The Three Faces of Bankruptcy Law

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INTRODUCTION

The Three Faces of Bankruptcy Law

Bankruptcy law is an ancient, peculiar feature of our legal landscape. Historically, it has existed from time to time as a collection of extraordinary remedies assembled to address three basic questions: (1) what is to be done with the person of an insolvent debtor, (2) what is to be done with the insolvent debtor's property, and (3) what is to be done with the insolvent debtor's liabilities?[1] It is peculiar for several reasons.

First, the need for a special collection of bankruptcy procedures is not so obvious. Non-bankruptcy law already provides vast mechanisms for collecting debts, distributing

[1] As used throughout, the term "debtor" refers to a person who owes unpaid debt obligations. A debtor may be either an individual or a firm. The term "insolvent" refers to a debtor's general inability (or in some cases unwillingness) to satisfy existing obligations, either as they mature ("equity insolvency") or because they exceed the value of the debtor's assets ("balance-sheet insolvency"). In contrast, the term "bankrupt" refers to the status of an insolvent debtor who has become caught up in a legal bankruptcy proceeding of some kind. It is worth noting that not all insolvent debtors will or should seek formal bankruptcy relief. *See* Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. & ECON. 595, 595 (1993) [hereinafter Schwartz, *Bankruptcy Workouts*] (observing that many firms that experience financial distress restructure their affairs without resort to bankruptcy); *see also* Joseph E. Stiglitz, *Some Aspects of the Pure Theory of Corporate Finance: Bankruptcies and Take-overs*, 3 BELL. J. ECON. MGMT. SCI. 458, 480 (1972) (noting that firms approaching insolvency may consider takeovers and mergers rather than bankruptcy). For example, some debtors experience insolvency as purely a temporary phenomenon—including most college students immediately upon graduation and many start-up firms. For these debtors, resort to bankruptcy is not typically warranted. Similarly, not all debtors experiencing financial distress are or will become insolvent, either in the equity-insolvency sense or the balance-sheet-insolvency sense. The concept of financial distress is thus not synonymous with insolvency.

property, and sorting the rights of competing claimants against a common obligor. One might well ask: why have yet another mechanism for doing so simply because one of the parties in interest—the debtor—has become insolvent? For much of United States history, the nation had no formal bankruptcy law,[2] and thus one potential answer to this question (albeit an incorrect one) is that there is no particular need for a distinct bankruptcy regime.

Second, few areas of the law have been the subject of such rancorous experimentation. In both England and the United States, bankruptcy law evolved in fits and starts, sparking controversy at every turn. As Justice Cardozo aptly remarked in his dissent in *Ashton v. Cameron County Water District*, the history is one "of an expanding concept . . . that has had to fight its way. Almost every change has been hotly denounced in its beginnings as a usurpation of power."[3] Although the details of these controversies have evolved over time, bankruptcy law remains a hotly polarizing topic.[4]

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[2] *See infra* note 370 (discussing the absence of a national bankruptcy law for much of the nineteenth century).

[3] 298 U.S. 513, 535 (1936) (Cardozo, J., dissenting).

[4] Relevant aspects of the evolution of Anglo-American bankruptcy law and how it has responded to the questions outlined above are referenced in Chapter 3. In brief, historical responses to the first question—what is to be done with the person of an insolvent debtor—have ranged from the extremes of (1) hanging or mutilating the debtor to (2) releasing him from his debts. Responses to the second question—what is to be done with the insolvent debtor's property—have ranged from (1) violently seizing the debtor's assets for the benefit of his creditors to (2) permitting him to retain at least some items free from the creditors' reach. Responses to the third question—what is to be done with the insolvent debtor's liabilities—have ranged from (1) prescribing fairly strict ratable treatment in the payment of the creditors' claims to (2) ranking the claims according to a priority scheme that permits a single creditor in some cases to recover ahead of all others. Given the broad variability of bankruptcy law's historic responses to these basic questions, together with the controversies that have followed whatever path the law has taken, the subject has long confounded debtors, creditors, legislators, jurists, commentators, and scholars alike.

Third, few areas of the law are so poorly understood and theorized, and the relevant deficiencies include (1) the absence of a satisfactory account of the need for a distinct body of bankruptcy remedies, and (2) the lack of an adequate theory explaining how bankruptcy law ought to respond to that need.[5] The first deficiency is foundational, the second is ordinal, and they should be addressed in the order stated. From a normative perspective, if there is no particular reason for having a bankruptcy law, then there is no particular reason to consider how it should be arranged.[6] Conversely, until the reasons for having a bankruptcy law are fully understood, discussions of its normative content are likely simply to "float . . . in the air."[7]

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[5] In comparison, a comprehensive and robust discourse has long existed, for example, on both the essential purposes of tort law and how it should be designed in light of those purposes, encompassing diverse economic, philosophical, and other perspectives. *See, e.g.*, JOHN F. WITT, THE ACCIDENTAL REPUBLIC 43-70 (2004); OLIVER W. HOLMES, JR., THE COMMON LAW 76-129 (1881) [hereinafter HOLMES, COMMON LAW]; Benjamin C. Zipursky, *Civil Recourse, Not Corrective Justice*, 91 GEO. L.J. 695 (2003); Martin Stone, *The Significance of Doing and Suffering*, published in PHILOSOPHY AND THE LAW OF TORTS 131 (G.J. Postema ed. 2001); Jules Coleman & Arthur Ripstein, *Mischief and Misfortune*, 41 MCGILL L.J. 91 (1995) [hereinafter Coleman & Ripstein, *Mischief*]; Tony Honore, *Responsibility and Luck: The Moral Basis of Strict Liability*, 104 L.Q.R. 530 (1988); Richard A. Epstein, *A Theory of Strict Liability*, 2 J. LEGAL STUD. 151 (1973) [hereinafter Epstein, *Theory*]; George P. Fletcher, *Fairness and Utility in Tort Theory*, 85 HARV. L. REV. 537 (1972); Guido Calabresi & Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View from the Cathedral*, 85 HARV. L. REV. 1089 (1971) [hereinafter Calabresi & Melamed, *Property Rules*]; Leon Green, *The Duty Problem in Negligence Cases*, 28 COLUM. L. REV. 1015 (1928).

[6] The term "normative" is used throughout in the sense of "ought" or "should" or "ideal." Thus, the "normative" content of bankruptcy law means the content that bankruptcy law ought ideally to have. *See, e.g.*, MERRIAM WEBSTER'S COLLEGIATE DICTIONARY 793 (10th ed.) (listing the third definition of normative as "prescribing norms"). In contrast, the "positive" or "descriptive" content of bankruptcy law means simply a description of the content of bankruptcy law as it is, rather than as it ought to be.

[7] RONALD H. COASE, THE FIRM, THE MARKET AND THE LAW 28 (1988) [hereinafter COASE, FIRM]. Before conceptualizing a solution to any problem, it is useful first to understand the nature of the problem one is attempting to address. *Cf.* Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 170 (1946) (Frankfurter, J.,

In academic circles, it is fashionable to conceive of bankruptcy law in one of three competing ways: (1) as a special debt-collection device that exists to address an insolvency-related problem known as the "collective-action dilemma" and that, as a substantive matter, properly mirrors the kinds of remedies creditors would bargain for if only they could negotiate collectively before extending credit (the "collective-action" approach);[8] (2) as a special debt-collection mechanism amenable to actual contractual ordering and justifiable as a way of reducing borrowing costs (the "contracting" approach);[9] and (3) as a set of alternative remedial loss-spreading rules superimposed on ordinary non-bankruptcy debt-collection structures and animated pragmatically by an assortment of historically competing and conflicting policy considerations (the "loss-spreading" approach).[10] This chapter summarizes these three approaches and explains

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concurring) ("[p]utting the wrong questions is not likely to beget right answers even in law").

[8] *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 10-13, 20-21 (1986) [hereinafter JACKSON, LOGIC]; *see also* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 827 (1987) [hereinafter Baird, *Loss*]. The collective-action dilemma is explained *infra* at 24-25. The collective-action approach advocated by Jackson and similar theorists is discussed *infra* at 24-27. The collective-action approach is a "debt-collection" theory because it conceptualizes bankruptcy law as fundamentally a debt-collection device, at least as applied to firms. *See infra* at 25.

[9] *See, e.g.*, Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199, 1200 (2005) [hereinafter Schwartz, *Normative Theory*]; *see also* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach for Corporate Bankruptcy*, 71 TEX. L. REV. 51, 100-07 (1992) [hereinafter Rasmussen, *Debtor's Choice*]. The contracting approach advocated by Schwartz and similar theorists is discussed *infra* at 57-84. Like the collective-action approach, the contracting approach is also a debt-collection theory because it conceptualizes business bankruptcy law as fundamentally a debt-collection device. *See infra* at 54-57.

[10] *See, e.g.*, Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 343-44 (1993) [hereinafter Warren, *Bankruptcy Policymaking*]; Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 776-77 (1987) [hereinafter Warren,

why each is inadequate. It also outlines my own theoretical account of (1) the reasons for having a remedial bankruptcy law, and (2) how bankruptcy law ought to be arranged in light of the reasons that justify its existence. Both aspects of this account are then fleshed out in greater detail in the chapters that follow.

Addressing the first question—the need for a distinct body of bankruptcy remedies—I argue that bankruptcy law is necessary to address a group of insolvency-related problems encompassing far more than simply the collective-action dilemma. These include (1) special problems of claims mediation and payment discrimination; (2) unique challenges of overinvestment, underinvestment, and other moral hazard; and (3) unrecoverable collection, monitoring, and related costs associated with a debtor's financial ruin.[11] As a group, these problems are worth remediating because they impair the functioning of ordinary markets, produce unique externalities, and otherwise generate waste, inefficiency, and unfairness. Bankruptcy law properly intervenes as a distinct corrective measure to address them because it would make no sense to burden ordinary non-bankruptcy markets with similar procedures; the need for a remedial bankruptcy response arises only in the insolvency context. Although a number of scholars have examined, or at least observed, various aspects of the problems of insolvency

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Bankruptcy Policy]; *see also* Elizabeth Warren & Jay L. Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197, 1200 (2005) [hereinafter Warren & Westbrook, *Contracting Out*]. The loss-spreading approach advocated by Warren and similar scholars is discussed *infra* at 101-05. In contrast to the collective-action and contracting accounts, the loss-spreading approach is not strictly a debt-collection theory because it conceptualizes bankruptcy law as fundamentally a vehicle for pursuing a variety of goals including, but not limited to, the payment of claims. *See infra* at 101-02.

[11] Each of the insolvency-related problems categorized above is addressed in detail in Chapter 2.

summarized above, the novelty of my approach lies in considering them together as a comprehensive justification for having a bankruptcy law in a manner that is organizationally and substantively distinct.[12]

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[12] References to the work of other scholars who have observed or examined one or more of the insolvency-related problems summarized above are included in the notes accompanying Chapter 2, including the work of Thomas Jackson, Douglas Baird, and others. It should be noted that one of Jackson's significant contributions to the theoretical literature is that, in crafting his particular theory of bankruptcy law, he begins purposefully by examining as a threshold question the need for having a distinct body of bankruptcy remedies, isolating the "collective-action dilemma" as the central justification. *See* JACKSON, LOGIC, *supra* note 8 at 10-13. It is only *after* identifying the collective-action problem as the basic justification for having a bankruptcy law that he then proceeds to discuss how bankruptcy law ought to be crafted in response to it, advocating his creditors'-bargain approach. Other scholars have tended to skip addressing rigorously the threshold question as a preliminary inquiry, preferring instead to examine bankruptcy law as a vehicle for the fulfillment of one set of policy objectives or another and, in the process, eliding the need for bankruptcy law with the desirability of the policies they identify, *see, e.g.*, Warren, *Bankruptcy Policymaking*, *supra* note 10 at 343-44, sparking a debate over methodology, *compare* Baird, *Loss*, *supra* note 8 at 824 (stating that "[t]he challenge facing anyone who wants to write about bankruptcy policy is to explain why a distinct bankruptcy law exists at all") *with* Warren, *Bankruptcy Policy*, *supra* note 10 at 776-78 (acknowledging differences in methodology). For a number of reasons, inadequate examination of the threshold question as a preliminary matter has tended to obscure the analysis, in part because it tends to result in the advocacy of solutions to problems that are themselves never clearly defined. *See infra* at 59, 116-17. Still other scholars have made claims about the normative value of bankruptcy law in ways that at least imply the existence of a discrete "problem" in need of some bankruptcy remedy. For example, Alan Schwartz contends that corporate bankruptcy law properly exists to reduce the cost of capital for firms. *See* Schwartz, *Normative Theory*, *supra* note 9 at 1200. Implicit in this approach is the idea that there is a problem with current capital cost structures, namely that the cost of capital for firms is too high, at least for the purposes Schwartz discusses—otherwise there would be no need for a business bankruptcy law to reduce it. Also implicit in this approach is that a properly crafted bankruptcy law might appreciably lower the cost of capital for firms—otherwise business bankruptcy law would be a waste of time. As I explain in responding to Schwartz's arguments, there are reasons to doubt both assumptions and, regardless, Schwartz's perspective is too narrow because it ignores more important problems, costs, and benefits that bankruptcy law does and should address. *See infra* at 95-101. In any event, my approach on the threshold question is distinctive in that the problem set I identify as justifying the need for a discrete bankruptcy law (1) is broader and more comprehensive than Jackson's collective-action explanation, (2) addresses an important

Turning to the second question—how bankruptcy law ought to respond to the problems that explain its existence—I argue that it is a mistake to conceive of bankruptcy law as merely a special type of debt-collection device or as an alternative loss-spreading mechanism superimposed on existing non-bankruptcy debt-collection structures. Among other reasons, these frames are inadequate to capture the subject's proper remedial scope. Rather, bankruptcy law is best conceptualized as creating and supporting a distinct "bankruptcy market" in its own right. Further, the bankruptcy market is best conceptualized as "corrective" in nature because its purpose is to remediate the problems of insolvency so that, among other goals, insolvent debtors and their property may once again return to, and participate fully in, ordinary non-bankruptcy markets unburdened by the waste, inefficiency, and distorted decision-making incentives that insolvency generates.

Operationally, the bankruptcy market properly performs its corrective function through its unique features of debt collection, debt forgiveness, and debt adjustment—its three distinct "faces"—that in combination orchestrate what is to be done with the bankrupt debtor's person, property, and liabilities. Specifically, the law's debt-collection remedies respond to certain of the problems of insolvency by directing the recognition and enforcement of an insolvent debtor's obligations in special ways. Its debt-forgiveness provisions respond by relieving the bankrupt debtor and certain of the debtor's property from the burdens of existing indebtedness. Its debt-adjustment mechanisms respond by realigning the creditors' rights and priorities between them as a

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threshold question that scholars such as Warren have tended to ignore or treat inadequately, and (3) is entirely distinct from Schwartz's approach.

group.[13] Among other things, these signature features of bankruptcy law aim to promote improved decision making regarding the disposition of the debtor and the debtor's assets, enforce as a secondary matter the payment of claims to reduce the regime's costs, and prioritize the debtor's liabilities. As I explain in Chapter 3, the solutions that these mechanisms offer to the problems of insolvency are beneficial, whether evaluated in terms of equity (fairness), efficiency (wealth maximization), or the preservation of entitlements (protected interests).

Given the desirability of these key features of bankruptcy law, the corrective-market approach is superior to the debt-collection and loss-spreading alternatives for a number of reasons. As a descriptive matter, it more accurately captures what bankruptcy law actually does and thus provides not only a better statement of the current regime against which alternative proposals can be evaluated, but also a more appropriate conceptual frame within which to evaluate its use and potential.[14] For example, the U.S.

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[13] The debt-collection, debt-forgiveness, and debt-adjustment mechanisms of bankruptcy law are discussed in Chapter 3. I also explain in Chapter 3 how each of these mechanisms responds to different categories of the problems of insolvency. For example, bankruptcy law's debt-collection devices properly respond to the specific problems of unrecoverable collection and monitoring costs, and its debt-adjustment mechanisms properly respond to the problem of payment discrimination. *See infra* at 228, 300.

[14] In offering this positive justification for the corrective-market account, I do not mean to suggest that the normative justifications for responding to the problems of insolvency can be derived merely from a descriptive statement of how the law currently functions. *See* DAVID HUME, A TREATISE OF HUMAN NATURE, book III, part I, section I (1739) [hereinafter HUME, TREATISE] (arguing that "ought" does not follow merely from a description of what "is," but "'tis necessary that . . . a reason should be given; for what seems altogether inconceivable [is] how this new relation can be deduced from others, which are entirely different from it"). These are separate inquiries, and the normative question is discussed immediately below. Because the corrective-market approach provides a better positive *and* normative description of bankruptcy law, it offers a better conceptual frame within which to evaluate how it should operate, and I have chosen it at least in part on the theory that it is both accurate and nontrivial. *See* RONALD M. DWORKIN, LAW'S EMPIRE 74 (1986) [hereinafter DWORKIN, LAW'S EMPIRE] (discussing

Bankruptcy Code (codified as Title 11 of the United States Code)[15] characteristically provides that, upon the commencement of a bankruptcy case, the debtor's property is vested in a special "bankruptcy estate"; the claims of creditors are exchanged for equitable shares in the estate (and are sometimes traded in a unique distressed-debt submarket); most debt-collection activity is curtailed in favor of court-supervised oversight of the debtor's affairs; and the debtor's liabilities are thereafter sorted, altered, negotiated, and extinguished under the auspices of a special regulatory system that effectively supplants non-bankruptcy mechanisms.[16] In other words, bankruptcy law establishes its own special forum and devices for addressing what is to be done with the person, property, and liabilities of insolvent debtors in ways quite different from non-bankruptcy markets.

More important, the corrective-market approach more appropriately accounts for and accommodates what bankruptcy law *should* be doing. As a normative matter, bankruptcy law's creation of its own distinctive market in response to the problems of insolvency is desirable because these problems are complex and, by their nature, require

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the challenge of coming up with conceptual labels because "it is difficult to find a statement of the concept at once sufficiently abstract to be uncontroversial . . . and sufficiently concrete to be useful").

[15] 11 U.S.C. § 101, et seq. (2000 & Supp. 2006).

[16] By operation of law, the debtor's filing of a bankruptcy petition creates a "bankruptcy estate" consisting of all of the debtor's non-exempt property, wherever located. 11 U.S.C. § 541 (2000 & Supp. 2006). Upon the commencement of the case, the "automatic stay" enjoins most forms of debt-collection activity against the debtor and the estate. 11 U.S.C. § 362 (2000 & Supp. 2006). Thereafter, creditors are entitled to file "proofs of claim" demonstrating their rights to payment from the debtor. 11 U.S.C. § 501 (2000 & Supp. 2006). Claims are subject to "disallowance," "subordination," "reaffirmation," "discharge," and "impairment," among other things, through a variety of devices. *See, e.g.*, 11 U.S.C. §§ 502, 510(c), 524(c), 727, 1123(b) (2000 & Supp. 2006); *see also infra* notes 72-76 & 240-41 (discussing these and other aspects of the bankruptcy process).

the power of a comprehensive and specially-tailored market regime to resolve them adequately. In particular, the problems of insolvency warrant remediation through the intervention of a corrective bankruptcy market of the kind the law currently supplies, rather than through the more limited debt-collection alternatives some scholars have offered (such as bankruptcy contracting and the like), because these alternatives are comparatively inferior as vehicles to address the problems of insolvency.[17] In addition, although the loss-spreading approach is capacious enough to accommodate bankruptcy law's debt-collection, debt-forgiveness, and debt-adjustment functions, it lacks an adequate conceptual means to define, limit, and coordinate their operation. The corrective-market approach corrects this deficiency in two ways. First, it defines and limits bankruptcy law's debt-collection, debt-forgiveness, and debt-adjustment mechanisms by tying them to the problems of insolvency. Second, it coordinates these mechanisms by prioritizing them. Specifically, (1) the debt-collection functions of bankruptcy law are subordinated to its debt-forgiveness features on the principle that the proper allocation of assets is more important than the payment of claims, and (2) obligations processed through bankruptcy's debt-collection procedures are subject to modification under its debt-adjustment mechanisms so that losses are channeled away from those who are characteristically poor loss-spreaders and toward those who are the cheapest avoiders of the costs of insolvency.[18]

Bankruptcy law properly privileges its debt-forgiveness and debt-adjustment features over its debt-collection functions for a number of reasons, including the goal of

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[17] *See infra* at 57-95.

[18] These features of the corrective-market approach, together with the normative justifications for them, are discussed in detail in Chapter 3.

ensuring appropriate asset dispositions in response to the problems of insolvency.[19] This does not mean, of course, that the payment of claims is unimportant in bankruptcy. Treating the payment of claims as unimportant would make any bankruptcy system too costly.[20] Rather, the enforcement of debts is properly streamlined to reduce the costs of enforcement and then relegated to secondary significance because ensuring the efficient deployment of assets is more important than vindicating the pre-bankruptcy collection rights of creditors *per se*.[21]

To be sure, many theorists conceptualize bankruptcy law in terms of its ability to promote and accomplish beneficial results and effects, offering competing perspectives on both (1) *what* constitute desirable outcomes in the insolvency context, and (2) *how* bankruptcy law should go about achieving them.[22] For example, scholars who characterize bankruptcy law as primarily a debt-collection vehicle typically argue in

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[19] As indicated above, I evaluate the various mechanisms of bankruptcy law and the solutions they offer to the problems of insolvency using three different standards: (1) equity (fairness), (2) efficiency (wealth-maximization), and (3) entitlement (the preservation of protected interests). I also use these standards to evaluate how bankruptcy prioritizes its various debt-collection, debt-forgiveness, and debt-adjustment mechanisms. I make use of these three different standards because none of them is perfect and collectively they provide a fuller picture of the desirability of the different functions of bankruptcy law. The relative merits and drawbacks of these standards are addressed in Chapter 3.

[20] *See, e.g.*, Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1427 (1985) [hereinafter Jackson, *Fresh-Start*] (explaining that a discharge mechanism that too generously extinguished debts at the creditors' expense would be disastrous for a credit-based economy such as ours); *infra* at 289.

[21] These aspects of my theory are fleshed out in greater detail in Chapter 3.

[22] The economic standard of "wealth maximization" is discussed in Chapter 3. Although I make use of this standard in evaluating bankruptcy law, I also use the standards of equity (fairness) and the preservation of entitlements (paramount interests protected by rights) because wealth maximization, by itself, is an incomplete metric with important limitations and drawbacks. *See infra* at 242-48.

response to the "what" question that bankruptcy law is wealth maximizing to the extent it "gets the creditors paid" at the lowest possible cost in accordance with their pre-bankruptcy payment entitlements. This is so, they contend, because that is what bankruptcy law is for, and a bankruptcy law that functions in this way is beneficial to the extent it (1) reduces borrowing costs and/or (2) avoids the misuse of public resources attendant in maintaining competing debt-collection systems (bankruptcy and non-bankruptcy) that perform the same debt-collection function in different ways—a problem of "forum shopping."[23]

In contrast, scholars who emphasize bankruptcy law's loss-spreading capabilities—in particular its debt-forgiveness and debt-adjustment features—typically argue in more eclectic fashion that, in addition to streamlining the recognition and enforcement of claims more efficiently than non-bankruptcy systems, bankruptcy law is ameliorative to the extent it relieves debtors from the burdens of excessive indebtedness and adjusts the payment rights of creditors. This is so, they argue, because *that* is what bankruptcy law is for on the theory that a bankruptcy law that functions in this way has the effect of avoiding costly features of the non-bankruptcy system of debt enforcement that fail adequately to protect the interests of debtors, creditors, and other constituents affected by a debtor's financial demise.[24]

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[23] *See* JACKSON, LOGIC *supra* note 8 at 3, 20-21; Schwartz, *Normative Theory*, *supra* note 9 at 1200; Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 155-56 (1989) [hereinafter Jackson & Scott, *Nature of Bankruptcy*]; Baird, *Loss*, *supra* note 8 at 827; Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173, 185-86 (Spring 1987) [hereinafter Baird, *World*].

[24] *See, e.g.*, Warren & Westbrook, *Contracting Out*, *supra* note 10 at 1200-01; Warren, *Bankruptcy Policy*, *supra* note 10 at 777, 779.

For a number of reasons, however, these competing responses to the "what" question are inadequate. As a positive matter, the actual ambition of bankruptcy law is a hybrid of the debt-collection and loss-spreading views—it expresses a dynamic combination of debt-collection, debt-forgiveness, and debt-adjustment values that do not single-mindedly pursue either the goal of reducing borrowing costs or the correction of deficiencies in non-bankruptcy debt-collection regimes *per se*. Rather, bankruptcy law pursues a variety of cost-reduction goals for a deeper and more comprehensive purpose: to remedy the problems of insolvency. Although it is certainly true that bankruptcy law may have the *effect* of reducing borrowing costs and/or correcting deficiencies in the general debt-collection system, its actual beneficial *purpose* remains something distinctly different, and it is important to avoid confusing purpose with effect. Similarly, the forum-shopping concern is largely overblown because it assumes that bankruptcy and non-bankruptcy markets perform the same debt-collection function when, in fact, they do not.[25] As a positive matter, the corrective-market approach offers a better response to the "what" question because, in accounting more fully for the debt-collection, debt-forgiveness, and debt-adjustment functions of bankruptcy as a coordinated response to the multi-faceted problems of insolvency, it more accurately captures bankruptcy law's actual remedial ambitions and virtues.

Moreover, the debt-collection and loss-spreading perspectives are normatively inadequate because they are alternatively too narrow and too broad. The debt-collection view is too narrow because, among other things, it overstates the value of the debt-collection function and correspondingly fails to account adequately for the beneficial

[25] The forum-shopping problem is discussed in greater detail *infra* at 47-53.

effects of bankruptcy law's debt-forgiveness and debt-adjustment mechanisms. In turn, the loss-spreading view is too free-floating because it is insufficiently anchored to the reasons for having a bankruptcy law in the first place and lacks a means to organize and limit the loss-spreading policies that scholars who advocate it have championed.[26] In contrast, the corrective-market approach occupies a distinct space between these perspectives (although it is concededly closer to the views of the loss-spreading advocates than it is to the views of the debt-collection enthusiasts), and offers a better normative answer to the "what" question because it defines bankruptcy law's remedial goals in ways that are more directly responsive to the problems of insolvency and avoids the under- and over-breadth defects of the debt-collection and loss-spreading theories. It is likewise superior because it evaluates bankruptcy outcomes not only in terms of whether they are wealth-maximizing in an economic sense, but also from the perspectives

[26] For example, few would quarrel with Warren's proposition that, as a general matter, bankruptcy law properly serves to "enhance the value of the failing debtor," but the real question is why bankruptcy law does so (versus some other law), and correspondingly what are the proper limits to the goal of enhancing the value of the failing debtor in bankruptcy and how is this goal to be orchestrated in concert with the other values Warren identifies. *See infra* at 102-09 (discussing Warren's articulation of the goals of bankruptcy law); Warren, *Bankruptcy Policymaking*, *supra* note 10 at 343-44 (arguing that bankruptcy law "aims, with greater or lesser efficacy, toward four principal goals: (1) to enhance the value of the failing debtor; (2) to distribute value according to multiple normative principles; (3) to internalize the costs of the business failures to the parties dealing with the debtor; and (4) to create reliance on private monitoring"). Consistent with his debt-collection focus, Jackson contends that bankruptcy law properly enhances the debtor's value *for the benefit of creditors*. *See* JACKSON, LOGIC, *supra* note 8 at 21 ("The key to effective implementation of [bankruptcy's goal of ameliorating the common-pool problem] is to trigger bankruptcy when, and only when, it is in the interests of the creditors as a group."). This view, however, is too narrow because, as discussed *infra*, it fails to account adequately for the value of the debt-forgiveness aspects of bankruptcy law that frequently override the collection of claims, and likewise takes inadequate account of its debt-adjustment features. *See infra* at 31-34.

of whether they are equitable (fair) and consistent with concepts of entitlement (protected interests).

Scholars diverge even further on the "how" question—namely, how bankruptcy law should go about achieving its goals. Those who focus on bankruptcy law as primarily a debt-collection device favor a regime that, as noted, either (1) mirrors the kinds of remedies creditors would bargain for if only they had the chance to do so before extending credit ("conceptual contracting"), or (2) permits actual *ex ante* bankruptcy contracting ("actual contracting").[27] As a group, these scholars are characteristically skeptical of the value of any legal process that uses substantive rules or judicial decision making to guide asset allocation issues or protect the interests of debtors or other constituents "disadvantaged" by non-bankruptcy debt-collection procedures, particularly rules that direct substantive outcomes different from those that would be achieved in ordinary non-bankruptcy markets.[28] They observe that, in the non-bankruptcy world, debt obligations are typically creatures of contract and courts typically enforce those contracts even though doing so may leave little or nothing for others. In response to the "how" question, these scholars characteristically ask: why should things in bankruptcy be different? They typically reply that things should not be different, other than as minimally necessary to address the collective-action problem in ways that enhance the

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[27] *See supra* notes 8-10, 12. The concept of "*ex ante*" contracting refers to bargaining at the time a creditor extends credit before the onset of insolvency. In contrast, the concept of "*ex post*" contracting refers to bargaining after the onset of insolvency. The concept of "*ex ante* effects" in bankruptcy refers to the impact of bankruptcy rules on behavior in non-bankruptcy markets. *See* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 578-80 (1998) [hereinafter Baird, *Uncontested Axioms*] (discussing the concept of "*ex ante* effects").

[28] *See, e.g., id.* at 587.

creditors' non-bankruptcy returns.[29] In other words, they argue that bankruptcy law's response to the "how" question should be essentially procedural only,[30] and should be tailored narrowly to serve only the goals they identify in their response to the "what" question (i.e., debt collection), with some of these scholars arguing that the best way to address the "how" question, at least in part, is through actual enforceable bankruptcy contracts.[31]

In contrast, scholars who focus on bankruptcy law's loss-spreading capabilities tend to favor a remedial system of the kind that currently exists—a court-supervised bankruptcy process with a mixture of procedural and substantive rules that guide asset-allocation issues and overtly protect the interests of a variety of constituents who would otherwise lose out in the non-bankruptcy debt-collection game. They observe that bankruptcy law properly deals with the totality of the legal obligations a debtor may owe, many of which are not creatures of contract (e.g., tort and tax obligations), and that it would make no sense to leave these and other obligations by the wayside simply because financial creditors have negotiated privately with the debtor for preferential treatment and have made no accommodation for the interests of others. They observe further that the

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[29] *See, e.g.*, JACKSON, LOGIC, *supra* note 8 at 20-21; Jackson & Scott, *Nature of Bankruptcy*, *supra* note 23 at 155-56; Baird, *Loss*, *supra* note 8 at 827.

[30] *See* Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 946-479 (2004) [hereinafter Mooney, *Normative Theory*] (describing the collective-action account as fundamentally a proceduralist approach); Baird, *Uncontested Axioms*, *supra* note 27 at 578-80 (characterizing the collective-action account as proceduralist in nature).

[31] *See, e.g.*, Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343, 346-48 (1999) [hereinafter Schwartz, *Contracting Reviewed*]; Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1821-22 (1998) [hereinafter Schwartz, *Contract Theory*]; Schwartz, *Bankruptcy Workouts*, *supra* note 1 at 621-24.

reason non-bankruptcy markets do not provide extensive protection for debtors and constituents other than financial creditors is because that is the role of bankruptcy law—to be invoked when needed.[32] In response to the "how" question, they characteristically ask: why should things in bankruptcy be the same? They typically reply that things should not be the same, and that bankruptcy law may prescribe a broad assortment of substantive and procedural protections that favor debtors and creditors who would otherwise fare poorly if left to their own devices in the non-bankruptcy world.[33] In other words, they argue that bankruptcy law's response to the "how" question is properly procedural *and* substantive to achieve the goals they champion in their response to the "what" question.

These competing responses to the "how" question, however, also exhibit both positive and normative flaws. As a positive matter, the views of those who advocate bankruptcy law as a debt-collection device are inadequate because the law does not permit actual *ex ante* bankruptcy contracting of the kind they propose and likewise does not operate exclusively as a procedural vehicle to enhance the return of creditors strictly in accordance with their non-bankruptcy payment entitlements in the manner creditors might bargain for *ex ante* if only they could negotiate collectively before extending credit.[34] Rather, as outlined above, bankruptcy law advances its debt-collection, debt-

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[32] *See* LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 239 (4th ed. 2003) [hereinafter LOPUCKI & WARREN, SECURED CREDIT]; Warren, *Bankruptcy Policy*, *supra* note 10 at 779.

[33] *See id*. at 777.

[34] Current law does not permit parties to contract out of available bankruptcy procedures. *See* Warren & Westbrook, *Contracting Out*, *supra* note 10 at 1199 (observing that "[b]ankruptcy law, as currently formulated, is a mandatory system"); Lucian A. Bebchuk & Andrew T. Guzman, *An Economic Analysis of Transnational Bankruptcies*, 42 J.L. &

forgiveness, and debt-adjustment goals through a complex combination of substantive and procedural protocols. At the same time, bankruptcy law's pursuit of its goals of debt collection, debt forgiveness, and debt adjustment through its procedural and substantive mechanisms is considerably constrained—more so than those who advocate bankruptcy law as a loss-spreading vehicle would appear to advocate.

As a normative matter, this restraint is appropriate. Although those who focus on bankruptcy law as a loss-spreading vehicle tend to favor a remedial system that approximates in many respects the corrective-market approach, the approach remains distinctive for two basic, inter-related reasons. First, rather than conceive of bankruptcy law as an "overlay" on non-bankruptcy debt collection systems as though both systems addressed essentially the same subject matter, it conceptualizes bankruptcy law as creating a distinct marketplace for distinct purposes. Second, rather than conceive of bankruptcy law as necessary to "fix" the debt-collection deficiencies of non-bankruptcy systems, it conceptualizes bankruptcy law as responding only to the problems of insolvency. As a result, it defines the mission of bankruptcy law more narrowly and avoids overrunning non-bankruptcy procedures and markets.[35]

In turn, bankruptcy law properly rejects both actual and conceptual contracting as a means to advance its goals because neither of these approaches is desirable in

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ECON. 775, 801 (1999) (observing that "it is not possible to contract out of the bankruptcy laws").

[35] For example, I am not nearly as sanguine as Warren and others on the desirability of upending the priority of secured credit in bankruptcy. *See infra* at 108-09.

responding to the problems of insolvency.[36] As Ronald Coase has explained, "the reason why some activities are not the subject of contracts is exactly the same as the reason why some contracts are commonly unsatisfactory—it would cost too much to *put the matter right*."[37] In the bankruptcy setting, "putting the matter right" means resolving the problems of insolvency in beneficial ways (including ways that are wealth maximizing), and *that* goal exceeds the capacity of *ex ante* contracting, whether actual or conceptual, when all of the relevant considerations are taken into account. For a variety of reasons, the relevant parties cannot be expected to bargain *ex ante* for an optimal disposition of the debtor, the debtor's property, and the debtor's liabilities (i.e., they cannot be expected to bargain for optimal debt-collection, debt-forgiveness, and debt-adjustment terms).[38] This is partly for epistemic considerations (e.g., the parties cannot anticipate all the relevant variables *ex ante* or easily acquire sufficient information);[39] partly for motivational reasons prior to the debtor's default (e.g., the parties have strong incentives in non-bankruptcy markets to contract in advance for remedies that are counterproductive

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[36] In particular, Jackson's creditors'-bargain approach employing the idea of conceptual contracting is discussed *infra* at 25-54; the views of those who advocate actual bankruptcy contracting, including Schwartz, are discussed *infra* at 54-95.

[37] COASE, FIRM, *supra* note 7 at 148 (emphasis added). Just as the law responds to some social problems better than non-legal solutions, different kinds of legal structures respond better than others to certain categories of social problems. *Cf.* SCOTT J. SHAPIRO, LEGALITY 172 (2011) [hereinafter SHAPIRO, LEGALITY] (explaining that, in many contexts, "it is extremely costly and risky for people to solve their social problems by themselves, via improvisation, spontaneous ordering, or private agreements, or communally, via consensus or personalized forms of hierarchy" and "[l]egal systems, by contrast, are able to respond to this great demand for norms at a reasonable price").

[38] For example, for a number of reasons creditors cannot be expected to negotiate debt-forgiveness covenants in their *ex ante* debt contracts. *See infra* at 69-75.

[39] *See infra* at 80.

in the insolvency context);[40] partly for coordination reasons (e.g., the parties cannot effectively coordinate their activities when their numbers are large);[41] partly for various reasons of non-cooperation incentives following the debtor's default (e.g., the debtor has incentives to be uncooperative with creditors, and creditors have incentives to be uncooperative with each other);[42] partly for reasons of the excessive direct costs of implementation (e.g., excessive negotiating, monitoring, and enforcement costs);[43] and partly for reasons of fairness and the preservation of entitlements (e.g., the parties who are most likely to bargain cannot be trusted to look out for the interests of others, and some parties cannot adequately look out for themselves).[44] All of this is not to say that

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[40] *See infra* at 69-75.

[41] *See infra* at 78-83.

[42] *See infra* at 81-82, 156-68. More recent scholarship suggests that the increasingly heterogeneous interests of creditors make it even more difficult to reach agreement on the best disposition of a debtor and its assets. *See* Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 650-53 (2010) [hereinafter Baird & Rasmussen, *Antibankruptcy*].

[43] *See infra* at 59-60, 73-74, 80-83.

[44] As Coase has quipped, "if self-interest does promote economic welfare, it is because human institutions have been devised to make it so." COASE, FIRM, *supra* note 7 at 134. Where the law recognizes an entitlement in C, there is a reason it does not generally permit A and B to bargain away C's right, whether through contract, the settlement of litigation, or otherwise. *See, e.g.*, Local Number 93 v. City of Cleveland, 478 U.S. 501, 529 (1986) ("Of course, parties who choose to resolve litigation through settlement may not dispose of the claims of a third party, and *a fortiori* may not impose duties or obligations on a third party, without that party's agreement."); United States v. Angle, 760 F. Supp. 1366, 1372 (E.D. Cal. 1991) ("The Supreme Court has taught us that a voluntary settlement cannot dispose of claims of a third party without that party's agreement.") (citing Martin v. Wilks, 490 U.S. 755, 767-68, 109 S. Ct. 2180, 2187 (1989)). Of course, the law may protect C's interest in any number of ways, some of which may permit C to bargain away his rights to some extent. *See* Calabresi & Melamed, *Property Rules*, *supra* note 5 at 1091-93 (1972). But even then, it may still protect C's interest against a variety of encroachments. As discussed *infra*, bankruptcy law serves to protect a variety of entitlements precisely in this way, including an

contracting has no place in bankruptcy. On the contrary, the corrective bankruptcy market does and should make use of contracts, but it properly does so on an *ex post* basis in the context of a regime designed specifically to facilitate contracting in the insolvency setting (i.e., one that takes into account and remediates as necessary the problems of insolvency that otherwise impede efficient contracting).[45]

In "putting the matter right" bankruptcy law also properly employs a court-supervised administrative process to oversee its substantive and procedural regulations. It may be true as a general matter that substantive regulations imposed by governmental agents "will not necessarily give better results than leaving the problem to be solved by the market."[46] But it is also true that "there is no reason why, on occasion, . . . governmental administrative regulation should not lead to an improvement in economic efficiency," which "would seem particularly likely when . . . a large number of people is involved and when therefore the costs of handling the problem through the market . . . may be high."[47] Because a large number of people with antagonistic interests and

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individual debtor's protected interest in his own human capital and the protected interests of certain creditors under certain circumstances. Notably, Jackson acknowledges that, at least with respect to individual debtors, bankruptcy law properly intervenes with substantive rules that protect the debtor's ability to obtain a discharge because, in part, individual debtors cannot be expected to look out adequately for themselves in this regard; individual debtors cannot be expected to look out adequately for others with respect to the externalities that their overconsumption of credit may generate; and the availability of discharge heightens the creditors' incentives to monitor and thus restricts improvident lending. *See* Jackson, *Fresh-Start*, *supra* note 20 at 1394-95, 1418-24, 1426. As discussed in Chapter 3, similar considerations support bankruptcy law's debt-adjustment functions.

[45] *See supra* note 27 (discussing the concepts of *ex ante* and *ex post* bargaining).

[46] COASE, FIRM, *supra* note 7 at 118.

[47] *Id*.

competing entitlements are characteristically involved in bankruptcy matters, and because the costs of handling the problems of insolvency contractually in the typical case would be extremely high (to the extent it could be done at all), bankruptcy presents such an occasion. This is not to say that the current system functions perfectly—it does not. It is to say, however, that bankruptcy is properly a situation in which the skepticism of those who advocate actual or conceptual bankruptcy contracting is misaligned.

In the views of some scholars, of course, "putting the matter right" in the insolvency context properly involves an exercise very different from the one outlined above. For example, rather than addressing more broadly the problems of insolvency, the relevant mission of the contractual exercise might be defined once again in narrow terms to mean simply (1) reducing the cost of capital for firms,[48] or (2) enhancing the value of the debtor so that this value may be distributed to creditors strictly in accordance with their non-bankruptcy payment priorities.[49] But as suggested above, these views are overly reductionist because, among other reasons, they inappropriately assume away many of the relevant problems, ignore the broader beneficial ambitions of bankruptcy law, and likewise ignore the costs of contracting in other respects. Thus, even if the goals of bankruptcy law were confined narrowly to these debt-collection values, *ex ante* bankruptcy contracting nonetheless would remain infeasible for at least some of the reasons summarized above.

In conducting the analysis, I take it as a given that the best response to the problems of insolvency is not simply what may be in the best interests of one particular

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[48] *See* Schwartz, *Normative Theory*, *supra* note 9 at 1200.

[49] *See* JACKSON, LOGIC, *supra* note 8 at 20-21.

group of creditors, or even what may be in the best interests of creditors generally, but rather "that which brings about the best outcome for the system as a whole."[50] This includes what is best for all of the participants, debtors and creditors alike, as well as those who otherwise bear the cost of a system of bankruptcy law. In that sense, bankruptcy policy cannot afford to focus myopically on procedures that have the effect of reducing borrowing costs, or in the alternative too expansively on substantive rules designed to ameliorate perceived deficiencies in non-bankruptcy markets generally. Rather, bankruptcy law's powerful debt-collection, debt-forgiveness, and debt-adjustment mechanisms should be focused more surgically to address the problems of insolvency that justify their invocation in the first place, with due regard to the impact they have on the operation of non-bankruptcy systems (e.g., its "*ex ante* effects").[51]

Finally, on the question of how best to measure the value of any particular bankruptcy procedure, one cannot evaluate adequately how bankruptcy law addresses the problems of insolvency simply by focusing on how the law reduces a single type of cost. Instead, because the problems of insolvency *and* the legal regulations that respond to them are necessarily complex,[52] and because bankruptcy procedures are both costly and cost-reducing on a number of fronts, the aim of bankruptcy law is properly to reduce more broadly the sum of (1) the costs of the problems of insolvency and (2) the costs of

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[50] COASE, FIRM, *supra* note 7 at 118.

[51] *See supra* note 27 (discussing the concept of "*ex ante* effects").

[52] *See* Alan Schwartz, *Contracting About Bankruptcy*, 13 J.L., ECON. & ORG. 127, 144 (1997) (observing that "good bankruptcy procedures probably will be complex"); *see generally* COASE, FIRM, *supra* note 7 at 77 ("Any economic situation is complex and a single economic problem does not exist in isolation.").

remediating the problems of insolvency.[53] Throughout this introductory chapter, I use my critiques of existing academic theories to set the stage for the discussion that follows and to illustrate the operation and importance of each of the three faces of bankruptcy law that both define its remedial content and offer a potent response to the problems that justify having a bankruptcy law in the first place.

THE CREDITORS' BARGAIN

In his seminal work *The Logic and Limits of Bankruptcy Law*, Thomas Jackson outlines the standard academic account of bankruptcy law's theoretical object and purpose.[54] Jackson argues that bankruptcy law is necessary to resolve a particular kind of "collective-action dilemma" in which the assets of an insolvent debtor are viewed as a "pool" of property available to satisfy the claims of creditors as a community of interests.[55] The dilemma arises because, following default, each individual creditor may seek to enforce its claim against the assets in the pool in a way that diminishes the pool's overall value for creditors as a whole, for example by seizing a particular item the debtor needs to conduct its operations, thereby destroying the value of the debtor's business as a going concern. Jackson explains: "[t]he basic problem that bankruptcy law is designed

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[53] *See* GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 26 (1970) [hereinafter CALABRESI, COSTS] ("I take it as axiomatic that the principal function of accident law is to reduce the sum of the costs of accidents and the costs of avoiding accidents."); *see also* Richard V. Butler & Scott M. Gilpatric, *A Re-Examination of the Purposes and Goals of Bankruptcy*, 2 AM. BANKR. INST. L. REV. 269, 277 (1994) [hereinafter Butler & Gilpatric, *Re-Examination*] (arguing that the emphasis of bankruptcy law should be on maximizing the total social value of a firm).

[54] It is appropriate to start with Jackson's work because, as one commentator has explained, it is "a kind of 'founding narrative' of bankruptcy thought." John D. Ayer, *The Role of Finance Theory in Shaping Bankruptcy Policy*, 3 AM. BANKR. INST. L. REV. 53, 66 (1995).

[55] JACKSON, LOGIC, *supra* note 8 at 10-13.

to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors *as a group* when there are not enough assets to go around."[56] The chief virtue of bankruptcy law, he argues, is that it forces creditors to work together for their collective benefit in managing the debtor's property and dividing its value among themselves.

Building on this narrative, Jackson next offers a theory of how bankruptcy law ought to resolve the collective-action dilemma through a distinct body of remedial bankruptcy procedures. He declares that "[b]ankruptcy law, at its core, is debt-collection law. That is what we all agree on."[57] Expanding on this essential frame, Jackson then characterizes the subject as addressing two fundamental inquiries: "(1) do we place limits on what creditors can take from their debtors; and (2) how do we decide rights among creditors when there are not enough assets to go around?"[58] Jackson responds to the first inquiry with a qualified "no": bankruptcy law properly limits what creditors may

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[56] *Id*. at 10; *see also* Robert K. Rasmussen, *Behavioral Economics, the Economic Analysis of Bankruptcy Law and the Pricing of Credit*, 51 VAND. L. REV. 1679, 1680-82 (1998) [hereinafter Rasmussen, *Behavioral Economics*] (explaining Jackson's approach); Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 444 (1992) [hereinafter Adler, *Bankruptcy*] ("In theory, bankruptcy's collective proceeding is superior to individual creditor actions, because individual creditors have perverse incentives to act in their own interests, even if such action would disserve the creditors' collective interest. Thus bankruptcy is beneficial to the extent it protects creditors from their own worst instincts."). In significant part, bankruptcy law helps resolve the collective-action problem by restraining the creditors from exercising their non-bankruptcy rights. Jackson & Scott, *Nature of Bankruptcy*, *supra* note 23 at 162 ("In order to implement a collective system of distribution, individual creditors must be restrained from exercising entitlements that they would otherwise enjoy under state law.").

[57] JACKSON, LOGIC, *supra* note 8 at 3.

[58] *Id*. at 4.

recover from their debtors only in cases involving individuals, not firms.[59] Jackson responds to the second inquiry with the idea that bankruptcy law should manage the debtors' property and distribute its value among creditors in accordance with a system of rules that mimic "the kind of contract creditors would agree to if they were able to negotiate with each other before extending credit"—a hypothetical "creditors' bargain."[60] He contends that "[t]his is an application of the famous Rawlsian notion of bargaining in the 'original position' behind a 'veil of ignorance.'"[61] Jackson and similar theorists,

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[59] *Id*. at 4-5, 225.

[60] *Id*. at 16-17 & n.22; *see also* Thomas H. Jackson, *Bankruptcy, Non Bankruptcy Entitlement, and the Creditors' Bargain*, 91 YALE L.J. 857, 860, 868 (1982) (observing that bankruptcy law should mirror the agreement that "one would expect the creditors to form among themselves were they to negotiate such an agreement from an *ex ante* position"); Douglas G. Baird, *The Uneasy Case for Corporation Reorganizations*, 15 J. LEGAL STUD. 127 (1986) [hereinafter Baird, *Uneasy Case*] (applying the "creditor's bargain" heuristic in the Chapter 11 context, stating "[a]n analysis of the law of corporate reorganizations should properly begin with a discussion of whether all of those with rights to assets of a firm . . . would bargain for [reorganization] if they had the opportunity to negotiate at the time of their initial investment"); *see generally* Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 VAND. L. REV. 741, 745-49 (2004) (discussing and critiquing the creditors' bargain theory). The idea is that contractual agreements are typically wealth-maximizing and, implicitly, the "creditors' bargain" would be too, if only creditors could actually get together and work out its terms before they lend. *See* Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 488, 491-94 (1980) (arguing that "wealth maximization . . . derives support from the principle of consent" and that, where creditors would presumably agree to a wealth-maximizing contract, their consent may be implied). At one time, Jackson and Baird were frequent collaborators and shared many of the same views on the normative purpose of bankruptcy law and the shortcomings of the existing law. *See, e.g.*, Douglas G Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1986) [hereinafter Baird & Jackson, *Bargaining*]; Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganization and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984) [hereinafter Baird & Jackson, *Corporate Reorganization*].

[61] JACKSON, LOGIC, *supra* note 8 at 17 n.22 (quoting JOHN RAWLS, A THEORY OF JUSTICE 136-42 (1971)).

including Douglas Baird and Robert Scott, downplay any re-distributional ambitions for bankruptcy law: as a general rule, they argue, creditors should receive their share of the value of the debtor's assets in accordance with their basic non-bankruptcy payment priorities.[62]

Though inventive and influential, this collective-action approach is fundamentally flawed. Moreover, the relevant flaws deserve explication because much of the current literature accepts at least some aspects of Jackson's approach as foundationally correct, particularly his claim that bankruptcy law is fundamentally a debt-collection device concerned with vindicating the creditors' non-bankruptcy payment rights and priorities. As we shall see, this has had the unfortunate effect of leading much of the academic discourse off into the weeds.

At the outset, Jackson's account of the common-pool dilemma is inadequate to explain the need for a distinct bankruptcy law for three reasons. First, it is incomplete because the dilemma is not implicated in every bankruptcy case: an insolvent debtor may

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[62] *See id*. at 20 ("What bankruptcy should be doing, in the abstract, is asking how much someone would pay for the assets of a debtor, assuming they could be sold free of liabilities. The resulting money is then taken and distributed to the holders of the liabilities according to their nonbankruptcy entitlements."); Jackson & Scott, *Nature of Bankruptcy*, *supra* note 23 at 155-56 (arguing that pre-bankruptcy payment entitlements should be altered only as necessary to maximize net asset distributions and not solely for distributional reasons); Baird, *Loss*, *supra* note 8 at 827 (arguing that the reason for having a bankruptcy law—to resolve the collective-action dilemma—does not afford an opportunity to reassess pre-bankruptcy payment entitlements); Mooney, *Normative Theory*, *supra* note 30 at 964 (arguing that, "however the approach [of redistributing wealth from those with legal entitlements to those without legal entitlements] may be disguised in noble rhetoric, service to these extraneous interests at the expense of or risk to rightsholders is prima facie theft") (footnote omitted); *see also* Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559, 576 (2001) (observing that a key theme of the collective-action approach is that bankruptcy law "should not . . . engage in post hoc reallocation of prebankruptcy entitlements").

be in need of bankruptcy relief even though there is but a single creditor, or one creditor with a priority right to all of the debtor's assets.[63] Second, it is under-inclusive because the dilemma turns out to be merely *one* of the reasons for having a distinct bankruptcy law—there are others of greater importance (discussed in detail in Chapter 2).[64] Third, it is seriously misleading because Jackson's articulation of the dilemma, with his focus on the interests of creditors and the payment of their claims, confuses effect with purpose and misstates the real ambition of bankruptcy law. It is certainly true that maximizing the value of the debtor's assets can have the *effect* of increasing payouts to creditors, but that is not bankruptcy law's normative *purpose*. Bankruptcy law's true ambition is broader and, among other things, lies in achieving wealth-maximizing dispositions of the debtor's assets, including prominently an individual debtor's human capital. In context, the payment of claims is merely of secondary importance.

To understand why this is so, consider a simple illustration. By definition, an insolvent individual characteristically cannot pay all claims in full. From purely a debt-

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[63] *See* Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganization*, 20 J. LEGAL STUD. 311, 312 (1991) [hereinafter Baird & Picker, *Noncooperative Bargaining*] (observing that "[i]n the case of a closely held firm [in which a single senior creditor is entitled to all the value of the debtor's assets], bankruptcy does not solve a collective action problem that the general creditors of a firm face when they are its residual owners" but that bankruptcy law is nevertheless applied because "some mechanism, perhaps a judicial one, is needed to decide whether [in fact the senior creditor is entitled to all the value of the debtor's assets because] the manager-shareholder and the senior creditor cannot be relied on to protect the rights of third parties").

[64] Jackson has acknowledged the existence of this criticism, if not its merit. *See* Thomas H. Jackson, *Comment on Baird, 'Revisiting Auctions in Chapter 11,'* 36 J. LAW & ECON. 655, 659 (1993) ("For the most part, the intellectual debate over bankruptcy policy that has emerged in the past decade is not whether dealing with the collection action problem is an appropriate bankruptcy policy but, rather, over whether it should be seen as essentially the sole bankruptcy policy. There are other theories out there—less 'competing' than 'additive'—as to the goals of the bankruptcy process.").

collection perspective, forcing the individual to devote his human capital to paying off his debts (for the rest of his life if necessary) would likely enhance the creditors' return and would thus appear to be desirable if this were the only consideration. Bankruptcy law, however, routinely sacrifices the creditors' interests by granting the debtor a discharge—essentially a release of his preexisting civil liabilities—which has nothing to do with getting the creditors paid.[65] Obviously the creditors' debt-collection interests do not control the analysis here, and the reason for this is straightforward enough: in context, compelling the payment of the creditors' claims would amount to little more than a wealth transfer—a shifting of wealth from one person to another without a compensating net benefit. What actually controls the analysis for bankruptcy purposes is the principle that forcing an insolvent debtor to labor exclusively for the sake of his creditors is not optimal when all of the relevant considerations are taken into account, including the interests of the debtor.[66] As explained in Chapter 3, one of the key principles at play here—namely that the optimal deployment of human capital is more important than the payment of debts—is one of great public significance, emerging over time as a primary feature of bankruptcy law, and in particular during the nineteenth century in tandem with the abolition of the common debt-collection practice of imprisonment for debt and the adoption of the anti-peonage value embedded in the Thirteen Amendment proscribing

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[65] *See infra* notes 72, 76 (discussing the discharge in bankruptcy).

[66] The failure of Jackson and other theorists to take into adequate account the interests of the debtor is what two scholars have called "the missing-debtor problem." ELIZABETH WARREN & JAY L. WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 886 (5th ed. 2006) [hereinafter WARREN & WESTBROOK, LAW].

involuntary servitude.[67] The principle evolved not only in the context of broader experience with punitive debt-collection regimes, but also the need for a formal system of debt forgiveness, and this experience in turn informed and shaped the content of U.S. bankruptcy law and its ameliorative goals.[68]

This is not to say that the payment of claims is irrelevant in bankruptcy. On the contrary, it is important, but for reasons that, owing to the debtor's insolvency, are of secondary significance.[69] Although it is true as a general matter that compelling the satisfaction of legal obligations is typically a good thing—hence the prevalence of

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[67] Forcing an individual to work to pay off civil indebtedness is a form of peonage akin to slavery. *See* Clyatt v. U.S., 197 U.S. 207, 215 (1907) (defining peonage as "a status or condition of compulsory service, based on indebtedness"); Bailey v. Alabama, 219 U.S. 219, 241 (1911) (stating that the Thirteenth Amendment is "a charter of universal civil freedom for all persons" and that its purpose is "to render impossible any state of bondage; to make labor free, by prohibiting that control by which the personal service of one man is disposed of or coerced for another's benefit, which is the essence of involuntary servitude"); The Civil Rights Cases, 109 U.S. 3, 20 (1883) (the Thirteenth Amendment is "an absolute declaration that slavery or involuntary servitude shall not exist in any part of the United States").

[68] An individual's interest in his human capital protected by a variety of rights is a form of entitlement, and the individual's rights in this regard may take the form of property rules, liability rules, and inalienability rules. *See* Calabresi & Melamed, *Property Rules*, *supra* note 5. Human capital is generally inalienable—one cannot agree to become a slave. At the same time, individuals can effectively rent their human capital for compensation, protected by property rules in the sense that the law "lets each of the parties say how much the entitlement is worth to him, and gives the seller a veto if the buyer does not offer enough." *Id.* at 1092. Human capital is likewise protected by liability rules in the sense of affording mechanisms of compensation for a variety of transgressions—for example, for injury to a person's ability to work or failure to abide by minimum wage and similar laws. *See id.* at 1113 n.44. Regardless of whether it is efficient in every sense, the entitlement to have and control one's own human capital is a fundamental distributional preference that bankruptcy law protects. This is addressed in Chapter 3.

[69] Among other things, bankruptcy's debt-collection features are necessary to avoid a problem of moral hazard and harmful *ex ante* effects. *See* Jackson, *Fresh-Start*, *supra* note 20 at 1427 (observing that "[b]ecause of the nature of credit, free access to discharge would be disastrous for a credit-based economy"). These are addressed in Chapter 3.

remedial non-bankruptcy debt-collection mechanisms—that conclusion does not hold true as the dominant consideration in the unique world of insolvency when all of the costs of enforcement *in that context* are taken into account (as examined in Chapters 2 and 3). Critically, the art and genius of bankruptcy law is to gauge the point at which the enforcement of obligations becomes counterproductive from a more generalized perspective. Accepting this challenge, bankruptcy law's broader remedial ambition is thus quite different from the debt-collection perspective Jackson and similar theorists bring to bear in describing the common-pool dilemma. This is significant because, if all that mattered were the interests of the creditors and the payment of their claims, there would be little need for a special system of bankruptcy remedies, at least of the kind that exists currently. Something more is at work here.

In addition, Jackson's debt-collection frame and bargaining heuristic are freighted with other descriptive and analytic errors. To begin with, it is not true as a positive matter that "all agree" that bankruptcy law is debt-collection law, and Jackson cannot claim legitimately that his view captures a normative consensus—a point Jackson acknowledges elsewhere, but attempts to diminish, in his recognition of the debt-forgiveness function of the discharge in bankruptcy.[70] For example, there is the contrasting view, expressed by one U.S. Court of Appeals, that "debt collection is not a proper purpose of bankruptcy."[71] The truth, of course, lies between these two positions.

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[70] *See, e.g.*, Jackson, *Fresh-Start*, *supra* note 20. Jackson downplays the significance of debt forgiveness in bankruptcy law, but his attempts to limit the discharge to situations involving individual debtors are unsuccessful. *See infra* at 38-41.

[71] Atlas Machine & Iron Works, Inc. v. Bethlehem Steel Corp., 986 F.2d 709, 716 n.11 (4th Cir. 1993) (citing In re Caucus Distributors, Inc., 106 B.R. 890, 928 (Bankr. E.D. Va. 1989); Report of the Commission on the Bankruptcy Laws of the United States, pt. I, at 75 (July 1973)); *see also* In re Roselli, 2013 WL 828304 *11 (Bankr. W.D.N.C. Mar.

Debt collection is neither the all-encompassing virtue nor the vanquished vice of bankruptcy law, but is merely *one* of its aspects, and properly so. As noted at the outset, there are others: for many centuries it has also embodied strong features of debt forgiveness and debt adjustment.

Bankruptcy's debt-forgiveness remedies include: (1) the signature discharge mentioned above (applicable to both individuals and firms) that operates to release the insolvent debtor from the grip of preexisting indebtedness, in whole or in part;[72] (2) various exemption provisions (applicable to individuals) that permit the debtor to retain certain assets free from the reach of general creditors;[73] and (3) certain mechanisms

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6, 2013) ("Debt collection is not a proper purpose for bankruptcy"); In re Murrin, 477 B.R. 99, 109 (D. Minn. 2012) (citing cases).

[72] *See* 11 U.S.C. §§ 727 (2000 & Supp. 2006) (providing for a discharge of debts in Chapter 7 cases), 1141 (2000 & Supp. 2006) (providing for a discharge in Chapter 11 cases), 1328 (2000 & Supp. 2006) (providing for a discharge in Chapter 13 cases), 524 (2000 & Supp. 2006) (prescribing the effect of a discharge). Significantly, although they are analytically distinct, bankruptcy law's debt-forgiveness features exist in tandem with its debt-collection features. *See, e.g.*, Williams v. U.S. Fid. & Guar. Co., 236 U.S. 549, 554-55 (1915) ("It is the purpose of the Bankrupt[cy] Act to convert the assets of the bankrupt into cash for distribution among creditors and then to relieve the honest but unfortunate debtor from the weight of oppressive indebtedness and permit him to start afresh . . . ."). Certain kinds of debts are not dischargeable in bankruptcy. *See, e.g.*, 11 U.S.C. § 523 (2000 & Supp. 2006) (prescribing exceptions to discharge); Kelly v. Robinson, 479 U.S. 36, 47-48 (1986) (holding that the Bankruptcy Code does not affect or discharge criminal restitution obligations).

[73] *See* 11 U.S.C. § 522 (2000 & Supp. 2006) (providing that an individual debtor may exempt various items from property, and providing that exempt property is not liable for most kinds of debts). Notably, exemptions do not insulate the debtor's property from the reach of most enforceable purchase-money security interests and voluntary real-property mortgage liens. *See id.* § 522(c). Although firms are not entitled to claim property as exempt within the technical reach of this term, they can effectively retain critical assets necessary to reorganize through the Chapter 11 reorganization process. *See* 11 U.S.C. §§ 1123(a)(5)(A) (2000 & Supp. 2006) (permitting a Chapter 11 plan to provide for the debtor's retention of all or part of its property), 1123(b)(5) (2000 & Supp. 2006) (permitting the modification of most liens), 1141(c) (2000 & Supp. 2006) (providing for the release of property of the reorganizing Chapter 11 debtor from the claims of creditors,

(applicable to individuals and firms) that strip certain of the debtor's assets free of encumbrances, such as liens and the like, so these assets may be more readily deployed in some fashion, including in the hands of a purchaser.[74] In turn, bankruptcy's debt-adjustment features (applicable to both individuals and firms) operate to rearrange the creditors' non-bankruptcy payment priorities between them as a group, elevating some and subordinating others.[75]

In addition, the argument that bankruptcy law is fundamentally a debt-collection device not only misses its vital debt-forgiveness and debt-adjustment aspects, it is also deeply ahistorical, and thus further fails as a positive matter. Although early English bankruptcy law did indeed include a retributive mercantile debt-collection regime, that regime did not succeed in achieving its stated purpose—to stem the tide of contemporary

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except as provided in the debtor's confirmed plan), 1141(d) (2000 & Supp. 2006) (providing for the discharge of the reorganizing debtor's debts, except as provided in the debtor's confirmed plan). In Chapter 11 cases, the holders of claims against the debtor, including the holders of secured claims, are protected in various ways. *See, e.g.*, 11 U.S.C. § 1129 (2000 & Supp. 2006) (prescribing the requirements for confirmation of a Chapter 11 plan, including the treatment of various kinds of claims); *see also* 11 U.S.C. § 722 (2000 & Supp. 2006) (permitting the redemption of certain assets subject to certain liens).

[74] *See* 11 U.S.C. §§ 363(f) (2000 & Supp. 2006) (providing for the sale of property free and clear of interests), 522(f) (2000 & Supp. 2006) (providing for the avoidance of certain liens that impair certain claimed exemptions), 1123(a)(5)(D) (2000 & Supp. 2006) (providing that a Chapter 11 plan may provide for the sale of the debtor's assets free of any lien), 1129(b)(2)(A)(II) (2000 & Supp. 2006) (providing protections for secured creditors in Chapter 11 cases where assets encumbered by the secured creditors' liens are to be sold under the terms of a confirmed plan).

[75] *See, e.g.*, 11 U.S.C. §§ 507 (2000 & Supp. 2006) (prescribing the basic priorities for claims in bankruptcy cases), 510 (2000 & Supp. 2006) (providing for the subordination of certain claims and interests), 725 (2000 & Supp. 2006) (providing for the disposition of property encumbered by a lien), 726 (2000 & Supp. 2006) (prescribing further distributional priorities in Chapter 7 cases), 1129(b) (2000 & Supp. 2006) (providing that, in order to be confirmed, a Chapter 11 plan must adhere to certain additional priority rules).

mercantile failures—and otherwise did not survive the test of time. In response to its flaws, and in conjunction with evolving views on the nature of risk, debt, and the problems of insolvency, English bankruptcy law evolved to include robust features of debt forgiveness and debt adjustment—features that were otherwise existing and emerging in the law generally. These features were then incorporated sporadically into U.S. bankruptcy procedures, where they continued to evolve in innovative ways. Collectively, it is the three distinct faces of bankruptcy law—debt collection, debt forgiveness, and debt adjustment—that give the subject its modern content and shape.[76] As we shall see, each is desirable in response to the problems that explain the need for a distinct body of bankruptcy remedies.

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[76] *See* Stellwagon v. Clum, 245 U.S. 605, 617 (1918) ("The federal system of bankruptcy [law] is designed not only to distribute the property of the debtor, not by law exempted, fairly and equally among his creditors, but as a main purpose of the act, intends to aid the unfortunate debtor by giving him a fresh start in life, free from debts, except of a certain character," and observing that "[o]ur decisions lay great stress upon this feature of the law"); Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188 (1902) (stating that "[t]he subject of "'bankruptcies' includes the power to discharge the debtor from his contracts and legal liabilities, as well as to distribute his property"); 11 U.S.C. § 507(a) (2000 & Supp. 2006) (specifying distributional priorities in bankruptcy); John J. McCoid, II, *Discharge: The Most Important Development in Bankruptcy History*, 70 AM. BANKR. L.J. 163, 164 (1996) [hereinafter McCoid, *Discharge*] ("[T]he discharge provision…, it seems, ranks ahead in importance of all others in Anglo-American bankruptcy history"); William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS. 13, 15 (1977) (noting the centrality of the discharge of debt in bankruptcy law); *see generally* United States v. Energy Resources Co., 495 U.S. 545, 549 (1990) (stating that "bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships"); Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 71 (1982) (Brennan, J., plurality opinion) (observing that "the restructuring of debtor-creditor relations . . . is at the core of the federal bankruptcy power"); Freeman Hunt, *A General Bankrupt Law*, 4 MERCH. MAG. & COMM. REV. 22, 32 (Jan. 1841) [hereinafter Hunt, *General Bankrupt Law*] (explaining that bankruptcy law is "[s]imply a declaration, by the supreme law-making power of the state, defining the extent to which, and the mode in which, under certain circumstances, it will enforce pecuniary obligations").

Critically, Jackson's debt-collection frame is inherently inadequate to accommodate these three elements of bankruptcy law. The concepts of debt forgiveness and debt adjustment do not derive from the debt-collection rationale. On the contrary, they are independent of it and exist in tension with it. Among other things, debt collection is a concept of *corrective* justice: through legally sanctioned means, the defaulting debtor is made to account for his failure to satisfy his obligations, through either an individual proceeding brought by a single creditor or a collective proceeding brought on behalf of creditors as a group. In sharp contrast, debt forgiveness is a concept of *distributive* justice: under certain conditions, the debtor's obligations are suspended, modified, or simply excused as a distinct exercise.[77] For insolvent individuals, debt forgiveness is generally beneficial because it enhances the value of the debtor's human capital and provides a fresh start. For insolvent firms, it is similarly beneficial because it enhances the value of the debtor's assets, including the firm's dedicated human capital, and enables the enterprise to reorganize. The concept of debt forgiveness is dominant in bankruptcy because, once again, it enforces the fundamental idea that the optimal deployment of a debtor's assets (including an individual debtor's human capital) is more important than the payment of claims.[78]

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[77] *See* JOHN FINNIS, NATURAL LAW AND NATURAL RIGHTS 188-193 (1980) [hereinafter FINNIS, NATURAL LAW] (defining and examining the commutative and distributive aspects of a just bankruptcy law); Coleman & Ripstein, *Mischief, supra* note 5 at 93 (1995) ("Corrective justice concerns the rectification of losses owing to private wrongs. In contrast, distributive justice concerns the general allocation of resources, benefits, opportunities, and the like. The duty to repair under corrective justice is *agent-specific*—only wrongdoers need make up the losses of others. The duties imposed by distributive justice are, in contrast, *agent-general*—everyone has a duty to create and sustain just distributions.").

[78] The positive and normative justifications for the debt-forgiveness aspects of bankruptcy law are discussed in greater detail in Chapter 3.

Like debt forgiveness, debt adjustment is also a concept of *distributive* justice: under certain conditions, the non-bankruptcy payment priorities of some creditors are modified in favor of others, also for a variety of normative reasons. For both insolvent individuals and firms, debt adjustment is generally beneficial to the extent it channels losses toward creditors who are the cheapest cost avoiders and the ablest loss spreaders. The cheapest cost avoiders include creditors who are capable of lending providently based on their access to evaluative criteria before extending credit, regardless of whether they elect to do so. The ablest loss spreaders include financial lenders who voluntarily engage in multiple credit transactions and have the capacity of spreading losses among a variety of obligors. Poor loss spreaders include (1) involuntary creditors, such as tort victims, and (2) captive voluntary creditors, such as employees who generally cannot hedge against potential wage-related losses by simultaneously taking on multiple forms of employment.[79]

A key distinction between these qualitatively different elements of bankruptcy law is that the law's debt-collection features seek to enforce the claims of creditors against the debtor and the debtor's property *for the sake of the holders of those claims*. In contrast, bankruptcy law's debt-forgiveness and debt-adjustment features seek to modify or eliminate the same claims *for the sake of others*, particularly debtors and other creditors, because doing so is normatively desirable. Because of its inability to account

[79] The positive and normative justifications for the debt-adjustment aspects of bankruptcy law are also discussed in greater detail in Chapter 3.

for the law's desirable debt-forgiveness and debt-adjustment features, Jackson's attempt to address the subject through his single focus, debt-collection frame is a non-starter.[80]

Similarly, Jackson's metaphor of the creditors' bargain is inadequate as a vehicle to conceptualize the normative content of bankruptcy law. Among other deficiencies, it is inadequate to explain the debtor's discharge because it cannot be argued plausibly that creditors as a group would agree prospectively to forgive the debtor's debts at the time they extend credit.[81] Jackson acknowledges this, contending that one must look elsewhere for a distinct discharge rationale,[82] but the debt-collection focus of his theory

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[80] Frames matter because they contextualize the debate and serve either to limit or expand its boundaries. *See* ERVING GOFFMAN, FRAME ANALYSIS: AN ESSAY ON THE ORGANIZATION OF EXPERIENCE 11 (1974) ("The problem . . . is that once a term is introduced . . . it begins to have too much bearing [and] [t]hus each succeeding section of the study becomes more entangled, until a step can hardly be made because of what must be carried with it"). Different labels trigger different mental structures: "[a]ll words are defined relative to conceptual frames. When you hear a word, its frame (or collection of frames) is activated in your brain." GEORGE LAKOFF, DON'T THINK OF AN ELEPHANT! KNOW YOUR VALUES AND FRAME THE DEBATE xv (2004); *see also* CHARLES TILLY, WHY? 58 (2006) [hereinafter TILLY, WHY] (commenting that "frames . . . focus attention on some kinds of information while screening out a great deal of other information that could, in principle, significantly affect their operation"). Jackson's debt-collection frame should be rejected because it cannot capture either the actual or ideal scope of bankruptcy law and artificially narrows its conceptualization. *See* DWORKIN, LAW'S EMPIRE, *supra* note 14 at 74 (to be helpful, a conceptual frame should be "at once sufficiently abstract to be uncontroversial . . . and sufficiently concrete to be useful").

