Federal Statutes

Other Authorities

BANKRUPTCY PRIMITIVES

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On the 25th Anniversary of the Bankruptcy Code, the American Bankruptcy Institute has called an academic symposium to assess where bankruptcy law has been in the last quarter century and where it is going or, perhaps more accurately, where it should go. I will leave to others the nuance of bankruptcy history. I will paint with a broad brush to give my perceptions of what the Bankruptcy Code always has been and of what it might be instead.

In Part I of these remarks, I discuss the bankruptcy fresh start for individuals and bankruptcy process as the central features of current law. I also provide some thoughts on the so-called "new world" of chapter 11 process. The new world, I argue, may not be so different from the old. In Part II, I reduce bankruptcy to what I contend are its primitive features: claim priority and the fresh start (not process). In Part III, I offer reform proposals in light of those features: free contracting among consensual parties and highest priority for nonconsensual claims.

I. FRESH START AND PROCESS

The Bankruptcy Code provides a fresh start for individual debtors and process for all. For individuals, bankruptcy process can be exceedingly simple. Many individuals pass through with little or no non-exempt property to be distributed among creditors and so, for them, bankruptcy process is little more than a gateway to bankruptcy's substance: the discharge. The discharge exempts not only property specifically excepted from collection,[1] but also what is for many individuals their most important asset, human capital. As a result of a bankruptcy discharge, most claims are extinguished (though a few—child-support obligations, e.g.—are singled

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[1] *See* 11 U.S.C. § 522 (2002) (providing for exemptions).

out for special treatment and survive discharge).[2]

For corporations, in contrast, process is (almost) everything. Whether a corporation is liquidated under chapter 7 or reorganized (or liquidated) under chapter 11, the Bankruptcy Code provides the rules that govern the disposition. These rules are largely mechanical. Unlike an individual debtor's discharge, bankruptcy offers no shelter of a corporate debtor's assets. There is no exempt property for a debtor's owners to retain despite insolvency. Everything of value goes to the creditors of an insolvent firm (at least as the Bankruptcy Code is written) and thus there is no discharge of obligations in the sense that an individual receives a discharge. (Although corporations reorganized under chapter 11 formally receive a discharge,[3] this is merely to implement a recapitalization, not to shield any assets from creditors in the way that discharge shields an individual debtor's exempt property and human capital.) Among creditors of a corporation, moreover, state-law priorities rule the day (with a few limited exceptions such as a small priority for unpaid employee wages earned on the eve of bankruptcy).[4] Secured creditors, for example, retain a priority interest in their collateral despite a bankruptcy petition. So, for a corporate debtor, bankruptcy neither shields assets nor (generally) establishes entitlements among creditors. It provides a process. As explored below, parties to the process can sometimes earn substantive advantage, but the Bankruptcy Code on it face is for the most part substantively neutral.

Historically, there have been two important sorts of criticism leveled at the Bankruptcy Code. The first is a suggestion that a discharge for individual debtors is too easily obtained even by those who are not in dire straights. The second criticism, applicable primarily to corporate bankruptcy, is that the chapter 11 process is cumbersome and expensive, so much so that a corporate debtor's owners and managers who are in control during chapter 11 can exploit the process at the expense of creditors' legitimate claims. Where such exploitation occurs, those claims are only nominally honored by the Bankruptcy Code and the process may yield an inefficient disposition of the debtor’s assets.

A. The Bankruptcy Act of 2003

Each of these criticisms has been addressed, to a limited extent, by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2003 (referred to hereafter as the Bankruptcy Act of 2003).[5] The Bankruptcy Act is still (and seemingly endlessly) pending before Congress. Individuals with relatively high income and a presumed ability to pay at least some of their obligations would be ineligible for chapter 7 and thus would be steered into chapter 13, which confers a

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[2] *See* 11 U.S.C. § 523 (providing list of exceptions to discharge).
[3] *See* 11 U.S.C. § 1141 (providing for discharge upon plan confirmation).
[4] *See* 11 U.S.C. § 507 (providing priority of expenses and claims).
[5] *See generally* Bankruptcy Abuse Prevention and Consumer Protection Act of 2003, H.R. 975, 108th Cong. (1st Sess. 2003) (passed by the House but still pending in the Senate).

more limited discharge than chapter 7. Corporations, if small, generally would be limited to a time in chapter 11 of less than a year, at least unless the prospect of a successful reorganization were clear. None of this, though, accomplishes entirely proper or complete reform, in my view.

The Bankruptcy Act is both overbroad and underinclusive with respect to individuals. The Act may catch some individual debtor abuse, but as a mandatory rule goes too far. Perhaps many of the debtors who would be forced into chapter 13 would have expected to benefit from a greater chapter 7 discharge and would be willing to pay more in interest on their debt obligations for such a discharge option. Mandatory chapter 13 for high-income debtors is also too narrow. Perhaps some or many debtors who would be able to choose chapter 7 under the Bankruptcy Act rules (or even those who would have only a chapter 13 option) would prefer to waive the right to broad discharge (or any discharge) and opt instead for cheaper loans. These issues are discussed more fully in Part III below, when I reach my own reform proposals.

The Bankruptcy Act not only fails with respect to individuals, but is also a blunt instrument in its treatment of abuse by corporate debtors. Large firms would be unaffected by the Act, and small firms could still use chapter 11, albeit for a shorter period of time, even if some process other than chapter 11 would be more suitable from the outset. Perhaps more to the point, it may be that few small firms stay in chapter 11 longer than they would be permitted to stay under the Bankruptcy Act. As discussed briefly later in these remarks, for small firms, chapter 11 may simply be largely irrelevant and so reform aimed at them is not much of a reform at all.

B. The New World of Chapter 11

Not only members of Congress but creditors too have reacted to the perceived problem of wasteful debtor-controlled reorganization. As Douglas Baird has explained at this symposium, for many corporate debtors in bankruptcy, creditors now quickly wrest from managers control of the chapter 11 process and more frequently than in the past liquidate firms whose assets may be worth more in the hands of new managers. This creditor response to perceived debtor abuse is more potent than the proposed bankruptcy legislation.

In my own prior scholarship, I have argued that ideal insolvency rules would be endogenous to a firm's capital structure and to the firm's likely economic prospects for survival in the event of financial setback.[6] Put simply, I argued that a well-designed firm subject to an optimal legal environment might well adopt a capital structure such that an uncured default on debt would imply not only financial failure but economic failure as well and that in the event of such default liquidation would thus be the appropriate disposition of the firm's assets. This argument might be read as a prediction of the creditor revolt that Baird documents. Indeed, the origins of

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[6] *See generally* Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343 (1997) [hereinafter Adler I].

Baird's creditor-control story, a paper written by Baird and Bob Rasmussen, cites my work as an explanation and justification of creditor-led liquidations now in vogue.[7] According to Baird and Rasmussen, modern firms tend to organize in fungible parts and thus have fewer firm-specific assets than in the past. Modern financially distressed firms, therefore, are in their view particularly unlikely to have going-concern surplus over liquidation value. It is thus in the creditors' interest, they argue, to use modern financial tools (and, they might have added, new secured credit provisions)[8] effectively to take charge of chapter 11 and sell off the debtor in operating segments or piecemeal if necessary. Put another way, Baird and Rasmussen argue that in the new world as in my idyllic world, financial distress implies economic failure.

As alluring as this story is, particularly to me, it is not the entire story. The sea change that Baird and Rasmussen describes may be less than salutary for at least two, opposing, reasons. First, market failure in the new world of chapter 11 may yield too much liquidation. Second, judicial error in this world may yield too little. Moreover, the same new-world forces that tend to drive inefficient continuation, ex post—individual creditor desire for an unwarranted return—may also yield violations of "absolute" (i.e., contractual) priority among claims and thus increase debtors' cost of capital, ex ante. The new world of chapter 11, therefore, may be inferior to the old world or may present many of the same problems as the old world. These possibilities will be explored fully in later work. For purposes of these remarks, a sketch of the arguments follows.

