plans of reorganization.[10] For cases filed prior to 1987, only 17% have resulted in confirmed plans as of July 1989.[11] Of these prior cases, only those filed in 1986 had a confirmation rate of over 20%.[12]

The figures become more distressing when one adds the fact that these percentages include confirmed plans which call for the piecemeal liquidation of the debtor rather than the continuation of the business. These "liquidation reorganizations" account for 20% to 30% of all confirmed plans.[13] Thus, at best only one-fourth of companies that file chapter 11 ever emerge from bankruptcy. Of these "successful" reorganizations, some of the debtors fail a second time. Taking liquidation reorganizations and subsequent failures into consideration, a chapter 11 filing eventually leads to the rehabilitation of the debtor only about 20% of the time.

Liquidating a company after it has failed to reorganize is more expensive than liquidating the company in the first place. Therefore, in most chapter 11 cases creditors would receive more if their debtors had originally filed for chapter 7 liquidation. While the gains from the confirmed reorganization could conceivably outweigh the losses generated in most cases, the preceding figures, more so than the tales of isolated debtors, raise legitimate questions about the efficiency of the current version of chapter 11. These questions are highlighted by the fact that the confirmation of a plan of reorganization in no way ensures that the reorganized entity will be viable. Emerging from chapter 11 is not a guarantee that the firm will survive for the indefinite future. Thus, it is far from certain that chapter 11, as currently written, is efficient.

Before condemning current law, however, it is necessary to define the inquiry. What does it mean for chapter 11 to be "efficient"? It seems to me that an assessment of the efficiency of the existing chapter 11 requires

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[10] *Id.* at 10.

[11] *Id.* at 11.

[12] *Id.*

[13] *Id.* at 12-13.

an examination of two distinct issues. The first is the goals that corporate bankruptcy law seeks to effectuate. Should bankruptcy maximize the wealth of those who have invested in the distressed company, or should the effects of failure on others be considered as well? Once the goal of bankruptcy law is established, the second issue is how well the current Code, as drafted by Congress and applied by the bankruptcy courts, compares to this normative ideal. In other words, to what extent does the Code embrace the desired goals of bankruptcy?

The issue of whether chapter 11 is effecicient can thus be viewed in two separate ways: whether chapter 11 efficiently advances a given goal or whether it embraces efficiency itself as a goal. Restated, the issue is whether efficiency is a means to an end or an end in and of itself. Certainly we have programs in this country that have little to do with efficiency but that nevertheless have strong societal support. Medicare and Social Security come readily to mind. These programs may not promote efficiency in the sense of maximizing the wealth of society, yet everyone would like to see these programs executed efficiently. Thus, the first question that must be answered in addressing the efficacy of chapter 11 is whether efficiency, rather than some form of redistribution of wealth, should be the goal of corporate bankruptcy.

The academic debate on this point has been fairly robust. Douglas Baird, Thomas Jackson, and Robert Scott have all argued that corporate bankruptcy in general and chapter 11 in particular should focus on maximizing the wealth of those who have invested in the debtor.[14] Outside of bankruptcy, the law defines those persons who have a right to enjoy a debtor's assets and the order in which such claimants are to be satisfied. Secured creditors are paid first, followed by unsecured creditors, followed by equity holders. When a firm is insolvent, the creditors are in fact the owners of the firm. In short, the scholars mentioned above argue that bankruptcy should work for the collective good of the owners of the debtor.

One point deserves emphasis: we are discussing only corporate bankruptcy. Talking about the efficiency of disposing of bloodless entities that already enjoy limited liability under state law is certainly a different discussion than focusing on the fate of individuals who seek relief under federal bankruptcy law. It makes sense to call the creditors of an insolvent

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[14] *See* T. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 20-27 (1986); Baird, *A World Without Bankruptcy*, 50 LAW & COMTEMP. PROBS. 173 (1987); Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U. CHI. L. REV. 690, 700-07 (1986).

firm the owners of the firm, and thus to conclude that bankruptcy should benefit them. It makes no sense, however, to treat creditors of individuals as owners of that individual. The notion of "fresh start" captures this difference. Individuals can use bankruptcy to get out of debt and begin anew. Such a concept, however, is meaningless in the case of corporations. Few reasons exist to suggest that a corporation should be able to get a "fresh start" over the objections of its owners.