[81] *See* Mooney, *Normative Theory*, *supra* note 30 at 1046, 1048 (observing that "a central feature—if not *the* central feature—of an individual's Chapter 7 bankruptcy case is the debtor's entitlement to a discharge of prebankruptcy claims" and commenting that Jackson's collective-action approach "does not provide a complete explanation of discharge . . . or a complete normative theory of discharge under past or current law").

[82] Jackson, *Fresh-Start*, *supra* note 20 at 1447 (commenting that "[i]t is difficult to argue that creditors would view [debt forgiveness] as a necessary part of a collective system for debt collection.").

conflicts abruptly with the debt-forgiveness reality of bankruptcy law and he does not supply a meta-principle to resolve this important conflict.[83]

In an effort to downplay this problem, Jackson and others argue that bankruptcy law's debt-forgiveness features—specifically the discharge—apply only to individuals as a special case and not to firms.[84] This argument, however, is both descriptively and normatively false. It is descriptively false because, under the Bankruptcy Code, firms are eligible for discharge relief and routinely obtain it as the key (or even sole) element of their bankruptcy reorganizations.[85] Moreover, the kind of discharge firms receive is often more generous than the one available to individuals, owing to the more numerous limitations and exceptions the current law places on the dischargeability of various categories of debts that individuals may owe.[86] Although it is certainly true that the forms of discharge relief available to individuals and firms are not precisely the same, they are substantively aligned in every important respect, and the argument that the

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[83] *Cf.* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 543 (2003) [hereinafter Schwartz & Scott, *Contract Theory*] (criticizing theories of contract that lack "a meta-principle that tells which . . . goals should be decisive when they conflict").

[84] *See, e.g.*, Jackson, *Fresh-Start*, *supra* note 20 at 1395-96 ("Discharge . . . is available only to individuals.").

[85] *See* 11 U.S.C. §§ 524 (2000 & Supp. 2006) (prescribing the effect of a discharge in bankruptcy), 1141 (2000 & Supp. 2006) (providing for a discharge of debts in Chapter 11 cases involving bankrupt firms).

[86] *See, e.g.*, 11 U.S.C. § 523 (2000 & Supp. 2006) (establishing exceptions to discharge in bankruptcy, many of which apply more readily to individuals as opposed to firms, and some of which apply only to individuals).

distinguishing characteristics between these forms mean that firms therefore do not receive a "discharge" simply indulges in "the narcissism of minor differences."[87]

In turn, Jackson's argument is normatively false because granting a discharge to a viable but insolvent firm is desirable. Without it the firm typically would not be able to reorganize as a going concern because it is the discharge of excessive indebtedness that deleverages the firm's balance sheet, thus relieving it of the financial distress that drove it into bankruptcy in the first place.[88] Representative examples include the numerous air carriers that have discharged a broad variety of liabilities as part of their successful Chapter 11 reorganization cases.[89] Although it is true that liquidating firms do not

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[87] In re Bellingham Insurance Agency, Inc., 702 F.3d 553, 572 (9th Cir. 2011) (citing SIGMUND FREUD, ON SEXUALITY 272 (Penguin 1991)). Among other things, the particular section of the Bankruptcy Code that defines the general scope of the bankruptcy discharge for both individuals and firms is the same. *See* 11 U.S.C. § 524 (2000 & Supp. 2006).

[88] Jackson counters that "[c]orporations must reorganize before they can obtain a discharge." Jackson, *Fresh-Start*, *supra* note 20 at 1396 n.7. This misses the point. It is not that firms reorganize and then, as an afterthought, receive a discharge. Firms receive a discharge *in order to* reorganize—the discharge itself is integral to the reorganization process because without it reorganization is almost never possible. Jackson counters again that "[t]he policy underlying [the discharge of firms] has little to do with the rationales underlying the fresh-start policy [applicable to individuals]." In truth, however, they are closely aligned. This is addressed in Chapter 3.

[89] *See, e.g.*, Holmes v. Air Line Pilots Ass'n, Internat'l, 745 F. Supp. 2d 176, 195-97 (E.D.N.Y. 2010) (dismissing certain claims brought against Delta Airlines on the basis of its 2007 Chapter 11 discharge in bankruptcy and summarizing the discharges obtained by other airlines). Although Chapter 11 reorganization practice has changed over the past two decades, resulting in more Chapter 11 "going-concern sales" (involving the transfer of the debtor's operating assets to a purchaser) and fewer "traditional" reorganizations (in which the debtor retains its assets after discharging a portion of its debts), this has not diminished the importance of the discharge, but has simply altered the focus of its application. *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 42 (discussing structural changes in debt holding patterns and business reorganization practices over the past two decades). The concept of a discharge in Chapter 11 includes the release of indebtedness that facilitates going-concern sales by permitting the assets to be transferred free and clear of preexisting claims, as in the case of the bankruptcy of General Motors

receive a discharge,[90] that is because there is no real point in providing them with one—just as there is no real point in permitting deceased individuals to commence bankruptcy proceedings to receive discharge relief.[91] In any event, even with firms in liquidation, other debt-forgiveness aspects of bankruptcy law routinely apply, including its deleveraging procedures that strip the debtor's assets of encumbering liens and other interests in the context of bankruptcy sales.[92] In sum, the claim that firms do not receive

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Corporation. *See infra* note 92. By analogy, Chapter 7 liquidation practice has also changed in many respects over the past two decades, particularly after the 2005 amendments to the Bankruptcy Code that made it more difficult for consumers to receive a discharge of their obligations, and required more debtors to make use of the repayment plan process of Chapter 13 rather than the liquidation process of Chapter 7. No one would argue seriously, however, that this evolution in practice has dislodged the centrality of the discharge in individual debtor cases.

[90] *See* 11 U.S.C. § 727(a)(1) (2000 & Supp. 2006) (limiting discharge in Chapter 7 liquidation cases to individuals); *compare id*. § 1141(d)(1) (2000 & Supp. 2006) (permitting the discharge of a reorganized Chapter 11 corporate debtor that continues in business) *with id*. § 1141(d)(3) (2000 & Supp. 2006) (denying a Chapter 11 discharge to a liquidating corporate debtor or to a corporate debtor that does not engage in business after consummation of its plan of reorganization).

[91] Unlike dead firms, which may still file for bankruptcy, deceased individuals and their probate estates are ineligible to do so. *See, e.g.*, In re Estate of Patterson, 64 B.R. 807 (Bankr. W.D. Tex. 1986); In re Brown's Estate, 16 B.R. 128 (Bankr. D.C. 1981); *see also* Harris v. Zion Sav. Bank & Trust Co., 317 U.S. 447, 452 (1943) (concluding under the former Bankruptcy Act of 1898 that the bankruptcy court property dismissed the debtor's case following the debtor's death). In this respect, bankruptcy relief is once again more generous to firms than natural persons. The rule that deceased individuals and their probate estates may not seek bankruptcy relief is subject to an exception: if an individual debtor dies *after* commencing a bankruptcy case, some courts have held that, *Harris* notwithstanding, the case may nonetheless proceed to conclusion and the debtor's debts may be discharged. *See, e.g.*, In re Perkins, 381 B.R. 530 (Bankr. S.D. Ill. 2007). This has the practical effect of granting relief to the debtor's probate estate.

[92] Even for firms that do not retain their assets through reorganization, but rather sell them through a bankruptcy sale to a third party, a signature feature of bankruptcy law is the release of debts and other encumbrances so the assets may be marketed and sold. *See* 11 U.S.C. § 363(f) (2000 & Supp. 2006) (providing for the sale of assets free and clear of liens and interests). For example, General Motors Corporation accomplished its reorganization in this way—immediately after filing for bankruptcy in 2009, it sold its

a discharge in bankruptcy would appear to be classically ad hoc—an assertion designed merely to save the theory rather than illuminate some relevant aspect of the subject matter.[93]

Jackson's focus on business reorganizations in an effort to quarantine the debt-forgiveness features of bankruptcy law encounters yet another problem: it is self-marginalizing because it avoids consideration of the most paradigmatic and pervasive type of bankruptcy case.[94] For centuries, the most paradigmatic and pervasive bankruptcy case has been that of the insolvent individual debtor, not any particular type of firm (business bankruptcies involving firms account for merely a small fraction of cases filed each year).[95] In turn, the dominant issue in individual debtor cases is the

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assets through a series of transactions to a purchaser, new General Motors LLC, leaving most of its liabilities behind (except those expressly assumed by the new entity). *See* In re Motors Liquidation Company, 430 B.R. 65, 70 (S.D.N.Y. 2010) (describing the bankruptcy sale of General Motors); *see also* Schomaker v. General Motors, Inc., 2011 WL 4433167 (W.D. Mich. Aug. 29, 2011), aff'd., 2011 WL 4404120 (W.D. Mich. Sept. 21, 2011) (dismissing claim asserted against purchaser of General Motors because purchaser did not assume liability through bankruptcy sale, but rather acquired assets free and clear of claims other than those assumed through the bankruptcy process).

[93] *See* SHAPIRO, LEGALITY, *supra* note 37 at 108-09 (criticizing an argument as "ad hoc" where "it is motivated solely by the desire to save the theory and not by any other independent consideration").

[94] As I use these terms, the most "paradigmatic" bankruptcy case is the one that most vividly illustrates the issues that bankruptcy law addresses. The most "pervasive" bankruptcy case is the most common.

[95] For example, the Administrative Office of the United States Courts, responsible for keeping statistics on bankruptcy filings, reports that, for 2012, there were 1,221,091 total bankruptcy filings, of which 843,545 were Chapter 7 cases (liquidations), 10,361 were Chapter 11 cases (reorganizations), 366,532 were Chapter 13 cases (individual wage earner plans), and 512 were Chapter 12 cases (family farmer plans). Of these, 40,075 were business filings, and 1,181,016 were non-business filings. *See* http://www.uscourts.gov/bnkrpctystats/bankruptcystats.htm (last visited June 2, 2013). Some commentators have argued that the Administrative Office's statistics understate the actual business-related filings because they do not appropriately capture filings by

bankruptcy discharge. The fact that Jackson's theory has little to say about these matters is a serious shortcoming, and it is no real answer simply to state that firms and individuals are "different."[96] Most firms teem with dedicated human capital, and some are comprised almost entirely of it. This is not to say, of course, that individuals and firms are the same. Of course they are not. The real question, however, is not whether there are differences between them (a tautology), but whether these differences call for fundamentally different bankruptcy regimes or different theoretical conceptualizations of bankruptcy law.

As it turns out, the real issue is not so much distinguishing individuals from firms, but rather distinguishing different kinds of firms from each other—those flush with valuable combinations of dedicated human capital and physical assets that are difficult to replicate (such as viable airlines, manufacturing companies, complicated service businesses, and the like) and those that have essentially no dedicated human capital and function more like fungible commodities (such as single-asset real estate ventures, real estate investment trusts, special-purpose securitization vehicles, and the like). Analysis of the problems that explain the need for a distinct bankruptcy law (addressed in Chapter 2) reveals that, generally speaking, the problems that bankruptcy law properly addresses

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individuals who were forced into bankruptcy because, among other things, they were overburdened with business debts from failed ventures. *See* Robert M. Lawless & Elizabeth Warren, *The Myth of the Disappearing Business Bankruptcy*, 93 CAL. L. REV. 743 (2005). Lawless and Warren calculate that, rather than comprising between two and four percent of all filings, business failures account for approximately seventeen percent of all filings. *Id*. at 747. Regardless of the source of their indebtedness, however, the overwhelming majority of bankruptcy filings are by individuals, not firms. Accordingly, individual cases are the most paradigmatic and pervasive.

[96] *See* Baird, *World*, *supra* note 23 at 181-83 ("Corporations and people are not the same.").

are common to both individuals and most firms, and that, with regard to firms, they simply arise in more complicated ways. Thus, rather than start the analysis with the example of a non-paradigmatic and non-pervasive case (the insolvent firm) and build a theory of bankruptcy law from there, it would seem preferable to start with the more paradigmatic and pervasive case (the insolvent individual), build a theory that properly takes this example into account, and then make adjustments as necessary to accommodate the differences between individuals and firms, and then between different kinds of firms. This is the path the law has taken, and Jackson does not explain why it is deficient.[97]

Jackson's metaphor of the creditors' bargain is also not, strictly speaking, a viable application of Rawls's theory of justice. Parties in the "original position" behind the "veil of ignorance" would not know that they are creditors when they agree to the fundamental principles that govern the formation of the structures of a just society—including a just bankruptcy law—because these parties are, by design, denied access to such facts.[98] As a result, they would not "bargain" in the original position *as creditors*,

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[97] Current bankruptcy law provides some distinctively different procedures for insolvent individuals and firms and, unsurprisingly, the rules for firms tend to be more complex. For example, only individual debtors may file for bankruptcy relief under the simplified repayment plan provisions of Chapter 13. *See* 11 U.S.C. § 109(e) (2000 & Supp. 2006) (specifying eligibility requirements for Chapter 13 relief). Both individuals and firms, however, may file for relief under the more complicated reorganization provisions of Chapter 11, although comparatively few individuals do so. *See* 11 U.S.C. § 109(d) (2000 & Supp. 2006) (specifying eligibility requirements for Chapter 11 relief); Toibb v. Radloff, 501 U.S. 157 (1991) (individual debtors are eligible for Chapter 11 relief).

[98] JOHN RAWLS, A THEORY OF JUSTICE 118-119 (revised ed. 1999) [hereinafter RAWLS, THEORY] (none of the parties in the original position "knows his place in society, his class position or social status; nor does he know his fortune in the distribution of natural assets and abilities, his intelligence and strength, and the like;" and "[a]s far as possible, then, the only particular facts which the parties know is that their society is subject to the circumstances of justice and whatever this implies."); *see* Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541, 559-61 (1993) (arguing that Jackson's approach is not really an application of the

but rather would bargain metaphorically with the possibility in mind that they might be either creditors or debtors. Rather than settle on some set of creditor-oriented debt-collection procedures as Jackson suggests, they would more likely settle on some combination of procedures of debt collection, debt forgiveness, and debt adjustment to the extent these features in combination produce beneficial results from a broader perspective of justice.

Jackson's theory also comes up short in terms of its potential implementation. His bargaining heuristic involves the exercise of imagining the kind of contract creditors might negotiate to dispose of an insolvent firm in order to distill the rules of bankruptcy law. In reality, however, no one has been able to employ this heuristic successfully to generate the details of a workable bankruptcy regime. This is not surprising. As Richard Epstein observed long ago in the context of critiquing the idea that "the function of the law of tort is to anticipate those contractual arrangements which parties would have made had the transactions costs been low enough to permit direct negotiations":

> Given the infinite variation in terms (what price? what services?) that we could expect to find in such contracts, it is difficult to believe that that theoretical observation could enable us to determine or even approximate any bargain which the parties might have made if circumstances had permitted. It is for good reason that the courts have always refused to make contracts for the parties.[99]

Rawlsian notion because in Jackson's model creditors are not ignorant of their status or self-interest).

[99] Epstein, *Theory*, *supra* note 5 at 203. The problem is all the more acute in bankruptcy because bankruptcy typically involves numerous parties with broadly diverse interests and asymmetric information, making the exercise of imagining how they might bargain *ex ante* in a group essentially intractable. *See* Schwartz, *Bankruptcy Workouts*, *supra* note 1 at 595 (observing that "[b]ankruptcies involve multiple parties. The theory of two-party asymmetric information bargaining games is both complex and inconclusive; many of the factors that affect solutions have been identified, but few general results exist. The theory of multiparty asymmetric information bargaining is in a more primitive state. Analysts use the full information theory because it is the only usable theory.").

A final but vitally important point about Jackson's theory also bears mention. It is remarkable the extent to which it struggles to align bankruptcy law with non-bankruptcy debt-collection procedures and, in the process, marginalize bankruptcy's debt-forgiveness and debt-adjustment features. Why? As Douglas Baird has explained, Jackson's account essentially "begin[s] with a faith in markets working effectively or, more precisely, not being subject to improvement through intervention of a legal mechanism such as bankruptcy law."[100] As applied, however, this perspective misses the mark.

Among other deficiencies, it assumes incorrectly that bankruptcy law is or should be no more than some narrow type of remedial "intervention" into ordinary markets, rather than a comprehensive body of law that creates and supports a distinct market in and of itself. Jackson's account indulges the suspicion that, but for the collective-action dilemma, ordinary non-bankruptcy markets would be perfectly adequate to accommodate the debt-collection interests of an insolvent debtor's creditors, with the further assumption that vindicating these interests is all that really matters. In other words, all that is needed is a surgical bankruptcy "fix" to address the collective-action dilemma and, once that fix is in place, ordinary markets can be trusted to do the rest. Jackson's view is inappropriately reductionist for at least three reasons.

First, as noted, the collective-action dilemma is merely one of the problems that bankruptcy law properly addresses. As discussed in Chapter 2, there are numerous others, and in order to provide a truly meaningful "fix" to the totality of these problems, bankruptcy law properly tackles much more than Jackson's perspective acknowledges,

[100] Baird, *Uncontested Axioms*, *supra* note 27 at 587.

and does so in ways that reveal the inadequacy of his account. Second, the reason bankruptcy law exists to address these special problems is because ordinary non-bankruptcy markets are not equipped to do so, and it would make no sense to burden them with bankruptcy procedures needed only in the event of a debtor's insolvency. Third, the problems of insolvency are sufficiently complex and costly to justify their own comprehensive remedial regime. In short, the problems that explain the need for a distinct bankruptcy regime require something more than minimalist tinkering with ordinary non-bankruptcy debt-collection mechanisms. What is needed is what bankruptcy law supplies—a comprehensive remedial market of its own. Viewed in this light, Jackson's reluctance to endorse bankruptcy law as a legal mechanism that interferes with the workings of ordinary non-bankruptcy markets is largely beside the point.

By analogy, regardless of one's skepticism about the desirability of using legal regulation to intervene in the workings of a market, one still would not want to use the market for children's books to sell automobiles. Likewise, because of the complex and distinct nature of what is at stake in the unique world of insolvency, one would not want to use ordinary markets to address the problems that arise in that unique world. This is unsurprising. As Coase has explained, markets are social institutions that are "created by the law or are dependent on it,"[101] and there are many different kinds of markets, each responding to its own set of problems and challenges with its own legalities. As discussed in Chapters 2 and 3, the problems that collectively explain the need for a distinct bankruptcy law also justify a distinct bankruptcy market. The question is what

[101] COASE, FIRM, *supra* note 7 at 28. Likewise, "[s]ocial functions are characteristically performed by legal institutions established and regulated by numerous laws." JOSEPH RAZ, THE AUTHORITY OF LAW 167 (2d ed. 2009) [hereinafter RAZ, AUTHORITY].

kind of market and with what mechanisms? (And in order to address that question more fruitfully, it is first necessary to understand more fully the totality of the problems bankruptcy law properly attempts to resolve.)

It is inadequate to respond, as Jackson and others do, that bankruptcy and non-bankruptcy regimes should be as closely aligned as possible because the creation of separate legal systems with different distributional rules sets up an opportunity for "forum shopping."[102] Different markets routinely make use of different remedial procedures, each with its own distributional mechanisms designed to achieve distinct goals. In defining access to particular markets and their unique procedures there is always a boundary problem, and bankruptcy law is no different.[103]

This is not to say that the problem of forum shopping is entirely irrelevant. It is to say that it is inherent in having different marketplaces for distinct purposes, including those with distinct regulations and procedures. More important, the problem of forum shopping in the insolvency context may be addressed by means less drastic than sacrificing the beneficial goals of bankruptcy law, particularly those underlying its debt-forgiveness and debt-adjustment procedures. Unsurprisingly, there is a long and elaborate history of limiting access to bankruptcy relief to those who truly need it and for whom access to its extraordinary panoply of remedies would not be abusive.[104] For

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[102] JACKSON, LOGIC, *supra* note 8 at 21-22 (making this claim); *see also* Baird, *Loss*, *supra* note 8 at 824-28 (discussing forum-shopping costs); Baird, *World, supra* note 23 at 181-83 (same).

[103] For example, one might attempt to sell firearms through the market for produce in order to take advantage of the different regulatory structure, but one would quickly be ejected from the produce marketplace.

[104] *See, e.g.*, Marrama v. Citizens Bank of Massachusetts, 549 U.S. 365, 367, 374-75 (2007) (observing that bankruptcy is intended for the "honest but unfortunate debtor,"

example, although solvent debtors occasionally seek refuge in the sheltering arms of the bankruptcy court to avoid obligations they can and should perform, they are characteristically ejected from that forum.[105] Bankruptcy is properly limited to insolvent individuals and firms because it is the special problems of insolvent debtors that bankruptcy law properly addresses, and Jackson does not explain why the relevant

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and bankruptcy relief may be denied for abusive conduct); American United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 145 (1940) (federal court has equitable power to prevent misuse of bankruptcy law); SEC v. United States Realty & Improv. Co., 310 U.S. 434, 457-58 (1940) (federal court has inherent power to dismiss bankruptcy case to avoid misuse of the proceeding).

[105] *See, e.g.*, First Nat'l Bank of Cincinnati v. Flershem, 290 U.S. 504, 517 (1934) (solvent corporation that voluntary defaulted on debt that it had the ability to pay could not resort to equity receivership process to restructure its obligation); In re Integrated Telecom Express, Inc., 384 F.3d 108, 112 (3d Cir. 2004) (financially healthy debtor was not entitled to resort to bankruptcy relief to avoid lease obligation); In re SGL Carbon Corp., 200 F.3d 154, 165-66 (3d Cir. 1999) (financially healthy debtor could not use Chapter 11 process to manage litigation because debtor was not in need of bankruptcy relief, stating "[c]ourts . . . have consistently dismissed Chapter 11 petitions filed by financially healthy companies with no need to reorganize under the protection of Chapter 11"); Marsch v. Marsch (In re Marsch), 36 F.3d 825, 828 (9th Cir. 1994) (ordering dismissal of case and imposing sanctions on solvent debtor who filed for bankruptcy to avoid state court judgment that she could have satisfied); Barclays-American/Business Credit Inc. v. Radio WBHP, Inc. (In re Dixie Broad., Inc.), 871 F.2d 1023, 1028 (11th Cir. 1989) ("The Bankruptcy Code is not intended to insulate financially secure sellers or buyers from the bargains they strike."); Caruso v. U.S.A. Motel Corp. (In re U.S.A. Motel Corp.), 450 F.2d 499, 505-06 (9th Cir. 1971) (dismissing bankruptcy petition of solvent corporation); Dunes Hotel Assocs. v. Hyatt Corp., 245 B.R. 492, 507-12 (D.S.C. 2000) (affirming dismissal of the Chapter 11 case of a solvent debtor and rejecting the use of Chapter 11 to effect "a post-deal negotiation of a lease"); Furness v. Lilienfield, 35 B.R. 1006, 1009 (D. Md. 1983) ("Chapter 11 was designed to give those teetering on the verge of a fatal financial plummet an opportunity to reorganize . . ., not to give a profitable enterprise an opportunity to evade contractual or other liability"); In re Francfair, Inc., 13 F. Supp. 513 (S.D.N.Y. 1935) (dismissing bankruptcy petition of solvent trust); In re Liberate Technologies, 314 B.R. 206 (Bankr. N.D. Cal. 2004) (dismissing Chapter 11 case of solvent debtor); In re Southern California Sound Sys., Inc., 69 B.R. 893, 900 (Bankr. S.D. Cal. 1987) (dismissal warranted where debtor was seeking merely to "take advantage of one of the remedies available under the Code").

safeguards protecting its boundaries are inadequate—or if they are inadequate, why they cannot be sufficiently fortified.

Jackson and similar theorists support their forum-shopping critique and analysis by invoking the Supreme Court's iconic decision in *Butner v. United States*.[106] *Butner*, however, does not support their cause, and ultimately Jackson's use of the case amounts to the extraction of a precedential drop from a vastly more complicated jurisprudential ocean that, in its totality, undercuts his theory.

In *Butner*, a creditor (Butner) held a mortgage lien on a piece of real estate the debtor (Golden) owned, but Butner did not have any interest in the rents Golden collected from the property under the law of the state where the property was located (North Carolina). After Golden filed for bankruptcy, Butner claimed an interest in the rents even though, under state law, he did not have one. Rejecting a line of decisions concluding that a bankruptcy court could, in the exercise of its equitable powers, create and enforce such an interest even though state law did not recognize it, the Supreme Court observed that, although Congress certainly had the power to authorize such a benefit, Congress "has not chosen to exercise its power . . . ."[107] Given Congress's inaction, the Court reasoned that "undefined considerations of equity provide no basis for adoption of a uniform federal rule affording mortgagees an automatic interest in the rents as soon as the

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[106] 440 U.S. 48 (1979); *see* JACKSON, LOGIC, *supra* note 8 at 55 (discussing Butner); BARRY E. ADLER, DOUGLAS G. BAIRD, AND THOMAS H. JACKSON, BANKRUPTCY CASES, PROBLEMS, AND MATERIALS 29-30 (2007) (same).

[107] Butner, 440 U.S. at 56.

mortgagor is declared bankrupt."[108] The Court then bolstered its conclusion with a prudential *Erie*-like analysis:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'[109]

Jackson contends that the "notion of forum shopping" quoted above is not only *Butner's* "fundamental point," it also properly circumscribes the breadth of bankruptcy law.[110] He extracts from the Court's analysis the larger debt-collection principle that "bankruptcy law should not create rights," but instead "should act to ensure that the rights that exist are vindicated to the extent possible" because "[o]nly in this way can bankruptcy law minimize the conversion costs of transferring an insolvent debtor's assets to its creditors."[111]

Jackson's interpretation of *Butner* is a misreading. To begin with, the fundamental point of the decision is not to elevate forum shopping concerns as the lodestar of bankruptcy law but rather to establish a principle of separation of powers:

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[108] *Id.* at 55-56. The Court continued: although "[t]he equity powers of the bankruptcy court play an important part in the administration of bankrupt estates to countless situations in which the judge is required to deal with particular, individualized problems," it "does not follow . . . that 'equitable administration' requires that all mortgagees be afforded an automatic security interest in rents and profits when state law would deny such an automatic benefit . . . ." *Id.* at 56.

[109] *Id.* at 55 (quoting Lewis v. Manufacturers Nat'l Bank, 364 U.S. 603, 609 (1961)).

[110] JACKSON, LOGIC, *supra* note 8 at 22.

[111] *Id.*

federal courts should not use their equitable authority to create novel rights in bankruptcy because establishing rights in bankruptcy is for Congress.[112] In context, Justice Stevens's comment about forum shopping is merely a supporting consequential flourish of rather ordinary pedigree: as an aside, federal courts also should not be in the business of creating novel rights in bankruptcy because doing so tends to inject uncertainty into commercial markets (among other things, it is uncertain what courts will do, when they will do it, and when they might stop) and runs the risk of different courts recognizing different rights with respect to a law that is supposed to be uniform.[113]

In addition, Jackson's conclusion that bankruptcy law should not create rights follows from his premise only if one assumes that the unmitigated costs of forum shopping he alludes to categorically outweigh the benefits of bankruptcy law's substantive debt-forgiveness and debt-adjustment functions, both of which undeniably create special rights in bankruptcy and have nothing to do with getting the creditors paid in accordance with their non-bankruptcy payment entitlements. *Butner* does not support

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[112] *See, e.g.*, Travelers Cas. & Sur. Co. v. Pacific Gas & Elec. Co., 549 U.S. 443, 451-54 (2007) (citing Butner and overturning a judicially-created limit on a creditor's right to include attorneys' fees as part of its claim, concluding that, although "Congress, of course, has the power to amend the Bankruptcy Code by adding a provision expressly disallowing claims for attorneys' fees," Congress has not done so and the federal courts are not empowered to create such a rule on their own); *see also* United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213, 229 (1996) (overturning judicially-created equitable rule that permitted subordination of tax penalties to other kinds of claims because the "categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority"); United States v. Noland, 517 U.S. 535, 543 (1996) (same); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) ("whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code").

[113] Of course, it is certainly possible to extrapolate a larger-forum shopping concern from the skeletal mention of it in the decision, but it is not a fair reading to claim that forum shopping is the decision's main point.

this assumption and for good reason. Over the past century, the Supreme Court has issued over 550 bankruptcy decisions,[114] and many of these recognize and enforce a robust panoply of special bankruptcy rights (such as the debtor's discharge) that affirmatively override the creditors' non-bankruptcy payment entitlements for reasons that have nothing to do with Jackson's debt-collection goal. More important, the Court has done so repeatedly without much apparent concern over forum-shopping costs.[115] Within the larger constellation of Supreme Court bankruptcy precedents, *Butner* stands merely for the unremarkable proposition that, in the absence of a contrary federal rule that *Congress* has authorized, state law establishes the rights of the parties against which bankruptcy law then operates.[116] In other words, state law typically supplies the input to the process, and bankruptcy law supplies the output. In reality, *Butner* is simply a

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[114] *See* KENNETH N. KLEE, BANKRUPTCY IN THE SUPREME COURT *v* (2008).

[115] *See, e.g.*, Local Loan Co. v. Hunt, 292 U.S. 234, 245 (1934) (extolling the debtor's discharge in bankruptcy). As the Supreme Court stated in its seminal decision in Wright v. Union Cent. Life Ins. Co., 304 U.S. 502, 517 (1938), "[b]ankruptcy proceedings constantly modify and affect the property rights established by state law." It does so, the Court has noted, because "federal bankruptcy law, not state law, governs the distribution of a bankrupt's assets to his creditors." American Sur. Co. v. Sampsell, 327 U.S. 269, 272 (1946). Just as bankruptcy priorities do not apply in state court or other non-bankruptcy proceedings, *see* United States v. Emory, 314 U.S. 423, 426 (1941), non-bankruptcy priorities do not govern in bankruptcy cases. Butner itself recognized that federal bankruptcy law not only can, but actually does create rights that adjust the creditors' state law entitlements. Butner, 440 U.S. at 54 (observing that "[t]he Bankruptcy Act does include provisions invalidating certain security interests as fraudulent, or as improper preferences over general creditors.").

[116] *See, e.g.*, Travelers Cas. & Sur. Co. v. Pacific Gas & Elec. Co., 549 U.S. 443, 450-51 (2007) ("we have long recognized that the '"basic rule" in bankruptcy is that state law governs the substance of claims, Congress having "generally left the determination of property rights in the assets of a bankrupt's estate to state law"'") (quoting Butner); Raleigh v. Illinois Dept. of Rev., 530 U.S. 15, 20 (1951) ("Creditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code.") (citing Butner).

pragmatic decision circumscribing the equitable powers of the federal courts to create novel rights and, in the process, outlines a relatively mundane aspect of the mechanics of bankruptcy procedure.

In sum, Jackson's account of bankruptcy relief as a narrow debt-collection vehicle is unsuccessful. By focusing on the collective-action dilemma as the essential justification for a distinct bankruptcy law, and then analyzing that law basically as merely another debt-collection device, Jackson starts off with an unfortunately stunted account and ends up assembling a box into which he is then "compelled to force situations which do not truly fit."[117] His creditors' bargain theory is similarly unworkable, in no small part because it is unresponsive to the reality of bankruptcy law and the totality of what it properly strives to accomplish. If the bankruptcy process were just another garden-variety debt-collection tool concerned exclusively with facilitating efficient wealth transfers from debtors to creditors, one might well question the desirability of its current collection of remedies because most of them have nothing to do with the debt-collection ambition Jackson identifies. But bankruptcy law is actually something altogether different from Jackson's portrayal, and ultimately his characterization articulates a straw man against which to press exaggerated forum-shopping concerns. As a normative matter, the questions remain: why should we have a distinct bankruptcy regime, and how should it be arranged? To answer these questions, we require a better account of the

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[117] Calabresi & Melamed, *Property Rules, supra* note 5 at 1127-28 ("Framework or model building has two shortcomings. The first is that models can be mistaken for the total view of the phenomena, like legal relationships, which are too complex to be painted in any one picture. The second is that models generate boxes into which one feels compelled to force situations which do not truly fit.").

justifications for a distinct bankruptcy law, as well as a better theory of how such a law should be crafted.

BANKRUPTCY CONTRACTING, SUPER-FORECLOSURE, AND THE COST-OF-CAPITAL METRIC

Responding to the challenge of coming up with a better bankruptcy regime, but without examining in a systematic way either the weaknesses of Jackson's seminal account or the full range of problems that explain the need for a distinct body of bankruptcy remedies, a second group of scholars has expanded on Jackson's creditors'-bargain concept and offered not only inventive proposals for bankruptcy reform, but also a second normative theory on the purpose of bankruptcy law, at least as it applies to insolvent firms. Rather than rely on a metaphoric contract to illuminate the rules of an ideal bankruptcy system, they have instead examined the potential use of actual private contractual arrangements as complete or partial substitutes for a system of state-supplied, court-supervised business bankruptcy proceedings.[118] These scholars propose that the

[118] *See* ELIZABETH WARREN & JAY L. WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 1029-42 (4th ed. 2001) (summarizing different approaches); Schwartz, *Contracting Reviewed*, *supra* note 31 at 346-48 (discussing private contracting about bankruptcy procedures); Stephen L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 527 (1999) (proposing that certain contractual waivers be enforceable in bankruptcy); Schwartz, *Contract Theory*, *supra* note 31 at 1821-22 (discussing private contracting about bankruptcy procedures); Schwartz, *Bankruptcy Workouts*, *supra* note 1 at 621-24 (same); Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 343-44 (1997) (explaining that "[a] system structured under an alternative, ex ante approach . . . would have investors abide by the consequences of predictions made at the time of investment about a firm's likely quality should it become unable to pay its debts. Unless initial investment contracts provide otherwise, a firm's failure to make good on its obligations would trigger a liquidation without any after-the-fact attempt to determine whether the firm were economically viable. If an ex ante insolvency process thus provided for liquidation upon default, viable firms surely would be liquidated" and arguing that "such an ex ante approach may be optimal"); Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 302 (1997) (arguing in favor of permitting contractual bankruptcy waivers in most cases); Philippe Aghion, et

law allow the parties (or certain of them) to designate in advance the debtor's disposition upon insolvency through the use of enforceable instruments (such as bankruptcy contracts, waivers, or corporate charter amendments), including those that mandate some type of structured whole-business "super-foreclosure" mechanism that automatically strips away the interests of "out-of-the-money" creditors and equity holders.[119] In

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al., *Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849, 850 (1994) (arguing in favor of a scheme in which "debt claims are converted into equity, and the decision about whether to reorganize or liquidate is then put to a vote" and contending that "[t]he merit of our scheme is that all claimants, once they are shareholders, have a common interest in voting for the efficient outcome"); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323-33 (1993) [hereinafter Adler, *Financial*] (proposing a "chameleon equity" firm as a hypothetical contractual arrangement, theorizing that that such an arrangement could eliminate the need for reorganization or dismantling of a viable firm by creditors); Rasmussen, *Debtor's Choice*, *supra* note 9 at 100-07 (discussing the concept of a corporation binding itself to liquidation or crafting an individual bankruptcy scheme); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 781-88 (1988) [hereinafter Bebchuk, *New Approach*] (proposing a "bidding-in" procedure for corporate reorganization); *see also* Mark J. Roe, *Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics*, 75 VA. L. REV. 219, 222-223 (1989) (asking why bankruptcy rules derived through the creditors' bargain heuristic cannot simply be arrived at by actual contracting or by allowing bankruptcy rules to be modified by contract). A number of commentators have criticized the various contracting approaches to bankruptcy law. *See* Warren & Westbrook, *Contracting Out*, *supra* note 10 at 1199 (discussing debate); *see also* Robert K. Rasmussen, *Empirically Bankrupt*, 2007 COLUM. BUS. L. REV. 179 (2007) (criticizing Warren & Westbrook); *see generally* Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503 (discussing contracting about bankruptcy); Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. at 524-34 (discussing debate over contracting about bankruptcy).

[119] *See supra* note 118 (citing examples of the various proposals). A standard foreclosure procedure typically operates against a single asset, such as a particular item of real estate. A "super-foreclosure" procedure is different because it applies to the entirety of the firm and its assets, essentially amounting to a whole-business foreclosure. The idea traces its origins in the equity receivership context to an 1848 Georgia case involving the defunct Monroe Railroad and Banking Company. *See* Gerrard Glenn, *The Basis of Federal Receivership*, 25 COLUM. L. REV. 434, 442 (1925) (discussing the Monroe Railroad case that allowed the foreclosure sale of the debtor's assets as a whole, rather than piecemeal). An "out-of-the-money" creditor is one who, through application of principles of absolute priority, is not entitled to a distribution in bankruptcy. Under principles of absolute

offering these proposals, some scholars have focused predominantly, and sometimes exclusively, on whether and to what extent bankruptcy procedures affect a firm's cost of acquiring capital—with Alan Schwartz proposing that this metric alone should matter.[120]

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priority, secured creditors are entitled first to the payment of their claims from the value of their respective collateral; unsecured creditors are entitled second to any surplus after the claims of secured creditors are satisfied; and equity interests are entitled third to any surplus remaining after unsecured creditors are paid in full. *See* Bank of America Nat'l Trust & Sav. Ass'n v. 203 North LaSalle St. P'ship, 526 U.S. 434, 444-45 (1999) (explaining the absolute priority rule as the right of the secured creditors of a bankrupt debtor to be paid ahead of unsecured creditors, and creditors to be paid ahead of stockholders) (citations omitted); Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510, 529 (1941) (discussing absolute priority rule); Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 116 (1939) (same); Northern Pac. Ry. Co. v. Boyd, 228 U.S. 482, 508 (1913) (concluding that fairness and equity required that "creditors . . . be paid before stockholders could retain [their equity interests] for any purpose"); Louisville Trust Co. v. Louisville, New Albany & Chicago Ry., 174 U.S. 674, 684 (1899) (reciting "the familiar rule that the stockholder's interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors" and concluding that "any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation"); Flynn v. Loewer Realty Co. (In re V. Loewer's Gambriuns Brewery Co.), 167 F.2d 318, 320 (2d Cir. 1948) (Hand, J., concurring) ("Both the shareholders and the creditors in any enterprise assume some risk of its failure, but their risks are different. The shareholders stand to lose first, but in return they have all the winnings above the creditors' interest, if the venture is successful; on the other hand the creditors have only their interest, but they come first in distribution of the assets"); James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporation Reorganization*, 18 COLUM. L. REV. 127 (1928) (coining the phrase "absolute priority rule"). If all of the debtor's assets are encumbered by liens, and there is not enough value in the assets to satisfy the claims of secured creditors, unsecured creditors are "out-of-the-money" because they are not entitled to any distribution. If there is enough value to satisfy the claims of all of the secured creditors with enough left over to permit a distribution to unsecured creditors but not to equity holders, then the unsecured creditors are "in-the-money" and therefore the "residual claimants," but the equity holders are "out-of-the-money."

[120] *See* Schwartz, *Normative Theory*, *supra* note 9 at 1200 (analyzing bankruptcy law under a cost-of-capital approach and stating that "[s]cholars, especially those of an economic bent, are coming to agree that a business bankruptcy law should function to reduce the cost of capital for firms" and that "[t]he novelty of this Article [lies] in its single-minded application to bankruptcy of the cost of capital metric and in its argument that only this metric should matter."); Schwartz, *Contract Theory*, *supra* note 31 at 1819

Some have argued that a bankruptcy procedure that maximizes the creditors' recoveries could have the effect of lowering the cost of capital for firms, and some have contended generally that a bankruptcy law committed to reducing the cost of capital would (and should) look quite different from the current bankruptcy system.[121]

Though inventive, these proposals are inadequate for many of the same reasons that Jackson's approach is unsatisfying. As a threshold matter, they adopt either overtly or *sub silentio* Jackson's debt-collection frame, and as a result unsurprisingly focus on ways to transfer wealth from debtors to creditors in accordance with the creditors' preexisting non-bankruptcy payment entitlements. But just as Jackson's focus on debt collection is far too narrow, these proposals are likewise myopic. Because bankruptcy law aims ambitiously to be ameliorative on a number of fronts, it casts a broader remedial net in responding to the problems that explain its existence in ways that are unlikely to be replicated through an *ex ante* contractual substitute, however clever its design. At bottom, the various proposals are, by themselves, inadequate to perform the truly interesting and important work of bankruptcy law. Likewise, the cost-of-capital metric is inadequate to capture or measure the subject's true value.

BANKRUPTCY CONTRACTING

Turning first to the general idea of contracting about bankruptcy (specific aspects of the super-foreclosure concept are treated subsequently), it is helpful to pause for a

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("[u]ntil better arguments are brought to the table . . . [b]ankruptcy systems should function only to reduce the costs to firms of debt finance").

[121] *See* Schwartz, *Normative Theory*, *supra* note 9 at 1200 (arguing that "a bankruptcy law committed to capital cost reduction would be considerably smaller and less centralized than the law we now have"); *see also* Schwartz, *Contracting Reviewed*, *supra* note 31 at 344-48 (defending virtues of contract theory and its benefits).

moment and examine more closely the fundamental premise on which this idea is constructed—that it is efficient to resolve *ex ante* by contract how best to dispose of an insolvent firm before the firm actually fails.[122] Analysis of the problems that explain the need for a distinct bankruptcy law (discussed in Chapter 2) reveals that one of the key points of having such a law is to *avoid* burdening non-bankruptcy markets with costly procedures that are needed only when a debtor becomes unable to pay all claims in full. As a group, the contracting proposals violate this principle by attempting to place one of *the* most complicated problems of insolvency back into the non-bankruptcy marketplace, namely how to dispose of an insolvent firm in the most beneficial fashion.[123] In essence, they typically propose that the parties endeavor in advance to prescribe a fix for a firm before the firm is actually broken (and its illness diagnosed) by selecting the remedial path the firm must take if it eventually goes belly up.[124] This initiative encounters a number of unresolved difficulties.

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[122] As used here, the term "*ex ante*" means at the time creditors initially lend to the firm. *See, e.g.*, Rasmussen, *Debtor's Choice*, *supra* note 9 at 66-67 (proposing that "[w]hen a firm is formed, it would be required to select what courses of action it wishes to have available if it runs into financial difficulties down the road" and arguing that "[t]he virtue of standardized options is that they reduce transactions costs and make communication to third parties easy"); *see also supra* note 27 (discussing the concepts of *ex ante* and *ex post* bargaining).

[123] If anything, the challenge of deciding how best to dispose of an insolvent firm has only become more complicated in recent years, owing to the increasingly heterogeneous interests of creditors, the episodic instability of capital markets, and other factors. *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 42 (discussing these issues and their implications for business reorganization law and practice).

[124] As discussed below, U.S. bankruptcy law does not operate in this way. First, it is overwhelmingly a voluntary procedure. Although creditors may petition to put a firm into bankruptcy involuntarily, that is an exceptionally rare occurrence. *See* 11 U.S.C. § 303 (2000 & Supp. 2006) (authorizing the commencement of involuntary bankruptcy cases in certain instances and under certain conditions); Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small*, 57

Critically absent from the various contracting proposals is any serious attempt to describe in a systematic way the full range of challenges current bankruptcy law faces in addressing the plight of insolvent firms—and, by extension, that any substitute contractual arrangement would have to address, in whole or in part. This shortfall is significant. Among other reasons, a comprehensive understanding of these challenges is essential to evaluate whether a contractual undertaking of some kind (as opposed to the mechanisms of the current law) would be capable of addressing them fruitfully. As a practical matter, any reform is worthwhile only to the extent it represents an improvement over existing legal structures, and the burden is on those proposing innovation to demonstrate that it does. This requires a competitive comparative analysis,[125] and

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BROOK. L. REV. 803 (1991) [hereinafter Block-Lieb, *Why*]; *see also* John C. McCoid, *The Occasion for Involuntary Bankruptcy*, 61 AM. BANKR. L.J. 195 (1987) (discussing the history of involuntary petitions in bankruptcy)**.** Second, the process is flexible to accommodate the vagaries of particular cases. Relatively few outcomes are foreclosed. Recognizing that circumstances change and that an initial *ex ante* contractual solution to a firm's insolvency might turn out to be suboptimal later, Schwartz has proposed a process of readjustments whereby new creditors would be able to negotiate adjusted insolvency terms, replacing the bargain with initial creditors. *See* Schwartz, *Contracting Reviewed*, *supra* note 31 at 347-48 ("A renegotiation-proof contract would have to be modified in those cases in which the creditors lent at different times because the optimal bribe [i.e., the payment to the owner/managers to make the optimal decision regarding the disposition of the firm in the event of insolvency] could change with changes in the relevant economic parameters. The contract thus would need a conversion term, such that if the optimal bribe later changed, the bribes in all prior contracts would be updated to equal the new optimal bribe: the portion of the bankruptcy return from whatever system the insolvent firm chose that would be sufficient to induce the firm to choose optimally."). This readjustment proposal, however, would magnify the transaction costs of bankruptcy contracting and, in the process, increase the burdens on non-bankruptcy markets to resolve in advance the problems of insolvent firms. *See* WARREN & WESTBROOK, LAW, *supra* note 66 at 885 ("All in all, the negotiations over possible bankruptcy clauses involve potentially huge transaction costs and a battle over the forms beyond anything taught in Contracts class.").

[125] *See* COASE, FIRM, *supra* note 7 at 154 ("whatever we may have in mind as our ideal world, it is clear that we have not yet discovered how to get to it from where we are. A better approach would seem to be to start our analysis with a situation approximating that

conducting that analysis reveals inherent weaknesses in the relevant proposals. A few examples illustrate the point.

To begin with, insolvent firms seeking to reorganize typically require, and often obtain, new capital after they become insolvent and enter bankruptcy, but before the reorganization process is complete—a stabilizing practice known as "dip financing" that the current law makes possible by permitting a new lender to capitalize a bankrupt firm's operations on preferred terms after the firm commences a Chapter 11 case.[126] It is implausible that a private bankruptcy contract could arrange for this financing *ex ante* or replicate efficiently the conditions that facilitate it, let alone constitute an improvement over existing law.

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which actually exists, to examine the effects of a proposed policy change, and to attempt to decide whether the new situation would be, in total, better or worse than the original one. In this way, conclusions for policy would have some relevance to the actual situation."); Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U.L.Q. 1159, 1163 (1994) [hereinafter Rasmussen, *Ex Ante*] ("an advocate of change must show that current bankruptcy law is worse than one of the proposed alternatives, not that it falls short of the unattainable goal of perfect efficiency").

[126] The term "dip" refers to the "debtor in possession." In Chapter 11 cases, the debtor typically remains in possession of its property while it attempts to reorganize and is thus referred to as the "debtor in possession" or "dip." *See* 11 U.S.C. §§ 1101 (2000 & Supp. 2006) (defining the term "debtor in possession"), 1107 (2000 & Supp. 2006) (prescribing the rights, powers, and duties of a debtor in possession in a Chapter 11 case); In re Curlew Valley Assocs., 14 B.R. 506, 509-11 (Bankr. D. Utah 1981) (explaining that the Bankruptcy Code allows the debtor to remain in possession of its property and run its business). "Dip finanancing" is the financing in Chapter 11 that the debtor in possession obtains during the reorganization process. *See* 11 U.S.C. § 364 (2000 & Supp. 2006) (authorizing additional borrowing after the debtor commences a Chapter 11 case); George G. Triantis, *A Theory of the Regulation of Debtor-In-Possession Financing*, 46 VAND. L. REV. 901 (1993) [hereinafter Triantis, *Theory*] (discussing dip financing in bankruptcy and proposing a regulatory model to insure that the debtor invests only in "firm value maximizing projects").

First, the parties to an *ex ante* bankruptcy contract cannot in any practical way bind a third party to make future loans to the firm should the firm ever become insolvent. Among other reasons, the identity of the third party lender, the availability of the loan, the price the lender would charge, and the relevant terms of the financing are all unlikely to be known until the debtor actually encounters financial difficulty.[127] The reality is that each dip loan is unique, and the process of obtaining dip financing is complex and sensitive to the particular circumstances of the firm at the time of insolvency.[128] In addition, unless the prior rights of existing creditors are somehow suspended or otherwise accommodated, no new lender would be willing to lend to an insolvent enterprise. Given these obstacles, all that an *ex ante* bankruptcy contract realistically might say about this crucial aspect of business reorganization is that, if reorganization is pursued, the debtor

[127] In addition, there is always the possibility of the problem of the disappearing lender—a lender that fails before the time to make the future loan arrives.

[128] Post-bankruptcy dip loans are governed by section 364 of the Bankruptcy Code. *See* 11 U.S.C. § 364 (2000 & Supp. 2006). After the commencement of a bankruptcy case, section 364(a) authorizes a debtor in possession to incur unsecured debt in the ordinary course of its business as an expense of administration without court approval. *Id.* § 364(a). In contrast, section 364(b) permits the debtor in possession to incur unsecured debt other than in the ordinary course of its business as an expense of administration only with court authorization. *Id*. § 364(b). Section 364(c) provides that, under certain conditions, the bankruptcy court may authorize the debtor in possession to incur unsecured debt on a priority basis, subject only to prior liens. *Id.* § 364(c). Finally, section 364(d) provides that, under certain conditions, the bankruptcy court may authorize the debtor in possession to incur debt secured by a lien with a priority that is equal or senior to existing liens. *Id*. § 364(d). Liens authorized under section 364(d) have the effect of "priming" existing forms of security. *See, e.g.*, In re Fontainebleau Las Vegas Holdings, LLC, 434 B.R. 716, 725 (Bankr. S.D. Fla. 2010) (explaining the concept of a priming lien). For a discussion of the dip lending process, see David A. Skeel, Jr., *The Past, Present and Future of Debtor-In-Possession Financing*, 25 CARDOZO L. REV. 1905, 1916-1921 (2004); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 923-26 (2003).

may use its best efforts to obtain appropriate dip financing—in other words, what it might say is essentially nothing.

Critically, unless the *ex ante* contract could replicate the relevant provisions of the current law in some enforceable way, it could not do what the current law does, namely facilitate dip lending by providing an environment (the bankruptcy marketplace) that makes it attractive for creditors to actually lend to an insolvent enterprise by, among other things, suspending the enforcement of prior claims and permitting priority for the new debt.[129] Given the complexity involved in this legal mechanism, it would be infeasible for a bankruptcy contract to replicate it. Recognizing this, the law takes a different tack. Rather than promote the use of *ex ante* contracts negotiated in ordinary debt markets to facilitate lending to insolvent firms, the law establishes and supports a special bankruptcy market to make this possible.

Second, even if a bankruptcy contract could meaningfully address the issue of dip financing with more concrete terms, no lender would be willing to bind itself to make a future loan to an insolvent business without charging a hefty up-front commitment fee. Thus, even if crafting an *ex ante* bankruptcy contract for future dip financing were feasible, it is unlikely that the parties would be interested in incurring the costs of negotiating it *ex ante* given that it may never be necessary to invoke the option.[130]

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[129] The automatic stay provisions of the Bankruptcy Code essentially enjoin the enforcement of most pre-bankruptcy debts. *See* 11 U.S.C. § 362 (2000 & Supp. 2006); *supra* note 16. Priority borrowing in bankruptcy is discussed in *supra* notes 126, 128.

[130] In theory, existing creditors might attempt to bind *themselves* (or some subgroup of them) to make a dip loan. This would avoid the problem of attempting to bind a third party, but would not avoid the problem of the cost—any existing creditor would require significant compensation for this kind of agreement. Recognizing implicitly that these kinds of arrangements are undesirable, current bankruptcy law renders unenforceable executory pre-bankruptcy lending commitments following the commencement of the

Next, insolvent firms seeking to reorganize often have to modify their collective bargaining agreements during the reorganization process. Current law permits this under supervised conditions after the bankruptcy case has been filed—once again as part of the special procedures of the bankruptcy market.[131] It is implausible that a private bankruptcy contract could specify *ex ante* the circumstances under which this would occur, let alone in a manner superior to existing law. Among other reasons, a firm's financial creditors cannot in advance bargain away the employees' rights, or dictate how their collective bargaining agreement must be modified. In addition, it is unlikely that anyone could know in advance what kinds of modifications may be necessary to assist in reorganizing the debtor. Moreover, even if these problems could be overcome, it is still unlikely that the parties would be interested in incurring the cost of this kind of negotiation on an *ex ante* basis.

Further, insolvent firms seeking to reorganize typically have to deal with such diverse issues as asbestos tort claims, underfunded pension obligations, and environmental clean-up liabilities. The current law supplies complex vehicles for resolving all of these matters—once again as part of the unique procedures of the

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debtor's bankruptcy case—in other words, a pre-bankruptcy agreement to make a loan is not enforceable once the case is commenced. *See* 11 U.S.C. § 365(c)(2) (2000 & Supp. 2006) (barring the assumption of executory contracts to make a loan or extend other debt financing or financial accommodation). As noted, post-bankruptcy dip loans to debtors in possession and trustees are governed by section 364 of the Bankruptcy Code. *See* 11 U.S.C. § 364 (2000 & Supp. 2006).

[131] For example, section 1113 of the Bankruptcy Code permits the rejection and renegotiation of collective bargaining agreements under certain conditions. *See* 11 U.S.C. § 1113 (2000 & Supp. 2006); In re Maxwell Newspapers, Inc., 981 F.2d 85, 89-91 (2d Cir. 1992) (discussing section 1113).

bankruptcy market.[132] It does not appear that a bankruptcy contract might do so, let alone in a fashion superior to existing law.

Apart from these and similar concerns, the various contracting approaches have broader conceptual flaws. As scholars have recognized, a key dilemma in the case of an insolvent firm is whether to reorganize or liquidate. Although it is common to conceptualize this as a binary choice,[133] it actually represents at least four distinct options. First, the firm might be placed essentially in foreclosure (meaning creditors might be allowed to seize the firm's assets and liquidate them piecemeal through various

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[132] The Bankruptcy Code provides complex mechanisms for dealing with asbestos tort liabilities. *See, e.g.*, 11 U.S.C. § 524(g) (2000 & Supp. 2006) (providing for the special treatment of asbestos tort liabilities, including the creation of a trust and the granting of injunctive relief to facilitate the settlement and payment of present and future claims); In re Combustion Engineering, Inc., 391 F.3d 190, 233-35 (3d Cir. 2004) (discussing section 524(g)); Yair Listokin & Kenneth Ayotte, *Protecting Future Claimants in Mass Tort Bankruptcies*, 98 NW. U. L. REV. 1435 (2004) (discussing the treatment of asbestos claims in bankruptcy and the representation of future claimants); Alan N. Resnick, *Bankruptcy as a Vehicle for Resolving Enterprise-Threatening Mass Tort Liability*, 148 U. PA. L. REV. 2045 (2000) (discussing the treatment of mass tort claims in bankruptcy). In conjunction with other law, the Code likewise provides complex mechanisms governing the treatment of pension benefits. *See, e.g.*, 11 U.S.C. § 1114 (2000 & Supp. 2006) (providing for the treatment of pension obligations in Chapter 11 cases); In re Kaiser Aluminum Corp., 456 F.3d 328 (3d Cir. 2006) (discussing the termination of pension plans in bankruptcy). A number of Code provisions address the treatment of environmental liabilities in bankruptcy. *See, e.g.*, 11 U.S.C. § 554 (2000 & Supp. 2006) (permitting the abandonment of property that is burdensome to the estate); Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Prot., 474 U.S. 494 (1986) (holding that a trustee many not abandon property in violation of state regulation reasonably designed to protect the public health and safety from environmental hazards); Kathryn R. Heidt, *Environmental Obligations in Bankruptcy: A Fundamental Framework*, 44 FLA. L. REV. 153 (1992) (discussing the treatment of environmental obligations in bankruptcy).

[133] *See* Schwartz, *Normative Theory*, *supra* note 9 at 1238 (describing options under the current law as "liquidation (Chapter 7 of the U.S. Bankruptcy Code) and reorganization (Chapter 11)."); Bebchuk, *New Approach*, *supra* note 118 at 775 ("Reorganization is one of the two routes that a corporation in bankruptcy may take. When a corporation becomes insolvent and bankruptcy proceedings are commenced, the corporation is either liquidated or reorganized.").

forced-sale procedures). Second, the firm might reorganize by selling its assets to a third party as a going-concern.[134] Third, the firm might reorganize on a stand-alone basis by retaining its property and achieving a streamlined capital structure by stripping away (discharging) excessive indebtedness.[135] Fourth, the firm might engage in some combination of these alternatives with respect to its distinct business operations and assets.

Central to resolving the multitude of choices inherent in selecting one of these disparate paths is deciding whether the firm is suffering from "financial distress" (meaning excessive indebtedness encumbering an otherwise viable operational core); "economic distress" (meaning excessive indebtedness encumbering a non-viable operational core); or some mixture of the two with respect to any separate business lines the firm may have.[136] If the firm is suffering merely from financial distress, it is potentially a candidate for any of the four options outlined above depending on a number of factors, including the state of the market in which the firm operates and the firm's access to capital, the identity of its creditors and their preferences at the time of insolvency, and managerial capabilities. If the firm is suffering from economic distress, it is a candidate for the first two options (including some combination of them). The hard questions include identifying (1) who is going to decide whether the firm, or what portion

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[134] For example, this is how General Motors Corporation achieved its reorganization. *See supra* note 92.

[135] For example, this is how many of the U.S. air carriers that have filed for bankruptcy relief have reorganized their businesses. *See supra* note 89.

[136] *See* Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 87-8 (1995) [hereinafter Rasmussen & Skeel, *Economic Analysis*] (explaining the difference between "financial distress" and "economic distress"); Rasmussen, *Ex Ante*, *supra* note 125 at 1167 (same).

of it, is suffering from financial or economic distress and on what basis, and (2) which option(s) to pursue, depending upon, among other things, how much risk the relevant decision-making constituents are willing to assume.

Conceptually, a bankruptcy contract might designate both a decision maker and an evaluative standard in response to these questions, but the devil truly lies in the details. To begin with, regardless of whether the contract designated the debtor or one or more creditors to make the relevant decisions at the time of insolvency, each has incentives in the insolvency context to make the wrong choices (these are explored in Chapter 2).[137] For example, insolvent debtors have incentives to take excessive risks, and secured creditors have incentives to engage in improvident foreclosure activities.[138] Because a debtor's insolvency distorts the parties' incentives in inefficient ways, some mechanism is needed to neutralize these incentives to clear the path for better decision making (or at least reduce their effects).[139] Bankruptcy law does this through its various mechanisms of debt collection, debt forgiveness, and debt adjustment. In contrast, bankruptcy contracting does not offer the feasible prospect of a comparatively superior apparatus because the alteration of the parties' incentives requires something more than a contractual stipulation—it requires the more powerful intervention of a corrective market.[140] In addition, further complications arise in crafting and applying the relevant

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[137] *See infra* at 129-89. In addition, as a general matter, individual constituents cannot be trusted to look out for the interests of others. *See infra* note 164.

[138] *See infra* at 138-55, 162-68.

[139] *See id.*

[140] For example, insolvent debtors have incentives to avoid information sharing. *See infra* note 164. Bankruptcy law supplies mechanisms for neutralizing these incentives,

evaluative standard (whatever it may be), and then achieving an appropriate disposition of the firm based on the outcome of that evaluation.

For example, the customary initial hindsight procedure for determining whether an insolvent firm is suffering from financial or economic distress is to review the firm's historic earnings before taxes, depreciation, and debt.[141] But that is only part of the analysis. The frequently more important question involves considering the firm's future prospects, including whether it is possible to reduce the firm's costs, increase its prices, and/or increase its sales. This kind of evaluation is highly sensitive to context and often turns on variables that are difficult to predict and account for *ex ante* in any meaningful way, including the nature of the market in which the firm operates at the time of insolvency. In addition, selecting an appropriate disposition of the firm turns on a number of variables, including the relevant constituents' appetites for risk (which constituents at the time of insolvency may be quite different from those around at the time a bankruptcy contract is negotiated). Finally, achieving an appropriate disposition frequently calls for methods of implementation beyond the scope of recognized contractual remediation.

To illustrate, suppose the debtor (Firm) is a manufacturing company with a solid product line, but a high cost structure owing to unfavorable long-term supply contracts it entered into in prior years. Suppose Firm negotiated its supply contracts at a time when

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paving the way for more informed decisions regarding the debtor's condition and prospects. The relevant incentives, and how bankruptcy law addresses them to facilitate decision making, are discussed in Chapters 2 and 3.

[141] If the earnings are significantly positive, this suggests that the debtor is suffering from financial distress—it simply has too much debt. If they are negative, this suggests economic distress. *See supra* notes 1, 136.

prices for the commodities it consumes were high, but prices have since fallen dramatically, giving Firm's competitors a devastating pricing advantage in the marketplace. One potential solution to Firm's problem under the current law would be for it to file for bankruptcy, reject its long-term supply contracts in favor of more competitive agreements, and reorganize. To the extent this outcome is optimal (because, among other things, Firm is suffering from financial rather than economic distress), an efficient bankruptcy contract would have to include mechanisms for recognizing the particular problem Firm has encountered and prescribing the same fix, among all the other possible problems Firm might have encountered and all the other corresponding resolutions.[142] Because at the time of contracting the number of possible future problems Firm might encounter are large, each generating its own potential resolution options, anticipating and accommodating them all in a bankruptcy contract in any concrete, detailed way is likely to be unworkable. In addition, from a contracting perspective, there is a significant feasibility problem to the particular solution involved in the hypothetical—Firm's ability to get out of its long-term supply contracts. By itself, a bankruptcy contract between Firm and, say, its bank lender could not accomplish this solution without either the consent of Firm's suppliers or some legal mechanism for rejecting Firm's supply agreements. Current bankruptcy law supplies such a mechanism and specifies its own criteria for invoking it, as well as the consequences of doing so

[142] For example, suppose in the alternative that Firm's problem was that no one wanted to buy its products because of their poor design. Unless there is an imminent, feasible solution to this problem, Firm is suffering from economic distress and should be liquidated. The question then becomes what is the best method of liquidation. That, in turn, will depend on such variables as the condition of the marketplace in which the liquidation would be conducted.

within the bankruptcy marketplace.[143] It would not appear that bankruptcy contracting offers any advantage here.[144]

In addition to these problems, bankruptcy contracting encounters additional conceptual challenges. These include (1) the understandable reluctance of lenders to agree in advance to the forgiveness of any portion of their claims, even though debt forgiveness may be a crucial aspect of the debtor's reorganization, (2) the problem of binding future parties to an agreement and the potentially negative effects this may have on the value of the lenders' claims, (3) general difficulties inherent in predicting future events, and (4) other challenging coordination and enforcement problems.

As indicated previously, a central mechanism for achieving the successful reorganization of a firm suffering from financial distress is through a reduction of the firm's indebtedness, either by deleveraging its balance sheet or disencumbering its assets in order that they may be sold.[145] At the time they lend, however, financial creditors have no interest in specifying the circumstances under which they would be willing to forgive

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[143] *See, e.g.,* 11 U.S.C. § 365 (2000 & Supp. 2006) (permitting the rejection of executory contracts without the consent of the non-debtor party).

[144] Schwartz has proposed a procedure whereby an initial bankruptcy contract could be readjusted as circumstances change, resulting in a series of bankruptcy contracts updated on the basis of more contemporaneous information. *See supra* note 124. In theory, the final contract might address the disposition of the debtor's assets based on the debtor's circumstances as an insolvent or nearly-insolvent enterprise, but this suggests that there is little point to the earlier superseded bankruptcy contracts. Further, it has not been explained how the final contract might address unilaterally the challenges outlined above (those of dip lending, collective bargaining modification, claims resolution, diagnosis of the firm's condition, remediation option selection, and implementation). In addition, the concept of the final contract appears to resemble a work-out agreement, discussed below. For a number of reasons, work-out agreements are difficult to negotiate, are of limited utility, and owe their success significantly to the shadow of existing bankruptcy law. *See infra* at 82-84.

[145] *See supra* notes 72, 76, 88.

their loans (either in whole or in part), and it is easy to understand why. Among other reasons, doing so would impair the presumed benefits of the "bonding role of debt."[146]

Schwartz has argued that maximizing the return of creditors is important because the more losses they suffer, the more they will tend to charge for credit. This is undesirable, he claims, because any increased cost of debt financing will have the effect of reducing a firm's incentives to engage in worthwhile projects—a problem of

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[146] For a discussion of the "bonding role of debt," see Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986) [hereinafter Jensen, *Agency Costs*] discussing the "control function of debt" to police managerial behavior); *see also* Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 68-73 (1982) [hereinafter Levmore, *Monitors*]; Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 226-34 (1989) (discussing the incentives that firms have to finance projects with debt rather than equity). As explained by one group of commentators:

> In practice, managers, who enjoy private benefits of control, may be unwilling to shrink or liquidate an unprofitable company. Moreover, the market for corporate control [e.g., supervision by equity holders] may not work well enough to force them to do so. Under these conditions, debt plays an important role in constraining or bonding managers to act in [the equity] holders' interests. Specifically, the managers of a highly leveraged firm face a choice: Reduce slack or go bankrupt.

Philip Aghion, Oliver Hart & John Moore, *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523, 531 (1992) [hereinafter Aghion, et al., *Economics*] (citing Sanford J. Grossman & Oliver D. Hart, *Corporate Financial Structure and Managerial Incentives*, printed in THE ECONOMICS OF INFORMATION AND UNCERTAINTY 107 (J.J. McCall ed. 1982)); *see also* Aghion, et al. at 532-33 ("In broad terms, we think that a good bankruptcy procedure is one that meets two goals: (1) it maximizes the ex post value of the firm (with an appropriate distribution of this value across claimants); [and] (2) it preserves the (ex ante) bonding role of debt by penalizing management adequately in bankruptcy states.") (internal emphasis omitted); Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411 (1990) [hereinafter Easterbrook, *Corporate Bankruptcy*] (arguing that corporate bankruptcy law has two functions: delivering a penalty for failure and reducing the costs of failure); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1082 (1995) [hereinafter Triantis & Daniels, *Role of Debt*] (arguing that creditors may be better able to keep managers in line than equity holders).

"underinvestment."[147] He explains that increased borrowing costs have a negative effect on a firm's incentives to engage in worthwhile projects because the firm has to share returns with creditors.[148] Under this view, the *less* a firm has to pay financiers (to a point) the better because the firm therefore has an incentive to pursue more worthwhile projects.[149] But among other difficulties, this observation is in tension with the notion

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[147] The concept of "underinvestment" refers to investment behavior that involves inadequate risk taking, such as stuffing money into a mattress. *See* David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1333 n.17 (1998) [hereinafter Skeel, *Evolutionary*] (illustrating the problems of "overinvestment" and "underinvestment"); *see generally* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977) [hereinafter Myers, *Determinants*] (discussing managerial behavior). In contrast, the concept of "overinvestment" refers to investment behavior that involves excessive risk taking, such as gambling the rent money.

[148] *See* Schwartz, *Normative Theory*, *supra* note 9 at 1217 ("When a firm is financed with debt, it must share its success state return with creditors, whom it must compensate for bearing the risk of nonpayment. As a consequence, a debt-financed firm's private marginal return is lower than the social marginal return. The firm will respond by 'underinvesting'; by choosing a lower effort then is socially optimal.").

[149] *See* Schwartz, *Normative Theory*, *supra* note 9 at 1204 ("Society thus should want an efficient bankruptcy system because lower interest rates [arising from increased payouts to financial creditors] increase the share of good state returns that firms can keep, thereby reducing the wedge between the socially efficient project set and the project set that debt-financed firms will pursue"). This is true, of course, so long as the number of worthwhile projects is greater than the number of pursuers. If worthwhile projects are relatively scarce (which seems at least plausible), firms will pursue them even though borrowing costs are high and they have to share returns with creditors, up to the point at which borrowing costs approach anticipated profits. Firms may even pursue projects where the anticipated profits are less than the borrowing costs if, for example, the availability of tax benefits more than compensates for the loss. Of course, there is a floor to how little a firm may pay to financiers: if the return on the loan is too low, financiers will not lend. In addition, the reasons creditors incur losses are diverse. First, they may extend credit improvidently. Second, debtors may pursue worthwhile projects incompetently (a matter of operational risk). Third, debtors may competently pursue projects that turn out to be not worthwhile (a matter of investment risk). Fourth, debtors may encounter difficulties beyond their control independent of operational and ordinary investment risk, resulting in default and nonpayment (for example, there may be an outbreak of war). It is at least conceivable that lowering borrowing costs by increasing payouts to creditors would amount to a wash—creditors would simply lend the gain improvidently, or to debtors

behind the bonding role of debt—the idea that debt financing has a disciplinary effect on firms that helps increase their productivity and reduce "agency costs."[150] Under this view, the *more* the firm has to pay financiers (to a point) the better because the firm then has incentives to be as productive as possible.[151] But as noted, one critically important way to achieve value maximization in the bankruptcy reorganization context is through debt forgiveness, the very idea of which is caustic to the premises underlying the bonding role of debt.[152] The key to resolving these competing considerations is by reference to timing and context.

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who pursue projects incompetently, who competently pursue projects that turn out to be not worthwhile, or encounter difficulties beyond their control. Accordingly, it is not necessarily true that increasing payouts to creditors will result in an overall reduction of borrowing costs for firms. *See also infra* at 99-100.

[150] In general, the phrase "agency costs" refers to the costs associated with the corporate form of organization in which those with capital (e.g., shareholders) invest in the firm and allow managers to act as their "agents" in handling the firm's affairs. As explained by one commentator, "the agency relationship exposes owners to the risk that managers will use owners' funds for management's benefit, thereby creating agency costs—the costs to the principal of obtaining faithful and effective performance by its agent." Edward S. Adams, *Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results*, 73 B.U. L. Rev. 581, 601 (1993) [hereinafter Adams, *Governance*]; *see also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) [hereinafter Jensen & Meckling, *Theory*] (defining agency costs as arising from a principal-agent relationship and equaling the "sum of: (1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, [and] (3) the residual loss") (note omitted).

[151] There is a ceiling to how much a firm will be willing to pay to financiers: if the price of the loan is too high, the cost in terms of the creation of an incentive for underinvestment will exceed the benefits of any reduction in agency costs.

[152] For example, deleveraging an insolvent firm's balance sheet may permit the firm to survive as a going concern, permitting creditors to recover more than they would in liquidation. Likewise, stripping liens from over-encumbered assets may permit them to be sold where otherwise they would find no purchasers. *See infra* at 99-100.

In solvent states, preserving the bonding role of debt is paramount—hence the preference in non-bankruptcy markets for the enforcement of debt obligations without debt forgiveness. It is only when a firm becomes *insolvent* (or nearly so) that there is any real need to consider debt forgiveness. Because insolvency may or may not happen, and if it does happen it may or may not be necessary to consider reorganization and debt forgiveness, it would be counterproductive for a lender to undertake the cost of addressing debt forgiveness in advance.

Among other reasons, doing so would necessarily increase the price of the loan by at least the amount of the transaction costs involved in negotiating in advance any debt-forgiveness option (not to mention the costs of monitoring the agreement)—a potentially enormous sum when the negotiation expense is multiplied across myriad transactions throughout the economy.[153] In the aggregate, the additional transaction costs are likely to exceed any benefit realized from any enhanced reorganization payout given the relative large amount of lending (in the trillions) compared to the relatively small reorganization benefit creditors realize from those few firms that successfully reorganize after becoming insolvent. In comparison, the cost of the state-supplied bankruptcy system would have to be truly enormous to justify the aggregate transaction costs of a substitute regime of bankruptcy contracting, but it turns out that the cost of current reorganization procedure is not that great.[154] Thus, the transactions costs involved in prescribing debt forgiveness

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[153] *See* WARREN & WESTBROOK, LAW, *supra* note 66 at 885 ("because it is hard to know in advance which companies would eventually end up in bankruptcy, the negotiations would also be necessary for a much wider swath of the American economy.").