1. Market Failure and the Risk of Over-liquidation

Market failure could induce too much liquidation in the new-world of chapter 11. To explain how, let me return for a moment to my own earlier scholarship, that on which Baird & Rasmussen in part relies.

In my earlier work, cited above,[9] I observed that optimal insolvency rules for a firm depend on the degree of failure the firm is likely to have encountered at the time it becomes financially distressed. A once robustly healthy firm that suffered a smalI setback might not be a good candidate for liquidation, yet if the firm were subject to high levels of debt, even a small shock could result in insolvency and default. For such a firm, reorganization might be a reasonable outcome. Yet, if financial distress would not likely occur until the firm had suffered substantial losses, continuation might be wasteful as compared to liquidation.

To address these concerns, and recognizing that investors might benefit from debt's discipline on a firm's management regardless of insolvency regime, I

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[7] Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 781–82 n.137 (2002) (citing Adler I, *supra* note 6, at 345).

[8] *See, e.g.*, U.C.C. § 9-109 cmt. 16 (2003) (explaining Article 9 presently makes it more convenient for creditors to take security interest in deposit accounts, while this was difficult or impossible under previous version of article).

[9] Adler I, *supra* note 6.

hypothesized that in a world free of legal impediments, investors might create and adopt through corporate charter a novel capital structure. This structure would be a mix of traditional debt and a debt-equity hybrid. In still earlier work, I called this hybrid "Chameleon Equity."[10] Chameleon Equity is a form of preferred stock with special features. These special features would allow an uncured default on preferred stock dividends (or liquidation preference) to trigger the elimination of a debtor's common equity interests and a conversion of the debtor's lowest-priority preferred equity into common equity. Chameleon Equity could also include a procedure that would oust management. Uncured default could thus transform the debtor's capital structure and force a change of control even though the holders of the Chameleon Equity, unlike ordinary creditors, could not individually collect on their obligations. What would distinguish Chameleon Equity from debt, therefore, would be that the latter includes, but the former would not include, an unconditional unilateral right to collect (the very definition of debt).

If the law honored the terms of Chameleon Equity, and did not otherwise impede its use (through unfavorable tax treatment, for example), investors might combine in a debtor's capital structure a good deal of this special preferred stock with a perhaps smaller amount of traditional debt, which would have a higher priority. Default on the lower priority Chameleon Equity, then, would not strongly signal economic failure and, correspondingly, a Chameleon Equity transformation would not spell the end of the firm, but would instead constitute a preordained reorganization (free from the ex post conflicts of chapter 11). If, however, financial failure were so severe that the debtor defaulted not only on its Chameleon Equity but also on its traditional debt, such default would be a reliable signal not only of financial distress but, given the extent of that distress, of economic failure as well. A bankruptcy process geared toward liquidation of insolvent firms might be optimal, therefore, so long as insolvency referred to an inability to pay the traditional debt rather than merely the Chameleon Equity.

In my earlier work, however, I also noted that the law does impede or disfavor the special preferred stock I describe as Chameleon Equity. For example, special rules for default on preferred stock might not be honored if a debtor's managers filed for bankruptcy rather than follow these rules, and tax law may make any equity, even preferred equity, more costly for investors than debt, the interest payments on which are deductible from corporate income. (The original work described additional impediments as well.) I concluded, therefore, that under current law I would not expect firms to adopt the optimal combination of capital structure and insolvency process. That is, either to discipline managers with fixed payment obligations or to achieve tax savings, investors might opt for a capital structure with more ordinary debt than would be ideal. Consequently, under current law, I would be somewhat surprised if, for a typical firm, financial distress strongly

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[10] *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 312 (1993) [hereinafter Adler II] (discussing "Chameleon Equity" as arrangement that could eliminate both need for reorganization and risk that creditors would dismantle viable firm).

implied economic failure. Firm assets may be more fungible now than in the past, but firms today nonetheless amass substantial assets, this despite the transaction costs of doing so. If insolvency does not imply economic failure, then neither should it imply liquidation.

For the foregoing reasons, to the extent Baird and Rasmussen claim that the routine demise of financially distressed firms is appropriate, the claim seems overstated. But this is not precisely (or entirely) their claim. As noted above, Baird and Rasmussen do emphasize that financially distressed modern firms are less likely today than in the past to be viable. But they also document the fact that financially distressed firms are not thrown to the wolves, even in the new world of chapter 11. Instead, the firms they study enter the chapter 11 bankruptcy process, where assets are not automatically liquidated piecemeal. Often now, a creditor is in control of the process, but the creditor does not define the process. A court still uses the Bankruptcy Code to supervise the disposition of a debtor in chapter 11, where potentially viable firms are either traditionally reorganized or, as is increasingly common, auctioned as a whole or in part. A piecemeal liquidation sale may be the result of such process, but this is not a preordained result. Even if one assumes that there will be an auction, a debtor worth more alive than dead might be expected to be sold alive as in that form the assets should attract the highest bid.[11] Indeed, Baird and Rasmussen claim that auctions within bankruptcy are more common now than in the past, not that these auctions are biased toward piecemeal liquidation. So one may wonder why the authors stress what they see as the fungibility of modern business assets.

The question of whether insolvency implies inviability is relevant to an auction-based bankruptcy regime if one assumes that there is market failure. If potential bidders are incapable of recognizing going-concern surplus or incapable of raising the funds to purchase a viable firm then an auction in bankruptcy might well yield piecemeal liquidation even of a firm worth more as a continuing enterprise. If one assumes market failure, then, the Baird and Rasmussen argument that assets of failed firms are fungible is necessary to justify the modern trend toward auctions.

Market failure is exactly the concern at the heart of the arguments made by debtors' counsel who protest the modern bankruptcy trend Baird and Rasmussen (mostly) champion. For instance, according to leading bankruptcy practitioners and debtors' counsel, Harvey Miller and Shai Waisman, examples abound where large commercial debtors could not resolve their disputes without the procedures of chapter 11.[12] Miller and Waisman cite cases such as Enron, Global Crossing, WorldCom, W.R. Grace, Armstrong, Conseco, A.H. Robbins, and Johns-Manville. Miller and Waisman see these as traditional reorganizations that preserved (at least

[11] *See generally* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986).

[12] *See* Harvey Miller & Shai Waisman, *The Erosion of Debtor Protections in the Face of Expanding Creditors Rights and Control*, Written Remarks at the NYU Workshop on Bankruptcy and Business Reorganizations, (Sept. 2, 2003).

some) going-concern value. Implicit in their analysis is that a quick auction under the modern trend of creditor-controlled chapter 11 would have wasted such value as no buyer would be found, at least on short notice, for even viable operating enterprises.

Debtors' counsel and other defenders of traditional bankruptcy reorganization also decry what they perceive as a cause of the creditor-control trend in chapter 11. In their account, viable but financially distressed firms pledge all of their liquid assets before bankruptcy, often to a creditor who would otherwise declare a default that would trigger an immediate bankruptcy petition. The debtor makes such a pledge in a last desperate effort to buy time in the hope of a reversal of fortune that might restore financial stability. The problem, as argued by Miller and Waisman, among others,[13] is that the terms of these pledges deprive the debtor of capital needed to preserve going-concern value. In other words, according to this argument, such a pledge holds the creditors at bay temporarily, but does not permit the financial flexibility that would be required for the debtor to maximize the value of its operation. As the firm's decline continues, the creditor who provided the emergency funding inevitably collects more and more of its debt. Then, absent a turnaround, the creditor eventually forces the debtor into bankruptcy anyway, where that creditor, limited in return to the amount of its claim, is happy to liquidate the firm, viable or not. Reversals of fortune are rare, even for a viable firm, or so it is argued. In the end, therefore, a creditor in control, both before and after a bankruptcy petition, claws back the debtor's capital, not at once, but too quickly. The creditor in control of this process may benefit but, according to critics, the debtor does not and thus neither do the creditors generally.

