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Citation: 3 Am. Bankr. Inst. L. Rev. 85 1995

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THE ECONOMIC ANALYSIS OF CORPORATE BANKRUPTCY LAW

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Firms fail. They do not pay their creditors, they lay off their employees, and they often close their doors. All agree that the demise of an enterprise visits hardship on those who have some connection with it. These regrettable costs are inevitable in a market economy, which, after all, is defined by its conviction that competition will lead to the elimination of some firms. What has generated extensive controversy, however, is how our legal system should mete out the consequences of such failure. This dispute reigns in the practicing bar, the popular press, and academia. Recent years have witnessed a growing unease with existing bankruptcy law. This tension has led Congress to establish the Bankruptcy Review Commission, which is charged with conducting an exhaustive review of the current bankruptcy system.[1]

Economic analysis offers much insight into the continued evolution of our insolvency system. By focusing on the role that bankruptcy law plays in our economy, economic analysis generates concrete proposals for increasing the efficiency of the way in which federal law addresses the problems raised by a firm in financial distress. This emphasis on efficiency, far from ignoring the consequences of a business collapse, seeks to minimize the costs imposed by such events. It offers an expeditious and accurate measure for determining which firms should continue their operations and which firms should not.

This Article sets forth the basic conclusions which flow from an economic analysis of bankruptcy law. Our overriding theme is that policymakers in reforming the current Bankruptcy Code should, where practicable, use the market to inform the disposition of firms which encounter financial distress. This policy prescription is not based on a romantic view of the perfect operation of the market. Like other institutions, markets have significant limitations. But in many contexts, markets tend to make better decisions than do other possible decision makers, most prominently courts, in regard to the proper allocation of assets. At bottom, a bankruptcy system must decide the fate of a firm in financial distress and economic analysis reveals that over a broad range of cases, markets can and should play an

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[1] Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, §§ 601-610, 108 Stat. 4106, 4147-50 (1994). The Commission is required to prepare a report containing its findings and conclusions together with its recommendations for legislative or administrative action within two years of its first meeting. *Id.* § 608, 108 Stat. at 4149. Congress stated that since it is generally satisfied with the basic framework established in the current Bankruptcy Code, the Commission should not seek to "disturb the fundamental tenets and balance of current law." 140 CONG. REC. H10,764 (daily ed. Oct. 4, 1994) (section-by-section description of 1994 Act).

even greater role in this process than they do presently.

Given the space limitations of this paper, we, of necessity, paint with a broad brush. The arguments we make and the proposed reforms we offer could be, and in some instances have been, set forth in greater detail. Nevertheless, we believe that even without the possible refinements, the analysis offered here goes a long way toward explaining and improving our existing bankruptcy regime.

I. AN INTRODUCTION TO THE ECONOMIC ANALYSIS OF BANKRUPTCY LAW

The economic analysis of bankruptcy law focuses on devising a set of rules which will increase overall social welfare. In bankruptcy, as in other settings, social welfare is characterized in terms of efficiency. Efficiency occurs when assets are put to their most productive use. This is a worthwhile goal because the more productive the assets, the more wealth there is for all of society to enjoy. To translate this general efficiency goal to the bankruptcy setting, we begin with the observation that bankruptcy law determines the future disposition of a firm whose liabilities (usually) exceed its assets.[2] An efficient bankruptcy law must address three general concerns. First, it should ensure that post bankruptcy assets are put to their highest valued use. Second, it must not create incentives for firms not in bankruptcy to engage in inefficient activities. Finally, it must accomplish the first two goals as cheaply as possible.

Before looking at the way in which the economic analysis of bankruptcy furthers these goals, we briefly address those who would reject the economic analysis of corporate bankruptcy law out of hand. One persistent criticism of economics is that it tends to ignore important societal concerns.[3] The general criticism often levelled at economics is that it ignores the distribution, as opposed to the amount, of societal wealth. In bankruptcy, this lack of concern with distributional issues translates into the criticism that economic analysis of bankruptcy law ignores the goal of preserving jobs and redistributing the value of the firm to those who are most in need.[4] The temptation for many is thus to

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[2] Note, however, that the Bankruptcy Code does not explicitly require that debtors, other than municipalities, be insolvent in order to be eligible for relief. *See* 11 U.S.C. § 109 (1988), *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 109 (West Supp. 1995) (listing eligibility requirements for bankruptcy relief).

[3] *See* Donald R. Korobkin, *Value and Rationality in Bankruptcy Decisionmaking*, 33 WM. & MARY L. REV. 333, 335 (1992) (arguing in favor of a "value-based account" which takes into account economic and non-economic values of those affected by financial distress); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777 (1987) (criticizing economic analysis as giving "quick answers, but only by sliding past the troublesome issues that pervade the resolution of real problems.").

[4] *See* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 354-61 (1993) (asserting that Code was adopted specifically to ameliorate harmful effects of business failures on parties who have no formal rights to the assets of the business). "The Code accounts for the rights of other parties that a business failure affects by giving a failing company an opportunity to sell itself as a going concern in chapter 7 or to reorganize in chapter 11." *Id.* at 355.

ignore, or at least discount heavily, the insights offered by economic analysis.

The preservation of jobs and the distribution of the value of the firm are undeniably important objectives. An efficient bankruptcy law, however, promotes, rather than ignores, these objectives.[5] Creditors decide whether or not to lend money to a firm, and at what price. To the extent that a bankruptcy law penalizes voluntary creditors in an effort to aid others, these creditors will raise the cost of credit. More expensive credit leads to a reduction in economic activity. The lower the amount of economic activity, the less jobs there will be in the country as a whole. Attempting to save jobs through an inefficient bankruptcy regime may therefore have the opposite of its intended effect. Using bankruptcy law to override the decisions of those who invest in the firm, whether as shareholders or creditors, comes at a cost. As in many aspects of social planning, there is no such thing as a free lunch.

The mere fact that distributing assets of a troubled firm away from consensual creditors will decrease the amount of economic activity does not necessarily imply that consensual creditors should receive the entire assets of the failed firm in accordance with their contractual priority. At times, one can articulate a justification for deviations from the distribution to which the various parties agreed. For example, when the issue is compensating tort claimants injured by the firm ahead of contractual creditors, such an increase in the cost of credit is justified from both an economic and moral standpoint.[6] Not only does compensating tort claimants seem intuitively fair, but it also forces corporations to take into account the injuries their behavior imposes on third parties. The basic point, however, is that one should articulate a reason for moving away from deference to private contracting.

In order to speak more precisely about the appropriate scope of private contracting as opposed to governmental regulation in the bankruptcy arena, it is first necessary to characterize the kinds of firms that are likely to wind up in bankruptcy. At the heart of the economic analysis of corporate bankruptcy law is the distinction between economic distress and financial distress. A firm that is experiencing economic distress is one in which its operating revenues are less than its operating costs. Such a firm should not continue in business. Its continued existence drains the economy. Indeed, in some instances, allowing the firm to continue in operation under the protection of the bankruptcy law may lead to widespread losses in the industry in which it operates.[7] From a societal point of view,

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[5] *See* Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1 (arguing that economic approach to bankruptcy law can promote social justice).

[6] *See* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1893 (1994) (arguing involuntary creditors should be given priority over secured creditors); Rasmussen, *supra* note 5, at 31-35.

[7] The most notable example is the airline industry. The Bankruptcy Code, as currently written, allows firms to suspend payments on their long-term debts during the pendency of the case. 11 U.S.C. § 362(a), *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 362(a) (West Supp. 1995). This means that

there is little justification in attempting to prop up firms which have failed in the market place.

Financial distress, on the other hand, does not necessarily imply that a firm should be shut down. Financial distress occurs when a firm cannot pay its bills. This failure to pay its bills results solely from the firm's capital structure. For example, when Johns-Manville, Federated Department Stores and Texaco filed for bankruptcy protection, few if any thought that these firms should be closed. They all were healthy firms in that their operating revenues exceeded their operating costs. The problem was their capital structure. In all cases, through various means, the firms had incurred more debt than they could pay off. They all were suffering from financial distress.

Economic distress and financial distress are conceptually distinct. Some firms that are quite healthy in the economic sense nevertheless cannot pay off their bills because they have excessive debt. On the other hand, some firms have no trouble paying their bills because they have sufficient cash on hand yet still are running at an operating loss. Despite the distinction between these two types of distress, they are positively correlated. Firms in economic distress often are in financial distress as well. Indeed, it is often the case that the economic distress is what is causing the financial distress.

Were it cheap and easy to determine with a high degree of accuracy whether a firm in financial distress was also encountering economic distress, matters would be simple. Inefficient firms would be liquidated under a procedure akin to the current Chapter 7.[8] Such firms should not remain in existence, and a quick, orderly piecemeal liquidation promises to put a halt to the continuing losses, while at the same time recovering as much value as possible for the creditors of the doomed enterprise. Economically viable firms, in contrast, would be reorganized under a procedure similar to the current Chapter 11.[9] The only problem with such firms is that they cannot operate under their current capital structure. A frictionless Chapter 11 proceeding would revamp a firm's capital structure, and allow it to continue as a viable going concern. Indeed, the evidence suggests that Congress, in enacting the current Bankruptcy Code, envisioned such a sorting of firms. Congress sought to liquidate failed firms through Chapter 7, while preserving viable

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firms in bankruptcy only have to pay the marginal cost, as opposed to the average cost, of their continued operation. In the airline industry, this allows carriers in bankruptcy to begin price wars that impose substantial losses on the entire industry. AVIATION FORECASTING & ECONOMICS, THE BANKRUPTCY VIRUS IN THE U.S. AIRLINE INDUSTRY: CAUSES AND CURES (1993).

[8] 11 U.S.C. §§ 701-766 (1988 & Supp. V 1993), *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. §§ 701-766 (West Supp. 1995).

[9] 11 U.S.C. §§ 1101-1174 (1988 & Supp. V 1993), *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. §§ 1101-1174 (West Supp. 1995). An additional alternative, for economically viable corporations, is to sell the firm intact to a third party under either Chapter 7 or Chapter 11. We discuss this alternative as well as the obstacles to intact sales under Chapter 7, *infra* part III. For simplicity, the focus in the present discussion is on the contrast between piecemeal liquidation and the traditional reorganization process.

firms through Chapter 11's reorganization procedures.[10]

Experience over the past sixteen years, however, has indicated that the current Bankruptcy Code does not distinguish well between firms that belong in Chapter 7 and those that belong in Chapter 11. A great majority of firms which file for Chapter 11 eventually end up being liquidated.[11] Such liquidation, however, occurs only after a firm has gone through the expense of attempting to reorganize.[12]

It should not be surprising that it is very difficult to determine the economic viability of a firm that is undergoing financial distress. The party with the best information regarding the future prospects of the firm—the firm's management—has an incentive to overstate the viability of the entity. Managers get paid as long as their firm remains in business. Moreover, managers of closely held firms often have a significant portion of their personal wealth invested in their firm. Any procedure which offers the prospect of revitalizing the business is therefore attractive to them.