[154] *See* Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. EMPIRICAL L. STUD. 111, 140 (2004) (reporting fees and expenses to represent approximately 2.2 percent of the value of the firm's assets in large Chapter 11 cases); Stephen Lubben, *The Direct Costs of Corporate*

in bankruptcy contracts would likely only exacerbate Schwartz's problem of underinvestment by increasing the cost of lending. Hence, firms do not negotiate debt forgiveness in advance.

Consistent with this observation, it is no surprise that, to the extent creditors explicitly negotiate bankruptcy contracts (which they do routinely, especially in their security agreements), they make insolvency an event of default and prescribe foreclosure (not debt forgiveness) as the remedy. This has the effect of keeping the feet of the firm's managers to the fire. Yet, as Schwartz and others have argued, foreclosure is often exactly the *worst* option the parties could select for handling a firm's insolvency because

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Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases, 74 AM. BANKR. L.J. 509, 515 (2000) (reporting the direct costs in large reorganization cases to be approximately 2 percent of the firm's assets); Brian Betker, *The Administrative Costs of Debt Restructuring: Some Recent Evidence*, 26 FIN. MANAGEMENT 56 (1999) [hereinafter Betker, *Administrative Costs*] (reporting the ratio of direct costs to assets to be 3.9 percent for large Chapter 11 cases). As a percentage of assets, the costs appear to be typically higher for small Chapter 11 cases. *See* Stephen P. Ferris & Robert M. Lawless, *The Expenses of Financial Distress: The Direct Costs of Chapter 11*, 61 U. PITT. L. REV. 629, 651 (2000) (estimating the ratio of expenses to assets to be 17.6 percent small Chapter 11 cases); Robert M. Lawless, et al., *A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies*, 1994 U. ILL. L. REV. 847, 868 (1994) (estimating the ratio to be approximately 8.66 percent for small Chapter 11 cases). The available evidence suggests that these costs of reorganization are not particularly high in comparison to the costs of other kinds of corporate transactions. *See, e.g.*, Easterbrook, *Corporate Bankruptcy*, *supra* note 146 (arguing that Chapter 11 is generally efficient and comparing the cost of corporate bankruptcy with the cost of other sorts of transactions); *see also* James S. Ang, Jess H. Chua & John J. McConnell, *The Administrative Costs of Corporate Bankruptcy: A Note*, 37 J. FIN. 219, 223-234 (1982) (estimating administrative costs in the range of seven to eight percent of asset values); Betker, *Administrative Costs*, at 57 (estimating administrative costs at approximately four percent of asset values); Lawrence A. Weiss, *Bankruptcy Resolution: Direct costs and Violation of Priority Claims*, 27 J. FIN. ECON. 285, 289-90 (1990) (estimating that the direct costs of Chapter 11 amount to approximately three percent of asset values); *see also* Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1077 (1984); Gregor Andrade & Steven N. Kaplan, *How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Become Distressed*, 53 J. FIN. 1443, 1488 (1998) [hereinafter Andrade & Kaplan, *How Costly*].

it is value-destroying.[155] Not surprisingly, actual bankruptcy contracts negotiated *ex ante* (which typically prescribe foreclosure) are unenforceable in bankruptcy. Instead bankruptcy law permits the invocation of the mechanisms of a corrective bankruptcy market that requires an evaluation of the circumstances of the insolvent firm based on relevant contemporary information in order to address how best to dispose of the firm and its property.

Review of the history of bankruptcy law supports these observations. For most of the nineteenth century, the United States had no formal bankruptcy regime.[156] Interestingly, there is no evidence that, during this period, creditors endeavored in any systematic way to write *ex ante* bankruptcy contracts to facilitate in advance value-maximizing dispositions of insolvent firms, as opposed to simply opting for individual debt enforcement and foreclosure in conjunction with their debt contracts in the event of default. With the rise of large business enterprises, particularly railroads, it became

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[155] *See* Schwartz, *Normative Theory*, *supra* note 9 at 1260-6. As the Supreme Court has observed: "property that must be sold [through a quick foreclosure liquidation procedure] is simply worth less. No one would pay as much to own such property as he would pay to own real estate that could be sold at leisure and pursuant to normal marketing techniques." BFP v. Resolution Trust Corp., 511 U.S. 531, 539 (1994); *see also id*. at 551 n.2 (Souter, J., dissenting). As Justice Souter has observed:

> Buyers no doubt hope for bargains at foreclosure sales, but an investor with a million dollars cash in his pocket might be ready to pay "as much" for a desired parcel of property on forced sale, at least if a rival, equally determined millionaire were to appear at the same auction. The principal reason such sales yield low prices is . . . that such free-spending millionaires are in short supply, and those who do exist are unlikely to read the fine print which fills the "legal notice" columns of their morning newspaper.

Id.; *see also infra* at 164-65.

[156] *See infra* note 370.

apparent that some mechanism other than foreclosure was needed to address the problems of insolvent firms. Instead of drafting comprehensive *ex ante* bankruptcy contracts with elaborate reorganization options, however, sophisticated lawyers created the equity receivership—a collective *ex post* court-centered reorganization procedure that evolved over time to deal with the problems of insolvent firms in ways that aimed to preserve their value. Congress later codified the equity receivership mechanism in modified form as part of the national bankruptcy law.[157] Presumably, if bankruptcy contracts were a viable, superior alternative, they would have been selected over the equity receivership mechanism that lawyers devised. In reality, the equity receivership arose precisely because, in the absence of a bankruptcy law, creditors routinely opted contractually for value-destroying debt-collection mechanisms such as foreclosure.

Creditors have other incentives to avoid contracting in advance over a given insolvency procedure (other than by prescribing foreclosure as the remedy). Financial creditors often sell their claims to third parties, either in the ordinary course after lending or upon the debtor's default or insolvency, and this trend has only increased in recent years.[158] Although in theory the selling creditor might rationally prefer the firm to engage in some form of reorganization in some states (because doing so would enhance the selling creditor's return by preserving the debtor's value as a going concern), a

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[157] *See* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 48-70 (2001) [hereinafter SKEEL, DEBT'S DOMINION] (describing the equity receivership procedure and the circumstances giving rise to it); *infra* note 165.

[158] *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 42 at 659-61 (describing modern claims trading practices); Rasmussen & Skeel, *Economic Analysis*, *supra* note 136 at 101-04 (noting increase in claims trading); David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 513-18 (1992) [hereinafter Skeel, *Nature*] (same).

purchaser of the claim might have a different view depending on its goals (for example, whether it wishes to take over the firm in its entirety, acquire merely part of it, or sell it in pieces to liquidate its purchased claim).[159] The seller's advance stipulation to permit reorganization in a particular way (as opposed to foreclosure) might have the effect of decreasing the value of its claim in the secondary claims-trading market because, to avoid the firm's reorganization option that the selling creditor extended, the purchasing creditor that desires some other outcome would have to buy the option back from the firm (or the lender would have to do so prior to the sale of its claim). Because insolvent firms tend to prefer reorganization even when this is not optimal,[160] the resulting need for a settlement with the firm could become both routine and costly, further exacerbating the costs and complexity of bankruptcy.[161] Again, it is not surprising that creditors select foreclosure as the default remedy in their debt contracts because, in reality, this is an option the *creditor* can control by waiving it if the creditor believes that, based on information

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[159] *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 42 at 670 (explaining how different holders of claims can have vastly different views on the best outcome of a debtor's bankruptcy case).

[160] *See* Schwartz, *Normative Theory*, *supra* note 9 at 1248 ("[T]he firm's owners and managers receive a private benefit from operating the firm during a bankruptcy procedure. This benefit is larger in the [reorganization] procedure because a reorganization takes longer to realize and thus permits the owners to be in charge for a longer period (and to have a greater probability of remaining in charge permanently). Only private benefits matter to the firm because, being insolvent, it has no claim to the monetary return a procedure could generate. There, the firm will always choose the [reorganization] procedure unless constrained.").

[161] Schwartz has suggested that creditors might offer the firm's managers a "bribe" to make the correct decision, overcoming their preference for reorganization in cases where it would not be optimal. *See* Schwartz, *Contracting Reviewed*, *supra* note 31 at 344-48. The prospect of creditors having to bribe managers to achieve liquidation, however, would necessarily increase the cost of lending. This would add to the overall cost of bankruptcy contracting.

available at the time of default, some other outcome would be in *its* best interests, and more important it is an option that does not undermine the bonding role of debt in solvent states.[162]

Problems also emerge in terms of (1) actually drafting the kind of bankruptcy agreements some scholars envision and coordinating their terms among the effected parties where these parties are constantly changing (and involve such diverse constituents as government agencies, financial creditors, and labor unions); (2) coalition formation when the parties have no immediate incentive to coalesce into interest groups (for example, the debtor is solvent); and (3) updating or renegotiating the terms of these agreements as circumstances change.[163] Among other critical details, it remains entirely unsettled what kinds of terms are permissible (e.g., can one creditor insist by contract that it take the entire business upon the debtor's default regardless of its value?), who should do the negotiating (e.g., can a bank speak for a tort victim?), and who is empowered to bind whom (e.g., can a vendor bind an employee?), especially given that no single

[162] The ability of one creditor to waive a particular remedy such as foreclosure is not, of course, a complete solution to the challenge of determining the best disposition of an insolvent firm. Among other reasons, there remains the collective-action dilemma—a creditor will tend to avoid waiving foreclosure so long as it fears others will not also forego their foreclosure rights. Creditors otherwise have incentives to pursue foreclosure even though doing so would not be value-maximizing on the whole. These incentives are discussed in Chapter 2.

[163] Robert Rasmussen would solve the first and second problems by having the firm stipulate the bankruptcy outcome in its charter or other organizing document. Rasmussen, *Debtor's Choice*, *supra* note 9 at 66-67. This, of course, would not solve the third problem. Schwartz would solve the third problem by permitting readjustment. *See supra* note 124. But that would increase the transaction costs and does not resolve the first and second problems.

creditor or group can be trusted to look out for the interests of others.[164] The law of corporate reorganization evolved into the relatively complex device it is today precisely because of the general inability of creditors to work well together and look out for their collective interests—which is, after all, Jackson's basic point in articulating the collective-action dilemma.[165] The advocates of the various contracting proposals have remained extremely vague on these challenging issues in part because they have no

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[164] As Jackson points out in articulating the collective-action dilemma, one reason for having a bankruptcy law is that, left to their own devices, individual creditors will look out only for themselves. *See also* Warren & Westbrook, *Contracting Out*, *supra* note 10 at 1214 (arguing that "the central feature of any proposal that calls for parties to contact for a set of applicable bankruptcy rules is the effect the scheme chosen will have on the rights of creditors who were not part of the negotiation" and that "[c]ontracting creditors can be expected to negotiate for a system that benefits themselves, not the parties who are absent from the negotiating table"); Baird & Picker, *Noncooperative Bargaining*, *supra* note 63 at 311-12 (arguing that "[a] bankruptcy proceeding is needed largely because [negotiations over the disposition of the firm's assets between senior creditors and the debtor] cannot be entirely the province of private contracting. If the firm is worth less than what the most senior creditor is owed, the general creditors should receive nothing, but some mechanism, perhaps a judicial one, is needed to decide whether this condition holds, as the manager-shareholder and the senior creditor cannot be relied on to protect the rights of third parties."). As Rasmussen has observed, absent mandatory regulations that protect the interests of parties absent from the bargaining table, allowing one group to select the debtor's disposition in the event of insolvency would "encourage consensual creditors to shift the costs of insolvency onto nonconsensual creditors." Rasmussen, *Debtor's Choice*, *supra* note 9 at 67.

[165] *See supra* at 24-25; *supra* note 164; *see also* In re Philadelphia & Reading Coal & Iron Co., 105 F.2d 358, 359-60 (3d Cir. 1939) (describing some of the abuses of early business reorganization practice under the equity receivership mechanism and section 77B of the former Bankruptcy Act of 1898); In re Albert Dickinson Co., Inc., 104 F.2d 771, 775 (7th Cir. 1939) (same). If anything, the inability of creditors to work cooperatively together has only increased in recent years, based on a number of factors. *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 42 (discussing the increasingly fragmented and heterogeneous interests of creditors and the complexities this poses for bankruptcy reorganization law and practice).

satisfying theory for resolving them,[166] in the process leaving the concept of bankruptcy contracting particularly vulnerable to the criticism that, "[n]ot being clear, it was never clearly wrong."[167]

In addition, the idea of bankruptcy contracting encounters difficulties owing to the limits of human knowledge and perception. Humans in general are not particularly gifted at predicting future events.[168] Yet, to be useful, a comprehensive *ex ante* bankruptcy contract would have to either (1) be quite detailed about how to deal with future events, or (2) prescribe adequate procedures for dealing with these events as they arise. The first requirement is not likely to be satisfied unless the drafters have both extraordinary gifts of prescience and unusual powers of persuasion to convince others to go along with their predictions. The second requirement seems remarkably like what bankruptcy law already does. Again, one reasonably might ask why it is useful to incur the costs of bankruptcy contracting when it may never be necessary in any particular case and bankruptcy law exists to address the problems of insolvency as and when they occur within the context of the bankruptcy marketplace.[169]

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[166] *See* Warren & Westbrook, *Contracting Out*, *supra* note 10 at 1201 (arguing that "contractualists are vague about how their schemes will be implemented and how they will work").

[167] COASE, FIRM, *supra* note 7 at 149.

[168] *See* NASSIM N. TALEB, THE BLACK SWAN 136-142 (2007) [hereinafter TALEB, SWAN] (making this point); *see also* SHAPIRO, LEGALITY, *supra* note 37 at 199 (observing that "committing to a course of conduct far in advance of action is inherently risky" and that "[b]ecause the future is often unclear and human beings do not have the ability to consider ever single contingency, it often makes sense to wait until more information is available before deciding how to respond").

[169] Schwartz has explained in an analogous context that creditors do not attempt to bargain with firms over their commitment of effort to particular projects because "it is difficult to know whether a borrowing firm is exerting the optimal amount of effort" and

A further problem arises in terms of policing the parties' contractual bankruptcy bargain after a debtor enters a state of insolvency. Suppose the parties negotiated an elaborate scheme specifying the particular disposition of the firm in different states based on certain triggering standards. Logically, if it were in the interests of one of the parties to dispute whether a particular triggering event had occurred (for example, because the outcome would impair its stake in the debtor compared to other possible outcomes), that party would dispute the event.[170] An analogous situation arises frequently in litigation over inter-creditor agreements—contractual arrangements among discrete creditor groups that typically grant one group (the senior creditors) control and decision-making rights over another (the junior creditors), often in connection with the disposition of the parties' mutual collateral.[171] When they perceive it to be in their interests, junior creditors often dispute these agreements or the occurrence of events that trigger their provisions,

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"it would be costly to describe in a contract the various efficient actions the firm should take in each of the many possible states of the world that could materialize." *See* Schwartz, *Normative Theory*, *supra* note 9 at 1216. In other words, financial creditors do not contract to micromanage the operational activities of their borrowers, and it is assumed that a firm's "effort" is "noncontractible." *Id*. Creditors face a similar barrier when it comes to the even more challenging exercise of navigating a firm remotely through the straits of insolvency through the provisions of an antecedent contract.

[170] *See* WARREN & WESTBROOK, LAW, *supra* note 66 at 886 (arguing similarly that those advocating bankruptcy contracting have "assumed that debtors will go willingly to the sacrifice, rather than manipulating or secreting assets and filing lawsuits"). As Merton Miller has put it, "[d]ebtors, like some poets, do not 'go gentle into that good night.'" Merton H. Miller, *Leverage*, reprinted in CORPORATE BANKRUPTCY 6 (J.S. Bhandari & L.A. Weiss eds. 1996) [hereinafter Miller, *Leverage*].

[171] Inter-creditor and subordination agreements are generally enforceable in bankruptcy. *See* 11 U.S.C. § 510(a) (2000 & Supp. 2006) (recognizing the enforceability of contractual subordination agreements in bankruptcy cases).

sometimes giving rise to costly battles.[172] By their nature, bankruptcy contracts would not only be costly to negotiate and maintain, they would likely be costly to enforce.

In the real world, as a debtor approaches or enters a state of insolvency, interested parties often come together and attempt to "work-out" a beneficial resolution of the debtor's affairs. Perhaps in the work-out context conditions might be ripe for creditors to band together and negotiate an elaborate bankruptcy contract to resolve the debtor's fate based on then-current information. Of course, at this juncture the hold-out problem typically looms large, as well as (1) the threat of debt-collection free-for-alls as creditors begin to exercise their non-bankruptcy rights following default, (2) difficulties of coalition formation, and (3) information-sharing obstacles.[173] It is thus at this point that the intervention of a corrective bankruptcy market with its own remedial rules and procedures is often most needed, and the negotiation of a work-out solution often difficult to achieve. This is not to say that work-outs do not happen. Of course they do, but usually the successful ones involve debtors with the least serious problems or the least complicated capital structures. In addition, in many instances a bankruptcy filing is often

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[172] *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 42 at 673-74 (explaining inter-creditor agreements and the potential for costly litigation over them).

[173] These are discussed in greater detail in Chapter 2. For an example of the difficulties involved in negotiating a complicated out-of-court debt restructuring, including the problem of hold-outs, see MICHAEL MORITZ & BARRETT SEAMAN, GOING FOR BROKE: THE CHRYSLER STORY 297-317 (1981). In order to avoid a variety of perceived abuses, various non-bankruptcy mechanisms designed to regulate non-bankruptcy markets actually promote hold-out behavior in the insolvency setting. A good example is the Trust Indenture Act, 15 U.S.C. § 77aaa, et seq. Among other things, the Act prevents the modification of the payment rights of the holders of public debt issued under its provisions without the holders' consent. This is to prevent the issuers of public debt from abusing majoritarian voting mechanisms to reduce their debt obligations. Rather than burden the operation of the Act with complex insolvency exceptions, bankruptcy law simply deploys a substitute mechanism.

the *cheaper* option, as compared to negotiating a time-consuming work-out contract among numerous competing constituents.[174] Further, successful work-outs characteristically owe a debt (at least in part) to the shadow of existing bankruptcy law—the threat that if the parties do not reach an agreement, they face a potentially lengthy court-supervised bankruptcy proceeding.[175]

From this vantage point, successful work-outs can be seen as occupying a distinct amelioratory niche—they work in the relatively few instances in which the parties perceive a contractual means to achieve a more efficient outcome than the state-supplied bankruptcy process. That, of course, does not mean that the state-supplied process is generally inefficient. It simply means that, by reason of its general applicability to a multitude of debtor types and circumstances, there may be some debtors that are able to achieve the same benefits more cheaply under some circumstances without invoking its provisions. Ironically, if resort to the state-supplied bankruptcy procedure could be supplanted in advance through the vehicle of a bankruptcy contract, this might have the effect of *diminishing* the prospect of successful work-outs by, among other things, removing the shadow of the very law that makes so many of them possible.

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[174] *See* Stuart Gilson, *Transaction Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. FIN. 161 (1997) (arguing that out-of-court workouts do not reduce debt sufficiently); Stuart Gilson, et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms Default*, 27 J. FIN. ECON. 315 (1990) (study of large, publicly traded companies).

[175] JACKSON, LOGIC, *supra* note 8 at 17 ("Bankruptcy law stipulates a minimum set of entitlements for claimants. That, in turn, permits them to 'bargain in the shadow of the law' and to implement a consensual collective proceeding outside of the bankruptcy process.") (quoting Robert H. Mnookin & Lewis Kornhausert, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950 (1979)).

As Schwartz acknowledges, "[t]o be sure, any contracting scheme, including a bankruptcy contracting scheme, requires supporting regulation."[176] Bankruptcy law provides such a supporting regulatory apparatus—one that facilitates the negotiation of a Chapter 11 plan (essentially an elaborate contract) to resolve the debtor's fate and likewise, by extension, facilitates work-outs prior to bankruptcy. The key here, though, is that Chapter 11 plans are negotiated *ex post* in the context of a comprehensive framework (the bankruptcy process) freighted with rules and procedures designed expressly to deal with the unique problems insolvent firms face that if left unresolved would preclude their reorganization or liquidation in the most optimal way (such as their need for dip lending). In contrast, non-bankruptcy markets do not truly support bankruptcy contracting, nor should they as there is no real reason to incur the costs of such a regime outside the insolvency setting. Once again, the perspective embedded in the bankruptcy contracting concept not only underestimates the complexity of the problems of insolvency but also runs afoul of the basic prohibition against fixing something that is not broken.

SUPER-FORECLOSURE

As the foregoing illustrates, it would not appear to be either feasible or beneficial to use enforceable bankruptcy contracts to specify *ex ante* the details of the disposition of an insolvent firm. Perhaps, however, some form of special super-foreclosure mechanism might be useful to accomplish some narrower ambition, such as to specify in advance a mechanism for identifying the relevant *decision maker*, rather than the decision itself, regarding what is to be done when a firm becomes insolvent, and perhaps additionally deleverage the firm's balance sheet so that the decision maker can make choices free

[176] *See* Schwartz, *Normative Theory*, *supra* note 9 at 1255.

from the distorting incentives that insolvency generates. This is the apparent strategy behind many of the super-foreclosure proposals that would essentially divest existing equity holders and out-of-the-money creditors of their stakes in the firm in favor of more senior creditors once a firm enters a state of insolvency.[177] These devices, however, encounter unresolved problems of their own.

To illustrate, imagine a solvent firm (Firm) with a fairly simple, fixed capital structure. At the outset (Time One), Firm is worth $1,000, has one shareholder (Investor) who runs Firm, and has five creditors: a secured creditor (Bank) holding a claim of $400 for a loan secured by a lien on Firm's assets; a tort creditor (Victim) holding a claim of $100 for an environmental tort Firm committed; an employee (Worker) holding a claim of $100 for unpaid wages and benefits; a supplier (Vendor) holding a claim of $100 for unpaid goods sold to Firm; and a government agency (Tax Collector) holding a claim of $100 for unpaid taxes. At Time One, Firm's capital structure thus consists of the following divisions: one equity holder consisting of Investor holding an interest worth $200; one class of unsecured claims totaling $400 held by Victim, Worker, Vendor, and Tax Collector, each with an individual claim of $100; and one secured claim totaling $400 held by Bank. Under principles of absolute priority, Bank has the highest payment priority entitlement by virtue of its lien; the unsecured creditors come next; and Investor has the lowest priority.[178]

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[177] *See, e.g.*, Adler, *Financial*, *supra* note 118 at 323-33; Rasmussen, *Debtor's Choice*, *supra* note 9 at 100-07; Bebchuk, *New Approach*, *supra* note 118 at 781-83; *see also supra* note 119 (discussing the term "out-of-the-money").

[178] *See supra* note 119 (discussing absolute priority). Under the current law, Tax Collector and Worker may actually out-rank Victim and Vendor because of the Bankruptcy Code's provisions prioritizing some unsecured claims over others. For the sake of simplicity, these effects are not considered in the example.

Six months later (Time Two), Firm has declined in value to $500, is now insolvent, and needs to reorganize. Suppose Firm had negotiated in advance a binding agreement that provides as follows: upon Firm's insolvency, Investor's interest is cancelled, and the creditors holding the next highest priority will own Firm if their claims are still in-the-money, meaning there is some value to Firm after more senior claims are accounted for.[179] Because Firm's value is $500, and Bank's senior claim is $400, the unsecured creditors are still in-the-money to the tune of $100, even though there is not enough to pay all of their unsecured claims in full. Under this arrangement, the unsecured creditors would become the new owners either automatically or on condition they buy out Bank's claim (we will see momentarily why Bank would want the buy-out requirement as a condition to its agreement to the contract).

Notice right away what this kind of arrangement does not do. It does not tell us anything about whether Firm is worth saving or how it might be salvaged. It does not provide Firm with any new working capital in the form of new loans or the like. It does not supply any particular mechanism to permit Firm to renegotiate its labor relationship with Worker, clean up the pollution it has caused, or remedy its failure to pay its taxes. It simply reduces Firm's debt and tells us who gets to run Firm at Time Two—namely, Victim, Worker, Vendor, and Tax Collector. Presumably the new owners could then decide what to do with Firm or sell their interests to someone else who would then decide.

It is worth asking: why should the law sanction such an arrangement? On its face, it is merely a debt-collection wealth-transfer mechanism. It is not designed to

[179] *See supra* note 119 (discussing the concepts of "in-the-money" and "out-of-the-money").

salvage Firm *per se.* In fact, it is likely to have the opposite effect and, along the way, reduce the creditors' chances of recovery.

One issue that looms large in the insolvency context is the "bankruptcy initiation problem."[180] As discussed in Chapter 2, individual debtors have incentives to gamble away their assets as they approach and enter a state of insolvency. They do this because they have little to lose, and something to gain, by taking increased risks.[181] This is wasteful. Insolvent individuals likewise have incentives to obscure the true nature of their financial condition to avoid default and foreclosure.[182] This is also wasteful. In the

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[180] *See* JACKSON, LOGIC, *supra* note 8 at 193-208 (observing that "[e]nsuring that bankruptcy cases are initiated only when they are needed, and then neither too early nor too late, is a difficult task" and discussing some aspects of the initiation problem from the perspective of the collective-action dilemma).

[181] *See infra* at 146-47; JACKSON, LOGIC, *supra* note 8 at 205 (making this point); Charles W. Adams, *An Economic Justification for Corporate Reorganizations*, 20 HOFSTRA L. REV. 117, 125-27 (1991) [hereinafter Adams, *Economic Justification*] (explaining that a debtor will tend to take greater risks in an attempt to increase returns as it sinks deeper into insolvency); Devra L. Golbe, *The Effects of Imminent Bankruptcy on Stockholder Risk Preferences and Behavior*, 12 BELL J. ECON. 321, 326 (1981) [hereinafter Golbe, *Effects*] (same); Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 21-22 [hereinafter LoPucki, *General Theory*] (observing that, when a debtor's assets exceed his or her liabilities, "the debtor is motivated in the direction high risk investment" because "high risk investment, regardless of its intrinsic merits, may offer the only possibility that the debts will be repaid and that there will be something remaining for the debtor"); Merton H. Miller, *The Wealth Transfers of Bankruptcy: Some Illustrative Examples*, 41 LAW & CONTEMP. PROBS. 39, 40 (1977) [hereinafter Miller, *Wealth Transfers*] (same); *see also* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 404 (1983) (observing that "[w]hen the firm is in distress, the shareholders' residual claim goes under water, and they lose the appropriate incentives").

[182] *See infra* at 186; Miniscribe Corp. v. Keymarc, Inc. (In re Miniscribe Corp.), 123 B.R. 86, 89 (Bankr. D. Colo. 1991) (discussing how press accounts of false reporting preceded bankruptcy proceeding); Andy Zipser, *Cooking the Books, How Pressure to Raise Sales Led Miniscribe to Falsify Numbers*, WALL ST. J., Sept. 11, 1989, at A1; *see also* Lee Berton, *Convenient Fiction: Inventory Chicanery Tempts More Firms, Fools More Auditors: A Quick Way To Pad Profits, It Is Often Revealed Only When Concern Collapses*, WALL ST. J., Dec. 14, 1992, at A1 (discussing false financial reporting);

case of firms, equity holders and managers have these same incentives,[183] which would only be exacerbated if the first thing that happens once insolvency is discovered is that equity holders forfeit their stakes or the managers lose their jobs. Significantly, it is

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Richard Korman & David Rosenbaum, *After Bankruptcy, More Trouble*, ENGINEERING NEWS RECORD, June 28, 1999, at 12 (discussing the bankruptcy proceedings of Guy F. Atkinson Co., a large international construction firm, and allegations that certain of Atkinson's former officers misled certain creditors regarding the firm's financial condition in order to induce the creditors to continue to do business with the firm); *Mercury Finance Co.: Reorganization Plan Filed Under Bankruptcy Code*, WALL ST. J., July 16, 1998, at A6 (observing that, before it filed for bankruptcy protection, "Mercury's stock price collapsed in January 1997 after it disclosed that its profits had been vastly overstated"); Richard Zoglin, *The Impressario in Exile*, TIME, Aug. 2, 1999, at 70 (discussing the bankruptcy proceedings of Livent, a well-known entertainment production company, preceded by allegations of fraud and "fiddl[ing] with the books to disguise Livent's precarious financial condition"). Of course, Enron may well stand out as the most infamous distributor of financial misinformation. *See, e.g.*, ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (N.B. Rapoport & B.G. Dharan eds. 2004) [hereinafter ENRON: CORPORATE FIASCOS]; MIMI SWARTZ & SHERRON WATKINS, POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON (2003) [hereinafter SWARTZ & WATKINS, POWER FAILURE].

[183] *See* Schwartz, *Normative Theory*, *supra* note 9 at 1220, 1238-40 ("the firm has an incentive to delay entry into the [bankruptcy] system in the hope that its fortunes will improve, thereby probably wasting assets"); Adler, *Bankruptcy*, *supra* note 56 at 448-49 ("[f]aced with the prospect of no payout, equity favors delay"). As one commentator has noted:

> If the firm's prospects are volatile, shareholders will want the managers to delay, in the hope of selling when the price is high. On average, however, delay will be costly. Equity claimants have reason to wait too long and to set unrealistic reservation prices, for their claims are worthless unless something unexpectedly good happens. Immediate sale at a realistic price wipes them out; debt claimants bear any erosion of value during a delay, yet have fixed claims and so do not realize the full gain if things turn out well. This is the standard conflict between debt and equity claims, and as usual is substantially aggravated during times of financial distress, when the equity claim is worth little.

Easterbrook, *Corporate Bankruptcy*, *supra* note 146 at 415; *see* Michelle J. White, *Public Policy Toward Bankruptcy: Me-First and Other Priority Rules*, 11 BELL J. ECON. 550, 553 (1980) [hereinafter White, *Public Policy*] (observing that "equity holders always favor continuance, since their interest disappears under liquidation").

precisely the law's failure to deal with these problems that doomed the Chapter X corporate reorganization procedure under the Bankruptcy Act of 1898.[184] To avoid these

[184] Corporate reorganizations under the former Bankruptcy Act of 1898 could be effected through confirmation of a plan of reorganization under the provisions of Chapter X, or through confirmation of an arrangement under Chapter XI—both added to the Act of 1898 through the Chandler Amendments in 1938. Chapter X was available only to corporations. Bankruptcy Act § 106(5), 11 U.S.C. § 506 (repealed 1979); Chapter XI was available to corporations, and also to individuals and partnerships engaged in business. *See* Bankruptcy Act § 306(3), 11 U.S.C. § 706 (repealed 1979). Under the provisions of Chapter X, a trustee automatically replaced the debtor's managers upon the commencement of the case. *See* SEC v. United States Realty & Improv. Co., 310 U.S. 434, 446-53 (1940) (discussing differences between Chapter X and Chapter XI). As a result, managers avoided Chapter X to avoid losing their jobs and losing control over their firms. Although managers typically remained in possession after filing for relief under the provisions of Chapter XI, Chapter XI was a much more limited procedure. Among other things, Chapter XI did not permit the adjustment of secured debt or the adjustment of the interests of equity holders—it permitted only the adjustment of unsecured claims. Moreover, the issue whether a corporation properly belonged in Chapter X or Chapter XI turned ambiguously on "the needs to be served," General Stores Corp. v. Shlensky, 350 U.S. 462, 466 (1956), and a proceeding could not be maintained in Chapter X if "adequate relief would be obtainable by a debtor's petition under the provisions of Chapter XI." 11 U.S.C. § 546 (repealed 1979). In enacting Chapter 11 to replace the former Chapters X and XI, Congress recognized these shortcomings, *see* H.R. REP. NO. 95-595, at 223 (1977), reprinted in 1978 USCCAN 5963, 6183 (observing that "Chapter X has become an unworkable procedure, and Chapter XI is inadequate to fill the void," and concluding that "Chapter XI needs to be expanded to permit adjustment of secured debt and equity"), and particularly the initiation problem occasioned by the automatic appointment of a trustee, observing that, because Chapter X automatically ousted existing management, "debtors too often wait[ed] too long to seek bankruptcy relief," H.R. REP. NO. 95-595, at 223-24 (1977), reprinted in 1978 USCCAN at 6193, and that a law that too often led to the appointment of a trustee "would exacerbate the problem," *id*.; *see also* In re Johns-Manville Corp., 36 B.R. 727, 736 (Bankr. S.D.N.Y. 1984) (explaining that one of the goals of the Bankruptcy Code was to ensure that debtors did not wait until the last minute to file for bankruptcy); Douglas E. Deutsch, *Ensuring Proper Bankruptcy Solicitation: Evaluating Bankruptcy Law, the First Amendment, the Code of Ethics, and Securities Law in Bankruptcy Solicitation Cases*, 11 AM. BANKR. INST. L. REV. 213, 217-18 (2003) (observing that one of the reasons debtors chose to use Chapter XI over Chapter X was to maintain possession and operation of the business). In response, the current corporate reorganization procedure—Chapter 11—does not automatically oust the debtor's managers upon the bankruptcy filing in favor of a trustee. *See infra* note 241. Instead they typically remain at the helm, at least initially. In addition, they are given an exclusive period to propose a Chapter 11 plan. *See* Karen Gross & Patricia Redmond, *In Defense of Debtor Exclusivity: Assessing Four of the 1994*

problems, it is helpful to reorganize troubled firms sooner rather than later, and to provide equity holders and managers with an incentive to do so—namely, to initiate some kind of beneficial restructuring or liquidation before there is nothing to salvage. Chapter 11 provides this incentive by allowing managers to continue to run their firms following a bankruptcy filing and by not automatically canceling the equity holders' interests.[185] By their nature, foreclosure mechanisms (including the super-foreclosure variety) do precisely the opposite and thus follow in the footsteps of the failed Chapter X reorganization procedure.

Continuing the hypothetical outlined above, under the super-foreclosure arrangement Investor would have every incentive to hide Firm's true financial condition, delay creditors, and gamble with Firm's assets in order to avoid the automatic

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Amendments to the Bankruptcy Code, 69 AM. BANKR. L.J. 287, 291 (1995) (arguing that exclusivity is an important incentive to encourage reorganization by permitting debtors to retain control). For a discussion of the differences between former Chapter X and the current Chapter 11, see SKEEL, DEBT'S DOMINION, *supra* note 157 at 160-83, 212-37.

[185] This does not mean that existing managers remain in control indefinitely once their companies have filed for bankruptcy. Although the typical annual turnover for chief executive officers of public corporations is somewhere between three and five percent, a much larger percentage resign within two years of their companies' bankruptcy filing. *See* Brian L. Betker, *Management Changes, Equity's Bargaining Power and Deviations from Absolute Priority in Chapter 11 Bankruptcies*, 68 J. BUS. 161, 174 (1995); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 723-37 (1993) [hereinafter LoPucki & Whitford, *Corporate Governance*]; *see also* Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355, 386 (1990) [hereinafter Gilson, *Bankruptcy*] (finding that "[o]n average, only 46% of incumbent directors and 43% of CEO's remain with their firms at the conclusion of the bankruptcy or debt restructuring"); Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241, 261 (1989) [hereinafter Gilson, *Management*] (finding that, "[i]n any given year, 52% of sampled firms experience a senior management change if they are either in default on their debt, bankrupt, or privately restructuring their debt to avoid bankruptcy").

cancellation of his interest. Indeed, because this cancellation is automatic, his incentive would be acute. This is not likely to encourage optimal dispositions.

One way to avoid this problem might be for the parties to employ strict micro-managerial monitoring devices to reveal periodically Firm's true financial condition. But that would be costly, and would only serve as a partial solution in any event. As Firm's condition deteriorates, it is easy to see how Bank would have an incentive to claim that Firm's value had declined more than it actually had, while collectively Victim, Worker, Vendor, and Tax Collector would have an incentive to claim exactly the opposite. If Firm is worth only $400, Bank becomes the sole owner. If Firm is worth $500, Victim, Worker, Vendor, and Tax Collector become the owners (subject to Bank's claim), but without any particular expertise in managing Firm—hence Bank's incentive to require that its claim be bought out before Victim, Worker, Vendor, and Tax Collector could actually become the new owners (Bank probably would not want to retain its stake with this crew at the helm). Of course, to the extent they cannot pony up $400 to buy out Bank's claim (which is likely), they would simply forfeit their interests—a $100 windfall to Bank.[186] Bank will have cause to fear that Firm will continue to deteriorate, eventually leaving Bank with nothing. This is likely to set the stage for not one but multiple battles over valuation: the first one that sets up Victim, Worker, Vendor, and Tax Collector as the new owners, and then potentially others as perceptions of Firm's shifting value

[186] Victim, Worker, Vendor, and Tax Collector are unlikely to come up with $400 for any number of reasons. First, one or more of them may lack the necessary funds. Second, one or more of them may disagree about Firm's value, and thus whether it is worth it to come up with the funds. This disagreement may turn on their different appetites for risk. Third, one or more of them may have no expertise or competence in evaluating Firm's circumstances and prospects, managing Firm's business, or assessing Firm's value. Fourth, one or more of them may have aligned with Bank to scuttle the purchase.

likewise shift. Perhaps this difficulty might be overcome by designating in advance a single, fixed valuation procedure in the event of Firm's default,[187] but that does not solve the problem of the parties' incentives to avoid triggering the mechanism, whatever it may be. Likewise it does not solve the problem of shifting values—if Firm's condition is not stabilized once Victim, Worker, Vendor, and Tax Collector become the new owners, but continues to deteriorate (which is plausible given that all the super-foreclosure procedure does is cancel Investor's interest and convert the unsecured creditors into the new owners), it seems likely that Firm will soon once again become insolvent and in need of another round of super-foreclosure. In addition, the procedure would be difficult to implement if one or more of the unsecured claims remained unliquidated at the time of Firm's insolvency—a fairly common occurrence.[188] This kind of procedure is unlikely to be desirable.

If all that mattered in bankruptcy were dividing up the value of an insolvent firm's assets for distribution to creditors (as Jackson's account suggests and many commentators accept uncritically), super-foreclosure might have some appeal in some settings. But that is not all that matters. As noted at the outset, bankruptcy law's true ambition is to be ameliorative in a broader sense, which in the case of insolvent firms means, among other things, salvaging viable business enterprises because such entities are themselves both beneficial and scarce. As purely a secondary matter, preserving a

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[187] *See, e.g.*, Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE L.J. 83 (2001).

[188] For example, suppose Victim's claim has not yet been determined. If Victim's claim were actually $1,000 rather than $100, it would be entitled to a larger ownership share and would control Firm. Until Victim's claim was determined, ownership of Firm would remain in flux. Of course, determining the precise amount of Victim's claim could take a considerable amount of time.

firm's going-concern value also permits larger payouts to creditors. But once again it is important to avoid confusing purpose with effect.

At this point it should be fairly clear how Jackson's idea that bankruptcy law is fundamentally a debt-collection regime has influenced the direction of the academic discourse, leading to proposals that focus on clever ways to distribute value to creditors rather than addressing more directly the challenging problems of deciding what to do with an insolvent debtor, its assets, and its liabilities in optimal ways. Like Jackson's creditors'-bargain approach, a key assumption behind super-foreclosure is that, once the condition of insolvency is eliminated through the transfer of ownership through some kind of mechanism that cancels out-of-the-money interests, ordinary non-bankruptcy markets will take care of the question of disposition (essentially, the new owners will "decide" what to do with the debtor's assets).[189] In theory, this might work well enough in cases in which the debtor is basically a durable, non-deteriorating commodity, such as a single-asset real estate venture that owns an office building. But what about more fragile enterprises that consist of complicated combinations of physical assets and dedicated human capital, the kind bankruptcy law really cares about? Here the bankruptcy initiation problem looms large because by the time super-foreclosure occurs there may be little left to the enterprise. Moreover, there is more than an air of unreality to the notion that simply transferring a firm's ownership to in-the-money creditors will necessarily generate optimal decisions over how best to dispose of the firm's assets.

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[189] *See* Bebchuk, *New Approach*, *supra* note 118 at 781-83 (describing process of dividing ownership interests in firm through super-foreclosure mechanism); *see also* WARREN & WESTBROOK, LAW, *supra* note 66 at 878 (following the foreclosure of junior interests, "[t]he new owner would then decide how to deploy the assets, whether through sale of assets or continuing operation of the business.").

The current law takes a different road. It first focuses on stabilizing the firm with existing management and equity holders in place to avoid the initiation problem and then, later on and only as a secondary matter, addresses distributing the firm's value. It attempts to stabilize the debtor *not* by initially installing in-the-money creditors in the driver's seat (who, in all likelihood, are busy operating their own businesses) or the purchasers of their interests, but rather by a process that enlists the aid of turnaround experts and other professionals skilled in assessing and addressing the problems of troubled firms.[190] As noted, it also attempts to neutralize the negative incentives the parties have—both debtor and creditors alike—to make suboptimal decisions regarding the exercise of their rights and the disposition of the debtor's property. As explained in Chapter 2, these negative insolvency-related incentives are numerous. The current bankruptcy process has various checks and balances to ensure that it is as fair as possible, and because the salvage of an insolvent but viable business takes flexibility, decision-making skill, and judgment, the current law attempts to foster an environment—the corrective bankruptcy market—where these are nurtured and put to good use.[191]

The allure of super-foreclosure is that it promises to routinize the process of transferring ownership of an insolvent enterprise. Transferring ownership, however, is a sideshow, diverting attention from the main event, and leading the discourse into the

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[190] *See* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1932-33 (2006) [hereinafter Baird & Bernstein, *Absolute Priority*] (discussing the use of turnaround specialists).

[191] If anything, increasing complexity in the patterns of corporate indebtedness and other factors underscore the need for such a dynamic environment, and the disutility of *ex ante* contracts to address them. *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 42 (discussing structural changes in debt holding patterns and other factors, and the corresponding difficulties this poses for business reorganization law and practice).

underbrush. What really matters is how bankruptcy law responds comprehensively to the problems that explain its existence through its mechanisms of debt enforcement, debt forgiveness, and debt adjustment, and how these seek to achieve improved dispositions of the debtor, the debtor's assets, and the debtor's liabilities. In addition, corporate bankruptcy law is complex because the reality of business reorganization is complex. This is not surprising. If optimal outcomes in this context were so simple, any old law (or contract) could do it.

THE COST-OF-CAPITAL METRIC

A few words also should be said about the idea that the normative aim of business bankruptcy should be singularly to reduce the cost of capital for firms, and correspondingly that any bankruptcy procedure should be measured in terms of how it accomplishes this goal—the "cost-of-capital" metric.[192] Once again, the idea here is that (1) increasing payouts to financial creditors will reduce borrowing costs by curtailing their losses; (2) reducing borrowing costs will increase the likelihood that firms will pursue a greater number of worthwhile projects because firms will have to share less of the returns with their lenders; and (3) all other things being equal, the increased pursuit of worthwhile projects is likely to be wealth maximizing. In other words, the cost-of-capital metric aims to measure a potentially wealth-maximizing dimension of the debt-collection aspects of bankruptcy law. The chief problem with this metric, however, is that it attempts to import improvidently into the insolvency context one narrow justification for non-bankruptcy debt-collection procedures and, in the process, ignores the other

[192] *See* Schwartz, *Normative Theory*, *supra* note 9 at 1203.

beneficial functions of the bankruptcy system. In this regard, it is aligned with Jackson's forum-shopping argument and suffers from similar weaknesses.

A second problem is also one noted previously—regardless of how it is structured, a bankruptcy procedure devoted to increasing payouts to creditors is unlikely to reduce borrowing costs significantly because any increase is likely to be trivial within the larger context of the overall lending market.[193] A third problem is that, even if increasing payouts to creditors in bankruptcy could reduce borrowing costs significantly, doing so will not necessarily result in the pursuit of more worthwhile projects. In fact, it may have the opposite effect—and in the process simply generate externalities born by other constituents. Recognizing this implicitly, bankruptcy law aims to be ameliorative in ways the cost-of-capital metric simply does not capture.

As applied to firms, bankruptcy law has traditionally sought to advance several recognized goals through its various features of debt collection, debt forgiveness, and debt adjustment: (1) orchestrating the claims of creditors and enhancing their return by reducing costs;[194] (2) deleveraging the firm's balance sheet so that it may reorganize and

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[193] *See supra* at 73. As noted, the overall lending market is enormous, involving many trillions of dollars. In contrast, the number of firms that file for bankruptcy is miniscule. *See supra* note 95. Although as a positive matter bankruptcy law aims to improve the payouts creditors receive, the difference between what they receive through the bankruptcy process and what they would have received in the absence of bankruptcy is not likely to be significant in the overall scheme of things.

[194] *See, e.g.*, Karen M. Gebbia-Pinetti, *Interpreting the Bankruptcy Code: An Empirical Study of the Supreme Court's Bankruptcy Decisions*, 6 CHAP. L. REV. 173, 187 (2000) (observing that one of the recognized policies of the Bankruptcy Code is "the maximization of value"); Warren, *Bankruptcy Policymaking*, *supra* note 10 at 346 ("A number of provisions [of the Bankruptcy Code] are designed to increase collection efficiency in a bankruptcy action; quick decisions, abbreviated trials, estimation of claims, elimination of duplicate efforts, restricted notification requirements, reduced waiting periods, minimal paperwork, automatic stays from collection, stipulated valuations, and emergency orders are all bankruptcy devices intended to capture value for

unencumbering assets to avoid misuse of economic resources;[195] and (3) adjusting the creditors' priorities and entitlements to facilitate ratable distribution and loss spreading.[196] The prominent feature of the cost-of-capital metric is that it selectively culls these policies, narrowly reducing them to one (the debt-collection goal of maximizing the return of financial creditors), but does not evaluate whether doing so is inappropriately reductionist or would have the effect of ignoring (or generating) offsetting costs.

By analogy, in considering legal rules that address the problem of products involved in accidents that inflict costs on multiple parties, one would not measure the utility of any particular regulation (for example, a particular liability rule) solely by its ability to lower the product owner's cost of acquiring the very product involved in the accident. For example, one would not evaluate a liability rule that precludes individual aircraft accident victims from recovering damages simply by whether it lowers the carrier's cost of acquiring aircraft precisely because doing so would ignore the costs of

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the estate under the adverse conditions that multiparty litigation and a failing business present.").

[195] *See supra* notes 72, 74, 76, *infra* note 334; *see also* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 527 (1984) (observing that "the policy of Chapter 11 is to permit successful rehabilitation of debtors"); United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983) (stating that "Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap'").

[196] *See* Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co., 547 U.S. 651, 654 (2006) ("the Bankruptcy Code aims, in the main, to secure equal distribution among creditors"); Young v. Higbee Co., 324 U.S. 204, 210 (1945) ("one of the prime purposes of bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt's assets"); Kothe v. R.C. Taylor Trust, 280 U.S. 224, 227 (1930) ("The broad purpose of the Bankruptcy Act is to bring about an equitable distribution of the bankrupt's estate"); 11 U.S.C. § 507 (2000 & Supp. 2006) (prescribing priorities for certain types of claims, including those of a debtor's employees).

the rule borne by individual crash victims.[197] Likewise, in cases in which a debtor's insolvency impacts multiple parties (which is almost always the case),[198] one cannot evaluate the efficiency of any bankruptcy law simply by looking at whether it reduces the transaction costs between the borrower and one type of creditor.[199]

To illustrate, imagine once again the hypothetical Firm discussed above. At the outset (Time One), Firm is worth $1,000, has one shareholder (Investor) who runs Firm, and has five creditors: a secured creditor (Bank) holding a claim of $400 for a loan secured by a lien on Firm's assets; a tort creditor (Victim) holding a claim of $100 for an environmental tort Firm committed; an employee (Worker) holding a claim of $100 for unpaid wages and benefits; a supplier (Vendor) holding a claim of $100 for unpaid goods sold to Firm; and a government agency (Tax Collector) holding a claim of $100 for unpaid taxes. Six months later (Time Two), Firm has declined in value to $500, is now insolvent, and needs to reorganize. Assume that Firm is worth more if it reorganizes than if it liquidates, and that Firm currently employs Worker under a long-term contract. Under the cost-of-capital metric, the ideal disposition of Firm is the one that results in the

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[197] *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1907-1909 (1991) (discussing incentives and risks to unlimited liability and the impact on cost shifting); *see generally* David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991) (discussing the financial effects of limited liability).

[198] *See* Warren & Westbrook, *Contracting Out*, *supra* note 10 at 1203 (arguing on the basis of an empirical analysis that most bankruptcies involve many different kinds of constituencies).

[199] *See id.* at 1214 (arguing that "if there are creditors who were absent from the bargaining table and cannot adjust behavior or prices to reflect each distinct risk profile [generated by each distinct bankruptcy bargain that binds them], then the efficiencies gained from permitting multiple bankruptcy systems are quickly overwhelmed by the inefficiencies that arise from forcing risks onto parties who cannot adjust their prices to reflect those risks").

greatest payout to creditors who in the future will correspondingly charge less for their extensions of credit. Taking into account the relative investment commitments of the various creditors (namely, that Worker may continue to work for Firm at a reduced amount even if Worker's claim is not paid because of Worker's age, firm-specific skills, a thin labor market, or other factors), and the ongoing ability of Firm to borrow from some creditors involuntarily (namely, it can incur future tort and tax liabilities without paying the claims of Victim and Tax Collector), Firm's ideal disposition under the cost-of-capital metric would be for it to (1) reject its employment agreement with Worker and continue to employ him at a reduced wage without paying his claim, and (2) reorganize its financial affairs by cancelling Investor's interest and transferring all of its value to Bank and Vendor. Most obviously, this outcome ignores the costs placed on Worker, Victim, and Tax Collector.

Finally, as noted, it does not necessarily follow that altering bankruptcy rules to improve the returns of financial creditors will necessarily result in the increased pursuit of worthwhile projects by firms. Assuming realistically a finite (rather than infinite) supply of worthwhile investments (or at least a spectrum of investments, not all of which are equally worthwhile), creditors who assume less risk because they share less of the burden of insolvency may respond by simply maintaining their overall risk exposure across their loan portfolios by lending any surplus to riskier businesses. The net result may be that lenders end up funding riskier projects with the costs borne by other constituents of insolvent firms.[200] To a point, forcing financial creditors to bear

[200] *See supra* note 149. An example is lending in the credit card industry. Historically, credit card issuers would engage in significant underwriting before extending credit. Currently, many issuers perform little (or no) underwriting and extend credit broadly,

("internalize") more of the costs of insolvencies than they would if they were permitted to garner more of the advantages of reorganization for themselves may actually maximize social welfare by *constricting* improvident lending (and thereby avoid at least some insolvencies).[201]

In any event, rather than pursue the singularly narrow goal embedded in the cost-of-capital metric, the current law of business reorganization aims to be beneficial in a broader sense. Every business fails eventually and most fail within a few years of their inception.[202] The reason bankruptcy law attempts to salvage viable firms is because

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with the costs borne generally by consumer constituents through the imposition of high interest rates and other charges. *See* TERESA A. SULLIVAN, ELIZABETH WARREN & JAY L. WESTBROOK, THE FRAGILE MIDDLE CLASS 108-111, 128-132, 134-38, 246-49, 254-55 (2000) [hereinafter SULLIVAN, WARREN & WESTBROOK, FRAGILE] (discussing lending in the credit card industry, its historical evolution, the current lack of underwriting, and interest rate insensitivity).

[201] Improvident lending includes indiscriminate lending with little or no regard to the riskiness of the loan and lending otherwise unaccompanied by the exercise of credit judgment. An example of lending without the exercise of significant credit judgment in the form of underwriting is most lending in the credit card industry. *See id*. at 246-47 (describing extensions of credit in the credit card industry, and explaining "[m]ost issuers, it appears, make little or no attempt to review the borrower's financial status after the initial issuance of the credit card except to raise the limit. The result is an absence of the credit judgment we have traditionally associated with lending, an almost complete disconnection between the circumstances of the borrower and the granting of the credit at the time it is granted."). While highly profitable for creditors, this type of lending, with its high interest rates and charges, can easily spiral out of control and spell financial disaster for debtors. *See id*. at 111-40 (chronicling how to go bankrupt with credit cards). Improvident lending is not limited to the consumer finance arena. *See id*. at 211 (describing bank failures during the twelve-year period between 1980 and 1992 from bad commercial and consumer loans).

[202] *See* TALEB, SWAN, *supra* note 168 at 221 ("Of the five hundred largest U.S. companies in 1957, only seventy-four were still part of that select group, the Standard and Poor's 500, forty years later. Only a few had disappeared in mergers; the rest either shrank or went bust."); Amy E. Knaup, *Survival and Longevity in the Business Employment Dynamics Data*, 128 MONTHLY LAB. REV. 50, 51-52 (2005) (reciting that although two-thirds of new employer establishments survive at least two years, only forty-four per cent survive four years or more); United States Small Business

viable firms are scarce commodities and are themselves vehicles for value creation, which is the primary justification for having firms in the first place. The reason bankruptcy law relieves an insolvent but viable firm from the burdens of excessive indebtedness is not to enhance the creditors' return, but to salvage the enterprise. And the reason bankruptcy law permits the adjustment of the priorities of the various creditors is to pursue the beneficial goal of loss spreading. Again, this is not to say that the payment of claims in bankruptcy is unimportant. It is to say that it is important for reasons that are of secondary significance—largely to avoid the moral hazard of having a bankruptcy law that excused obligations too loosely.[203] Because the cost-of-capital metric cannot appropriately capture the law's true value, it is deficient.

BANKRUPTCY LAW AS AN ASSORTMENT OF LOSS-SPREADING NORMS

In contrast with both Jackson's collective-action approach and the views of those who advocate bankruptcy contracting and the like, other scholars, including Elizabeth Warren, Jay Westbrook, and Lynn LoPucki, reject the idea of bankruptcy law as exclusively, or even predominantly, a debt-collection device as Jackson conceptualizes it. Although these scholars generally acknowledge some version of the collective-action dilemma as one aspect of the phenomenon of insolvency,[204] and have at times identified

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Administration, Advocacy Small Business Statistics and Research: Frequently Asked Questions, #5, available at http://app1.sba.gov/faqs/faqindex.cfm?areaID=24 (detailing that from 2001 to 2005 inclusive, roughly 570,000 to 670,000 small businesses started each year, and roughly 540,000 to 587,000 closed each year).

[203] The relevant concepts of "loss spreading" and "moral hazard" are discussed in Chapter 3.

[204] *See* Warren & Westbrook, *Contracting Out*, *supra* note 10 at 1200 (stating that "[t]he details of the current bankruptcy system are labyrinthine, but they can be described generally as constraining the collection rights of each creditor individually in order to promote a somewhat more efficient liquidation or reorganization for the benefit of all

debt-collection rationales as integral to the bankruptcy process,[205] they also contend that there are other competing reasons for having a bankruptcy law, and have likewise offered their own analytical rubric to compete with Jackson's debt-collection frame. In particular, Warren contends that bankruptcy law is fundamentally a loss-spreading regime animated by an assortment of competing and sometimes conflicting policy goals, including (1) enhancing the value of the debtor's assets, (2) distributing that value equitably among a broad number of constituents, (3) forcing creditors to internalize the cost of credit to avoid losses, and (4) avoiding the need for public bailouts.[206]

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concerned."); *see also* 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, 391 (1993) (discussing the superiority of a collective federal bankruptcy procedure for the disposition of the debtor's assets).

[205] *See* LoPucki, *General Theory*, *supra* note 181 at 315-16 (arguing that "[t]he state remedies/bankruptcy system exists to facilitate the lending of money" and explaining that "[t]he underlying assumption is that if creditors have no means of coercing the repayment of loans, they will be unwilling to make them in the first place and the economy will suffer" and, thus, "coercion of repayment remains a function that is central to the system").

[206] *See* Warren, *Bankruptcy Policymaking*, *supra* note 10 at 343-44 (arguing that bankruptcy law "aims, with greater or lesser efficacy, toward four principal goals: (1) to enhance the value of the failing debtor; (2) to distribute value according to multiple normative principles; (3) to internalize the costs of the business failures to the parties dealing with the debtor; and (4) to create reliance on private monitoring"); Warren, *Bankruptcy Policy*, *supra* note 10 at 777 ("I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. . . . As I see it, no one value predominates, so that bankruptcy policy becomes a composite of factors that bear on a better answer to the question, 'How shall the losses be distributed?"); *see also* Karen Gross, *On the Merits: A Response to Professors White and Girth*, 73 AM. BANKR. L.J. 485, 486-493 (1999) (arguing that bankruptcy law does and ought to take account not only of debtors and creditors, but also of affected communities); Baird, *Uncontested Axioms*, *supra* note 27 at 577-80 (discussing the main schools of thought on the aims of bankruptcy law); Nathalie D. Martin, *Noneconomic Interests in Bankruptcy: Standing on the Outside Looking In*, 59 OHIO ST. L. J. 429, 461-503 (1998) (arguing that noneconomic interests can be adversely affected by bankruptcy and that they should be taken into account by the bankruptcy system). Warren characteristically avoids models that ignore the details of the

Describing how bankruptcy law spreads losses in fulfillment of its embedded policy norms, Warren and LoPucki characterize the bankruptcy process as a federal overlay imposed on existing state-law debt-collection structures, establishing in combination a single comprehensive "system" of rights and remedies, with the federal component essentially balancing deficiencies in the debt-collection aspects of its state law counterpart, including its scheme of distributional entitlements.[207] In contrast with Jackson's forum-shopping concerns, Warren and Westbrook view the adjustment of non-bankruptcy distributional entitlements as a vibrant feature of bankruptcy regulation,[208] and as one intertwined with the issue of how best to preserve a debtor's value and spread the losses occasioned by the debtor's financial demise. Warren contends that it is only because bankruptcy law engages in adjusting the distributional rights of creditors that non-bankruptcy law remains free to function the way it does unburdened with the

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bankruptcy system, and relies more on positive analysis of the law and its underlying policies than abstract theory. *See* Warren, *Bankruptcy Policy*, *supra* note 10 at 777-78 ("I begin with a historical observation about legal structures, I surmise the concerns of the drafters, and I end with only tentative conclusions and more complex answers.").

[207] *See* LOPUCKI & WARREN, SECURED CREDIT, *supra* note 32 at 239 (arguing that "[m]ost of the creditor's rights are found in state law; most of the debtor's rights are found in bankruptcy law. The two sets of laws combine to create a system in which the debtor who has the ability to cure a default and make the installment payments generally will have the opportunity to do so."); LoPucki, *General Theory*, *supra* note 181 at 351 (arguing that federal bankruptcy law and the state law system of remedies perform the same functions and concluding that "in dealing with the debtor in financial difficulty the bankruptcy subsystem performs the functions of the state remedies/bankruptcy system better than the state remedies subsystem in nearly every respect").

[208] *See* Warren & Westbrook, *Contracting Out*, *supra* note 10 at 1200-01 (stating that bankruptcy law accomplishes more efficient liquidations and reorganizations than non-bankruptcy law "by shrinking the collection rights of the most powerful creditors in order to achieve somewhat greater distribution among all those who have a stake in the debtor").

protections bankruptcy supplies.[209] Consistent with these views, these scholars are characteristically antagonistic to the priority of secured claims in bankruptcy at the expense of other stakeholders,[210] and they tend to favor reorganizations over liquidations[211] with the value of any reorganization surplus distributed broadly across a number of constituencies affected by the debtor's financial failure.[212]

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[209] *See* Warren, *Bankruptcy Policy*, *supra* note 10 at 779 (arguing that, "[w]ithout the refined and balanced system of debtor-creditor law—which includes a well-developed concept of bankruptcy—contract law itself would look very different, and its enforcement would be considerably more constrained").

[210] *See* Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1379-83 (1997) [hereinafter Warren, *Making Policy*] (arguing for the reformation of Article 9 and a reduced priority for secured claims); Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1467 (1997) [hereinafter Klee, *Barbarians*] (arguing that the case for full priority for secured creditors in bankruptcy remains unproven and that unrepresented parties may deserve higher priority); Lynn M. LoPucki, *The Unsecured Creditors' Bargain*, 80 VA. L. REV. 1887, 1920-24 (1994) [hereinafter LoPucki, *Unsecured*] (challenging the efficiency of the secured creditor's priority); *see also* Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 921-26 (1996) [hereinafter Bebchuk & Fried, *Uneasy Case*] (critiquing the secured creditor's priority in bankruptcy).

[211] *See, e.g.*, Lynn M. LoPucki, *The Nature of the Bankrupt Firm*, 56 STAN. L. REV. 645, 666-70 (2003) (arguing that reorganization is preferable because liquidation sales sometimes destroy value rather than capture it); *but see* Douglas G. Baird & Robert K. Rasmussen, *Reply*: *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 699 (2003) (arguing that "[a]ny going-concern surplus can be captured for creditors via a sale").

[212] *See* Warren, *Bankruptcy Policy*, *supra* note 10 at 777 (describing the loss-spreading function of bankruptcy law); *see also* KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM 3, 8 (1997) (arguing that bankruptcy law should provide protection to disadvantaged constituencies); Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031, 1035 (1994) (discussing a framework of bankruptcy that takes into account the interests of communities affected by a debtor's failure); Butler & Gilpatric, *Re-Examination*, *supra* note 53 at 289 (arguing that "the goal of the bankruptcy system should be economic efficiency in a broad sense: to maximize the value to society of the debtor firm by preserving the private and social components of its going concern surplus when such a surplus exists, or by achieving the highest possible liquidation value when it does not"); David G. Carlsen, *Contemporary Issues in Bankruptcy and Corporate Law: Bankruptcy*

With their relatively complex conceptualizations of the structures and purposes of bankruptcy law, and their focus on its interplay with state-law debt-collection mechanisms, these scholars more successfully describe the complexity of the phenomenon of insolvency and its impact on those affected by it, and likewise the complexity of bankruptcy law's response to this phenomenon. Among other things, they take into fuller account the vital role and significance of the debtor's discharge, and also the importance of having some centralized mechanism of "control" over the debtor, its assets, and its liabilities as a means of fulfilling bankruptcy law's discrete policy objectives.[213] As a normative matter, however, their approach falls short in terms of explaining both the need for a distinct collection of bankruptcy remedies and how those remedies ought to be arranged.

First, to say that the content of bankruptcy law expresses a collection of competing and sometimes conflicting policy goals offers little normative guidance in deciding what the make-up of that collection should be, or how best to resolve conflicts

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Theory and the Creditors' Bargain, 61 U. CIN. L. REV. 453, 471 n.72 (1992) (criticizing Jackson's account for its exclusion of constituents other than creditors); *see generally* Julie A. Veach, Note, *On Considering the Public Interest in Bankruptcy: Looking to the Railroads for Answers*, 72 IND. L. J. 1211, 1229-30 (1997) (arguing that railroad reorganizations offer clues about how to give a greater number of interested parties voices in the bankruptcy process).

[213] *See* WARREN & WESTBROOK, LAW, *supra* note 66 at 409 ("The law's immediate responses to the filing of a bankruptcy petition . . . put the courts in overall charge of the debtor and its business and therefore empower these agents of government to impose socially mandated policies on the process of sorting out the effects of a debtor's general default."); Jay L. Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 803-05 (2004) (discussing how centralized control over the debtor, its assets, and its liabilities ensures the fulfillment of the policies that bankruptcy law champions).

between the relevant policies when they clash.[214] It is not enough simply to say that bankruptcy law expresses a number of policies and then offer a descriptive list with supporting commentary (albeit extensive in scope). Among other considerations, without some organizing theory to help separate the wheat from the chaff, the content of bankruptcy law is left vulnerable to improvident manipulation. Instead of responding coherently to the reasons that justify its existence, it is susceptible to becoming (and at times has become) a vehicle of inept social experimentation. For example, in recent years well-organized and well-funded interest groups have successfully lobbied Congress to alter the policy focus of the Bankruptcy Code and implement costly obstacles to bankruptcy relief, with disappointing results.[215] In order to evaluate the policies that bankruptcy law expresses (or should express), it is first essential to understand why having *any* set of bankruptcy policies is worthwhile. In other words, it is essential to understand more fully the problems that bankruptcy law properly aims to redress. Once that it done, the analysis can then proceed to examine more fruitfully both the specific

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[214] *Cf*. Schwartz & Scott, *Contract Theory*, *supra* note 83 at 543 (criticizing contract theories that lack a governing principle to resolve conflicts between the relevant goals that the theories endorse).

[215] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 252-61 (critiquing various bankruptcy reform proposals); Kara J. Bruce, *Rehabilitating Bankruptcy Reform*, 13 NEV. L.J. 174 (2012) (discussing bankruptcy reform, the extensive 2005 amendments to the Bankruptcy Code, the role of interest groups, and criticisms of the amendments); Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603 (2005) (noting the responsiveness of the 2005 amendments to interest-group initiatives); Henry J. Sommer, *Trying to Make Sense Out of Nonsense: Representing Consumers Under the "Bankruptcy Abuse prevention and Consumer Protection Act of 2005"*, 79 AM. BANKR. L.J. 191 (2005) (criticizing the 2005 amendments to the Bankruptcy Code); Charles J. Tabb, *A Century of Regress or Progress? A Political History of Bankruptcy Legislation in 1898 and 1998*, 15 BANKR. DEV. J. 343, 350-53 (1999) (discussing the politics surrounding proposed bankruptcy reform in 1998).

policies that bankruptcy law ought to embody and the best conceptual framework for organizing them.

Second, the absence of a governing theoretical framework is not solved by conceptualizing bankruptcy law as a "loss-spreading" regime because, by itself, this label is too vague. Many legal institutions spread losses, and this thematic characterization raises several fundamental questions, including what kind of loss-spreading mechanism is the most appropriate in this context and why? Among other difficulties, the concept of loss-spreading is, without more, susceptible to the criticism that it, too, is merely a vehicle of wealth transfer. What remains to be explained is how loss spreading in the bankruptcy context can be beneficial and in what way. For example, it is certainly true that there are deficiencies in current non-bankruptcy debt-collection mechanisms. But rather than attempt to correct these deficiencies through a system of bankruptcy law that applies only sporadically when a debtor happens to commence a federal bankruptcy case, why not correct them directly through reform of the non-bankruptcy debt-collection mechanisms themselves?[216] As Warren, Westbrook, and others have recognized, a debtor's insolvency is not an opportunity to correct every perceived distributional injustice that happens to show up in a bankruptcy case.[217] Bankruptcy law's loss-spreading ambitions should be more carefully defined and tailored so that bankruptcy law does not take on problems of a more general nature best left to resolution in some other market.

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[216] *See* Baird, *Loss*, *supra* note 8 at 823-24 (making this point).

[217] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 197 ("It is always a mistake . . . to think that the law can fix everything.").

For example, Warren and others have expressed hostility toward the enforcement of the priority of security interests in bankruptcy because doing so prefers the holders of those interests (typically financial creditors) over others (such as tort victims, employees, and small trade creditors).[218] A security interest, however, often has its greatest utility to a secured creditor when the debtor is insolvent. By definition, an insolvent debtor cannot pay all claims in full, and a properly taken security interest ensures that the secured party will recover at least the value of its collateral ahead of other claimants. If the bankruptcy market did not recognize the payment priority of security interests in prescribing the division of the debtor's assets (at least to the point of delivering to the secured creditor what the secured creditor would have received outside the bankruptcy context), then one of the most essential values of these financing devices would be destroyed. One might well question whether that would be a desirable achievement, particularly given the size of the secured lending market (in the trillions of dollars).[219] Security interests are presumably beneficial in some way. If they are not, then perhaps they should be eliminated or restricted as a matter of non-bankruptcy law. If they are *generally* beneficial, but not so only in the special world of insolvency, then perhaps bankruptcy

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[218] *See supra* note 210, *infra* note 238.

[219] *See* Steven L. Harris & Charles W. Mooney, Jr., *Measuring the Social Costs and Benefits and Indentifying the Victims of Subordinating Security Interests in Bankruptcy*, 82 CORNELL L. REV. 1349 (1997) [hereinafter Harris & Mooney, *Measuring*] (arguing against the subordination of security interests because doing so would promote inefficient conduct); Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL L. REV. 1396, 1414-19 (1997) [hereinafter Schwartz, *Priority*] (arguing that the case for restricting security interests in bankruptcy is weak); Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436, 1460-61 (1997) [hereinafter Scott, *Truth*] (arguing that secured creditors' claims should be accorded full priority because they facilitate positive value projects).

law might restrict them in some appropriate way—to the extent doing so would not completely erode their optimal utility generally. But that remains to be demonstrated.

Third, the concept of bankruptcy law as simply a component of a single "system" of overlapping and interlocking federal and state remedies obscures more than it reveals. In particular, it obscures the properly distinct features and boundaries of the bankruptcy marketplace,[220] and begs the critical question of when is it appropriate to invoke bankruptcy law's unique body of remedial mechanisms. The bankruptcy and non-bankruptcy markets are not fungible. Consistent with any coherent theory of credit and risk, debtors may not simply resort to the non-bankruptcy markets to incur credit in the first instance and then transport themselves at will to the bankruptcy market to discharge their obligations regardless of their financial circumstances.[221] Access to the bankruptcy market is necessarily constrained, and more than anything else the criteria for access to that market separates it from the non-bankruptcy world.

Similarly, bankruptcy law does not exist to cure deficiencies in the debt-collection mechanisms of non-bankruptcy markets as those mechanisms apply *generally* within those markets. Bankruptcy law properly exists to address the problems of insolvency within the context of the bankruptcy marketplace when it is appropriate for debtors to be in that special place, and the criteria for access to the bankruptcy market should be based on the need for bankruptcy relief, namely the presence of the problems that justify having a bankruptcy market in the first place. Although there is much about the loss-spreading

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[220] *See* LoPucki, *General Theory*, *supra* note 181 at 352, 362 (complaining that, as part of a single system, state debt-collection law and bankruptcy law interact "inadvertently," and arguing in favor of a better channeling mechanism).

[221] *See* Jackson, *Fresh-Start*, *supra* note 20 at 1427 (observing that free access to discharge relief would be disastrous to an economy that is based on credit).

approach that is admirable—especially its rejection of Jackson's narrow debt-collection frame in favor of a more eclectic view of the debt-collection, debt-forgiveness, and debt-adjustment aspects of bankruptcy law—the loss-spreading approach requires greater theoretical definition to guide its implementation.

In sum, just as Jackson's conception of bankruptcy law as a debt-collection device to implement a hypothetical creditors' bargain is too narrow, the conceptualization of bankruptcy law as a loss-spreading vehicle intertwined with non-bankruptcy debt-collection mechanisms as a means to express an assortment of competing and conflicting policy goals is also unsatisfying and requires a better theoretical organization. Whereas Jackson's approach focuses too rigidly on the debt-collection aspects of bankruptcy law, the view that bankruptcy law is fundamentally a loss-spreading regime focuses too loosely on the re-distributional power of its debt-adjustment and debt-forgiveness features. Once again, the questions persist: why should we have a distinct bankruptcy regime and how should it be arranged?

As summarized at the outset, I argue that the purpose and art of bankruptcy law is essentially to turn a sow's ear into a silk purse. The sow's ear equates to the problems of insolvency. The silk purse is what bankruptcy law does with the person, property, and liabilities of the debtor in response to these problems because these problems are costly. The key to understanding the role of bankruptcy law, however, is to understand that the problems it properly addresses are all *insolvency*-related. Ordinary non-bankruptcy debt-collection systems are not so limited. They govern the typical mine run of debt-collection activities involving debtors both solvent and not. Bankruptcy law unavoidably interferes with their operation—indeed, it essentially supplants them. But as a normative

matter it does so only in defined circumstances, and then again only to achieve beneficial dispositions of the debtor, its property, and its liabilities.