Like the theory that insolvent firms are inefficiently liquidated at auction, this scenario of the avaricious eve-of-bankruptcy creditor is a story of market failure. This must be so because a viable debtor in a well-functioning market would be able to attain financing on more favorable terms from other sources. In a well-functioning market, a viable debtor could obtain friendlier new capital either entirely outside of bankruptcy or as a pre-arranged debtor-in-possession ("DIP") loan made just after the debtor filed a bankruptcy petition and just before a predatory creditor could sweep up all of the debtor's working capital. Instead, according to critics of the modern trend, good firms are strangled by the greed of existing creditors—frequently secured creditors—because no practical alternative exists. It is, in fact, a preexisting creditor's apparent monopoly position as a DIP lender that is most often cited as the reason a creditor—typically a secured creditor—gains control over the bankruptcy process in the new world of chapter 11.

These market failure stories help establish the battle lines between scholars such as Baird and Rasmussen, who favor the new world of chapter 11, and others such as

[13] Some of these arguments were made orally in a panel presentation that included Harvey Miller at the 2003 New York University Workshop on Reorganization and Bankruptcy, New York, New York. The presentation was a discussion of Miller & Waisman, *supra* note 12, but the conversation allowed Miller, and others, to elaborate beyond the paper.

Miller and Waisman, who pine for the old world.[14] Baird and Rasmussen do not see a market failure and, in any case, apparently would not be much disturbed if there were such failure as they assume that financially distressed firms are also highly likely to be inviable. Miller and Waisman see both market failure and viable, though financially distressed firms.

Despite the theoretical plausibility of market-failure claims, one might be skeptical. This new-world version of the market-failure story may be of recent issue, but the genre is ageless. Defenders of traditional reorganization have long opposed calls for market-based bankruptcy reform with assertions that capital markets are imperfect and there is a long-standing response. Market failure may well occur, and likely does from time to time, perhaps in generally depressed industries where few potential purchasers possess liquid assets sufficient to bid on competitors.[15] Still, one might reasonably speculate that large-scale market failure is rare, at least with respect to the financing of large firms, which can avail themselves of expensive investment bankers and the increasingly sophisticated tools of corporate finance.

It is possible to conclude, therefore, that although Baird and Rasmussen may overstate the extent to which modern business assets of financially distressed firms are fungible and thus may overstate the extent to which financial distress under current law implies economic failure, they may be right that a simple auction of an insolvent firm is superior to a traditional chapter 11 process (though perhaps not as good as what investors freed from legal constraint would adopt). Again, this argument is not new. Where capital markets function well, for at least some firms, an auction may provide a good resolution of financial distress (though not a costless one, as even sales consume resources). The question arises, therefore, whether the new world of chapter 11 is one that embraces the sort of auction that is a plausible alternative to traditional reorganization. As I hope now to demonstrate, the answer to this question is no, at least for a potentially significant number of firms.

2. Cramdown, Absolute Priority, and the Risk of Excessive Continuation

What I hope to establish here is that the new world of bankruptcy

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[14] There are others as well in the debate over secured creditor control. *See, e.g.*, David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 918–19 (2003). Skeel takes a middle ground, identifying virtues and flaws with the new world of chapter 11. Like Waisman & Miller, Skeel focuses on what he believes will be too much liquidation at the hands of secured creditors in control of the reorganization process. He does not focus on market failure, though, and while he notes the risk that a secured creditor may finance inefficient continuation, a topic to which I turn immediately below, he understates this risk, in my view, as he does not account for the full range of secured creditor incentives. *See also* Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, AM. BANKR. INST. J., Sept. 2003, at 12. Warren & Westbrook argues that secured creditors should not be permitted to use bankruptcy as a private debt-collection system, a concern not implicated by the discussion in text.

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

reorganization is not as much of a deviation from traditional chapter 11 as Baird & Rasmussen suggests. My concern with the new world of chapter 11 is the same as the traditional concern in the old world, that whoever controls the bankruptcy process can use it as a tool for self interest. Unlike debtors' counsel and their compatriots, I do not (greatly) fear that a creditor in control of a debtor in chapter 11 will liquidate a viable firm, but rather that such a creditor will continue or threaten continuation of an inviable one and overcompensate itself in violation of absolute priority along the way. In anticipation of such an outcome, debtors as a group would face an inflated cost of capital. The traditional concern is that a debtor's managers or shareholders might favor, or claim to favor, inefficient continuation. But it is possible too that a debtor's creditor, even a secured creditor, can profit from the continuation bias inherent in judicial valuation, which is an integral part of both the new and old world of chapter 11.

To the extent that the old world of chapter 11 permitted debtors inefficiently to continue their operations in reckless pursuit of a business reversal, creditor planning and control can be seen as a positive step to facilitate liquidation, as noted above. And many of the cases that Baird & Rasmussen documents do represent quick ends to failing firms: A secured lender steps in to provide DIP finance so that a debtor's live tissue can be preserved, and sold, while the main event is excision of dead matter, or less colloquially, liquidation.

This does not describe every new chapter 11, however. Sometimes, even where interests in a debtor are sold as part of chapter 11, the sale is not an outright cash auction of the debtor or its assets. There are strings attached.[16] Prepetition creditors retain an interest under the plan, and the plan may be imposed on some creditors through old-fashioned chapter 11 cramdown (or after settlement under threat of cramdown). As a whole, the reorganization process in these cases may not be traditional—e.g., the controlling interest in the debtor may be sold on the market—but one might wonder why the debtor is not sold free and clear of encumbrances, with the proceeds distributed down the priority hierarchy as long as they last. When a free-and-clear sale does not occur, there is reason for suspicion. Not only managers can hijack the reorganization process.

To illustrate, imagine that when Debtor files a chapter 11 bankruptcy petition it is subject to $200 in debt, $100 of which is unsecured general debt, $100 of which is secured by a debtor's tangible and otherwise specifically identifiable assets but not by any going concern value or synergy among the assets.(The security interest does not attach, for example, to future receivables or other derivatives of good will). Assume that Debtor's value depends on the disposition of its assets and that there are three choices for such disposition: (i) immediate liquidation of Debtor's tangible

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[16] This description of a hypothetical "new world" chapter 11 case is derived from Douglas G. Baird and Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003). This follow-up to the Baird & Rasmussen article discussed extensively in text provides detailed descriptions of many recent large-firm bankruptcies and offers, for example, that 56% of the large-firm cases concluded in 2002 "were sales of one sort or another." *Id.* at 675.

and identifiable assets would yield $50; (ii) orderly liquidation through a sale of discrete business units to multiple buyers would yield $100; and (iii) continuation of business under current configuration would yield an expected value of $90, based on a 50% chance of a $130 value and a 50% chance of a $50 value. Assume that Debtor's managers and its creditors know all this, but that the bankruptcy court knows only Debtor's immediate liquidation value and that such value is the worst possible outcome; distinctions between sale of business units and continuation of the whole enterprise are beyond the court's ken.

From these assumptions, the efficient outcome for Debtor is an orderly liquidation, which is much better than an immediate liquidation and somewhat better than continuation. Assume, however, that neither orderly liquidation nor continuation can occur without an infusion of new capital. Specifically, assume that a $20 short-term DIP loan is required to avoid immediate liquidation. This loan would bridge the time between Debtor's chapter 11 petition and the conclusion of the bankruptcy case. Assume that the court recognizes the need for the bridge loan and assume that Debtor's managers seek to obtain one. Along comes the secured creditor ("SC") who offers the new $20 loan for a $15 repayment obligation.[17] Not surprisingly, the best outside offer of a DIP loan is $20 for a $20 return.[18] What, then, explains SC's offer? The answer is that the loan comes with conditions. These conditions include a rollup provision tied to a proposed prearranged reorganization plan.

In a rollup, a prepetition secured creditor receives priority not only for a debtor's obligation to repay new funds lent to finance the debtor's operation (at least until it is sold) but for the full amount of the creditor's prepetition debt regardless of whether the creditor's claim was fully or only partially secured. This practice, increasingly part of the chapter 11 new-world of creditor-in-control, has raised cries of protest from unsecured creditors who complain about breaches in priority. This illustration will make the case that the unsecured creditors may be right, at least some of the time, even if the court ostensibly grants the rollup only if, in the court's estimation, the unsecured creditors are protected. To see why, consider how a secured creditor could exploit a potential judicial valuation error by proposing a DIP loan conditioned on a rollup and Debtor support for the secured creditor's reorganization plan.