Even restricting the focus to corporate bankruptcy, other scholars, such as Elizabeth Warren and Jay Westbrook, have argued that bankruptcy should address additional issues. One issue is the effect that bankruptcy has on a debtor's employees and the accompanying community.[15] These scholars are concerned with those who have legally recognizable interests in the debtor's assets outside bankruptcy. However, they contend that the concerns of such parties must be balanced against the concerns of others who do not have a legally recognizable nonbankruptcy claim against the debtor but are nevertheless affected by the continued operation of the debtor.

I have already cast my lot with those who embrace efficiency as the touchstone of federal bankruptcy policy.[16] While I share the concern of those who worry about the effect that the collapse of a company may have on those who have little or no legal claim to its assets, I have yet to understand why these concerns should be addressed only in bankruptcy. It is one thing to express compassion for displaced workers, retirees who are left with real bills but worthless promises, or communities struggling with a disappearing industrial base. It is quite another to assert that these problems should be addressed by bankruptcy law. Realizing that many companies that fail never file a bankruptcy petition, the societal effect of system-wide business failures seems not to be a *bankruptcy* concern. Put simply, all of the problems associated with corporate failure are not necessarily bankruptcy problems. Rather, bankruptcy is best viewed as an avenue of debt collection which is justified because it provides more to the debtor's claimants than the otherwise applicable nonbankruptcy collection system. In other words, bankruptcy is efficient when it maximizes the value of the debtor's assets and minimizes the creditors' collection costs.

Once efficiency has been selected as the standard for determining the

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[15] *See* E. WARREN & J. WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 397-403 (1991); Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009 (1987); Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 796 (1987).

[16] *See* Rasmussen, *Bankruptcy and the Administrative State*, 42 HASTINGS L.J. 1567 (1991).

success of chapter 11, the next question is how well the current law measures up to this yardstick. As with other matters of private law, it is helpful to begin the analysis by asking which collection remedies the debtor and those to whom the debtor owes money would have chosen if bargaining were costless and the parties fully informed. As Ronald Coase pointed out in his seminal work *The Problem of Social Cost*,[17] the parties would reach the efficient solution in such a hypothetical world.[18] This heuristic device was first used to explicate bankruptcy by Dean Thomas Jackson, who dubbed it the "Creditors' Bargain."[19]

The original work by Dean Jackson and Doug Baird employing this technique explained a surprising amount of then current bankruptcy law. The article offered new insights into the treatment of executory contracts, combined the anti-last minute grab and anti-secret lien elements of preference law, justified the trustee's strong arm powers, and explained the necessity of the automatic stay.[20] Nonetheless, the theory diverged from positive bankruptcy law in some regards. Most prominently, Baird and Jackson argued that secured creditors receiving adequate protection should be compensated not only for the physical depreciation of the property, but also for the delay in the exercise of their foreclosure rights.[21] While the Bankruptcy Code can certainly be interpreted to embrace this proposition,[22] the Supreme Court in *United Savings Association v. Timbers of Inwood Forest Associates*[23] held that adequate protection does not protect against temporal depreciation.[24] Despite this difference between theory and practice, the Creditors' Bargain offered fresh insights into bankruptcy policy.

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[17] Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

[18] Coase's work dealt with the assignment of property rights, and Coase's insights have been extended to contract law. *See* Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615, 617-18 (1990).

[19] *See* Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982). As one commentator has pointed out, those using the Creditors' Bargain begin the Coaseon inquiry in the wrong place. Rather than inquiring what the parties would have bargained for at the time of investment, they start the hypothetical bargain assuming that the investors already have their state law collection remedies. *See* Picker, Security Interests, Misbehavior and Common Pools (August 1991) (unpublished manuscript).

[20] Most of the insights of the Creditors' Bargain are compiled in T. JACKSON, *supra* note 14.

[21] *See* Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984).

[22] *See* Comment, *Compensation for Time Value as Part of Adequate Protection During the Automatic Stay in Bankruptcy*, 50 U. CHI. L. REV. 305 (1983).

[23] 484 U.S. 365 (1988).

[24] *Id.* at 382.