To better understand how and why this is so, it is useful first to examine in a more focused way the problems of insolvency that justify having a distinct bankruptcy law. That is the purpose of Chapter 2. Chapter 3 follows with an examination of the debt-collection, debt-forgiveness, and debt-adjustment features of bankruptcy law that address the problems of insolvency. As I explain, each of these features properly responds to distinct categories of the problems of insolvency in distinct ways. I then evaluate these features and the solutions they offer using three different standards: (1) equity (fairness), (2) efficiency (wealth-maximization), and (3) entitlement (the preservation of protected interests). I also use these standards to evaluate how bankruptcy prioritizes its various debt-collection, debt-forgiveness, and debt-adjustment mechanisms. In addition, Chapter 3 offers the details of my theory on how bankruptcy law ought to respond to the problems of insolvency through the vehicle of a corrective bankruptcy market that incorporates these mechanisms. Finally, Chapter 3 offers a brief conclusion.

CHAPTER 2

The Problems of Insolvency

Bankruptcy law is characteristically complex, time-consuming, and expensive. So why have it? Is it to solve the collective-action dilemma? Is it to help drive down the costs of credit? Is it to cure various defects in non-bankruptcy debt-collection systems for the sake of promoting a handful of important policy objectives? Or is it for some other reason?

It must be admitted that it is at least theoretically possible that a bankruptcy system might be crafted purely as a debt-collection regime focused exclusively on addressing the collective-action dilemma. But as discussed in the preceding chapter and elaborated below, bankruptcy law is not so narrowly instrumental and for good reason: the collective-action dilemma is not the only problem in need of remediation—there are others of greater significance.

Likewise, it is possible that a bankruptcy system might be constructed purely as a debt-collection device devoted exclusively to reducing borrowing costs. But as also discussed in the preceding chapter, this assumes that borrowing costs are in need of remediation and, more dubiously, that bankruptcy law might meaningfully reduce them. More important, focusing on the reduction of borrowing costs is again too instrumentally narrow because it assumes away other problems and costs that bankruptcy law properly addresses.

Finally, it is possible that a bankruptcy system might be crafted as an "add-on" to state law debt-collection devices for the sake of rewiring these devices to promote a number of policy goals. But as discussed in the preceding chapter, bankruptcy law is not so invasively super-normative. General defects in non-bankruptcy debt-collection systems should be remedied as such. Bankruptcy law, so to speak, has its own fish to fry. In order to gain some purchase on the kinds of problems that bankruptcy law properly addresses, however, it is first useful to pause for a moment and consider more generally the role of law as a problem-solving mechanism, as well as how the relevant problem set for any particular branch of law may be identified.

Although scholars have long wrangled over the most useful articulation of the concept of "law," and in the process have offered a number of competing perspectives of varying clarity and coherence,[222] one thing appears relatively uncontroversial: laws

[222] John Austin (1790-1859) defined it as the command of the sovereign backed by threats. JOHN AUSTIN, THE PROVINCE OF JURISPRUDENCE DETERMINED, Lecture VI (1832) (defining laws as commands, and stating that a law is "a rule laid down for the guidance of an intelligent being by an intelligent being having power over him"). Oliver Wendell Holmes, Jr. (1841-1935) defined it famously as "the prophesies of what the courts will do in fact . . . ." Oliver W. Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 460-61 (1897) [hereinafter Holmes, *Path*]. Similar to Austin, Hans Kelsen (1881-1973) defined it as "the primary norm, which stipulates the sanction." HANS KELSEN, GENERAL THEORY OF LAW AND STATE 61 (1945). Karl Llewellyn (1893-1962) defined it as "[w]hat officials do about disputes . . . ." KARL N. LLEWELLYN, THE BRAMBLE BUSH 5 (Oxford 2008). Criticizing Holmes, Llewellyn remarked that "[n]o vast literature is dedicated to answering the questions 'What is chemistry?' or 'What is medicine?'" and quipped that no one would think to respond to these questions with such answers as "a prediction of what doctors will do." *Id*. at 1. Breaking ranks with earlier theorists, H.L.A. Hart (1907-1992) avoided offering a definition of the law "in the sense of a rule by reference to which the correctness of the use of the word can be tested," preferring instead to "advance legal theory by providing an improved analysis of the distinctive structure of a municipal legal system" together with "a better understanding of the resemblances and differences between law, coercion, and morality, as types of social phenomenon." H.L.A. HART, THE CONCEPT OF LAW 17 (Oxford 2d ed. 1994) [hereinafter HART, CONCEPT]. In particular, Hart avoided a court-centered approach, offering instead

address certain kinds of social phenomena. More specifically, they address social phenomena that satisfy what Scott Shapiro has called the "circumstances of legality," meaning social problems of a serious nature that are sufficiently "complex, contentious,

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the idea of law as a broader form of social regulation, stating that "[t]he principle functions of the law as a means of social control are not to be seen in private litigation or prosecutions, which represent vital but still ancillary provisions for the failures of the system," but rather are to be seen "in the diverse ways in which the law is used to control, to guide, and to plan life out of court." *Id*. at 40; *see also* RAWLS, THEORY, *supra* note 98 at 236 (defining "legal order" as a "system of rules addressed to rational persons"). Charting his own course, Ronald Dworkin (1931-2013) also avoided defining the subject in a short descriptive phrase, instead contending more abstractly "that legal reasoning is an exercise in constructive interpretation, that our law consists in the best justification of our legal practices as a whole, that it consists in the narrative story that makes of these practices the best they can be." DWORKIN, LAW'S EMPIRE, *supra* note 14 at *i*; *see also* PAUL W. KAHN, THE REIGN OF LAW 45 (1997) [hereinafter KAHN, REIGN] (articulating an approach to the rule of law "as a set of beliefs by which members of the American culture understand themselves and their world"); LON FULLER, THE MORALITY OF LAW (1969) (elaborating an internal morality of law). Scott Shapiro has offered still another take, conceptualizing law as fundamentally a sophisticated social planning tool, arguing that "[b]y providing a highly nimble and durable method of social planning, the law enables communities to solve the numerous and serious problems that would otherwise be too costly or risky to resolve." SHAPIRO, LEGALITY, *supra* note 37 at 170. Shapiro observes that humans are planning creatures, *id*. at 119; laws facilitate planning in contexts in which shared activity may be particularly complex or contentious, *id*. at 134; and "whenever the law properly addresses a particular social problem, it does so because, given current social conditions, alternative methods of planning are somehow deficient," *id*. at 175. Central to this view is the idea that the law properly addresses significant *problems* of social planning. *See id*. at 170. As I discuss in greater detail in this chapter and Chapter 3, bankruptcy law addresses certain social problems (the "problems of insolvency") that arise from economic failure, including the failure of plans. Among other things, bankruptcy law does this to facilitate future planning activities within ordinary non-bankruptcy markets by remediating the problems of insolvency so that insolvent debtors and their property may once again return to, and participate fully in, ordinary markets unburdened by the waste, inefficiency, and distorted decision-making incentives that insolvency generates. The need for bankruptcy law arises in the first instance, however, because the problems of social failure that I identify are typically complex and contentious—hence the need for some kind of law to address them. In turn, they are properly the subject of bankruptcy law because they are all insolvency related and it would make no sense to burden non-bankruptcy legal systems with mechanisms for their resolution—it is far more appropriate to deal with them through a specialized body of bankruptcy law. For an earlier discussion of various aspects of the problems of insolvency, see G. Eric Brunstad, Jr., *Bankruptcy and the Problems of Economic Futility: A Theory on the Unique Role of Bankruptcy Law*, 55 BUS. LAW. 499 (2000).

or arbitrary" to be appropriate for legal ordering and resolution, as opposed to those better left to "nonlegal forms of ordering behavior, such as improvisation, spontaneous ordering, private agreements, communal consensus, or personalized hierarchies."[223] We may refer to problems that satisfy these criteria as "legal problems," in contrast with the more general category of "social problems" from which they are extracted.

Of course, it is not enough for our purposes simply to define in broad terms the kinds of social problems that the law generally addresses. What is needed is some further elaboration to isolate the subset of legal problems that *bankruptcy* law properly attempts to tackle. This requires identifying an appropriate process of descriptive categorization and explanation.[224]

Within our general conception of legality, different kinds of laws obviously address different categories of legal problems. For example, immigration laws respond to immigration problems; tort laws address problems of social behavior giving rise to torts;

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[223] SHAPIRO, LEGALITY, *supra* note 37 at 170. Shapiro derives his definition of the "circumstances of legality" in part from Hume's concept of the "circumstances of justice." *See* DAVID HUME, AN ENQUIRY CONCERNING THE PRINCIPLES OF MORALS, part I, section 3 (1751); SHAPIRO, LEGALITY at 170 n.11. I make use of it here (in somewhat modified form) because it illuminates the fundamental concept that laws address specific kinds of social problems and, implicitly, that before addressing how a particular kind of law should be arranged, it is first necessary to determine the nature of the specific legal problems in need of some form of legal remedy.

[224] *See also* RAZ, AUTHORITY, *supra* note 101 at 167 ("The aim of the analyst should be to propose a classification of the social functions of the law which is of use to the reformer, but is not too closely tied to any particular viewpoint."). Although it may seem obvious, it is important in this setting to consciously distinguish problems from solutions. The identification of problems and the identification of solutions are discrete inquiries. For example, a social problem does not disappear simply because we have concluded that it is not worth remediating on the theory that the available solutions are worse than the problem. We may call this the "problem/solution dichotomy." It is important as a tool for organizing the analysis of problem identification as distinct from the analysis of selecting appropriate solutions to problems. *See also supra* note 7, *infra* note 226.

contract laws respond to problems with the creation and enforcement of contractual agreements; and criminal laws address problems of social conduct giving rise to crimes.[225] It is also true that laws generate social effects, which may in turn lead to more problems and perhaps more laws (or revisions of laws), but the first step in conceptualizing what a particular law should look like is to identify the particular legal problem or problems that give rise to the need for the specific law in question. Logically, bankruptcy law should address bankruptcy problems. But what are these? The answer to this threshold question is critical because, without it, one cannot proceed meaningfully to the subsequent question of how bankruptcy law ought to respond to the problems that justify its existence.[226]

In order to answer the threshold question adequately, it is necessary both to describe the relevant problems *and* explain why, in fact, they constitute a distinct set in order then to proceed to make correlative value judgments about the relevant problems. As Eugene Meehan has stated, "[v]alue judgments are absolutely contingent upon

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[225] Among other things, if no one ever stole anything, there would never have been any need for the proscription "thou shalt not steal." As Shapiro observes, "[l]egal institutions are supposed to enable communities to overcome the complexity, contentiousness, and arbitrariness of communal life by resolving those social problems that cannot be solved, or solved as well, by nonlegal means alone." SHAPIRO, LEGALITY, *supra* note 37 at 171. By extension, in a purely ideal world that lacked social problems, there would be no need for law. We may call this the "no problem, no law" hypothesis. This is not a circular tautology because, although laws may themselves create social problems, social problems may exist without laws. Social problems come first, laws second.

[226] As noted, because laws properly respond to social problems (perceived or real) that satisfy the circumstances of legality, without such social problems there would be no real need for law. *See supra* note 223. It follows that it is necessary to identify the problems one is hoping to resolve legally before turning to how the law might actually go about doing so. *See also supra* notes 7, 224.

descriptions and explanations."[227] For example, until a situation has been described accurately, and the consequences of the choices open to the actor have been identified by an accurate explanation of the nature of the situation, "no [meaningful] choice can be made."[228] That is because "[e]very choice implies a description and an explanation of the empirical world" and "[w]ithout adequate descriptions and explanations, the actor in the situation is forced to choose among unknown [alternatives]—a contradiction in terms . . . [resulting in] randomness."[229]

Stated somewhat differently, there is an embedded *normative* aspect to the process of problem identification for the purposes of defining an area of law such as bankruptcy. The inquiry is not simply the positive one of what problems bankruptcy law happens to address. The real challenge is to identify the problems that bankruptcy law *ought* to remedy. This is more complicated, requiring both a description of a potential problem to be included on the list (the positive inquiry) and an explanation why it should be there (the normative inquiry). Once that is done, however, the analysis can then proceed to how bankruptcy law might be arranged to address the relevant problems. This chapter is devoted to identifying and explaining why a particular set of social problems—the problems of insolvency—are properly the subject of a discrete area of law devoted to their resolution called "bankruptcy law." Chapter 3 addresses the subsequent normative question of how bankruptcy law should go about resolving them.

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[227] EUGENE J. MEEHAN, VALUE JUDGMENT AND SOCIAL SCIENCE 54 (1969).

[228] *Id*. at 54-55.

[229] *Id*. at 55.

DEFINING THE RELEVANT PROBLEM SET

The problems that justify having a distinct bankruptcy law cannot be the same as the problems of the law generally; they are necessarily narrower. In addition, the problems that justify having a distinct bankruptcy law cannot be the same as, say, the general problems that tort and contract law remedy; they are necessarily different if, indeed, bankruptcy law is to have its own distinct content and successfully avoid the forum-shopping problem.[230] Traditionally, bankruptcy law has focused on addressing a number of problems that arise when a debtor becomes insolvent.[231] Accordingly, it makes sense to begin with some analysis of what the "problems of insolvency" actually are and whether they warrant a special body of law to address them. As we shall see, the essential problems of insolvency are sufficiently "complex, contentious, and arbitrary" to satisfy the circumstances of legality.[232] They are likewise sufficiently unique to justify having a distinct bankruptcy law to remedy them because they are all insolvency related and it would make no sense to treat them as part of some other body of law. Social problems that satisfy these criteria—namely, those that are sufficiently complex and contentious to satisfy the circumstances of legality—and are also sufficiently insolvency

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[230] *See supra* at 12, 47-53 (discussing the forum-shopping problem).

[231] The term "insolvent" is defined in *supra* note 1.

[232] A problem is "complex" to the extent it is not capable of simple, expedient resolution. A problem is "contentious" to the extent it invites social conflict. A problem is "arbitrary" to the extent it naturally invites relatively arbitrary resolution, such as whether cars should be driven on the right- or left-hand side of the road—in such cases it may matter more that a decision selecting one or the other as the rule is made, rather than which decision is made. *See* SHAPIRO, LEGALITY, *supra* note 37 at 109 ("preferences for everyone riding on the right could always be changed to the left if it were supposed that almost everyone rides on the left instead"). Behavior may also be arbitrary in a different sense: it may be irrational. Irrational behavior can be a social problem that is both complex and contentious, and can also lead to social failure in the form of insolvency.

related to justify a special body of law to address them, may be thought of as satisfying the "circumstances of bankruptcy legality."

Although they overlap in some respects, the unique problems of insolvency that bankruptcy law properly addresses fall into three separate categories: (1) special problems of claims mediation and payment discrimination; (2) unique challenges of overinvestment, underinvestment, and other moral hazard; and (3) unrecoverable collection, monitoring, and related costs associated with a debtor's financial ruin. These problems are each described below, together with an explanation of why they are properly the subject of a distinct body of bankruptcy law.

Problems of Claims Mediation and Payment Discrimination

Most debtors owe debts to more than one creditor. In the case of an individual, it is not uncommon for the debtor to have a dozen creditors or more, ranging from the finance company that financed the debtor's car, the utility company that supplies the debtor with electricity each month, and the bank that extends credit through the debtor's use of a credit card. In the case of a firm, there may be thousands, even tens of thousands of creditors (or more). By definition, a solvent debtor can satisfy all claims in full. Thus, in the context of solvency, there is generally no need to decide, for example, whether a tort liability is more important than a contractual debt, or whether a tax obligation is more important than a debt for child support. Similarly, so long as the debtor remains solvent, there is generally no reason for complaint if on a temporal basis the debtor pays one debt ahead of another—by definition, a solvent debtor can still pay all other claims in full. If a debtor becomes insolvent, however, things are quite different.

Because an insolvent debtor cannot satisfy all claims in full, there arises the problem of conflicts between competing obligations such as, for example, tax collectors and tort victims, employees and bondholders, the local environmental protection agency and the local finance company.[233] Similarly, the debtor's inability to satisfy all claims in full gives rise to the possibility (and frequent reality) of payment discrimination—the debtor's payment of some claims ahead of others for reasons that typically have little or nothing to do with the relative merit of the competing claims or some normative evaluation of whether one should be paid ahead of others.

Moreover, the views of the affected parties on how to resolve these conflicts and discriminations are not likely to be consensual. For example, an unpaid tort victim is not likely to agree that the payment of a tax obligation is more important than the satisfaction of his claim. Similarly, employees are not likely to agree that their claims should be paid only after a debt to a finance company has been satisfied in full. In turn, the unpaid creditors of an insolvent debtor are likely to look jealously at the funds the debtor has transferred to some other creditor who thereby receives payment in full. Accordingly, these aspects of the phenomenon of insolvency—conflicts among competing claims and payment discriminations—are likely to be both complex and contentious. Because they are also uniquely insolvency related and it would make no sense to address them through non-bankruptcy laws, they properly satisfy the circumstances of bankruptcy legality and are thus properly the subject of a special bankruptcy law.

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[233] *See* Barry A. Adler, *The Law of Last Resort*, 55 VAND. L. REV. 1661, 1663, 1674 (2002) [hereinafter Adler, *Law*] (observing that, when obligations conflict, bankruptcy law "fills the breach" with a means to "choose among them," and arguing that bankruptcy law must reconcile "mutually insupportable obligations").

CLAIMS MEDIATION

In the insolvency context, conflicts among competing claims typically arise in one of two distinct ways. First, they occur between different obligations arising under the same body of law (such as between two tort claims, or between two contractual debts). As a general rule, tort law itself does not supply any overt mechanism for prioritizing one type of tort claim over another (e.g., a claim for negligence versus a claim for conversion). It simply prescribes rules regarding the imposition of liability. The question of priority among conflicting obligations is left to some other body of law, in part because it is difficult to conceive how tort law might handle this issue given the involuntary nature of tort obligations, and in part because the issue typically only matters if the tortfeasor cannot satisfy all claims in full (i.e., becomes insolvent).

In contrast, contract law commonly facilitates the prioritization of competing claims among creditors, but only incompletely. For example, two creditors holding potentially conflicting obligations may enter into a binding contractual subordination agreement. Under the terms of their contract, one creditor agrees (in exchange for some type of consideration) that its claim will have a priority junior to the claim held by the other creditor.[234] In general, however, agreements of this kind bind only the specific parties that elect to enter into them, and two creditors cannot by agreement alone subordinate the claim of a third party who has not consented to be subordinated.[235] Accordingly, the general reach of these types of instruments is limited to the specific

[234] *See supra* note 171, *infra* note 244 (discussing subordination agreements); *see also* 4 ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY ¶ 510.03 (16th ed. 2012) [hereinafter COLLIER ON BANKRUPTCY] (describing the nature and enforceability of subordination agreements in bankruptcy).

[235] *See id.*; *supra* note 44.

parties who have agreed to prioritize their claims among themselves, and does not typically affect the debtor's general creditor body.

A partial exception exists in the form of security interests. Under the law of secured transactions, a debtor and creditor may enter into a contract granting the creditor a priority right in specific items of the debtor's property (the "collateral") in exchange for some kind of consideration. In theory, the secured creditor essentially "purchases" its priority right to the collateral, even though the debtor typically remains in possession of the property.[236] If certain conditions are satisfied, this contract will be binding on other creditors irrespective of their consent (and even irrespective of whether they receive actual notice of the secured creditor's interest).[237]

One essential purpose of security interests is to assure that the secured party will have an isolated source of payment ahead of other claimants, ostensibly to induce the secured creditor to engage in transactions with the debtor on terms more favorable than the debtor could obtain otherwise.[238] The result is akin to what would happen if the

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[236] The Uniform Commercial Code treats the interest of the secured creditor as a "purchase." *See* U.C.C. § 9-201(b)(29) (defining the term "purchase" to include the taking of a security interest). This, of course, is a fiction, but is one that facilitates a large amount of lending.

[237] *See* U.C.C. § 9-201(a) (providing that "except as otherwise provided in [the Uniform Commercial Code], a security agreement is effective according to its terms between the parties, against purchasers of collateral, and against creditors."); *see also* 4 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 33-2 (5th ed. 2002) ("The sentence means what it says; the secured creditor, even an unperfected secured creditor, has greater rights in its collateral than *any other* creditor, unless the [UCC] provides otherwise.") (emphasis added).

[238] *See, e.g.*, Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929, 934-47 (1985) [hereinafter Kripke, *Law*] (arguing that secured financing provides a number of micro- and macroeconomic benefits, including permitting the debtor to acquire assets either that the debtor otherwise would not be able to obtain at all, or at a greater cost). Scholars have

secured party had actually purchased the item of collateral for value and taken possession of it, thereby removing it from the pool of assets other creditors could look to for the satisfaction of their claims (replaced by the consideration the secured creditor supplies in exchange for its priority right).[239] In theory, the added benefit of a secured transaction to the debtor and the debtor's other creditors is that the secured party who has "purchased"

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both criticized and defended the general efficiency of security interests. *See, e.g.*, Thomas H. Jackson & Alan Schwartz, *Vacuum of Fact or Vacuous Theory: A Reply to Professor Kripke*, 133 U. PA. L. REV. 987 (1985) [hereinafter Jackson & Schwartz, *Vacuum*] (challenging Kripke's account and arguing that the efficiency of security interests has not been demonstrated); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984) [hereinafter White, *Efficiency*] (arguing that security interests are generally efficient); Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984) [hereinafter Schwartz, *Continuing Puzzle*] (disputing White's account). Some scholars have also challenged the priority treatment of secured claims in bankruptcy and have offered proposals for reform. *See* Warren, *Making Policy*, *supra* note 210 at 1379-83 (arguing for the reformation of Article 9 and the treatment of a secured creditor's priority); Klee, *Barbarians*, *supra* note 210 at 1467 (arguing that the case for full priority remains unproven and that unrepresented parties might deserve higher priority); Bebchuk & Fried, *Uneasy Case*, *supra* note 210 at 921-26 (arguing that permitting secured creditors fully priority in bankruptcy may be inefficient in some cases and offering a proposal for reform); LoPucki, *Unsecured*, *supra* note 210 at 1920-24 (challenging the efficiency of the secured creditor's priority). Others have criticized these critics. *See* Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425 (1997) (criticizing Bebchuk and Fried's proposal and arguing in favor of the secured creditor's priority); Harris & Mooney, *Measuring*, *supra* note 219 (arguing against subordination proposals); Schwartz, *Priority*, *supra* note 219 at 1414-19 (arguing that the case for restricting priority in bankruptcy is weak); Scott, *Truth*, *supra* note 219 at 1460-61 (arguing that secured creditors' claims should be accorded full priority because they facilitate positive value projects).

[239] In general, creditors cannot look to items of property their debtor has sold to a third party for the payment of their claims because these items do not belong to the debtor; they belong to the purchaser. One exception is property the debtor has transferred fraudulently, which may be recovered to satisfy the claims of the debtor's creditors under state or federal law. *See infra* note 345 (discussing fraudulent transfers).

the item nonetheless leaves it with the debtor so the debtor can make use of it, thereby generating a return. There may be other benefits as well, although these are contested.[240]

Again, however, the reach of contractual security agreements is limited. It elevates the priority only of the particular secured party, and only with respect to the secured party's particular collateral. It does not address conflicts between the obligations of creditors who are not secured, or property that is not encumbered with a valid security interest. Accordingly, like subordination agreements, security interests are only partial, incomplete prioritization vehicles.

Second, conflicts may arise between different obligations arising under different bodies of law (such as between a tort claim and a contract claim, or between a tax claim and a criminal fine). In general, no body of law (other than bankruptcy law) *generally* mediates disputes of this kind—although some bodies of law, such as state foreclosure law, may regulate the priority of claims with respect to specific items of property that pass through the foreclosure process. As discussed, a limited exception exists for secured claims, which have a priority elevated above most other types of claims, including tort liabilities.

As suggested above, if the debtor remains *solvent*, there is little need for priority mechanisms that mediate conflicts between competing obligations for the simple reason that, absent insolvency, these obligations do not really compete in the practical sense of

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[240] *See* GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 259-61 (1965) (arguing that a secured creditor may act as an effective monitor, preventing harm to other creditors); *see also supra* notes 210, 238, *infra* note 672. Procedurally, a secured creditor's collection rights are typically more streamlined, and potentially more expeditious, than those enjoyed by other creditors. *See* U.C.C. § 9-601 et. seq. (prescribing special enforcement and collection rights for holders of security interests); *see also* 4 COLLIER ON BANKRUPTCY, *supra* note 234, ch. 506 (describing a secured creditor's rights in bankruptcy).

getting paid. If a solvent debtor defaults on an obligation, any creditor may obtain payment without depriving other creditors of their due—that is what solvency essentially means. Once the debtor becomes insolvent, however, the situation changes entirely. Because the conflict among competing obligations arises truly as a result of the debtor's insolvency, it is properly a bankruptcy question.

Having identified the problem of conflicting obligations, one might well ask: instead of addressing them through a mechanism of bankruptcy law, why not simply modify existing legal structures to remedy them? For example, tort law might prescribe a mechanism of prioritization among competing tort claims, and contract law might do the same within its sphere. But here we confront the fact that it is only in the context of insolvency that the problem assumes any real significance. There is simply no need for contract or tort law to undertake the challenge outside the insolvency arena—other than in the special case of subordination agreements and security interests, which are only partial prioritization mechanisms in any event. Moreover, even if, for example, tort law were to specify a mechanism for prioritizing competing tort claims, it would still be necessary to harmonize the tort priority regime with any competing regime supplied by some other body of law (e.g., contract law), and thus a separate body of law would still be necessary to resolve the conflicts that emerge between the priority rules of different bodies of law. Different laws respond to different kinds of social problems and do so in different ways (presumably because this is desirable). Bankruptcy law is no different,

and the problem of conflicting payment obligations arising in the insolvency context properly falls within its bailiwick.[241]

The existence of subordination agreements and security interests as creatures of contract law (and, in the case of security interests, also property law) does not undermine this observation. The fact that some priority issues may be resolved profitably by

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[241] Notably, bankruptcy law prescribes several comprehensive mechanisms for prioritizing claims. By operation of law, the commencement of a bankruptcy case creates a bankruptcy estate consisting of all of the debtor's interests in property wherever located. 11 U.S.C. § 541 (2000 & Supp. 2006). The bankruptcy court presiding over the case is vested with exclusive *in rem* jurisdiction over all property of the estate, and the estate is formed *in custodia legis*. 28 U.S.C. § 1334(e); Tennessee Student Assistance Corp. v. Hood, 541 U.S. 440, 447 (2004); Straton v. New, 283 U.S. 318, 320-21 (1931). In addition, the filing of a bankruptcy petition triggers the automatic stay, which enjoins most debt collection activities against the debtor and property of the estate during the bankruptcy proceeding. 11 U.S.C. § 362(a) (2000 & Supp. 2006). In lieu of non-bankruptcy debt collection procedures, a creditor holding a debtor's pre-bankruptcy monetary obligation is deemed to hold a claim against the debtor's estate, and the creditor is entitled to file a proof of claim with the bankruptcy court. 11 U.S.C. §§ 101(5) (2000 & Supp. 2006), 101(10) (2000 & Supp. 2006), 501(a) (2000 & Supp. 2006), 502(b) (2000 & Supp. 2006); FED. R. BANKR. P. 3001, 3002; *see* Katchen v. Landy, 382 U.S. 323, 336 (1966) ("bankruptcy . . . converts the creditor's legal claim into an equitable claim to a pro rata share of the *res*"). Only creditors that file proofs of claim may receive distributions from the estate. FED. R. BANKR. P. 3002(a); New York v. Irving Trust Co., 288 U.S. 329, 333 (1933). In a Chapter 7 (liquidation) case, a Chapter 7 trustee is appointed or elected, and is responsible for collecting and liquidating the estate, and distributing the proceeds among creditors. 11 U.S.C. §§ 701 (2000 & Supp. 2006), 702 (2000 & Supp. 2006), 704 (2000 & Supp. 2006). The trustee distributes property in accordance with several provisions of the Code that prioritize claims. 11 U.S.C. §§ 507 (2000 & Supp. 2006), 725 (2000 & Supp. 2006), 726 (2000 & Supp. 2006). In a Chapter 11 (reorganization) case, a trustee is not ordinarily appointed, and the debtor typically remains in possession of estate property as a debtor in possession. 11 U.S.C. § 1101(1) (2000 & Supp. 2006). The debtor in possession has many of the responsibilities of a trustee. 11 U.S.C. § 1107 (2000 & Supp. 2006). A principal goal of Chapter 11 is the formulation and confirmation of a plan of reorganization that will specify the disposition of the debtor's property and the payment of claims. 11 U.S.C. § 1123 (2000 & Supp. 2006) (prescribing contents of plan); *see also supra* note 75 (discussing the debt-adjustment functions of bankruptcy law).

contract does not mean that they all must be addressed in that way.[242] Nor does it mean that we should accept the outcome of non-bankruptcy priority contracting come what may. As noted, the primary utility of both subordination agreements and security interests is to provide an enhanced prospect of payment for a particular creditor in the event the debtor is unable to pay all obligations in full. If the debtor is solvent, all creditors ultimately will be paid irrespective of whether they have rights under a subordination agreement or by virtue of a security interest. It is only when the debtor becomes insolvent that these devices have particular distributional bite.[243]

Critically, to the extent that subordination agreements and security interests prescribe distributional entitlements in the context of bankruptcy cases, that is so *only* because bankruptcy law recognizes them as effective in that setting.[244] Presumably, bankruptcy law permits the limited contractual allocation of priorities achieved through subordination agreements and security interests because doing so is generally desirable,

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[242] *See* SHAPIRO, LEGALITY, *supra* note 37 at 213 (observing that "when simpler methods of organizing behavior work, it would be irrational to abandon or overturn them in favor of accomplishing the very same ends through more sophisticated methods" and stating that "[t]hus, when customs or contracts solve moral problems, the law will typically let them stand" and "legal systems often rely on custom and contract when they judge these methods of solving moral problems to be superior to legal planning").

[243] As noted, they may have other value outside the insolvency setting. *See supra* note 240 (discussing a secured creditor's enhanced and streamlined debt-collection rights).

[244] *See* 11 U.S.C. §§ 510(a) (2000 & Supp. 2006) (recognizing the enforceability of contractual subordination agreements in bankruptcy cases), 506 (2000 & Supp. 2006) (prescribing the treatment of secured claims in bankruptcy); *see also* United States v. Ron Pair Enterprises, Inc., 489 U.S. 235 (1989) (discussing section 506); United Sav. Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365, 371-73 (1988) (further explaining section 506); 4 COLLIER ON BANKRUPTCY, *supra* note 234, ch. 506 & 510 (discussing the operation of these sections).

at least to a certain extent.[245] To the extent it is not, bankruptcy law specifically modifies the rights of secured parties for its own purposes,[246] and thus the efficacy of security interests is not left entirely to non-bankruptcy law. Rather, security interests work in one way outside the bankruptcy setting and in a different way in bankruptcy cases for reasons peculiar to bankruptcy law.[247] In other words, to the extent subordination agreements and security interests prescribe distributional priorities that are recognized in bankruptcy settings (albeit in modified form), they are, by incorporation, part of the fabric of

[245] *See supra* notes 75, 171, 219, 210, 234, 238, 240, 244.

[246] *See, e.g.*, 11 U.S.C. §§ 362(a) (2000 & Supp. 2006) (enjoining the enforcement of a security interest once a bankruptcy case is commenced), 506 (2000 & Supp. 2006) (limiting security interests to the value of the underlying collateral and voiding certain security interests), 547 (2000 & Supp. 2006) (permitting the avoidance of security interests that constitute preferences), 1123(b)(5) (2000 & Supp. 2006) (permitting the proponent of a Chapter 11 plan of reorganization to modify the rights of the holders of secured claims), 1129(b)(2) (2000 & Supp. 2006) (permitting the proponent of a Chapter 11 plan to gain confirmation of the plan that modifies the rights of a secured party over the objection of the secured party if certain criteria are satisfied); *see also* RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065 (2012) (discussing the operation of section 1129(b)); Associates Commercial Corp. v. Rash, 520 U.S. 953 (1997) (discussing the treatment of certain secured claims in bankruptcy); Dewsnup v. Timm, 502 U.S. 410 (1992) (same); United States v. Ron Pair Enterprises, Inc., 489 U.S. 235 (1989) (same).

[247] Among other things, current bankruptcy law embodies the general policy of equality of distribution among creditors and prescribes various distributional rules to effect this policy. *See, e.g.*, Nathanson v. NLRB, 344 U.S. 26, 29 (1952) (stating that the "[t]he theme of the Bankruptcy Act is 'equality of distribution,' and if one claimant is to be preferred over others, the purpose should be clear from the statute.") (quoting Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941)); *see also* Union Bank v. Wolas, 502 U.S. 151, 154-55, 160-61 (1991) (discussing preference law under the Bankruptcy Code and how it facilitates the policy of equality of distribution); Begier v. IRS, 496 U.S. 53, 58 (1990) (same); *supra* note 75. At the same time, current bankruptcy law also prescribes specific priority rules that elevate the claims of certain creditors over others for distributional purposes—typically those who are poor loss spreaders. *See, e.g.*, 11 U.S.C. § 507 (2000 & Supp. 2006); *see also supra* note 258.

bankruptcy law.[248] This is appropriate. First, the problem of conflicting payment obligations that they address is complex and contentious. Second, it is acutely insolvency related because the conflict arises as a consequence of the debtor's inability to satisfy all obligations in full. The problem is thus properly a bankruptcy matter.

PAYMENT DISCRIMINATION

A problem closely related to that of conflicting payment obligations is the problem of payment discrimination. Once again, if a debtor is solvent, it generally makes little difference which creditor receives payment first on a temporal basis because, by definition, a solvent debtor is able to pay all claims in full. Thus, if the debtor defaults in paying a particular debt, the creditor's recourse to ordinary legal relief, such as by obtaining a judgment and satisfaction of that judgment through execution, is usually fully effective without adverse impact on other creditors because collection of the claim leaves ample resources behind for the satisfaction of other obligations.

Unsurprisingly, non-bankruptcy law is not typically concerned with forcing solvent debtors to pay one obligation before others on a temporal basis. If the debtor becomes insolvent, however, the payment of one claim ahead of others (or the assurance of the payment of a particular claim ahead of others such as by granting the preferred creditor a security interest in specific items of the debtor's property) may irrevocably compromise remaining claims simply because the debtor may retain insufficient resources to pay other debts. In other words, the debtor's payment (or assurance of priority payment) of the preferred claim may create a discriminatory "externality" with

[248] *See* Adler, *Law*, *supra* note 233 at 1665 (arguing that bankruptcy law includes "any law, from whatever source, that governs or permits insupportable obligation," that "where such obligations are necessarily inconsistent, the law provides a resolution," and that "[t]his is bankruptcy law").

respect to unpaid claimants.[249] In general, this discrimination may arise in one of six distinct ways.

First, in deciding which obligations to pay, an insolvent debtor may simply choose to pay some creditors over others, perhaps based on whim, but more likely based on self-interest. For example, an insolvent individual may value his or her home more than other assets and thus may pay the mortgage ahead of other claims—regardless of whether doing so is in the best interests of the debtor, creditors as a group, or society as a whole.[250] Similarly, the manager of an insolvent firm who has guaranteed personally a particular obligation may cause the firm to pay that obligation first, thereby reducing his

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[249] As Coase has explained:

> An externality is . . . usually defined as the effect of one person's decision on someone who is not a party to that decision. Thus, if A buys something from B, A's decision to buy affects B, but this effect is not considered to be an "externality." However, if A's transaction with B affects C, D, and E, who are not parties to the transaction, because, for example, it results in noise or smoke which impinge on C, D, and E, the effects on C, D, and E are termed "externalities."

COASE, FIRM, *supra* note 7 at 24. In the case of payment discrimination, an insolvent debtor's choice to pay creditor A, thereby leaving inadequate resources to pay creditor B, creates an externality with respect to creditor B.

[250] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 200, 218-19, 224-26 (observing that homeowners often make decisions regarding their homes that are based on emotional considerations and may continue to strive to keep their houses even though doing so may simply make them worse off financially). This is an illustration of the "endowment effect"—the tendency of people to overvalue what they have because it is theirs. *See* Richard H. Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 43-47 (1980) [hereinafter Thaler, *Positive Theory*] (discussing the "endowment effect").

individual liability.[251] In either situation, the debtor's voluntary choice has the effect of discriminating against creditors who are not paid.

Second, the debtor may choose under pressure to pay certain creditors, leaving fewer funds to satisfy competing claims. Certainly the most persistent creditors (particularly those who threaten or actually pursue debt-collection remedies) may receive payment ahead of others.[252] But debtors may also prefer certain kinds of persistent creditors, while purposefully stalling others who are equally vocal. For example, if the debtor is in the manufacturing business and requires a continuous supply of materials from one particular vendor to continue operations, the debtor may meet its obligations to that vendor ahead of the claims of other persistent creditors simply to stay in business.[253]

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[251] *See* Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1187-88 (7th Cir. 1989) (finding that the bankrupt corporation made payments on loans guaranteed by three corporate insiders, including the corporation's president, during the year prior to the corporation's filing for bankruptcy); Smith v. Tostevin, 247 F. 102, 103 (2d Cir. 1917) (L. Hand, J.) (finding that bankrupt husband made payment on his bank loan one week before filing for bankruptcy in order to obtain the bank's release of stock that his wife had pledged as security for the loan); *see also* David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 495 (1994) [hereinafter Skeel, *Rethinking*] (observing that "[w]hile many prebankruptcy preferences may reflect a debtor's legitimate efforts to allocate scarce resources in the face of financial distress, others stem from insiders' less appropriate desires to help themselves to the firm's assets at the expense of other creditors").

[252] *See* Miniscribe Corp. v. Keymarc, Inc. (In re Miniscribe), 123 B.R. 86, 88 (Bankr. D. Colo. 1991) (observing that the debtor would make preferential payments "to various creditors based upon each creditor's 'threshold of pain' . . . a term which describes when a creditor would complain of late payment and threaten to either ship the goods C.O.D. or terminate its relationship with Miniscribe").

[253] One commentator has suggested that this may be optimal. *See* James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27, 50 (1991) (arguing that "[d]ebtors will tend to prefer those creditors who have specialized in dealing with them and whose losses from nonpayment therefore are likely to be greatest."). This, however, is not necessarily so. For example, a debtor's tort obligations may dwarf its liabilities to critical trade vendors "who have specialized in dealing [with the debtor]," and, comparatively,

Third, regardless of whether payments are made under pressure or not, certain creditors may make off with funds from sources controlled by the debtor in which others have a superior interest. For example, a secured creditor may hold a lien on a defaulting debtor's accounts, as well as the cash proceeds arising from the debtor's collection of its accounts. But until the secured creditor manages to take control of the collateral (which may take a significant amount of time, particularly if the debtor resists), the debtor may use the cash to pay other creditors in the sense that, by fiat, the debtor simply makes these payments.[254]

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the debtor's inability to pay tort claims may have a more devastating effect on the victims of the debtor's torts as compared to trade creditors because of the tort victims' relative inability to spread their losses. A second commentator has likewise suggested that a distressed firm should be entitled to make preferential payments to "whomever it chooses." *See* Schwartz, *Normative Theory*, *supra* note 9 at 1228. Among other things, Schwartz has argued that "creditors cannot force a distressed firm to pay preferences" because debtors can threaten bankruptcy in order to stave off such debt-collection activity. *Id*. at 1225. While this may be somewhat true with respect to certain financial creditors that lack leverage over the debtor in the form of prospective advances of credit or sales of needed goods, it is not true for other creditors who may exert such leverage. Non-bankruptcy laws also privilege certain creditors (such as tax claimants and employees) with enhanced sanctions (including criminal fines) if their claims are not paid. Timing also matters. For example, creditors may well ignore an insolvent debtor's threat of filing, even if facially credible, on the theory that it is better to obtain payment currently and take the risk of the debtor's filing than forego payment currently because there are many reasons why a debtor may elect to delay filing even though some creditors engage in aggressive debt-collection activities and receive payment of their claims as a result. These reasons for delay may include the debtor's near-settlement with other, more important creditors, or the debtor's need to line up post-filing financing before commencing a bankruptcy case. *See supra* at 60 (discussing post-filing financing in bankruptcy).

[254] Debtors often make transfers to creditors holding junior claims, leaving more senior creditors without recourse. *See, e.g.*, U.C.C. § 9-332(a) ("A transferee of money takes the money free of a security interest unless the transferee acts in collusion with the debtor in violating the rights of the secured party"); *see also* U.C.C. § 9-332(a) cmt. 2 ("This section affords broad protection to transferees who take funds from a deposit account and to those who take money."); LoPucki, *General Theory*, *supra* note 181 at 344 (observing, for example, that "[d]ebtors in financial difficulty commonly ignore the 'priority' of the obligation to pay withheld taxes to the IRS and instead pay what they regard as more

Fourth, different obligations often incorporate different types of default mechanisms, and creditors benefiting from stricter covenants may simply be able to exercise their rights sooner than others. Hence, some creditors may receive payment ahead of others for reasons having nothing to do with the overall validity or legal priority of their claims.[255]

Fifth, the debtor may assure the payment of the claim of a particular creditor ahead of others, such as by granting the creditor a security interest in one or more items of the debtor's property. Although the creditor may not thereby receive payment in full at the time the security interest is granted, the grant of the security interest may effectively assure priority payment.[256]

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pressing obligations that formally have a low priority."). Conversely, a secured creditor holding a lien on one type of collateral essential to the debtor's operations might pressure the debtor to sell other assets quickly and at low prices in order to convert the proceeds into the type of collateral in which the creditor holds a lien. *See* Anthony T. Kronman, *The Treatment of Security Interests in After-Acquired Property Under the Proposed Bankruptcy Act*, 124 U. PA. L. REV. 110, 144 (1975) (discussing this type of pressure).

[255] As one court has noted in an analogous context: "In bankruptcy, as in life, timing matters." In re Piper Aircraft Corp., 162 B.R. 619, 628 (Bankr. S.D. Fla. 1994), aff'd, 168 B.R. 434 (S.D. Fla. 1994), aff'd, 58 F.3d 1573 (11th cir. 1995). That is why most debt contracts have cross-default provisions. If, however, a creditor is unaware of the debtor's default to another creditor, it may not know that it may assert its rights under a cross-default covenant.

[256] *See, e.g.*, Corn Exchange Nat. Bank & Trust Co., Philadelphia v. Klauder, 318 U.S. 434 (1943) (treating as a preference an assignment of accounts receivable in consideration of a loan). One commentator has argued that assuring payment of preexisting unsecured debts may be beneficial "so that financially distressed firms could borrow more easily." *See* Schwartz, *Normative Theory*, *supra* note 9 at 1230. But it depends. Presumably, lenders will extend new value to distressed firms if they can be assured of full repayment for the new value given. In theory, assuring payment of preexisting indebtedness is not necessary as a condition of obtaining new credit because a lender who will make a profit from the new extension of credit will do so rather than succumb to the sunk-cost fallacy and refuse to deal with the debtor unless the old debt (the sunk-cost) is paid. *See* In re Kmart Corp., 359 F.3d 866, 873 (7th Cir. 2004) (Easterbrook, J.) (discussing the sunk-cost fallacy). A lender who is willing to extend

Finally, payment discrimination may arise solely as a result of fortuity. For example, if two different obligations mature at different times, the debtor may simply pay the first to mature. In addition, some claimants (for example, tort victims who have not yet manifested any injury arising from the debtor's prior conduct) may not even know they have a claim at the point at which the debtor turns over his last nickel to some other creditor.[257]

By definition, if a debtor is *solvent* and remains so, creditors suffering from any of these types of discriminations do not really suffer because they may still obtain full, compensatory relief simply by compelling the debtor to pay their claims. In general, this is the relief that ordinary debt-enforcement mechanisms provide. In the context of a solvent debtor, this relief is a complete answer to the problem of payment discrimination because, by definition, solvent debtors can afford to pay, and thereby can make all creditors whole.

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new credit and receives assurance of repayment for both its new value and its existing claims inflicts a type of payment discrimination on other existing creditors. Moreover, the harm may be grossly disproportionate. For example, the lender may extend new value to the debtor in the amount of $1 million in exchange for the assurance of repayment (through the granting of liens) of the $1 million of new value plus the assurance of repayment of $10 million of existing unsecured indebtedness. The lender would agree to this arrangement because it greatly benefits the lender, and the debtor would agree if doing so merely came at the expense of other creditors. Courts, however, have sometimes rejected this kind of maneuver. *See* In re Saybrook Mfg. Co., 963 F.2d 1490, 1491 (11th Cir. 1992).

[257] The problem of unmanifested tort claims has arisen repeatedly in the bankruptcy context, both with respect to commonplace negligence claims and in the mass-tort product-liability area. *See* In re UNR Indus., Inc., 725 F.2d 1111, 1118-21 (7th Cir. 1984) (discussing whether it is appropriate to appoint a representative for future asbestos claimants who have not yet developed an injury from exposure to asbestos products manufactured by the debtor); Roach v. Edge (In re Edge), 60 B.R. 690, 691 (Bankr. M.D. Tenn. 1986) (involving an injury from the prepetition negligence of an insolvent dentist that did not manifest itself until after the dentist filed for bankruptcy).

On the other hand, if the debtor is *insolvent* (or threatens to become insolvent in the near term), the situation is very different. Because the victims of payment discrimination may receive little or nothing if the debtor lacks the wherewithal to pay all claims in full, resort to traditional non-bankruptcy enforcement devices may well fail to provide an adequate response to their plight precisely because these devices do nothing more than require the debtor to pay valid claims.[258]

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[258] Not surprisingly, current bankruptcy law prescribes mechanisms to remedy payment discrimination, such as through the avoidance and recovery of preferences. *See* 11 U.S.C. §§ 547 (2000 & Supp. 2006) (providing for the avoidance of certain preferential payments that have the effect of preferring certain creditors over others), 550 (2000 & Supp. 2006) (providing for the recovery of preferential payments); Union Bank v. Wolas, 502 U.S. 151, 154-55 (1991) (discussing preference law under the Bankruptcy Code); Begier v. IRS, 496 U.S. 53, 58 (1990) (same); In re Bullion Reserve of North America, 836 F.2d 1214, 1217 (9th Cir. 1988) (explaining that "[t]he dual purpose of §547 . . . is to discourage creditors from racing to the courthouse to dismember the debtor during its slide into bankruptcy and to further the prime bankruptcy policy of equal distribution among similarly situated creditors."). Remedies for payment discrimination have been an essential feature of bankruptcy law for many centuries. *See* Central Virginia Comm. College v. Katz, 546 U.S. 356, 372 (2006) (observing that the authority to avoid and recover preferences in bankruptcy "has been a core aspect of the administration of bankruptcy estates since at least the 18th century"). Edward Coke first explained the basic idea in 1584, as well as its central premise of equality of distribution. *See* The Case of Bankrupts, 76 Eng. Rep. 441, 473 (K.B. 1584) (stating that "it would be unequal and unconscionable, and a great defect in the law, if, after he hath utterly discredited himself by becoming a bankrupt, the law should credit him to make distribution of his goods to whom he pleased . . . ."); *see also* Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 714-25 (1985) [hereinafter Countryman, *Concept*] (discussing the history of preference law). By 1758, the recovery of preferential transfers in a manner similar to that prescribed by the current Bankruptcy Code had become established law. *See* Worsely v. DeMattos, 1 Burr. 467, 482, 96 Eng. Rep. 1160 (K.B. 1758) (Mansfield, C.J.) (a debtor's voluntary payment to a creditor, not in the regular course of business, was "void with respect to other creditors"); *see also* 32 & 33 Vict., ch. 71, § 92 (1869) (Eng.) (providing that any payment by a debtor to a creditor within three months of the bankruptcy "with a view of giving such creditor a preference over the other creditors shall . . . be . . . void as against the trustee of the bankrupt"). During the colonial era, different States likewise experimented with preference laws. *See* PETER J. COLEMAN, DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY, 1607-1900, 69, 212 (1974) [hereinafter COLEMAN, DEBTORS] (discussing Vermont and Delaware laws); F. REGIS

In response to these problems, one might ask: instead of addressing payment discrimination through a mechanism of bankruptcy law, why not simply modify existing enforcement mechanisms to address it? Here, however, we again confront the fact that it is only in the context of *insolvency* that the problem of payment discrimination assumes any real significance. Accordingly, there is no real point in addressing the problem in every collection action regardless of the solvency of the obligor.[259] Because the problem is peculiarly one of insolvency, there is simply no reason to incur the costs of addressing it in every context and thus violate the rule against fixing something that is not broken.[260] In addition, because the insolvency-related problem of payment discrimination is complex and contentious, it satisfies the circumstances of bankruptcy legality and is properly the subject of bankruptcy law.

NOEL, A HISTORY OF THE BANKRUPTCY LAW, 43-44 (2002) [hereinafter NOEL, HISTORY] (discussing Maryland law); Thomas E. Plank, *Bankruptcy and Federalism*, 71 FORDHAM L. REV. 1063, 1086-87 (2002) (discussing Maryland law); Bankruptcy Act of 1898 (as amended by the Chandler Act), ch. 575, § 60(b), 52 Stat. 870 (providing for the avoidance of preferential payments).

[259] *See* John C. McCoid II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 159-60 (1981) (observing that "[s]o long as a debtor is solvent, every creditor can expect to be paid in full, and each may act independently without affecting others. There is generally no occasion for collective action.").

[260] It is at least conceivable, of course, that doing nothing to address the problem of payment discrimination is an appropriate response in the insolvency context if the available solutions are worse than the problem. *See supra* notes 253, 256 (discussing suggestions that payment discriminations arising under non-bankruptcy law may be optimal). For many centuries, however, bankruptcy law has sought to remedy the problem of payment discrimination through its preference provisions. *See supra* note 258 (summarizing history of preference law in bankruptcy). This may be appropriate not only to vindicate bankruptcy law's debt-adjustment values, but also to help remedy the bankruptcy initiation problem. *See supra* at 87-90 (discussing the initiation problem). To the extent insolvent debtors and creditors have incentives to avoid making and accepting preferential payments, this may help encourage debtors in need of bankruptcy relief to file for bankruptcy sooner rather than later, when it may be more efficacious.

PROBLEMS OF OVERINVESTMENT, UNDERINVESTMENT, AND OTHER MORAL HAZARD

In addition to the problems of claims mediation and payment discrimination discussed above, a debtor's insolvency also generates additional problems of overinvestment, underinvestment, and other moral hazard.[261] The problem of overinvestment arises owing to an insolvent debtor's enhanced incentives to engage in wasteful delay and excessive risk taking. The problem of underinvestment arises as a result of the creditors' incentives to take actions that lead to value-diminishing debt-collection "free-for-alls," and likewise problems of stagnating and overburdened assets,

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[261] *See* Skeel, *Evolutionary*, *supra* note 147 at 1333 n.17 (illustrating the problems of "overinvestment" and "underinvestment"); *see generally* Myers, *Determinants*, *supra* note 147 (discussing managerial behavior). The problem of overinvestment includes the incentive that both insolvent individuals and the shareholders of an insolvent firm have to encourage managers to pursue excessively risky investments. *See* EDWARD CHANCELLOR, DEVIL TAKE THE HINDMOST, A HISTORY OF FINANCIAL SPECULATION 252 (1999) [hereinafter CHANCELLOR, DEVIL] (discussing the Hunt brothers' risky attempt to corner the silver market in 1979-80, which triggered additional desperate efforts to recover their fortune after they became insolvent); ALAN C. SHAPIRO, MODERN CORPORATE FINANCE 463-64 (1990) (detailing the efforts of the bankrupt Hunt brothers, who, after sustaining huge losses stemming from their failed attempt to corner the international silver market, sought to persuade the bankruptcy court over the objection of creditors to permit them to continue to fund an excessively risky offshore oil venture that, while offering the brothers the prospect of potential gain, represented a negative net present value for their creditors once the risks of the venture were taken into account). In contrast, the problem of underinvestment includes taking too little entrepreneurial risk. In general, a problem of moral hazard arises whenever one is in the position of taking on risk, but someone else will bear the cost if things go badly. Problems of moral hazard thus involve externalities. *See supra* note 249 (discussing externalities). The classic example of a problem of moral hazard is insurance. If an individual's car is not insured, he has an incentive to drive carefully, make sure the car is locked when not in use, and otherwise avoid injury to the vehicle and others. With insurance, however, this incentive is reduced because the insurer bears the loss of injury. Customary insurance practices and legal regulation aim to compensate for this kind of moral hazard, at least in part, by requiring insureds to bear at least some of any loss through deductibles, limits, and the like, and by penalizing certain forms of bad behavior, such as purposefully destroying property to obtain a recovery from an insurer. The problems of overinvestment and underinvestment can also be problems of moral hazard, particularly in the insolvency context.

including most prominently a debtor's human capital. An additional problem of moral hazard arises owing to an insolvent debtor's increased incentives to shelter his assets, including making outright gratuitous transfers—a species of fraud. Like the problems of competing claims and payment discrimination, these aspects of the phenomenon of insolvency are complex and contentious. Moreover, they are all characteristically insolvency related in ways similar to the problems of claims mediation and payment discrimination, and it would make no sense to modify non-bankruptcy legal systems to address them. As a consequence, they satisfy the circumstances of bankruptcy legality and are properly the subject of bankruptcy law.

INCENTIVES FOR DELAY AND EXCESSIVE RISK TAKING

A major problem that arises as a consequence of insolvency is the debtor's increased incentives to delay debt-collection activity and gamble with his assets. In order to understand the magnitude of this problem and why it is properly a concern of bankruptcy law, it is first helpful to examine a debtor's incentives to manage his assets in solvent states and compare these to the radically skewed incentives of the insolvent debtor.

In general, an individual debtor's ownership interest in property permits him to make use of his assets in any number of useful (or even not-so-useful) ways. If the debtor's efforts are successful in generating profits, these are for the debtor to keep and use as he sees fit. That is the prerogative that comes with equity.[262] In contrast, creditors are only entitled to the payment of their claims and, absent default, have no right to the

[262] I refer to "equity" here as the interest of an owner to enjoy the value, including the upside potential and profits, of an item of property.

debtor's property above and beyond their fixed payment entitlements. The same is generally true for both individuals and firms.[263]

As long as a debtor remains solvent, the value of his overall ownership interest has two fundamental aspects relevant to the payment of claims: the present value of the assets as measured by what they are worth if sold in some market today, and the assets' potential future value in terms of their ability to increase or decrease in value in some way, either as a result of the debtor's investment of the assets by putting them to some productive use, the debtor's investment of labor to improve the assets, or through changing market conditions independent of the debtor's efforts (which potential future value obviously might be quite different from current value). In addition, as long as the debtor remains solvent, the debtor will possess what might be thought of as ordinary (or "normal") risk incentives in the use of his property. This simply means that, because the debtor has a stake in the outcome of the investment, he will usually make decisions based upon his own judgment of success or failure and his own personal preference for risk,

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[263] As Judge Learned Hand (1872-1971) explained the concept:

> Both the shareholders and the creditors in any enterprise assume some risk of its failure, but their risks are different. The shareholders stand to lose first, but in return they have all the winnings above the creditors' interest, if the venture is successful; on the other hand the creditors have only their interest, but they come first in distribution of the assets . . . . [E]very creditor rightly assumes that his risk is measured by the collective claims of other creditors, and by creditors he understands those alone, who like him, have only a stipulated share in the profits [calculated on the basis of their claims]. To compel him to divide the assets in insolvency with those who at their option have all along had the power to take all the earnings, is to add to the risk which he accepted.

Flynn v. Loewer Realty Co. (In re V. Loewer's Gambrinus Brewery Co.), 167 F.2d 318, 320 (2d Cir. 1948) (L. Hand, J., concurring); *see also* Rasmussen, *Behavioral Economics*, *supra* note 56 at 1685 (observing that, in contrast to equity holders, "[c]reditors, through the market, are limited to a competitive rate of return").

recognizing that he has both something to gain and something to lose from any particular investment decision. In general, markets rely on such rational decision making to function smoothly and predictably.

Further, as long as an individual debtor remains solvent (and absent some special arrangement or relationship between the debtor and others relevant to the disposition of a particular asset), the law does not regulate strictly the risks that he may take with his property—other than risks that impact other persons in such as way as to justify specific regulation of some kind, such as excessive noise, pollution, and the like. Rather, the law typically leaves it to the debtor to enjoy the gains or losses from his choices. Moreover, absent some contractual agreement to the contrary, or some special relationship imposed by law, creditors are not typically entitled to dictate what the debtor may do with his property, and the debtor does not owe creditors any general fiduciary obligation in this regard.[264]

The relationship between the creditors and managers of a solvent firm are similarly aligned.[265] In general, the law does not regulate strictly the kinds of investment

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[264] *See* Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953, 965 n.39 (1981) [hereinafter Eisenberg, *Bankruptcy Law*] (observing that "[a]n unsecured creditor has no enforceable interest in particular property of the debtor. The creditor either must obtain a security interest in property or execute upon property in enforcing a judgment").

[265] *See* In re STN Enters., 779 F.2d 901, 904 (2d Cir. 1985) (stating that the "directors of a solvent corporation do not owe a fiduciary duty to creditors"); *see also* 3 WILLIAM M. FLETCHER, ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 849 (perm ed. 1965). As stated in FLETCHER:

> it is difficult to perceive upon what principle a director of a corporation can be considered a trustee of its creditors. He is selected by the shareholders, not by creditors; he has no contractual relation with the latter . . . [and] it is not pretended that in the latter case the agent would be the trustee of the creditors of his principal. And . . . by the great weight of

choices that managers may make.[266] Instead, the firm (and in some limited circumstances the managers themselves) must bear the losses associated with poor investment decisions. Hence, although managers may owe fiduciary duties to the firm's equity holders on whose behalf they toil, and may be liable to them if they take negligent risks or otherwise violate their duties,[267] no similar duty or potential cause of action exists between the managers and creditors of a *solvent* firm.[268]

> authority such trust relation is distinctly repudiated, when the corporation is a going concern.

Id. (quotations omitted).

[266] *See* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and its Proper Domain*, 38 VAND. L. REV. 829, 836 (1985) [hereinafter Baird & Jackson, *Fraudulent Conveyance*] (describing the normative premise of the "business judgment rule" that "a firm's investment decisions should be made by its managers even though that freedom necessarily conflicts to some extent with creditor security," and observing that "[t]his conflict motivates creditors to bargain for limitations on the ability of a debtor to engage in certain activities"). Exceptions to the general rule of legal noninterference with the discretion of managers to make investment decisions include legal restrictions on the investment activities of the managers of certain nonprofit organizations and trusts. *See* Lewis D. Solomon & Karen C. Coe, *Social Investments by Nonprofit Corporations and Charitable Trusts: A Legal and Business Primer for Foundation Managers and Other Nonprofit Fiduciaries*, 66 UMKC L. REV. 213, 220 (1997).

[267] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (1991 & Supp. 1998); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 358, 360-62 (Del. 1993) (holding that rebuttal of the business judgment rule will only be successful where the plaintiff can show that a director breached one of the triad of fiduciary duties: good faith, loyalty, or due care), modified on reh'g, 636 A.2d 956 (Del. 1994); Sirn v. VLI Corp., 621 A.2d 773, 775-78 (Del. 1993) (holding that a director's duty to disclose all material facts bearing on a merger arises under the duties of due care and loyalty); Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701, 713-15 (Del. 1983) (holding that minority shareholders were entitled to damages where a merger did not meet the test of fairness because of misrepresentations by directors). As long as the corporate managers act in good faith and use due care to discover the relevant facts, the business judgment rule will normally restrict courts from second-guessing their ordinary business decisions. *See* Wolgin v. Simon, 722 F.2d 389, 393 (8th Cir. 1983) (stating that "where the matter under consideration is one that calls for the business judgment or discretion of a corporation's board of directors the courts will not interfere so long as that judgment is exercised fairly and honestly"); Joy v. North, 692 F.2d 880, 885 (2d Cir.

Among other things, the relative absence of regulation over the investment choices of solvent individuals is grounded on the perceived normative value of maintaining a relatively diverse risk-taking environment wherein individuals are free to

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1982); Panter v. Marshall Field & Co., 646 F.2d 271, 293-95 (7th Cir. 1981). Some jurisdictions permit firms to insulate managers from liability for breaches of the duty of due care. *See* ALASKA STAT. § 10.06.210(1)(N) (Michie 1998); ARK. CODE ANN. § 4-27-202(B)(3) (Michie 1996); GA. CODE ANN. § 14-2-202(b)(4) (1994); KAN. STAT. ANN. § 17-6002(b)(8) (1995); MASS. GEN. LAWS ch. 156B, § 13(b)(1½) (1998); MISS. CODE ANN. § 79-4-2.02(b)(4) (1996); N.Y. BUS. CORP. LAW § 717 (McKinny 1999); OR. REV. STAT. § 60.047(2)(c) (1998). Some jurisdictions are more strict with respect to a director's duty of loyalty. *See* DEL. CODE ANN. tit. 8, § 102(b)(7)(i) (1991) (exempting duty of loyalty from a firm's ability to insulate directors from liability in breach of fiduciary actions).

[268] Two commentators have explained this rule in the following terms: "Managers owe fiduciary duties to equity investors, but not debt investors or employees, because these claimants can contract at low cost, while the costs of [specifying the details of the relationship, including the roles and duties of managers] are prohibitively high for residual claimants." Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 437 (1993); *see supra* note 119, *infra* note 735 and accompanying text (discussing the concept of a "residual claim"). According to these commentators, there is no need for any special duty to creditors because it is relatively easy for creditors to enter into contracts prescribing their rights. Equity holders, on the other hand, entrust the debtor's assets to "specialists" (i.e., managers) to perform a variety of specific functions that are not easy to circumscribe in contractual terms. This explanation is interesting, but incomplete, and other considerations may also inform the rule, perhaps in equally compelling ways. For example, equity holders as a group may be relatively poor monitors as compared to their creditor colleagues, thus justifying their heightened protection. *See* Roberta Romano, *Comment on Easterbrook and Fischel, "Contract and Fiduciary Duty"*, 36 J.L. & ECON. 447, 448 (1993). Similarly, the diversity of the interests and preferences of equity holders may require the more generalized standard of "fiduciary responsibility" to avoid inevitable conflicts between their relative preferences if established on a contractual basis (e.g., one equity investor might wish to contract with the debtor to pursue a relatively conservative investment approach while another might prefer a more aggressive one). Finally, Easterbrook and Fischel's model does not account adequately for the interests of involuntary creditors, such as tort victims, who do not have any realistic opportunity to contract with the debtor. The point here, however, is not to resolve the issue of how best to explain why managers owe fiduciary obligations to equity holders, but rather to illustrate the general absence of a similar duty with respect to the creditors of a solvent firm.

take risks and reap either the rewards or losses of their own investment decisions.[269] It is also based on the normative assumption that individual debtors are good decision makers regarding the investment of assets within their control (or at least function better than the alternatives, such as state-directed investment rules).[270] Moreover, so long as the debtor remains solvent, creditors can be said to suffer no immediate harm to their interests arising from any loss occasioned by the debtor's investment choices because the creditors do not directly suffer the effects of the loss—because the debtor remains solvent, they may still be paid. Likewise, debtors will tend to manage their affairs without taking either excessive or inadequate risks because they have both something to lose and something to gain by their choices. This collection of relatively unrestricted entitlements (e.g., ownership rights and general non-interference with investment decisions)

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[269] *See* Baird, *Uneasy Case*, *supra* note 60 at 130-31. Baird has observed:

> For the most part, investors who pool their assets may divide rights of payout, control, withdrawal, and priority among themselves as they see fit. This fact of corporate law reflects the general principle that individuals can, for the most part, deploy their assets and enter into contracts as they please.

Id.

[270] *See* Jackson, *Fresh-Start*, *supra* note 20 at 1404. Jackson has stated that,

> [n]ot only the American law of contracts, but also much of American society in general, is structured around the premise that individuals should for the most part have the freedom to order their own affairs as they please, because rational, self-interested actors will tend to make decisions that maximize their own utility.

Id.; *see also* ANTHONY T. KRONMAN & RICHARD POSNER, THE ECONOMICS OF CONTRACT LAW 1-7 (1979) (arguing that bilateral exchange pursuant to voluntary agreements tends to transfer resources to their highest and best uses). As I discuss in Chapter 3, this principle has important implications for the debt-forgiveness aspects of bankruptcy law. In essence, insolvency impairs the ability of individuals and firms to engage in rational self-direction. Debt forgiveness restores that capacity.

presumably maximizes social welfare by creating an environment in which actors are free to make decisions for themselves and by harnessing their incentives to engage in productive activities. It works presumably because solvent debtors have incentives to operate within a normatively optimal range of risk-taking preferences that avoids the relatively unpredictable extremes of both overinvestment (excessive risk taking) and underinvestment (taking too little risk).[271]

Similarly, in the context of a solvent firm, this system of rules also reflects certain additional assumptions. Among other things, while managers may sometimes shirk their responsibilities to equity holders in order to pursue their own personal gain,[272] it is probably true that, to the best of their abilities, most managers will typically avoid leading firms into financial ruin, if only to preserve their own positions.[273] But once the debtor approaches or enters a state of insolvency (for whatever reason), things change in several material and cumulative respects.

First, an insolvent debtor no longer takes risks exclusively for his or her own account. Upon the debtor's default, creditors have the legal right to exhaust the value of

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[271] *See supra* notes 147, 261 (discussing the concepts of "overinvestment" and "underinvestment").

[272] *See* Jensen & Meckling, *Theory*, *supra* note 150 at 308 (discussing this problem).

[273] *See* Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277, 279 (1991) (making this point). Among other things, managers may wish to avoid losing their jobs, as well as any negative impact on their careers associated with the firm's failure. *See* PHILIP B. NELSON, CORPORATIONS IN CRISIS 98 (1981) (describing the stigma attached to bankruptcy); *see also supra* note 185, *infra* note 292 (discussing the likelihood that managers will lose their positions once the firm commences a bankruptcy proceeding).

the debtor's non-exempt property through the enforcement of their claims.[274] Because of this right, any further diminution in the value of the debtor's property arising from the debtor's risk taking will necessarily and directly reduce the value of the creditors' stake.

Second, if the debtor is insolvent, the value of the debtor's interest (once claims are taken into account) lies in the potential future increase in the value of his property. Again, because creditors have the right to the payment of their claims ahead of the defaulting debtor's right to retain and use non-exempt property, the creditors may, through the collection of their claims, exhaust entirely the current value of an insolvent debtor's non-exempt assets. Thus, the only hope an insolvent debtor may have of recovering his position is if the debtor can stall the creditors from collecting on their claims long enough so that the value of the assets may increase faster than the accrual of interest and other recoverable charges (or the debtor is able somehow to add new assets to the pool, obtain forgiveness of debt, or shelter assets from the reach of creditors).[275]

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[274] Only individuals may claim exempt assets; firms characteristically may not. *See supra* note 73 (discussing exemptions).

[275] As one commentator has noted in the context of an insolvent firm:

> If the firm's prospects are volatile, shareholders will want the managers to delay, in the hope of selling when the price is high. On average, however, delay will be costly. Equity claimants have reason to wait too long and to set unrealistic reservation prices, for their claims are worthless unless something unexpectedly good happens. Immediate sale at a realistic price wipes them out; debt claimants bear any erosion of value during a delay, yet have fixed claims and so do not realize the full gain if things turn out well. This is the standard conflict between debt and equity claims, and as usual is substantially aggravated during times of financial distress, when the equity claim is worth little.

Easterbrook, *Corporate Bankruptcy*, *supra* note 146 at 415; *see* White, *Public Policy*, *supra* note 183 at 553 (observing that "equity holders always favor continuance, since their interest disappears under liquidation"); *see also infra* notes 276-78 (discussing an

Third, building on the foregoing, the debtor's risk incentives typically change in ways that may be harmful to creditors. As noted, an insolvent debtor's hope of recovering his stake lies only in the prospect of increasing the value of the assets at a rate greater than the accrual of interest and other charges on the creditors' claims (assuming no debt forgiveness, no new assets are brought into the picture, and the debtor cannot shelter assets). The usual way to increase return, however, is through increased risk taking.[276] Hence, the deeper the debtor's insolvency, the greater the debtor's *incentive* to take additional risks because that is commonly perceived as the only path to the debtor's recovery. In other words, the debtor is more likely to engage in excessive risk taking because the debtor has nothing to lose and something to gain by doing so, and the

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insolvent debtor's incentives to gamble with his or her assets). As another commentator has explained:

> Faced with the prospect of no payout, equity favors delay for two reasons. First, delay allows . . . resolution of the bankruptcy, and thus prolongs the opportunity for a reversal of fortune large enough to return the firm to solvency and return equity investors to a stake in the firm. If equity can control the firm, moreover, it can increase the risk of the debtor's investments and thereby enhance this opportunity. However unlikely the reversal of fortune, and whatever the cost to creditors of the protraction—directly or from investment risk unjustified by expected returns—equity gains from prolongation of its option on the firm's value. Second, the costs of the protracted procedure itself provide equity with an advantage. Even without a realistic hope that the debtor will become solvent, equity can impose the costs of delay until it wrests an extracontractual settlement from senior claimants. Equity, if able, may hold the debtor hostage and allow it to deteriorate in order to extract ransom from the debtor's contractual owners, the creditors.

Adler, *Bankruptcy*, *supra* note 56 at 448-49 (footnotes omitted).

[276] *See* John Cassidy, *Time Bomb*, THE NEW YORKER, July 5, 1999, at 31 (paraphrasing "the oldest law in finance: that higher returns can be generated only at the cost of higher risk").

debtor's insolvent state thus tends to influence the debtor into taking abnormal risks.[277] Obviously, this is likely to lead to the debtor's gambling with the creditors' money, thereby increasing their potential losses. In addition, it skews the debtor's behavior within the market—instead of acting under the influences of normal risk incentives, the debtor is acting under the influences of the high octane lure of speculative recovery.

A famous illustration of this phenomenon is the story arising from the early history of FedEx (formerly known as Federal Express). "Federal Express was near financial collapse within a few years of its inception. The founder, Frederick Smith, took $20,000 of corporate funds to Las Vegas in despair. He won at the gambling tables, providing enough capital to allow the firm to survive."[278] Although FedEx was able to survive owing to this gambling exercise, the more probable outcome in most cases is that the debtor's excessive risk taking will only exacerbate the creditor's losses and generally squander the debtor's resources and time.

Acknowledging that an insolvent debtor has incentives to take excessive risks, and likewise that an insolvent debtor who continues to take risks is actually trading on the creditors' account, the law generally recognizes that, looking through the lens of debt-collection, insolvent debtors become, in some sense, the caretaking "managers" of their assets for the creditors' benefit.[279] Specifically, courts have recognized that, upon the

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[277] *See supra* notes 275, 277 (discussing this point); JACKSON, LOGIC, *supra* note 8 at 205 (same); Adams, *Economic Justification*, *supra* note 181 at 125-27 (same); Golbe, *Effects*, *supra* note 181 at 326 (same); LoPucki, *General Theory*, *supra* note 181 at 321-22 (same); Miller, *Wealth Transfers*, *supra* note 181 at 40 (same).

[278] STEPHEN A. ROSS, ET AL., CORPORATE FINANCE 421-22 (4th ed. 1996).