Recall that if Debtor continues there is 50% chance that it will be worth $130 and a 50% chance that it will be worth $50, for an expected value of $90. Recall also that an orderly liquidation would yield $100 with certainty, but the court does not know this. It is assumed that the court knows only the relatively easy-to-determine, non firm-specific piecemeal liquidation value of Debtors' assets. Given its ignorance, perhaps the court can be persuaded that for Debtor the orderly

[17] More realistically, this offer would be of a $20 loan for a return of $20 in principal, but at a below-market interest rate. For convenience, however, this illustration ignores the time value of money.

[18] Assume, for simplicity, that a third party would demand only $20 because the short term of the bridge loan allows it to be fully secured and, again, ignore the time value of money.

liquidation value does not exceed $65 while the going-concern value is $90. In this case, the court might confirm a reorganization plan that provides the general creditors ("GCs") anything more than what the court sees as their (orderly) liquidation share, $10.[19] (That is, by the court's estimate, after the secured creditor received its $50 collateral value, there would be $15 to divide ratably between the GCs' $100 claim and SC's $50 deficiency claim.)

Now consider a reorganization plan that SC might propose in connection with its DIP loan offer. After repayment of the DIP loan, SC is to receive a new $100 obligation fully secured by all of Debtors assets (the new security interest broad enough to capture any source of Debtor's post-confirmation value). An outside purchase of the reorganized Debtor's new equity has been arranged by SC. The proceeds of that sale, $17.50, are to go to the GCs. All of Debtor's prepetition claims and interests are otherwise discharged. Debtor's managers, or their replacements, support this reorganization plan and propose it on behalf of Debtor. The GCs object and urge the court to find a different buyer or buyers for Debtor or its assets.

Will the court confirm this plan? Perhaps so. As noted above, the court believes, counterfactually, that in orderly liquidation the GCs would receive only $10 and $17.50 is more than $10. But confirmation would be inappropriate. This is clear because, by assumption, continuation is $10 less valuable than orderly liquidation.

One can see the inefficiency also by summing the actual (not court estimated) returns to the various parties, first under the reorganization plan, then under orderly liquidation. Under the plan, following the DIP loan, SC expects $77.50, which reflects a 50% chance of $100 (if the firm succeeds and is worth $135, i.e., $130 based on its prepetition assets plus the net $5 contributed by SC in the DIP bridge loan) and a 50% chance of $55 (if the firm fails and is worth $55, i.e., $50 based on its prepetition assets plus $5 contributed by SC in the DIP bridge loan). For their part, the GCs would receive the $17.50 equity-sale proceeds, while the equity purchaser would expect $17.50 (the amount it would pay), which reflects a 50% chance of $35 (if the reorganized Debtor succeeds and is worth that amount in excess of Debtor's $100 debt obligation to SC). In orderly liquidation, SC would receive $68.33, which reflects its $50 collateral value and its 1/3 of the $55 surplus above that value (assuming again the below-market DIP loan from SC). The GCs would receive $36.67, which reflects their 2/3 of the surplus above collateral value. In sum, reorganization instead of orderly liquidation provides SC a $9.17 gain and imposes on the GCs a $19.17 loss. The gain, of course, is $10 less than the loss,

[19] If the court would approve any plan that SC proposed, because the immediate liquidation proceeds would leave nothing for the GCs, SC would favor orderly liquidation, not continuation under the plan described later in the illustration. It is unlikely, however, that a court would consider a zero return to the GCs and a $100 return to SC on a loan secured by only $50 worth of collateral "fair and equitable" for the purposes of 11 U.S.C. § 1129(b) (2002). In any case, this illustration is just that, an illustration, and does not exhaust the possibilities of absolute priority violations or inefficient continuation from cramdown where a creditor controls the reorganization process.

because continuation imposes a $10 cost to society in wasted resources. (Note that SC benefits from its plan even when the plan is compared to orderly liquidation orchestrated from the outset and financed with a DIP loan at market rather than with SC's $5 below-market loan, as $77.50 is $10.83 more than $66.67, which is SC's orderly liquidation return based on its $50 collateral value and a third of a $50 surplus; the GCs suffer from the plan correspondingly, as $17.50 is $15.83 less than $33.33, which is two thirds of a $50 surplus, and, needless to say, the $10 lost to inefficiency remains.)

Faced with confirmation of SC's plan, the GCs might strike a deal with SC, agreeing to grant SC its expected return from continuation and some part of the $10 surplus from orderly liquidation in exchange for SC's abandonment of its inefficient reorganization plan. But coordination for such a side deal might be difficult, as some of the GCs would predict judicial victory rather than defeat on the valuation issue and hold out for their absolute priority entitlement under orderly liquidation, leaving the burden of settlement too great on the other GCs. Or, in time, cramdown might be averted after all, but the GCs may simply accept the inefficient plan because once the process has moved down the road toward reorganization, all parties might wish to avoid further costs of conflict and accept the inevitable where it no longer makes sense to start over despite the existence of an alternative, such as orderly liquidation, that would have been a superior disposition if pursued from the outset. The decision to continue could be reversed post-confirmation, of course, but this would require the consent of all parties, including Debtor's new shareholders, and the coordination required for such an agreement outside of the chapter 11 framework would be more difficult still.

The suggestion that the GCs might bargain with the SC to avoid the above-illustrated failure of the bankruptcy process is tantamount to a suggestion that bankruptcy itself is unnecessary. Coasean bargains—i.e., bargains to efficient outcomes—are always possible, and these would prevent any inefficient disposition, but in a conflict-ridden, uncertain environment such as this, one should not rely on mutual agreement among the parties. Were this not so, corporate bankruptcy law itself would be largely unnecessary. (Although I argue below that corporate bankruptcy *is* largely unnecessary, that argument is premised on an ex ante bargain among investors, not on the ability of creditors holding ordinary debt under current law to work out their differences ex post).

There is a related point to be made. This illustration exhibits not only a secured creditor scheme for inefficient continuation, but the secured creditor's motivation for such continuation, namely a desire to achieve an unwarranted return in violation of absolute priority. Even if continuation of the debtor were efficient, as would be the case under a different set of assumptions, or if a bargain could be reached to avoid inefficient continuation, a secured creditor (like any party) in control of the reorganization process might use that control and cramdown or its threat to achieve a return in violation of absolute priority. Anticipation of this outcome generally would increase all debtors' cost of capital, ex ante, even if inefficient continuation were avoided, and fewer worthwhile projects would be financed. This is because an extracompensatory return to secured claims such as SC's elevates a security interest to a plenary priority interest and thus further subordinates a debtor's general obligations contrary to the debtor's capital structure design. That design might well include cost savings associated with the limitation of a secured claim's priority to the value of the claim's collateral, perhaps to isolate secured and general creditor screening or monitoring on specific and distinct business assets. A full discussion of this and other reasons a debtor might limit and thus differentiate claim priority is beyond the scope of these remarks.[20] Suffice it to say here that absolute priority honors a debtor's decision to finance with multiple priority levels and that, as the current illustration demonstrates, cramdown has the potential to undermine this decision, yielding the risk of both ex post and ex ante inefficiencies.

Then there is the matter of transaction cost. Suppose the GCs and SC could negotiate to avoid the $10 loss from inefficient continuation. In addition to any violation of absolute priority inherent in the settlement, the process of dividing the $10 surplus could be costly. Whether the debtor or a creditor is in control of the reorganization process, dollars can be wasted in a squabble over pennies. A recent study of bankruptcy reorganization (and auctions) by Arturo Bris, Ivo Welch, and Ning Zhu documents violations of absolute priority and examines the direct costs of reorganization. According to the study, these costs are heterogeneous, not always modest, and sometimes quite high.[21] Indirect costs, such as may occur if debtor's management is distracted by the bankruptcy process, would make matters worse still. Most of the observations in the Bris et al. study predated the new world of chapter 11 described by Baird & Rasmussen. But where a corporate debtor is reorganized rather than sold outright, no strings attached, there may be little reason to assume that the new world of chapter 11 will fare better than the old on this score.