To make matters worse, it is significantly harder than it is with healthy firms for parties other than managers to obtain reliable information about a firm that is operating under financial distress.[13] Lack of available cash may impose extraordinary constraints on management decision making. Thus, one cannot simply look at the operating results of a firm immediately prior to the bankruptcy filing and assume that they represent an accurate picture of the firm's viability.

In addition to the difficulty in distinguishing among firms, a second problem that has emerged under the current Bankruptcy Code is the cost of the Chapter 11 proceeding. It turns out that Chapter 11 does not provide a quick and easy method for revamping a firm's capital structure. One study, for instance, found the average

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[10] *See* H.R. REP. NO. 595, 95th Cong., 2d Sess. 222 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 ("The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.").

[11] One nationwide survey reported that the confirmation rate for Chapter 11 cases filed between 1979 and 1986 was 17%. Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319, 320 (1991) (reporting results from EDWARD M. FLYNN, ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS-STATISTICAL ANALYSIS AND REPORTS DIVISION, BANKRUPTCY DIVISION, STATISTICAL ANALYSIS OF CHAPTER 11 at 10 (1989)). Even after a Chapter 11 plan is confirmed, conversions to Chapter 7 are not infrequent. *Id.*

[12] *Id.* at 320 (noting that bankruptcy court allowed Eastern Airlines to spend over $600 million before going out of business). The costs of bankruptcy include both its direct costs and indirect costs such as lost opportunities and difficulties with suppliers. For discussions of various bankruptcy costs, see Robert H. Mnookin & Robert B. Wilson, *Rational Bargaining and Market Efficiency: Understanding Pennzoil v. Texaco*, 75 VA. L. REV. 295, 313 (1989) (noting one expense of bankruptcy is diversion of management to reorganization issues and away from daily management activities); Lawrence A. Weiss, *Bankruptcy Resolution and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990) (concluding direct costs average 3% of book value of debt plus market value of equity at end of fiscal year preceding bankruptcy).

[13] *See* Robert Gertner & Randal C. Picker, Bankruptcy and the Allocation of Control 2-7 (Feb. 16, 1992) (unpublished manuscript, on file with the *American Bankruptcy Institute Law Review*).

duration of a Chapter 11 proceeding to be over seventeen months.[14] As elsewhere, time is money and the costs of bankruptcy are high. The professional fees in the bankruptcy of a large, publicly-held company can run into the tens of millions of dollars.[15] Thus, not only does the current system fail to distinguish between those firms which should be liquidated and those which should continue, but it also consumes a good bit of a firm's assets in the process. This fact has generated much of the literature on the economic analysis of bankruptcy law.[16] Economic analysis offers proposals that attempt to better differentiate among firms, and at a lower cost.

One variable often mentioned in fashioning bankruptcy policy is the business cycle. Operating results are not constant across time and the business cycle often contributes to the onset of financial distress. In times when the economy as a whole is performing well, individual businesses tend to perform well, and to generate sufficient revenues to cover their debt payments. Similarly, when the economy is stagnant, individual businesses tend to perform worse than they do in boom times, and thus are more likely to be unable to pay their debts as they become due. Thus, it is no surprise that a downturn in the economy leads to an increase in the number of bankruptcy petitions filed.[17]

The fact that financial distress is more prevalent at some times than it is at others does not imply that the existence of the business cycle should dictate bankruptcy policy. In order to justify an attempt to reorganize, the operating revenues of a business must exceed operating losses throughout the business cycle considered as a whole. Firms that eke out a profit in good times and lose substantial sums of money in bad ones are inefficient, and therefore should not remain in operation.

Indeed, many firms that should remain in operation can borrow money in order to avoid financial distress during a downturn in the business cycle. If in fact a firm can, over the long haul, cover its operating expenses with its operating revenues, it should be able to borrow against its future earnings in order to even out its cash flow. There are years in which many cyclical businesses experience losses, often significant losses. Indeed, those who invest in the stock market often refer to

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[14] Lynn M. LoPucki, *The Trouble With Chapter 11*, 1993 WIS. L. REV. 729, 739-745.

[15] *See* Steve H. Nickles & Edward S. Adams, *Tracing Proceeds to Attorneys' Pockets (and the Dilemma of Paying for Bankruptcy)*, 78 MINN. L. REV. 1079, 1080-81 (1994) (stating combined attorney fees in Eastern Air Lines, Pan American Airlines, and LTV bankruptcies totalled over $250 million); Edward A. Adams, *Bankruptcy Fees here are Highest in Nation*, N.Y. L.J., June 25, 1993, at 1 (discussing $770 million paid in professional fees in Southern District of New York bankruptcies between 1989 and 1992).

[16] *See* Jagdeep S. Bhandari & Lawrence A. Weiss, *The Untenable Case for Chapter 11: A Review of the Evidence*, 67 AM. BANKR. L.J. 131, 134 n.10 (1993) (compilation of articles which attempt to measure costs of bankruptcy and make inferences from such measurements regarding efficiency of Bankruptcy Code).

[17] *See Today's News*, N.Y. L.J., Jan. 9, 1991, at 1 (reporting 33% increase in New York bankruptcy filings in 1990 as a result of recession); Steven Pearlstein, *Business Failures Reported to Be Up Sharply in 1st Quarter*, WASH. POST, Apr. 27, 1991, at D11 (pointing to increase in business bankruptcy filing rate as evidence of widening recession).

"cyclical industries." Yet the firms in this category do not invariably experience financial distress because they often can cover their losses either through reserves built up when times were good, or through borrowing in the credit markets.

Given that many firms can anticipate and respond to them, business cycles should not play a systematic role in bankruptcy policymaking. To make a case for devising a bankruptcy regime attuned to the gyrations of the economy, the following situation must exist. There must exist a number of firms[18] that, despite being economically viable in the long run, experience financial distress because currently their operating expenses exceed their operating revenue, and they cannot cover these losses either through retained earnings or through borrowing in the credit markets. The most likely candidates for such a situation are closely held firms. In such firms, there often is little information about their future prospects, and it may be the case that in fact they will be economically viable, but no bank will lend money to them because the bank cannot distinguish between those firms which are economically viable and those which are not.

We admit that there is no hard data on whether or not such a state of affairs exists. Yet it is common knowledge that under the current bankruptcy system, which attempts to promote corporate reorganization, most firms which file for Chapter 11 reorganization eventually close their doors.[19] The number of firms filing for bankruptcy which are economically viable appears to be quite small.

II. MARKETS OR COURTS: WHO SHOULD DECIDE?

The suggestion that bankruptcy should be seen as a mechanism for deciding how to allocate a debtor's assets raises institutional questions that go to the heart of the bankruptcy process. Who should decide whether a debtor's distress is financial in nature, so that the debtor should be reorganized, or whether the debtor faces economic distress and is therefore a candidate for liquidation? What role should a bankruptcy court, on the one hand, and market processes, on the other, play in bankruptcy?[20] In order to underscore the significance of the choice of institutions in the bankruptcy context, we begin by putting the choice in historical perspective. We then move to a more general discussion of the appropriate roles of courts and markets.

[18] We would require a number of firms rather than a single or a few firms because we do not believe that bankruptcy law, which applies to all firms in financial distress, should be driven by situations which do not occur often.

[19] Rasmussen, *supra* note 11, at 322 ("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.").

[20] In addition to the bankruptcy court and market processes, a third possible decision maker, of course, is Congress. Although we focus throughout this part on a comparison of courts and markets, legislative decision makers are included in the analysis by implication, in that we view the other two institutions through the perspective of Congress and suggests several ways that the Bankruptcy Code could be amended to create a more efficient balance between courts and markets.

The drafters of the former Bankruptcy Act[21] felt strongly that courts should be the primary decision maker once a corporation filed for bankruptcy. In order to police the perceived problem of self-dealing by insiders, the Act provided for pervasive court involvement from the beginning of the bankruptcy case. The bankruptcy court,[22] together with the Securities and Exchange Commission,[23] not only would police the parties' behavior, but also would play a major substantive role in the process, selecting the trustee,[24] presiding over the first creditors' meeting,[25] and conducting an extensive valuation at confirmation that effectively gave the court control over the decision whether a corporation should be liquidated or reorganized.[26]

Leaving nearly complete oversight authority to bankruptcy judges is entirely appropriate with respect to some kinds of issues. Judges are particularly adept at policing misbehavior by the parties: addressing issues such as whether a pre-bankruptcy transaction should be struck down as a fraudulent conveyance,[27] or whether to equitably subordinate a claim due to a creditor's misconduct.[28] It is therefore not surprising that both the former Act and the current Bankruptcy Code are replete with provisions whose effect is to place the bankruptcy court in such a role.[29] To be sure, a debtor and its creditors theoretically could contract in advance to specify what behavior is or is not appropriate, thus significantly reducing

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[21] Bankruptcy Act of 1898, Ch. 541, 30 Stat. 544, *amended by* Act of June 22, 1938 (Chandler Act), ch. 575, 52 Stat. 840, *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

[22] Under the old Act, the judicial decision maker actually was a bankruptcy "referee" rather than a judge. *See* 11 U.S.C. § 62(a) (1976) (repealed 1978) (providing for appointment of referees by bankruptcy court); *id.* § 66 (delegating most powers of bankruptcy court to referees). For simplicity, we use the terms "judge" and "court" when discussing either the Act or the Code.

[23] *See, e.g., id.* §§ 572-573 (providing for submission of proposed Chapter X reorganization plans to SEC and for SEC to submit advisory report to court recommending whether plan should be approved); *id.* § 608 (providing for intervention of SEC in Chapter X proceeding as party in interest); *id.* § 665(a) (requiring that notice of all steps taken in Chapter X proceeding be submitted to SEC).

[24] *Id.* §§ 11(17), 72(a), 556.

[25] *Id.* § 91.

[26] *Id.* § 621 (listing requirements for Chapter X plan confirmation).

[27] Fraudulent conveyances can be avoided under two distinct sections of the Code. 11 U.S.C. § 544(b) (1988) (authorizing trustee to avoid prepetition transfers of debtor that are "voidable under applicable law by a creditor holding an unsecured claim . . . ."); *id.* § 548 (1988 & Supp. V 1993) (authorizing trustee to avoid transfers made by debtor within one year of filing, *inter alia*, where debtor did not receive reasonably equivalent value in exchange, and was insolvent or rendered insolvent by the transfer).

[28] *See* 11 U.S.C. § 510(c) (1988) (authorizing bankruptcy court to subordinate, on equitable grounds, all or part of claim to all or part of another claim, or order lien securing subordinated claim be transferred to estate).