Although the Creditor's Bargain offered a coherent view of bankruptcy, it failed to explain the existence of chapter 11. The traditional justification for chapter 11 has been that some companies are worth more as a going concern than if they were liquidated; thus, it is in the creditors' best interest to reorganize the enterprise. Doug Baird, employing the notion of what the parties would have bargained for in a world without transaction costs, mounted a full-scale assault on this justification for chapter 11.[25] Baird agreed that some companies are worth more intact than if sold piecemeal, but he attacked the implicit assumption that a reorganization under chapter 11 was the only way to capture the "going concern surplus" for the creditors. The linchpin of Baird's analysis was the recognition that a chapter 11 reorganization was nothing but a sale of the debtor as a going concern to the debtor's existing claimants. Baird questioned whether this sale was more advantageous to creditors than an actual sale of the firm as a going concern in the market. Why, Baird asked, would creditors prefer a stake in the reorganized firm, where their shares would be determined by a judge, to the current cash value of their interests as determined by the market? Baird thus recognized that the real question for proponents of chapter 11 is not whether the debtor should be kept intact, but why creditors would prefer judicial valuations as opposed to market valuations. Indeed, because the formulation of a chapter 11 plan is probably more costly than the sale of the debtor as a going concern, the chapter 11 valuation procedures must produce more accurate results than the market. Any system based on such a premise must give one pause.[26]

Baird's argument for disposing of companies through the market rather than through judicial supervision seems irrefutable in the case of publicly traded corporations. It is hard to believe that judges can outguess the New York Stock Exchange regarding the value of distressed companies. If they can, they are in the wrong line of work and should be stock traders. Moreover, it is hard to imagine that any of the debtor's creditors assess any special value to the debtor not shared by the market. Finally, it is difficult to believe that a reorganization is necessary to retain current management. First, it may be the case that current management should

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[25] Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986).

[26] Baird's suggestion is more radical than the earlier one suggested by Mark Roe that the court in a chapter 11 proceeding should sell 10% of the firm on the open market to get a valuation of the firm. *See* Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983). Roe's suggestion implicitly assumes that markets have a homogenous view of risk. Such an assumption is open to question. *See* Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235 (1990).

not be retained in light of the fact that the company is in bankruptcy. New owners who put down cold hard cash would seem to evaluate better than a bankruptcy judge whether the current management should be retained. Second, even if current managers should be retained, they should be able to reach an agreement on their own with a third-party purchaser to remain with the firm.

Baird did not suggest, however, a total elimination of chapter 11. He did sketch out a situation where a hypothetical sale may bring more benefits to claimants than a real one. He suggested that if a number of claimants provided idiosyncratic value to the company, such as a manager who has special knowledge and expertise in running the company or a financier who has previously dealt with the company and can thus provide financing at a lower cost than others, a third party may be unable to strike a deal with all the parties who add above-market value to the debtor. In such a situation, a deal among existing claimants may leave the firm worth more than if it were sold to outside parties.

The success of Baird's attempt to save chapter 11 from his own attack is unclear. Even assuming that some debtors meet Baird's criteria for a hypothetical sale, it is undetermined whether such sales should be allowed to take place. The benefits derived from these cases must be weighed against the screening costs. It is one thing to identify in the abstract debtors that should undergo a nonmarket sale; it is quite another to identify them in the real world. Indeed, given how the parties view the disposition of the presiding bankruptcy judge, they are likely to engage in strategic behavior to maximize their own claims. For example, a debtor who does not want to be cashed out in a market sale will argue for a hypothetical sale instead. A creditor, on the other hand, may seek a market sale if the creditor fears that the hypothetical sale would give to other parties not only the gain realized from the hypothetical sale but also some of the value that would have gone to the creditor in a real sale. Thus, once the problem of implementation is considered, the justification for the current version of chapter 11 becomes uncertain.

Recent theoretical work by Thomas Jackson and Robert Scott suggests another justification for chapter 11 in addition to that offered by Baird.[27] Jackson and Scott's work expands on the Creditors' Bargain. One element which the original Creditors' Bargain concept, along with Baird's

[27] *See* Jackson & Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 189-90 (1989); Scott, *Sharing the Risks of Bankruptcy: Timbers, Ahlers, and Beyond*, 1 COLUM. BUS. L. REV. 183 (1989).

application of it to chapter 11, did not consider was that certain claimants may be risk averse. Baird and Jackson's view of bankruptcy included the assumption that all parties were risk neutral. Stated differently, Baird and Jackson assumed that all creditors were concerned only with expected value and not at all with value distributions. Under such a belief structure, all parties would be indifferent given the choice of receiving $100 in cash or a 1 in 100 chance of receiving $10,000.