The above illustration, while stylized, reflects the new-world reorganization features that Baird & Rasmussen favors: There is a creditor in control of the bankruptcy process from the start, with a DIP loan the source of such control; the reorganization plan is prearranged; the process is quick and orderly; a market sale

[20] For a more complete discussion, *see generally* Barry E. Adler, A Simple Game-Theoretic Solution to the Tension Between Cramdown and Holdup in Corporate Reorganization (Dec. 12, 2003) (unpublished manuscript, on file with the author) (describing various reasons to limit priority of secured credit including screening specificity and monitoring specificity, theories attributed to F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986) and Thomas H. Jackson & Anthony Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L. J. 1143 (1979), respectively).

[21] *See* Arturo Bris, Ivo Welch, & Ning Zhu, The Costs of Bankruptcy: Chapter 7 Cash Auctions vs. Chapter 11 Bargaining (Yale ICF Working Paper No. 04-13, 2004), *available at* http://ssrn.com/abstract=523562 (describing mean direct bankruptcy costs, as a percentage of assets, for a combined sample of large and small firms as just less than 10% and collecting other studies). For a description of direct bankruptcy costs in large-firm chapter 11 cases, see, e.g., Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 285 (1990) (estimating that the direct costs of bankruptcy average three percent of the firms' book value of debt plus the market value of the equity). Bris, Welch, and Zhu also report high costs for chapter 7 liquidations, but a discussion of this result, or what might explain it, is beyond the scope of these remarks.

determines the debtor's new equity ownership. The only thing traditional about this reorganization is the cramdown against general creditors. Such cramdown (or its threat), though traditional, is also part of the new world. Baird & Rasmussen recognizes this, but does not highlight the point. In contrast, I emphasize cramdown here because, as this illustration demonstrates, the old-world cramdown feature also yields an old-world concern here in the new world: chapter 11 as a vehicle for inefficient continuation or its threat as a strategic means to violate absolute priority.

It is possible also to draw similar illustrations of absolute priority violation and inefficient continuation in different settings, including those where the debtor emerges from bankruptcy solvent. Imagine a reorganization plan prearranged by a secured creditor who is also the DIP lender. According to the terms of the plan the secured claim is to be satisfied by most of the reorganized firm's new equity, a minority share of which will be distributed on account of the debtor's prepetition general claims. The general creditors might object that the secured creditor is receiving property worth more than the amount of the secured claim, but a court might side with secured creditor and confirm. If the general creditors are right about the valuation, such cramdown would violate absolute priority and could also yield the reorganization of an inviable firm, as the secured creditor, in control, would prefer overcompensation in even an inefficient reorganization to an efficient liquidation that would leave it merely fully compensated. Moreover, if the reorganized firm included a substantial amount of new debt to others, the firm’s post-confirmation equity owners might not have an incentive unilaterally to liquidate even an inviable firm, preferring instead to continue their option on the firm’s value.

The point here is that the specific features of any illustration are relatively unimportant. Instead, there are general lessons to be learned. The source of the inefficient outcomes is judicial valuation error combined with strategic behavior on the part of a party who controls the bankruptcy process and stands to benefit from that error. This has always been so. As noted above, in the past, the fear was that the debtor's equity owners or managers, who controlled the process, were in a position to benefit from inefficient continuation or its threat. Now it is frequently the creditors who control the process and stand to benefit from such control. The players may have changed, but the game remains the same. Liquidation (or any market sale) is light. Cramdown (or the threat of cramdown) is darkness. Darkness breeds mischief.

There is another generalization one may make about the above illustrations. In the illustrations, the particular lever for costly strategic behavior was the increasingly common post-petition loan by a prepetition creditor. Threats to efficiency by prepetition lenders wearing two hats are not new. In my own earlier work, I have shown more formally than in the above illustrations that new loans from prepetition lenders can exacerbate what finance economists call an "overinvestment problem" (what I have called here simply inefficient continuation).[22] Others have written on this topic as well.[23] What is new, perhaps, is that the creditors who may benefit from making new loans are armed with more potent weapons: rollups and control of process. The conclusion I draw from this generalization is that there is more to fear from the new-world of chapter 11 than its proponents, including Baird and Rasmussen, might lead us to believe.

The new world of corporate reorganization, moreover, is not yet ubiquitous. Not every firm in chapter 11 comes quickly under creditor control. Therefore, even if one trusted creditors to make efficient continuation decisions and to honor absolute priority, the standard concerns about debtor abuse of chapter 11 would persist at least for those firms, however few, that continue to reorganize under the traditional chapter 11 process and thus under the substantial influence, if not complete control, of debtor managers. Although cases are hard to classify, examples of such firms in bankruptcy, even among only large, publicly traded companies, may include WorldCom and United Airlines. I do not mean to overstate this point. Experience reveals fewer and fewer cases in which breaches in priority award assets to shareholders of an insolvent firm. And managers typically lose their jobs upon their firm's bankruptcy.[24] But any interested party directly or indirectly in control of the reorganization process poses a threat to continue a debtor inefficiently or to coerce a payment in exchange for acquiescence in an efficient liquidation. This has long been accepted where a debtor's managers are in control—whether the managers' ambition is to serve themselves, the debtor's shareholders, or the debtor's community. (Whether service to community is a noble or misguided objective of strategic behavior is left for discussion elsewhere; for better or worse my focus here is on the harm caused by such behavior.) The new world control shift from debtor to creditor for some or most firms, whatever its merits, does not diminish the strategic problem posed by those firms that remain under debtor control.

All this is not to deny that there have been important changes in chapter 11 practice. There is no question that today fewer large firms are reorganized intact than under a traditional chapter 11 process.[25] When a corporate debtor files a chapter 11 bankruptcy petition, the firm's controlling interest is "in play." In addition, bankruptcy courts have become accustomed to such a process and it is a rare judge today who would resist creditor demand to sell, particularly as more and more bankruptcy creditors are distressed-debt professionals (a.k.a. "vulture capitalists") who have purchased debt precisely so that they can seek to direct the

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[22] *See* Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575, 590–94 (1995) (discussing the over-investment problem as justification for voidable preference law).

[23] *See, e.g.*, George G. Triantis, *A Theory of the Regulation of Debtor-In-Possession Financing*, 46 VAND. L. REV. 901 (1993) (analyzing over- and under-investment in DIP financing, but not addressing issues related to cross-collateralization such as those presented here).

[24] *See, e.g.*, Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241, 246–47 (1989) (reporting that top management of a firm two years prior to financial distress remains unchanged two years after distress only about 34% of the time, only 29% of the time when distress results in bankruptcy).

[25] *See, e.g.*, Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy*, 56 STAN. L. REV. 645, 645–46 (2003) (criticizing Baird & Rasmussen, but conceding that liquidation rates have increased substantially).

bankruptcy process toward a sale of the debtor's assets. But a sale may occur for less than the entirety of a debtor and when this occurs, violation of absolute priority and inefficient continuation remain possibilities. Thus, as compared to possible alternatives (such as firms that include Chameleon Equity in their capital structures), chapter 11—new world or old—may be suboptimal. And while fewer firms may be affected than in the past, bankruptcy law has always been directed toward a solution for relatively few firms, as at any given time most firms either succeed or fail without use of bankruptcy law. A better solution is preferable even to a good one. Bankruptcy reform, even radical reform, should remain on the table.

II. BANKRUPTCY PRIMITIVES

As stated or intimated above, and as described more fully below, I want to suggest that ideal bankruptcy law would differ from current law with respect to the discharge of individuals and with respect to the process-centric rules of chapter 11. As just discussed, recent reform proposals and changes in practice do not fully address the problems with current law, so the question becomes: What would? In answering this question, I want first to break bankruptcy law down to its essential elements. In earlier scholarship I have noted that debt as a financial instrument is not a "primitive" in that it can be broken down into two parts: a fixed obligation and a right of the holder unilaterally to enforce that obligation.[26] Here I similarly want to reduce bankruptcy law, which operates on debt, to its essential components, or "primitives."