[29] In addition to the fraudulent conveyance and equitable subordination sections, the Code includes numerous good faith provisions, each of which gives the bankruptcy court substantial authority to police the bankruptcy process. *See, e.g.*, 11 U.S.C. § 105(a) (1988) (granting bankruptcy court general equitable power to enter any orders it deems necessary); 11 U.S.C. § 1126(e) (1988) (disqualification of votes not cast in good faith). While the provisions allowing the trustee to avoid pre-bankruptcy transfers deemed to be preferential are per se in nature, the statutory exceptions leave significant room for judicial oversight. *See* 11 U.S.C. § 547(c) (1988) (listing circumstances which validate otherwise preferential transfers).

the need for judicial involvement in some of these areas.[30] But the cost of devising such finely-tuned contracts could be substantial, and the parties themselves might often fail to do so. Consequently, giving bankruptcy courts a central role in policing misbehavior is an important and appropriate focus of the bankruptcy laws.

In contrast to their expertise in policing misbehavior, however, judges are not as effective at performing other functions. The most obvious of these is making business decisions.[31] Because market participants are penalized by the markets if they make bad decisions (they lose money), and rewarded for making good decisions (they make money), a market player has a strong incentive to make wise business decisions. By contrast, since a bankruptcy judge does not have a personal stake in the firm, she does not bear the consequences of any business decision made in the bankruptcy context. As a result, judges are not nearly as well positioned to make business decisions as are market players.

The discussion thus far suggests several general conclusions about the appropriate roles of courts and the market in deciding how the assets of a debtor should be allocated. At its heart, the decision whether to reorganize the debtor, or to sell its assets either intact or piecemeal, is a business decision. In view of this, market players rather than a bankruptcy court should make the decisions as to what should be done with the debtor and its assets.[32] Courts should be limited to what they do best: policing for misbehavior.

As an alternative to judicial valuations, bankruptcy law should rely on market transactions or contractual arrangements among the parties wherever possible. It is important to note that, in addition to arguing for extensive reliance on market processes within the bankruptcy context, this conclusion may also call for forgoing

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[30] For arguments to this effect, see Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107 (1994); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 322-23 (1993).

[31] *See In re* Airlift Int'l, 18 B.R. 787, 789 (Bankr. S.D. Fla. 1982) (indicating congressional intent to limit court involvement in business decisions by granting trustee broad authority under § 1108); *In re* Curlew Valley Assoc., 14 B.R. 506, 509-14 (Bankr. D. Utah 1981) (providing in depth analysis of statutory and policy reasons for limiting courts' power over business decisions of trustee).

[32] The argument that courts should police misbehavior but leave business decisions to market forces has analogues in other areas of the law. In the corporate law context, for instance, courts have long articulated a policy of closely scrutinizing transactions for possible misbehavior, while adopting a highly deferential stance toward the handling of business decisions. *See, e.g.*, Pollitz v. Wabash R.R., 100 N.E. 721, 723-24 (N.Y. 1912) (recognizing that business decisions of directors are without limitation and are free from restraint as long as corporate power is not exercised for private or personal gain). Thus, corporate managers are held to a strict duty of loyalty, whereas courts give them broad discretion in the duty of care context through the relaxed scrutiny of the business judgment rule. The analogy between corporate law and bankruptcy seems particularly appropriate, given that bankruptcy is in many respects simply an extension of corporate law. *See* David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 475 n.7 (1994) [hereinafter Skeel, *Rethinking the Line*] (suggesting reintegration of state corporate law and federal corporate bankruptcy would produce cohesive policy); David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 463 (1992) [hereinafter Skeel, *Corporate Voting*] (maintaining Chapter 11 can be viewed as extension of state corporate rules).

the traditional reorganization process altogether in some cases. The traditional reorganization process entails a "hypothetical sale" of the debtor's assets, pursuant to which existing claimants exchange their claims or interests for cash or for new claims against the reorganized debtor.[33] Rather than market decision makers, such as buyers, making the final determination as to the value of a business, as they would with an actual sale, the hypothetical sale of chapter 11 leaves ultimate authority on valuation issues to the bankruptcy court.[34] Because market participants are better situated to make such calls, an actual sale or other market disposition of a debtor's assets may, in many contexts, be an attractive alternative to the traditional view of reorganization as comprising negotiations among the parties which culminate in a reorganization plan upon which the court does or does not give its blessing.

An obvious objection to emphasizing markets and private ordering in bankruptcy is that, although market players may generally be in a better position to make business decisions than bankruptcy courts, their focus is dangerously myopic. In particular, market participants look only at their own bottom line, and as a result fail to take into account the full consequences of their decision making process. This concern, which the economics literature refers to as an "externality" problem,[35] is a legitimate one which warrants judicial or legislative intervention in some contexts.[36] Yet, as we noted earlier in addressing the general reluctance to consider economic analysis, it is important to ask whether such a problem exists before intervening in market transactions and to consider the costs of judicial oversight or other intervention.[37]

We want to emphasize that our endorsement of markets is based on a comparison of markets to the other alternatives. We do not believe that markets are

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[33] Robert Clark is generally credited with being the first to characterize reorganization as a "hypothetical sale" of the debtor's assets to its existing creditors. Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1250-54 (1981). The metaphor is in a sense historical rather than simply academic since, in the equity receivership era that preceded the former Bankruptcy Act, debtors used the pretense of a foreclosure sale as a means of reorganizing a corporation. *See* 5 COLLIER ON BANKRUPTCY ¶ 1100A.04 (Lawrence P. King ed., 15th ed. 1992) (describing operation of equity receiverships).

[34] *See, e.g.*, 11 U.S.C. § 1129(a)(7) (1988) (requiring determination as to whether members of an impaired class will receive at least as much under the reorganization plan as they would in liquidation); *id.* § 1129(b) (requiring determination that non-consensual plan adheres to absolute priority rule).

[35] *See* Bailey Kuklin, *The Gaps Between the Fingers of the Invisible Hand*, 58 BROOK. L. REV. 835, 839 (1992) (stating "[a]n externality is a 'neighborhood' or 'third party' effect of a market exchange: an effect on someone's well-being which is not taken into account in the market exchange."). *See generally* EDWIN MANSFIELD, MICROECONOMICS: THEORY & APPLICATIONS 372-74 (3d ed. 1979).

[36] *But see* FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 17, 23, 25-27, 37-39 (1991) (arguing that agency costs rise and social wealth falls when managers are asked to consider welfare of community instead of simply maximizing return to equity holders). Easterbrook and Fischel suggest that instead of regulating corporate governance, societal welfare is best promoted by providing disincentives to corporate acts which may be harmful to society, *e.g.*, penalties for pollution. *Id.* at 38.

[37] *See supra* notes 2-5 and accompanying text.

efficient in the sense that they always make the correct decision. Recent work has demonstrated that in many instances, markets, even when there are no problems of the sort we considered earlier,[38] may reach the wrong conclusion. When all firms in a market must make a similar decision, such as which technology they should adopt in making their products, they sometimes make the wrong decision. This occurred where the market for videotapes selected the VHS format over the Betamax format.[39] The same suboptimal decision may result when firms select which legal rules should govern their conduct.[40] At other times, lack of information may lead market participants to make decisions which are inefficient.

Yet markets need not be perfect to be adopted. They must, instead, merely be better than the available alternatives. As our analysis makes clear, we think that the markets pass this test when business decisions such as the appropriate allocation of a debtor's assets are required. Many of the problems which may impair markets have the same or greater tendency to impair bankruptcy courts. This is especially true given that courts do not have their own money on the line when they make decisions. Markets may not be perfect, but they can be expected to perform more effectively than courts when it comes to making asset allocation decisions.[41]

The single biggest advance of the current Bankruptcy Code is that it shifted the bankruptcy laws in precisely this direction. Chapter X of the Act, for instance, which was designed to apply to publicly held corporations, mandated that the court immediately displace a debtor's existing management and appoint a trustee to run the company in their stead.[42] While this step might make sense for a corporation whose managers had engaged in serious misbehavior or for firms in a state of complete collapse, it proved highly disruptive for other debtors. This led the managers of many debtors to try to avoid Chapter X at all costs.[43] The Code responds to these problems by leaving existing management in place and making the

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[38] *See supra* notes 2-3 and accompanying text.

[39] *See* Andrew Tanzer, *Sharing*, FORBES, Jan. 20, 1992, at 82 (describing effects of Sony's decision to promote Betamax format and Matsushita's victory in promoting the VHS format).

[40] *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 80 VA. L. REV. (forthcoming 1995).

[41] *Cf.* James W. Bowers, *The Fantastic Wisconsylvania Zero Bureaucratic-Cost School of Bankruptcy Theory: A Comment*, 91 MICH. L. REV. 1773, 1790-92 (1993).

[42] *See* 11 U.S.C. § 556 (1976) (repealed 1978) ("Upon the approval of a petition, the judge shall, if the indebtedness of a debtor, liquidated as to the amount and not contingent as to liability, is $250,000 or over, appoint one or more trustees.").

[43] *See* David A. Skeel, Jr., *Markets, Courts and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 517-18. Chapter X of the Act, applicable to publicly held corporations, required the replacement of management by a trustee and strict compliance with the absolute priority rule. *Id.* at 517. On the other hand, Chapter XI, which did not specifically exclude publicly held corporations from its coverage, allowed managers to stay in control and did not mandate preservation of absolute priority. *Id.* As a result, many managers of publicly held corporations filed under Chapter XI. *Id.* at 518.

appointment of a trustee exceptional rather than the norm.[44] Permitting a debtor's existing managers to continue running the corporation[45] not only smoothes the transition into bankruptcy, but also ensures that market players rather than a judicial officer make the ongoing business decisions for the firm.

Yet the Code still imposes numerous impediments to adopting market approaches to the central issues of bankruptcy. For instance, the Code seems in some respects to discourage the sale of a debtor as an intact entity, assuming instead that the only allocation alternatives are reorganization under Chapter 11 or piecemeal liquidation under Chapter 7.[46] The Code also is nearly entirely mandatory in nature. This, together with the longstanding view that a debtor cannot waive its right to file for bankruptcy,[47] leaves little room for parties to devise their own contractual alternatives (or additions) to existing bankruptcy rules.[48] If nothing else, the analysis of this part should make clear that one issue warranting serious discussion is whether these hurdles should be lowered in order to create more room for market solutions to bankruptcy-related issues.

III. THE MARKET IN ACTION IN BANKRUPTCY

On initial inspection, our economic analysis seems to call for a strikingly different conception of bankruptcy than the one practicing lawyers deal with every day. Whereas we have emphasized the strengths of market processes in determining how a debtor's assets should be allocated, the traditional perception views bankruptcy as pervasively and inescapably judicial. Bankruptcy, in this conception, is a manifestation of market breakdown, not a place where the market can do its work.