[279] Early decisions held that an insolvent debtor's officers and directors were essentially trustees obligated to preserve the value of the assets of the corporation for the benefit of creditors. *See* Alexander v. Hillman, 296 U.S. 222, 240 (1935) (holding that the debtor's

debtor's insolvency, creditors have an equitable interest in the assets of the debtor that deserves consideration. In essence, their relative rights undergo an equitable transformation to accommodate new economic interests and obligations.[280] In particular, an insolvent firm has been described as owing fiduciary duties to creditors that it would not otherwise owe if solvent, although some courts have denied that this results in any substantive shift in duties.[281]

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officers "are to be dealt with just as if they were technically trustees for creditors and stockholders"); New York Credit Men's Adjustment Bureau, Inc. v. Weiss, 110 N.E.2d 397, 398 (N.Y. 1953) (stating that "[i]f the corporation was insolvent at that time it is clear that defendants, as officers and directors thereof, were to be considered as though trustees of the property for the corporate creditor-beneficiaries"); Davis v. Woolf, 147 F.2d 629, 633 (4th Cir. 1945) (noting that "[t]he law by the great weight of authority seems to be settled that when a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but by the fact of insolvency, become trustees for the creditors") (citations omitted).

[280] *See* Butler & Gilpatric, *Re-Examination*, *supra* note 53 at 283 (reasoning that the going concern surplus of an insolvent firm belongs to the creditors as owners of the firm). Scholars have built on this "ownership" premise in evaluating bankruptcy law, arguing, for example, that Chapter 11 bankruptcy procedures are a way to transfer formal ownership to give effect to the creditors' entitlement. *See, e.g.*, Rasmussen, *Debtor's Choice*, *supra* note 9 at 80 (arguing that the "extant provisions of Chapter 11 are in effect a sale of the corporation to its creditors").

[281] *See* Pay 'N Pak Stores, Inc. v. Court Square Capital, Ltd. (In re PNP Holdings Corp.), No. 96-35835, 1998 WL 133560, at *4 (9th Cir. Mar. 18, 1998) (recognizing a shift in fiduciary duty to creditors once the debtor has become insolvent); FDIC v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982) (observing that "when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors"); Henderson v. Buchanan (In re Western World Funding, Inc.), 52 B.R. 743, 763 (Bankr. D. Nev. 1985) (same); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., Civ. A. No. 12150, 1991 WL 277613, at *36 n.55 (Del. Ch. Dec. 30, 1991) (mem.) (concluding that the directors of a solvent debtor "in the vicinity of insolvency" have duties to creditors, not just shareholders); *see also* Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1512-23 (1993) (reviewing the various court opinions in which corporate directors were held to owe creditors a fiduciary duty); LoPucki & Whitford, *Corporate Governance*, *supra* note 185 at 706-710 (arguing that officers and directors of an insolvent corporation owe fiduciary duties to both the shareholders and the creditors of the corporation). *But see* Norwood P. Beveridge, Jr., *Does a Corporation's*

On the other hand, even though the creditors of an insolvent debtor may be viewed as the new equitable "owners" of an insolvent debtor's property, this does not mean that they automatically gain control of this property or can easily forestall the debtor's gambling with the assets. Although non-bankruptcy debt-enforcement devices typically provide various mechanisms to enable creditors to obtain satisfaction of their claims from the debtor's assets, and although these mechanisms may include procedures that enable creditors to seize certain items in advance of their obtaining a judgment (or

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Board of Directors Owe a Fiduciary Duty to its Creditors?, 25 ST. MARY'S L.J. 589, 592-94 (1994) (criticizing the view that the managers of a solvent or insolvent corporation have any fiduciary duties to creditors). In recent years, Delaware courts have clarified that, for purposes of Delaware law, the substantive duties of a firm's officers and directors do not change when a firm approaches or becomes insolvent, at least not to the extent of suspending the business judgment rule or creating any novel causes of action that creditors may pursue. *See* Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 792 (Del. Ch. 2004) (stating that "the fact of insolvency does not change the primary object of the director's concern, which is the firm itself" and "[t]he firm's insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value and logically gives them standing to pursue claims to rectify that injury"); *see also* North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007) (stating that "[t]o recognize a new right for creditors to bring fiduciary claims against . . . directors would create a conflict between those directors' duties to maximize the value of an insolvent corporation for the benefit of all those having an interest in it"); Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 205 (Del. Ch. 2006) (rejecting "deepening insolvency" cause of action under Delaware law and emphasizing that the directors of an insolvent corporation have no fiduciary duty to choose a relatively conservative approach over a more aggressive investment strategy). The rules may be different in other jurisdictions. *See* Official Committee of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged), 659 F.3d 282 (3d Cir. 2011) (applying Pennsylvania law). In any event, consistent with the idea that the creditors' interests in an insolvent enterprise are paramount, insolvent firms are typically prohibited from paying dividends to shareholders. *See* CAL. BUS. & PROF. CODE § 501 (West 1998); D.C. CODE ANN. § 29-218 (1996); IOWA CODE ANN. § 491.41 (West 1999); MASS GEN. LAWS ch. 156B, § 61 (1992 & Supp. 1999); N.J. STAT. ANN. § 14A:7-14.1 (West Supp. 1999); N.Y. BUS. CORP. LAW § 510(a) (McKinney 1986); OHIO REV. CODE ANN. § 1701.33(C) (Anderson 1997); 15 PA. CONS. STAT. § 1551 (1995); *see also* MODEL BUS. CORP. ACT § 6.40(c)(1) & (2) (1998).

have them placed in the hands of a receiver), these devices are also typically freighted with numerous safeguards that can lead to lengthy proceedings.[282]

For example, creditors may be required to prove their claims to ensure that the debtor is not made to satisfy fictitious, or otherwise defective, obligations. Similarly, allegations of creditor fraud and other misconduct bearing on, or perhaps reducing, a particular claim may have to be tried. Significantly, these procedures typically entail varying degrees of delay. If the debtor is solvent, creditors are not harmed by the debtor's resort to these procedures in the sense that, if the creditors prevail in pursing their claims, they will ultimately receive full payment (including, perhaps, interest to compensate for the lost time-value of money and collection costs, if provided by contract, statute, or rule). Moreover, if the debtor is solvent, the debtor has incentives to avoid defaulting needlessly on legitimate obligations because doing so avoids the consequences of default, including debt-collection activity and harm to the debtor's reputation. But if the debtor is *insolvent*, unique challenges arise.

First, if a debtor is insolvent other than on a temporary basis, default is usually inevitable and unavoidable.[283] Second, the debtor's incentive to delay may cause the

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[282] For example, it can sometimes take years for a commercial dispute to wind its way through the court system. *See* Skeel, *Rethinking*, *supra* note 251 at 528 n.241 (noting that "many cases take as long as five to six years to come to trial in Chicago and other major cities"). Additional federal glosses on state law protections may entail further delay. For example, the Supreme Court has invalidated certain types of collection remedies that fail to provide adequate notice and an opportunity for a hearing to the debtor. *See* North Ga. Finishing, Inc. v. Di-Chem, Inc., 419 U.S. 601, 606-08 (1975) (invalidating Georgia's garnishment statute); Fuentes v. Shevin, 407 U.S. 67, 96-97 (1972) (invalidating the Florida and Pennsylvania replevin statutes).

[283] Some debtors, of course, experience insolvency only on a temporary basis. *See supra* note 1. But in many cases, insolvency leads to default. *See* Baird & Jackson, *Corporate Reorganization*, *supra* note 60 at 119 n.69 (1984) (observing that "whenever a firm is insolvent, defaults are inevitable").

debtor to take advantage of the time-consuming safeguards embedded in ordinary debt-collection procedures regardless of whether there is any substantive merit to the debtor's efforts (e.g., because the creditors' claims are truly defective for some reason).[284] Third, during the course of any delay in enforcement (which may be considerable), the debtor will often continue to control his property. As a result, the debtor may continue to deploy his assets in accordance with the debtor's preferences influenced by the debtor's incentive to take excessive risks—at least in the sense that the debtor, by fiat, will continue to do so regardless of any new "fiduciary" obligation to creditors.[285] If the insolvent debtor's risk preferences differ from those of at least some of the new creditor-owners (which they often will), then the debtor's continued control may result in costs to these creditor-owners in the form of losses they would not suffer if the assets were managed in accordance with the *creditors'* preferences (e.g., investments that are less risky than those the insolvent debtor would be inclined to pursue) or in accordance with the preferences of a solvent debtor with normal risk-taking incentives.

Additional complications arise in the context of insolvent firms. Before the onset of insolvency, managers owe their loyalties to the firm's equity owners. Once the firm becomes *insolvent*, however, managers may owe new fiduciary obligations to creditors.[286] Yet, because the managers of an insolvent firm typically remain subject to

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[284] *See supra* note 275 (discussing the debtor's incentives for delay).

[285] Rarely, if ever, will a court enjoin a debtor's ongoing operations pending the outcome of a commercial dispute between a debtor and creditor. *See* Grupo Mexicano de Desarrollo, SA v. Alliance Bond Fund, Inc., 527 U.S. 308, 321 (1999) (following "the well-established general rule that a judgment establishing the debt was necessary before a court of equity would interfere with the debtor's use of his property").

[286] *See supra* note 281 (discussing the potential shift of the duties of the managers of an insolvent firm from shareholders to creditors).

dismissal by preexisting equity holders (or may hold equity stakes themselves),[287] their loyalties may be divided and, as a practical matter, they may pursue the interests of the equity holders at whose pleasure they continue to serve.

Because the creditors of an insolvent firm have the right to exhaust the value of the firm's assets through the enforcement of their claims, equity holders have nothing to lose and everything to gain by the managers' increased risk taking, and thus have a "perverse incentive" to compel managers to take excessive risk, again generating a problem of overinvestment.[288] In some cases, of course, equity holders may be ineffective in coordinating and promoting their interests (e.g., because they are too numerous and diffuse).[289] In other instances, however, they may well coalesce into a cohesive and organized force, and exert a strong influence on management decisions, particularly where the owners and managers of the firm are one and the same.[290]

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[287] *See* Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.), 801 F.2d 60, 69 (2d Cir. 1986) (holding that the equity holders of an insolvent company could hold a meeting to replace the corporate directors absent a finding that the equity holders intended to completely derail the debtor's reorganization); In re J.P. Linahan, Inc., 111 F.2d 590, 592 (2d Cir. 1940) (stating that "the right of the majority of stockholders to be represented by directors of their own choice and thus to control corporate policy is paramount and will not be disturbed unless a clear case of abuse is made out"); *see also* Skeel, *Rethinking*, *supra* note 251 at 507 (discussing the Manville decision).

[288] *See* Skeel, *Evolutionary*, *supra* note 147 at 1333 (discussing the concept of "perverse incentives"); *see also supra* notes 147, 261 (discussing the concept of "overinvestment").

[289] *See* Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 39-55 (1988) (describing various problems in coordinating shareholder voting, including voter apathy); *see generally* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 4-18 (1994) (outlining the development of the model of detached, fragmented ownership of American firms).

[290] CHANCELLOR, DEVIL, *supra* note 261 at 330 (observing that "[b]ecause the interest of management is nowadays more closely aligned with shareholders through executive

Moreover, individual self-interest may color the managers' decision making in inappropriate ways,[291] thus yielding additional variables in the cost equation.

This is not to say, of course, that the managers of an insolvent firm never represent the interests of creditors. Managers, particularly those who have no significant equity position in the firm, may prefer less risky investments than equity holders in order to prevent the complete failure of the firm and the loss of any firm-specific investment that they have made (such as their investment in accumulating expertise in managing the particular business of the debtor) and that they would forfeit if they were to lose their positions. Certainly risk of job loss incident to bankruptcy is significant.[292] But that is not the only consideration, and many managers, particularly those with significant equity positions, may well be inclined toward increased risk taking.[293]

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stock-option schemes" the shareholders "hold the whip and will crack it when necessary").

[291] For example, managers might discriminate in favor of the payment of claims that they have guaranteed personally, even though preferring other claims might have more beneficial effects for the firm. *See supra* note 251 (citing cases involving a manager's payment of a claim that he guaranteed ahead of other claims); *see also* Rasmussen, *Behavioral Economics*, *supra* note 56 at 1685 (observing that "managers, in selecting which investments to pursue, will act in their own self-interest. Thus managers will make investment decisions based on how management will fare both when the decisions turn out to be successes . . . and when they turn out to be failures.").

[292] *See supra* note 185 (discussing likelihood that managers will be replaced before and after a firm files for bankruptcy); Baird & Bernstein, *Absolute Priority*, *supra* note 190 at 1932-33 (observing that "[o]ld managers frequently are replaced (often before the Chapter 11 case even begins) with turnaround specialists whose loyalties, if any, are with the senior creditors."); Gilson, *Bankruptcy*, *supra* note 185 at 386 (reporting findings on management displacement); Gilson, *Management*, *supra* note 185 at 261 (same).

[293] As one commentator has argued, the evidence suggests that

> even prior to insolvency and outside bankruptcy, in many firms the managers' equity investments are large enough and their fiduciary duties are strong enough [to equity holders] to align management and equity

All of the foregoing are forms of agency costs and, of course, agency costs are certainly nothing new.[294] Nor are they limited to insolvency situations.[295] What is unique in the insolvency context, however, is the degree to which the relevant risk incentives change, depending on the depth of the debtor's financial crisis and the debtor's prospects for recovery. In non-bankruptcy systems, agency costs may be controlled in a variety of ways (e.g., by creating incentives to avoid them, including imposing liability rules for certain types of behaviors)[296] and, at least ideally, the costs of these controls

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> interests. After insolvency, and once inside bankruptcy, that incentive not only persists but is enhanced, because when bankruptcy's potential effect on the managers' jobs becomes real, managers' interests in the debtor are pared to their equity investments and abilities to use the reorganization process to prolong their employment or to exact other personal benefits.

Adler, *Bankruptcy*, *supra* note 56 at 450 (footnotes omitted).

[294] *See supra* note 150 (discussing the concept of "agency costs"); Adams, *Governance*, *supra* note 150 at 601 (same); Jensen & Meckling, *Theory*, *supra* note 150 at 308 (same). For an extreme historical example, see ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 741 (R.H. Campbell, et al. eds. 1976) (describing the management of the South Sea Company, a notoriously speculative venture at the center of the South Sea Bubble crisis in England in 1720); CHANCELLOR, DEVIL, *supra* note 261 at 58-95 (discussing the South Sea Bubble).

[295] *See* Erica M. Ryland, *Bracing for the "Failure Boom": Should a Revlon Auction Duty Arise in Chapter 11?*, 90 COLUM. L. REV. 2255, 2255-58 (1990) [hereinafter Ryland, *Bracing*] (discussing agency costs in the non-bankruptcy context); *see generally* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980) (discussing agency costs generally).

[296] *See* Adams, *Governance*, *supra* note 150 at 601-03 (arguing that, although market forces and contractual relationships act to control agency costs, corporate law also attempts to control agency costs by imposing upon management the fiduciary duties of care and loyalty); Ryland, *Bracing*, *supra* note 295 at 2255-58 (explaining how state corporate law has attempted to control agency costs in the non-bankruptcy context); Skeel, *Evolutionary*, *supra* note 147 at 1332-33 (observing that "[m]uch of corporate law and of the parties' own contractual arrangements can be seen as efforts to minimize . . . agency costs").

should not exceed the costs they avoid.[297] Moreover, one would expect that, in non-bankruptcy systems, the relevant controls would be tailored to the norms of non-bankruptcy circumstances (e.g., the assumption that the equity holders of a solvent firm have appropriate incentives to compel managers to act in normatively appropriate ways).

Insolvency, however, creates a novel cost context in which key assumptions underlying normal legal regulation and the operation of ordinary markets no longer hold true.[298] Indeed, the situation is radically different. Because (1) insolvency creates special incentives for wasteful delay and excessive risk taking, (2) these problems are complex and contentious, and (3) it would make no sense for ordinary non-bankruptcy law to address them, they satisfy the circumstances of bankruptcy legality and are thus properly the subject of bankruptcy law.[299]

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[297] *See* COASE, FIRM, *supra* note 7 at 26-27 (arguing that legal regulation is often necessary to control costs, but that the losses sought to be avoided should be greater than the costs of the controls). Some commentators have challenged the effectiveness of certain non-bankruptcy legal controls on agency costs, particularly shareholder derivative actions. *See* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991) (questioning the utility of derivative actions); Skeel, *Rethinking*, *supra* note 251 at 498 (discussing debate on the utility of derivative actions).

[298] *See* Adams, *Governance*, *supra* note 150 at 605-07 (explaining that agency costs are greater when corporations become insolvent); Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633, 641-46 (1993) [hereinafter Baird, *Revisiting*] (discussing the agency costs that arise during bankruptcy).

[299] Current bankruptcy law seeks to reduce the costs associated with delay and excessive risk-taking. For example, in Chapter 7 cases a trustee (who may be elected by creditors) displaces the debtor and liquidates the debtor's non-exempt assets for the creditors' benefit, subject to court supervision, the opportunity for creditor involvement, and supervision by the office of the United States Trustee. *See supra* notes 16, 241 (outlining procedures in Chapter 7 cases). In Chapter 11 reorganization cases, the debtor typically remains in control of the assets, but is subjected to court supervision, information-sharing requirements, scrutiny by creditors, and shared decision-making. *See supra* notes 16, 126, 241 (outlining procedures in Chapter 11 cases). In addition, the provisions of Chapter 11 create a structured bargaining process for the resolution of the debtor's fate through shared decision making (i.e., decision making superintended by special forms of

DUELING STAKEHOLDERS, THE DEBT-COLLECTION "FREE-FOR-ALL," AND STAGNATING AND OVERBURDENED ASSETS

In addition to the problems addressed above that focus on an insolvent *debtor's* incentives to mismanage his property, there are similar problems related to the behavior of creditors. These arise from the way in which creditors perceive their competing interests in the debtor and the debtor's property, the circumstances of their diverse relationships with the debtor, and their heterogenous perspectives on risk. As a group, these problems are characteristically complex and contentious, and likewise sufficiently insolvency related that it would make no sense to address them through the modification of ordinary non-bankruptcy procedures. Accordingly, they also satisfy the circumstances of bankruptcy legality. In order to explain these problems fruitfully, however, it is helpful first to distinguish the interests and incentives of different illustrative creditor constituencies.

DUELING STAKEHOLDERS

Just as the risk preferences of an insolvent debtor may differ substantially from those of a solvent debtor or any particular creditor, the risk preferences of one creditor may be quite different from those of another. Similarly, they may also have quite different perspectives on the nature of their respective relationships with the debtor and their interests in the debtor and the debtor's property. A comparison of three hypothetical creditors illustrates the point.

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legal regulation), either culminating in a sale of the debtor's business or the negotiation of a plan providing for the disposition of the debtor's assets and the payment of claims. *See* Baird & Bernstein, *Absolute Priority, supra* note 190 at 1932, 1950-51 (observing that a Chapter 11 proceeding may involve the sale of the business or a stand-alone reorganization, and discussing the dynamics of the negotiation process). The shared decision-making process is designed to negate incentives for delay and excessive risk-taking.

First, suppose an insolvent debtor is obligated to a secured creditor for some amount of funded indebtedness (i.e., loans of money) and is in default on his obligation. If the value of the creditor's collateral is sufficient to pay off the claim in full, the secured creditor may well wish to dispose of its collateral as quickly as possible after the debtor's default (regardless of the impact of doing so on the debtor's operations or other creditors), thereby permitting the creditor to obtain a quick recovery and allow it to reinvestment the funds with some other borrower.[300] Secured creditors typically have some idea of what they believe their collateral is worth (even if their estimate may not be precisely accurate). They are also typically suspicious that an insolvent debtor will tend to gamble with their collateral. Accordingly, the secured creditor may be understandably squeamish about the debtor's continued use of any collateral after default, particularly any use that might result in any diminution in the collateral's value (e.g., its use to run the debtor's business, or to pay other claims). Creditors of this type (with much to lose and little to gain from the debtor's continued use and control of collateral) may be classified as generally tending to be highly risk averse—a conclusion perhaps bolstered by the fact that they took security in the first place.[301]

Second, the insolvent debtor may also be indebted to an unsecured trade creditor who supplies the debtor with goods and services. If the current value of the debtor's assets (after deducting the value of secured claims) is insufficient to pay the trade creditor in full for its prior unpaid invoices, the trade creditor might nonetheless be willing to cut

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[300] *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 42 at 667 (observing that, traditionally, senior secured lenders have been "biased toward liquidation").

[301] *See* Triantis, *Theory*, *supra* note 126 at 910-12 (discussing a secured creditor's preference to avoid risk with respect to its collateral).

the debtor some slack and continue to extend credit to the debtor if the debtor's prospects for continued operation are at least reasonable. To begin with, this may be the only way that the trade creditor may be able to recover a greater percentage of its unpaid invoices. In addition, the trade creditor's willingness on this score would likely increase if the creditor is able to continue selling new goods to the debtor with some assured means of payment, such as on a C.O.D. or some other type of cash basis, particularly if the payments come from some other creditor's collateral (e.g., the proceeds of the debtor's accounts receivable in which a secured creditor may hold a security interest). Significantly, these new sales will likely generate profit for the trade creditor, and this profit might be thought of as a means of offsetting some of the trade creditor's losses if the old debt is not paid.[302] Similarly, the debtor's continued ability to make purchases from the trade creditor will allow the trade creditor to retain a customer, thereby preventing (or at least mitigating) the loss of any investment that the trade creditor made in acquiring and retaining the debtor as a customer in the first place.[303] Hence, because of the trade creditor's particular position (with something to lose from the debtor's continued operations, but also something to gain), the trade creditor may well be less risk averse than the secured creditor regarding the debtor's continued operations.

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[302] A trade creditor's profit structure is often quite different from that of a secured lender. A secured lender may have a profit margin of a few basis points. Trade creditors, however, may have as much as a 40-60% mark-up on their products (and sometimes more). The amount of margin in any particular case can vary tremendously. *See* Rasmussen, *Behavioral Economics*, *supra* note 56 at 1693 (observing that financial intermediaries such as banks "tend to make investments [i.e., loans] that have a capped upper limit on the potential return they will receive" in contrast to those who sell goods to a firm).

[303] The trade creditor may have made a sizeable investment in one form or another in attracting and keeping the debtor as a client.

Third, the insolvent debtor may be indebted to an employee for unpaid wages or other employment benefits. If the current value of the debtor's assets is insufficient to pay the employee's unpaid claim in full, but the debtor continues to employ the claimant, he may be quite willing to cut the debtor a great deal of slack if the alternative is the liquidation of the debtor's property and a consequent loss of employment (assuming assured payment for future services). Hence, the employee (with a lot to gain and relatively little to lose from the debtor's continued operation) may be even less risk averse than the trade creditor regarding the debtor's continued operations.[304]

The picture may be complicated even further by a host of additional factors of almost infinite variation. For example, a secured creditor may also hold an unsecured claim. This unsecured claim might be an entirely separate claim against the debtor, or might arise simply because the value of the collateral underlying the creditor's secured claim is insufficient to pay the claim in full, leaving a "deficiency."[305] The holder of

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[304] One commentator has explained the competing interests of various creditor constituencies as follows:

> under certain circumstances, the value-maximizing decision might be to discontinue a financially distressed business that is currently unprofitable, but that nonetheless is a viable economic entity in the longer term. In such a situation, promoting the interests of the firm's investors would presumably defeat the interests of the firm's employees in preserving their jobs. Financial distress creates a political arena, in which various constituencies of the firm pursue competing and often incommensurable aims. In financial distress, pursuing one set of aims typically frustrates other aims.

Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669, 732 (1993).

[305] Deficiency claims commonly arise in the foreclosure context and they represent the difference between the amount of the debt owed and the value of the collateral where the former is greater than the latter (in contrast, where the value of the collateral exceeds the amount of the debt, the difference is known as a "surplus"). *See, e.g.*, ARIZ. REV. STAT.

both a secured and unsecured claim may harbor conflicting motivations, depending on the amount of each claim and the particular circumstances of the case.[306]

In addition, informational asymmetries may cause some creditors to view the debtor's prospects inaccurately, coloring their preferences.[307] Similarly, some creditors may hold ancillary rights of payment from alternative sources, such as third-party guarantors, or have purchased derivative enhancements, such as credit default swaps.[308]

ANN. §§ 33-727, 33-729, 33-730 (West 1990); CONN. GEN. STAT. § 48-14 (1994); TEX. PROP. CODE ANN. § 52.004 (West 1995). Like commercial law generally, bankruptcy law recognizes and provides a means to calculate a secured creditor's deficiency claim. Under the Bankruptcy Code, to the extent that the amount of a secured creditor's claim is greater than the value of the collateral securing the claim, the secured creditor is commonly left with an unsecured deficiency claim against the debtor's bankruptcy estate. *See* 11 U.S.C. § 506(a) (2000 & Supp. 2006); Associates Commercial Corp. v. Rash, 520 U.S. 953, 961 (1997) (explaining that section 506(a) "tells us that a secured creditor's claim is to be divided into secured and unsecured portions, with the secured portion of the claim limited to the value of the collateral"); United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 371-72 (1988) (explaining the operation of section 506(a)).

[306] *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 42 at 685 (observing that creditors may wear "multiple hats" by holding different kinds of debts of the debtor).

[307] For example, different creditors may have different access to a debtor's financial information. *See* Fischer Black, *Bank Funds Management in an Efficient Market*, 2 J. FIN. ECON. 323, 326 (1975) [hereinafter Black, *Bank Funds*] (observing that banks may have more immediate access to a debtor's financial records available as part of the bank's overall relationship with the debtor).

[308] *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 42 at 679-84 (discussing credit default swaps, which enable a creditor to recover the face amount of its loan from a counterparty upon the occurrence of a "credit event" such as the debtor's bankruptcy). In general, the Bankruptcy Code does not affect a creditor's rights against third party guarantors who are not themselves in bankruptcy. *See* 11 U.S.C. § 524(e) (2000 & Supp. 2006) (providing that "[e]xcept as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt"). In some circumstances, however, a bankruptcy court may issue an injunction staying collection actions against third-party guarantors if, among other things, the injunction is necessary to permit the debtor to reorganize successfully. *See* Regency Realty Assocs. v. Howard Fertilizer, Inc. (In re Regency Realty Assocs.), 179 B.R. 717, 719 (Bankr. M.D. Fla. 1995). In the Regency case, the court explained that

Finally, even creditors that hold similar kinds of claims may harbor vastly different risk preferences. For example, one secured creditor may be the administrator of a conservatively run pension fund, while another might be the administrator of a high-yield junk-bond portfolio or hedge fund.[309]

As long as the debtor can pay all claims in full, the motivations and risk preferences of the creditors are relatively unimportant because the debtor may accommodate all of the creditors' various biases and risk tolerances simply through the payment of their claims as required by the parties' individual agreements or by law. Once the debtor becomes *insolvent*, however, the motivations of the creditors become critically relevant because of (1) their new status as creditor-owners and their ability to exercise a variety of remedies against the debtor following the debtor's default, and (2) the debtor's corresponding inability to orchestrate their diverse perspectives and interests through performance. At the same time, because the preferences of creditors may be rationally divergent, it may be difficult (if not impossible) for a diverse group of them to

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> in a Chapter 11 reorganization case the Bankruptcy Court may use its power granted by § 105 to temporarily protect non-debtors by injunctive relief. The classic scenario which warrants such relief is an affirmative showing with competent proof that the non-debtors sought to be protected (1) have the financial wherewithal and (2) they are willing to contribute their credit, funds or properties to fund the plan of reorganization of the Debtor.

Id.; *see also* Chase Manhattan Bank v. Third Eighty-Ninth Assocs. (In re Third Eighty-Ninth Assocs.), 138 B.R. 144, 148-49 (S.D.N.Y. 1992) (upholding an injunction staying collection actions against one third-party guarantor because he was intimately involved with the debtor's management and necessary for a successful reorganization).

[309] *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 42 at 670, 671 ("Banks and hedge funds, though owning the same instrument, often have drastically different business models" and, hence, very different views on risk; "[f]ar from having a liquidation bias, a hedge fund may affirmatively want to advance a reorganization plan in which it ends up with the equity of the business.").

agree among themselves on an appropriate disposition of the debtor's property, let alone reach a collective agreement with the debtor.[310] In many instances, this incendiary set of circumstances is likely to lead to a debt-collection "free-for-all," with deleterious consequences.

THE DEBT-COLLECTION FREE-FOR-ALL

In the absence of an agreement forestalling collection activity, once a debtor becomes insolvent (or nearly so), claimants with the most conservative risk tolerances will likely begin to exercise their rights of enforcement on an immediate basis for any number of reasons. First, under applicable non-bankruptcy law, it may be their general right to do so (assuming the existence of a default). Second, they may fear payment discrimination if they do not take immediate steps to collect their claims—particularly secured creditors who fear that the debtor will use their collateral to satisfy the claims of other creditors. Third, they may not wish the debtor (or other creditors) to take increased risks with their collateral. Fourth, they may take a dim view of the debtor's prospects, even assuming that the debtor is likely to be able to stave off other creditors for the time being. Significantly, some creditors may take this view systematically—not because of any individual assessment of any particular debtor, but simply because they generally hold the view that the reasons for an insolvent debtor's decline are typically endogenous

[310] *See supra* at 78-80 (discussing difficulties associated with reaching agreement among creditors regarding the disposition of the debtor, the debtor's assets, and the debtor's liabilities). Because their claims are individual in nature, the creditors of an insolvent firm typically have rights that are more complex as a group than those of any class of ordinary shareholders of a solvent firm. For example, ordinary shareholders typically receive *pro rata* dividends, and have no individual collection rights entitling them to liquidated sums of money at prescribed points in time. Creditors, on the other hand, have widely divergent payment rights, as well as individual collection entitlements. This diversity obviously complicates the handling of claims in the bankruptcy context.

(e.g., arise from poor management) rather than exogenous (i.e., arise from circumstances beyond the debtor's control). Creditors may tend to take this view because it is often difficult to determine whether a particular debtor's demise is actually the result of incompetence or simply arises from circumstances beyond the debtor's control.

Moreover, once some creditors begin to exercise their rights, others will often follow suit, if for no other reason than to avoid the prospects of being left behind while the debtor pays other claims. This, in turn, will often precipitate a rush of collection activity, leading to a debt-collection free-for-all.[311] Although all creditors might participate (other than those whose obligations are not yet in default or who did not know that accelerating collection activity had begun),[312] the preferences of creditors with the lowest risk tolerances will often initiate the process. But just as a debtor's high-risk tendencies may lead to unsound asset speculations and the incurrence of agency costs at the expense of creditors,[313] the low risk tolerances of certain creditors may lead to unsound asset liquidations at the expense of others affected by a debtor's financial downfall.

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[311] *See* JACKSON, LOGIC, *supra* note 8 at 16 n.20 (observing that creditors are most likely to "attempt to collect their claims at roughly the same time" upon learning of a debtor's insolvency); Theodore Eisenberg, *Bankruptcy in the Administrative State*, 50 LAW & CONTEMP. PROBS. 3, 33 (1987) (observing that "[b]ankruptcy sends a signal to everyone dealing with a bankrupt debtor: 'Get out now with as much as you can as fast as you can'").

[312] *See supra* at 134 (discussing how certain creditors may not yet even know they hold claims against the debtor at the time other creditors begin collecting on their claims).

[313] *See supra* note 150 (discussing the concept of "agency costs").

For a number of reasons, quick foreclosure liquidations typically realize lower prices.[314] For example, as one commentator has summarized: "[e]stimates suggest that a typical home loses something like half its value when it goes into foreclosure . . . . In addition, foreclosures disrupt lives, create neglected properties, and leave whole neighborhoods suffering."[315] Similarly, the piecemeal dismemberment of an insolvent firm's assets may well destroy its enterprise value.[316] Creditors understand this, and thus

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[314] *See supra* note 155 (discussing this point); *see, e.g.*, BFP v. Resolution Trust Corp., 511 U.S. 531, 539 (1994) ("property that must be sold [through a quick liquidation procedure] is simply worth less" because "[n]o one would pay as much to own such property as he would pay to own real estate that could be sold at leisure and pursuant to normal marketing techniques."); SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 222 (observing that quick foreclosure sales "are notorious for fetching low prices.").

[315] ALAN S. BLINDER, AFTER THE MUSIC STOPPED, THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD 321 (2013) [hereinafter BLINDER, AFTER].

[316] *See* DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 40 (2d ed. 1990) (noting that when secured creditors act in their own self-interest and exercise their rights to the collateral, the going concern value of the debtor may be destroyed); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992) [hereinafter Bradley & Rosenzweig, *Untenable*] (explaining that, in adopting the Bankruptcy Code in 1978, "Congress believed that assets would be more highly valued if utilized in the industry for which they were designed, rather than scrapped"); Butler & Gilpatric, *Re-Examination*, *supra* note 53 at 272-73 (arguing that, if the creditors individually press their claims, the total value of the firm may decline because, "the firm may have a greater value to its creditors as a going concern than in liquidation"); *see also* Adams, *Economic Justification*, *supra* note 181 at 129 (arguing that "[t]here are situations . . . in which an insolvent corporation is worth saving," naming Texaco, Manville, and A.H. Robbins as examples); Theodore Eisenberg & Soichi Tagashira, *Should We Abolish Chapter 11? The Evidence from Japan*, 23 J. LEGAL STUD. 111, 113 (1994) (arguing that even a low rate of reorganization among small and mid-sized Chapter 11 cases yields more to creditors than liquidation); *supra* note 195 (discussing the rehabilitative purposes of Chapter 11 reorganization). On the other hand, efforts to reorganize debtors sometimes may do more harm than good. *See* Baird & Jackson, *Bargaining*, *supra* note 60 at 741. For example, with respect to firms suffering from economic distress, Baird and Jackson have argued that

> [s]ome firms that cannot meet their obligations are not worth keeping intact as going concerns. These are the manufacturers that sell computers

often threaten to exercise their rights in order to extract payment from debtors experiencing financial distress precisely because the exercise of their rights may be disastrous to the enterprise.[317] Typically, however, the insolvent debtor's acquiescence will lead only to more debt-collection activity. The consequence is that the debtor's assets are likely to be caught up in a frantic debt-collection drama rather than being put to more productive use.

In situations involving *solvent* debtors, the ability of a creditor with risk-averse preferences to trigger a debt-collection free-for-all is controlled in important ways. To begin with, even the most risk-averse creditor cannot exercise its rights in the absence of the debtor's default, or in a manner contrary to applicable contractual or legal requirements. Thus, so long as the debtor complies with his obligations, precipitous debt-collection activity cannot proceed. In turn, the ability of a creditor to demand hair-trigger

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> no one will buy and the restaurants that serve food no one will eat. The firm's assets are worth more sold piece by piece than as a unit.

Id.; *see also* Baird, *Revisiting*, *supra* note 298 (arguing in favor of auctioning off the debtor assets to avoid the unwarranted costs of reorganization); William L. Cary, *Liquidation of Corporations in Bankruptcy Reorganization*, 60 HARV. L. REV. 173, 194 (1946) (observing that "[r]ehabilitation of the debtor, though it may be possible, is not always the best solution, either for the creditors and security holders or for the economy as a whole"); *see generally* Baird & Bernstein, *Absolute Priority*, *supra* note 190 at 1936 ("If reorganization law should facilitate absolute priority (as we believe it should) and if it already takes close to maximum advantage of markets (as we believe it does), reform should focus on its appraisal mechanism and the challenge of minimizing the variance associated with its valuations.").

[317] *See* Block-Lieb, *Why*, *supra* note 124 at 847 (arguing that the creditors' exercise of their rights "can close down a debtor's business or render an individual virtually penniless. Creditors know this and often threaten to pursue [their] remedies solely to intimidate the debtor into payment."); *see also* Arthur A. Leff, *Injury, Ignorance and Spite—The Dynamics of Coercive Collection*, 80 YALE L.J. 1, 17-18 (1970) (discussing the use of collection remedies); LoPucki, *General Theory*, *supra* note 181 at 355 (discussing collection remedies and creditor behavior).

default terms is controlled by market forces through the availability of credit with less stringent conditions.[318]

In addition, because a solvent debtor can pay all claims in full, other creditors who understand that the debtor is solvent are less likely to take precipitous action even if the debtor happens to default on his obligations to one creditor. Moreover, following default, a solvent debtor is more likely to be able to pay off an aggressive risk-averse creditor, thus stopping any further debt-collection activity in its tracks. Hence, as long as the debtor remains financially sound, the opportunity for an aggressive risk-averse creditor to trigger a debt-collection free-for-all is constrained.

So long as the debtor remains financially healthy, matters thus tend to proceed in fairly routine, stable, and predictable ways, and relevant legal structures generally reflect this reality. Apart from prescribing certain types of remedial procedures and a relatively limited number of mandatory rules, non-bankruptcy law does not strictly limit the contractual options of creditors to declare defaults and exercise their rights, presumably because debtors and creditors are efficient decision makers in structuring and policing their own contractual arrangements. Further, in the context of a solvent firm, the presence of debt obligations is thought to help police the behavior of managers.[319]

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[318] In a competitive market, a financially healthy firm should be able to shop for the best terms, including less costly (i.e., less restrictive) covenants. *See* Douglas W. Diamond, *Monitoring and Reputation: The Choice Between Bank Loans and Directly Placed Debt*, 99 J. POL. ECON. 689, 690 (1991) [hereinafter Diamond, *Monitoring*] (observing that financially healthy debtors may be able to borrow funds from the public debt markets at lower cost as compared to other forms of lending); *see also* Rasmussen, *Behavioral Economics*, *supra* note 56 at 1683 (observing that "[r]ational debtors have the incentives to borrow money and purchase goods at the lowest possible cost. They force creditors to compete for the opportunity to supply credit.").

[319] This is the so-called bonding role of debt. *See supra* note 146; Aghion, et al., *Economics*, *supra* note 146 at 531 (citing Sanford J. Grossman & Oliver D. Hart,

Without debt, it is argued, managers might tend to shirk their responsibilities more readily because of the general inability of diverse shareholders to police their conduct effectively.[320] Creditors, on the other hand, may be better able to keep managers in line by establishing and monitoring consistent benchmarks for their performance.[321]

In contrast, an insolvent debtor's situation is quite different. First, default is the norm.[322] Second, the more insolvent the debtor becomes, the more likely it is that the interests of the various parties affected by the debtor's financial demise will diverge. As noted above, just as increasingly insolvent debtors are more likely to adopt riskier strategies in order to recover their positions, risk-averse creditors are more likely to grow squeamish and insist on exercising their rights. Because risk-averse creditors hold the collection trump card (in the absence of some form of external constraint), a debtor's deepening financial crisis is only all the more likely to trigger an avalanche of collection activity.

Corporate Financial Structure and Managerial Incentives, printed in THE ECONOMICS OF INFORMATION AND UNCERTAINTY 107 (J.J. McCall ed. 1982)) (observing how "debt plays an important role in constraining or bonding managers to act in [the equity] holders' interests"); Jensen, *Agency Costs*, *supra* note 146 at 324 (discussing the "control function of debt" to police managerial behavior); *see also* Triantis & Daniels, *Role of Debt*, *supra* note 146 at 1082 (arguing that creditors may be better able to keep managers in line than equity holders).

[320] *See* Jensen, *Agency Costs*, *supra* note 146 at 324 (arguing that "debt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers"); *see also supra* note 150 (discussing the concept of "agency costs").

[321] *See* Triantis & Daniels, *Role of Debt*, *supra* note 146 at 1082 (making this point with respect to bank lenders).

[322] *See supra* note 283; Baird & Jackson, *Corporate Reorganization*, *supra* note 60 at 119 n.69 (making this point).

Notably, the foregoing sketches out the basic circumstances of the collective-action dilemma.[323] As a group, everyone with an interest in an insolvent debtor (including creditors) may be better off if a debt-collection free-for-all is avoided. Yet creditors individually have incentives to engage in value-destroying debt collection activities and often do, generating a problem of underinvestment in the general sense of fomenting the suboptimal deployment of the debtor's assets.[324]

Often enough, the costs of the ensuing debacle are difficult to justify. For example, they may arise not because creditors with risk-averse preferences are in any real jeopardy, but simply because these creditors harbor risk-averse tolerances and have nothing to lose from exercising their rights. But even where creditors with highly risk-averse preferences actually are in some form of jeopardy (owing perhaps to deteriorating collateral), creditors as a group may still fare much worse in a debt-collection free-for-all than if the debtor's assets were shepherded in a more value-enhancing manner. Because the problem of the debt-collection free-for-all stems from insolvency and is likewise complex and contentious, it is properly a bankruptcy question.[325]

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[323] *See supra* at 24-25; JACKSON, LOGIC, *supra* note 8 at 10 (explaining the problem of collection action, and observing that, when a debtor is insolvent, "the system of individual creditor remedies may be bad for the creditors *as a group* when there are not enough assets to go around" because creditors will tend to act in self-interested ways in seeking repayment, without regard to whether their individual collection activities reduce the value for all creditors).

[324] *See supra* note 147 (discussing the concept of "underinvestment").

[325] Bankruptcy law currently prescribes a number of mechanisms to address the problem of the debt-collection free-for-all. As noted, the commencement of a bankruptcy case triggers the automatic stay, which enjoins most debt collection activities against the debtor and property of the estate during the bankruptcy proceeding. *See* 11 U.S.C. § 362(a) (2000 & Supp. 2006); *supra* note 16. While secured creditors are enjoined from foreclosing on their collateral, they are entitled to protection against the erosion of their security, thus protecting them (albeit imperfectly) from the risk of the debtor gambling

STAGNATING AND OVERBURDENED ASSETS

In addition to the debt-collection free-for-all, additional problems arising in the insolvency context include the challenges of stagnating and overburdened assets. These may take three very different forms.

First, insolvent debtors who have defaulted on their obligations will not always act on their incentives to take excessive risks, but may instead take the opposite tack if necessary to appease a particularly influential creditor, particularly a secured creditor holding a tight grip on key assets.[326] Individual debtors (as well as the managers of insolvent firms) who cannot avoid the imminent debt-collection activities of an influential risk-averse creditor may sometimes make improvidently conservative investment decisions as a form of appeasement, even if this means foregoing reasonable opportunities that would otherwise enhance the debtor's value.[327] This illustrates another example of the potential for insolvency to generate conditions for underinvestment.[328]

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with their collateral. *See* United Sav. Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365, 368-75 (1988) (discussing adequate protection); Baird & Jackson, *Corporate Reorganization*, *supra* note 60. The liquidation provisions of Chapter 7 attempt to reconcile the interests of all creditors charged with representing their collective interests. *See supra* note 241 (discussing the liquidation provisions of Chapter 7). Through its shared decision-making mechanisms (i.e., decision making superintended by special forms of legal regulation), the reorganization provisions of Chapter 11 attempt to reconcile the diverse interests of creditors as a group through a negotiated plan of reorganization, or agreement on some other disposition of the debtor's assets. *See supra* notes 241, 299 (discussing the shared decision-making mechanisms of Chapter 11).

[326] *See supra* at 131, 163-64.

[327] *See* Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.), 596 F.2d 1092, 1098 (2d Cir. 1979). In Otte, the court observed that

> [t]he debtor in possession [in a Chapter 11 case] is hardly neutral. Its interest is in its own survival, even at the expense of equal treatment of creditors, and close relations with a lending institution tend to prevent the

In the case of a solvent debtor, this problem may be avoided by the simple expedient of avoiding default. It may also be avoided by obtaining alternative financing from less controlling lenders (albeit perhaps on more expensive terms). If a debtor is insolvent, however, alternative financing is likely to be in extremely short supply, and ordinary market protections are unlikely to be of assistance.

Second, the assets of insolvent debtors are frequently over-encumbered, meaning that the total amount of the debt secured by all liens attached to them exceeds the assets' value. As a result, the assets may be underutilized because the debtor may be impaired in his efforts to sell them to some third party (or otherwise dispose of them) because creditors (and in some instances the shareholders of an insolvent firm) may have perverse incentives to block value-maximizing dispositions.

For example, suppose that two creditors, a bank and an investment company, hold liens on the debtor's equipment. In addition, suppose that the value of the debtor's equipment is $100,000, and the amount of the debt owed to the bank is $100,000. Suppose also that the amount owed to the investment company is $30,000. It is reasonable to assume that, absent special circumstances, no third party would be willing to purchase the equipment if the liens remained attached to it because no rational buyer would pay $130,000 (the amount necessary to discharge the liens) for an asset worth $100,000. Conversely, if the debtor were otherwise unable to satisfy the investment

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> exploration of other available courses in which a more objective receiver or trustee would engage.

Id.

[328] *See* Triantis, *Theory*, *supra* note 126 at 910-12 (discussing how certain creditors of an insolvent debtor, particularly those extending credit on a secured basis, may cause the debtor to under-invest through excessively risk-adverse debt covenants).

company's claim, the investment company could be expected to refuse to consent to the voluntary release of its lien unless it received some form of compensation out of funds that would otherwise go to the bank—in other words, it would use its liens to hold the equipment hostage.

In the case of a solvent debtor, this type of holdout behavior has a ready solution: the debtor may simply pay the claim of the investment company and sell the asset. In the insolvency context, however, this type of problem often has no ready solution, short of foreclosure by the senior secured party to free the asset of encumbrances. But foreclosure may be precisely what the debtor and other creditors may well wish to avoid in order to maximize the collateral's value—and, if nothing else, avoid an unnecessary deficiency claim.

Third and most important, insolvency otherwise tends to promote misapplication of the debtor's resources, including, in the case of individuals, the debtor's human capital. To begin with, as noted above, insolvent debtors tend to engage in a variety of activities to stave off the creditors' debt-collection activities. At times, these avoidance efforts can be quite complex and time-consuming, and sometimes involve intricate schemes including gratuitous transfers (discussed below). These avoidance efforts also ultimately tend to be futile in the long run. Obviously, the debtor's labor and other resources could be devoted more productively toward other endeavors.

In addition, as a general rule, the creditors' debt-collection rights against a debtor typically extend not only to a debtor's current assets, but also to whatever property a

debtor may obtain in the future.[329] If the debtor's current obligations are sufficiently onerous, they may well exhaust the entirety of the value of the fruits of the debtor's foreseeable endeavors, excluding exempt property. To the extent that the debtor cannot reap the benefits of his labor owing to the collection activities of persistent creditors, the debtor's incentive to engage in productive activities and acquire and hold property is reduced, if not eliminated entirely.

Under applicable non-bankruptcy law, the ability of creditors to enforce their claims has obvious value, in spite of its cost on defaulting debtors, and this value is presumably greater than the cost.[330] Among other reasons, without debt enforcement mechanisms, there would be little incentive to lend and commerce would grind to a halt.[331] Moreover, as a general rule, the law leaves it to creditors to decide whether or not

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[329] *See* Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188 (1902) (observing that creditors are entitled generally to payment *in personam* from the debtor or *in rem* from the debtor's property).

[330] In a classic essay, Walter Blum observed the point regarding the need to respect the creditor's non-bankruptcy collection rights in the face of the potential harshness of vindicating those rights. *See* Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 565-80 (1950). But as Coase has suggested in an analogous context:

> The problem which we face in dealing with actions which have harmful effects is not simply one of restraining those responsible for them. What has to be decided is whether the gain from preventing the harm is greater than the loss which would be suffered elsewhere as a result of stopping the action which produces the harm.

Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 27 (1960) [hereinafter Coase, *Problem*]. Although there are benefits to the enforcement of claims, the issue is how far those benefits extend in the context of insolvency, and whether they effectively hit an even greater wall of countervailing costs.

[331] *See* LoPucki, *General Theory*, *supra* note 181 at 315 (noting that debt-collection remedies facilitate lending); *see also* Jackson, *Fresh-Start*, *supra* note 20 at 1427

to pursue individual debt-collection activity, presumably because leaving the decision to them is generally desirable.[332]

Enforcing debts against insolvent debtors, however, presents a special cost scenario. A particular creditor who pursues a debtor vigorously may succeed in collecting some or all of its claim, but obviously not all of the creditors of an insolvent debtor will be able to do so. In the meantime, their direct collection and monitoring costs are likely to be relatively high (as discussed in greater detail below), as will be the direct costs of the debtor's efforts to stave them off—some or all of which are likely to be unrecoverable.[333]

Further, the creditors of an insolvent debtor are likely to be indifferent to the resulting incentives for the misuse of the debtor's human capital generated by their debt-collection activities. Typically, creditors care about the payment of their claims. As between forgiving a debt voluntarily and pursuing a debt with the consequence of diminishing the likelihood of the optimal deployment of the debtor's human capital, one

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(observing that "[b]ecause of the nature of credit, free access to discharge would be disastrous for a credit-based economy").

[332] As a consequence, unless the parties settle voluntarily for less, the law recognizes the discharge of a debt only through full repayment. *See* Beldock v. Faberge (In re S & W Exporters, Inc.), 16 B.R. 941, 945 (Bankr. S.D.N.Y. 1982) (stating that "once application of payment has been made and the debtor notified, the debt is discharged"); 60 AM. JUR. 2D PAYMENT § 136 (1987) (providing that "[w]hen payment is made in full and it is applied to the underlying debt, the debt is discharged").

[333] *See infra* at 180-89 (discussing the collection and monitoring costs occasioned by debt-collection activities against insolvent debtors).

would predict that creditors would routinely chose the latter because they will likely reap no benefit from the former.[334]

The problems of stagnating and overburdened assets, including prominently the potential misuse of the debtor's human capital, present unique challenges as illustrated above. In addition, their resolution is likely to be complex and contentious. Moreover, because they arise as a consequence of insolvency, it would make no sense to burden ordinary non-bankruptcy devices to address them. Accordingly, they are properly the province of bankruptcy law.

GRATUITOUS TRANSFERS

Another problem that also arises in the insolvency context is the problem of an insolvent debtor's gratuitous transfers—an acute problem of moral hazard. Taxes aside,

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[334] Bankruptcy law has long experimented with mechanisms to address this problem, particularly the effects of insolvency and debt-collection activity on a debtor's human capital. The most important remedial mechanism is the debtor's discharge. *See supra* at 32, *infra* at 273-300 (discussing the debtor's discharge); *see also* McCoid, *Discharge*, *supra* note 76 (discussing the development of discharge in bankruptcy). As a general theme, bankruptcy law otherwise addresses the problems outlined above by restructuring the basic relationships between creditors and their insolvent debtors. As the Supreme Court has explained: "[t]he especial purpose of all bankruptcy legislation is to interfere with the relations between the parties concerned—to change, modify or impair the obligations of their contracts." Ashton v. Cameron County Water Improvement Dist., 298 U.S. 513, 530 (1936); *see also* United States v. Energy Resources Co., 495 U.S. 545, 549 (1990) (stating that "bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships"); Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 71 (1982) (Brennan, J., plurality opinion) (observing that "the restructuring of debtor-creditor relations . . . is at the core of the federal bankruptcy power"); Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188 (1902) (stating that "[t]he subject of "'bankruptcies' includes the power to discharge the debtor from his contracts and legal liabilities, as well as to distribute his property"); Adler, *Bankruptcy*, *supra* note 56 at 444 (discussing how "[b]ankruptcy law alters contracts between creditors and their debtor"); Hunt, *General Bankrupt Law*, *supra* note 76 at 32 (explaining in 1841 that bankruptcy law is "[s]imply a declaration, by the supreme law-making power of the state, defining the extent to which, and the mode in which, under certain circumstances, it will enforce pecuniary obligations").

our system of law generally permits the unrestricted transfer of assets, either in exchange for some form of consideration or purely as gifts from one person to the next. As long as a debtor remains solvent, it is typically of no particular concern to creditors that the debtor might give away one or more of his assets because, by definition, a solvent debtor still retains the wherewithal to pay all claims in full from the property that remains.[335] Hence, as a general matter, the law does not strictly regulate gift giving in the sense of either policing the merits of any particular gift (such as by revoking a gift that is not "meritorious" in some sense), or demanding that all creditors be paid in full before a gift may be made. Instead, the law trusts in general that the owners of property are the best decision makers concerning the disposition of their assets, including transactions in the form of gifts.

If the debtor/owner is *insolvent*, however, the situation is very different, at least with respect to the impact of any gift on creditors. The donation of an asset means that the debtor will have even less means than before to satisfy the creditors' claims,[336] thus

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[335] An exception exists in the case of a creditor's entitlement to a unique item. For example, a solvent debtor may sign a contract to sell a particular painting, but before consummating the sale, may deliver the painting to a relative for free. The purchaser under the contract may have an interest in recovering the painting, notwithstanding that the debtor may be able to satisfy a damage claim for breach of contract. *See* Fast v. Southern Offshore Yachts, 587 F. Supp. 1354, 1357 (D. Conn. 1984) (specific performance of the delivery of a customized yacht was warranted because the yacht was "undeniably unique"); Bander v. Gossman, 611 N.Y.S.2d 985, 988 (Sup. Ct. 1994) (stating that "specific performance may be decreed where the goods are unique") (citing U.C.C. § 2-716(1)); *see also* Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 275-78 (1979) [hereinafter Schwartz, *Specific Performance*] (discussing justifications for the doctrine of specific performance).

[336] *See* 1 GERRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES 1 (rev. ed. 1940) [hereinafter GLENN, FRAUDULENT CONVEYANCES] (noting that a fraudulent conveyance is "an infringement of the creditor's right to realize upon the available assets of this debtor"); Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C. L. REV. 1165, 1172 (1995) [hereinafter Zaretsky, *Fraudulent*

generating an externality with respect to these creditors.[337] In general, these kinds of gratuitous transfers may arise in one of four typical ways.

First, a spiteful debtor faced with a horde of clamoring creditors may simply wish to frustrate their collection efforts. To this end, the spiteful debtor may give away all of his assets with the affirmative intent that creditors receive nothing.[338]

Second, an unscrupulous debtor faced with the prospect of losing everything might transfer some or all of his assets to sympathetic third parties, such as relatives or friends. The debtor-transferor might then claim to be impoverished while, at the same time, continuing to enjoy the benefits of the assets now ostensibly owned by someone else.[339]

Transfer] (arguing that "gifts by insolvents, even if done without any fraudulent intent, are objectionable because they can only harm creditors by reducing the already insufficient property available"); *see also* Robert C. Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505 (1977) [hereinafter Clark, *Duties*].

[337] *See supra* note 249 (discussing the concept of an "externality"); *see also* Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 777-86 (1984) (explaining the purpose of fraudulent transfer law to protect creditors against debtor misbehavior). Gratuitous transfers are thus properly a problem of moral hazard because, by transferring assets in exchange for little or no consideration, an insolvent debtor increases the risk of his nonperformance of his obligations to his creditors and, because he is insolvent, the cost of this increased risk falls on their shoulders. *See supra* note 261 (discussing the concept of "moral hazard").

[338] *See* Sherman v. Third Nat'l Bank (In re Sherman), 67 F.3d 1348, 1351-54 (8th Cir. 1995) (reciting that the debtors transferred eleven real properties to their parents in order to frustrate the collection efforts of their creditors); Martino v. Edison Worldwide Capital (In re Randy), 189 B.R. 425, 438-39 (Bankr. E.D. Ill. 1995) (observing that the commissions paid to brokers for their efforts in marketing the debtor's "Ponzi" scheme were made with actual intent to hinder, delay, or defraud the debtor's creditors).

[339] *See* Kaylor v. Craig (In re Craig), 144 F.3d 587, 591-93 (8th Cir. 1998) (observing that husband transferred assets in exchange for a house that was placed in his wife's name); Taylor v. Rupp (In re Taylor), 133 F.3d 1336, 1338 (10th Cir. 1998) (noting that seventeen days before the husband filed for bankruptcy, the Taylors traded in one car that they owned jointly for a new car that the wife alone owned).

Third, a debtor might simply make gifts or sell property at less than fair-market value without any particular ill intent toward creditors.[340] For example, the debtor might liquidate precipitously some or all of his assets at less than fair-market value to satisfy the demands of certain persistent creditors who hope to be paid quickly from the proceeds before other creditors begin making demands for payment. This may occur if a creditor insists on the quick liquidation of certain assets (and prompt payment of its claim from the proceeds) as a condition of the creditor's continuing to do business with, or extend further credit to, the debtor. The effect of the quick liquidation on creditors who are not paid is the same: the debtor is left with fewer means to satisfy remaining debts. In contrast, if the assets had been sold at a better price, creditors as a group might be much better off.

Fourth, the debtor may simply incur an obligation (or grant an interest in his assets) without corresponding benefit. For example, an insolvent firm may obligate itself contractually to pay money to a shareholder without receiving anything of value in exchange.[341] Like outright transfers of assets, transactions of this kind prejudice creditors, such as by diluting their ability to recover from the debtor.[342]

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[340] *See* Dietz v. St. Edward's Catholic Church (In re Bargfrede), 117 F.3d 1078, 1080 (8th Cir. 1997) (concluding that the payment made by the debtor from his pension fund to satisfy the debt of his wife was a fraudulent transfer because the debtor received no tangible value for the payment); Misty Management Corp. v. Lockwood, 539 F.2d 1205, 1212 (9th Cir. 1976) (concluding that the payment of only $108,000 for real property worth $375,000 did not constitute a "fair equivalent" consideration).

[341] *See* Gaddis v. Allison, 234 B.R. 805 (D. Kan. 1999) (transfers to shareholder by insolvent company for no consideration deemed to be a fraudulent transfer under Kansas fraudulent conveyance act); Block v. Warehouse Consultants, Inc. (In re Americana Servs., Inc.), 175 B.R. 1018 (Bankr. W.D. Mo. 1994) (transfers to shareholders by insolvent corporation were fraudulent under Missouri fraudulent transfer statute); Yoder v. T.E.L. Leasing, Inc. (In re Suburban Motor Freight, Inc.), 124 B.R. 984 (Bankr. S.D. Ohio 1990); Dwyer v. Jones (In re Tri-State Paving, Inc.), 32 B.R. 2 (Bankr. W.D. Pa.

Like payment discriminations, the real consequences to creditors of these kinds of gratuitous transfers are typically felt only in the context of insolvency. If a debtor is solvent (and thus can otherwise make creditors whole), creditors will almost never have need to recover gifts the debtor makes.[343] Accordingly, there is generally no reason to address the consequences of gratuitous transfers in every debt-collection situation. Conversely, if the debtor is *insolvent* at the time a gift is made, becomes insolvent as a result, or the transfer threatens to render the debtor insolvent, the situation is very different. Resort to traditional debt-collection devices, such as attachment and execution, will typically fail to provide an adequate remedy because, as a general rule, assets the debtor has transferred to others are no longer available to satisfy claims.[344]

1982) (holding that transfer of funds to stockholders from insolvent corporate-debtor was fraudulent transfer).

[342] An interesting twist on the scenarios outlined above arises in the case of the "insolvent heir"—one who refuses a bequest because he or she would rather see the property go elsewhere than to his creditors. *See generally* Adam J. Hirsch, *The Problem of the Insolvent Heir*, 74 CORNELL L. REV. 587 (1989).

[343] An exception may exist if the creditor has an interest in the particular item of property transferred and the item is not fungible. *See supra* note 335.

[344] An exception may exist for transferred property encumbered by a specific interest, such as a security interest. For example, as a general rule, a security interest that has attached to specific property continues with respect to the property notwithstanding the transfer. *See, e.g.*, U.C.C. § 9-315(a)(1) (providing that "a security interest . . . continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest"). There are qualifications to this rule. *See, e.g.*, U.C.C. § 9-316(a) (providing that security interest does not continue after a period of time following the transfer of the collateral to a new owner located in another jurisdiction).

Without question, resolution of the problem of gratuitous transfers in the insolvency context is likely to be complex and contentious. Because the problem also typically arises as a consequence of insolvency, it is properly a bankruptcy matter.[345]

[345] As with payment discrimination, it is conceivable that the law might do nothing to respond to the problem of gratuitous transfers. Current bankruptcy law, however, prescribes remedies, including its fraudulent transfer provisions. *See* 11 U.S.C. §§ 548 (2000 & Supp. 2006) (providing for the avoidance of fraudulent transfers), 550 (2000 & Supp. 2006) (providing for the recovery of avoided transfers). Historically, gratuitous transfers were viewed as a species of fraud, violating "the policy of the law that the debtor be just before he be generous," Hearn 45 St. Corp. v. Jano, 27 N.E.2d 814, 816 (N.Y. 1940), and fraudulent transfer remedies have been an essential feature of bankruptcy law for many centuries. *See* 1 GLENN, FRAUDULENT CONVEYANCES, *supra* note 336 at 79-103 (tracing the history of fraudulent transfer law); Baird & Jackson, *Fraudulent Conveyance*, *supra* note 266 at 829-31 (discussing the historical evolution of fraudulent transfer rules); Zaretsky, *Fraudulent Transfer*, *supra* note 336 at 1168-71 (discussing historical evolution of fraudulent transfer rules); 13 Stat. Eliz., ch. 7, § 1 (1571) (Eng.) (proscribing fraudulent transfers). In addition to the Bankruptcy Code, state law also prescribes remedies for fraudulent transfers, which the Bankruptcy Code largely incorporates by reference. *See* 11 U.S.C. § 544 (2000 & Supp. 2006). Under both the Bankruptcy Code and state law, fraudulent transfer remedies are of several types. To begin with, they operate to avoid transfers the debtor made with actual (subjective) intent to deny creditors their recoveries. *See* 11 U.S.C. § 548(a)(1)(A) (2000 & Supp. 2006) (granting the bankruptcy trustee the power to avoid a transfer of the interest of the debtor in property made "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted"); Uniform Fraudulent Transfer Act § 4(a)(1) (1984) (providing that a transfer "by a debtor is fraudulent to a creditor . . . if the debtor made the transfer . . . [w]ith actual intent to hinder, delay, or defraud any creditor of the debtor"). In addition, they operate to avoid the transfers of insolvent (or nearly insolvent) debtors that are at least to some extent objectively gratuitous. *See* 11 U.S.C. § 548(a)(1)(B) (2000 & Supp. 2006) (granting the bankruptcy trustee the power to avoid a transfer of the interest of the debtor in property if the debtor "received less than reasonably equivalent value" in exchange for the transfer and the debtor was insolvent, became insolvent, or was likely to become insolvent at the time of the transfer); Uniform Fraudulent Transfer Act § 4(a)(2) (providing that a transfer by a debtor is fraudulent as to a creditor if the debtor made the transfer "[w]ithout receiving a reasonable equivalent value in exchange for the transfer" and if the debtor's financial condition falls below certain criteria). Although some fraudulent transfer scenarios can be quite simple, others can be extraordinarily complex, such as those involving certain types of leveraged buyout transactions. *See* United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986) (analyzing complex leverage buyout under Pennsylvania fraudulent conveyance law); *see also* Douglas G. Baird, *Fraudulent Conveyances, Agency Costs, and Leveraged Buyouts*, 20 J. LEGAL STUD. 1 (1991) (discussing the application of fraudulent transfer

DEADWEIGHT COLLECTION AND MONITORING COSTS

Finally, a debtor's insolvency will typically generate additional problems in the form of unrecoverable or "deadweight" collection and monitoring costs.[346] Because these, too, are likely to be complex and contentious in their resolution and are also insolvency-related problems, they are likewise properly the subject of bankruptcy law.

In the ordinary course of extending credit and collecting claims, creditors typically incur a variety of transaction costs.[347] These costs may range from the relatively trivial expense of preparing an invoice and following up with a reminder notice, to the more onerous expense of hiring an attorney and pursuing legal action. Creditors typically absorb these expenses and pass them along (if they can) as costs of

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law in the context of a leverage buyout); Baird & Jackson, *Fraudulent Conveyance*, *supra* note 266 at 850-54 (discussing the interplay between leveraged buyout transactions and fraudulent transfer law); Zaretsky, *Fraudulent Transfer*, *supra* note 336 at 1178-92 (same).

[346] *See* Miller, *Leverage*, *supra* note 170 at 3, 5-6 (discussing the concept of "deadweight costs" arising in the context of financial distress as those costs that are essentially unrecoverable).

[347] As Coase has explained, "transaction costs" are, essentially, the "costs involved in carrying out market transactions." Coase, *Problem*, *supra* note 330 at 37. As Coase has further explained:

> In order to carry out a market transaction, it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost.

Id.; *see also* Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 148 (1979) (describing transactions costs as "search and information costs, bargaining and decision costs, policing and enforcement costs").

doing business. Critically, in deciding what collection efforts to pursue against a defaulting debtor, creditors will be guided by their own cost-benefit analyses in deciding what actions to take.

For example, if the amount of the creditor's claim is relatively small (e.g., $10,000), one would not often expect the creditor to expend $40,000 hiring an attorney and pursuing a lawsuit to obtain payment from a defaulting debtor, unless the creditor had the ability to transfer the collection expense directly to the debtor or some third party.[348] In contrast, if the claim is large (e.g., $10 million), one might expect the creditor to be willing to expend a significant sum to obtain payment, regardless of whether the creditor could transfer the collection expense to someone else. But before spending significant sums on collection activities, creditors also typically assess whether the expenditure is likely to be fruitful from whatever information they may have. For example, if a creditor is certain the debtor will not be able to pay any part of its claim (let alone any part of the costs of collection), the creditor may elect to forego further collection activity even if its claim is large. Conversely, if the creditor is certain of

[348] Creditors often incorporate collection recovery provisions in their contracts with debtors, such as those that provide that the creditor can recover its attorneys' fees incurred in collecting a debt. Similarly, some laws also provide for the recovery of such costs. *See* CONN. GEN. STAT. § 52-514(c) (1991) (providing for the recovery of legal costs for attaching or levying creditors whose claims are allowed before the appointment of a receiver over a debtor corporation or partnership); Ai. v. Frank Huff Agency, Ltd., 607 P.2d 1304, 1307 n.3 (Haw. 1980) (citing Hawaii state statute for the proposition that attorneys' fees could be recovered by a licensee filing suit for the collection of a debt). If the debtor is solvent, and the creditor can recover its costs, the creditor may be willing to incur the costs of collection even if they exceed the amount of the debt.

collection (including costs) to at least some extent, the creditor may pursue the debtor relentlessly.[349] These considerations inform any rational debt-collection decision.

In order to protect their interests and evaluate their options, creditors also typically engage in monitoring—and incur monitoring expenses—to detect collection problems as early as possible, to keep themselves apprised of the debtor's financial condition, and to insure compliance with any contractual or other legal obligations bearing on the creditors' ability to collect their claims. Monitoring expenses may include the relatively minor cost associated with supervising a debtor's payment history on prior invoices or obtaining periodic credit reports from a credit-reporting agency. They may also include the more significant expense of obtaining and analyzing detailed financial reports, conducting field audits of the debtor's assets, or otherwise policing the debtor's compliance with complicated financial covenants.[350] Like collection costs generally, monitoring expenses will vary depending on the circumstances of the parties, the nature

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[349] A creditor may also be willing to incur collection costs disproportionate to its expected collection payoff from any particular debtor if pursuing the debtor vigorously brings some other benefit to the creditor, such as improving the creditor's ability to collect from other debtors by establishing a reputation for tough debt-collection practices.

[350] *See* Miller, *Wealth Transfers*, *supra* note 181 at 40 (explaining the use of restrictive covenants and monitoring to protect creditors "from risk-increasing changes in the nature of the firm after their original bargain with it has been struck"); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225, 242-43 (1992) (comparing forms of monitoring); Clifford W. Smith & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 122-24 (1979) (discussing types of contractual bond covenants designed to limit risky behavior); *see also Private Placement Enhancement Project*, *Model Forms* (copies on file with author) (providing examples of and explaining various covenants in debt contracts); *see generally* Levmore, *Monitors*, *supra* note 146 (discussing the role of monitoring and the potential for inefficient over-monitoring and under-monitoring). Even tort creditors may engage in monitoring. For example, a tort creditor who has filed suit against the debtor may attempt to monitor the debtor's financial condition to determine whether any judgment may be paid and to detect transfers of the debtor's assets.

of the transaction in question, and general market conditions, including whether the relevant debt is short- or long-term in nature, how much risk the creditor is willing to assume in extending credit, and how much competition there may be for the debtor's business.[351] In general, creditors who are to be paid large sums over extended periods (and thus assume long-term risk of default and nonpayment) are more likely to insist on more elaborate (and more expensive) monitoring procedures than creditors who will be paid small amounts in full within a short cycle.

As long as the debtor remains solvent, collection and monitoring costs will tend to remain relatively low because creditors will tend to incur them only as necessary, and the debtor will tend to avoid them through timely payment strategies and monitoring compliance, as well as by selecting available lenders with the least costly monitoring requirements. Obviously, a debtor who pays his debts in a timely manner will avoid the cost of having to respond to a creditor's more onerous debt-collection activities, including any direct obligation to pay the creditor's collection costs. Likewise, the debtor will avoid harm to his reputation occasioned by default. In addition, a debtor who

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[351] For example, different creditors may have different access to a debtor's financial information, and thus different monitoring costs. *See* Black, *Bank Funds*, *supra* note 307 at 326 (observing that banks may have lower monitoring costs to the extent they have immediate access to a debtor's financial records available as part of the bank's overall relationship with the debtor). In addition, some creditors may not feel the need to incur significant monitoring expenses because they may hope to "free-ride" off the monitoring activities of others. *See* Levmore, *Monitors*, *supra* note 146 at 53-54 (discussing the free-rider problem in the monitoring context). Further, instead of borrowing from a lender with relatively onerous monitoring requirements, a financially healthy firm may elect to borrow funds on different terms from some other source. *See* Diamond, *Monitoring*, *supra* note 318 at 690 (observing that financially healthy debtors may be able to borrow funds from the public debt markets at lower cost as compared to other forms of lending); *see also* Rasmussen, *Behavioral Economics*, *supra* note 56 at 1683 (observing effects of competitive markets on borrowing terms).

consistently pays his debts over time may suffer less monitoring burdens or at least avoid increased monitoring expenses.

In general, non-bankruptcy law does not typically intervene to reduce the costs of individual monitoring and debt-collection practices, at least not in the sense of mandating the use of collectivized procedures to reduce redundancies among claimants. Although overlapping collection and monitoring costs might not be theoretically ideal,[352] and the parties might benefit from certain collectivized procedures (such as the collectivized monitoring provisions of bond indentures under the Trust Indenture Act),[353] the probable reason why redundancies are at least tolerable is that they are most often less onerous than the costs of avoiding them through resort to collectivized mechanisms.[354]

For example, as long as a debtor remains financially healthy, it would make little sense to force all of the debtor's creditors to participate in some common debt-collection procedure (such as a class-action-style lawsuit involving all claimants) simply because the debtor is engaged in a collection dispute with one creditor. In the typical case, the added cost of dragging everyone into the dispute could not be justified. Similarly, so long as the debtor remains solvent, it probably would make no sense to force every creditor to participate in some type of collectivized monitoring procedure. In the commercial world, monitoring arrangements span a broad spectrum depending on the

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[352] *See* Levmore, *Monitors*, *supra* note 146 at 76-83 (discussing possible inefficiencies in monitoring structures and arguing that legal rules should pay attention to these inefficiencies).

[353] 15 U.S.C §§ 77aaa-77bbbb (1994).

[354] *See* SHAPIRO, LEGALITY, *supra* note 37 at 213 (observing that "when simpler methods of organizing behavior work, it would be irrational to abandon or overturn them in favor of accomplishing the very same ends through more sophisticated methods").

circumstances of the parties and the particular transactional setting at issue, and forcing participation in some alternative procedure to reduce overlapping costs suggests once more the rule against fixing something that is not broken.[355]

As the debtor approaches and enters a state of insolvency, however, redundant collection and monitoring costs typically become more prominent, more onerous, less recoverable, less effective, and, hence, less desirable.[356] First, as the debtor begins to default, more and more creditors typically will begin to take various steps to protect their individual interests, including the commencement and prosecution of collection actions.[357] Second, as the debtor's financial deterioration becomes more apparent (owing to missed payments and other indications), monitoring activities and demands also tend to increase. At the same time, these activities tend to be increasingly inefficient, not only because they are needlessly redundant (i.e., many creditors pursuing separately the same collection and monitoring activities at the same time),[358] but also because they become

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[355] Among other reasons, a collectivized procedure would likely provide too much monitoring for some creditors, and too little for others. The discussion here is not meant to suggest that legal innovations in monitoring (or innovations that reduce the need for more expensive monitoring, such as reviewing credit scoring information available electronically as opposed to other forms of monitoring) are not warranted. It is simply to suggest that forcing all creditors to participate in a single monitoring scheme is likely to be inefficient where the debtor is solvent.