Let "bankruptcy law" have its traditional meaning: a set of special federal provisions that address a debtor's inability to meet all of the debtor's obligations. Assuming that there will be any bankruptcy law, there is exactly one function such law must serve. That is, by logical necessity—whether explicitly in a code or by explicit or implicit deference to state law—bankruptcy law must establish priority among conflicting claims. Put another way, the only essential element of bankruptcy law is for it to provide or adopt a property regime.[27] If the Bankruptcy Code is silent, then state law priorities will prevail. Otherwise priorities are established as dictated by the Code. Thus, whether by congressional action or inaction, bankruptcy law establishes priorities among conflicting claims. There is choice as to how bankruptcy law will do this, but not as to whether it will, as even derogation of power has affirmative consequences.

Another component of bankruptcy law, at least as we know it today in the United States, is not literally necessary but is central: the discharge of an individual debtor. Society could function if an individual were forced to bear the burden of debt indefinitely, regardless of the circumstances, but there are good arguments to be made that society would not be the better for such treatment of individuals. Human beings tend to be risk averse, and it is perfectly reasonable to assume that many or most would benefit from debt relief as insurance against hard times.[28] Thus the discharge that is at the heart of individual bankruptcy cases seems sensible, at least as a default rule.

These two features of bankruptcy law—establishment of priorities and discharge of an individual's debt—are what I refer to here as bankruptcy primitives.

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[26] *See* Barry E. Adler, *The Law of Last Resort*, 55 VAND. L. REV. 1661, 1676 (2002).

[27] *Cf., e.g.*, Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. 373 (2002) (describing property right as having a priority-setting function with a general emphasis on the role of notice); Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773 (2001) (describing property right as a priority-setting function with a general emphasis on the role of reliance).

[28] *See, e.g.*, Barry Adler, Ben Polak & Alan Schwartz, *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL STUD. 585, 589 (2000) (comparing consumer bankruptcy to partial wage insurance).

Were I a lawmaker, I would focus on setting these features optimally. It is not clear that bankruptcy law should venture beyond these primitives.

To those familiar with the intellectual discussion of bankruptcy law, the striking omission from my short list of bankruptcy's essential functions is the omission of bankruptcy as a process, one that solves the collective-action problem among creditors who might, if left to their own devices, destroy a valuable going concern in a grab race for assets. (The Miller & Waisman defense of traditional chapter 11, noted earlier, was in this vein.) Douglas Baird and Thomas Jackson have in the past stressed process as the sole legitimate role of bankruptcy law (other than discharge for an individual debtor).[29] However, the threat of a grab race exists only if one accepts as given the status quo of corporate finance, where creditors hold conflicting debt obligations unconstrained by any prior agreement to settle up among themselves in the event that the debtor cannot pay them all in full.

Prior agreement among creditors (or investors of any sort) is possible, at least in principle. The Chameleon Equity construct discussed earlier in these remarks represents just such an agreement, one that could be included in a corporate charter and that could thus bind investors, all forewarned, to a collective rather than a competitive resolution of financial distress.[30] This Chameleon Equity resolution, moreover, would automatically recapitalize a firm upon an uncured default and, therefore, would do away with post-default negotiation or valuation by market or judge. Consequently, many of the problems associated with chapter 11, new world or old, would be avoided.

Thus, in an environment free of regulatory constraint (including, but not limited to, the mandatory features of the Bankruptcy Code itself), one might expect debtors and creditors to solve their collective action problem ex ante, i.e., at the time of investment, by providing in a charter for the provision of a customized process in the event of default. That process might include Chameleon Equity, but might not. Chameleon Equity is not a panacea. For example, its capital structure transformation is triggered by payment default, for example, which may not correlate sufficiently well with underlying insolvency. Other contractual alternatives might be preferred by some firms.[31] Whatever the contractual determination, though, a bankruptcy code need not be the source of a specific process, that is unless various claimants held conflicting rights to a particular process. Only where such conflict existed would bankruptcy law need to serve one of its primitive functions with regard to process.

To be sure, any firm that hoped to preserve the possibility of going-concern value might include in its self-authored insolvency process a feature analogous to

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[29] *See generally* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986).

[30] *See* Adler II, *supra* note 10, at 322 (describing assets grab race in absence of bankruptcy regime, but noting that investors might "incorporate a pre-established restructuring plan into their initial investment contracts").

[31] For a different approach to bankruptcy contracting, one that focuses on an attempt to extract information from managers of a financially distressed firm, see, e.g., Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1821 (1998).

the automatic stay of current law, channeling claims to a common arbiter, so the disposition of a debtor's assets could take place at once in a single forum. But perhaps little else of chapter 11 process would routinely survive customization. Small firms might find any custom design prohibitively expensive, but these firms, typically dominated by an entrepreneur and a single creditor, get little out of the current chapter 11 bankruptcy process anyway, an observation that prompted the small-firm provisions of the Bankruptcy Act of 2003, discussed above. Thus, law-supplied process, central to the original Baird and Jackson bankruptcy paradigm, may serve little useful purpose, and is not, in any case, a bankruptcy primitive.

III. Reform Proposals

With the foregoing as background, I would recommend to Congress that it consider different and greater changes to bankruptcy law than proposed in the pending legislation. These recommendations have two themes: greater freedom of contract where relationships are consensual and higher priority for holders of nonconsensual claims.

A. Freedom of Contract

Bankruptcy law could better serve its basic functions with greater freedom of contract both for individual and corporate debtors. Individuals are discussed first, then corporations.

1. Individual Debtors

As noted above, the Bankruptcy Act of 2003 would limit the discharge of relatively high-income individual debtors by eliminating their chapter 7 option. If these debtors sought bankruptcy relief, they would have to file for chapter 13, which is available to individuals with regular income, and upon the demand of a general creditor contribute future disposable income to repay prebankruptcy obligations. As a mandatory rule, this provision seems needlessly harsh.

Imagine, for example, that a restaurant manager quits her job with a fast-food chain and opens a diner financed primarily by bank debt that the manager guarantees. The diner struggles from the beginning and the manager finds that she cannot both pay the diner's debts and support her family. Initially, however, she is not ready to give up. She gets her job back with the fast-food chain and she moonlights at the diner. Her husband, who was formerly a caretaker for the couple's children but did not work outside the home, now also pitches in at the diner. Still the debts pile up and revenues do not increase. The debtor is finally ready to quit and closes the restaurant. To repay her debts she sells the assets she has of value (her home is fully mortgaged) but cannot fully satisfy her obligations. She contemplates bankruptcy.

This scenario is fictional but not fanciful. It reflects the plight of many debtors who seek bankruptcy protection. Under the proposed Bankruptcy Act, this debtor might be forced to repay the debts of her failed business even while her family gets by on bare essentials. Under chapter 7, she could have a truly fresh start and her family could enjoy the entire benefit of her manager's salary.

In this illustration, moreover, the results of the Bankruptcy Act proposal might not be merely a poor outcome ex post. In anticipation of failure, the debtor, if risk averse, might never attempt to open the diner even if the gamble were a good one ex ante. In this case, the Bankruptcy Act would here discourage desirable investment.

To be sure, the debtor might have opened the diner in corporate form and not personally guaranteed the business debts. But without some personal responsibility, the debtor might well have found that no lender would finance so risky a business. Perhaps the ideal balance, at least for this debtor, would be for her to guaranty the diner's loans but retain the option to receive a full discharge of her obligations. Creditors presumably would charge the debtor more for fully dischargeable loans than for loans that could not be discharged or that could be discharged only in part, but the debtor's guaranty would not be entirely meaningless. To discharge her obligations the debtor would have to sell all her nonexempt assets and would suffer a reputational hit (at least in the credit market) of having filed a chapter 7 bankruptcy petition. Where chapter 7 is an option, therefore, a lender would be expected to charge a higher interest rate than if a debtor could seek relief only under chapter 13, but that interest rate might not be prohibitive and a deal could perhaps be struck.