Yet, as we noted above, Congress's decision to allow a debtor's existing managers to continue to run the business moves away from the traditional, anti-market conception of bankruptcy in important respects.[49] In order to illustrate the increasing importance of market processes, and to underscore the congruence between our analysis and much of existing practice, we turn now to a discussion of

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[44] 11 U.S.C. § 1104(a) (1988) (providing for appointment of trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management . . ." or "if such appointment is in the interest of creditors, any equity security holders, and other interests of the estate . . . .").

[45] *See id.* § 1107 (giving debtor in possession practically all rights, powers, and duties of trustee).

[46] For a discussion of the bias in Chapter 7 toward piecemeal liquidation rather than intact sales to a third party, see Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEG. STUD. 127, 146-47 (1986) (arguing intangible assets, such as debtors' lawsuits against others should be transferable by trustee to third party buyer and investors should have same rights under liquidation as under reorganization).

[47] *See infra* notes 50-51 and accompanying text.

[48] Some have argued that small firms can arrange their capital structure so as to avoid the costs of bankruptcy. *See* Douglas G. Baird, *The Reorganization of Closely Held Firms and the "Opt Out" Problem*, 72 WASH. U. L.Q. 913 (1994).

[49] *See supra* notes 42-45 and accompanying text.

recent trends toward more market-oriented approaches in several areas of bankruptcy law. Throughout the analysis, we use our discussion of the appropriate roles of the market and judicial oversight to assess whether these trends should be encouraged or restrained.

A. *Agreements to Waive the Automatic Stay*

Courts have long held,[50] and commentators have long assumed,[51] that debtors cannot waive their right to file for bankruptcy. Courts therefore refuse to enforce agreements that have such an effect. Yet courts also have frequently stated that the Bankruptcy Code should be interpreted in such a way as to encourage pre-bankruptcy settlements.[52] In the context where these two ideas most obviously intersect, prepackaged bankruptcy,[53] they arguably do not stand in tension, since prepackaged bankruptcy works more like a specialized use of the bankruptcy process than an attempt to circumvent bankruptcy altogether.[54]

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[50] *See* Klingman v. Levinson, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987) (providing that because of public policy, debtor cannot contract away right to discharge in bankruptcy) (dictum); *In re* Southern Land Title Corp., 301 F. Supp. 379, 396 (E.D. La. 1968) (stating agreements in derogation of right to seek reorganization are most strictly construed if they are not void against public policy); Alsan Corp. v. Dipierro (*In re* Dipierro), 69 B.R. 279, 282 (Bankr. W.D. Pa. 1987) (stating debtor cannot contract away right to bankruptcy discharge in advance of bankruptcy filing); *In re* Tru Block Concrete Prods., Inc., 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983) (advance agreement to waive right to file petition in bankruptcy is wholly void as against public policy).

[51] *See, e.g.*, Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 AM. U. L. REV. 337 (1993). "[C]ourts have uniformly invalidated, on public policy grounds, any waivers of the right to file a voluntary petition in bankruptcy." *Id.* at 402 (citation omitted).

[52] *See* United Savs. Ass'n v. Timbers of Inwood Forest Assoc. (*In re* Timbers of Inwood Forest Assoc.), 793 F.2d 1380, 1405-06 (5th Cir. 1986) (noting various Code sections which evince congressional intent to encourage speedy out-of-court workouts); *In re* Colonial Ford, Inc., 24 B.R. 1014, 1023 (Bankr. D. Utah 1982) (enforcing out-of-court workout by invoking § 305(a)(1) power to dismiss case where dismissal would serve interests of all parties).

[53] In a prepackaged bankruptcy, the debtor develops a reorganization plan and solicits acceptances prior to filing a bankruptcy petition. *See e.g.*, Republic Health Corp. v. Coral Gables (*In re* Republic Acquisition Co.), 134 B.R. 194, 196 n.1 (Bankr. N.D. Tex. 1991) (prepackaged plan is negotiated between debtor and creditor prior to Chapter 11 filing) (citing *In re* T.S. Indus. Inc., 117 B.R. 682, 688-89 (Bankr. D. Utah 1990)). The debtor then files the plan together with its petition, thus dramatically reducing the length of the bankruptcy case.

[54] Congress explicitly contemplated that some debtors would use this strategy. *See* 11 U.S.C. § 1126(b) (1988) (allowing prepetition solicitation or rejections if in "compliance with any applicable non-bankruptcy law" or, if there is no such law, acceptance or rejection was solicited after disclosure of adequate information to holder); FED. R. BANKR. P. 3018 (listing requirements for prepetition acceptance or rejection of plan by equity security holders and creditors); *see also Republic*, 134 B.R. at 196 n. 1 (prepackaged plans are specifically contemplated by the Bankruptcy Code) (citing *In re* T.S. Indus. Inc., 117 B.R. 682, 688-89 (Bankr. D. Utah 1990)); *In re* Southland Corp., 124 B.R. 211, 223-24 (Bankr. N.D. Tex. 1991) (citing Bankruptcy Rule 3018 "acceptances or rejections of a plan may be obtained before the commencement of a case under the code.").

However, agreements which purport to waive bankruptcy's automatic stay,[55] another area gaining increasing prominence, arguably bring courts' hostility toward waiver and their sympathy for pre-bankruptcy workouts into direct conflict. Cases involving stay waivers raise the important question of whether a debtor and its creditors should be permitted to alter or opt out of particular provisions of the Bankruptcy Code.

Thus far, the cases considering whether a debtor can waive its right to the automatic stay fit a consistent pattern. Most are single asset real estate cases (many involving individuals rather than businesses) where the debtor agrees to waive the automatic stay in connection with a pre-bankruptcy workout with its principal lender.[56] When the debtor's problems continue and it defaults on the workout agreement, it files for bankruptcy and argues that the purported waiver of the stay is unenforceable.

Courts have upheld a debtor's prior agreement to waive the stay in several of these cases.[57] *In re Powers*[58] is illustrative. In *Powers*, the court concluded that prepetition waivers are not per se unenforceable and emphasized that honoring such agreements would effectuate the policy of encouraging pre-bankruptcy settlement.[59] As in several other cases, the *Powers* court seemed swayed by its perception that the debtor's effort to renege on its agreement amounted to bad faith.[60] Other courts have refused to uphold such waivers, however. The most prominent decision to invalidate such a provision, *Farm Credit of Central Florida v. Polk, ACA*,[61] seemed to be based, in part, on an implicit premise that allowing the debtor to waive the automatic stay would effectively be a waiver of bankruptcy, contrary to

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[55] 11 U.S.C. § 362(a) (1988), *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 362(a) (West Supp. 1995).

[56] *See, e.g.*, *In re* Club Tower L.P., 138 B.R. 307, 311 (Bankr. N.D. Ga. 1991) (stating prepetition agreement waiving right to relief from stay is enforceable against debtor). *But see In re* Cheeks, 167 B.R. 817, 819 (Bankr. D.S.C. 1994) (extending *Club Tower* holding to all classes of debtors, not just single asset real estate cases).

[57] *See, e.g.*, *In re* Powers, 170 B.R. 480, 484 (Bankr. D. Mass. 1994) (holding debtor's prepetition waiver of automatic stay is primary factor in determining whether there is "cause" for relief from automatic stay); *Cheeks*, 167 B.R. at 819 (stating that under stay waiver agreement, debtor has only foregone a single benefit of Bankruptcy Code in exchange for creditor forbearance); *Club Tower*, 138 B.R. at 312 (holding enforcement of pre-petition settlement agreements furthers legitimate public policy of encouraging out of court restructurings and settlements) (citing *In re* Colonial Ford, Inc., 24 B.R. 1014, 1023 (Bankr. D. Utah 1982)).

[58] 170 B.R. 480 (Bankr. D. Mass. 1994).

[59] *Id.* at 482.

[60] *Id.* at 484 (citing *In re* McBride Estates, 154 B.R. 339 (Bankr. N.D. Fla. 1993) for proposition that debtor opposition to lift stay motion is sanctionable if debtor had previously entered into stay waiver agreement with motioning creditor); *see also In re* Orange Park S. Partnership, 79 B.R. 79, 82 (Bankr. M.D. Fla. 1987) (finding bad faith where, *inter alia*, the debtor had no valid basis to rescind the agreement).

[61] 160 B.R. 870 (M.D. Fla. 1993).

the longstanding policy against such waivers.[62]

How should bankruptcy courts deal with the parties' efforts to contract around the automatic stay? As the foregoing analysis of the respective strengths of market and judicial decision making suggests, giving parties the flexibility to make their own arrangements makes far more sense than imposing a wholly mandatory bankruptcy regime. It is not accidental that most stay-waiver cases arise in the single asset real estate context, and involve disputes between the debtor and a single creditor. Many of these cases do not present the kinds of collective action problems that bankruptcy law is designed to address, and thus arguably do not belong in bankruptcy. In such a case, a debtor might quite rationally agree to forego bankruptcy, which is likely to impose delay costs and other expenses on the creditor without providing any significant offsetting benefit. Enforcing a stay waiver has the advantage of minimizing these costs by eliminating delays and thus benefitting both parties.[63]

A stay waiver is far more problematic if a debtor has more than a single significant creditor. Although the waiver may make sense as between the parties who agreed to it, other creditors may not have any idea that the debtor has relinquished its right to the automatic stay. For these creditors, the waiver imposes significant costs. Most important, the debtor's promise to give up its principal creditor's collateral may sacrifice the benefits of any collective proceeding. It is difficult to reorganize a business, for instance, if the lender has foreclosed on all of the debtor's equipment or inventory. If other creditors knew that the debtor had agreed to a stay waiver, they could adjust their relationship with the debtor accordingly (perhaps, by monitoring more closely or insisting on more restrictive credit terms). What makes waivers in existing agreements particularly problematic is the element of secrecy and the costs they impose on other creditors.[64]

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[62] *Id.* at 873. "The automatic stay provision is intended to preclude the opportunity of one bankruptcy creditor to pursue a remedy against the debtor to the disadvantage of other bankruptcy creditors and thus, to promote the orderly administration of the bankrupt's estate." *Id.* (citing Triangle Management Servs. v. Allstate Sav. & Loan Ass'n, 21 B.R. 699, 700 (N.D. Cal. 1982)).

[63] Even in the absence of a stay waiver, creditors also have challenged a debtor's right to use the bankruptcy process in single asset real estate cases in several other ways. For instance, creditors have invoked the implied prohibition against petitions filed in bad faith. *See In re* Aurora Invest., Inc., 134 B.R. 982, 985 (Bankr. M.D. Fla. 1991). "[I]t is now established peradventure that the court may dismiss a Chapter 11 case for cause if the court finds the petition was filed in 'bad faith.'" *Id.* (citation omitted). Classification schemes used by debtors in single asset real estate cases in order to confirm a reorganization plan have also been challenged by creditors. *See* Linda J. Rusch, *Single Asset Cases And Chapter 11: The Classification Quandary*, 1 AM. BANKR. INST. L. REV. 43, 43-45 (1993) (describing argument typically made by undersecured creditor that its claim cannot be classified separately from the unsecured claims of other creditors when the purpose of such classification is to create an accepting class of impaired claims).