Jackson and Scott's work relaxes the assumption of risk neutrality. They assert that both creditors and managers of small closely-held firms may be risk averse. Certainly this assumption is true in some cases. Often owner/managers of small businesses have most of their life savings tied up in their business, either directly through capital infusions or indirectly through guarantees of the firm's debts. Given this fact, I would be surprised to find very many owner/managers who, when confronted with two deals, one of which ensured that the value of the firm would remain constant and the other of which promised a 51% chance that the value of the business would double and a 49% chance that it would go to zero, would choose the latter deal over the former. Certainly, entrepreneurs are not the most risk averse segment of society. The fact that they are forgoing steady employment in exchange for the opportunities of success and failure contained in running their own business suggests that they are less risk averse than I am. Nevertheless, it seems realistic to assume some degree of risk aversion among the equity holders of small firms.

Jackson and Scott attempt to delineate the deal that debtors and creditors would reach due to the debtors' risk aversion. In such a deal, they argue, creditors and managers may agree to share the risks of business failure over which none of the parties has any control, such as the risk that oil prices will unexpectedly double. When such a risk materializes, Jackson and Scott assert that the true ex ante bargain would divide the losses among the various claimants. For example, if a small firm which makes asphalt were to become insolvent because of an unexpected rise in oil prices, the owner/manager should not be cashed out through a market sale. Had the parties been able to bargain about this contingency beforehand, they would have agreed to share some of these losses. Scott has dubbed this expanded view of bankruptcy the "Common Disaster Model."[28]

The insight provided by the Common Disaster Model is not without force. To the extent that it takes into account risk aversion, the model

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[28] This name comes from admiralty law. *See* Scott, *supra* note 14.

certainly has an intuitive appeal. Many owners of closely-held firms would pay a higher rate of return to financiers in order to be protected against unforeseeable business reversals. In such a situation, the ex ante agreement would preclude the creditor from exercising its nonbankruptcy rights and putting an end to the venture.

While the insight that risk aversion should be taken into account is valuable, its use in explaining existing law is not. Jackson and Scott use the existence of risk aversion to justify current law's limited version of adequate protection. Jackson and Scott suggest that the result in *Timbers* can be supported once the notion of risk sharing is recognized. Although *Timbers* applies to all bankruptcies, it looms largest in chapter 11 cases because such cases tend to take longer to complete than chapter 7 cases. Thus, to the extent that *Timbers* is efficient, chapter 11 may also be efficient.

In an attempt to justify *Timbers*, Jackson and Scott suggest that not giving the secured creditor the time value of its interest is a type of "insolvency insurance" for the junior interests. The debtor pays a higher rate of interest in exchange for the secured creditor contributing the time value of its interest to those below it in the case of a bankruptcy proceeding.

There are a number of problems with this explanation of the *Timbers* rule.[29] First, the implicit payments from senior to junior creditors are not tied to risk aversion. While some junior parties may be risk averse, others may not. Yet the *Timbers* sharing is done in all bankruptcies. Undersecured creditors must bear part of the cost of reorganization, regardless of whether the entity reorganizing is Eastern Airlines, a family farmer, or the local bookstore. Thus, for some creditors such risk sharing probably does not reflect the true ex ante bargain that they would strike.

A second problem is that in cases involving risk averse parties, there is no guarantee that *Timbers* sharing will occur. In cases in which all senior creditors are oversecured, no assurance is given to the junior creditors, regardless of how risk averse they are. The oversecured creditors are paid interest on their claims during the pendency of bankruptcy.[30] If risk aversion were a concern of bankruptcy, tying *Timbers* sharing to the

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[29] For other criticisms of this point, see Roe, *Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics*, 75 VA. L. REV. 219 (1990); Adler, Bankruptcy and Risk Allocation (to be published in 77 CORNELL L. REV. (1992)).

[30] 11 U.S.C. § 506(b) (1988). Section 506(b) provides:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any

amount of collateral the senior creditor has securing the loan seems strange.