This illustration, and countless similar circumstances, support the view that the Bankruptcy Act's discharge limitation should not be mandatory. A debtor should be able to opt out of the Bankruptcy Act's treatment of high-income debtors. Perhaps a public registry could be established where debtors could declare such intention to opt out. A debtor on that registry, whatever her income, could then file under chapter 7 so long as she had no debts still outstanding from a time prior to entry on the registry. She could take her name off at any time and would then lose the chapter 7 option while any debts were outstanding from a time that her name was not on the registry. This process, while perhaps unfamiliar, would not be complex, less so than the process of filing and maintaining financing statements now routine under Article 9 of the Uniform Commercial Code.

More complicated systems are also possible, as where a debtor would subject some but not all of her obligations to chapter 7 discharge thus favoring those obligations exempt from discharge. If such a mixed system of opt-out were adopted, a public registry would be unnecessary as a debtor could always file for chapter 7 but in that proceeding would be able to discharge only those debts designated as fully dischargeable in the relevant loan agreement.

There is, of course, a flip side to an option for greater discharge rights. The question arises whether a debtor should be permitted to opt not for greater discharge rights but for less protection than the law would otherwise provide. Ostensibly this question is easily answered by one who generally believes in freedom of contract. The answer is simply "yes." Although some debtors might want much insurance against hard times and may be willing to pay a price in higher interest rates for such insurance, as in the above illustration, it is also the case that some debtors might not want so much insurance and would be unwilling to pay the price if given the choice. Generally, society does not require individuals to purchase insurance against risk of loss that the individual herself would bear. It is not immediately clear why insurance against financial distress is different.

Take the debtor from the prior example, but now assume that she has no family to support. She believes that the restaurant she hopes to open could not possibly survive long term unless it were able to sustain losses for a period of years longer than her bank as primary lender is willing to endure unless she can pledge her future income as a restaurant manager (or even from a job with relatively low income) should the business fail. Chapter 13 would permit the bank to demand disposable income for 3 years, but that's not enough for the bank, which cannot be sure that the debtor would qualify for chapter 13 at the time she filed for bankruptcy (even if she were compelled to file were she eligible) and, in any case, the bank would like a pledge of disposable income for 6 years. Also, the bank would like to supply its own definition of disposable income rather than leave that definition to a bankruptcy court. The debtor, who is young and ambitious, might wish to accept these terms, as she is confident that she will eventually make a great success, earning wealth and self-fulfillment. The American Dream.

This latest version of the restaurateur illustration suggests that a debtor should be able to waive the right to discharge at least to the extent that the debtor would not become a burden to society while repaying her obligations. A registry such as the one suggested above could list debtors as either eligible or ineligible for either chapter 7 or chapter 13. Or, as noted above, debts could be handled on an individual basis, by reference to the loan agreement.

On reflection, however, matters are not quite this simple. As a policy consideration, an individual debtor's option out of a full discharge right is not symmetrical to an option in. Even if one puts aside risks of externalities—such as the risk that a debtor would become a burden to society or would not support her family—a debtor's renunciation of a discharge option is problematic. Well rehearsed in the psychology literature is the fact that individuals frequently make important life decisions that they later regret.[32] Hyperbolic discounting of future burdens as well as lack of self control and forgetfulness have all been identified as sources of excessive consumer borrowing and spending. Moreover, lenders, even in a competitive market, may be able to take advantage of these biases (as individuals who miscalculate the true cost of credit may not react rationally to what they fail to perceive as lower-cost offers). Allowing an individual to opt-out of discharge,

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[32] *See, e.g.*, Richard H. Thaler & H.M. Shefrin, *An Economic Theory of Self-Control*, 89 J. POL. ECON. 392 (1981).

therefore, might well exacerbate these problems.

Although the problems of psychological bias are real and important, they do not necessarily justify a mandatory rule on discharge, but rather may inform the appropriate default rule and the manner in which one must opt out of that default rule. Perhaps the default rule should permit full chapter 7 discharge that could not be waived absent a debtor's signature on a written, fully informative disclosure document. This document could be worded in plain language—to account for the possibility that the debtor is not sophisticated about legal matters—with appropriate spaces for initials (or sentences handwritten by the debtor) on key provisions of the waiver. Significantly, these key provisions could include a summary of the psychological biases individuals are known to suffer and an explanation of the consequences the debtor might encounter as a result of such biases.

One could, of course, object to a waiver of discharge even if the waiver is explicit, written, and based on full disclosure. The psychological biases that plague an individual's borrowing decisions may also affect her ability to assess her susceptibility to the biases themselves. One might worry, moreover, that unsophisticated debtors might be persuaded to sign or write out a document that they don't understand even if the writing itself recites that they do understand. But these arguments are, at base, parentalistic. They rest on a belief that a lawmaker knows more than an individual what's best for that individual. Such an argument is not necessarily mistaken, but it is harder to defend than a simple appeal to protect individuals from misinformed decisions.

Whatever one's view on whether the bankruptcy law should permit an opt out of a full-discharge regime, it seems (at least to me) relatively uncontroversial that debtors should be permitted to opt into such a regime. Thus, as discussed above, if Congress is to restrict the use of chapter 7 it should do so only as a default rule.

2. Corporate Debtors

The case for freedom of contract is more straightforward for corporate debtors. As discussed above, the process of chapter 11, while perhaps less relevant than in the past, may not be ideal where it does matter. Given the option, investors might choose to customize the process that will follow an uncured default. That process may include an automatic allocation of interests among the creditors or may contain no special provision to address default, leaving resolution to state-law collection remedies. (The latter might be favored by firms with a capital structure such that financial distress would with high probability imply economic failure; recall that this is the conjecture that Baird & Rasmussen proposes with respect to modern firms generally and that I suggest would be true in a hypothetical legal environment that favored a mix of Chameleon Equity and traditional debt.) Chapter 11 is not for every firm, and the Bankruptcy Code should not permit chapter 11 to be an option for a debtor with a corporate charter that provides an alternative process in the event of default. As of now, it seems likely that at least some courts would treat a waiver of bankruptcy as illegitimate even for a corporate debtor. This should change. As noted above, in my earlier work on this topic, I observed that not only the Bankruptcy Code but other laws posed impediments to free corporate contracting about insolvency. Among these are tax law, corporate law, and commercial law.[33] A detailed explanation is beyond the scope of these remarks. Suffice it to say here that although reform of the Bankruptcy Code to permit contracting around chapter 11 would not solve every legal problem a financially distressed corporate debtor confronts, removal of one obstacle would be a start. If contract were the source of process, corporate bankruptcy law usefully could be reduced to its fundamental element, establishment of priority among conflicting claims.

Others have proposed that bankruptcy law provisions not be mandatory. Robert Rasmussen, for instance, has suggested that the law provide a menu of bankruptcy processes from which debtors could choose.[34] There is merit in this proposal, as such a menu could help create useful standards on which parties might come to rely. To be provocative, however, my recommendation here is that bankruptcy law go not even this far in the provision of process, which is not a primitive, so that the innovation of the private sector might yield an array of contractual processes potentially superior to a government-sponsored menu of standard forms.

B. *Bankruptcy Priority*

What I will argue now is that bankruptcy law should not shy away from the creation of claim priority. It may seem odd that one would treat the establishment of priority, now primarily a product of contract and state law, as a special role for bankruptcy law (this, ironically, while the traditional domain of special bankruptcy law, process, is considered an appropriate matter of contract). But as I hope now to explain, the difference between contractual or state-law priority and priority provided by bankruptcy law need not differ greatly but should in one circumstance, that where claims are held by nonconsensual creditors.

Priority among claims can be established by contract but only if the contract is among the affected creditors (rather than merely between debtor and creditors). If a debtor corporation issues senior and junior debentures, for example, purchasers of the junior interest explicitly agree to their subordination and there is no conflict between the obligations. The Bankruptcy Code honors this contractual arrangement if state law would. Bankruptcy law must do more, however. It must also address a situation in which a debtor issues obligations that do not include subordination provisions. So, for example, a debtor might pledge the same collateral to two different creditors on account of different loans. If the debtor cannot fully repay both loans, state real estate mortgage law or Article 9 of the UCC will establish priority between the claims. The Bankruptcy Code generally honors the state law

[33] Adler II, *supra* note 10, at 313.