[64] It is interesting to note that several of the cases upholding stay waivers seem to recognize this problem, at least implicitly, as is evidenced by their suggestion that stay waivers bind only the parties to the agreement and do not preclude third parties from raising objections to the waiver. *See In re* Powers, 170 B.R. 480, 483 (Bankr. D. Mass. 1994) (stating debtor's waiver does not bind third parties); *In re* Cheeks, 167 B.R. 817, 819 (Bankr. D.S.C. 1994) (asserting court's jurisdiction to hear third party objections to stay

This analysis of stay waivers thus suggests that they offer real benefits in some cases, particularly those that are primarily two party disputes, but that their secrecy may be costly to other parties. From this perspective, courts' current reluctance to enforce stay waivers in cases involving multiple creditors[65] seems wholly appropriate. Yet the cases also raise the question of whether there might be a means of ensuring disclosure, in order to give a debtor and its creditors more flexibility to contract around bankruptcy in multiple creditor contexts.[66] One possibility might be to establish a filing system similar to that used to provide notice of a security interest or mortgage.[67] Although a filing requirement would reduce the secrecy problem, it has the downside of forcing creditors to use the filing system, who would not otherwise do so. On the other hand, many creditors, such as trade creditors, might rely on Dun & Bradstreet or other credit agencies to keep abreast of a debtor's status.[68]

Another approach, for corporate debtors,[69] would be to honor the parties' attempts to contract out of bankruptcy so long as the debtor included the stay waiver in its corporate charter.[70] Like a filing requirement, the charter approach minimizes secrecy by providing a central location for evidence of any stay waiver. This approach, however, also has limitations. Creditors would need to periodically examine a debtor's charter to ensure the debtor had not entered into a stay waiver since the charter was last checked. Nevertheless, as with the filing alternative, creditors could minimize the inconvenience by relying on regular reports of a credit agency.

Although neither approach is perfect, both would address many of the concerns that stay waivers in multi-party contexts have generated. Pursuing these or other

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relief).

[65] *See Polk*, 160 B.R. at 873 (refusing to enforce stay waiver where multiple creditors, not party to the waiver agreement, would be adversely effected). "Since the purpose of the stay is to protect the creditors, as well as Polk [the debtor], Polk could not have unilaterally waived the automatic stay against the interest of his creditors." *Id.*

[66] It is interesting to note that in cases involving multiple creditors, stay waivers given by a debtor to its principal lender can be seen as a mechanism for effectuating the "selective stay" proposal Doug Baird and Randal Picker have advocated. Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311 (1991). We discuss this proposal in more detail *infra*, note 125 and accompanying text.

[67] The framework for providing notice by filing of a security interest is set forth in Article 9 of the Uniform Commercial Code. U.C.C. § 9-302 (1990) (filing requirement and exceptions to filing); *id.* § 9-304 (permissive filing); *id.* § 9-401 (filing locations); *id.* § 9-402 (information required in financing statement). State real estate law provides somewhat similar recording requirements for interests in real estate. *See, e.g.*, N.Y. REAL PROP. LAW § 291 (McKinney 1994) (recording of conveyances).

[68] *See* ELIZABETH WARREN & JAY L. WESTBROOK, THE LAW OF DEBTORS AND CREDITORS, 8-9 (2d ed. 1991) (discussing means of tracking and reporting debtor's behavior).

[69] It bears underscoring that our focus in this Article is on corporate debtors. Individual debtors raise other issues that we do not consider here.

[70] One of us has discussed the benefits of this kind of approach in an earlier work. Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 100-02 (1992).

disclosure mechanisms offers the important benefit of enhancing contractual flexibility as an alternative to a wholly mandatory bankruptcy regime.

B. *The Trading of Claims in Bankruptcy*

Stay waivers reflect an effort by a debtor and its principal creditor to avoid bankruptcy altogether, or at least to limit its effects. Market processes also have begun to play an increasing role within a bankruptcy case. Perhaps the most prominent example of this is the exponential increase in the trading of bankruptcy claims.[71]

As we discussed earlier, one of the most frequently criticized aspects of bankruptcy in recent years has been the inordinate time it takes to resolve many cases.[72] For some creditors, including many suppliers, the lengthy delay before receiving any payment on their claims can be a significant hardship. The market for claims can provide a way for such creditors to cash out their stake early on, rather than waiting until the case is finally resolved at some point in the future.[73] Active claims trading also provides a market assessment of the value of a debtor and the likely result of any reorganization, and in some cases can help to create a market for control of a Chapter 11 debtor.[74]

Prior to the amendment of rule 3001(e),[75] which governs the assignment of claims, several courts established special procedures for determining whether they would honor a creditor's agreement to sell its claim, despite the fact that the rule seemed on its face to give courts only the ministerial function of recording

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[71] *See Bankruptcy Funds; Preying on the Busted,* THE ECONOMIST, May 13, 1989 at 86 (stating that by 1989, the pool of capital available for claims trading was approximately $3 billion); C. Kenneth White, *Trading Claims in Bankruptcy; Trends, Issues and Investment Opportunities*, 366 PLI REAL ESTATE L. & PRACTICE COURSE HANDBOOK SERIES NO. 9, (Jan.-Mar. 1991) (stating that $5 billion of bankruptcy claims were traded between 1985 and 1990); Jonathan Auerbach, *MGRE Claims Selling Out at 82 cents on the $1; Merry-Go-Round Enterprises*, DAILY NEWS REC., Jan. 19, 1994 at 11 (stating trading of claims has evolved into $10 billion market); Ross Kaufman, *Redress Distress by Trading the Debt; Activity in Secondary Market Increases*, N.Y. L.J., Oct. 12, 1993, at 11 (estimating trading at $13 billion in 1993).

[72] *See, e.g*, LoPucki, *supra* note 14, at 729 (analyzing several studies which show significant increases in the amount of time debtors spend in Chapter 11).

[73] *See, e.g.*, Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 4 (1990) [hereinafter Fortgang & Mayer, *Trading Claims*]. Fortgang and Mayer have written a series of articles on the trading of claims in bankruptcy. *See also* Chaim J. Fortgang & Thomas M. Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, 13 CARDOZO L. REV. 1 (1991) [hereinafter Fortgang & Mayer, *Developments I*]; Chaim J. Fortgang & Thomas M. Mayer, *Developments in Trading Claims: Participations and Disputed Claims*, 15 CARDOZO L. REV. 733 (1993) [hereinafter Fortgang & Mayer, *Developments II*].

[74] *See* Richard N. Tilton & Kenneth M. Lewis, *Trading in Claims; The Case for a Free Market*, N.Y. L.J., Oct. 7, 1993, at 5; Fortgang & Mayer, *Trading Claims*, *supra* note 73, at 4-8.

[75] FED. R. BANKR. P. 3001(e) (amended 1991). The amendments to Bankruptcy Rule 3001(e) became effective in August 1, 1991. 11 U.S.C. app. Rule 3001(e) (Supp. V 1993).

transfers.[76] The current version of rule 3001(e)[77] rejects the parental roles taken by the courts in *In re Revere Copper and Brass, Inc.*[78] and *In re Allegheny Int'l, Inc.*[79] As the Advisory Committee note makes clear, the rule is intended to limit the court's responsibility to adjudicating disputes raised by the parties themselves.[80] The rule also omits any requirement that the parties disclose the terms of the transfer, and permits only the seller to raise any objections. In view of our discussion of the appropriate roles of markets and courts, it should be immediately apparent that the amendments to rule 3001(e) represent a promising development in the trading of claims. The problem with pervasive judicial involvement is that it unnecessarily chills the market for claims. Taking courts out of the business of second guessing the parties' transactions gives potential buyers much more incentive to purchase claims, thus increasing the availability of the kinds of benefits described above.

This is not to say that all impediments to a robust market for claims have disappeared. There still are several significant roadblocks, the most significant of which are tax related. Under existing tax laws, the trading of claims can, in certain circumstances, jeopardize a debtor's ability to preserve its net operating losses.[81] Because of this, courts have imposed substantial limitations on claims trading in several recent cases.[82] An obvious way to enhance the beneficial effect of market processes would be to alter the net operating loss rules to eliminate their interference with claims trading.

Thus far, the discussion has implicitly assumed that claims traders buy claims because they expect to receive more for the claim in connection with a reorganization plan than they paid for it. Although most claims buyers fit this description, some traders buy claims in order to further an effort to take control of a reorganizing debtor. These traders are most interested in buying votes to further their plan or to stymie an opposing plan.

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[76] *See In re* Allegheny Int'l, Inc., 100 B.R. 241, 243-44 (Bankr. W.D. Pa. 1988) (requiring buyers to give seller current estimate of value of claim, plus right to rescind); *In re* Revere Copper and Brass, Inc., 58 B.R. 1, 2-3 (Bankr. S.D.N.Y. 1985) (requiring sellers be given 30 days to rescind sale due to court's perception sellers had not been given adequate explanation of their options).

[77] FED. R. BANKR. P. 3001(e).

[78] 58 B.R. 1 (Bankr. S.D.N.Y. 1985).

[79] 100 B.R. 241 (Bankr. W.D. Pa. 1988).

[80] FED. R. BANKR. P. 3001 advisory committee's note.

[81] *See* IRC § 382 (West Supp. 1995). Section 382 provides that upon an ownership change in the stock of a debtor corporation, the debtor may use only a specified fraction of its net operating loss carryforwards to shelter income in any given year. Fortgang & Mayer, *Developments II*, *supra* note 73, at 756 n.10.

[82] The bankruptcy courts in both the Ames Department Stores and Pan Am cases issued orders restricting the trading of claims, as did the debtor in the Munsingwear prepackaged bankruptcy case. Fortgang & Mayer, *Developments II*, *supra* note 73, at 756-59. The problem in each of the cases centered on the fact that the IRC § 382 limitation does not apply if pre-confirmation shareholders and qualified "old-and-cold" holders of claims collectively receive 50% of the stock of the debtor under its plan. *Id.* at 756 n.120; *see* IRC § 382(*l*)(5)(A) (West Supp. 1995). In order for a debtor to determine if the limitation will apply, the debtor must investigate each proof of claim to determine the status of the filer. *Id.* at 756-59.

Courts and commentators have been highly critical of various aspects of such efforts. In *In re Allegheny International Inc.*,[83] a leading case on the propriety of buying claims to further an acquisition effort, the bankruptcy court sharply criticized the buyer's use of its veto power to block the debtor's plan.[84] The court disqualified the buyer's vote based on section 1126(e), which authorizes disqualification of votes cast in bad faith.[85] Inappropriate use of blocking power by a claims buyer is, as the court suggested, a legitimate concern.[86] On the other hand, close judicial scrutiny of every claims trader whose ultimate goal is to take over the debtor could reintroduce the kinds of judicial interference problems that the amendments to rule 3001 were designed to reduce.[87] One of us has argued that the current voting structure, in particular the fact that a claims buyer need only obtain one-third in value of a class of claims in order to assert veto power, contributes to the problem in cases like *Allegheny*.[88] Amending the voting rules to provide for simple majority voting with respect to both amount and number would make inappropriate exercise of veto power more expensive and less attractive to a claims trader.[89] Good faith might still be an issue in some cases, but not as a matter of course.