[356] *See* JACKSON, LOGIC, *supra* note 8 at 16. n.20 (observing that, following a debtor's insolvency, "[a] single inquiry into recurring collection questions is likely to be less expensive (both for creditors and for the debtor) than the multiple inquiries necessary in an individualistic remedies system.") (citing John Weistart, *The Costs of Bankruptcy*, 41 LAW & CONTEM. PROBS. 107 (1977)).

[357] *See supra* at 162-64.

[358] As one commentator has explained:

> since each rational creditor can anticipate that there will be a race to the debtor's assets once the firm becomes insolvent, each creditor has an

dynamically less effective (e.g., as monitoring becomes less effective, this has a negative impact on the efficiency of collection activities because it leaves creditors less well informed).

In general, financially healthy debtors have incentives to disclose their true financial condition in order to, among other things, attract capital and clients—they have a good story to tell. In contrast, insolvent debtors have incentives to hide their financial problems because, among other things, full disclosure might prompt creditors to take precipitous action and scare away clients—they have a bad story to tell.[359] Certainly more than one bankruptcy filing has been preceded by disclosures of shocking accounting irregularities in previous financial reporting that gave the appearance of financial health.[360]

> incentive to monitor the affairs of the debtor. To the extent that much of this monitoring is repetitive, this represents an excess cost. Second, once the race to the assets begins, each creditor will spend money to collect on its debt. These multiple expenditures are again a cost that, all things being equal, should be avoided.

Rasmussen, *Behavioral Economic*, *supra* note 56 at 1681-82.

[359] *See supra* at 87, 138-55 (discussing an insolvent debtor's incentives to stall creditors' collection efforts and avoid disclosing accurate financial information); *see also* Ian Ayres, *The Possibility of Inefficient Corporate Contracts*, 60 U. CIN. L. REV. 387 (1991) (using game theory to explain a corporate debtor's incentives to provide lenders with false signaling in order to conceal the riskiness of their activities); Carol J. Loomis, *Lies, Damned Lies, and Managed Earnings*, FORTUNE, August 2, 1999, at 74, 77 (discussing incentives that managers have to avoid negative accounting disclosures, how minor cover-ups can lead to major fraud, and remarking that "[l]et business go south, and abusive financial reporting can veil huge amounts of deterioration"); *see generally* Andrade & Kaplan, *How Costly*, *supra* note 154 (discussing the bankruptcy and financial distress costs of highly leveraged transactions since the mid-1980's that resulted in a more than a 30% default rate).

[360] *See supra* note 182 (listing examples); Miniscribe Corp. v. Keymarc, Inc. (In re Miniscribe Corp.), 123 B.R. 86, 89 (Bankr. D. Colo. 1991) (discussing how press accounts of false reporting preceded bankruptcy proceeding); *Mercury Finance Co.:*

As a general matter, creditors understand that insolvent debtors may be more than coy in revealing their true financial condition and may respond by increasing their monitoring activities at the first sign of trouble in order to accumulate information and assess whether and to what extent they should engage in collection activities.[361] This can be a difficult exercise, not only because it can be time-consuming to form an accurate picture of the debtor's financial health, but also because the debtor may mask his problems. For example, a creditor may begin to receive late payments from the debtor and, upon inquiry, receive all kinds of explanations from the debtor that purport to assure the creditor that the problem is only temporary, or the product of some administrative error, or something similarly innocuous. If the problem is only temporary, the creditor would not want to act precipitously. Moreover, payment problems are, in fact, temporary, or otherwise relatively innocuous, in a sufficient number of instances, and collection costs are themselves sufficiently burdensome, that the creditor may not necessarily want to jump automatically to aggressive debt-collection efforts at the first sign of trouble. What the creditor does want, however, is accurate information so it can decide whether the debtor's problem is more serious than represented, and whether the creditor will be paid in a relatively timely fashion without having to pursue aggressive debt-collection measures. Hence, creditors tend to increase their monitoring demands if signs of trouble emerge.

Reorganization Plan Filed Under Bankruptcy Code, WALL ST. J., July 16, 1998, at A6 (discussing false reporting prior to bankruptcy filing).

[361] *See* Rasmussen, *Behavioral Economics, supra* note 56 at 1681-82 (offering this observation).

Debtors, of course, understand that creditors will tend to become nervous about their deteriorating financial circumstances. Debtors also understand that if creditors learn of their insolvency, they may begin to take precipitous action to avoid, among other things, nonpayment or payment discrimination. The debtor may naturally attempt to assuage the creditors' fears. If the creditors' concerns cannot be quelled, however, things can unravel fairly quickly. To avoid ruin as long as possible, insolvent debtors thus have an incentive to keep their true financial condition secret and resist covertly, and sometimes fraudulently, their creditors' monitoring efforts.[362]

All of this activity is costly. In addition to the direct expenses that creditors incur in assessing and reacting to the debtor's deteriorating circumstances, the debtor must also incur direct costs in responding to the creditors' increased collection and monitoring activities. For example, the debtor's employees may be forced to devote more and more of their time to responding to the demands of creditors rather than running the debtor's business, and the debtor may have to hire counsel to defend against various debt-collection efforts. More often than not, the debtor's incurrence of these costs will only further deplete the debtor's limited resources, leaving even less for the overall satisfaction of claims. As a result, many of the escalating costs associated with increased

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[362] *See, e.g.*, TOM BOWER, MAXWELL: THE FINAL VERDICT 220-84, 343-68 (1995) (describing the chaotic events leading up to the ultimate collapse of the financial and business empire of Robert Maxwell); *see also supra* at 87, 186 (discussing an insolvent debtor's incentives to hide financial problems). Recognizing that debtors may tend to under-disclose financial problems, creditors may also overreact in individual cases involving honest and straightforward debtors out of the suspicion the debtor is underreporting. Moreover, because different creditors have different access to a debtor's financial information, creditors with inferior access may assume the worst based on incomplete data, thus potentially exacerbating the problem. *See supra* note 351 (discussing that different creditors are likely to have different access to a debtor's financial information).

collection and monitoring activities are pointless and unrecoverable, becoming deadweight in nature.[363]

As noted at the outset, the resolution of these problems is likely to be complex and contentious. In addition, these problems are insolvency related. Accordingly, they satisfy the circumstances of bankruptcy legality and are properly the subject of bankruptcy law.

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[363] Not surprisingly, bankruptcy law has traditionally offered a variety of collective procedures designed to reduce dead-weight collection and monitoring costs. *See* 11 U.S.C. §§ 521 (2000 & Supp. 2006) (requiring a debtor to file "a list of creditors, and unless the court orders otherwise, a schedule of assets and liabilities, a schedule of current income and current expenditures, and a statement of the debtor's financial affairs"), 704 (2000 & Supp. 2006) (providing that "[t]he trustee shall . . . collect and reduce to money the property of the estate"), 1103 (2000 & Supp. 2006) (granting powers to a creditor's committee as the representative of creditors, ostensibly to reduce duplication of monitoring that creditors otherwise would undertake and over administration of the debtor), 1104 (2000 & Supp. 2006) (allowing for the appointment of a trustee or examiner in a Chapter 11 reorganization case), 1125 (2000 & Supp. 2006) (governing certain common disclosure in Chapter 11 cases regarding the debtor's plan of reorganization); *see also* Warren, *Bankruptcy Policymaking*, *supra* note 10 at 346 (observing that "[t]he Bankruptcy Code reduces the costs of collection from a troubled debtor by collectivizing creditor activities."). As Warren has explained:

> A number of provisions [of the Bankruptcy Code] are designed to increase collection efficiency in a bankruptcy action; quick decisions, abbreviated trials, estimation of claims, elimination of duplicate efforts, restricted notification requirements, reduced waiting periods, minimal paperwork, automatic stays from collection, stipulated valuations, and emergency orders are all bankruptcy devices intended to capture value for the estate under the adverse conditions that multiparty litigation and a failing business present.

Id.

CHAPTER 3

Remediating the Problems of Insolvency and the Contours of the Bankruptcy Market

Chapter 2 was devoted to identifying a set of special social problems—the "problems of insolvency"—that are sufficiently unique, complex, and contentious that they satisfy the "circumstances of bankruptcy legality," meaning they qualify for potential resolution under a special legal system called "bankruptcy law." To summarize, the relevant problems include those of (1) claims mediation and payment discrimination; (2) overinvestment, underinvestment, and other moral hazard; and (3) unrecoverable collection, monitoring, and related costs associated with a debtor's financial ruin. As we have seen, what is unique about these problems, and what ties them all together, is that they are all insolvency-related. Moreover, because the need to resolve them arises only in the insolvency context, it would make no sense to burden ordinary non-bankruptcy legal systems with costly procedures to address them. On the contrary, that is what bankruptcy law is for.

This chapter is devoted to addressing how bankruptcy law ought to respond to the problems of insolvency, and immediately two questions arise. First, regardless of whether the problems of insolvency satisfy the circumstances of bankruptcy legality, why should bankruptcy law actually attempt to resolve them, as opposed to simply letting them be? Although disheartening, financial failure is a fairly common fact of life for

many, and certainly the law does not attempt to resolve every disheartening social problem simply because it is unique, complex, and contentious.

Second, harkening back to the theories of other scholars discussed in Chapter 1, if bankruptcy law should undertake to resolve the problems of insolvency, how should it go about addressing this challenge? Should it deploy the kinds of legal remedies creditors would bargain for if only they could get together and negotiate these remedies collectively before extending credit (conceptual contracting)?[364] Should it facilitate the negotiation and enforcement of actual bankruptcy agreements to address them (actual contracting)?[365] Alternatively, should it adopt remedies that promote the avoidance of public bailouts, enhance the debtor's value, force creditors to internalize the costs of credit, and distribute value equitably across a number of constituents (loss spreading)?[366] Or should it be doing something else?

Turning to the first question—whether bankruptcy law has anything truly meaningful to offer in addressing the problems of insolvency—Holmes observed that "the public generally profits by individual activity" and argued that "[s]tate interference is an evil, where it cannot be shown to be a good."[367] He concluded that, at least in the context of accidents, losses should ordinarily be left to lie where they fall, unless it can be

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[364] *See supra* at 24-27 (discussing the creditors'-bargain approach and the concept of conceptual contracting).

[365] *See supra* at 54-58 (discussing actual bankruptcy contracting).

[366] *See supra* at 101-05 (discussing the loss-spreading approach).

[367] HOLMES, COMMON LAW, *supra* note 5 at 95-96. Holmes observed that legal regulation responds to the "felt necessities of the time," quipping that "[t]he life of the law has not been logic: it has been experience." *Id*. at 1.

shown that placing them somewhere else would constitute a material public gain.[368] Bankruptcy law currently responds to the problems of insolvency with elaborate mechanisms of debt collection, debt forgiveness, and debt adjustment that have the effect of shifting insolvency-related losses in a variety of ways, sometimes dramatically.[369] But is intervention of any kind really beneficial?

It must be admitted that it is at least abstractly possible that the problems of insolvency deserve no special treatment, and certainly the losses they generate could be left to lie where they fall.[370] But as even cursory review of these problems reveals, a debtor's financial failure characteristically generates serious forms of waste, inefficiency, and unfairness. As a result, it is perhaps unsurprising that no one today argues that the law should do nothing about them.[371] In other words, the modern consensus appears to

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[368] *Id.* at 94-96, 106-111; *but see* Calabresi & Melamed, *Property Rules*, *supra* note 5 at 1091 (1972) ("When a loss is left where it falls in an auto accident, it is not because God so ordained it" but rather "it is because the state has granted the injurer an entitlement to be free of liability"); *see also* CALABRESI, COSTS, *supra* note 53 at 261-63 (criticizing Holmes's approach).

[369] *See, e.g.*, *supra* notes 72-76, 241, 246-47, 258, 299, 325, 334, 345, 363.

[370] After all, for much of the nineteenth century, the United States had no national bankruptcy law. It was not until 1898 that Congress enacted a permanent system of bankruptcy remedies. *See* CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY (1935) [hereinafter WARREN, BANKRUPTCY HISTORY] (chronicling the often heated congressional debates over bankruptcy legislation during the nineteenth century, the sporadic enactment of national bankruptcy laws in 1800, 1841, and 1867, and the eventual enactment of the permanent Bankruptcy Act in 1898); NOEL, HISTORY, *supra* note 258 at 157-80 (discussing the enactment of the Act of 1898); Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898), amended by the Chandler Act, ch. 575, 52 Stat. 840 (1938) (repealed 1979), and replaced by the current Bankruptcy Code, 11 U.S.C. §§ 101-1330 (1994 & Supp. III 1997).

[371] By way of comparison, the earliest English and American bankruptcy laws addressed directly only some of the problems of insolvency, and by failing to discharge the obligations of honest but hopelessly insolvent individuals who had been imprisoned for their debts in accordance with prevailing debt-collection procedures, these early laws

be that letting the problems of insolvency go unresolved is not a wise option.[372] But what then *should* the law be doing to address them?

Turning to the second question—the merits of the theoretical approaches of other theorists—neither actual nor conceptual contracting appear to offer workable solutions, as discussed at length in Chapter 1.[373] On the other hand, the loss-spreading goals of avoiding public bailouts, enhancing the debtor's value, forcing creditors to internalize the costs of credit, and distributing value equitably across a number of constituents at least

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ignored a costly problem. *See* COLEMAN, DEBTORS, *supra* note 258 at 9 (noting that the common practice of imprisonment for debt during the colonial era often left the debt unpaid and "deprived the community of the prisoner's labor"); NOEL, HISTORY, *supra* note 258 at 70-72 (describing the appalling conditions in debtors' prisons in the U.S. during the colonial era); *see also* BRUCE H. MANN, REPUBLIC OF DEBTORS 78-108 (2002) (discussing the practice of imprisonment for debt in the U.S. during the late seventeenth and early eighteenth centuries); CRAIG MULDREW, THE ECONOMY OF OBLIGATION: THE CULTURE OF CREDIT AND SOCIAL RELATIONS IN EARLY MODERN ENGLAND 274-98 (1998) [hereinafter MULDREW, ECONOMY] (discussing debt-collection practices and procedures in early modern England); *infra* note 604 (discussing the gradual abolition of imprisonment for debt in the United States during the nineteenth century). Moreover, as Charles Warren has related, Congress's inability to pass bankruptcy legislation during the nineteenth century was not so much a problem of inattention, but rather disagreement over what the content of bankruptcy law should be. *See* WARREN, BANKRUPTCY HISTORY, *supra* note 370 (chronicling the repeated attempts to pass bankruptcy legislation, with only sporadic success, during the nineteenth century). Regarding the magnitude of the problem of imprisonment for debt, Warren estimated that, as late as 1833, as many as 75,000 persons annually were sent to jail for debt in the United States. *Id*. at 52 n.8.

[372] It is sometimes true, of course, that the losses occasioned by the problems of insolvency should be left to lie were they fall. For example, suppose an insolvent debtor is deceased and has no assets. Absent special circumstances, bankruptcy law would have little to offer in such a situation. Likewise, suppose an insolvent firm is not viable and has few or no assets. Absent special circumstances, the best course in such a case may likewise be one of non-intervention. *See supra* at 65-66, *infra* at 288-89 (discussing the appropriate treatment of firms that suffer from economic distress and are not salvageable, as opposed to those suffering merely from financial distress that may be salvaged if, among other things, they are able to deleverage their balance sheets).

[373] *See supra* at 24-95.

have the virtue of capturing in a more comprehensive manner some of the general aspects of bankruptcy law's remedial ambitions and effects. As also discussed in Chapter 1, however, the loss-spreading account is both problematic and incomplete.[374] Among other things, although having a bankruptcy law that apportions losses tends to avoid the need to consider public bailouts, no one really argues that routine public bailouts would be a sound idea even if we did not have a bankruptcy law. Except in the most extraordinary situations, the systematic use of public funds to resolve the problems of insolvency is a potential solution that we may safely set aside.[375]

In addition, although it is true as a descriptive matter that bankruptcy law endeavors to enhance the debtor's value, force creditors to internalize the costs of credit,

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[374] *See supra* at 101-10.

[375] It is true, of course, that the government sometimes administers public bailouts, including recently in salvaging the domestic automobile industry and certain banking and other financial institutions in the wake of the financial crisis of 2007-2008, and likewise at various other times in the past in response to certain financial disasters. *See, e.g.*, BLINDER, AFTER, *supra* note 315 (discussing the financial crisis of 2007-2008 and the government's response to it); Chrysler Corporation Loan Guarantee Act of 1979, Pub. L. No. 96-185, 93 Stat. 1324 (1979); *see also* JAMES S. OLSON, SAVING CAPITALISM: THE RECONSTRUCTION FINANCE CORPORATION AND THE NEW DEAL, 1933-1940 (1988) (discussing the role of the reconstruction finance corporation during the Great Depression); JAMES S. OLSON, HERBERT HOOVER AND THE RECONSTRUCTION FINANCE CORPORATION, 1931-1933 (1977) (discussing the formation of the reconstruction finance corporation, initially to make loans to banks to facilitate lending to businesses); Press Release, Pension Benefit Guarantee Corporation, PBGC Protects Benefits of 82,000 LTV Workers In Largest-Ever Federal Pension Takeover (Mar. 29, 2002), http://www.pbgc.gov/-media/news-archive/news-releases/2002/pr02-16.html. In general, however, the public bailout approach has been thought to be unworkable except in extraordinary circumstances. Of some relevance, the Constitution limits Congress's bankruptcy power to establishing "*uniform* Laws on the subject of Bankruptcies throughout the United States." U.S. CONST. art. I, § 8, cl. 4 (emphasis added); *see* Railway Labor Executives' Ass'n v. Gibbons, 455 U.S. 457, 471 (1982) ("A law can hardly be said to be uniform throughout the country if it applies only to one debtor and can be enforced only by the one bankruptcy court having jurisdiction over that debtor."); *see also infra* at 206-07 (discussing further the public-bailout option and the special problems of moral hazard that it may generate).

and distribute value equitably across a number of constituents, these seemingly laudable ambitions require further refinement and a more fully elaborated normative anchor. More precisely, it is important to understand exactly why these goals and effects are desirable, how they should be prioritized when they conflict, and how bankruptcy law should go about accomplishing them. Here again it is important to distinguish positive from normative analysis,[376] and in order to identify whether bankruptcy law should be doing these things and in what way, it is necessary to articulate more systematically the relevant framework and principles that properly guide the selection and organization of bankruptcy law's remedial possibilities.

Rejecting Holmes's theories—particularly his judge-centered view of law as "the prophesies of what the courts will do in fact"[377]—H.L.A. Hart observed that one of the key benefits of having legal regulation is to be seen "in the diverse ways in which the law is used to control, to guide, and to plan life out of court."[378] Drawing on the work of Michael Bratman, Scott Shapiro observes in similar fashion that a critical virtue of law—and in his view *the* critical virtue—is that "[b]y providing a highly nimble and durable method of social planning, the law enables communities to solve the numerous and serious problems that would otherwise be too costly or risky to resolve."[379] Shapiro

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[376] *See supra* note 14 (discussing Hume's observation that one cannot derive an "ought" purely from an "is").

[377] Holmes, *Path*, *supra* note 222 at 460-61; *see also supra* note 222 (discussing Holmes).

[378] HART, CONCEPT, *supra* note 222 at 40; *see supra* note 222 (discussing Hart's views on law).

[379] SHAPIRO, LEGALITY, *supra* note 37 at 170; *see id*. at 119 (citing Bratman); *supra* notes 222-23, 225, 232 (discussing Shapiro's views on legality); *see also* MICHAEL E. BRATMAN, INTENTION, PLANS, AND PRACTICAL REASON (Stanford 1999); MICHAEL E. BRATMAN, FACES OF INTENTION (Cambridge 1999) [hereinafter BRATMAN, FACES].

crystallizes this idea into his "Planning Thesis," summarized as the postulate that "[l]egal activity is an activity of social planning."[380]

Laws perform this general function in a variety of recognizable ways. Among other things, they set up markets to facilitate exchange; provide for the recognition and regulation of firms to organize economic and other activity; authorize transactions of various kinds for a number of useful social purposes; and direct the resolution of significant disputes in ways that avoid (hopefully) resort to violent forms of self-help and retribution. All of these things involve and facilitate social planning. But as the sociologist Charles Tilly has observed, "people rarely accomplish exactly what they consciously plan, and constantly find events unrolling differently from what they

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Bratman summarizes: "We are planning agents. Our purposive activity is typically embedded in multiple, interwoven quilts of partial, future-directed plans of action. We settle in advance on such plans of action, fill them in, adjust them, and follow through with them as time goes by. We thereby support complex forms of organization in our own, temporally extended lives and in our interactions with others; and we do this in ways that are sensitive to the limits on our cognitive resources." *Id*. at 1. Shapiro observes that the "pragmatic justifications for the requirements of rationality" underlying the planning account, together with the "content of the requirements themselves," are "the subject of philosophical controversy." SHAPIRO, LEGALITY, *supra* note 37 at 119 n.4 (citing John Broome, *Normative Requirements*, 12 RATIO 398 (1999); R. Jay Wallace, *Normativity, Commitment, and Instrumental Reason*, 3 PHILOSOPHERS' IMPRINT 1 (2001); Kieran Setiya, *Cognitivism about Instrumental Reason*, 117 ETHICS 649 (2007)).

[380] SHAPIRO, LEGALITY, *supra* note 37 at 195-204. Shapiro explains further that, in his view, "the fundamental problem to which law is a solution is not any particular moral quandary," but rather that "law is an answer to a higher-order problem, namely, the problem of how to solve moral quandaries in general." *Id*. at 173. Characterizing laws, like intentions, as a type of "universal means," he argues that "[j]ust as there are no specific ends that intentions are supposed to serve, there are no substantive goals or values that laws are supposed to achieve or realize." *Id*. On the other hand, regardless of whether law is merely an answer to the higher-order problem of solving moral quandaries in general, we use it routinely to solve specific problems. In order to be useful, law must be able to address the specific, not simply the general. *See infra* note 388 (discussing Shapiro's view on how law accomplishes this).

anticipated."[381] In other words, the best laid plans often go awry, and inevitably some of these failed plans will lead to bankruptcy.

Of course, one might object to Tilly's observation on the ground that it seems a bit extreme. After all, most individuals manage on a daily basis to accomplish at least some of their plans. For example, most manage to get out of bed in the morning, get to work on time, and keep their scheduled appointments—at least often enough to form relatively predictable patterns of behavior. These smaller types of plans, however, are not the real concern. For our purposes, what matters most about Tilly's observation is that when it comes to the *major* plans of life that typically unfold over longer periods of time—and also tend to involve much greater investments of time, energy, and other resources—all sorts of unexpected circumstances may and often do intercede, sometimes with disastrous results. For individuals, these may include a variety of unhappy events, such as divorce, loss of employment, or illness, to say nothing of circumstances such as war, famine, flood, or earthquake.[382] For businesses, particularly smaller ones, the potential list of unanticipated calamities is even longer.[383] As Tilly has also observed, the ubiquity of our encounters with unplanned events is well illustrated in the prominence of one of our most pervasive social practices: as a matter of social competency, we all

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[381] TILLY, WHY, *supra* note 80 at *i*.

[382] *See infra* at 264 (discussing the most common causes of insolvency). Of course, the intervening circumstances of life can also include events that turn out to be happy in nature, such as the birth of an unplanned child.

[383] This may be due in part to the way in which society privileges the creation of routine supportive planning structures for individuals. As noted previously, most new businesses fail within the first four years of their inception. *See supra* note 202 (discussing rates of failure for new businesses). Most individuals last longer and benefit from more developed supporting social structures to help ensure that they may.

develop the ability (with varying degrees of diplomacy, tact, and honesty) to offer reasons of repair that seek to explain in reconciliatory ways the circumstances that cause our plans to change when those changes result in inconvenience (or worse) to others.[384] Inevitably, some major planning disasters will lead to financial ruin and, characteristically, the problems of insolvency. With the Planning Thesis in mind, the question arises: as a means to facilitate planning activity, what should the law say about the costs of these failed plans?

Before proceeding further, however, it is worth pausing for a moment to consider whether Tilly's observation actually poses a challenge to the Planning Thesis.[385] It seems

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[384] As Tilly has observed, "much reason giving repairs relations, as someone who has inflicted damage on someone else tells a story to show that the damage was inadvertent or unavoidable and therefore, despite appearances, does not reflect badly on the relationship between giver and receiver." *Id*. at 20. Moreover, the more our excuses are accepted by others, the more generally acceptable they tend to become. The acceptability of a broad range of social excuses is perhaps justifiable in part because it is often difficult to know, for example, if the person who fails to show up for an appointment actually experienced some sympathetic mishap or simply skipped the commitment. It is also perhaps justifiable because everyone makes use of social excuses and only someone without any social grace whatsoever would refuse to accept at least some of them some of the time. This can be thought of as a process of "normalization." *See, e.g.*, IAN AYRES, CARROTS AND STICKS 79 (2010) [hereinafter AYRES, CARROTS] (describing the work of Robert Cialdini and the problem of normalizing theft). Legal procedure, however, has caught on to the inadequacy of much excuse giving, and the standard for "excusable neglect" sufficient to justify missing certain legal deadlines is more exacting than many prevailing social practices. *See* Pioneer Investment Servcs. Co. v. Brunswick Assocs. Ltd. P'ship, 507 U.S. 380 (1993) (discussing the excusable neglect standard).

[385] Among other things, if the Planning Thesis is correct, but plans often go awry as Tilly observes, then law must inevitably facilitate a kind of social activity (i.e., planning) that is frequently a source of frustration and failure (e.g., starting a new business, particularly a restaurant). Moreover, to the extent individuals and groups are relatively poor planners because, for example, it is hard for them to take accurate account of future events, laws must also have the ironic effect of facilitating activities that individuals and groups are not particularly adept at handling. On the other hand, Shapiro points out that one of law's virtues is that it helps compensate for the relative inability of individuals and groups to plan. *See, e.g.*, SHAPIRO, LEGALITY, *supra* note 37 at 151 ("Without some method for correcting or guiding behavior, information asymmetries, cognitive incapacities, and

undeniable that the costs of insolvency characteristically arise from financial *failure*, including failed plans, but is it correct to say that these costs *always* arise from social planning activities? If not, then how else do they arise and how might this affect the analysis?[386]

In general, it seems relatively clear that financial failure *is* characteristically associated with social planning activities. To begin with, the kinds of failures that generate the problems of insolvency typically arise as a result of social activities that involve indebtedness of some sort, and it is hard to imagine an activity involving indebtedness that does not also involve at least some kind of planned social activity, successful or otherwise. More important, what makes at least some of the problems of insolvency so pressing is not simply that they arise out of failure, but that a debtor's insolvency generates consequences that profoundly affect ongoing and future social planning. For example, an insolvent debtor's incentives to gamble with his assets and avoid debt-collection efforts have clear implications for how the debtor will plan his activities and conduct himself in the marketplace. Likewise, the creditors' incentives to engage in debt-collection free-for-alls have implications of a similar nature. It would

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divergent preferences threaten to plunge joint ventures into chaos."). As Shapiro explains, laws do this by establishing "institutions of social planning" that "compensate for the deficiencies of alternative forms of planning in the circumstances of legality." *Id.* at 171.

[386] For example, it might be possible to draw a distinction between financial failure arising from poor plans and financial failure arising from the poor execution of plans. The making and execution of plans, however, would both seem to be forms of planning activity—after all, the point of making plans is generally to bring them to fulfillment. *See supra* note 222; BRATMAN, FACES, *supra* note 379 at 1 (observing that one of the purposes of plans is to follow through with them).

thus seem entirely appropriate to view the problems of insolvency as integral to social planning activities.

But there remains a deeper concern. Social planning is not always a good thing, and not simply because some plans fail. Although laws undeniably facilitate social planning activities, many plans turn out badly, not merely because some innocent ones fail, but also because some are harmful, including sinister ones that seek to accomplish illicit goals or make use of illicit means. In other words, not all plans are of the same moral character or worth. Without more, to say that the aim of law is to facilitate social planning is to say that it facilitates both good and bad plans indifferently, including those that may be extremely unjust or immoral. And it is at best awkward to conclude that the aim of law is to facilitate social plans regardless of whether they are good, bad, or ugly.

As Shapiro points out, "[t]he claims of law are far too serious to accept the possibility that they are amoral in nature,"[387] but in positivist fashion, he also contends that "there are no substantive goals or values that laws are supposed to achieve or realize."[388] In other words, as a form of "universal means," law is like clay that may be

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[387] SHAPIRO, LEGALITY, *supra* note 37 at 111.

[388] *Id*. at 173. Shapiro explains that the determination of legal validity is a sociological inquiry, rather than a moral one. He contends that "[i]f we want to discover the existence or content of the fundamental rules of a legal system, we must look . . . only to what officials think, intend, claim, and do around here." *Id*. at 177. A key virtue of this approach, he claims, is that laws effectively settle normative questions so the relevant parties engaged in social planning activities need not think about them: "The logic of planning requires that plans be ascertainable by a method that does not resurrect the very questions that plans are designed to settle. Only social facts, not moral ones, can serve this function." *Id*. In other words, the point of law as a facilitator of social planning is precisely to avoid moral questions. Shapiro argues: "[l]egal authority, rights, and obligations are possible . . . simply because highly impersonal shared practices of social planning are possible." *Id*. at 182. In other words, a system of law exists as an extension of human planning capacity and rationality; from the "legal point of view," *it* is because it *is*. *Id*. at 186-88.

shaped with particular values in mind, but does not itself have any of its own (other than perhaps to help social planning along), at least not in the sense of any that are directed toward the resolution of specific problems. This raises an important question: at what point and in what way do normative criteria, or "norms," enter into the calculus to shape the content of law and our evaluation of it so that law may, in turn, encourage positive social planning activities, discourage those that are negative, and—most critical for our purposes—assist in repairing the consequences of failed plans that lead to insolvency? Moreover, how are these norms to be selected?

In the absence of consensus, the task of identifying appropriate norms to guide the selection of rules that govern social planning activities is itself often a serious social problem (e.g., what are the norms to be used in deciding whether each citizen should be allowed to have unlimited children or only two?). It is also a task that is sufficiently complex and contentious that it would appear to satisfy the circumstances of legality. But unlike most other social problems that invite resolution through social planning activities, it is difficult to conceive of the process of selecting the norms that shape our conception of what law ought to produce (e.g., just outcomes) as the same thing as, for example, the process of planning the details of a particular market regulation in accordance with those norms (e.g., builders must use wiring of a sufficient quality to avoid fires). Among other things, we do not typically think of justice or morality as something the law creates in the same fashion as zoning regulations or building-code requirements, which are products of legal processes. Rather, we typically think of justice and morality as things that law takes account of and settles only in the sense of deciding which contested version of justice or morality to follow. Justice may be a matter of

outcomes in the sense that laws may be viewed as unjust based on their effects,[389] but it is also a matter of inputs into the legal process itself.[390] But what then are the norms to be used in selecting the norms?

It is certainly true that we may often accept the authority of others to prescribe and enforce rules that govern our planning activities simply because they have that power. At the same time, however, we also expect that those rules will be just or moral, and this is not simply an empty aspiration. If the rules are not just or moral, we expect that they can and will be changed.[391] Shapiro offers the sociological view that law reflects "what officials think, intend, claim, and do around here," and this has the virtue of settling vexing problems so that individuals can go about their planning activities without first having to worry about settling a variety of nettlesome and troubling issues; officials do that for them.[392] But is this perspective a completely satisfying answer? Are justice and morality properly localized and cabined in this way as an instrumental means to facilitate social planning? And if justice and morality are not purely instrumental to social planning or localized in a particular person or institution, how do we select the

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[389] *See* DWORKIN, LAW'S EMPIRE, *supra* note 14 at 180 ("Justice is a matter of outcomes: a political decision causes injustice, however fair the procedures that produced it, when it denies people some resource, liberty, or opportunity that the best theories of justice entitle them to have").

[390] For example, regardless of its relative wisdom, no one today would view the law promulgated by a single person to be just even though all were bound by compulsion to obey it, or a judicial pronouncement adverse to a party where that party had no opportunity to participate.

[391] *See* RAWLS, THEORY, *supra* note 98 at 236 ("If deviations from justice . . . are too pervasive, a serious question may arise whether a system of law exists as opposed to a collection of particular orders designed to advance the interests of a dictator or the ideal of a benevolent despot.").

[392] SHAPIRO, LEGALITY, *supra* note 37 at 177; *supra* note 388.

norms that guide the creation of legal rules within a system that purports not to have any of its own, at least not inherently? In other words, how is it possible to identify the "ought" of justice or morality that we hope drives our system of law from the "is" of the desire to promote social plans, unless the very desire to promote social plans is itself instrumental to some deeper ambition ripe with normative purpose that laws also attempt to express?[393]

As intriguing as these questions may be, however, we need not resolve them at this juncture, or for that matter accept every aspect of Shapiro's insightful account of law, in order to proceed with the analysis. Regardless of whether laws always facilitate social planning or do so only some of the time, and regardless of whether laws facilitate planning activities with or without the benefit of an intrinsic system of norms that expresses a set of deeper social beliefs, it remains true that (1) laws serve as complex problem-solving mechanisms that respond to complex and contentious social phenomena, and (2) norms inevitably come into the picture at some point to help us resolve them.[394]

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[393] Paul Kahn has argued that "[t]he rule of law . . . is not simply talk about whatever is judged to be of interest to a collection of speakers. The discourse of law is not just a matter of giving reasons." KAHN, REIGN, *supra* note 222 at 44. Rather, "[t]he reasons of law are uniquely its own." *Id*. He continues, "[w]e must stop approaching law's claims as if they were descriptive of actual institutions or processes of decision making" and instead "approach the rule of law as a set of beliefs by which members of [a] culture understand themselves and their world." *Id*. at 45. He states, "[t]he rule of law is a structure of the imagination before it is a structure of political events." *Id*. Following Dworkin, Kahn also "breaks down the distinction between law and morality." *Id*. Unlike Dworkin, however, he does not claim that there is a single correct set of answers to the various questions of law. He observes that, although the "rule of law is indeed a complete account of our experience of the political," it remains "a contested account." *Id*. Borrowing from this observation—that there are different conceptions of law's normative ambitions—I use several standards to evaluate potential solutions to the problems of insolvency, rather than one.

[394] After all, the basic idea behind the concept of law as a means to facilitate social planning is precisely that social planning serves as a powerful problem-solving device.

The problems of insolvency are clearly social problems within the scope of this more generic problem-solving framework, and in order to determine how bankruptcy law might fruitfully address them as a problem-solving exercise, it is useful to know two basic things: (1) the nature of the relevant problems in sufficient detail to permit the identification of potentially appropriate solutions (a question of correlation based on adequate information); and (2) the relevant norms to be used in evaluating potential solutions and selecting the best ones from the plausible alternatives. As discussed at the outset, I make use of three different normative standards: equity (fairness), efficiency (wealth-maximization), and entitlement (the preservation of protected interests). As we shall see, each has its own particular virtues and shortcomings. Collectively, however, they offer a fairly comprehensive means to evaluate whether bankruptcy law's actual or potential solutions to the problems of insolvency are beneficial. Before applying these different evaluative standards, however, it is first necessary to organize the inquiry by identifying more precisely how and why bankruptcy law's actual and potential debt-collection, debt-forgiveness, and debt-adjustment solutions correlate to different categories of the problems of insolvency.

See SHAPIRO, LEGALITY, *supra* note 37 at 170; *supra* notes 222, 225. If follows that, at a more general level of abstraction, law is a problem-solving tool. We may call this expanded conception the "Problem-Solving Thesis," postulated as "legal activity is an activity of problem-solving addressed to social problems that satisfy the circumstances of legality." In addition to being broad enough to encompass the challenge of how law might encourage positive social planning activities and discourage negative ones, it is also capacious enough to encompass the task of deciding how law might assist in repairing the consequences of failed plans that lead to insolvency. In addition, the relevant norms that ought to be used in resolving these challenges may also be viewed as social problems that satisfy the circumstances of legality, and are thus appropriate for a legal response in the sense of being incorporated into the analysis. The question then becomes one of selecting the relevant norms.

CATEGORIZING THE PROBLEMS OF INSOLVENCY AND THEIR POTENTIAL SOLUTIONS

In theory, there are many potential ways to respond to the problems of insolvency, including various combinations of distinct remedies of debt collection, debt forgiveness, and debt adjustment. A debt-collection remedy is one concerned with the enforcement of the creditors' claims against an insolvent debtor and/or the debtor's property in response to one or more of the problems of insolvency—for example, some kind of collectivized and streamlined procedure for the recognition and enforcement of claims to reduce the problems of deadweight collection costs. A debt-forgiveness remedy is one concerned with the release of the debtor and/or the debtor's property from some or all of the debtor's liabilities in response to one or more of the problems of insolvency—for example, some kind of discharge of the debtor's liabilities to remedy the problem of overburdened human capital. A debt-adjustment remedy is one concerned with the prioritization of the competing claims of creditors in response to one or more of the problems of insolvency—for example, some kind of claims-prioritization protocol to address the problem of claims mediation.

Note that, as these examples illustrate, each of the three types of remedies outlined above may be thought of as correlating to certain specific problems of insolvency, at least suggesting the possibility that we might fruitfully organize the various problems and their potential remedies in this way—i.e., debt-collection solutions in response to the debt-collection problems, debt-forgiveness solutions in response to the debt-forgiveness problems, and debt-adjustment solutions in response to the debt-adjustment problems. As it turns out, that is the case, but in order to understand why that

is so, it is first necessary to consider whether there are viable solution strategies to the problems of insolvency that defy these categorizations.

Here it is worth observing that there is indeed one potential debt-collection solution that, all by itself, solves all the problems of insolvency—a variant of the public-bailout remedy discussed above. Specifically, upon a debtor's financial demise, the state might intervene with a public payment program that ensures that all of the debtor's debts will be paid in full on a "non-recourse" basis, and we may call this the "bailout-insurance" option.[395] This may be thought of as an "exclusive" remedy because, by itself, it handily excludes the need for any other debt-collection, debt-forgiveness, or debt-adjustment relief for the simple reason that, if this type of public-bailout device were known to be readily available, creditors would be assured of the full satisfaction of their claims and all of the various problems of insolvency would simply disappear. For example, there would be no incentive for creditors to engage in debt-collection free-for-alls because they would always be assured of full payment. Likewise, there would be no possibility of payment discrimination in any meaningful sense, and gratuitous transfers would become a non-concern. Significantly, the bailout-insurance option is a form of debt-collection, debt-forgiveness, and debt-adjustment procedure all rolled up into one: it simultaneously pays, extinguishes, and distributes in one fell swoop.

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[395] The solution is a non-recourse type of insurance because, after paying all of the debtor's debts, the state would not have recourse to the debtor to recover what it paid to creditors. Of course, to the extent the state merely substituted for the creditors and could assert a claim against the debtor for amounts the state paid to the creditors, the debtor would remain insolvent and the problems of insolvency would persist.

There is, however, an enormous potential for moral hazard associated with such a scheme.[396] Because the state would effectively insure the payment of claims, creditors would have little incentive to lend providently, and debtors would have every incentive to incur obligations profligately, including tort liabilities imposed involuntarily on their tort victims. Similar *ex ante* effects explain why other forms of public bailouts are always the remedy of absolute last resort. As noted above, no one advocates the use of public-bailout programs (except in the most limited and extraordinary of circumstances), and we can safely set them aside as a form of routine solution to the problems of insolvency.[397]

In contrast, it is also worth noting that, unlike the bailout-insurance option outlined above, there are no other exclusive debt-collection, debt-forgiveness, or debt-adjustment options that, by themselves, cause all of the problems of insolvency simply to disappear. For example, suppose that, once a debtor became insolvent, the law simply divested the debtor of all of his property, liquidated it for the benefit of creditors, and either required the debtor to work exclusively to pay off his debts or permitted the debtor to be sold off into slavery. We may call this the "Roman-divestiture" option, named after the procedure under the Law of the Twelve Tables (c. 450 B.C.) that permitted the defaulting insolvent debtor to be sold into slavery to satisfy the creditors' claims.[398] This

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[396] *See supra* note 261 (discussing the concept of "moral hazard"); *see also* JACKSON, LOGIC, *supra* note 8 at 232 (observing that "[t]he difficulty with a solution whereby the government uses its revenues to make grants to reduce the losses that creditors sustain . . . is that it aggravates the problem of moral hazard.") (internal marks and citations omitted).

[397] *See supra* note 375 (discussing some examples of public bailout measures).

[398] *See* Louis E. Levinthal, *The Early History of Bankruptcy Law*, 66 U. PA. L. REV. 223, 231-32 (1918) [hereinafter Levinthal, *Early History*] (describing the procedure); *see also* ALLAN C. JOHNSON, ET AL., ANCIENT ROMAN STATUTES 9-18 (C. Pharr. ed. 1961). Holmes believed that this procedure gave the creditors the option of either selling the debtor as a slave or putting him to death. HOLMES, COMMON LAW, *supra* note 5 at 14 ("a

debt-collection remedy would not be exclusive in nature because implementing it would not eliminate all of the problems of insolvency or the need for other forms of relief. Indeed, it would only likely make many of these problems worse. For instance, the harshness of the penalty would tend to exacerbate the debtor's incentives to avoid the creditors' debt collection efforts, engage in deception, and gamble with his property. In addition, following the liquidation of the insolvent debtor and his property, the question of dividing the proceeds would remain. Similarly, the problem of stagnating assets would also persist unless there was also some procedure to avoid encumbrances on overburdened assets so they might be sold or otherwise put to productive use. In addition, the Roman-divestiture option is quite obviously unpalatable for other important reasons. Once again, no one today advocates this kind of solution, and we may safely set it aside.

Alternatively, suppose that, once a debtor became insolvent, the law simply cancelled all of the debtor's obligations in full. We may call this the "automatic-debt-cancellation" option. This would be a type of exclusive debt-forgiveness remedy because, by eliminating all of the debtor's debts, there would be no need for any debt-collection or debt-adjustment relief—the debts simply would be gone.[399] If this type of debt-forgiveness option were known to be available, debtors would be assured of complete relief from their obligations if they should become insolvent, but at least some

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debtor who did not pay his debts . . . was dealt with on the same footing as a thief" and "if a man was indebted to several creditors and insolvent, . . . they might cut up his body and divide it among them" or "[i]f there was a single creditor, he might put his debtor to death or sell him as a slave").

[399] It is different from the bailout-insurance option because, instead of paying the creditors' claims, the state would simply extinguish them, forcing the creditors to bear the losses.

of the problems of insolvency would still persist—for example, those of payment discrimination and gratuitous transfers arising from transactions the debtor made before becoming insolvent and obtaining a complete release of all debts. Indeed, the automatic-debt-cancellation option would likely exacerbate these problems as creditors scrambled for payment before the remedy took effect. In addition, the blanket cancellation of the debtor's indebtedness would itself likely generate other undesirable *ex ante* effects. Among other things, it is likely that financial creditors would be reluctant to lend and debtors would have every incentive to engage in conduct that gave rise to tort liabilities and other types of involuntary debts because those would be freely cancellable. Once again, no one advocates this type of exclusive debt-forgiveness remedy and we may safely set it aside as well.

Similarly, suppose that, upon a debtor's insolvency, the law provided for the prioritization of the debtor's debts—for example, it stipulated that the claims of tort victims must be paid ahead of all other claims—but offered no accompanying debt-collection or debt-forgiveness remedy. We may call this the "simple-prioritization" option. By its nature, this would not be an exclusive remedy because, if implemented, it would not obviate the need for debt-collection and debt-forgiveness relief. Nor would it resolve all of the problems of insolvency. Unlike the automatic-debt-cancellation option, it would not terminate all debt-collection activities; and unlike the bailout-insurance option, it would not cause the problems of insolvency simply to disappear. On the contrary, most of them would remain. For these reasons, consideration of the simple-prioritization option need not detain us long because it, too, is plainly inadequate as a comprehensive remedy.

In addition, just as it would be unwise to attempt to resolve the problems of insolvency with any of the single-remedy solutions discussed above (i.e., the bailout-insurance, Roman-divestiture, automatic-debt-cancellation, and simple-prioritization options), it would also be infeasible to attempt to remedy the problems of insolvency with merely some combination of two of the three types of remedies categorized above (debt collection, debt forgiveness, and debt adjustment).[400] For example, a bankruptcy law that made use of streamlined, collectivized debt-collection procedures to avoid the problem of deadweight collection costs (a debt-collection solution) and prioritized the payment of claims to address the problem of claims mediation (a debt-adjustment solution) would not resolve the problems of overburdened and stagnating assets. What is needed to address the latter is some kind of debt-forgiveness solution. Because this analysis holds as a general matter (i.e., different combinations of merely two of the three solution categories are inadequate to remedy all of the problems of insolvency), it follows that the problems of insolvency cannot be remediated comprehensively without incorporating into the remedial mix some kind of remedy from each of the categories, including some kind of debt-forgiveness solution. In other words, among other things, we can safely reject a "no-discharge" option if the goal is to resolve all of the problems of insolvency.

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[400] By way of illustration, it might be possible as a conceptual matter to adopt a debt-adjustment mechanism that eliminates the need for a special debt-collection remedy to address various debt-collection problems such as deadweight collection costs. For instance, the law might direct in far-fetched fashion that, upon a debtor's insolvency, the first creditor to file a claim with some public agency (regardless of the size of the claim) would receive the exclusive right to seize and keep all the debtor's assets to the exclusion of all others. This solution, however, is infeasible because, among other things, it would over-compensate the creditor, perhaps even grossly so, if the value of the creditor's claim exceeded the value of the debtor's assets.

Once the bailout-insurance, Roman-divestiture, automatic debt-cancellation, and no-discharge options are eliminated as feasible alternatives, the various problems of insolvency can be readily categorized individually as either problems of debt collection, debt adjustment, or debt forgiveness in the sense that, as a matter of correlation, they are categorically subject to debt-collection, debt-adjustment, or debt-forgiveness solutions. For example, assuming that bankruptcy law should not abandon completely the enforcement of claims against insolvent debtors and their property (i.e., the automatic-debt-cancellation option is eliminated), the problem of deadweight collection costs is properly a debt-collection issue because, so long as creditors may pursue their claims in bankruptcy against the debtor or the debtor's property in some fashion, the problem of deadweight collection costs will persist in the collection process unless remediated in some way. Similarly, assuming that the automatic debt-cancellation and bailout-insurance options are eliminated, the problem of claims mediation is one of debt-adjustment because, so long as creditors may pursue their claims in some fashion against the insolvent debtor or his property, there remains the need for some device to sort and prioritize their conflicting rights to payment because they cannot all be paid in full. Likewise, once the bailout-insurance, Roman-divestiture, and no-discharge options are eliminated, the appropriate solution to the problem of overburdened human capital is one of debt-forgiveness of some kind (as opposed to possible solutions of debt collection or debt adjustment) because only debt forgiveness is responsive to the problem with these assumptions in place. As a result, we are now in a position to categorize generally each of the various problems of insolvency in terms of their basic characteristics and identify

the general kinds of correlative solutions that are potentially responsive to them (i.e., individual solutions of debt collection, debt adjustment, or debt forgiveness).

Of course, in addition to describing in *general* terms the appropriate categories of remedies that correlate to specific problems of insolvency, there is also the challenge of identifying and fleshing out the details of the best solutions among the alternatives *within* each category—a question of optimality. For example, in responding to the problem of overburdened human capital, what specific kind of discharge should the law permit in combination with what other types of remedies? Should the debtor receive an *in personam* discharge of liabilities, but be required to surrender all of his property toward the *in rem* satisfaction of claims,[401] or should the debtor be able additionally to claim some property as exempt? Are all liabilities subject to discharge or merely some of them? Answering these more specific questions requires additional normative guidance, as well as empirical investigation. Moreover, the choice of norms used in the analysis matters because different evaluative criteria may point in different directions. For example, efficiency analysis supports the collectivization of debt-collection remedies in bankruptcy to reduce deadweight collection costs. In contrast, some other form of analysis might support maintaining remedial individualization (although that does not turn out to be true under the particular evaluative standards used here).

Further, because remediating the problems of insolvency unavoidably blends a number of norms in responding to the various categories of problems outlined above, it is also important to have a "norm-that-prioritizes-the-norms" to the extent they conflict. For example, it is critical to decide whether the debt-forgiveness features of bankruptcy

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[401] *See supra* note 329 (distinguishing *in personam* and *in rem* liability).

law are more important than its debt-collection mechanisms. This, in turn, takes the overall analysis into the realm of relative fairness considerations, complex efficiency evaluations, and relative entitlements.

Along the way, it will also be necessary to consider a number of important ancillary questions. For example, should bankruptcy law respond to the problems of insolvency by authorizing their resolution through contracts of some kind, administrative regulation, or some comprehensive market mechanism? In addition, if a market mechanism is to be used, what kind? Moreover, if bankruptcy law makes use of courts, should they be classic dispute-resolution courts or more specialized problem-solving courts? Finally, it is important to address at the outset a few epistemic challenges that tend to obscure inquiries into how bankruptcy law should respond to the problems of insolvency, including those involving questions of morality and cognitive bias, and it is to those challenges that the discussion now turns.

EPISTEMIC COMPLEXITIES

Suppose hypothetically that the particular problem under study is a specific type of car crash. In identifying appropriate potential solutions (e.g., fines, driver retraining requirements, license suspension, etc.), it would be useful to know something about the nature and details of the crashes in question. For example, suppose it is known that all of the relevant crashes are caused by young drivers between the ages of eighteen and twenty-five. Right away one would eliminate from the range of possible solutions any that would force drivers between the ages of forty-five and fifty to attend driver-retraining programs because there would be no correlation between the problem and this particular solution. The same is true for the problems of insolvency—once the nature of

a particular problem is identified in sufficient detail, it is then possible to begin categorizing it for purposes of narrowing the range of potentially fruitful solutions, as illustrated above with respect to the problems of insolvency and their potential remedies.

In doing so, however, it is important to acknowledge that, in considering any problem with an eye toward selecting a possible solution, things are never quite as straightforward as they seem. Among other things, the more one knows about the details of a problem, the more one becomes susceptible to preconceived frames of analysis and potential biases that can color the evaluation. For example, continuing the hypothetical above, suppose it is known that the relevant car crashes are all caused by drunks who intentionally steer their vehicles into walls. Once these additional details are revealed, the concept of moral fault tends to interject itself and potentially co-opt the analysis because "drunk" and "intentionally" tend to trigger moral responses such as "fault" and "blame." In turn, these responses may trigger preferences for particular solutions, such as "punishment" rather than "retraining." Of course, this may or may not be warranted. The point is that it is important to be conscious of the potential for these kinds of reactions and examine deliberately whether they are, in fact, appropriate. As we shall see momentarily, this is particularly important in conducting any inquiry into the nature of the problems of insolvency and in evaluating their potential resolution.

Before addressing the details of some particularly significant and potentially distracting epistemic complexities associated with the phenomenon of insolvency, however, it is first useful to introduce another evaluative concept relevant to categorizing the problems of insolvency and the relevant types of remedies that appropriately correlate to each. In attempting to find a solution to any challenging problem of significance, it is

often helpful to consider whether it is a puzzle or a mystery. Puzzles are characteristically problems that have already occurred and are solvable once the necessary pieces have been collected. They turn on what is known at the time a solution is attempted and, if all the relevant pieces are present, typically require simply an appropriate puzzle-solving strategy to put them together. Mysteries, on the other hand, are problems for which solutions must be determined in other ways. They turn on what the investigator can plausibly discover, deduce, and assume, and they generally require more skill, nuance, and creativity to identify a plausible, satisfactory resolution.[402]

We know enough about the law and human behavior in general, and the problems of insolvency in particular, that we should be able to treat these problems more like puzzles, at least at a general level for purposes of creating a serviceable evaluative framework. But returning to the epistemic challenge outlined above, there is a deeper difficulty involved in working with what we know about insolvency: as a general matter, there are profound reasons why we are likely *to want* to believe certain things about insolvent debtors and their condition and, correspondingly, to disbelieve others, which may color our preferences for certain solutions at the expense of others. These include (1) the existence of a peculiar concept of non-reciprocal morality embedded in the idea of debt, and (2) a particular form of bias arising in connection with bankruptcy's social stigma. Both of these threaten to convert the puzzles of insolvency into deep, inscrutable mysteries.

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[402] *See* GREGORY F. TREVERTON, RESHAPING NATIONAL INTELLIGENCE FOR AN AGE OF INFORMATION 11 (2001).

For example, regardless of whether one thinks of debtors as generally rational or not,[403] they are susceptible to important behavioral biases that suggest that they are not optimal cost avoiders when it comes to the problems of insolvency. Specifically, they are vulnerable to certain cognitive weaknesses that can lead to risk-assessment decision-making errors that, in turn, can devolve fairly rapidly into insolvency under conditions of financial stress. A key example is a form of optimism bias that may be referred to as the "Antonio problem" after the character in Shakespeare's play, *The Merchant of Venice*.[404]

In the play, Antonio was willing to pledge a lethal pound of his flesh in exchange for a loan from the money lender Shylock because Antonio felt certain he could repay the

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[403] *See, e.g.*, STUART VYSE, GOING BROKE: WHY AMERICANS CAN'T HOLD ON TO THEIR MONEY (2008) [hereinafter VYSE, GOING BROKE] (arguing that consumer spending is not rational); *see also* DANIEL ARIELY, PREDICTABLY IRRATIONAL (2008) (discussing ways in which human behavior is not rational). It is with no small irony that Hamlet remarks: "What a piece of work is man!" WILLIAM SHAKESPEARE, HAMLET, act 2, sc. 2, ln. 295.

[404] *See* AYRES, CARROTS, *supra* note 384 at 145-65 (explaining and discussing the Antonio Problem); WILLIAM SHAKESPEARE, THE MERCHANT OF VENICE [hereinafter SHAKESPEARE, MERCHANT OF VENICE]. Optimism bias is a form of judgment error in which individuals believe that their own probability of suffering a bad outcome is less than it actually is. *See* SARAH CONLY, AGAINST AUTONOMY 21-22 (2013) (noting that human are "unduly prone to think that we ourselves are less likely than others to suffer misfortune . . ."); David M. DeJoy, *The Optimism Bias and Traffic Accident Risk Perception*, 21 ACCIDENT ANALYSIS AND PREVENTION 333 (1989). Some disagree that optimism bias is a form of judgment error on the theory that it is simply a "preference" or "taste" for increased risk taking. *See generally* Richard A. Posner, *An Economic Analysis of Sex Discrimination Laws*, 56 U. CHI. L. REV. 1311 (1989). One problem with this perspective, however, is that the "preference" or "taste" is not typically conscious—the person does not think he is actually taking any increased risk and so acts as though he is not. Rationally, if the individual understood the actual risk (and with it the likely consequences of his choice), the individual would not assume the risk unless the potential payoff was more than he originally thought it would be because he now has an accurate value for the relevant risk. It is only because the actual risk remains hidden that it is assumed, and the inability to see actual values in this context is what constitutes a form of bias. *See, e.g.*, HUME, TREATISE, *supra* note 14 at book III, part II, section VII (arguing that individuals irrationally discount the future in order to maximize short-term benefit at the expense of long-term gain).

debt and avoid the penalty.[405] Like many debtors desirous of a loan, he discounted heavily the risk of his potential failure to repay his debt on time. In contrast, his creditor Shylock exhibited the superior skill at more shrewdly assessing the actual risk of Antonio's default. As it turned out, Antonio could not repay the loan until at least one of his three ships returned from sea. During the era, of course, this was hardly a risk-free contingency, but Antonio brushed it aside. After Antonio predictably defaulted, Shylock demanded his penalty, and the matter was taken to court. Before recounting how the tale ends and explaining its significance, however, it is first essential to identify a few crucial historical features lurking in the background.

When modern credit practices first began to emerge in sixteenth-century England (at around Shakespeare's time), credit extensions were (1) common for everyday necessities, (2) local in nature, and (3) wholly subjective in character.[406] They typically arose between people who knew each other under circumstances in which hard currency was scarce, credit substituted for currency in ordinary transactions, and creditors lacked the underwriting tools they have today. Forbearance in collection was a common

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[405] The term of the debt, evidenced by Antonio's written and notarized bond, was for three months. When Antonio's friend, Bassanio, balked at the stipulated penalty, Antonio brushed him off: "Why, fear not, man, I will not forfeit it! Within these two months—that's a month before this bond expires—I do expect a return of thrice three times the value of this bond." SHAKESPEARE, MERCHANT OF VENICE, *supra* note 404, act I, sc. III, ln. 168-71. In addition, Antonio took out the loan entirely for emotional reasons: out of his love for Bassanio, to whom he gave the proceeds. This underscores another distinguishing feature between debtors and creditors: although debtors often enough take on indebtedness for emotional reasons, most creditors rarely lend on that basis (Shylock being somewhat of an exception: he loaned the money to Antonio out of hatred, not simply for profit, but his hatred arose in part because Antonio frequently lent money to others without charging interest, which Shylock bemoaned for bringing down interest rates generally, *see id.*, act I, sc. III, ln. 41-52).

[406] *See* MULDREW, ECONOMY, *supra* note 371 at 60-119.

occurrence, often for lengthy periods. In addition, charitable debt forgiveness was a religious obligation owed and extended to deserving debtors (e.g., those innocent of the sin of luxury), and informal debt forgiveness was routine even for those who were less than fully deserving (although perhaps practiced more frequently out of the impracticality of collection than empathy or conscience).[407]

Critically, the concept of debt during Shakespeare's time had a certain moral value that has endured across the centuries in the idea of a debtor's moral responsibility to satisfy his pecuniary obligations.[408] What has disappeared, however, is the specific social context in which that idea arose (e.g., close communities, scarce hard currency, credit between parties intimately familiar with one another, and a very delicate

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[407] *See id*. at 60-119, 302-06 (observing that the annual level of debt-forgiveness by mid-seventeenth-century England was "20 times the average figure of positive charity and possibly more" and stating that "however the creditor felt about forgiving such debts, they were still forgiven, and many contemporary sources described such forgiveness as a form of charity").

[408] Thus, the U.S. Supreme Court has stated that, even after a debt has been discharged in bankruptcy, the debtor still retains a *moral* obligation to pay it, though not a legal one. *See* Zavelo v. Reeves, 227 U.S. 625, 630 (1913) ("It is settled . . . that a discharge, while releasing the bankrupt from legal liability to pay a debt that was provable in the bankruptcy, leaves him under a moral obligation that is sufficient to support a new promise to pay the debt."); *see also* Kesler v. Department of Pub. Safety, 369 U.S. 153, 170 (1962) ("This Court has held that a moral obligation to pay the debt survives discharge"), overruled in part on other grounds, Perez v. Campbell, 402 U.S. 637 (1971). The relevant concept is an old one. *See* Trueman v. Fenton, 98 Eng. Rep. 1232, 1235-36 (K.B. 1777) ("[A]ll the debts of a bankrupt are due in conscience, notwithstanding he has obtained his certificate [of discharge]; and there is no honest man who does not [pay] them, if he afterwards has it in his power to do so. Though all legal remedy may be done, the debts are clearly not extinguished in conscience."). One source for this principle is biblical: "The wicked borrow and do not repay, but the righteous give generously." PSALMS 37:21 (King James); *see also* MULDREW, ECONOMY, *supra* note 371 at 123-95 (observing various facets of the development of the debtor's moral obligation to repay indebtedness in sixteenth-century England).

interdependence of credit and debt).[409] More important, what has also vanished is the idea of the *creditor's* reciprocal moral obligations of forbearance and forgiveness, which during Shakespeare's time were just as important as the debtor's moral obligation to pay his debts, if not more so.[410] After all, that is the ultimate point of Shakespeare's tale: because Shylock was not merciful in his dealings with the defaulting Antonio—even after being warned in court of his moral duties (in some of the most beautiful language ever written)—Shylock ends up losing everything when he attempts to enforce his claim. In biblical terms (referenced explicitly in the play), Shylock winds up suffering the fate of

[409] During the sixteenth century, for example, a prevailing social norm was that a creditor should not seek to take advantage of his debtor by sharp practices, including charging interest on debts, because credit was a vital necessity, excessive charges threatened the debtor's viability, and the failure of one debtor threatened others in the community. *See* MULDREW, ECONOMY, *supra* note 371 at 41-51, 95-119, 123-147, 305-07. Among other things, usury was both a sin and illegal until 1571 (although it was allowed temporarily by statute between 1545 and 1552), and this ban was traced to biblical proscription. *See* LUKE 6:35 (King James) ("lend, hoping for nothing again"); George L. Flint, Jr., *Secured Transactions History: The Fraudulent Myth*, 29 N.M. L. REV. 363, 372 (1999). Even after the legal ban on usury was lifted, however, interest rates were capped by statute and, from a social and religious perspective, the charging of interest remained a dodgy commercial pursuit commonly challenged on moral grounds. *See* MULDREW, ECONOMY, *supra* note 371 at 114 (observing among other things that it was not until Elizabethan times that a charge for lending was termed a rate of interest rather than a practice of usury). This is illustrated in THE MERCHANT OF VENICE, where Antonio expresses his disgust for Shylock's practice of lending on interest. *Id*., *supra* note 404, act I, sc. 3, ln. 63-147; *see also* DANTE ALIGHIERI, INFERNO 171, canto XI, ln. 106-111 (M. Musa trans. Penguin 1971) (placing usurers in the lower reaches of hell and commenting that "the usurer . . . scorns Nature in herself and in her pupil, Art—he invests his hope in something else").

[410] *See* MULDREW, ECONOMY, *supra* note 371 at 82, 174, 304-307 (observing average forbearance periods in excess of eight months and noting similarly a creditor's obligation of debt forgiveness as a form of charity practiced in the sixteenth century as a form of sociability and Christian virtue).

the non-reciprocating "unmerciful servant" for violating his paramount moral obligations of forgiveness and forbearance.[411]

Today, credit extensions are also common, but no longer characteristically local or subjective. Rather, they tend to be highly routinized transactions between parties who are typically strangers to each other and at least one of which is customarily an institution, such as a bank or finance company. Moreover, financial debts are typically enforced and collected by credit managers and their agents who do not often find the

[411] When Shylock seeks to enforce Antonio's bond in the Duke's court, the Duke asks him directly: "how shalt thou hope for mercy, rend'ring none?" SHAKESPEARE, MERCHANT OF VENICE, *supra* note 404, act IV, sc. I, ln. 89. This question is a direct reference to the biblical parable of the unmerciful servant. MATTHEW 18:21-35 (King James). In the parable, a servant was brought before the king for his failure to pay a large debt to the sovereign. When the king threatened punishment, the servant begged for mercy, which the king granted. Having received the king's forgiveness, however, the servant nonetheless refused mercy to his own debtor, instead having the debtor imprisoned for a sum he could not pay. When the king learned of this, he rescinded his forgiveness, remarking "[s]houldn't you have had mercy on your fellow servant just as I had mercy on you?" In Elizabethan times, virtually everyone was indebted to someone else, default and insolvency were common and very real possibilities (even for members of the aristocracy), and forbearance and forgiveness were essentially a form of insurance: by showing mercy to his debtor, a creditor could later expect mercy from his own creditor. *See* MULDREW, ECONOMY, *supra* note 371 at 95-119; *see also* JOHN STEINBECK, THE GRAPES OF WRATH 251 (Penguin 2006) ("And a kind of insurance developed in these nights. A man with food fed a hungry man, and thus insured himself against hunger."). Having failed to show Antonio mercy, Shylock loses everything when the tables are turned and he becomes the debtor. SHAKESPEARE, MERCHANT OF VENICE, *supra* note 404, act IV, sc. I, ln. 361-406. In the end, however, Antonio (now Skylock's creditor) shows Skylock mercy by returning to him half of his wealth, provided Shylock turns over a new leaf—a perfectly moral outcome in Elizabethan terms. As Portia explains during her oration: "The quality of mercy is not strained, it droppeth as the gentle rain from heaven upon the place beneath. It is twice blessed: It blesseth him that gives and him that takes." *Id*. ln. 190-93; *see also* DEUTERONOMY 15:1-2 (King James) ("At the end of every seventh year you must cancel your debts. This is how it must be done. Creditors must cancel the loans they have made to their fellow Israelites. They must not demand payment from their neighbor or relatives, for the Lord's time of release has arrived."); WILLIAM SHAKESPEARE, MEASURE FOR MEASURE, act II, sc. II, ln. 79-83 ("No ceremony that to great ones longs, not the King's crown, nor the deputed sword, the marshal's truncheon, nor the judge's robe become them with one half so good a grace as mercy does").

words "charity" or "forbearance" in their job descriptions. In other words, they typically constitute a class of "amoral agents."[412]

For our purposes, however, the most relevant thing about the Elizabethan concept of the debtor's moral responsibility is that it has endured without any corresponding moral obligation on the creditor's part, even though today financial creditors are in a much better position to prevent over-spending because of their often superior ability to evaluate how much indebtedness their potential obligors can actually handle.[413] The reasons for this include (1) that creditors do not characteristically suffer from the Antonio problem in extending credit; (2) they frequently deal with large volumes of repeat transactions and therefore acquire a comparatively superior experience in evaluating credit risk; and (3) they have access to sophisticated predictive models, information, and other underwriting tools to assist them in making credit decisions. Nonetheless, many financial creditors routinely offer credit to debtors they know (or should know) cannot tolerate the burden without remarkably enhanced risk of failure. Yet the entirety of the moral obligation today rests on the debtor, and none on the creditor. As a result, we are left with a lopsided, one-way moral equation that seems in some respects to point in the wrong direction.

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[412] *See* Ronald D. Milo, *Amorality*, 92 MIND 481 (1983) (defining an "amoral agent" as one who is unaware of, or indifferent to, the morality of his actions). The problem of the amoral agent helps explain the need for discharge relief in bankruptcy as a replacement for the balancing and reciprocal moral concepts of forbearance and forgiveness. *See infra* at 280-85; *see also* Jacob Nebel, *A Counterexample to Parfit's Rule of Consequentialism*, 6 J. ETHICS & SOC. PHIL. 1, 3 (2012) ("Even if amoral agents cannot be morally blameworthy, it seems clear that they can act wrongfully).

[413] I use the term "financial creditors" to include creditors that extend credit commercially, as opposed to, for example, most tort victims.

This non-reciprocal moral artifact will always tend to skew the analysis because it relentlessly casts defaulting debtors in a certain moral light and directs attention away from the activities of creditors. As a result, it is also likely to color perceptions of other common credit practices that have the effect of increasing the systemic likelihood of insolvency. As Ian Ayres has observed: "[c]redit card companies and movie rental stores exploit cognitive weaknesses when they jack up the price of late fees that consumers don't think they are ever going to pay. Why should you worry about the interest rate on your credit card if you always pay on time?"[414] In reality, however, many consumers occasionally miss a payment or two (and thus incur late fees), and many more routinely do not pay off their entire balances at the end of each month, ending up saddled with interest charges that can exceed thirty per cent. Unfortunately, these kinds of rates can quickly spiral out of control if a debtor experiences financial difficulty, accelerating the slide into bankruptcy.[415] Moreover, it is revealing that, in the vernacular of the credit-card industry, the term "deadbeat" does not refer to the consumer who fails to pay his bills. On the contrary, it refers to the consumer who timely pays off his entire credit-card balance each month, thereby avoiding the lucrative interest that the credit card company would otherwise demand.[416] Although initially the credit card industry got off to a rocky start, by the mid-1970s the cards had caught on and, over the years, credit card companies

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[414] AYRES, CARROTS, *supra* note 384 at 146; *see also* VYSE, GOING BROKE, *supra* note 403 at 97-101 (discussing the history of the credit card industry and some of the practices of credit card issuers).

[415] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 111-40 (chronicling how to go bankrupt with credit cards, particularly given how quickly high interest rates can mount up).

[416] *See* VYSE, GOING BROKE, *supra* note 403 at 25 ("The worst customer is one who never carries a balance on her credit card—commonly known in the industry as a 'deadbeat.'").

have earned hundreds of billions of dollars as a result of the rates and fees they routinely charge.[417]

A second epistemic complexity is perhaps even more daunting than the first. Bankruptcy has always been perceived as a serious and very public type of social failure, akin to an acute form of public shaming.[418] To the extent most people who have never gone through it think about it at all, they tend to regard it as something remarkably unpleasant that happens only to other people. In reality, insolvency is far more likely to occur to anyone than most perceive,[419] and the common perception is simply another example of optimism bias, only here with a few potentially pernicious twists.

First, perhaps one reason most individuals are likely to think that insolvency only happens to others is because, in general, they tend to perceive (and overrate) their own ability to stave off disaster as a consequence of their own consciously deliberative planning capabilities. How many times have we heard: "Well, I certainly manage to plan things out in advance, so why can't so-and-so when it comes to his financial affairs?" Although no one is perfect, it is tempting to believe that our planning skills are at least adequate to stave off disaster, if for no other reason than that we have somehow managed to avoid disaster so far and our planning capabilities seem like the most

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[417] *See id*. at 97-101 (discussing the origins of the credit card in 1949, its rise in popularity, and some industry practices designed to encourage consumers to maintain high balances).

[418] *See, e.g.*, MULDREW, ECONOMY, *supra* note 371 at 274, 285 (discussing loss of credit as a "moral failure" in early modern England and the stigma of insolvency and bankruptcy).

[419] *See supra* notes 95, 202 (discussing bankruptcy filing rates and business failure rates); SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 6 (2000) (observing that "even the most secure family may be only a job loss, a medical problem, or an out-of-control credit card away from financial catastrophe.").

plausible explanation—especially for those of us who wish to avoid the unpleasant idea that financial ruin lurks more or less randomly around the corner in everyone's lives. By extension, when evaluating other people and their failed plans, particularly those resulting in financial distress, it would seem tempting to suspect that there must be something wrong with their deliberative planning processes because, once again, we like to think that our own planning ability is what keeps us safe. Such perceptions, however, tend to overrate our ability to plan and underrate the potential effects of unforeseen variables.

Perhaps one reason for this is because so much of our planning experience takes place in the context of short-term activities, such as getting up in the morning when the alarm goes off, making a cup of coffee using a coffee-maker, ordering a new shirt on-line, heading home on the train at the end of the day, and so on. When it comes to these kinds of plans, our conscious deliberations appear to rule the day because so many of these plans are successful with relatively little deliberative effort—in other words, they seem easy. What this kind of superficial assessment tends to overlook, however, is the vast unseen social and technological mechanisms that conspire in favor of the successful implementation of the average person's *generic* short-term plans.

Everything from the website of our favorite on-line store to the predictable pattern of the local public transportation system are designed to make it relatively easy to execute routine planning activities, and the trend in technology is only to make this more so and even less apparent. And it is but a small step from there to conclude that, because the success of so many of our little plans appears to be the product of our own deliberative genius, perhaps that is also the case with respect to *all* of our planning activity. That

perception, however, would be a classic "illusory correlation."[420] In reality, the more complex our plans (including, in particular, the longer they take to accomplish), the more likely they are to outstrip our planning capabilities simply because of the possibility for so many contingencies to creep into the picture. In addition, because many of the variables tend to be hidden from view, we will tend to discount them heavily—out of sight, out of mind.[421] Yet these unforeseen events are the ones that are most likely to trip us up.