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

entitlement. In this way, bankruptcy law—here by reference to state law—fulfills a fundamental purpose, the essential primitive of priority as I describe it above.

That bankruptcy law generally follows state-law entitlements is unobjectionable in these examples. States may differ somewhat in how they establish priority, in real estate mortgages, under their own versions of Article 9, or by reference to a race for a judgment lien on unencumbered assets. But the differences among jurisdictions are small and the applicable rules almost always sensible. A perfected interest in a debtor's assets requires some form of public notice, usefully warning other potential lenders whether that notice is provided by filing in an appropriate records office or by having a sheriff seize property on behalf of a lender who seeks to become a lien creditor. It is not clear that a uniform rule in bankruptcy would serve any additional purpose, though it would offend notions of federalism and could inhibit experimentation among jurisdictions. (Similarly, the Bankruptcy Code's deference to state law exempt-property rules for individual debtors is largely unobjectionable at least so long as a debtor does not change the rules on his creditors by moving to a new state before filing a bankruptcy petition.).[35]

These priority rules are property rules as they establish entitlements when claims conflict. But at least to the extent that lenders understand these rules before they extend credit, the rules can also be characterized as contractual because no investor holds a junior claim without knowledge that a senior claim exists, or may later come into existence, with priority established through notice of the senior interest. One who lends under these rules and does not establish priority herself implicitly consents to actual or potential subordination. So even if one thinks of priority as naturally and properly contract-based, bankruptcy law's deference to state-law entitlement appropriately establishes priority among lenders consistent with a contract regime. Thus far, then, current bankruptcy law's adherence to state law seems reasonable.

One might note that I have not here invoked the now standard proceduralist response to any suggestion that bankruptcy law alter state-law entitlement. That response, crafted primarily by Douglas Baird and Thomas Jackson, is that bankruptcy law is about process—a solution to the collective-action problem—and not about priority or entitlements.[36] In the Baird & Jackson paradigm, any appeal to the idea that a particular bankruptcy entitlement is good or bad is met with a claim that good or bad it may be, but a bankruptcy issue it is not. In the bankruptcy-primitives paradigm I have sought to establish here, however, the standard approach is turned upside down. Process is not a bankruptcy issue, entitlement is.

My disagreement with my colleagues (and casebook coauthors) Baird and Jackson, with whom I seldom find issue, stems from an analysis of the primary reason they give to oppose special bankruptcy law entitlement: the cost of forum

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[35] On exempt property and jurisdiction jumping, see generally Marcus Cole, *The Federalist Cost of Bankruptcy Exemption Reforms*, 74 AM. BANKR. L.J. 227, 230–36 (2000) (relying on empirical evidence to find jurisdiction jumping relatively limited, but nevertheless "demonstrably real and symbolically potent.").

[36] *See generally* JACKSON, *supra* note 29.

shopping. Their concern is, or has been, that if different substantive rights existed inside bankruptcy, as compared to out, parties who would benefit from the substantive bankruptcy result would have a perverse incentive to invoke the potentially cumbersome and costly bankruptcy process for a debtor not otherwise a good candidate for the process. The forum shopping concern, however, has always been easy to overstate and, in any case, has to some extent withered on the vine.

Note that, in general, a bankruptcy entitlement–such as whether a security interest should fully be honored—establishes priority among creditors, not between creditors and their debtor. This is significant, as under current law creditors cannot force a debtor into bankruptcy against her or its will unless the debtor has failed to pay debts as they came due.[37] If one might imagine that almost every such debtor would be a good candidate for bankruptcy—at least as opposed to some state law legal process—regardless of how assets would be distributed to creditors within bankruptcy, then forum shopping is not an important concern and any costs of forum shopping could easily be outweighed by a competing interest in favor of special bankruptcy entitlement. Moreover, as Baird points out, at this symposium and in his article with Rasmussen, the most potentially costly form of bankruptcy process, chapter 11, has declined in significance as in many chapter 11 cases a subset of a debtor's creditors take control despite (or within) the formal rules of chapter 11 and quickly dispose of the debtor's assets as they would like. If the process is thus not generally costly, forum shopping for that process is not as great a concern and, again, might be easily outweighed by competing considerations.

Earlier in these remarks I emphasized that the chapter 11 process may still be costly for some firms. In these cases, one might be more concerned about forum shopping. But in a world in which bankruptcy served only its most basic functions, process would be determined by contract, as I have proposed here and elsewhere. In such a legal environment, bankruptcy law would establish only entitlements (and a discharge as a default rule for an individual), leaving all of process to contract in light of such priority. So long as the Bankruptcy Code made clear that contractual process would override any attempt by state law to impose its own legal process—as bankruptcy law should—forum shopping would not even be an issue. There would be a single set of entitlements, that established by bankruptcy law, and a single relevant process, that established by contract (assuming consistent contractual provisions) or, absent contractual provision, that of applicable state law.

This said, so far, the approach I recommend here does not conflict with the proceduralist paradigm. As noted, I see no reason to change current bankruptcy law's deference to state law for priority among lenders. But not all creditors are lenders. In a small number of bankruptcy cases, tort creditors (or other nonconsensual claimants) are owed significant sums. State law generally treats such claims as general obligations that, outside of bankruptcy, are subject first to any perfected security interest then to a creditors' race. The first to establish a judgment lien on any of a debtor's unencumbered assets has priority. And if there

[37] *See* 11 U.S.C. § 303 (2002).

are no or few unencumbered assets from which a nonconsensual creditor can collect, the result is that the nonconsensual creditor simply loses. In bankruptcy, this system of state law priority translates into a ratable return for nonconsensual creditors who share priority with other general creditors, all junior to any perfected security interest, which survives a bankruptcy petition.

There is little to support so low a priority for nonconsensual claims. Standard economic analysis suggests that nonconsensual claims should have the highest priority, even above secured creditors. Otherwise investors—shareholders and lenders together—can externalize the risk of a debtor's operation and internalize the benefits. A classic example would be where a cab company pledged all of its cars to secured creditors (or, the economic equivalent, leased rather than owned them) then simply folded if a negligently driven taxi ran down a pedestrian who successfully sued the company. This result not only strikes most as unfair based on any theory of justice, but induces excessive activity by the cab company and insufficient precaution. Every consideration, therefore, seems to favor nonconsensual-claim priority, which would cause a company's investors to internalize both the cost and the benefit of corporate activity (at least to the full extent of corporate assets).[38]

Were I asked to suggest a reform to the Bankruptcy Code, I would recommend highest priority for nonconsensual creditors, which would include accident victims such as the pedestrian, sufferers of environmental contamination, children owed support, and others with no relationship with the debtor or an insufficient opportunity to bargain with the debtor prior to the injury that gave rise to the claim. Where a firm devised its own process for resolution of financial distress, as I propose a firm should be permitted to do, one limitation on contractual design would be that nonconsensual creditors are awarded a return ahead of all investors.

A response that one might anticipate to this proposal, at least from some corners, is that the tort system is out of control, imposing liability on actors that have not behaved negligently or otherwise in a way that society should wish to discourage. In the extreme version of this claim, it is said that many injuries are fabricated or vastly overcompensated in damages awards. The lack of affordable medical care, for example, is blamed on soaring malpractice premiums. The newspapers are full of such allegations. True or not, however, one can at least hope that rather than two malfunctioning legal systems—tort and bankruptcy—lawmakers might repair each. I at least hope this might be the case.

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[38] *Cf.* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) (arguing against even shareholder limited liability where plaintiff is tort victim).

CONCLUSION

Bankruptcy law as we know it serves many functions, perhaps too many. These remarks constitute a thought experiment, where contract handles most of what bankruptcy law now regulates, and where bankruptcy serves simply to reach where contract cannot.