Based on aspects of *Allegheny*, several commentators have suggested a somewhat different limitation on acquisition-motivated claims buying.[90] In their view, claims traders who either contemplate or have proposed a reorganization plan should be required to give earlier claims sellers the benefit of any subsequent decision to increase the plan's payout to such claims since the purchases can be seen as, in effect, part of the plan.[91] The problem with this approach is that it would unnecessarily interfere with the markets for claims and corporate acquisitions.[92] Outside of bankruptcy, acquirors routinely buy stock of the target corporation (at

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[83] 118 B.R. 282 (Bankr. W.D. Pa. 1990).

[84] *Id.* at 289-90 (finding purchasers of claims acted in bad faith).

[85] *Id.* at 290; *see* 11 U.S.C. § 1126(e) (1988).

[86] *Id.* at 299.

[87] It is important to keep in mind, in this regard, that buying claims and using the voting power connected with them to further a takeover effort is not inherently malignant. On the contrary, absent clear misbehavior, this strategy may enable third parties who would otherwise be thwarted by Chapter 11 to acquire the debtor and, in doing so, to reorganize it. Federated Department Store's purchase of claims and use of these claims to force Macy's to agree to a merger in the Macy's bankruptcy case is a recent example of how acquisition-motivated claims buying can lead to results that are widely viewed as beneficial. *See Macy Exit From Bankruptcy*, N.Y. TIMES, Dec. 19, 1994, at D4 (reporting how purchase of claim by Federated led to confirmation of plan merging Federated and Macy's).

[88] Skeel, *Corporate Voting*, *supra* note 32, at 513-15 (concluding that amendment of § 1126 voting rules would reduce need for judicial supervision over voting process).

[89] *Id.* at 488-90, 515-18.

[90] Fortgang & Mayer, *Developments I*, *supra* note 73, at 33.

[91] *Id.*

[92] For a related criticism that focuses primarily on doctrinal issues, see Herbert P. Minkel, Jr. & Cynthia B. Baker, *Claims and Control in Chapter 11 Cases: A Call For Neutrality*, 13 CARDOZO L. REV. 35, 83-90 (1991).

prices below those the acquiror ultimately pays) before making a merger proposal or tender offer. This strategy, which is sometimes referred to as obtaining a "toe-hold", gives the acquiror leverage in its negotiations and can reduce the costs of the acquisition effort. Claims buyers can be seen as engaging in similar behavior when they buy claims in connection with an acquisition effort. Forcing a buyer to give sellers the benefit of any subsequent change in the plan would significantly chill acquisition activity.[93] Nor is the seller a particularly strong candidate for sympathy—the possibility that the plan will later offer a higher payout is a risk sellers take when they sell their claims.

The kinds of problems discussed above are themselves evidence, in a sense, of the burgeoning role of market processes in the context of bankruptcy claims. With the increase in claims trading, courts inevitably have faced questions as to how to respond to these new developments. Our analysis suggests that courts should encourage, rather than interfere with, the market in order to facilitate the significant benefits claims trading offers in bankruptcy.

C. Bankruptcy Auctions and Liquidating Reorganizations

One final example further illustrates the pervasiveness of market influences even in existing bankruptcy cases. In addition to stay waivers, which epitomize efforts to contract around bankruptcy, and claims trading, which epitomizes the development of markets in connection with bankruptcy, the participants in some cases have relied on market devices such as auctions to address the central bankruptcy issue of valuing a debtor's assets.

To appreciate the significance of this development, recall that bankruptcy has long been assumed to entail a judicial valuation of the debtor's assets.[94] Bankruptcy lawyers and the parties they represent have embraced the assumption that the valuation issue will be addressed through inter-party negotiations that are guided by the court, and which culminate in a judicial determination as to whether the parties have properly valued the debtor's assets. So deeply held is this vision of bankruptcy that judicial valuation and piece-meal liquidation have often seemed the only choices for resolving the valuation issue.

Despite this emphasis on judicial valuation and the disincentives to using other methods of determining a debtor's value, the parties in several prominent cases have conducted auctions of a debtor's business. One recent example involved the

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[93] Easterbrook and Fischel have made this point on many occasions in the corporate law literature. *See* EASTERBROOK & FISCHEL, *supra* note 36, at 126-27; *see also id.* at 179-80 (arguing that two-tier tender offers—in which bidder offers a higher price for shares needed to acquire control of corporation than for shares tendered after bidder has acquired controlling interest—do not reduce value of firm and can only succeed for bidder placing highest value on firm's assets).

[94] *See supra* notes 33-34 and accompanying text.

auctioning of the Baltimore Orioles baseball team.[95] Rather than valuing the team judicially in connection with a subsequent reorganization plan, the parties agreed to an auction of the team early in the case.[96] Other bankruptcy cases involving auctions include *In re Financial News Network, Inc.*[97] and *In re Eastern Airlines, Inc.*,[98] which ended with an auction after a series of ill-fated attempts to reorganize.[99]

These cases are high profile examples of the fact that judicial valuation is not the only way, and often is not the best way, to determine what a business is worth. An arguably more pervasive illustration stems from the Bankruptcy Code itself. By its terms, Chapter 11 permits *liquidating* reorganization plans; that is, the parties can agree to a reorganization plan that calls for sale or other disposition of a debtor's assets, rather than continuation of the business under its existing management.[100] As with Chapter 7 liquidations, the parties face various obstacles to conducting an intact sale of a business in connection with a liquidating reorganization. It is unclear, for instance, whether a debtor can prevent a secured creditor from retrieving collateral that may be necessary to a sale, since the Bankruptcy Code requires that the stay be lifted if the creditor's collateral is not necessary to a "reorganization."[101] But a remarkably large number of chapter 11 debtors do confirm plans that involve sales of one form or another.[102]

Auctions and other market valuation mechanisms are not foolproof. For example, if many of a debtor's competitors are also in financial trouble, the market for the debtor's assets may be relatively limited. Moreover, even if appropriate buyers exist, auctions may sometimes prove unsuccessful because they are poorly conducted. An early auction in the *Allegheny* bankruptcy failed, at least in part, for this reason.[103] The important points for present purposes, however, are that market transactions often are an attractive alternative to more impressionistic judicial valuations of a bankruptcy debtor, and that courts and the parties frequently

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[95] *See* Murray Chass, *Going, Going, Sold: Orioles Auctioned for $173 Million*, N.Y. TIMES, Aug. 3, 1993, at B9.

[96] Kenneth N. Gilpin, *Banks Act on Owner of Orioles*, N.Y. TIMES, Mar. 31, 1993, at D4.

[97] No. 91 B 10891 (Bankr. S.D.N.Y. Mar. 1, 1991).

[98] No. 89 B 10449 (Bankr. S.D.N.Y. Mar. 9, 1989).

[99] *See* Gail Appleson, *Judge Confirms Eastern's Bankruptcy Plan*, REUTER BUS. REP., Dec. 22, 1994 (auctioning of Eastern Airlines' assets).

[100] 11 U.S.C. § 1123(a)(5)(D) (1988) (plan can provide for sale of all or any part of debtor's assets).

[101] *Id.* § 362(d)(2) (requiring bankruptcy court to lift automatic stay with respect to property that debtor does not have equity in, and which is not necessary to effective reorganization).

[102] *See* Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 602-03 (1993) (stating that of 22 firms where core business survived liquidation sale of its assets, 7 involved sale of business to third party).

[103] *See*, Claire Ansberry, *Takeover Mayhem: When Will Somebody—Anybody—Rescue Battered Allegheny*, WALL ST. J., Apr. 19, 1990, at A1. The initial auction for Allegheny, which at one point promised to pay nearly 100% of the unsecured claims, collapsed after the debtor and bankruptcy court withdrew from several ostensible final bidding deadlines in the face of continued jockeying among the bidders and the debtor's creditors and shareholders. *Id.*

turn to market mechanisms even under existing law.

These market devices might prove even more attractive if existing impediments to their use were removed. Courts already have taken steps in this direction. In *In re Koopmans*,[104] for instance, Judge Mabey held that the "necessary to an effective reorganization" requirement in section 362(d)(2) should be read to permit a debtor to retain property it needs to liquidate its assets.[105] Another major obstacle to market sales is that a sale, like the trading of claims, can destroy a debtor's net operating losses.[106] Amending the net operating loss rules to diminish this effect might further enhance the flexibility of the Bankruptcy Code, and its amenability to market alternatives to judicial valuation.

In sum, even apart from major bankruptcy reform, the trend in the courts in recent years has been toward increased reliance on the market in determining the fate of the firm. In the next section, it is proposed that this trend be extended.

IV. PROPOSALS FOR REFORM

The main thrust behind most proposed reforms coming from the law and economics movement is the attempt to increase the role of the market in determining the fate of firms in financial distress. As the preceding section illustrated, bankruptcy courts under the Bankruptcy Code have taken tentative steps in some cases to introduce a modicum of market valuation into the reorganization process.[107] The reforms suggested by an economic analysis of bankruptcy law take this trend to its logical conclusion, and consider ways that market processes could be used as an alternative to Chapter 11. In this section, we discuss four prominent proposals.

A. *The Elimination of Bankruptcy Law*

Michael Bradley and Michael Rosenzweig captured national attention with their proposal to eliminate Chapter 11 in its entirety.[108] Under their proposal, when a firm defaults on a debt payment, the interests of existing shareholders are automatically eliminated.[109] The debt holders who have the lowest priority lose

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[104] 22 B.R. 395 (Bankr. D. Utah 1982).

[105] *Id.* at 407.

[106] *See supra* note 81 and accompanying text.

[107] *See supra* part III.

[108] Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992); *see* Howard Gleckman, *Why Chapter 11 Needs to be Rewritten*, BUSINESS WEEK, May 18, 1992, at 116 (noting Bradley and Rosenzweig proposal as possible remedy for bankruptcy system fraught with waste); Peter Passell, *Critics of Bankruptcy Law See Inefficiency and Waste*, N.Y. TIMES, Apr. 12, 1993, at A11 (same).