Second, when financial disaster strikes others, it is more comforting to view it as endogenous to its victims, rather than randomly exogenous, especially if we already happen to subscribe to the view (consciously or not) that bankruptcy is typically a problem of moral failure that characteristically happens to immoral people—coalescing into a form of "group-based bias"[422] premised on a kind of "fundamental attribution error" that those who fail have some kind of undesirable fixed disposition that correlates to financial ruin.[423] Because of our susceptibility to group-based bias and fundamental

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[420] An "illusory correlation" exists when two co-variables actually work together to produce a result (i.e., our conscious deliberations *and* facilitating infrastructures and conventions), but we acknowledge only the one we perceive. *See* Loren J. Chapman & Jean P. Chapman, *Genesis of Popular But Erroneous Diagnostic Observations*, 72 J. ABNORMAL PSYCHOLOGY 193 (1967) (discussing the problem of "illusory correlation").

[421] *See* DANIEL KAHNEMAN, ET AL., JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 190-200 (1982) (discussing the "availability heuristic" and the tendency of people to ignore factors that are not immediately present).

[422] *See, e.g.*, Christine Jolls & Cass R. Sunstein, *The Law of Implicit Bias*, 94 CAL. LAW REV. 969 (2006) (discussing the concept of "group-based bias"). This propensity is supported in the insolvency context by our susceptibility to optimism bias—the belief that we are less likely than others to suffer misfortune. *See supra* note 404 (discussing optimism bias).

[423] *See* VYSE, GOING BROKE, *supra* note 403 at 38 (discussing the concept of "fundamental attribution error") (citing Lee D. Ross, *The Intuitive Psychologist and His*

attribution error, and likewise our propensity to reason superficially on the basis of "similarity matching," the explanation for the disaster of bankruptcy we are most likely to accept is also the one we most want to believe: that financial disaster only happens to "those other people."[424] In its most benign form, this supports the idea that, unlike the rest of us, bankrupt debtors simply do not plan well, perhaps because of weaknesses in their deliberative processes. In its most aggressive form, it supports the idea that bankrupt debtors characteristically suffer from some moral deficiency that we do not share, such as profligacy. In addition, consistent with the concept of "hindsight bias,"[425] it is then perhaps merely a small additional step to the conclusion that, because a particular person filed for bankruptcy relief, it was *inevitable* that he would (confirming

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Shortcomings: Distortions in the Attribution Process, in ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY (L. Berkowitz ed. 1977)). Vyse explains that "[w]e conclude that people—other people in particular—do the things they do because of the fixed dispositions they possess. . . . But when we turn our detective's eye upon ourselves, the view is quite different. We are intimately familiar with the details of our past and how they have shaped us. In addition, we know, in a way outsiders never can, the external forces that press upon us at the moment we act. The very same behavior viewed from the inside and from the outside will often be explained in very different terms. The student understands the late term paper as a natural result of various random and unique circumstances, but the professor believes she has uncovered a core feature of the student's personality." *Id.*

[424] "Similarity matching" refers to the process of reasoning based on matching similarities rather than logic. *See* JAMES REASON, HUMAN ERROR 39 (Cambridge 1990) [hereinafter REASON, HUMAN ERROR] (discussing "similarity-matching"). For understandable reasons of cognitive efficiency, we tend to rely on such simplifying heuristics rather than more laborious forms of analysis. *Id*. at 40. This is inherent in the concept of "bounded rationality"—namely, that our ordinary reasoning capabilities tended to be bounded rather than expansive.

[425] *See* Hal R. Arkes, et al., *Eliminating the Hindsight Bias*, 73 J. APPLIED PSYCH. 305-307 (1988) (discussing "hindsight bias" as the tendency to view events as inevitable simply because they occur, rather than as one of several possible outcomes).

all suspicions), rather than a *probabilistic* outcome of no greater likelihood than the risk of failure most debtors face.

Moreover, once a generalized conclusion of this kind catches on, people will typically prefer to take notice of information that verifies it over evidence that suggests it is wrong—a form of "confirmation bias."[426] These tendencies are only exacerbated when the particular association individuals are trying to avoid is an extreme one, such as economic ruin. Financial failure and the stigma of bankruptcy are sufficiently unpleasant to contemplate that they must be the product of other peoples' moral fault or similar defects—or so we would like to believe in order to lessen our own anxieties in a stressful and uncertain world fraught with financial peril. Although the evidence does not back this notion up—the vast majority of bankruptcy filings appear to be made by ordinary people who took ordinary risks and failed for perfectly ordinary reasons that virtually everyone is vulnerable to[427]—it retains credibility because, at the end of the day, people tend to believe what they want to believe, particularly when they have a strong psychological interest in believing it, which is at the heart of the phenomenon of "self-serving bias."[428]

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[426] *See* Anthony G. Greenwald, et al., *Under What Conditions Does Theory Obstruct Research Progress?* 93 PSYCH. REV. 216 (1986) (discussing the "pervasive phenomenon of confirmation bias—the tendency for judgments based on new data to be overly consistent with preliminary hypotheses" as applied in the area of scientific research). Confirmation bias can be very powerful. *See* REASON, HUMAN ERROR, *supra* note 424 at 39 (discussing findings that show "an often overwhelming tendency to verify generalizations rather than falsify them").

[427] *See supra* at 223, *infra* at 261-64 (discussing this point).

[428] The concept of "self-serving bias" refers to the tendency of individuals to interpret information in ways directed by their own self-interest. *See, e.g.*, George Loewenstein, et al., *Self-Serving Assessments of Fairness and Pretrial Bargaining*, 22 J. LEG. STUD. 135

The point at this juncture, however, is not to clinically dissect and debunk these sorts of perceptions about bankruptcy. It is simply to reveal their potential presence and then set them aside before proceeding to a hopefully less encumbered evaluation of the nature of the problems of insolvency and an appropriate set of solutions to remedy the substantial costs they generate.

RESOLVING THE PROBLEMS OF DEBT COLLECTION

Of the various problems of insolvency discussed in Chapter 2, three fall into the debt-collection category: (1) deadweight collection and monitoring costs, (2) gratuitous transfers, and (3) debt-collection free-for-alls. These are each properly debt-collection problems that correlate to debt-collection solutions because, once the bailout-insurance and automatic-debt-cancellation options are eliminated, they are subject to amelioration only through modifications to available debt-collection procedures. They are not properly debt-forgiveness problems because they have nothing to do with debt forgiveness and, once the automatic-debt-cancellation option is eliminated, cannot be resolved through more limited forms of discharge relief.[429] Likewise, they are not problems of debt adjustment because they cannot be resolved simply by the prioritization

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(1993) (discussing the phenomenon of "self-serving bias" in the context of pretrial bargaining).

[429] *See supra* at 208 (discussing the automatic-debt-cancellation option). Until a debt is actually forgiven and all possibility of payment foreclosed, these costs will typically endure. Because bankruptcy law properly avoids eliminating all debt-collection rights, debt-forgiveness mechanisms will not obviate the need for some sort of debt-collection remedy. *See supra* at 209.

of claims.[430] Having categorized these three problems, the question becomes: how might bankruptcy law beneficially resolve them?

As discussed in Chapter 2, deadweight collection and monitoring costs arise as a result of characteristically sharp increases in monitoring and debt-collection activities in the wake of a debtor's financial distress, generating expenses that usually cannot be recovered.[431] One far-fetched solution to this problem might be to mandate the collectivization of all debt-collection and monitoring procedures regardless of the debtor's solvency—call this the "Stalinization" approach. As discussed previously, however, this extreme notion is undesirable because it would burden ordinary debt-collection mechanisms needlessly.[432] A far less drastic remedy would be to mandate a set of procedures that collectivize and streamline the debt-collection process only in the bankruptcy setting and, unsurprisingly, that is what bankruptcy law actually does.[433]

As also discussed in Chapter 2, insolvent debtors have a variety of special incentives to make gratuitous transfers that harm creditors in ways that would not typically arise if the debtors were solvent.[434] Although this problem could be remedied by simply banning all gift-giving regardless of the debtor's insolvency—call this the

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[430] For example, even if the law were to provide that tort claims are more important than contract claims, creditors holding either type would still seek to enforce them following the debtor's default, generating deadweight collection costs. *See supra* at 180-89.

[431] *See id.*

[432] *See supra* at 184-85.

[433] Bankruptcy law has elaborate mechanisms for channeling and collectivizing the recognition and payment of claims, and also the collection and dissemination of information regarding the debtor's assets and finances. *See supra* notes 16, 241, 363.

[434] *See supra* at 174-79.

"Scrooge" approach—that solution is also obviously untenable. A less drastic remedy would be for the law to permit the avoidance and recovery of gratuitous transfers in the insolvency setting in order to redistribute the value of these transfers to creditors and, once again, this more surgical cure is what bankruptcy law actually prescribes.[435]

Finally, as further discussed in Chapter 2, the creditors of insolvent debtors have incentives to engage in value-destroying, debt-collection free-for-alls.[436] As noted, this problem is central to the collective-action dilemma.[437] One extreme way to avoid debt-collection free-for-alls would be simply to ban all debt-collection activity when a debtor gets into trouble—call this the "manna-from-heaven" approach. By itself, however, this idea is also unrealistic. Another solution would be to suspend ordinary non-bankruptcy debt-collection mechanisms in the insolvency context and replace them with bankruptcy procedures that collect and dispose of the debtor's property in ways that are more value maximizing, which again is what bankruptcy law endeavors to accomplish.[438]

Having identified these various solutions to the debt-collection problems of insolvency, the question becomes: setting aside the Stalinization, Scrooge, and manna-from-heaven approaches, are the particular solutions that bankruptcy law actually embodies truly beneficial? Although the answer seems rather obviously yes (at least in instances in which there is sufficient value at stake for a sufficient number of

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[435] *See supra* note 345 (discussing fraudulent transfer remedies in bankruptcy).

[436] *See supra* at 162-68.

[437] *See supra* at 24-25.

[438] *See supra* notes 16, 74, 246-47, 299, 325, 363 (discussing the automatic stay restraining debt-collection activity and bankruptcy law's various procedures for the orderly disposition of the debtor's assets).

stakeholders to make it worthwhile to initiate some kind of bankruptcy process), the question is still worth evaluating more rigorously to see exactly why.

As suggested above, outcomes in bankruptcy will be beneficial only to the extent they represent improvements over outcomes that would be realized through the application of non-bankruptcy mechanisms.[439] (In contrast, a potential solution would be optimal to the extent it constitutes the best bankruptcy solution among the various beneficial alternatives.) Although there may be many different ways to evaluate whether an outcome is beneficial, I use three standards here: (1) equity, (2) efficiency, and (3) entitlement. Even though each offers a distinct way to consider the desirability of any particular solution to the debt-collection problems of insolvency, they all point in the same direction in this instance: the various debt-collection solutions of bankruptcy law summarized above are, by the collective light of these standards, generally worthwhile. This conclusion, of course, does not preclude the possibility that these solutions are subject to improvement, but it does help identify the path forward.

EQUITY

Why equity? First, the principles of equity, and the large body of precedents applying them, represent a vast experience with human behavior. Second, courts of equity (including bankruptcy courts) are classic problem-solving courts that have long been involved in devising strategies to resolve complex social problems like the problems of insolvency. Third, equity is the life blood of bankruptcy law. Fourth, equity is rich with norms, particularly those relevant to addressing defects in legal outcomes and filling the law's remedial gaps.

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[439] For example, the Stalinization, Scrooge, and manna-from-heaven approaches are obviously not beneficial because they would not generate improved overall outcomes.

In the Anglo-American tradition, bankruptcy law has always been a distinct branch of equity. Consistent with this tradition, bankruptcy courts have long been constituted as equitable tribunals, and equitable principles have long governed proceedings in bankruptcy cases.[440] In the United States, Congress has codified the relevant principles in the various provisions of the Bankruptcy Code, which has the effect of directing their application as a matter of more precise statutory prescription rather than as a product of the chancellor's discretion.[441] Still, bankruptcy law retains an unmistakable equitable edge.

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[440] *See* Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934) (stating that "courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity."); *see also* Young v. United States, 545 U.S. 43, 50 (2002) (recognizing that bankruptcy courts "are courts of equity and apply the principles and rules of equity jurisprudence") (citation and marks omitted); United States v. Energy Resources, 495 U.S. 545, 549 (1990) (stating that "bankruptcy courts, as courts of equity, have broad authority to modify debtor-creditor relationships"); Bank of Marin v. England, 385 U.S. 99, 103 (1966) (stating that "[t]here is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction"); Pepper v. Litton, 308 U.S. 295, 304 (1939) (observing that "a bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the [Bankruptcy] act, it applies the principles and rules of equity jurisprudence"); H.R. Rep. No. 95-595, at 359 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6315 (providing that, under the Bankruptcy Code, "[t]he bankruptcy court will remain a court of equity" (citing Local Loan Co., 292 U.S. at 240)).

[441] *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) (stating that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code"); In re Lapiana, 909 F.2d 221, 223 (7th Cir. 1990) (stating that "bankruptcy, despite its equitable pedigree, is a procedure for enforcing pre-bankruptcy entitlements under specified terms and conditions rather than a flight of redistributive fancy or a grant of free-wheeling discretion such as the medieval chancellors enjoyed (equity itself is no longer a discretionary system in that sense)."); In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co., 791 F.2d 524, 528 (7th Cir. 1986) (stating that "[t]he fact that a proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be."); United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986) (stating that the Bankruptcy Code does not authorize "the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity"); Stebins v. Crocker

As an historical matter, Aristotle famously defined equity as "justice that goes beyond the written law."[442] As applied, however, this sweeping pronouncement cannot be taken at full face value, at least not in its broadest and most expansive sense. Bankruptcy law never was, and cannot legitimately claim to be, simply a font of free-ranging discretion available to rewrite at whim fundamental legal principles of general applicability in the name of justice simply because a debtor cannot pay his debts and wishes to invoke the assistance of a court of equity to fend off his creditors.[443] The law generally stipulates liability rules and enforcement mechanisms that are presumably desirable in the contexts in which they typically apply, and these should not be casually swept aside. Rather, equity has a narrower and more precise mission, and the key to understanding the role of bankruptcy law as an equitable device lies in the special nature of the problems of insolvency and the need for some special set of remedies to address them because, once again, it would make no sense to burden ordinary non-bankruptcy legal mechanisms with procedures to address these extraordinary problems that arise only in the insolvency setting.

Citizens National Bank (In re Ahlswede), 516 F.2d 784, 787 (9th Cir. 1975) (stating that "the chancellor never did, and does not now, exercise unrestricted power to contradict statutory or common law when he feels a fairer result may be obtained by application of a different rule"); Guerin v. Weil, Gotschal & Manges, 205 F.2d 302, 304 (2d Cir. 1953) (stating that "[a]lthough it has been broadly stated that a bankruptcy court is a court of equity, the exercise of its equitable powers must be strictly confined within the prescribed limits of the Bankruptcy Act") (internal citation omitted).

[442] ARISTOTLE, THE ART OF RHETORIC 144-45 (J. Freese trans. Harvard 1926).

[443] *See supra* note 441, *infra* note 453.

Refining further Aristotle's definition, Joseph Story conceived of equity as "the correction of the law, wherein it is defective by reason of its universality."[444] Elaborating further, Story explained that because "[e]very system of laws must necessarily be defective; . . . cases must occur, to which the antecedent rules cannot be applied without injustice, or to which they cannot be applied at all."[445] For the sake of simplicity, we may refer to Story's conceptualization of the general need for equity as the "universality" problem. For our purposes, a debtor's financial ruin typically gives rise to special circumstances within the ambit of this problem—those defined by the presence of the special problems of insolvency that the law, by reason of its universality, should not undertake to resolve because doing so would burden ordinary legal procedures needlessly.

As Story also observed, equity operates on the basis of the application of a collection of fundamental normative precepts.[446] These precepts include a general overarching principle of restraint embodied in the maxim "equity follows the law."[447] This general principle is intended explicitly to confine equity's scope to matters that properly fall within the ambit of the universality problem. Equity likewise operates on

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[444] 1 JOSEPH STORY, STORY'S EQUITY JURISPRUDENCE 3 (13th ed. 1886) [hereinafter STORY'S EQUITY JURISPRUDENCE] (paraphrasing Aristotle's concept of equity in ARISTOTLE, NICOMACHEAN ETHICS 316-317 (H. Rackham trans. Harvard 1934)); *see also* FDIC v. Colonial Realty Co., 966 F.2d 57, 60 (2d Cir. 1992) (recognizing this principle as underlying the equitable provisions of the Bankruptcy Code).

[445] 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 6-7.

[446] *Id.* at 17.

[447] *Id.* at 60. This principle is reflected in the concept that equity will intervene only if the party seeking to invoke it lacks an adequate remedy at law. The key concept is "adequacy." As discussed below, bankruptcy law addresses a number of social problems that non-bankruptcy law addresses inadequately by reason of its universality.

the basis of a collection of more specific principles designed to guide the resolution of matters that otherwise satisfy the general principle of restraint. These include the reciprocity maxim that "he who seeks equity must do equity";[448] the equal-innocence maxim that "where there is equal equity the law must prevail";[449] the execution maxim that "equity looks upon that as done which ought to have been done";[450] the distribution maxim that "equality is equity";[451] and the anti-forfeiture maxim that equity will not enforce an unjust penalty.[452]

From the foregoing, we may distill from Story's observations two classes of evaluative norms of relevance here, one general and the others specific. First, the general principle of restraint limits access to equity's remedial measures by restricting them to situations in which it can be shown that the law is either defective in its application for some particular reason or leaves a significant remedial void (which explains the role of injunctive relief). Thus, the general principle of restraint essentially directs an evaluation of necessity in the application of equity's remedial structures. Second, the specific evaluative concepts, such as "equality is equity," guide the selection of appropriate

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[448] 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 65; Cherno v. Dutch Am. Mercantile Corp., 353 F.2d 147, 155 (2d Cir. 1965) ("he who seeks equity must do equity"); *see also* Smith v. World Ins. Co., 38 F.3d 1456, 1462 (8th Cir. 1994) (noting that the requirement that "he who seeks equity must do equity" is part of the doctrine of unclean hands).

[449] 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 63.

[450] *Id*. at 68.

[451] *Id*. at 67.

[452] 2 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 644-61 (observing that "[t]he whole system of Equity Jurisprudence proceeds upon the ground that a party having a legal right shall not be permitted to avail himself of it for the purposes of injustice, or fraud, or oppression, or harsh and vindictive injury.").

remedies to address pertinent defects in legal outcomes. Collectively, it is through the application of both the general principle of restraint and any relevant specific equity norm that equity as a whole aims deliberately to be ameliorative in the bankruptcy setting by correcting deficiencies in legal procedures in response to the problems of insolvency.

There are several reasons, however, why resort to the norms of equity is not entirely satisfying as an overall evaluative standard and thus should not be the only one we consider. To begin with, in spite of their surface plausibility, the various principles of equity can be somewhat vague as reflected in their characteristically aphoristic formulation.[453] Likewise, other than the principle of restraint, equity does not provide a particularly comprehensive or systematic means to choose between its available doctrinal options or reconcile them when they conflict. Moreover, although equity attempts overtly to ferret out and improve defects in legal procedures, it is not particularly self-

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[453] This is unsurprising given that equity evolved as a tool of judicial discretion. John Selden (1584-1654) famously complained:

> [e]quity is a Roguish Thing, for Law we have a Measure, know what to trust to, Equity is according to the Conscience of him that is Chancellor, and as that is larger or narrower, so is Equity. 'Tis all one as if they should make the Standard for the Measure, we call a Chancellor's Foot, what an uncertain Measure would this be? One Chancellor has a long Foot, another a short Foot, a Third an indifferent Foot: 'Tis the same thing as the Chancellor's Conscience.

JOHN SELDEN, TABLE-TALK: BEING THE DISCOURSES OF JOHN SELDEN 54-55 (2nd ed. 1696). Story (1799-1845) rejected Selden's criticism, pointing out equity's limited role consistent with the principle of restraint, commenting: "[s]o far however is this from being true, that one of the most common maxims upon which a Court of Equity daily acts is, that equity follows the law, and seeks out and guides itself by analogies of the law." 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 17. In his COMMENTARIES, William Blackstone (1723-1780) quipped dismissively: "if a Court of Equity in England did really act, as many ingenious writers have supposed it (from theory) to do, it would rise above all law, either common or statute, and be a most arbitrary legislator in every particular case." 3 WILLIAM BLACKSTONE, COMMENTARIES 433 (1765) [hereinafter BLACKSTONE, COMMENTARIES].

reflective in the remedies it deploys. For example, it does not purport to evaluate overtly, other than on an ad hoc basis, whether its remedies themselves generate significantly negative *ex ante* effects in non-bankruptcy settings, although this consideration may be implied as part of the process of applying the principle of restraint. As a result, although the general and specific norms of equity can help point us in the right direction in terms of identifying and evaluating beneficial solutions to insolvency-related defects in the legal system generally, they should be used with caution and likewise in conjunction with other evaluative standards.

Taken together, the debt-collection problems of deadweight collection and monitoring costs, gratuitous transfers, and debt-collection free-for-alls rather obviously constitute problems that satisfy the principle of restraint. They are special challenges that arise in the insolvency context in connection with the use of ordinary debt-collection mechanisms for which those mechanisms do not have an adequate response because it would be counterproductive to burden them with special procedures needed only in the insolvency setting. In addition, these debt-collection problems correlate to more specific equity norms.

First, the problems of debt-collection free-for-alls and deadweight collection and monitoring costs correlate to the specific norm that equity is available to remedy "equitable waste," defined as acts causing needless loss that, although "not inconsistent with the legal rights of the party committing them," nonetheless generate inequitable externalities.[454] We may refer to this norm as the "equitable-waste" prohibition. Historically, the circumstances constituting equitable waste, and triggering the remedy of

[454] 2 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 220.

injunction to prevent it, included those in which the owner of a particular item of property, including an insolvent individual, no longer had appropriate incentives to maintain the property for the benefit of others also holding an interest in the same property.[455] From the perspective of the equitable-waste prohibition, bankruptcy law's debt-collection solutions to the problems of debt-collection free-for-alls and deadweight collection and monitoring costs—namely its special procedures that collectivize and streamline monitoring and debt-enforcement activities—seem obviously beneficial. These solutions include bankruptcy's devices for halting debt-enforcement activities upon the commencement of a bankruptcy case (i.e., the automatic stay), as well as bankruptcy's mechanisms for replacing non-bankruptcy debt-collection and information-gathering procedures with those that aim to facilitate and streamline the recognition and enforcement of claims and likewise the dissemination of accurate information concerning the debtor and his property (e.g., provisions regarding the creation of a bankruptcy estate, the preparation and disclosure of information, the determination of claims, the avoidance of value-destroying foreclosures, and the preservation of businesses as going concerns to preserve their value).[456] These devices all have their origins in equity,[457] and are likewise reflected in and derived from the earliest English bankruptcy procedures superintended initially by the Lord Chancellor and other officials of the Crown.[458]

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[455] *See id*. at 220-21.

[456] *See supra* notes 16, 195, 241, 246-47, 299, 325, 363 (discussing these devices).

[457] *See, e.g.*, 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 558-62 (discussing a court's powers in equity to compel creditors to prove their claims in a collective proceeding involving the administration of estates).

[458] For example, the first English bankruptcy statute enacted in 1542, titled "An Act Against Such Persons As Do Make Bankrupt," Bankruptcy Act, 1542, 34 & 35 Hen. 8, c.

In turn, the problem of gratuitous transfers correlates to the specific equity norm that a debtor must be "just [to his creditors] before he be generous [to his friends]."[459] We may refer to this as the "just/generous" principle. From the perspective of the just/generous principle, bankruptcy law's solution to the problem of gratuitous transfers—namely, avoiding and recovering these transfers for the benefit of creditors under its fraudulent transfer provisions—is also plainly beneficial.[460]

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4 (Eng.), vested the Lord Chancellor and other officials with authority to "take order" of the debtor's affairs following the debtor's commission of an "act of bankruptcy," such as the debtor's defaulting on his obligations and then fleeing to parts unknown. *See* Levinthal, *Early History*, *supra* note 398 at 15. The Act vested the relevant officials with the authority to summarily collect and administer the debtor's assets and then distribute their value ratably among the debtor's creditors. *See* Bankruptcy Act, 1542, 34 & 35 Hen. 8, c. 4, § 1 (Eng.); Levinthal, *Early History*, *supra* note 398 at 14. The subsequent Bankruptcy Act of 1570 vested this authority in a group of bankruptcy commissioners who likewise possessed the power to assemble, liquidate, and distribute the debtor's property in a collective proceeding. *See* Bankruptcy Act, 1570, 13 Eliz. c. 7 (Eng.); Charles J. Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 8 (1995) [hereinafter Tabb, *History*] (discussing the powers of the commissioners and the proceedings before them under the 1570 Act).

[459] Hearn 45 St. Corp. v. Jano, 27 N.E.2d 814, 816 (N.Y. 1940); 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 359; *see also supra* note 345 (discussing the policy behind the avoidance and recovery of gratuitous transfers in bankruptcy).

[460] *See id.* (discussing the various fraudulent transfers laws available in bankruptcy to avoid and recover transfers of the debtor's property). The just/generous principle appears to have been conceived specifically in response to the problem of gratuitous transfers. *See* 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 359-84 (discussing the concept and its application). Among other things, fraudulent transfer principles trace their origins to ecclesiastical proscriptions condemning a transfer by a decedent made in fraud of creditors, either in the form of an outright gift or a sale without adequate consideration. *See* Richard H. Helmholz, *Bankruptcy and Probate Jurisdiction Before 1571*, 48 MISSOURI L. REV. 415, 421 (1983) [hereinafter Helmholz, *Bankruptcy and Probate*] (noting that, under a church provincial constitution made in 1343 and known as the "*Cordis dolore*," the transferee of a fraudulent transfer was required on pain of excommunication to return the transferred property to the decedent's estate). As Thomas Jackson and others have observed, fraudulent transfer laws are also available outside of bankruptcy as a matter of state law. *See* JACKSON, LOGIC, *supra* note 8 at 147. Once a bankruptcy case is commenced, the state-law mechanisms are incorporated into the bankruptcy process through section 544 of the Bankruptcy Code. 11 U.S.C. § 544 (2000

This does not mean that there are no challenging difficulties that arise from time to time in applying these equitable principles in specific settings. For example, it is one thing for fraudulent conveyance laws to avoid a transfer between a debtor and his relative where the transfer is for little or no consideration and both the debtor and the relative conspired together to make the transfer with full knowledge that doing so would frustrate the debtor's creditors. To illustrate, suppose the debtor transferred title to a valuable parcel of real estate worth $1 million to his sister in exchange for $1 under circumstances in which the sister was aware of the debtor's insolvency and understood that the debtor simply wished to shield an asset from the creditor's reach. Under these circumstances, the sister should hardly be heard to complain of any inequity in having to disgorge the property.[461]

On the other hand, it is another thing for fraudulent transfer law to avoid and recover property from an innocent transferee under circumstances in which she believed she received the property in a fair exchange and was not involved in conspiring with the debtor to deprive the debtor's creditors of their due. This situation implicates the equal-

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& Supp. 2006); *see supra* note 345. The Code also has its own fraudulent transfer provision, section 548. 11 U.S.C. § 548 (2000 & Supp. 2006); *see supra* note 345; *see also* Baird & Jackson, *Fraudulent Conveyance*, *supra* note 266 (discussing the avoidance of fraudulent transfers in bankruptcy). One reason fraudulent transfer law is an option that is available upon a debtor's insolvency apart from a full-blown bankruptcy proceeding is that the avoidance and recovery of a fraudulent transfer may be a complete remedy in and of itself. If a sufficiently valuable asset is recovered, creditors may be satisfied in full, or sufficiently satisfied that resort to more extensive bankruptcy proceedings might not be worth the effort. In this way, fraudulent conveyance laws may be viewed by themselves as a kind of mini-bankruptcy procedure.

[461] *See supra* at 176 (discussing this kind of situation).

innocence maxim that "where there is equal equity the law must prevail."[462] For example, suppose the transferee bought a parcel of real estate through an arms-length foreclosure sale. Although she may have acquired the property for a low price, that is not unusual because foreclosure sales characteristically yield low values.[463] Should fraudulent transfer law regularly undo these kinds of sales if the debtor later files for bankruptcy? That is a much more challenging question, involving as it does a choice between the competing interests of perhaps equally innocent parties—the transferee who got a good deal legitimately and the insolvent debtor's creditors who lose out because the deal was perhaps too good.[464]

We need not, however, resolve all the complexities involved in the application of the various principles of equity outlined above to conclude that, from the perspective of equity as a general evaluative standard, bankruptcy law's solutions to the problems of deadweight collection and monitoring costs, debt-collection free-for-alls, and gratuitous

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[462] 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 63. Story explained that "the equity is equal between persons who have been equally innocent and diligent." *Id*. Thus, "[i]t is upon this account that a Court of Equity constantly refuses to interfere either for relief or discovery against a bona fide purchaser of the legal estate for a valuable consideration without notice of the adverse title . . . ." *Id*.

[463] *See supra* notes 155, 314 (discussing how state-law foreclosure sales typically realize depressed prices as compared to other methods of disposition).

[464] In BFP v. Resolution Trust Corp., 511 U.S. 539 (1994), the U.S. Supreme Court determined in a 5-4 decision that fraudulent transfer law is not generally available in bankruptcy cases to undo non-collusive state-law foreclosure sales conducted in conformity with applicable foreclosure procedures. Among other things, the majority reasoned that doing so would place a cloud over the title to every transferred property—the transferee could not be certain of ownership so long as the debtor could still file for bankruptcy after the sale and potentially undo the transfer. The Court reasoned that, if Congress intended that result in enacting the federal bankruptcy law, Congress was required to make that intent more clear. *See also* JACKSON, LOGIC, *supra* note 8 at 148-50 (discussing the application of fraudulent transfer laws in the context of foreclosure sales).

transfers are generally beneficial. This, of course, should come as no great surprise given that the relevant equitable concepts that these solutions embody are essentially internal to bankruptcy law itself. Nonetheless, it is useful to understand why this is so. Moreover, as discussed below, these solutions are also beneficial under both efficiency and entitlement analysis.

EFFICIENCY

Why efficiency? To begin with, efficiency analysis seeks to evaluate legal outcomes from a critical cost/benefit perspective that it distinctly different from equity analysis. Whereas equity deploys a system of principles of fairness to remediate certain kinds of problems, efficiency aims to calculate the larger social utility of these remedies. Similarly, generic concepts of efficiency are typically external to the particular law and set of legal outcomes at issue. Thus, efficiency analysis is thought to be more objective in nature. As we shall see, that view is problematic because there is no feasible metric of absolute social utility that is, in fact, purely objective. And as a consequence, economists often conduct efficiency evaluations using a narrower standard tailored to the particular circumstances, for example, by evaluating bankruptcy procedures in terms of how they reduce the cost of borrowed funds, which sometimes omit from the analysis important cost considerations that the metric does not capture.[465] But in the real world no metric is flawless and, in conjunction with other standards, efficiency analysis can at least provide a potentially helpful sense of whether a particular remedial scheme is beneficial.

When economists speak of efficiency, they generally refer to one of two kinds: Pareto or Kaldor-Hicks efficiency, and generally the latter far more often than the

[465] *See supra* at 95-101 (discussing the drawbacks of using the cost-of-capital metric to evaluate bankruptcy rules).

former.[466] An outcome is Pareto superior (and therefore definitely wealth enhancing in economic terms) to the extent it makes at least one person better off without making anyone else worse off. In contrast, an outcome is Kaldor-Hicks efficient (and therefore wealth enhancing, albeit in a different sense from Pareto optimality) to the extent it makes at least one person better off *more* than it makes everyone else worse off: the net benefit must be greater than the net harm, but someone may still suffer uncompensated loss for the sake of someone else's gain. Because "the conditions for Pareto superiority are almost never satisfied in the real world," economists tend to use Kaldor-Hicks efficiency as their evaluative standard.[467] In other words, because it is so rarely achieved in the real world, Pareto superiority is essentially utopian. In contrast, because it permits outcomes that confer benefits on some at the expense of others (with the caveat that the net gain must simply be greater than the net loss), Kaldor-Hicks efficiency is essentially utilitarian. As a result, one must be careful using Kaldor-Hick efficiency because of the possibility for unfairness, perhaps even gross unfairness, inherent in applying the traditional utilitarian calculus.

For example, imagine a world consisting of two population groups of equal size: half are happy freeloaders (the grasshoppers), and half are miserable workaholics (the

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[466] *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 13-14 (4th ed. 1992) [hereinafter POSNER, ECONOMIC ANALYSIS]; *see also* Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509 (1980) (discussing Kaldor-Hicks efficiency); John R. Hicks, *The Foundations of Welfare Economics*, 49 ECON. J. 696 (1939); Nicholas Kaldor, *Welfare Propositions in Economics and Interpersonal Comparisons of Utility*, 49 ECON. J. 549 (1939).

[467] POSNER, ECONOMIC ANALYSIS, OF LAW, *supra* note 466 at 14; *see* Calabresi & Melamed, *Property Rules, supra* note 5 at 1094 n.10 (observing that "in the world in which lawyers must live, anything close to Pareto efficiency, even if desirable, is not attainable").

ants). Suppose it would make the grasshoppers much happier if the ants were enslaved and forced to toil for the grasshoppers' benefit, but would make the ants only marginally less happy (after all, they are already pretty miserable). The result would be Kaldor-Hicks efficient on a traditional utilitarian calculus because the gain for the grasshoppers exceeds the loss to the ants.[468] That is so because, under traditional utilitarian theory, there is no mechanism for making interpersonal comparisons of utility: "push-pin is as good as poetry."[469] In other words, all that matters in the analysis is the quantity of gain in happiness for the grasshoppers as compared to the quantity of loss in happiness for the ants. The relative quality of their experiences from a moral or other perspective is irrelevant. This potential for "monstrous results," as well as lesser inequalities, is a standing criticism of both traditional utilitarianism and standard welfare economics.[470]

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[468] Under traditional utilitarian analysis, the moral worth of an action or outcome is to be evaluated on the basis of whether it produces or lessens happiness, described by Henry Sedgwick (1851-1957) as "the surplus of pleasure over paid." HENRY SEDGWICK, THE METHODS OF ETHICS 413 (7th ed. 1907); *see also* JEREMY BENTHAM, INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION (1789).

[469] 1 JOHN S. MILL, DISSERTATIONS AND DISCUSSIONS 389 (1859); *see* JEREMY BENTHAM, THE RATIONALE OF REWARD, book 1, ch. 1, 206 (1830) ("Prejudice apart, the game of push-pin is of equal value with the arts and sciences of music and poetry. If the game of push-pin furnish more pleasure, it is more valuable than either").

[470] *See* Richard A. Posner, *Utilitarianism, Economics and Legal Theory*, 8 J. LEG. STUD. 103, 105, 116-17, 132 (1979) [hereinafter Posner, *Utilitarianism*] (observing that many practitioners of welfare economics "regard their activity as applied utilitarianism;" noting in particular Bentham's proposal for eliminating beggars by enslaving them, as well as other examples of "monstrous" outcomes and inequalities; and observing that "the utilitarian, despite his professed concern with *social* welfare, must logically ascribe value to all sorts of asocial behavior, such as envy and sadism, because these are common sources of personal satisfaction and hence of utility"); *see, e.g.*, RONALD M. DWORKIN, TAKING RIGHTS SERIOUSLY (1977) (rejecting utilitarianism as a basis for normative legal theory); ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 41 (1974) (commenting on the "utility monster"); RAWLS, THEORY, *supra* note 98 at 27 (rejecting utilitarianism because it "does not take seriously the distinction between persons").

Another problem with the traditional utilitarian calculus is that it is essentially impossible to conduct. In the traditional analysis, the relevant thing to be maximized—the "maximand"—is overall happiness. Happiness has the attraction of at least appearing to be intrinsically valuable and thus worth maximizing for its own sake. At the same time, however, the psychological concept of happiness is also inherently amorphous. Among other things, how do we measure relative happiness in order to determine whether a particular outcome supplies even more of it to some people than it denies to others?[471]

In an effort to lessen these problems in conducting Kaldor-Hicks efficiency evaluations, Richard Posner has suggested that we narrow the maximand to some lesser, more manageable construct to avoid the flaws of utilitarianism (and also welfare economics). To that end, he has offered a more refined economic concept of "wealth maximization" to replace happiness in the equation. Posner explains that "[t]he only kind of preference that counts in a system of wealth maximization is . . . one that is backed up by money—in other words, that is registered in a market."[472] Recognizing that many things are not exchanged explicitly for dollars in traditional markets, Posner next contends that the relevant market may also be non-explicit in nature, in which case the

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[471] *See* Posner, *Utilitarianism, supra* note 470 at 114 ("in the two centuries that have elapsed since Bentham announced the felicific calculus [of comparing relative levels of happiness] no progress toward the discovery of such a metric has been made"); *see also* 2 FRIEDRICH A. HAYEK, LAW, LEGISLATION, AND LIBERTY 17-23 (1976) ("the practice of utilitarianism presupposes omniscience"). This problem is not solved by expanding the maximand from happiness to the "broadest concept of satisfaction" in the sense that "people . . . are able to satisfy their preferences . . . to the greatest extent possible" because, if anything, this would appear only to worsen the quantification problem. *See* Posner, *Utilitarianism, supra* note 470 at 111-12.

[472] *See id.* at 119; *see also* RICHARD A. POSNER, THE ECONOMICS OF JUSTICE (1981).

particular activity must be monetized in some other way. For example, activities such as marriage, child-rearing, or tort injury must be converted to their monetary equivalents as though these things could be bought and sold on an explicit market.[473] In this way, economists might then begin to make overall utility calculations based on the relative pricing of things (including ourselves) on the assumption that this pricing would serve as an accurate proxy for individual and societal value (as opposed to the idea that pricing merely constitutes a purely instrumental means to facilitate exchange for those things that are tradeable for money).

Unsurprisingly, the Posnerian exercise of commodifying everything in terms of its price has been sharply criticized on a number of grounds, including that it (1) renders a rather incomplete and impoverished account of human activity, (2) reflects a rather cynical understanding of "the price of everything and the value of nothing,"[474] and (3) does not truly escape the flaws of utilitarianism.[475] One observation underlying these criticisms is that switching the maximand from happiness to wealth maximization replaces something that is arguably inherently valuable (happiness) with something that is purely instrumental (wealth). By itself, maximizing wealth does not tell us anything

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[473] *See* Posner, *Utilitarianism*, *supra* note 470 at 119-21.

[474] OSCAR WILDE, LADY WINDERMERE'S FAN, act. I, sc. 1 (1892).

[475] *See, e.g.*, Ronald M. Dworkin, *Is Wealth a Value?*, 9 J. LEG. STUD. 191, 201 (1980) [hereinafter Dworkin, *Wealth*] (arguing that the bare improvement in social wealth is not an improvement in value; that "[m]oney or its equivalent is useful so far as it enables someone to lead a more valuable, successful, happier, or more moral life"; and that "[a]nyone who counts it for more than that is a fetishist of little green paper"); Anthony T. Kronman, *Wealth Maximization as a Normative Principle*, 9 J. LEG. STUD. 227, 241 (1980) [hereinafter Kronman, *Wealth*] ("if wealth maximization is desirable, it is only because it leads to something else which we value for its own sake, and the suggestion that we should sacrifice anything (especially respect for individual rights) because more wealth is good in itself, is absurd").

about what to do with the wealth we have maximized or take into account whether along the way we have actually worsened overall social conditions by creating less opportunity and inequality or otherwise generally increased overall dissatisfaction. Another problem is that the preoccupation with wealth accumulation for its own sake is closely associated with traditional concepts of greed, miserliness, and covetousness. In defining morality as exclusively the pursuit of wealth enhancement, we are faced with the startling proposition that, not only are those who are preoccupied with wealth enhancement moral, they are exclusively paragons of virtue.

A related problem is that the wealth-maximization perspective is otherwise essentially dehumanizing. For example, as part of the monetization exercise, human capital becomes a commodity that may be bought and sold, including to the highest bidder willing to pay the highest price. As Posner concedes, under the wealth-maximization calculus, those who have accumulated sufficient amounts of money might legitimately enslave others,[476] and likewise permissibly engage in racism.[477] These

[476] Posner states: "A less welcome implication of the wealth-maximization approach is that people who are very poor . . . count only if they are part of the utility function of someone who has wealth." Posner, *Utilitarianism, supra* note 470 at 128. He observes: "[f]rom a wealth-maximization standpoint, if A . . . sells himself into slavery to B, or if C borrows money from D with a penalty clause that provides that in the event of default D can break C's knees, there is no economic justification for refusing to enforce either contract unless some element of fraud or duress is present." *Id*. at 134; *but see* Dworkin, *Wealth, supra* note 475 at 204 ("It is implausible to think that a society that seeks wealth maximization single-mindedly will achieve more total utility than a society what seeks wealth maximization but puts an upper bound on the level of inequality it will tolerate in the name of social wealth"); Kronman, *Wealth, supra* note 475 at 240 ("Even if there is no justification for making those who are already wealthy share what they have, there is something offensive in the suggestion that their wealth is a reason for giving them even more").

[477] Posner states that, where the presence of some ethnic group upsets the neighbors "by an amount greater than the members of the minority would be willing to pay to remain in

examples harken back to the "monstrousness" problem of traditional utilitarianism. In addition, Posner's conceptualization of wealth maximization suffers from a quantification problem of its own: it is almost certainly impossible to monetize accurately much, if not most, of the vast expanse of human activity necessary to make the calculation work.[478]

Accordingly, like the evaluative norm of equity discussed above, economic efficiency in the form of wealth maximization—whether of the traditional utilitarian sort or the Posnerian variant—cannot be our only metric.[479] Nonetheless, that does not mean that conducting an efficiency-type cost/benefit analysis is unhelpful.[480] Among other reasons, it is at least true that "sometimes improvements in social wealth cause improvements of other sorts,"[481] and likewise the cost/benefit conclusion that efficiency analysis suggests is sometimes sufficiently clear and non-controversial that it also helps point us in the right direction (for example, when a particular solution to a problem generates gains to some people that are large and losses to others that are relatively trivial—although it is important to remain skeptical about claims of triviality).

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the neighborhood," then "some form of segregation would be wealth maximizing." Posner, *Utilitarianism, supra* note 470 at 134.

[478] Posner suggests as much, contending only that it is "a less serious problem than that of measuring happiness." *Id*. at 130.

[479] *See, e.g.*, Dworkin, *Wealth, supra* note 475 at 212 ("It will not do to say that distributive justice is whatever state of affairs is produced by wealth maximization").

[480] As Posner points out, although "relatively few of the people in our society who think about these things consider wealth maximization or some version of efficiency the paramount social value, few judge it a trivial one." Posner, *Utilitarianism, supra* note 470 at 110.

[481] Dworkin, *Wealth, supra* note 475 at 203.

Evaluated from the perspective of either traditional utilitarian efficiency or Posnerian wealth maximization, bankruptcy law's debt-collection solutions in the form of its special procedures that (1) collectivize and streamline monitoring and debt-enforcement activities, (2) avoid and recover fraudulent conveyances, and (3) suspend and replace ordinary non-bankruptcy debt-collection devices (such as foreclosure) with more value-preserving mechanisms all appear to be rather wealth-enhancing solutions to the problems of deadweight collection and monitoring costs, gratuitous transfers, and debt-collection free-for-alls. Bankruptcy law's debt-collection mechanisms are generally efficient because they are specifically designed to reduce the costs and improve the performance of non-bankruptcy devices in the insolvency setting, and they do not appear to generate significant offsetting costs of their own, at least not those that are greater than the costs they avoid. Once again, there may be specific challenges that arise in applying these devices in specific settings that undermine their efficiency and perhaps require some degree of operational refinement and qualification.[482] But we need not resolve the details of all of these in order to conclude that bankruptcy's solution mechanisms outlined above in response to the debt-collection problems of insolvency are generally desirable from an efficiency standpoint.

ENTITLEMENT

Why entitlement? There are several reasons, but first it is necessary to define the concept. In general, an entitlement is an interest protected by a legal right of some kind. For example, a creditor characteristically has an interest in obtaining the satisfaction of

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[482] *See, e.g.*, JACKSON, LOGIC, *supra* note 8 at 151-92 (discussing some of the potential pitfalls of running a collective proceeding in bankruptcy, including some of the costs arising from delay and strategic behavior).

debts owed to him, and his interest constitutes an entitlement to the extent it is protected by a legally cognizable right, such as the right to collect from the debtor *in personam* or from the debtor's property *in rem*. Not all debts are protected in this way; some are "moral obligations" only.[483] In addition, rights are frequently freighted with conditions and restrictions, including temporal limitations, recovery parameters, and procedural requirements, and rights may be lost under a variety of circumstances. Nonetheless, a creditor's entitlement to recover claims against others is generally recognized to be important and valuable.

Similarly, an individual debtor has an interest in his own human capital and the property he possesses, and these interests also constitute entitlements to the extent they are also protected by rights. By law, corporate debtors have similar interests and rights. Unquestionably, the various interests and rights of debtors and creditors interact with each other in complex ways and they sometimes conflict. Critically, these various interests and rights reflect fundamental judgments about who persons are, what they truly own, and what they owe to each other.[484] As Paul Kahn has put it, "[t]o be a person is to have legal rights and responsibilities,"[485] and in this way law reflects a fundamental understanding of our existence without our larger community. In evaluating whether a particular legal solution to a particular social problem is beneficial, especially one that

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[483] *See supra* note 408 (citing cases discussing the distinction between enforceable legal obligations and moral obligations that are exclusively a matter of conscience).

[484] *See* Calabresi & Melamed, *Property Rules, supra* note 5 at 1090 ("The first issue which must be faced by any legal system is one we call the problem of 'entitlement.' . . . [T]he fundamental thing that law does is to decide which of the [persons asserting an interest in something] will be entitled to prevail.").

[485] KAHN, REIGN, *supra* note 222 at 35.

alters in some way a preexisting entitlement, it is useful to consider the nature of the alteration from the perspective of the entitlement itself. Among other virtues, a preference for respecting entitlements may help temper both the potential inequities of efficiency analysis and the potential vagueness of equity.

Analytically, a creditor's interest in realizing on his claims may be protected by different categories of rights. First, the interest may be protected by a "property rule" in the sense that "someone who wishes to remove the entitlement from its holder must buy it from him in a voluntary transaction in which the value of the entitlement is agreed upon by the seller."[486] For example, a creditor's interest in realizing on his claims is protected in this way to the extent he has the right to assign his claims to others in a voluntary exchange of some kind. Second, a creditor's interest may be protected by a "liability rule" in the sense that someone may be able to do something to impair the value of the interest, but as a result may be required "to pay an objectively determined value" for the impairment.[487] For example, a creditor's interest is protected in this way to the extent he has the right to collect damages from someone else for doing something that impairs the value of his claims.[488] Third, a creditor's interest may be protected by an "inalienability rule" in the sense that "its transfer is not permitted between a willing buyer and a willing seller."[489] For example, some claims are not transferrable, such as a claim that an

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[486] *Id*. at 1092.

[487] Calabresi & Melamed, *Property Rules, supra* note 5 at 1092.

[488] For example, A may assert a claim for damages against B if B tortiously interferes with A's contractual right to the satisfaction of some obligation from C.

[489] *Id*. at 1092.

individual may have against an insurer or public agency to receive certain forms of disability income.

From an efficiency perspective, entitlements may come with different bundles of rights in order to maximize social welfare.[490] In addition, certain rights may be assigned to certain interests in order to achieve various distributional goals as a matter of distributive justice (i.e., the just distribution of goods and opportunities throughout society).[491] Moreover, they may be assigned for "other justice reasons,"[492] which may include principles of corrective justice (i.e., the idea that individuals are accountable for the consequences of their actions where those actions cause harm).[493]

In the first instance, the creditor's specific rights that define his ability to collect his claims are fundamentally a concern of non-bankruptcy law.[494] What matters for our purposes is (1) the relative importance of the particular rights a creditor has in connection with a particular claim, (2) how those rights are impacted by the debt-collection problems of insolvency, and (3) how they are impacted by the potential debt-collection solutions outlined above. Among other things, to the extent a creditor holds an entitlement that is impaired by a particular problem of insolvency, and a particular solution has the effect of

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[490] *Id*. at 1093-98.

[491] *Id*. at 1098-1101 (observing, for example, that "[w]henever a society wishes to maximize the chances that individuals will have at least a minimum endowment of certain particular goods—education, clothes, bodily integrity—the society is likely to begin by giving the individuals an entitlement to them").

[492] *Id*. at 1102-05.

[493] *See supra* note 77 (discussing corrective justice).

[494] *See supra* note 116 (discussing how a creditor's basic rights of collection are defined in the first instance under applicable non-bankruptcy law).

lessening that impairment, then the solution would be beneficial from the perspective of entitlement analysis.

Bankruptcy law's debt-collection solutions to the problems of debt-collection free-for-alls and deadweight monitoring and collection costs readily qualify as beneficial under this analysis. Indeed, the whole point of the solutions to these problems outlined above is to lessen the costs of debt-collection activities for the sake of increasing their efficacy. Bankruptcy law's remedial provisions in response to the problem of gratuitous transfers would also seem to qualify, but the analysis is a bit more complicated.

Whenever a fraudulent conveyance is avoided and recovered, two expectations are defeated in order to vindicate the creditor's recoveries: the expectation of the debtor that the transfer would be effective, and the similar expectation of the transferee. In the circumstances in which fraudulent conveyances are characteristically avoided and recovered, however, the expectations of the debtor and the transferee are normatively weak, at best. For example, it is difficult to say that a debtor and a transferee who engage in what amounts to a type of fraud have a legitimate entitlement to have their fraudulent conduct respected. There are, of course, circumstances in which the fraudulent nature of the transfer may be less than clear, such as in the case of the innocent foreclosure transferee in the hypothetical discussed previously.[495] But the necessity of drawing lines to distinguish truly fraudulent conveyances from those that are not is inevitable, and from the creditors' perspective, their enhanced ability to recover their claims as a result of the remedy is obviously ameliorative.

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[495] *See supra* at 240-41.

In sum, bankruptcy law's debt-collection solutions to the problems of debt-collection free-for-alls, deadweight collection and monitoring costs, and gratuitous transfers would appear to be beneficial from the perspective of entitlement analysis. In seeking to enhance the creditors' debt-collection entitlements, they do not trammel the legitimate protected entitlements of debtors and others, except perhaps on the margins. Accordingly, entitlement analysis joins with equity and efficiency analysis in demonstrating the desirability of these solutions. As we shall see, however, things are not quite as straightforward with bankruptcy law's debt-forgiveness and debt-adjustment mechanisms.

RESOLVING THE PROBLEMS OF DEBT FORGIVENESS

Of the various problems of insolvency discussed in Chapter 2, two fall into the debt-forgiveness category: (1) an insolvent debtor's incentives to engage in wasteful debt-collection-avoidance activities, such as delay, deception, and inappropriate risk taking; and (2) the waste associated with stagnating and overburdened assets, including an insolvent debtor's human capital. These are each properly debt-forgiveness problems that correlate to debt-forgiveness solutions because, once the bailout-insurance and automatic-debt-cancellation options are eliminated, these problems are subject to amelioration only through some form of debt-relief mechanism.[496] Correspondingly, they are not debt-collection problems because they have nothing to do with enforcing the creditors' claims for the creditors' benefit and are not resolved merely by tinkering with

[496] *See supra* at 206, 208 (discussing the bailout-insurance and automatic-debt-cancellation options).

debt-collection methods.[497] Likewise, they are not problems of debt adjustment because they cannot be resolved simply by the prioritization of obligations. Having categorized these two problems, the question becomes: how might bankruptcy law beneficially resolve them?

As discussed in Chapter 2, an insolvent debtor's incentives to engage in wasteful collection-avoidance activities, such as delay, deception, and inappropriate risk taking, arise as a result of the debtor's perceptions of the consequences of likely and actual debt-collection activity. A debtor who is about to lose everything will tend to take whatever steps he believes are expedient to prevent the oncoming disaster. Unfortunately, insolvent debtors are likely to misperceive the circumstances in the sense of misjudging how best to extract themselves from their predicament, and several cognitive challenges will likely conspire to fuel the debtor's misperceptions and foster unfortunate wasteful outcomes.

First, as the dark clouds of disaster begin gradually to roll in, the debtor may nonetheless believe unrealistically that his increasingly desperate efforts will somehow succeed—a form of optimism bias.[498] Second, the debtor may overvalue assets that may be dragging him down, such as an over-encumbered home accompanied by a mortgage liability he cannot afford, and the debtor may thus cling to these assets even though he would be better off giving them up and would not be willing to pay such a steep price to

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[497] So long as the debtor cannot pay all claims in full, adjusting the various debt-collection devices that creditors may use to enforce their claims will not eliminate an insolvent debtor's incentives to engage in wasteful activities to avoid debt collection and the resulting loss of property, nor will it eliminate the waste associated with stagnating and overburdened assets. So long as the debtor remains insolvent, these problems will endure.

[498] *See supra* note 404 (discussing optimism bias).

acquire them if they were not already his—an example of the endowment effect.[499] Such misperceptions are only likely to prolong the debtor's wasteful efforts to stave off the inevitable.

As also discussed in Chapter 2, insolvency otherwise has the unfortunate effect of depressing the productive deployment of human capital, as well as the use of other property the debtor may own. As Richard Posner has observed, "[p]eople have an incentive to work harder when they work for themselves than when they work for other people."[500] An insolvent person who must devote the entirety of the fruits of his labor toward the hopeless chore of paying off his debts is not likely to be as productive as a solvent person who is able to keep and enjoy for himself at least some of them. We may call this effect of insolvency and debt-collection the "productivity-depressant" factor.

A further complexity is that, as a debtor sinks deeper into insolvency, he is likely to try to cut back dramatically on spending. Reductions in spending, however, require discipline and self-control, and "there is increasing evidence that self-control is a limited resource that can be depleted if it is overused."[501] Ironically, at the very time when an insolvent debtor could use extra doses of self-control, he is likely to find it increasingly in short supply. We may call this the "self-control" paradox. In addition to the insolvent

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[499] *See* Thaler, *Positive Theory*, *supra* note 250 at 43-47 (discussing the endowment effect); *see also* Daniel Kahneman, et al., *Experimental Tests of the Endowment Effect and the Coase Theorum,* 98 J. POL. ECON. 1325 (1990) (same); *see supra* note 250 and *infra* at 269-70 (discussing the endowment effect).

[500] Richard A. Posner, *The Value of Wealth: A Comment on Dworkin and Kronman,* 9 J. LEG. STUD. 243, 246 (1980).

[501] AYERS, CARROTS, *supra* note 384 at 56; *see also* Mark Muraven & Roy Baumeister, *Self-Regulation and Depletion of Limited Resources: Does Self-Control Resemble a Muscle?,* 126 PSYCH. BUL. 247 (2000) (reviewing evidence that self-control may be a limited resource that can be depleted).

debtor's already acute incentives to devote his dwindling energies and resources to fruitless debt-collection-avoidance activities, deception, and asset gambling, the added challenges of the productivity-depressant factor and self-control paradox are likely only to increase wasteful conduct and outcomes.[502] In addition, as explained previously, the debtor's over-encumbered assets are also likely to stagnate in the sense that, but for the debtor's insolvency, they could be put to better use.[503]

One far-fetched solution to these problems might be to simply excuse all of an insolvent debtor's obligations as a matter of law—we may call this the "deliverance" approach. As discussed previously, however, this extreme automatic-debt-cancellation option is undesirable because it would go too far.[504] A less drastic remedy would be for the law to permit the release (discharge) of some or all of the debtor's obligations in exchange for the debtor's surrender of some or all of his assets so that these assets might be disposed of in some way, with the resulting value used toward the full or partial satisfaction of the creditors' claims. The discharge would have the effect of liberating the debtor's human capital so that it could be devoted to more productive use, while permitting at least the potential of some recovery for creditors (assuming the debtor had any non-exempt assets left at the time he commenced his bankruptcy case). Any property the debtor was able to keep as exempt would help with his fresh start. In addition, the law might also prescribe some mechanism for the release of encumbrances on overburdened and stagnating physical assets so that these, too, might be put to more

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[502] *See supra* at 138-55 (discussing and illustrating these various incentives).

[503] *See supra* at 169-74 (discussing and illustrating this problem).

[504] *See supra* at 208-09.

productive use, with the encumbrances shifted to the proceeds. Once again, this is what bankruptcy law actually does.[505] In Chapter 7 cases, for example, debtors must surrender their non-exempt assets in order to obtain a discharge—the assets are then liquidated for the creditors' benefit.[506] In Chapter 13 "wage-earner reorganization" cases, debtors may keep most of their assets, but they must dedicate their earnings for prolonged periods (between three and five years) toward the payment of the creditors' claims in order to keep these assets and receive a discharge of debts they cannot pay.[507] In Chapter 11 cases, firms and individuals may retain the assets they need to reorganize, but in order to do so they must distribute to their creditors payments and/or other interests (such as stock or other securities) that are collectively worth more than the bare liquidation value of the assets they propose to keep.[508] The question becomes: is this beneficial?

Once more, the answer seems fairly obviously yes—at least from the perspective of solving the debt-forgiveness problems of insolvency. At the same time, of course, granting the debtor discharge relief must inevitably conflict with the creditor's collection interests, but we may postpone considering that conflict until after we have examined as a threshold matter whether discharge relief is desirable in its own right in response to the debt-forgiveness problems of insolvency. It turns out that it is, but in order to understand why, it is first useful to examine in more detail how insolvency typically unfolds. This is

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[505] *See supra* notes 72-76, 334 (discussing the discharge and exemption mechanisms of bankruptcy law). Like the automatic-debt-cancellation option, the deliverance approach would obviously be undesirable because it would be too costly. *See supra* at 208 (discussing the automatic-debt-cancellation option).

[506] *See supra* notes 73, 241, 299, 363.

[507] *See* 11 U.S.C. § 1325(b)(1)(B) (2000 & Supp. 2006); *supra* notes 72, 97.

[508] *See supra* notes 73, 241, *infra* note 752.

important because, on the one hand, we naturally would be bearish on discharge if it turned out that insolvent debtors who seek bankruptcy relief are typically the scheming architects of their own financial demise through the intentional squandering of their property. On the other hand, we are more likely to be bullish on discharge if it turned out that insolvent debtors who seek bankruptcy relief are typically honest but unfortunate individuals who characteristically find themselves in a jam for relatively sympathetic reasons. Of course, it is true that there will always be at least some insolvent debtors whose circumstances align with the former description. The real question is what the overall picture looks like and who the outliers are so that discharge relief may be tailored accordingly (e.g., perhaps to excuse the merely negligent, but not the fraudulent). Thus, before analyzing the debt-forgiveness solutions of bankruptcy law from the distinct perspectives of equity, efficiency, and entitlement, it is first important to understand something more about how insolvency and the problems of debt-forgiveness generally arise.

THE (TYPICALLY) ACCIDENTAL NEED FOR BANKRUPTCY RELIEF

It is a common belief that the need for bankruptcy relief is essentially endogenous rather than exogenous, and correspondingly, that bankruptcy is a self-inflicted wound indicative of at least some sort of dereliction of duty, if not outright moral infirmity.[509] This belief is also one that has existed for a very long time and has been rationalized and expressed in a variety of unflattering ways, including through moral, religious, and punitive exegesis. For example, in 1716, the prominent Boston minister and slave holder

[509] *See, e.g.*, Bradley & Rosenzweig, *Untenable*, *supra* note 316 (arguing that insolvency is generally endogenous); *see also supra* at 162-63, 223-27 (discussing this common perception and some possible reasons for it).

Cotton Mather thundered with Calvinistic fury: "People there are, too many, who do bring Debts upon themselves, in such a manner, and in such a measure, that a Folly nothing sort of Criminal, is to be charged upon them. And when they have brought such Debts upon themselves, their Delay to get from under them, is what also amounts to a Crime, for which they are to be Indicted, as not having the Fear of God before their Eyes."[510]

Certainly many of Mather's contemporaries shared his view, and undoubtedly some people still share it today. But regardless of the popularity of this kind of polemics, on reflection, the idea that bankruptcy is endogenous seems rather odd. Although not everyone who experiences insolvency ends up filing for bankruptcy, insolvency is very much the condition of virtually every debtor who does file, and most individuals experience insolvency at least temporarily at some point in their lives. For example, most college graduates embarking on their careers with significant student-loan obligations start out that way, and many elderly persons live out their final years unable to support themselves financially. Likewise, most firms experience periods of insolvency, sometimes at their inception and sometimes later in their existence (or both), and most ultimately collapse at some point, leaving as their final legacy a tattered state of financial

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[510] Cotton Mather, *Fair Dealing Between Debtor and Creditor* (Boston 1716). Mather (1663-1728) brought the same religious fervor to his views on the subject of slavery, arguing "[i]t is allowed in the Scriptures, to the Gentiles, that they may keep Slaves." Cotton Mather, *A Good Master Well Served: A Brief Discourse on the Necessary Properties and Practices of a Good Servant, in Every Kind of Servitude*, p. 52 (Green & Allen 1696); *see also* 2 KINGS 4:1 (King James) (in the parable of Elijah and the poor widow, the bible indicates that, like thieves who have failed to provide restitution, insolvent debtors (or their children) might be delivered to their creditors as slaves); Mooney, *Normative Theory*, *supra* note 30 at 946 (analogizing the failure to respect the paramount right of creditors to be paid to "prima facie theft").

disarray.[511] In other words, insolvency is ubiquitous and widespread, and it sometimes leads to bankruptcy. From this perspective, bankruptcy can be viewed simply as a common complication of a rather common condition (insolvency) that for some reason got out of control—and in reality it is both easy for insolvency to get out of control, as well as for individuals to underestimate how readily this can occur.

It is certainly true that, for some, the path to bankruptcy will be littered with poor choices, even reckless ones. But the same can be said of the trajectory of many obligors who never file for bankruptcy relief. Not all solvent debtors are good decision makers. At the same time, not all debtors in bankruptcy are poor ones. Ultimately, the problem with most bankrupt debtors is not that they are debtors, or even necessarily that they are insolvent. The real problem is that they are *too* insolvent. Admittedly, this conceptualization runs counter to popular wisdom. Yet there are reasons why the conventional view of bankrupt debtors as endogenously culpable is largely a myth. In truth, most bankruptcies are "accidental" in the classic sense of the concept: occurrences that are neither expected nor intended by debtors at the time they engage in ordinary activities that give rise to debt obligations.[512]

True enough, there is ample anecdotal evidence to support the popular view that bankruptcy is often the result of fraud, greed, or extravagant misbehavior. Revelations of flagrant corporate mismanagement in the wake of spectacular financial collapse grab the

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[511] *See supra* note 202 (discussing the failure rate for firms).

[512] The concept is borrowed from insurance law. The classic formulation of an accident for insurance purposes is an occurrence that is neither expected nor intended from the standpoint of the insured. *See* 10 COUCH ON INSURANCE 3D, §§ 139.13 to 139.14, at 139-32 to 37 (L.F. Russ & T.F. Segalla eds. 1998).

headlines and stir the public ire.[513] In reality, however, these are not the typical cases—far from it. Much more common are the far more modest failures of ordinary individuals and business ventures, but their relatively unremarkable tales are not the stuff that sells newspapers or drives attention to the most popular internet blogs.[514] Moreover, nearly everyone has an unsympathetic relative, colleague, or acquaintance who seems habitually to live beyond his means and appears destined for the bankruptcy court, somehow managing to avoid it either through the kindness of others or divine intervention—the classic bankruptcy archetype. In the common mythology, only rarely is bankruptcy conceived of as the consequence of purely innocent misfortune, and the notion that bankruptcy is largely endogenous rather than exogenous thus persists.

Empirically, however, the popular conception simply does not hold. As one group of scholars has observed based on their extensive investigations, bankruptcy is typically exogenous: "[t]he debtors in our sample experienced a series of random shocks and structural shifts: an earthquake in California, Operation Desert Storm in Texas military towns, corporate downsizing, and a sea change in family structure. Most of these changes were beyond their control."[515] Conversely, these scholars have observed

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[513] *See, e.g.*, ENRON: CORPORATE FIASCOS, *supra* note 182; SWARTZ & WATKINS, POWER FAILURE, *supra* note 182; Geraldine Fabrikant, *Global Crossing: 2 Different Worlds*, N.Y. TIMES, February 28, 2002, at C7 (detailing the extravagant spending of Global Crossing executives while the company foundered in bankruptcy).

[514] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 (discussing at length the plight of middle-class debtors, their susceptibility to bankruptcy, and the nature of their circumstances).

[515] *Id*. at 73.

that the stereotypes of bankrupt debtors as wanton profligates, lazy deadbeats, and careless spendthrifts are largely overblown.[516]

Rejecting popular mythology, modern bankruptcy law in general, and its discharge provisions in particular, have long embodied the fundamental perspective that bankruptcy is characteristically the product of largely innocent misfortune arising as the byproduct of ordinary risk taking. In the vernacular, bankruptcy law has come to be built around the paradigm of the "honest but unfortunate debtor,"[517] and the logical premises underlying this conception are not difficult to discern.

In any large population (of, say, a hundred million individuals and tens of thousands of firms), a certain percentage of those who do nothing more than take perfectly ordinary risks (i.e., risks of the same type as those taken by their peers) will suffer the adverse consequences of their risk taking for wholly unremarkable reasons. For example, prior to encountering financial difficulty, most individuals will hold jobs, have dependents, consume services, borrow money to make purchases, incur tax

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[516] *See id.* at 34 ("With greater detail, the bankruptcy stereotype was eventually elaborated as a twenty-something male, a high school dropout who held an unskilled or, at best, semiskilled job."); *but see id.* at 250 ("We have not listed 'irresponsibility' as a cause of bankruptcy because it is too hard to define or quantify, but we are not unmindful of its effects.").

[517] *See* Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367, 374 (2007) (observing that "[t]he principal purpose of the Bankruptcy Code is to grant a fresh start to the honest but unfortunate debtor" and noting that the "[t]he class of honest but unfortunate debtors" who file for bankruptcy "includes the *vast majority* of the hundreds of thousands of individuals who file Chapter 7 petitions each year") (emphasis added and internal citation omitted); *see also* Local Loan Co. v. Hunt, 292 U.S. 234, 244-45 (1934) (elaborating this principle at greater length). Although this has changed somewhat in recent years, particularly with the 2005 amendments to the Bankruptcy Code that have made it more difficult to obtain discharge relief, the general view still holds that most bankrupt debtors are honest but unfortunate, as illustrated by the U.S. Supreme Court's observation in *Marrama* that most individuals who file for bankruptcy relief are honest but unfortunate, and those who seek to abuse the bankruptcy system are typically outliers.

obligations, and, in the process, assume the risk that they may not be able to satisfy all of these obligations in the event of misfortune. Prior to encountering financial distress, these individuals will generally behave no differently than others similarly situated.[518] Moreover, their conduct will likely be socially appropriate: as a society, we want individuals to assume the risks associated with normal consumer activities financed through credit because, among other reasons, if they did not, economic growth would be curtailed and we would all be worse off.

It is inevitable, however, that some individuals engaged in perfectly ordinary economic activity will suffer financial reversals that will render them insolvent. They may lose their jobs, become ill, get divorced, suffer the effects of accidents or criminal conduct, or otherwise find themselves in the clutches of calamity.[519] For most, an occasional brush with misfortune will not spell financial ruin and bankruptcy. Different individuals, however, will experience misfortune in different doses and at different points of vulnerability. Of these, some will become insolvent for a sufficiently lengthy period, or in a sufficient magnitude, that they will find themselves in need of bankruptcy relief.

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[518] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 3 (observing that "bankrupts do represent a fair cross-section of the American middle class."); Elizabeth Warren, *Financial Collapse and Class Status: Who Goes Bankrupt?*, 41 OSGOODE HALL LAW. REV. 115 (2003) (reporting that the data demonstrate that families in bankruptcy represent a broad cross-section of the middle class).

[519] One group of investigators explains that the relevant "data permit us to quantify the stress that arises from five sources: the increased volatility of jobs and income; the explosion of consumer debt with sky-high interest rates; divorce and changing parenting patterns that are increasing the number of single-adult households; the astonishing ability to treat medical problems—at astonishing prices; and the fierce determination that Americans have to buy and retain a family home at all costs." SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 2.

Similarly, firms within the general population will typically engage in a host of risk taking incident to ordinary commercial activity. Among other things, they will borrow money to fund their operations, hire managers and other employees, incur tax liabilities, obtain goods and services on credit, lease property, enter into long- and short-term contracts, incur contingent obligations, and make myriad investment choices. In doing so, these firms assume the risk that, for one reason or another, they may not be able to meet their obligations in full.

Just as it is desirable for individuals to engage in ordinary risk taking, commercial growth is also enhanced by firms that assume entrepreneurial risk. The reality of the commercial world, however, is that—once again—most small firms ultimately fail within a few years of their inception and eventually most large ones fail as well.[520] Significantly, most of these failures are not initiated by fraud or other wrongdoing. Among other causes, the managers may have simply misperceived the marketplace, made the wrong investment choices, suffered catastrophic losses from unforeseen calamities, lost key employees or relationships, found themselves the victims of wrongdoing, run afoul of competitive pressures, or discovered that the buyers of their goods or services no longer are able or willing to pay for them. Although many firms encounter setbacks without collapsing, different firms experience and respond to financial turmoil in different ways. Of these, some will also become insolvent for a sufficiently lengthy period, or in a sufficient magnitude, that they find themselves in the throes of economic chaos.

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[520] *See supra* note 202 (discussing data regarding the prevalence of business failures).

Once again, it is unsettling to think that the world is full of such a broad variety of personal and commercial perils and that insolvency can arise at any time for any number of reasons.[521] Moreover, it is not necessarily in our collective best interests to dwell publicly on these perils if doing so would have the effect of dissuading individuals and firms from engaging in desirable risk taking. But in approaching the subject of bankruptcy, the failure to grasp the realities of insolvency can lead to unfortunate choices.

For example, some commentators sympathetic to the view that insolvency is largely endogenous have marked with alarm the rising incidence of bankruptcy filings over the last thirty years. Surely, they contend, the rising tide of insolvency is the product of an increased incidence of debtors who cannot control themselves and of the lax bankruptcy laws that coddle them.[522] There is little reason to believe, however, that this perspective is substantially justified. On the contrary, a more compelling case can be made that the rising tide of bankruptcy is not the product of increasing malfeasance, but

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[521] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 6 ("[Debtors] are a silent reminder that even the most secure family may be only a job loss, a medical problem, or an out-of-control credit card away from financial catastrophe.")

[522] *See, e.g.*, ELIZABETH WARREN & AMELIA W. TYAGI, THE TWO-INCOME TRAP 71-72 (2003) [hereinafter WARREN & TYAGI, TWO-INCOME] (summarizing the views of politicians and commentators who have criticized bankrupt debtors as profligate spenders and financial manipulators); *see also* Vern Countryman, *Consumers in Bankruptcy Cases*, 18 WASHBURN L.J. 1, 1 (1978) ("The basic reason for this burgeoning rate of consumer bankruptcies is not difficult to discern. . . . Some consumers are no more able to cope with [the] rush of consumer credit than are some automobile drivers able to cope with the rush of traffic. The automobile drivers end up in the hospital, the consumers in the bankruptcy court.").

is instead the result of broader economic trends that suggest no criticism of bankruptcy law's embedded paradigm of the "honest but unfortunate debtor."[523]

Over the last thirty years, income levels for most Americans have either remained stagnant or have declined, while the availability and use of credit has risen sharply.[524] During the same period, health care costs have soared while health insurance has declined, although recent legislation has been enacted to reverse that trend.[525] Education costs have likewise soared, as have the costs of dependent care.[526] In the meantime, as income growth has shifted away from lower- and middle-class workers, subsidized public

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[523] *See supra* notes 72, 104, 517, *infra* note 717; *see generally* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 238-61 (2000).