Another problem with Jackson and Scott's explanation is that the debtor, who is likely to be even more risk averse than unsecured creditors given that it cannot diversify its risk, does not share in the senior creditor's contribution when the enterprise becomes insolvent. The absolute priority rule requires that all creditors be paid in full before the debtor receives any interest in the reorganized firm.[31] Thus, equity holders are unlikely to receive any of the sharing mandated by *Timbers*. Yet, equity holders would be more in need of sharing because they cannot diversify their risk the way creditors can. Thus, *Timbers* seems to have little to do with considering risk aversion.

A final problem with the Jackson and Scott position is that the "insolvency insurance" is not bought by the parties who receive its benefit. The debtor pays the premiums through a higher interest rate to the secured creditor. If the debtor flourishes, this premium is money that it will never enjoy. Yet, if the venture ends in bankruptcy, the proceeds of the insurance do not go to the debtor, who has paid the premiums, but to the debtor's unsecured creditors. This simply does not appear to be a deal to which most debtors would consent given the opportunity.

Jackson and Scott also suggest that risk aversion may help explain other contours of chapter 11. Specifically, they posit that risk aversion may be driving courts' willingness to depart from the absolute priority rule. According to this rule, if a bankruptcy court approves a plan over the objection of the creditors, the plan must ensure that no junior class of creditors, including equity holders, receives a share of the reorganized company unless all senior creditors either consent to the plan or are paid in full.[32] Some courts, however, have confirmed plans of reorganization which allowed equity holders to retain an interest in the reorganized company even though all creditors were not paid in full.[33] Such participation

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> reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

Id.

[31] 11 U.S.C. § 1129(b) (1988).

[32] *Id.*

[33] Jackson & Scott, *supra* note 27, at 188; *see* Case v. Los Angeles Lumber Co., 308 U.S. 106 (1939) (the equity holder can retain an interest in the reorganized company proportionate to the equity holders' share of the reorganized company); Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (*In re* U.S. Truck Co.), 800 F.2d 581 (6th Cir. 1986); Official Creditors' Comm. v. Potter Material Serv. (*In re* Potter Material Serv., Inc.), 781 F.2d 99 (7th Cir. 1986); *In re* Landau Boat Co., 13 Bankr. 788 (W.D. Mo. 1981).

has been justified on the grounds that the equity holders are providing a fresh contribution to the enterprise. Jackson and Scott suggest these courts are reacting to the problem of risk aversion by letting risk averse equity holders continue with the enterprise. Nevertheless, because of the uncertain nature of the fresh contribution exception, which has scant statutory support and is not universally accepted, Jackson and Scott ultimately refuse to endorse these decisions.

Thus, it seems that Jackson and Scott's exploration of risk aversion fails to give any justification for existing law. However, I think that the notion of risk aversion should not be abandoned. The problem is not with the insight, but rather with the attempt to use it to justify current bankruptcy law. I think that drawing on the notion of risk aversion may produce a more efficient chapter 11. A complete examination of such an attempt would extend well beyond the bounds of this paper. Let me nevertheless sketch its outlines.[84]

The central insight proferred by Jackson and Scott, that some debtors are risk averse, is certainly correct. Some equity holders exist who would be willing to pay a somewhat higher rate of interest to ensure that they would have a chance to remain involved in the corporation. However, some debtors would rather pay a lower rate of interest to get the possibility of a higher return on their investment. Indeed, some debtors, such as realtors, probably would get a better rate of interest with no bankruptcy at all.

The fact of the matter is that debtors come in different types. Eastern Airlines differs significantly from the "mom and pop" bookstore. It strikes me as odd to think that a single type of corporate reorganization proceeding would be the optimal choice for every firm. Nevertheless, chapter 11 as it is now written gives all debtors the nonwaivable right to attempt to reorganize under its provisions. If given the choice at the outset, perhaps some debtors would be willing to pay for such a right. Others, however, would not. As Baird points out, it is hard to think of any reason why the shareholders of publicly traded firms who are able to diversify their portfolios would take a smaller return in exchange for the ability to file a chapter 11 petition.

Despite such divergence in interests, current law requires that all debtors pay for the chapter 11 option through higher interest rates. By forcing such a deal on those not willing to pay for it, chapter 11 is un-

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[84] For a fuller exposition and defense of this idea, see R. Rasmussen, Debtor's Choice: A Menu Approach to Corporate Bankruptcy (October 1991) (unpublished manuscript).

questionably inefficient. This does not mean that chapter 11 should be repealed and all debtors forced into liquidation through chapter 7. Rather, it simply means that chapter 11 does not produce benefits in all cases. Instead of weighing the inevitable costs of current law against its possible benefits, adopting a menu approach to corporate bankruptcy is far more sensible. Under such a system, different types of reorganization proceedings would exist. In their corporate charter, debtors would have to choose the type of proceeding for which they would be eligible.