[109] Bradley & Rosenzweig, *supra* note 108, at 1082.

their debt claims and instead become the new shareholders.[110] If the default which triggered the elimination of the original shareholders was on debt owed to the now new shareholders, the firm is no longer in default since the debt no longer exists.[111] If, on the other hand, the default was on a debt owed to a more senior debt holder, the firm is still in default on that obligation.[112] The new shareholders would be given a short time to cure this default, either through additional borrowing or infusion of their own cash into the firm.[113] Failure to cure such default would start the process over again, with the interests of the new shareholders eliminated, and the next lowest class of debt holders becoming shareholders.[114] The process repeats itself until the firm is no longer in default.[115]

The crux of the proposal is its elimination of the problems associated with financial distress by eliminating financial distress itself. Under this system, no firm would ever experience a prolonged period where it could not pay its bills. This elimination of traditional financial distress provides two major benefits over current law. The first is that it eliminates the need for any court-supervised restructuring of the firm's capital structure.[116] Gone would be Chapter 11 and its cumbersome procedures. In its place would be a system which relied entirely on the market.[117] If a firm cannot raise sufficient cash either through its operations or through the credit and stock markets to meet its debt payments, this failure reflects the market's conclusion that the firm is worth less than its outstanding debt. The market, rather than a bankruptcy judge, would have the ultimate responsibility for valuing the firm.

Another benefit of this proposal is that it eliminates any need for a judicial decision as to whether the firm should remain intact or be liquidated. Each succeeding group of shareholders can make the decision as to the best use of the firm's assets. The party whose interest is most at stake—the residual claimant—is the one charged with making all business decisions regarding the firm, including whether or not it should continue in operation. The disinterested bankruptcy judge is replaced by the interested owner.

The proposed regime of automatic cancellation has received much criticism, some of which we share.[118] We find two challenges are persuasive. The first is

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[110] *Id.*

[111] *Id.*

[112] *Id.* at 1083-84.

[113] *Id.* at 1084.

[114] *Id.*

[115] *Id.*

[116] *Id.* at 1085.

[117] *Id.*

[118] For a detailed critique of automatic cancellation and other recent proposals, see Skeel, *supra* note 43. For other assessments of automatic cancellation, see Bhandari & Weiss, *supra* note 16, at 131; Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669 (1993); Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992); Robert K. Rasmussen, *The Ex Ante Effects of*

that this proposal presupposes an active market for the firm.[119] While such a market exists for publicly traded firms, it does not exist for the vast majority of privately held companies. Such companies, which tend to be smaller, would have to look to private lenders to stave off the possibility of default.[120] The lender with the best information regarding the prospects of the firm, likely its financing bank, may be unwilling to lend additional funds because default may transfer the value of the firm to it. We are thus leery of mandating a legal system of automatic cancellation for all firms.

The second concern that we have with automatic cancellation is its potential for increasing the cost of contracting.[121] Defaults occur regularly under current law with no untoward consequences. Lenders often write covenants which are designed to be broken well before a firm reaches financial distress. These covenants serve as an early-warning system for the lender and can indicate a need for increased monitoring of the firm's activity. Because the lender does not expect a default to lead to an automatic calling of the loan, there is room for flexibility in drafting covenants. An overly broad covenant, while raising the possibility that the borrower may end up in technical default, imposes little cost on the borrower.

This state of affairs would change dramatically in a world of automatic cancellation. In such a world, default is everything. Default causes the shareholders to lose their interest in the firm. While a borrower may be willing to accept an overly broad covenant under current bankruptcy law, it would not be willing to accept such a term under automatic cancellation.[122] This suggests that lenders and borrowers would expend a great deal of effort in drafting covenants. The extent of such additional effort, however, is a matter of speculation. Whether such costs will exceed the gains from eliminating Chapter 11 is a matter on which the authors of this Article have little basis to offer even an educated guess.[123]

B. Auctions

As noted earlier, some bankruptcy courts have begun a limited use of auctions to dispose of the assets of a financially troubled firm.[124] One prominent reform proposal is to extend this incipient trend and require auctions for all firms which

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Bankruptcy Reform on Investment Incentives, 72 WASH. U. L.Q. 1159 (1994) [hereinafter Rasmussen, *Ex Ante Effects*]; Rasmussen, *supra* note 70, at 51; Elizabeth Warren, *The Untenable Case For Repeal of Chapter 11*, 102 YALE L. J. 437 (1992).

[119] *See* Bradley & Rosenzweig, *supra* note 108, at 1081 n.87.

[120] *See* Skeel, *supra* note 43, at 483-84 (explaining that issuance of equity is not a viable option to privately held companies due to prohibitive transactions costs).

[121] *See* Rasmussen, *Ex Ante Effects*, *supra* note 118, at 1159.

[122] *See* Skeel, *supra* note 43, at 490.

[123] *See id.*

[124] *See supra* notes 95-99 and accompanying text.

file for bankruptcy.[125] Bankruptcy courts would auction off all firms to the highest bidder within a relatively short time from when they filed for bankruptcy relief. The motivating force behind this proposal is a belief that there is a need to get bankruptcy courts out of the business of valuing firms. Instead, the market would value enterprises by replacing the hypothetical sales of Chapter 11 reorganizations with real sales.

Despite the obvious attractions of this proposal, there are two drawbacks. The first is that, as with automatic cancellation, auctions work best with a publicly traded firm.[126] The key to a successful auction is to have a number of bidders interested in the firm. The level of interest generated will depend largely upon existing public information about the firm. To the extent that a potential investor has some level of knowledge about the firm, it may be willing to investigate the firm further in order to decide whether or not to bid. If, however, little is known about the firm, it may be difficult to interest potential buyers to learn enough about the firm in order to make a bid.

A second problem with the auction proposal arises from the fact that often, the most likely buyers for a firm are its competitors. As was demonstrated during the takeover boom in the 1980's, it is often the case that a firm's competitors can put the firm's assets to their best use. This creates a problem because the fortunes of firms in any particular industry tend to move in sync. If one firm in the industry is experiencing financial distress which forces it to file for bankruptcy, it is likely that other firms in the industry have also seen a downturn in their prospects.[127] The result is that these competitors may not be able to raise the cash necessary to bid for the firm in bankruptcy. Thus, auctions may not bring the highest value for the firm.[128]

C. *Selective Stay*

Both the automatic cancellation and auction proposals are geared toward publicly held firms. A reform aimed at smaller, privately held corporations is the

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[125] *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, 218-24 (1986) (recommending the sale of companies as going concerns); Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J. L. ECON. & ORG. 523 (1992) (using new proposal of Lucian A. Bebchuk as part of a market-based proposal to replace Chapter 11); Baird, *supra* note 46, at 139 (recognizing that actual sale of firm as going concern in the market could be more valuable).

[126] *See* Skeel, *supra* note 43, at 479 (suggesting mandatory auctions may be implausible for smaller corporations).

[127] *See* Andrei Shliefer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343 (1992).

[128] *See* Skeel, *supra* note 43, at 479 (suggesting that if competitors cannot bid, then small number of bidders will dominate auction process). For a critique focusing on different aspects of the auction proposal, see Rasmussen, *supra* note 121, at 1201-04.

selective stay.[129] This bankruptcy system would impose a stay on all small creditors of the debtor once the debtor files for bankruptcy. The debtor's large financing creditor, in contrast, would not be subject to the stay. The justification for such a regime is as follows. Most small firms need their current managers, who are generally the primary shareholders as well, to stay with the firm if it remains in business. The outside party with the best information regarding the future prospects of the firm is the financing bank, which has learned a good deal about the business during the course of the loan. If the firm is worth more as a going concern than it would be if it were liquidated, it is in the interest of the bank to reach a deal with the manager/owners to restructure the debt and keep the firm in business. One impediment to reaching such an agreement is the demands of various small creditors of the debtor. Their insistence on being repaid could, absent a stay of collection efforts, lead to a piecemeal liquidation of the firm. The selective stay would prevent this destructive race to the assets while the bank and the manager/owners attempt to restructure the firm's major debt. If the bank believes that the firm is worth more dead than alive, it can convert the bankruptcy proceeding into a piecemeal liquidation.

The major benefit of this regime is that it substitutes the judgment of the financing bank for that of the bankruptcy court in valuing a firm. The bank has better incentives to value firms accurately. If a firm is worth more as a going concern, the bank will benefit from restructuring the debt because it will receive a higher repayment than if the firm is sold piecemeal. Conversely, if in fact the liquidation value of a firm is greater than the going concern value, it is the bank that pays the price of the firm's continued existence. It thus makes a good deal of sense to have the financing bank, rather than the bankruptcy court, determine the ultimate fate of a firm.

The major limitation of the selective stay proposal is that it applies only to a subset of firms. Namely, it applies to those firms with a single financing creditor. The scheme breaks down for firms with more than one creditor. With two-party bargaining between the bank and the owners of a firm, one can be fairly confident that an agreement will be reached on the division of the going-concern surplus of the firm, if a surplus exists. Once we move to three-party bargaining, however, the possibility of bargaining failure increases dramatically.

D. The Menu Approach

The proposals considered thus far share a common theme in that they attempt to introduce a greater role for the market in resolving the problems generated by financial distress. Although each has a number of putative benefits, we do not endorse the wholesale adoption of any of these proffered regimes. In short, the

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[129] The selective stay was first proposed by Douglas G. Baird & Randal C. Picker. Baird & Picker, *supra* note 66.

problem is that none of the proposals is clearly superior to current law for all firms. Some firms may do better with a set of private contracts, others may find a mandatory auction or a selective stay preferable, and still others may benefit from retaining Chapter 11 in its existing form. Simply put, one size does not fit all.[130]

Given this heterogeneity in the preferences of firms, we see two possible courses of action. The first is that Congress could attempt, on a categorical basis, to decide which type of bankruptcy proceeding should apply to which type of firm. Some steps in this direction would make sense, such as developing separate proceedings for closely held and public corporations (as the 1994 amendments take some tentative steps toward doing).[131] Rather than simply attempt to decide in the abstract which regime should apply to which firms, however, we believe that Congress should go further, and give the market the flexibility to choose between existing law and alternatives such as those we have discussed.

Under the proposal we endorse, Congress would enact alternative bankruptcy regimes. One would be based on current law, another on a system of automatic cancellation, another on a mandatory auction, and a final one on the selective stay. Firms, at the time they are incorporated, would be required to select which bankruptcy scheme would apply if they later encounter financial distress.[132] We believe that Congress should enact these measures rather than leaving the matter entirely to private contract for two reasons. The first is that by having these regimes incorporated in a statute, it would be easy for those who lend money to become aware of the workings of the competing systems. Potential creditors would thereby be benefitted by a reduction in the amount of money spent on determining status in the event the firm files for bankruptcy. The second benefit would be a reduction in the cost of contracting. If each individual firm had to draft its own set of insolvency rules, the costs could be significant. It is more efficient for Congress to establish possible alternatives and then allow the owners of the firms to select

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[130] Even in the context of the current Bankruptcy Code, there is a realization that Chapter 11's universal approach to all firms is inappropriate. *See* LoPucki, *supra* note 14, at 749-52; Skeel, *supra* note 43, at 518-20.

[131] *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 217, 108 Stat. 4106, 4127-28. This amendment allows businesses whose total indebtedness as of the date of filing does not exceed $2,000,000 to elect to be treated as "small businesses" for the purposes of reorganization under Chapter 11. Id. § 217(a), (d) 108 Stat. at 4127. The amendment includes several provisions which will expedite the process by which small businesses may reorganize under Chapter 11. 140 CONG. REC. H10,752, H10,764 (daily ed. Oct. 4, 1994) (section-by section description of 1994 Act). For example, creditors' committees are not required in small business bankruptcies, § 217(b), 108 Stat. at 4127, and small business debtors can take advantage of liberalized requirements for plan disclosure and solicitations of acceptances. *Id.* § 217(e), 108 Stat. at 4127-28. For small businesses, the exclusivity period is reduced to 100 days and all plans must be filed within 160 days from the date the debtor filed for Chapter 11 relief. *Id.* § 217(d), 108 Stat. at 4127.

[132] For a detailed treatment of this proposal, see Rasmussen, *supra* note 70. Another issue, which we do not consider here, is whether states should be encouraged to, or discouraged from, developing partial alternatives to the Bankruptcy Code, as several states have begun to do. For an extensive discussion, see Skeel, *Rethinking the Line*, *supra* note 32 (discussing Delaware provision and arguing in favor of state regulation).

from them.

The market would influence firms' decisions in that firms rely on the market for capital. If a firm selects a bankruptcy regime which imposes costs on creditors by providing benefits to shareholders, creditors will raise the rates of interest that they charge. Lenders quite possibly would offer different interest rates based on the particular bankruptcy regime selected. To the extent that shareholders want a set of bankruptcy rules that protects their interest, they can pay for it. Thus, those who have their money on the line—a firm's owners—will be the ones to decide which set of bankruptcy rules will govern at the onset of financial distress.

Freedom of choice, of course, does not always guarantee perfect results. Some people make mistakes. Yet such mistakes do not lead most commentators to call for government regulation of the contracting process. This is because, on balance, those directly affected by the relevant decision tend to make fewer mistakes than do other institutions whose assets are not on the line. The inevitable erroneous selection thus does not counsel abandonment of the menu proposal.

More problematic, however, is recent work which suggests that even when people do not make mistakes, free choice may not lead to optimal results. The economic work in what is called "network externalities" suggests that a vigorous market may not lead to the efficient outcome.[133] This potential problem arises when the value of the various selections a decision maker must choose among turns on how many other parties have selected them. Perhaps the most famous example of this effect is the triumph of the VHS format for videotape over the Betamax format. Most agree that Betamax was the better technology. However, once VHS gained an advantage in market share, those deciding to enter the market determined that the larger installed base of VHS required that they use that technology rather than the superior Betamax format.

There are various types of network externalities, and we see no reason to catalogue them here.[134] Rather, we want to examine the potential ways in which network externalities could affect firms choosing from a menu of bankruptcy options. As an initial matter, simply having a menu—as opposed to a system of private contracting around a given default bankruptcy system—reduces the potential for network externalities leading to inefficient selections.[135] Perhaps the greatest danger is that given the general familiarity with current law, those choosing from

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[133] *See* Brian Arthur, *Competing Technologies and Lock-in by Historical Events*, 99 ECON. J. 116 (1989); Stanley M. Besen & Joseph Farrell, *Choosing How to Compete: Strategies and Tactics in Standardization*, J. ECON. PERSP., Spring 1994, at 117; Joseph Farrell & Garth Saloner, *Standardization, Compatibility, and Innovation*, 16 RAND J. ECON. 70 (1985); Michael L. Katz & Carl Shapiro, *Network Externalities, and Compatibility*, 75 AM. ECON. REV. 424 (1985). Michael Klausner has applied this work to the problem of corporate selection of charter terms. *See* Klausner, *supra* note 40. Both of us have noted the similarity between corporate selection of charter terms and selection of a bankruptcy regime. *See* Rasmussen, *supra* note 70, at 111-12; Skeel, *Rethinking the Line*, *supra* note 32, at 474.

[134] For an excellent description of these problems, see Klausner, *supra* not 40.

[135] *See id.*

the menu will "lock in" on this selection.[136] If this were the case, and if Chapter 11 were inefficient, firms should not be allowed to select Chapter 11 as their insolvency regime. We hesitate to advocate such a solution for two reasons. First, there are those who believe that Chapter 11 may be efficient. Second, even if it is not, if there are large gains from selecting a new type of bankruptcy option, we believe that law firms will invest the necessary resources to learn the details of the other choices on the menu. Law firms clearly have an incentive to do so in that if they can, through specialized knowledge, allow firms to raise capital at a lower interest rate, they will have an advantage over their competitors. Thus, on balance, the potential of network externalities does not counsel against either rejecting the menu approach, nor excluding Chapter 11 from the available options.

In proposing this menu approach to insolvency law, we recognize that just as one set of bankruptcy rules is not optimal for all firms, one set of insolvency rules may not be optimal for a single firm throughout its entire existence.[137] As described above, different types of firms may want different types of bankruptcy law. Yet a single firm will have different characteristics at different times in its life. Many of today's Fortune 500 firms were at one time small, closely-held companies. For our proposed regime to work, it must have the flexibility to accommodate changes in the nature of a firm.

The simple answer—allow the firm to amend its choice at any time—should be rejected.[138] The different types of bankruptcy proceedings that have been proposed—Chapter 11, automatic cancellation, mandatory auctions, and selective stay—differ widely in how they treat the shareholders and managers of a failing firm. By and large, current law is viewed as overly protective of the interests of both shareholders and managers.[139] A law which allows amendment of a firm's bankruptcy choice at any time would enable the owners and managers of a firm, upon recognizing that their firm is encountering financial difficulties, to switch to the regime which best protects their interests.[140]

Such gamesmanship would rob the proposal of its greatest attraction; the ability

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[136] One of us has noted this problem elsewhere. *See* Rasmussen, *supra* note 118, at 1210 n.142.

[137] Rasmussen, *supra* note 70, at 116-17.

[138] *See id.* at 117 (discussing drawbacks of giving firms unlimited freedom to change bankruptcy options as needs change).

[139] *See* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 450 (1992).

[140] *See* Rasmussen, *supra* note 70. For discussions of related concerns in corporate law, see Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1399-1404 (1989) (discussing contractual freedoms of corporations during creation of a charter and after formation); Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1822-29 (1989) (criticizing ability to opt-out of corporate law norms by amending charter); 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) (advocating need for judicial review of opt-out amendments to corporate charters for both substance and process); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1443-44 (1989) (discussing effects of post-formation amendments on the relationships within corporation).

of the market to price the cost of the competing bankruptcy regimes. Lenders would never trust the original selection made by a firm's owners. They would know that at any time when financial distress was imminent, the owners could have their firm select the regime which most favored the owner's interests. Lenders would thus assume that regardless of the initial choice made by owners, the regime which best protected the owners of the firm would govern the resolution in times of financial distress.[141]

There are two ways out of this problem of opportunistic amendment. The first recognizes that this behavior is akin to insider preferences. Insiders of firms are best positioned to recognize when a firm is about to run into financial difficulties. An insider preference occurs when an insider uses this knowledge to have the firm pay off a debt which the insider is owed. This maneuver ensures that the insider is paid what she is owed while the general creditors are not. To prevent such opportunistic behavior, the current Bankruptcy Code avoids payment on an unsecured debt owed to an insider made within one year of filing for bankruptcy.[142] The belief is that while the insider may have some forewarning of impending financial distress, the period when she can detect oncoming financial distress, but the creditors of the firm cannot, is not likely to exceed one year.

A similar solution exists for the problem of opportunistic amendment of a firm's bankruptcy rules. The law could require a lag between the time a corporation's announcement that it intends to change its bankruptcy selection and when that change is effective.[143] For example, there could be a requirement that a change only becomes effective after one year. By announcing its intention to change its insolvency rules, a firm would invite its creditors to examine the proposed change. If the firm's creditors believed that this change was an attempt to enrich the owners and the managers at their expense, they could initiate an insolvency proceeding prior to the change taking effect.[144]

A second way to resolve the mid-stream amendment problem is to rely on the market. Lenders would be aware of the risk posed by a firm's change in insolvency rules. Indeed, it is in a firm's interest to credibly commit not to change its bankruptcy selection. In this situation, a lender could contract with a firm's shareholders and managers that the firm would not change the insolvency rules without its consent.[145] By requiring the firm to obtain prior approval, the lender would guard against opportunistic behavior on the part of the owners and the managers.

We believe that both solutions should be adopted. We suggest that as a general

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[141] For a more detailed explanation of this problem and potential solutions, see Rasmussen, *supra* note 70, at 116-21.

[142] 11 U.S.C. § 547(b)(4)(B) (1988).

[143] *See* Rasmussen, *supra* note 70, at 119.

[144] *See* 11 U.S.C. § 303 (1988), *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 303 (West Supp. 1995) (providing for involuntary bankruptcy cases).

[145] *See* Rasmussen *supra* note 70, at 119.

matter, newly selected bankruptcy rules should not be permitted to become effective until one year after a firm has selected them. This one year period, however, could be extended by consent of the firm. Alternatively, a firm could, by contract, condition the exercise of its right to change its bankruptcy selection on the approval of its lenders. A mandatory one-year provision should be retained in order to protect smaller creditors from opportunistic amendments since they may not have either the sophistication or the interest to protect themselves by contract. Those creditors who desire even larger constraints on amendments should be permitted to attempt to bargain for such constraints.

CONCLUSION

There is a growing awareness that, while courts play a crucial role in areas such as policing misbehavior, markets are better than courts at deciding the fate of a financially troubled firm. The current Bankruptcy Code recognizes this awareness in a variety of areas. We applaud this attempt to have those with their money on the line make the decisions regarding the future of firms in financial distress. In most areas of corporate law, firms are free to select the legal standards that govern their internal operations.[146] The general wisdom supporting this freedom of choice is that the shareholders of the firm are better able to identify those rules which maximize firm value than are legislators. This reasoning should be extended to bankruptcy law as well. Bankruptcy law governs the future of a firm and the various claims to a firm's assets. Those who invest in firms are best positioned to select the set of insolvency rules which best fit the particular firm at issue. The market will thus judge the efficacy of the various bankruptcy reform proposals.

Even if Congress declines to give corporations broad flexibility to choose among the various approaches to bankruptcy, the foregoing analysis suggests that the increasing role of market processes in bankruptcy should be encouraged. In addition to making better decisions than courts with respect to allocation issues, market processes can also help to speed up the reorganization process in many contexts. So long as the existing bankruptcy framework is in place, market processes cannot eliminate delays, but they can help streamline the process and provide ways for claimants to cash out their interests without having to wait until the end of a case.

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[146] *See generally* EASTERBROOK & FISCHEL, *supra* note 36, ch. 1; Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544, 551-62 (1990) (arguing state corporate law is trivial since it does not prevent companies from endorsing any set of governing rules they want).