Under such a system, the decision as to which option to choose would be treated like other decisions made when the company was formed. When businesses incorporate, decisions regarding capital structure, management policy, and others are made at the outset. Why should the avenues available upon insolvency be any different?

In other words, we should have optional bankruptcy schemes. Companies would be required to place in their corporate charter the type of bankruptcy for which the company would be eligible. For example, one option would be no federal bankruptcy law at all. The equity holders of a company choosing this option would know that upon insolvency, creditors will be able to exercise their state law collection rights. A second choice would be a market sale of the firm. For companies selecting this option, once a bankruptcy petition is filed, an investment banking firm would simply evaluate the assets and decide how to sell them. Because such firms price their services by the value of the deal, the right incentives exist to secure top dollar for the debtor. A third type of bankruptcy would leave the owners with a fixed percentage of the value of the firm and would allow the owners the opportunity to work out a consensual deal with the creditors for continuation of the business. The equity holders' entitlement under this form of bankruptcy would be taken out of either senior or junior debt.

While these three options are merely examples of possible choices a debtor could make upon incorporation, optional schemes of bankruptcy have a number of virtues. First, risk averse and risk neutral debtors could identify themselves when they incorporate. If Jackson and Scott are right in asserting that some parties would pay a higher rate of interest in exchange for insolvency protection, they can do so during the incorporation process. If Baird is right in asserting that some parties would find a market sale in their best interests, let them specify their preference up front. If the expected gains created by any kind of bankruptcy proceeding are simply not worth the cost of the proceeding, the debtor could forego its ability to seek such a proceeding in the future.

In such a world, creditors would adjust their interest rates based on the type of debtor with whom they are dealing. A financier who knew that its debtor would share the risks in the event of insolvency would charge more than one who knew it could rely on its state law collection rights. Thus, equity holders would be forced to decide not simply whether they want a certain level of protection, but also whether they are willing to pay its cost. Such a decision-making process would be more efficient than the current state of affairs in which all borrowers must pay for the ability to seek reorganization under chapter 11.

A second advantage of this approach over the existing attempts to justify current chapter 11 is that it does not present the same screening problem. While Baird, Jackson, and Scott purport to identify a type of debtor for which the current version of chapter 11 may be efficient, they are still faced with the problem of deciding which debtors in fact exhibit the requisite characteristics. A menu approach does not suffer from such a shortcoming. If the current version of chapter 11 is the correct bargain for a certain type of business, the debtor can choose that bargain when it incorporates. Bankruptcy judges will not have to guess whether this is a type of debtor that would benefit from a hypothetical sale.

Of course, the debtor could not have complete freedom to amend its corporate charter on this point. Few creditors would base their interest rates on a debtor's charter which called for a market sale if they knew that the debtor could simply amend its charter to choose forced sharing. Neither, however, should the choice of a potential reorganization proceeding be irrevocable. Things change. At one time, Steve Wozniak and Steve Jobs were Apple Computer; now they are not. The type of bankruptcy which made sense when the company was run from a garage may not be appropriate when the company has billions of dollars in sales every year.

One solution to this dilemma would be to allow a corporation to freely give up protection that its equity holders enjoy, but to require payment to all creditors if equity holders seek to amend the charter to allow for a type of bankruptcy which is more protective of their interests. Thus, if a company selected the option in which the equity holders enjoy a guaranteed share in the event of insolvency, it should be free to amend its charter to require a market sale that respects nonbankruptcy priorities in full. If the corporation wanted to change from a market share to an equity holder protection option, however, it would either have its creditors' consent or pay them off in full.

While such an optional system of corporate bankruptcy needs to be explored in greater depth, it promises to be more efficient than current

law. There is little reason to believe that the current provisions of chapter 11 are efficient. Yet this does not mean that chapter 11 should be repealed and all debtors forced to proceed under chapter 7. Rather, a better solution to the corporate reorganization conundrum is to allow debtors to sort themselves when they incorporate. Such an approach may go a long way toward making chapter 11 efficient.