[524] *See* VYSE, GOING BROKE, *supra* note 403 at 51, 171 (observing that real wages for many have declined, putting more pressure on many individuals); SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 18 ("Stagnant incomes have affected many Americans for twenty years. . . . At the same time, the willingness of consumers to borrow and of lenders to lend has increased dramatically."); *see also, e.g.*, David C. Johnston, *I.R.S. Says Americans' Income Shrank for 2 Consecutive Years*, N.Y. TIMES, July 29, 2004, at C1.

[525] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 141 ("Medical costs have burgeoned, especially in the past decade, at the same time that job security, including medical insurance benefits, has declined."); *see also, e.g.*, Hilary Waldman, *Millions More Lack Health Insurance*, HARTFORD COURANT, Sept. 30, 2003, at A1; Bernard Wysocki, Jr., *At One Hospital, A Stark Solution for Allocating Care*, WALL ST. J., Sept. 23, 2003 (detailing a Galveston hospital's strict rationing of medical care on financial grounds); Timothy Aeppel, *Skyrocketing Health Costs Start to Pit Worker vs. Worker*, WALL ST. J., June 17, 2003, at A1.

[526] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 251 ("Tuition at four year colleges doubled at both public and private institutions between 1985 and 1994 . . . . More families are extending themselves to the limit to finance college educations and more students are leaving school staggering under loans they promised to repay."); *see also, e.g.*, John Hechinger, *U.S. Gets Tough on Failure to Repay Student Loans*, WALL ST. J., Jan. 6, 2005, at A1; Jane J. Kim, *Putting a Cap on Tuition Expenses*, WALL ST. J., July 27, 2004, at D2 (describing trend of colleges freezing tuition rates for entering classes to avoid annual hikes in response to general); Jennifer Washburn, *The Tuition Crunch*, THE ATLANTIC MONTHLY, Jan./Feb. 2004, at 140.

services for these groups have also declined.[527] Although divorce rates have remained largely unchanged, the economic impact of divorce on single, working mothers continues to be worse than on men, increasing their risk of insolvency.[528] Similarly, as the population has aged, more individuals find themselves faced with the costs of dependent elder care with fewer resources to respond.[529] In addition, as a general trend, individuals have come to rely more and more on debt financing for many routine purchases, contributing to an ever-expanding culture of credit.[530]

In an environment of shrinking or stagnant incomes, rising costs, and increased reliance on debt, it is wholly unsurprising that there would be a steady increase in the incidence of insolvency and of bankruptcy filings. It is equally unsurprising that this increase would accelerate during periods of general economic distress, such as in the aftermath of the economic downturn of 2007-2008, which are typically characterized by rising unemployment, credit contraction, and further cuts in social services.

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[527] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 169 (discussing "deep cuts in welfare programs"); *see also* Sarah Lueck, *Facing Crunch, States Drop Thousands from Medicaid Rolls*, WALL ST. J., June 26, 2003, at A1.

[528] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 175 (observing that "economic hardships following divorce continue to fall disproportionally on women."). This has been the case for some time. *See, e.g.*, *No-fault Divorce 'An Economic Disaster' for Wives, Children*, U.S. NEWS & WORLD REP., Nov. 4, 1985, at 63.

[529] *See, e.g.*, Jane Gross, *Elder-Care Costs Deplete Savings of a Generation*, N.Y. TIMES, Dec. 30, 2006, at A1 ("[N]ever has old age lasted so long or been so costly.").

[530] *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 111 (noting that, increasingly, Americans "do not pay—they finance. Quietly, without much fanfare, Americans have taken to buying school shoes and pizza with debt—and paying for those items over months or even years."); *see also* Jeff Gelles, *Credit Cards a Seductive Trap for Consumers*, THE STAR-LEDGER, Nov. 6, 2005, at 4 ("[A] third of the cardholders [in one study] use credit-card debt for basic living expenses, such as groceries, utilities, mortgage or rent payments, or insurance—adding interest charges to the ongoing cost of necessities.").

On the other hand, what *is* somewhat surprising is that, rather than flock to the bankruptcy courts at the first sign of distress, insolvent debtors actually tend to exhibit strong reluctance to take advantage of available bankruptcy relief.[531] Although bankruptcy filings have risen steadily over the past three decades, they seem not to have kept pace with the rising incidence of insolvency. In recent years, debtors have tended to wait longer after the onset of insolvency to commence their bankruptcy cases and, as a result, have tended to be in worse shape when they finally do.[532] Among other things, it is again possible to see evidence in these trends of the endowment effect—the idea that individuals will cling to property they own because they own it, even though they would be better off if they simply cut it lose, and would not be willing to pay such a steep price to keep it if it were not already theirs.[533] In any event, far from signaling the continued erosion of the so-called "stigma" of bankruptcy, this may suggest the opposite: as insolvency cuts deeper into the middle class, debtors are increasingly desperate to avoid

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[531] *See* WARREN & TYAGI, TWO-INCOME, *supra* note 522 at 73 (observing that, although millions of families in financial difficulty would be better off if they filed for bankruptcy, only a small percentage of them actually do); SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 21 ("Ironically, many debtors wait too long to file for bankruptcy."); *see generally id.* at 31 ("[T]he American middle class is running hard to stay in place. . . . As good jobs become scarce and wages and benefits erode, workers act to forestall potential losses by working longer hours and taking second jobs, while families send more workers into the labor force.").

[532] *Id.* ("An earlier filing would have stopped the calls and might have saved his job, giving [the debtor] a better postbankruptcy position and perhaps a chance to attempt some repayment.").

[533] *See supra* note 250 (discussing the endowment effect).

the humiliation of bankruptcy and file only when their circumstances become particularly dire.[534]

In addition, of the individuals who do file for bankruptcy relief, only a small fraction appear capable of paying any significant portion of their debts.[535] Further, those who file typically do so in the wake of some combination of lost employment, catastrophic illness, or divorce (sometimes all three).[536] It is true, of course, that many individual debtors who file for bankruptcy have significant credit card debt—an aspect of insolvency that is often cited uncritically as evidence of malfeasance.[537] But the same can be said of many millions of others who are solvent and will never file for bankruptcy: credit card debt has become an every-day feature of modern American life, and the fact that bankrupt debtors have this form of indebtedness is simply a reflection of the reality of how the consumer economy functions. *Of course* most bankrupt debtors have significant credit card debt. With characteristically indiscriminate availability and extraordinarily high rates of interest, it is one of the most common reasons for the need for bankruptcy relief.

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[534] *See* WARREN & TYAGI, TWO-INCOME, *supra* note 522 at 72-75 (making this point); *see generally* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 32 ("Arguments that the stigma attached to bankruptcy has declined are typically made by journalists who are unable to find any bankrupt debtors willing to be interviewed for the record and by prosperous economists who see bankruptcy as a great bargain.").

[535] *See id.* at 204 ("More than two out of three debtors who file for Chapter 13 are unable to continue their payments through to a successful conclusion.")

[536] *See id*. at 15-18, 19-21.

[537] *See id*. at 129 ("Debtors have taken on higher and higher consumer debt relative to their incomes, and they have fallen in greater numbers into bankruptcy."); *but see id.* at 22 ("[T]he proportion of people who have filed for bankruptcy because they have run up consumer debt to unmanageable levels is somewhat more modest than many might guess—perhaps about one in ten.")

In evaluating the causes of individual insolvencies, it is certainly true that some debtors end up filing for bankruptcy because they have engaged in fraudulent or foolhardy behavior far outside the norm, and these include some famous examples. Stories of the musician who could not get by on $140 million, the scam artist guilty of spectacular fraud, and the sports star who lost it all at the gaming tables linger in the collective consciousness and contribute to the stereotype of the abusive debtor.[538] But the insolvencies of many other famous individuals, including Abraham Lincoln in 1833 and Rembrandt Van Rijn in 1656, are not particularly dramatic or culpable.[539] In truth, the reality of bankruptcy is that the typical filing is simply an outgrowth of the consequences of ordinary risk taking that did not happen to pan out as expected.

In contrast to individual bankruptcy filings, the growth in business filings has been far less dramatic, suggesting even less reason to believe that business failures are

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[538] *See, e.g.*, Richard Sandomir, *Tyson's Bankruptcy Is a Lesson in Ways to Squander a Fortune*, N.Y. TIMES, August 5, 2003, at A1 (discussing how boxing legend Mike Tyson managed to squander nearly $400 million made over the course of his career); Carol M. Cropper, *The Basinger Bankruptcy Bomb*, N.Y. TIMES, January 1, 1995, at A1 (describing the circumstances of the bankruptcy of the celebrity Kim Basinger).

[539] *See* DAVID H. DONALD, LINCOLN 47-65 (1995) (chronicling how Abraham Lincoln became destitute from business losses in 1833); PAUL CRENSHAW, REMBRANDT'S BANKRUPTCY (2006) (exploring Rembrandt's life, his 1656 bankruptcy, and the subsequent auctioning of his assets in 1657 and 1658). Bankruptcy filings by popular music entertainers include those of Toni Braxton (twice), Jerry Lee Lewis, Willie Nelson, Wayne Newton, Cyndi Lauper, Tom Petty, Marvin Gaye, Natalie Cole, MC Hammer, Meatloaf, Tammy Wynette, and Michael Jackson. Walt Disney put his first movie company (called "Laugh-O-Gram") into bankruptcy, and Henry Ford filed for bankruptcy two years before he founded the Ford Motor Company. TV and movie personalities who have filed for bankruptcy include Debbie Reynolds, Gary Coleman, Zsa Zsa Gabor, Burt Reynolds, Ed McMahon, and Larry King. Athletes who have filed for bankruptcy include Jose Conseco and Johnny Unitas. Oscar Wilde was forced into bankruptcy in 1895. Henry Heinz, the condiment manufacturer, lost his business to bankruptcy in 1875, but succeeded later. Each of the first four candy companies that Milton Hershey founded failed—only the fifth was a success.

increasingly the product of malfeasance. Nevertheless, in characterizing the forces at work behind these filings, some commentators have again embraced the perception that business bankruptcy, like individual bankruptcy, is fundamentally an endogenous event.[540] It is certainly true, of course, that some business failures fit this paradigm. Enron, Worldcom, and several other spectacular examples come to mind.[541] The far more typical business bankruptcy case, however, is considerably less colorful or culpable.

In general, firms that file for bankruptcy relief do so for any number of relatively mundane reasons. The local hardware store may have found itself unable to compete with the newly opened branch of a national chain. A large clothing retailer may have miscalculated prevailing fashion trends. A real estate investment firm may have suffered the unexpected loss of an anchor tenant at its major property. A storied airline with an illustrious history may have been unable to compete effectively in the rough and tumble of a deregulated market.[542] In varying degrees, these examples reflect the unfortunate consequences of the assumption of, for the most part, purely ordinary business risks.

It is a truism that business is risky, especially for small enterprises. Indeed, when the sobering likelihood of failure is taken into account, it is difficult to accept as fully rational the average entrepreneurial decision to start a firm. Yet it would hardly be in our

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[540] *See supra* note 509.

[541] *See* ENRON: CORPORATE FIASCOS, *supra* note 182 (discussing examples of spectacular corporate disasters); SWARTZ & WATKINS, POWER FAILURE; *supra* note 182; Simon Romero & Alex Berenson, *Worldcom Says It Hid Expenses, Inflating Cash Flow $3.8 Billion*, N.Y. TIMES, June 26, 2002, at A1.

[542] *See, e.g.*, Stanley Ziemba, *Pan Am Fails, Closes Aviation Chapter; Another Step Toward Big 3 Domination*, CHICAGO TRIB., December 5, 1991, at Business 1; Agis Salpukas, *Eastern Airlines Is Shutting Down and Plans to Liquidate Its Assets*, N.Y. TIMES, Jan. 19, 1991, at A1.

collective best interests to discourage this from occurring. In the aggregate, the inevitable companion of desirable commercial activity (like the shadow to the body) is the risk of insolvency and, inevitably for some debtors, bankruptcy.

With this overall perspective in mind, the relevant question at hand becomes: are the debt-forgiveness mechanisms that bankruptcy law prescribes beneficial responses to the debt-forgiveness problems of insolvency?[543] In order to answer that question, the discussion returns to consideration of our standards of equity, efficiency, and entitlement.

EQUITY AND DISCHARGE RELIEF

From an historical perspective, exhuming the equitable norms underlying bankruptcy law's debt-forgiveness mechanisms is a somewhat complex affair. Consistent with the principle of restraint—that equity follows the law—if a creditor possessed a legal right to collect from his debtor, an English court of equity sitting during the sixteenth century might well have thought it an odd notion to intervene and release him from all liability simply because he was insolvent. After all, existing debt-collection procedures were not particularly solicitous of defaulting obligors and included such devices as imprisonment for debt.[544]

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[543] If so, we can then proceed subsequently to address how to resolve the inevitable conflict between these mechanisms and bankruptcy law's debt-collection devices.

[544] *See* Jay Cohen, *The History of Imprisonment for Debt and Its Relation to the Development of Discharge in Bankruptcy*, 3 J. LEG. HIST. 153, 154-55 (1982) (discussing the practice of imprisonment for debt); *see also* MANN, REPUBLIC, *supra* note 371 at 78-108 (discussing imprisonment for debt during the early years of the republic); MULDREW, ECONOMY, *supra* note 371 at 274-98 (discussing debt-collection practices and procedures in sixteenth- and seventeenth-century England, including imprisonment for debt); COLEMAN, DEBTORS, *supra* note 258 at 9 (describing imprisonment for debt in colonial America); NOEL, HISTORY, *supra* note 258 at 70-72 (describing conditions in American debtors' prisons). As fans of Charles Dickens may recall, imprisonment for debt was the fate of Mr. Micawber, who was taken off to the local goal for unpaid debts. *See* CHARLES DICKENS, DAVID COPPERFIELD 152-54 (Bantam 1981). Mr. Micawber's

On the other hand, during the sixteenth and early seventeenth centuries, the Privy Council (consisting of certain senior advisers, ministers, and other officials of the Crown) entertained and granted a number of the petitions of insolvent debtors seeking relief from creditors on equitable grounds—essentially administering bankruptcy remedies, including those that effectively discharged the debtor's obligations. Perhaps over time Chancery (the central English court of equity in London) or some other tribunal spun off from the Privy Council (each of the major centralized English courts evolved in this way) might have developed fixed doctrines and regularized procedures that allowed for different forms of discharge relief for insolvent obligors, perhaps on the equitable theory that the repeated attempt to collect debts from a hopelessly insolvent debtor effectively constituted an inequitable form of waste or amounted to a form of unjust penalty. After 1623, however, Parliament set the essential development of bankruptcy protocols (including discharge relief) on a decidedly different path. In particular, it enacted a succession of bankruptcy statutes that gradually evolved to include a formal discharge mechanism, but as the result of legislative experimentation rather than the incremental processes of the common law or discretionary proceedings in Chancery or the Privy

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experience mirrored that of Dickens's own father, John, who was imprisoned for debt in Marshalsea Prison in London. *See* PETER AKROYD, DICKENS 69 (1990). The character Little Dorrit was also born there. *See* CHARLES DICKENS, LITTLE DORRIT (Wordsworth 1992).

Council.[545] Still, existing equitable procedures had a clear impact on the development of the early law and, as noted, bankruptcy law today remains a branch of equity.[546]

Most historical accounts locate the first English bankruptcy procedure in a statute enacted in 1542 during the reign of Henry VIII,[547] but significant aspects of bankruptcy practice can be traced to earlier experiences in the context of handling the estates of insolvent decedents. As Richard Helmholz has explained, the records of the English ecclesiastical courts exercising probate jurisdiction "show conclusively that English bankruptcy practice has antecedents and perhaps even roots in the canon law administered by the Church courts."[548] On reflection, this seems unsurprising. Many individuals at the time died with unsettled claims and debts, and often enough (which is to say very often indeed), a decedent's debts to others exceeded the value of the decedent's tangible property together with his collectible claims against third persons, leaving an insolvent estate.[549] Naturally, the ecclesiastical courts and their successors in

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[545] *See* Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 329-44 (1991) [hereinafter Tabb, *Historical Evolution*] (discussing the history of English bankruptcy laws); *see also* W. J. JONES, THE FOUNDATIONS OF ENGLISH BANKRUPTCY: STATUTES & COMMISSIONS IN THE EARLY MODERN PERIOD 18 (Am. Phil. Soc. 1979) [hereinafter JONES, FOUNDATIONS].

[546] *See supra* note 440.

[547] Bankruptcy Act, 1542, 34 & 35 Hen. 8, c. 4 (Eng.); *see, e.g.*, Tabb, *Historical Evolution*, *supra* note 545 at 329 (citing to this statute); *see also* EDWARD CHRISTIAN, THE ORIGIN, PROGRESS AND PRESENT PRACTICE OF THE BANKRUPT LAW 1 n.2 (Clarke & Sons 1812) (discussing this statute); Levinthal, *Early History*, *supra* note 398 at 15 (same).

[548] Helmholz, *Bankruptcy and Probate*, *supra* note 460 at 416.

[549] *See* MULDREW, ECONOMY, *supra* note 371 at 30-34, 173-95, 272-312 (discussing rise in inventories taken upon the death of an individual, and high rates of indebtedness, default, and insolvency).

equity developed mechanisms to administer the collection of the decedent's claims against others, liquidate the decedent's property, and apportion the estate in partial satisfaction of the insolvent decedent's debts. Characteristically, they did so using the tools of equity.[550]

In the case of a deceased individual, of course, there was generally no need to provide an *in personam* discharge to liberate his human capital from the burden of oppressive obligations. *Mortem obit omnia debita*—death already accomplished that.[551] Living flesh-and-blood individuals, however, were a different story. The Bankruptcy Act of 1542 provided no statutory discharge mechanism; it was exclusively a debt-collection device designed to assist in collecting debts from insolvent merchants.[552] Nonetheless, on numerous occasions in the sixteenth and early seventeenth centuries, the Privy Council intervened and essentially coerced equitable bankruptcy relief from frequently unwilling creditors for the benefit of petitioning insolvent debtors.[553]

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[550] *See, e.g.*, Helmholz, *Bankruptcy and Probate*, *supra* note 460. The defects in ecclesiastical jurisdiction over the administration of decedents' estates, and the role of the English courts of equity assuming a broader and more comprehensive jurisdiction, is discussed in 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 551-55.

[551] *But see* CHANCELLOR, DEVIL, *supra* note 261 at 163-64 (offering the example of a creditor's refusal in 1865 to release the corpse of a debtor before his debts were paid).

[552] *See supra* note 547.

[553] JONES, FOUNDATIONS, *supra* note 545 at 36. For a detailed discussion of the many interventions of the Privy Council on behalf of distressed debtors, see Israel Treiman, *Majority Control in Compositions: Its Historical Origins and Development*, 24 VA. L. REV. 507 (1938) [hereinafter Treiman, *Majority Control*]; *see also* David A. Smith, *The Error of Young Cyrus: The Bill of Conformity and Jacobean Kingship, 1603-24*, 28 L. & HIST. REV. 307 (2010) (discussing the "bill of conformity" filed by some insolvent debtors to achieve coerced compositions); Ian P.H. Duffy, *English Bankrupts 1571-1861*, 24 AM. J. LEGAL HIST. 283, 284 (1980) [hereinafter Duffy, *English Bankrupts*] (discussing interventions by the Privy Council).

In some of these cases, relief from the Privy Council arrived in the form of a grant of additional time for the repayment of debts,[554] sometimes in the form of a stay of proceedings,[555] and sometimes for periods that could range from six months to "5 or 6 yeeres," depending on the debtor's particular circumstances.[556] In some of these matters the Council "seems to have acted without paying any attention at all to the wishes or the interests of the creditors."[557] Instead, the Council's decision turned on whether the debtor deserved "pitie or commiseracion" owing to unfortunate circumstances.[558]

In other cases, the Council sought to persuade the creditors to enter into consensual composition arrangements with their debtors, in which they would agree to reduce their debts in exchange for fractional recoveries from the debtor's assets—in essence, permitting the debtor to pay what he could from his property in exchange for a release of liabilities.[559] In order to accomplish a composition, the Council would appoint

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[554] Treiman, *Majority Control*, *supra* note 553 at 512.

[555] *See* 9 JOHN R. DASENT, ACTS OF THE PRIVY COUNCIL OF ENGLAND 81 (1890) [hereinafter DASENT, PRIVY COUNCIL].

[556] *See, e.g.*, 10 DASENT, PRIVY COUNCIL, *supra* note 555 at 315; *id.* Vol. 11, at 171, 427; *id.* Vol. 13, at 420; *id.* Vol. 14, at 251; *id.* Vol. 22, at 252; *id.* Vol. 26, at 118-119.

[557] Treiman, *Majority Control*, *supra* note 553 at 512-13.

[558] 9 DASENT, PRIVY COUNCIL, *supra* note 555 at 224-25 (staying proceedings of debtor who suffered "grete losses . . . and other casualties in the seas . . . [so that] by tyme and by sale of suche merchaundizes as he hath remayninge . . . he maketh accompt to be able to make full satisfaction of his said debtes"); *see also id.* Vol. 14, at 269-70 (releasing a "poore man . . . so as thereby he might provyde the sooner to paie his credytors by suche porcions as they should finde his habilitie hable to afforde."); *id.* Vol. 10, at 93 (debtor "alleageth to have been verie uncharitablye handeled by his said creditours"); *id.* Vol. 13, at 420 (debtor "had verie hard penyworthes of his creditours"). Among other things, the Privy Council appears to have been motivated by the biblical proscription: "Do not withhold good from those who deserve it, when it is in your power to act." PROVERBS 3:27 (King James).

[559] Treiman, *Majority Control*, *supra* note 553 at 513.

special commissioners (sometimes with particular political or ecclesiastical clout)[560] and then instruct these commissioners to gather the particular debtor's creditors together and persuade them to agree to a consensual arrangement.[561] If the commissioners were unsuccessful because of one or two "obstinate creditors," the Council "would order these dissenting creditors either to submit an explanation of their conduct in writing, or to appear in person before the Council Board."[562] Creditors who continued to "persist in their extremitie" were committed to prison.[563]

Unsurprisingly, creditors incarcerated in this fashion were not pleased, and some brought suit challenging the practice.[564] As a consequence, the Council switched its method to indirect pressure on dissenting creditors, directing the commissioners to instruct holdouts that, if they did not play ball, they could expect no relief in the future from the strictness of the law in her majesty's courts if ever they should find themselves

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[560] *Id.*

[561] *See, e.g.*, 12 DASENT, PRIVY COUNCIL, *supra* note 555 at 40-41) (directing appointed commissioner "to call before him the creditours of [the debtor] and to deale with them to forbeare to sue or moleste him in anie sorte for anie suche debte as is due unto them from him until the retorne of [another man who was indebteded to the debtor] . . . and if the said creditours shall refuse to forbeare to moleste him then to comaunde them to appere before their Lordships").

[562] Treiman, *Majority Control*, *supra* note 553 at 513-14 (internal quotations omitted).

[563] *See, e.g.*, 17 DASENT, PRIVY COUNCIL, *supra* note 555 at 6-7 (writing to the commissioner that if he "shall perceive that [the creditor] continue his wonted perversenes, and not shewe him selfe redy to be conformable to your direction and accomplish the contentes of the said order, to comitt him to prison, ther to remaine until he shall shewe th'effectes of more obedience and charitye, and consente to the enlargement of the said Androwes in such sorte as hath been heretofore by your endeavors and travel accorded and agreed upon."); *id.* Vol. 18, at 91 ("if Rawlyns shall refuse, then shall they commit him to prisone").

[564] *See id.* Vol. 19, at 441; *id.* Vol. 20, at 41; *see also* Miller v. Seare, 2 Bl. 1141; 96 Eng. Rep. 673 (K.B. 1773) (determining that an action would lie against the commissioners of a bankrupt debtor if the commissioners exceeded or abused their authority conferred by bankruptcy statute).

in need of it.[565] On the whole, the efforts of the Council to persuade obstinate creditors to agree to compositions approved by a majority appear to have been largely successful.[566]

Unfortunately, debtors sometimes abused the procedure, such as by making false allegations solely to hinder their creditors,[567] and other defects arose in its application.[568] In 1623, Parliament effectively ended the practice of coercive Privy Council intervention by channeling insolvency matters to the statutorily prescribed bankruptcy procedures. Specifically, Parliament enacted a provision that mandated that any debtor who brought a petition against his creditors (e.g., a petition in the Privy Council) seeking a stay of debt-collection activity or a coerced composition would be deemed to be a bankrupt and thus forced into a formal bankruptcy proceeding subject to the potentially harsh penalties of the bankruptcy law.[569] This effectively overrode the Council's ability to intercede.[570]

Parliament subsequently enacted the first statutory discharge mechanism as part of the Bankruptcy Act of 1705, "enabling an honest and cooperative bankrupt to obtain a discharge from prebankruptcy debts."[571] Specifically, the statute provided in relevant

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[565] 22 DASENT, PRIVY COUNCIL, *supra* note 555 at 384 (instructing the commissioners to inform dissenting creditors that if "anye informacion shalbe broughte at anye tyme against them upon aye penall statute or other advantage taken againste them in any matter by stricktness of law, they are to looke for noe favor but all extreamitie that maie be used, in respecte of the contempt they shewe to her Majestie's authoritie and harde disposicion to theis poor men oppressed by their rigorous dealing.").

[566] Treiman, *Majority Control*, *supra* note 553 at 514.

[567] *Id*. at 515.

[568] *Id.* at 516 (such as the ability of a relatively large number of creditors holding small claims to effectively outvote a relatively small number of creditors holding large claims).

[569] Bankruptcy Act, 1623, 21 Jac. 1, c. 19, § 2 (Eng.).

[570] JONES, FOUNDATIONS, *supra* note 545 at 40; *see also id*. at 37 (cautioning that "one must be careful not to exaggerate the extent of Privy Council activity").

[571] Tabb, *Historical Evolution*, *supra* note 545 at 33; *see* Bankruptcy Act, 1705, 4 & 5 Anne, c. 17, § 7 (Eng.).

part that "all and every person and persons so becoming bankrupt . . . who shall . . . in all things conform . . . shall be discharged from all debts by him, her, or thems due and owing at the time that he, she, or they did become bankrupt."[572] Although other provisions of the 1705 bankruptcy statute treated certain fraudulent bankrupts extremely harshly,[573] the discharge provision introduced a formal statutory mechanism for the release of the honest but unfortunate debtor from the grip of oppressive indebtedness and thus marked a milestone in the Anglo-American history of bankruptcy law.

From the perspective of equity's traditional role as a vehicle to ameliorate deficiencies in legal processes and outcomes, as well as its particular impulse to avoid circumstances giving rise to equitable waste, the discharge of insolvent debtors as a means to address the debt-forgiveness problems of insolvency—namely, an insolvent debtor's incentives to engage in wasteful delay, deception, and inappropriate risk taking, and the waste associated with stagnating and overburdened assets, including an insolvent debtor's human capital—is consistent with equity's traditional normative values and is likewise beneficial as applied in the bankruptcy context. As William Blackstone acknowledged in his *Commentaries*, "at present the laws of bankruptcy are considered as laws calculated for the benefit of trade, and founded on the principles of humanity as well as justice: and to that end they confer some privileges, not only on the creditors, but also

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[572] *Id.*

[573] For example, capital punishment was introduced for bankrupts who failed to surrender to the bankruptcy commissioners, refused to be examined, fraudulently disposed of goods, or concealed or embezzled property worth more than twenty pounds or withheld books. Bankruptcy Act, 1705, 4 & 5 Anne, c. 17, §§ 1, 18 (Eng.) (providing that such debtors could be made to "suffer as a felon, without benefit of clergy"—meaning in the terminology of the time put to death); *see also* Bankruptcy Act, 1706, 6 Anne, c. 22, § 1 (Eng.); Bankruptcy Act, 1732, 5 Geo. 2, c. 30, § 1 (Eng.).

on the debtor or bankrupt himself."[574] In addition, the "humanity" of the discharge was also consistent with important religious values and other norms of sociability. As one scholar has emphasized,

> [t]here was also much religious stress on forgiveness in this period. The Lord's Prayer, as it was translated in the King James and earlier versions, is the most obvious example, with its emphasis on forgiveness rather than giving:
>
> > Give us this day our daily bread.
> > And forgive us our debts,
> > as we forgive our debtors.
> > And lead us not into temptation.
>
> These lines express the morality of credit in early modern England because they assume that transgression was inevitable and needed forgiveness. Forgiveness was a universal virtue because anyone might eventually fall into straightened circumstances and might need to be forgiven . . . .[575]

Of course, it is important to avoid both over- and understating the significance of the statutory discharge introduced in the 1705 Bankruptcy Act, as well as its value. It is certainly true, as one commentator has stated, that "the discharge provision . . . ranks ahead in importance of all others in Anglo-American bankruptcy history."[576] At the same time, the details of appropriate discharge relief would take centuries to work out and remain controversial to this day. Key issues include the reconciliation of discharge relief with the needs and realities of a credit-based economy and also other equitable limits on its scope to avoid misuse. Consistent with commercial reality, discharge relief ultimately cannot be of the freely-available "deliverance" variety—a complete washing away of all

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[574] 2 BLACKSTONE, COMMENTARIES, *supra* note 453 at 471.

[575] MULDREW, ECONOMY, *supra* note 371 at 306.

[576] McCoid, *Discharge*, *supra* note 76 at 164.

liabilities regardless of their nature and regardless of the debtor's circumstances. Doing so would itself be inequitable because such expansive relief would go too far. The question arises: from an equitable perspective, where should the line be drawn in order to maintain the overall beneficial nature of discharge relief?

Although it may be fair as a general matter for insolvent individuals to receive some form of *in personam* release of indebtedness, the concept is tempered in equity by the reciprocity maxim that "he who seeks equity must do equity." For example, a debtor who has committed fraud or some other form of serious malfeasance should not be able to look to bankruptcy law to escape his resulting liabilities.[577] The reciprocity maxim animates the principle that bankruptcy relief is for the "honest but unfortunate debtor," and consistent with this concept, discharge relief is only available to release the debtor from the kinds of liabilities that honest but unfortunate debtors typically incur (e.g., those that that do not demonstrate that the debtor is, in fact, a dishonest schemer). Thus, an insolvent debtor may be discharged from liabilities arising from his negligence, but not those arising from his intentional fraud.[578]

Further consistent with the paradigm of the honest but unfortunate debtor, it is also generally equitable for individual debtors to receive some form of *in rem* release with respect to a modest amount of their property necessary for their support and to

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[577] JONES, FOUNDATIONS, *supra* note 545 at 9 (explaining that "there was always a sense that some distinction should be made between debtors whose inability was due to misfortune or chance, and those whose circumstances were the consequence of dishonesty, fraud, or reckless behavior.").

[578] *See, e.g.*, 11 U.S.C. § 523 (2000 & Supp. 2006) (prescribing exceptions to discharge in bankruptcy, including those arising from certain kinds of intentional fraud); Kelly v. Robinson, 479 U.S. 36, 47-48 (1986) (holding that the Bankruptcy Code does not affect or discharge criminal restitution obligations).

enable them to start anew following bankruptcy.[579] Accordingly, bankruptcy law permits debtors to claim certain assets as exempt from the reach of creditors, such as certain categories of personal items and possibly a homestead allotment.[580] It would be fundamentally inequitable, however, for an insolvent debtor to file for bankruptcy relief in order to receive a discharge of his debts, but retain a vast wealth free from the claims of unpaid creditors—once again, "he who seeks equity must do equity."

Significantly, these general principles apply not only to insolvent individuals, but also insolvent business enterprises. It bears emphasis that the particular debtors benefiting from the earliest forms of discharge relief—whether dispensed by the Privy Council or later under the Bankruptcy Act of 1705—were characteristically merchant

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[579] The first U.S. bankruptcy statute enacted in 1800 permitted the debtor to retain "necessary wearing apparel, and the necessary wearing apparel of his wife and children, and necessary beds and bedding of such bankrupt," to receive an additional percentage of the value of his estate based on creditor recoveries, and, during the course of the proceeding, "such allowance out of the bankruptcy estate . . . as [the commissioners] in their opinion may [think] requisite for the necessary support of the said bankrupt and his family." Bankruptcy Act of 1800, ch. 19, §§ 5, 34, 35, 53, 2 Stat. 19 (1800) (repealed 1803); *see* William J. Woodward, Jr., *Exemptions, Opting Out, and Bankruptcy Reform*, 43 Ohio State L.J. 335, 336-42 (1982) (discussing the history of exemption laws); *see also* Bankruptcy Act, 1732, 5 Geo. 2, c. 30 (Eng.). With amendments, the Act of 1732 was the English bankruptcy law in effect at the time of the ratification of the U.S. Constitution and the passage of the first U.S. Bankruptcy Act of 1800, and it served in many respects as the model for the Act of 1800. *See* Tabb, *History*, *supra* note 458 at 12 (discussing how the 1732 English statute served as a model for the Act of 1800). The Act of 1732 exempted from surrender to the commissioners the bankrupt's "necessary Wearing Apparel and the necessary Wearing Apparel of the Wife and Children of such Bankrupt," and exempted from the reach of creditors on future execution "the Tools of Trade, the necessary Household Goods and Furniture, and necessary Wearing Apparel of such Bankrupt and his Wife and Children." Bankruptcy Act, 1732, 5 Geo. 2, c. 30, § 9 (Eng.). It likewise provided for certain allowances out of the debtor's estate under certain conditions. *See id*. §§ 7, 8.

[580] *See* 11 U.S.C. § 522 (2000 & Supp. 2006) (providing that an individual debtor may exempt various items from property, and providing that exempt property is not liable for most kinds of debts); *see supra* notes 16, 73 (discussing bankruptcy law's exemption provisions).

traders. Because business activities at the time were conducted in the usual course by individuals or partnerships, and because bankruptcy was available *only* for merchant traders under the Act of 1705,[581] it follows that the discharge provision in the Act was essentially an entrepreneurial rehabilitation measure. As Lord Hardwicke explained in *Ex Parte Burton*, the Act of 1705 "was made in consideration of two long wars which had been very detrimental to traders, and rendered them incapable of paying their creditors."[582] More specifically, although when first introduced in Parliament the 1705 Act was largely "in response to the notorious frauds of Thomas Pitkyn in 1704" and was initially "intended simply to increase the penalties for dishonesty," subsequently "several M.P.s, influenced by the heavy losses recently sustained by traders as a result of the French wars and storms, proposed additional clauses for the relief of honest bankrupts."[583]

In this way, merchant traders were able to obtain release from their commercial liabilities in order to reorganize their affairs and continue in business. In the same way today, insolvent firms that are worth salvaging are able to obtain a discharge from their

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[581] *See* Tabb, *Historical Evolution*, *supra* note 545 at 334-35 (noting that only traders were eligible for bankruptcy under the early bankruptcy statutes). In England, the restriction limiting bankruptcy to traders was not eliminated until 1861. *See* Bankruptcy Act of 1861, 24 & 25 Vict., c. 134, §§ 69, 86 (Eng.); 15 WILLIAM S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 98 (A. Goodhart & H. Hanbury eds. 1965); Duffy, *English Bankrupts*, *supra* note 553 at 291-92. In the United States, the first Bankruptcy Act—the Act of 1800—was also limited to merchant traders. *See* Bankruptcy Act of 1800, ch. 19, § 1, 2 Stat. 19 (1800) (repealed 1803). Bankruptcy relief was made available to other debtors in the second U.S. bankruptcy statute enacted in 1841. *See* Bankruptcy Act of 1841, ch. 9, § 1, 5 Stat. 440 (1841) (repealed 1843).

[582] 26 Eng. Rep. 163; 1 Atk. 155 (Ch. 1744).

[583] Duffy, *English Bankrupts*, *supra* note 553 at 286 (citing Daniel Defoe, *Remarks on the Bill to Prevent Frauds Committed by Bankrupts* 1-7, 19-20 (1706)). For a discussion of the Pitkin affair, see Emily Kadens, *The Last Bankrupt Hanged: Balancing Incentives in the Development of Bankruptcy Law*, 59 DUKE L.J. 1229, 1255-60 (2010).

unmanageable obligations.[584] Although firms today may not claim property as "exempt" in the same manner as individuals, they may effectively do so by retaining the assets they need to operate in exchange for agreeing to distribute to creditors a recovery greater than the assets' liquidation value.[585] Any excess indebtedness beyond the amount the debtor agrees to pay under a Chapter 11 plan is discharged.[586]

Consistent with the equitable notion that discharge relief is available only to honest but unfortunate debtors, and in order to further prevent bankruptcy from becoming an attractive nuisance, the debt-forgiveness remedies of bankruptcy law are properly limited in other respects. For example, there is a periodicity restriction—a debtor who obtains bankruptcy relief is not eligible for additional relief for a number of years.[587] Collectively these limitations flesh out the equitable parameters of the debt-forgiveness aspects of bankruptcy law in order to avoid problems that would diminish their desirability.

Finally, the debt-forgiveness aspects of bankruptcy law address the problem of stagnating physical assets by making available certain mechanisms (applicable to

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[584] *See supra* at 38-40; *supra* notes 72, 76, 85, 87-89 (discussing the discharge available to insolvent firms in Chapter 11 cases).

[585] *See supra* notes 72, 241, *infra* note 752.

[586] *See supra* at 38-40; *supra* note 73.

[587] *See, e.g.*, 11 U.S.C. §§ 727(a)(8) (2000 & Supp. 2006) (providing that a debtor may not receive a discharge in a Chapter 7 case if the debtor "has been granted a discharge under this section, [or] under section 1141 . . . in a case commenced within 8 years before the date of the filing of the petition"), 1328(f) (2000 & Supp. 2006) (providing that, in a Chapter 13 case, the court may not grant a discharge "if the debtor has received a discharge . . . in a case filed under chapter 7, 11, or 12 of this title during the 4-year period preceding the date of the order for relief under this chapter, or . . . in a case filed under chapter 13 of this title during the 2-year period preceding the date of such order").

individuals and firms) that strip a variety of property free of encumbrances, such as liens and the like, so these assets may be more readily deployed in some fashion, including in the hands of a purchaser.[588] This is consistent with the rule that "[t]he usual course of enforcing a lien in equity, if not discharged, is by the sale of the property to which it is attached."[589]

As the foregoing illustrates, already embedded in the equitable concept of a discharge is some consideration of the interests of creditors. The interests of creditors are addressed further below as part of the discussion of how best to reconcile the various debt-collection, debt-forgiveness, and debt-adjustment remedies of bankruptcy law. For present purposes, it is sufficient to observe that, from an equitable perspective, bankruptcy law's debt-forgiveness solutions to the debt-forgiveness problems of insolvency are generally beneficial because they are fully consistent with its evolved principles of forgiveness and the avoidance of waste. At the same time, the debt-forgiveness features of bankruptcy law cannot be unlimited; they are necessarily tempered to avoid unfairness.

THE EFFICIENCY OF DISCHARGE RELIEF

The debt-forgiveness features of bankruptcy law may be equitable, but are they also efficient? Once again, the answer is generally yes. The problems that the debt-

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[588] *See* 11 U.S.C. §§ 363(f) (2000 & Supp. 2006) (providing for the sale of property free and clear of interests), 522(f) (2000 & Supp. 2006) (providing for the avoidance of certain liens that impair certain claimed exemptions), 1123(a)(5)(D) (2000 & Supp. 2006) (providing that a Chapter 11 plan may provide for the sale of the debtor's assets free of any lien), 1129(b)(2)(A)(II) (2000 & Supp. 2006) (providing protections for secured creditors in Chapter 11 cases where assets encumbered by the secured creditors' liens are to be sold under the terms of a confirmed plan).

[589] 2 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 560.

forgiveness features of bankruptcy law address—namely, an insolvent debtor's incentives to engage in wasteful delay, deception, and inappropriate risk taking, and the waste associated with stagnating and overburdened assets—are themselves inefficient drags on our larger economic system. Accordingly, the debt-forgiveness mechanisms of bankruptcy law are beneficial from an efficiency standpoint so long as the costs associated with these mechanisms are not greater than the costs they avoid, and it seems fairly clear that, in this sense, the benefits outweigh the burdens.

As noted, the various limits that bankruptcy law imposes on the availability and scope of its debt-forgiveness devices—for example, denying discharge relief in the case of willful malfeasance and requiring the surrender of non-exempt assets to be used toward the payment of claims—are designed specifically to reduce the potential costs of these devices in two major ways: (1) by avoiding having bankruptcy become a shelter for fraud and other serious types of wrongdoing, and (2) by avoiding the potentially negative *ex ante* effects associated with an overly generous bankruptcy procedure. On balance, these kinds of limits appear to be at least adequate to ensure that the benefits of bankruptcy law's discharge remedies outweigh their costs. That, of course, does not mean that bankruptcy law's discharge devices cannot be improved. It simply means that, from an efficiency standpoint, they appear to generate beneficial results when compared to outcomes under non-bankruptcy regimes.

In the case of insolvent individuals, the key virtue of bankruptcy's discharge mechanism is that, by restoring the debtor to a solvent state, it effectively normalizes the debtor's incentives to make productive use of his assets, including his human capital, by neutralizing his insolvency-related incentives to engage in wasteful activities. As a

result, the formerly insolvent debtor will have the same general incentives that solvent individuals typically have to make use of their assets productively. In other words, the debt-forgiveness aspects of bankruptcy law restore productive autonomy. As argued earlier, the mere fact that an individual has become insolvent and in need of bankruptcy relief does not mean that he is necessarily a hopeless case unable in the future to make appropriate decisions regarding the use of his human capital—at least in the sense of being no better or worse on average than others who sometimes exercise questionable judgment yet remain solvent.[590] In any event, even if it did mean that he is hopeless in some sense, an individual cannot be separated from his human capital and, absent some kind of medical impairment, will remain in control of it even though he may be susceptible to bouts of poor judgment.[591]

In the case of insolvent firms that are worth salvaging (i.e., those suffering from financial distress as opposed to economic distress), the key virtue of bankruptcy law's discharge mechanism is essentially the same.[592] By restoring the firm to a solvent state, the discharge effectively normalizes the incentives of the various stakeholders to make the most productive use of the firm's assets by neutralizing their incentives to engage in wasteful activities. As with individuals, the mere fact that a firm has become insolvent and in need of bankruptcy relief does not mean that the firm cannot succeed in the future. Many firms that have gone through bankruptcy—including most domestic air carriers, many domestic car manufacturers, numerous energy companies, and many large

[590] *See supra* at 260-64.

[591] *See supra* notes 44, 68.

[592] *See supra* notes 1, 136, 141, 372 (discussing the concepts of "financial distress" and "economic distress").

retailers—have prospered afterwards. Although a firm suffering from economic distress should be liquidated in some fashion, financial distress is by definition remediable by deleveraging the debtor's balance sheet, which is what discharge relief accomplishes.

One criticism of the discharge is that granting it on an *ex post* basis (i.e., after creditors have extended credit) creates an *ex ante* incentive for debtors to take improvident risks on the theory that they are effectively shielded from the consequences of their risk taking.[593] This criticism assumes, however, that debtors generally take into account the effects of a discharge when they engage in *ex ante* risk taking and, more important, that they are not only aware of, but are encouraged by, the possibility of obtaining bankruptcy relief. This seems quite implausible. Even though bankruptcy relief includes the possibility of a discharge, the prospect of a bankruptcy filing is not encouraging. On the contrary, it is by design essentially discouraging. Bankruptcy is no picnic and debtors do not happily flock to its particular brand of humiliation.[594]

As discussed previously, individuals tend systematically to discount the possibility of future financial failure.[595] In fact, they tend to do so to such a great extent

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[593] *See supra* notes 20, 69, 261, 396 (discussing such kinds of possible incentive effects); *see also* Eisenberg, *Bankruptcy Law*, *supra* note 264 (arguing that debtors are in a better position to assess the risks of their financial activities than creditors, and that there should be a presumption of non-dischargeability of obligations).

[594] As noted above, debtors in Chapter 7 cases must surrender their non-exempt assets for liquidation, and debtors in Chapter 13 cases must commit to extended repayment plans. *See supra* at 258. In addition to the burdens these procedures impose, under the Fair Credit Reporting Act, 15 U.S.C. § 1681, et seq., the filing of a bankruptcy petition leaves a black mark on the debtor's credit report for an extended period: typically ten years from the date of the filing of a Chapter 7 petition and seven years from the date of the filing of a petition under Chapter 13. *See, e.g.*, 15 U.S.C. § 1681c (setting general limit of ten years).

[595] *See supra* note 404 (discussing optimism bias).

that they generally tend to avoid thinking about it at all in any great depth unless and until they have to. For this additional reason, it seems unlikely individuals would systematically contemplate and calculate the availability of bankruptcy relief as a means to lessen the consequences of their risk taking, and thus take more risks than they would otherwise take if completely unaware of the possibility of a bankruptcy discharge. For example, when debtors borrow to purchase a home, they are often nervous about their ability to repay the loan, in part because mortgage loans typically involve significant sums, potentially uncertain values, and a commitment to make payments for a long period of time. It seems implausible, however, that these borrowers would somehow feel less nervous, and thus more prone to taking risks, by contemplating deliberatively that bankruptcy awaits them if things go badly. If anything, this would seem only likely to increase their anxiety because bankruptcy is not typically viewed as an attractive option, thus *lessening* their willingness to take risks. On the whole, it seems more realistic to assume that, because the prospect of bankruptcy is generally discouraging rather than encouraging, and people tend not to think about it at all in any great detail unless and until they have to, the availability of a discharge has little or no effect on *ex ante* risk taking in the typical case—financially healthy individuals will take roughly the same financial risks with or without the possibility that they might someday have a need for discharge relief.[596] Things might be different, of course, if the law made bankruptcy much more attractive than it does—in other words, the law made it generously encouraging rather than discouraging. But that is not the case.

[596] This is perhaps best illustrated by how strenuously debtors seek to avoid bankruptcy even when they would clearly benefit from it. *See supra* at 269-70.

Another criticism of the discharge is that, by reducing the value of the creditors' collection rights, it increases the cost of capital overall.[597] Though perhaps true to some extent, the real question is whether the benefits of the discharge outweigh its plausible impact on borrowing costs. Among other things, if a discharge were not available, it is doubtful that, in most instances, a creditor's right to pursue an insolvent debtor endlessly would result in much of a meaningful recovery. As noted, insolvent debtors who file for bankruptcy typically lack much of an ability to satisfy any significant portion of their debts.[598] This helps explain why, following default, most creditors routinely write off accounts with insolvent individuals within a relatively short period of time and take no further action to collect.[599]

In contrast, granting a discharge has numerous benefits. As discussed above, it has the effect of restoring productive autonomy.[600] Further, by helping place the cost of lending on creditors, it may have the effect of discouraging improvident lending practices.[601] In addition, Thomas Jackson has argued that granting discharge relief may

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[597] *See supra* at 70-71.

[598] *See supra* at 270*; infra* note 718.

[599] *Cf.* FEDERAL RESERVE BANK OF NEW YORK, INDUSTRY SOUND PRACTICES FOR FINANCIAL AND ACCOUNTING CONTROLS AT FINANCIAL INSTITUTIONS 11 (2006) ("Charge-offs are usually required within 90 to 180 days unless documentation is provided as to why the account should not be charged-off (i.e., why the balance is still collectible).").

[600] *See supra* at 287-88.

[601] Improvident lending includes indiscriminate lending with little or no regard to the riskiness of the loan, and lending otherwise unaccompanied by the exercise of credit judgment. An example of lending without the exercise of credit judgment is most lending in the credit card industry. *See* SULLIVAN, WARREN & WESTBROOK, FRAGILE, *supra* note 200 at 246-47 (describing extensions of credit in the credit card industry, and explaining "[m]ost issuers, it appears, make little or no attempt to review the borrower's

be beneficial for other reasons, including that it may (1) help individual debtors compensate for the risks associated with their inability to diversify the investment of their human capital (i.e., although debtors may well understand that the loss of employment can be devastating financially, they typically are unable to take on multiple jobs at the same time to hedge against this possible loss); (2) lessen dependence on other forms of public assistance that may be less efficient, such as welfare benefits; and (3) help safeguard the interests of those who may rely on the debtor for their support and well-being.[602] Although there is certainly more that could be said about the efficiency of bankruptcy law's existing system of discharge relief, and likewise further specific investigations that bear on the general analysis offered here, the available evidence suggests that traditional discharge remedies are essentially beneficial from an efficiency standpoint when compared to outcomes under non-bankruptcy law.[603]

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financial status after the initial issuance of the credit card except to raise the limit. The result is an absence of the credit judgment we have traditionally associated with lending, an almost complete disconnection between the circumstances of the borrower and the granting of the credit at the time it is granted."). While highly profitable for creditors, this type of lending, with its high interest rates and charges, can easily spiral out of control and spell financial disaster for debtors. *See id.* at 111-40. Improvident lending is not limited to the consumer finance arena. *See id*. at 211 (describing bank failures during the twelve-year period between 1980 and 1992 from bad commercial and consumer loans); *see also* JACKSON, LOGIC, *supra* note 8 at 229-30, 249 (creditors may be better able than debtors to assess the risks of extending credit, and discharge relief gives them an incentive to conduct such assessments).

[602] *See id.* at 225-52.

[603] *See also* Easterbrook, *Corporate Bankruptcy*, *supra* note 146 (arguing that business reorganizations in Chapter 11 are generally efficient because of their ability to preserve values at costs that are comparable to other types of major corporate transactions).

Regardless of whether discharge relief is efficient, however, it may still be worth having as a matter of right to protect important interests. Chief among these is an individual debtor's interest in his own human capital and, to a lesser extent, the property he possesses. As suggested, these interests are not the same. An individual's interest in his own human capital is much more important than his interest in whatever property he may possess and, unsurprisingly, these interests are protected in different ways. Nonetheless, an individual's interest in both his own human capital and at least some quantum of the property he possesses is sufficiently important that discharge relief has long sought to protect them as part of the larger bundle of rights that protect these interests generally.

To begin with, an individual's interest in his own human capital is protected by a strong inalienability rule. Although a person may be incarcerated if duly convicted of a felony, and thus in that way deprived of the free use of his own human capital, he may not be imprisoned as a means to compel him to work or collect an ordinary civil debt, he may not be sold into slavery, and he may not himself voluntarily alienate his human capital through indentured servitude or peonage.[604]

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[604] *See* Clyatt v. U.S., 197 U.S. 207, 215 (1907) (defining "peonage" as "a status or condition of compulsory service, based on indebtedness" and observing that it is proscribed by the Thirteenth Amendment); Bailey v. Alabama, 219 U.S. 219, 241 (1911) (stating that the Thirteenth Amendment is "a charter of universal civil freedom for all persons" and that its purpose is "to render impossible any state of bondage; to make labor free, by prohibiting that control by which the personal service of one man is disposed of or coerced for another's benefit, which is the essence of involuntary servitude"); The Civil Rights Cases, 109 U.S. 3, 20 (1883) (the Thirteenth Amendment is "an absolute declaration that slavery or involuntary servitude shall not exist in any part of the United States"). During the colonial era, imprisonment for debt was a common debt-collection practice borrowed from England. *See* COLEMAN, DEBTORS, *supra* note 258 at 9 (noting

An individual's interest in his own human capital is also protected by a strong property right. For example, anyone who wishes to make use of an individual's human capital by hiring his labor must pay him for his services in a transaction in which the individual has the right to decline if he does not like the price. In addition, minimum wage laws and the like assist the individual by ensuring that he does not rent out his human capital too cheaply.[605]

Finally, an individual's interest in his own human capital is protected by a variety of liability rules. For example, an employer's failure to pay an employee his wages for the labor he has performed is, in most instances, a crime.[606] Laborers likewise benefit from a variety of legal rules designed to compensate them for harm to their ability to work or otherwise engage in productive activities. These include a variety of tort laws

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the common practice of imprisonment for debt during the colonial era). The first State to abolish the practice was Kentucky, which did so by statute in 1821. By the time Massachusetts abolished the practice in 1857 (other than in cases of fraud), most other states had done so. In 1839, Congress abolished the practice in federal courts sitting in states that had also abandoned it. *See* WARREN, BANKRUPTCY HISTORY, *supra* note 370 at 52 (discussing the gradual abolition of the practice of imprisonment for debt in the United States during the nineteenth century); Edwards v. Kearzy, 96 U.S. 595, 602 (1877) (observing that imprisonment for debt "is a relic of ancient barbarism" and that "[e]very right-minded man must rejoice when such a blot is removed from the statute-book"). As noted previously, Warren estimates that, at late as 1833, 75,000 persons annually were sent to jail for debt in the United States. *See id*. at 52 n.8; *supra* note 371.

[605] *See, e.g.*, David Neumark & William Wascher, *Minimum Wage and Low-Wage Workers: How Well Does Reality Match the Rhetoric*, 92 MINN. L. REV. 1296 (2008) (discussing state and federal minimum-wage laws, beginning with the first such law enacted in Massachusetts in 1912).

[606] *See, e.g.*, Massachusetts v. Morash, 490 U.S. 107, 109-110 (1989) (discussing state wage-collection statutes and citing laws from 48 states). Under New York law, the ten largest shareholders of a closely-held corporation may be liable for unpaid wages and benefits. *See* N.Y. BUS. CORP. LAW § 630 (McKinney 1983).

and tort-law substitutes designed to compensate individuals for injury to their productive capabilities.[607]

Regardless of whether these rules are individually efficient, they reflect exceptionally strong societal preferences for certain distributional arrangements that express cherished principles of distributional justice. Although one might imagine a society that did not place such emphasis on individual autonomy, integrity, and self-direction, our society plainly valorizes these fundamental concepts. Unsurprisingly, they find both expression and protection in a variety of legal structures, including the discharge features of bankruptcy law.

Regardless of exactly how or when normative values enter into the picture in the creation, application, and evaluation of rules of law, they inevitably do. In this regard, we ask a lot of law because our collective understanding of its normative underpinnings is bound to be varied and disputed in many respects. It may well be that, in our individual conceptions of justice and morality, something is either just and moral or it is not, but justice and morality are themselves highly contested concepts. In the meantime, problems need to be addressed. Law is always something of an uncomfortable compromise between (1) our disparate ideals of justice and morality, including concepts

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[607] *See, e.g.*, Price V. Fishback & Shawn E. Kantor, *The Adoption of Workers' Compensation in the United States, 1900-1930*, 41 J.L. & ECON. 305 (1998) (discussing the origins and rationales of workers' compensation statutes in the United States); *see also* RICHARD A. EPSTEIN, TORTS *xxx* (1999) [hereinafter EPSTEIN, TORTS] (arguing that, "at its core," tort law fundamentally protects an individual's "right to use and dispose of his own labor and the further right to exclude others from the use of their property" and is based on the "bedrock proposition" that "each person owns his or her own body and has the exclusive right to use his or her talents as he or she sees fit," which concept he refers to as the "basic autonomy assumption" of tort law); *see generally* JULES L. COLEMAN, RISKS AND WRONGS 326 (1992) (discussing how rights protect particularly important legitimate interests).

of distributive justice, and (2) our demands for expediency in addressing the circumstances of the here and now.

This is not to say that law is hopelessly indeterminate any more than it is to say that we are. As Scott Shapiro suggests, law includes a process that actually settles things in the form of rules that permit us to engage in social planning,[608] even if only temporarily. But because law derives from us in such fundamental and closely connected ways, it cannot be purely instrumental unless we are prepared to say that *we* are purely instrumental. And if we are not purely instrumental (and, by extension, neither is the law), then both we and it must have some inherent value and it becomes impossible to conclude that there are a great many among us who are inherently worthless as a matter of legal status. Perhaps more than any other, bankruptcy law expresses that value in the way in which it preserves and protects through its discharge mechanisms an individual's interest in his own human capital.

In any event, as a matter of law and legal tradition, an individual debtor's interest in his own human capital is clearly of exceptional importance. The remaining questions become (1) how the problems of debt-forgiveness impact this interest, and (2) how this interest is affected by bankruptcy law's solutions to these debt-forgiveness problems. To the extent an individual debtor's interest in his human capital is impaired by a particular problem of insolvency, and a particular solution has the effect of lessening that impairment, then the solution would be beneficial from the perspective of entitlement analysis.

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[608] *See* SHAPIRO, LEGALITY, *supra* note 37 at 177.

An insolvent debtor's incentives to engage in wasteful debt-collection avoidance activities, such as delay, deception, and inappropriate risk taking, and likewise the productivity-depressant factor that arises from an insolvent debtor having to devote the fruits of his labor exclusively to the satisfaction of his debts, all burden a debtor's human capital in ways that fundamentally impair its value, and likewise by extension the principles of individual autonomy, integrity, and self-direction that underlie the rights that protect it. Conversely, the bankruptcy remedy of discharge obviously relieves this burden and promotes these principles. Accordingly, from the perspective of entitlement analysis, the remedy is beneficial as compared to outcomes under non-bankruptcy law systems.

In contrast with an individual debtor's interest in his own human capital, the debtor's interest in the property he possesses is not typically protected by an inalienability rule. In general, property is freely transferrable from one person to the next, but there are important exceptions. For example, some forms of property essentially "substitute" for an individual debtor's human capital and the debtor's interest in these forms may also be protected by an inalienability rule. In particular, if the debtor is disabled or of an advanced age, he may not be able to rely on his own labor to maintain self-supporting autonomy. In such circumstances, the debtor's interest in such things as pension benefits, insurance or other disability payments, and social security income may constitute the equivalent of wages the debtor might otherwise have earned through the employment of his human capital. At law, the debtor's interests in these types of

property are characteristically placed beyond the reach of creditors.[609] In addition, a debtor may also have an interest in certain other items of personal property that creditors may not reach under the laws of the particular state where the debtor lives.[610]

Although as a general matter an individual debtor's interest in much of the property he may possess may not be protected by inalienability rules (other than the special kinds of property noted above), his interest typically will be protected by a variety of property rules. As a consequence, anyone wishing to purchase an item must pay him an agreed price. Similarly, the debtor's interest in the property he possesses will characteristically be protected by a variety of liability rules. If someone damages his property, they may be called upon to account for the harm they have caused and compensate the debtor as a result.[611]

These interests in physical assets are less protected than an individual debtor's interest in his own human capital. Nonetheless they are valuable, and the relevant questions become (1) how the problems of debt-forgiveness impact the debtor's interest, and (2) how this interest is affected by bankruptcy law's solutions to these problems. An

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[609] *See, e.g.*, 42 U.S.C. §§ 407, 1383 (1983 & Supp. 1991) (exempting social security benefits from seizure by creditors); 38 U.S.C. § 3101 (1979 & Supp. 1991) (exempting veterans' benefits from seizure by creditors); Patricia E. Dilley, *Hidden in Plain View: The Pension Shield Against Creditors*, 74 IND. L.J. 355 (1999) (discussing laws that protect pension rights from creditors); Daniel L. Skoler, *The Status and Protection of Social Security Benefits in Bankruptcy Cases*, 67 AM. BANKR. L.J. 585 (1993) (discussing the protected status of social security benefits).

[610] *See, e.g.*, Stephen G. Gilles, *The Judgment-Proof Society*, 63 WASH. & LEE L. REV. 603, 630-32 (2006) (discussing and citing examples of state exemption laws); *see also* Lea Shepard, *Creditors' Contempt*, 2011 BRIG. YOUNG U.L. REV. 1509, 1536-38 [hereinafter Shepard, *Contempt*] (discussing various state exemption laws and the ways in which creditors may coerce debtors into forfeiting their exemption rights).

[611] *See, e.g.*, EPSTEIN, TORTS, *supra* note 607 at *xxx* (observing as one of the functions of tort law how it protects a person's interest in property).

insolvent debtor's incentives to engage in wasteful debt-collection avoidance activities, such as delay, deception, and inappropriate risk taking, and likewise the productivity-depressant factor, all burden a debtor's interest in the property he possesses by undermining his decision making over their productive use and by otherwise impairing their value. Conversely, the bankruptcy remedy of discharge obviously relieves this burden, as does bankruptcy law's exemption provisions.[612] Accordingly, from the perspective of entitlement analysis, these remedies are also beneficial. Similarly, bankruptcy law's procedures for disencumbering stagnating physical assets are also beneficial because they also empower productive decision making over the use of these assets.

There is, of course, more to be said about this analysis. In particular, bankruptcy law could do more to improve the value of the debtor's entitlements, including expanding its discharge and exemption mechanisms. But as discussed above and taken up again below in the context of examining further how best to prioritize bankruptcy law's various debt-collection, debt-forgiveness, and debt-adjustment functions, enhancing the value of

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[612] *See supra* at 32-34 (discussing bankruptcy law's discharge and exemption features); *see also* Rousey v. Jacoway, 544 U.S. 320 (2005) (explaining that funds in an individual retirement account are exempt under the Bankruptcy Code and considering the purposes of the exemption provisions); Lawrence R. Ahern, III, *Homestead and Other Exemptions under the Bankruptcy Abuse Prevention and Consumer Protection Act: An Observation on 'Asset Protection' After 2005*, 13 AM. BANKR. L. REV. 585 (2005) (discussing exemptions in bankruptcy). Although non-bankruptcy law typically supplies significant exemption protections, the recognition and enforcement of the debtor's exemption rights outside of bankruptcy is often difficult and sporadic, owing in part to the debtor's frequent unfamiliarity with his rights and relevant debt-collection procedures (in comparison with creditors' general familiarity with the relevant rights and procedures). As a result, exemption rights are frequently overlooked or forfeited inadvertently. *See* Shepard, *Contempt*, *supra* note 610 at 1522-38 (discussing this problem). By streamlining the process and enforcing more systematically the debtor's exemption rights, bankruptcy law offers greater protection for these rights.

the debtor's entitlements is not the only consideration. At this point, however, it is sufficient to conclude that, from an entitlement perspective, the outcomes that bankruptcy law's debt-forgiveness mechanisms generate are generally beneficial in resolving the debt-forgiveness problems of insolvency as compared to outcomes generated under non-bankruptcy systems.

RESOLVING THE PROBLEMS OF DEBT ADJUSTMENT

Of the various problems of insolvency discussed in Chapter 2, two fall into the debt-adjustment category: (1) claims mediation, and (2) payment discrimination. These are each properly debt-adjustment problems that correlate to debt-adjustment solutions because, once the bailout-insurance and automatic-debt-cancellation options are eliminated, these problems are subject to amelioration only through the application of some form of debt-adjustment mechanism.[613] Correspondingly, they are not debt-collection problems because they cannot be resolved by resort to devices designed simply to enforce the creditors' claims in some way.[614] Likewise, they are not problems of debt forgiveness because, so long as bankruptcy law recognizes some kind of claims-enforcement procedure, they cannot be resolved by debt-forgiveness solutions, such as by granting the debtor a discharge or permitting the debtor to retain exempt assets. Having

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[613] *See supra* at 206, 208 (discussing the bailout-insurance and automatic-debt-cancellation options). Although the automatic-debt-cancellation option would resolve the problem of claims mediation, as noted previously, it would not resolve the payment discrimination problem. In fact, it would likely make it worse as creditors scrambled for payment before the remedy took effect. *See supra* at 209.

[614] So long as the debtor cannot pay all claims in full, tinkering with the debt-collection devices that creditors may use to enforce their claims in bankruptcy will not eliminate the need for some kind of mechanism to prioritize the various conflicting obligations and will not address the problem of the debtor's preferred payment to some creditors over others.

categorized these two problems, the question becomes: how might bankruptcy law beneficially resolve them?

As discussed in Chapter 2, the problem of claims mediation arises in the insolvency context by virtue of the debtor's inability to satisfy all claims in full. Some mechanism is needed to sort and prioritize the conflicting obligations. One far-fetched solution might be that, after a debtor files for bankruptcy, claims would be prioritized on a first-come, first-served basis—we may call this the "race-to-the-courthouse" approach. Specifically, the first creditor to appear in bankruptcy court and file a claim would be paid first, the second creditor to appear and file would be paid second, and so on, until there was nothing left to distribute. This kind of approach, however, would only exacerbate the other problems of insolvency. For example, creditors anxious about recovering their claims would be even more likely to attempt to rip the debtor apart at the first sign of trouble, generating even more frenetic and precipitous debt-collection free-for-alls. They would also likely increase their monitoring activities so that, once the debtor files for bankruptcy, they could rush to be the first to file a claim, even though their increased monitoring activity to detect the debtor's bankruptcy filing would likely simply add to the problem of deadweight monitoring expenses. This solution would also be susceptible to unfair manipulation in the form of the debtor tipping off a favored creditor, perhaps in exchange for some form of illicit accommodation. A less drastic solution to the problem of claims mediation would be for the law to adopt a general

share-and-share-alike approach, with provision for some form of priority for certain kinds of debts, such as secured claims. This is what bankruptcy law actually does.[615]

As also discussed in Chapter 2, insolvent debtors tend to engage in payment discrimination in the form of paying some creditors ahead of others before they file for bankruptcy. One potential solution to this problem might be that, once a debtor began defaulting on his obligations, the payment of all claims would be banned until the debtor commenced a bankruptcy case. Thereafter, payments to creditors would be made only in accordance with bankruptcy law's distribution scheme—we may call this the "no-payment-til-Christmas" option. This kind of solution, however, would also be unworkable. Among other things, triggering the ban based on the debtor's default would often be too drastic. Many debtors default and then recover without any real need for bankruptcy relief. In addition, without the ability to pay at least some claims following default, such as those of employees and necessary suppliers in the case of firms, the debtor would not be able to continue to operate. Further, the insolvent debtor would likely take advantage of the ban to gamble with his assets and engage in other wasteful activities. A less drastic solution to the problem of payment discrimination would be to discourage insolvent debtors and their creditors from engaging in preferential payment transactions by providing that, if the debtor files for bankruptcy within a certain amount of time after they are made, the payments may be recovered and redistributed through the bankruptcy process. Once again, that is the remedy that bankruptcy law actually

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[615] *See supra* notes 75, 247, 258 (discussing the debt-adjustment mechanisms of bankruptcy law that provide for general equality of distribution with exceptions for certain categories of claims).

supplies.[616] The question becomes: are these remedies to the problems of claims mediation and payment discrimination beneficial?

Once more, the answer would seem to be yes—at least from the perspective of resolving the debt-adjustment problems of insolvency. At the same time, of course, adjusting the collection rights of creditors must inevitably conflict with the creditor's individual collection interests, but we may postpone considering that conflict until after we have examined as a threshold matter whether bankruptcy law's debt-adjustment devices are desirable in their own right in response to the debt-adjustment problems of insolvency. It turns out that they are, but in order to help understand why, we may again revisit the evaluative standards of equity, efficiency, and entitlement.

EQUITY AND RELATIVE PAYMENT PRIORITIES

The use of equitable devices to resolve the debt-adjustment problems of claims mediation and payment discrimination is consistent with the principle of restraint that "equity follows the law."[617] Like the other problems of insolvency, they arise in connection with the operation of ordinary debt-collection mechanisms for which those mechanisms lack an adequate response because it would be counterproductive to burden them with special procedures needed only in the insolvency setting. In addition, the problems of claims mediation and payment discrimination readily correlate to several specific equity norms, including the equality norm that "equality is equity."[618]

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[616] *See supra* notes 158, 260 (discussing the debt-adjustment mechanisms of bankruptcy law that provide for the avoidance and recovery of preferential payments).

[617] *See supra* at 234-35 (discussing the principle of restraint).

[618] *See supra* at 235-36 (discussing the norm of "equality is equity").

Historically, equity recognized a particular form of distributional relief in cases involving the administration of insolvent estates premised on the filing of a creditors' bill seeking the equal treatment of claims. As Story explained, "[b]ills of this sort have been allowed upon the mere principle that, as executors and administrators have vast powers of preference at law, Courts of Equity ought, upon the principle that equality is equity, to interpose upon the application of any creditor by such bill to secure a distribution of the assets without preference to any one or more creditors."[619] In other words, the bill was designed specifically to prevent unwarranted preferences—the unjustified payment of some creditors ahead of others. But regardless of equity's preference for "equality is equity," the practice in early ecclesiastical administration was not one of strict equality. Moreover, although the early English bankruptcy statutes championed the equality norm, bankruptcy procedure, like procedure in administration generally, eventually evolved to incorporate a system of priorities that reflects a richer and more complex equitable landscape.

As Richard Helmholz has explained, although the general distributional rule in the ecclesiastic administration of insolvent decedents' estates in early modern England was that of "a ratable award, called a *rata bonorum* or *defalctio*," the reality was that "not all creditors were invariably treated alike."[620] For example, the expenses of administering the estate, including the court's fees, the costs of calling together the creditors, the making of an inventory of the debtor's assets, and the decedent's funeral expenses, were

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[619] 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 558.

[620] Helmholz, *Bankruptcy and Probate*, *supra* note 460 at 425-26.

typically paid ahead of other claims.[621] Similarly, debts evidenced by a writing of some kind were preferred over those without any such "specialty."[622] Moreover, sometimes the widow's portion of her husband's estate would be given priority over the claims of creditors, and sometimes the claim of the decedent's landlord would be preferred.[623]

In its own way, equity also came to recognize the general priority of liens and other charges upon collateral. Applying the principle of restraint, Story observed that "[i]n the course of the administration of assets[,] Courts of Equity follow the same rules in regard to legal assets which are adopted by Courts of Law" and thus "recognize and enforce all antecedent liens, claims, and charges, in rem, existing upon the property, according to their priorities, whether these charges are of a legal or of an equitable nature, and whether the assets are legal or equitable."[624] On the other hand, with respect to "equitable assets" not liable for specific charges, a court of equity would "regard all debts in conscience as equal . . . and equally entitled to be paid; and here they follow their own favorite maxim that equality is equity" such that "if the funds fall short, all the creditors are required to abate in proportion."[625] Significantly, courts applied this concept in the

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[621] *See id*. at 424.

[622] *See id*. at 423. In the fifteenth and sixteenth centuries, most debts were informal in nature and not memorialized in a written instrument of some kind, such as a formal bond or a note. Debts that were reduced to a formal writing were referred to as debts with "specialty." *See* MULDREW, ECONOMY, *supra* note 371 at 60-69, 95-98, 103-19 (explaining the informal nature of most credit arrangements during the early modern period and the limited use of "specialty" to evidence indebtedness in the case of formal instruments such as sealed bonds and the like).

[623] Helmholz, *Bankruptcy and Probate*, *supra* note 460 at 424-25.

[624] 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 567.

[625] *Id*.

administration context to reconcile the competing claims of the creditors, but not as between the creditors and legatees. For the latter kind of interest, equity came to recognize a variant of the principle of absolute priority: creditors were entitled to be paid ahead of legatees because, consistent with the just/generous principle, the creditors "have a priority right to satisfaction out of the assets" that must in equity come ahead of the interests of the beneficiaries of the debtor's largesse.[626]

Adopting a robust version of the equality maxim, the first English bankruptcy statute, the Act of 1542, provided for a pro-rata distribution to creditors "rate and rate alike according to the quantity of their debts."[627] Likewise, the second bankruptcy statute, the Act of 1570, also provided for a similar "rate and rate alike" distributional scheme.[628] In 1584, Edward Coke elaborated the equitable nature of this distributional scheme in *The Case of Bankrupts*, in which a debtor transferred goods to a particular preferred creditor at the expense of others after bankruptcy had ensued.[629] The court observed that the purpose of the Act of 1570 "was to relieve the creditors of the bankrupt equally, and that there should be an equal and rateable proportion observed in the

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[626] *Id*. at 99; s*ee also id*. at 568 ("After some struggle in the Courts of Equity upon this point, it is at length settled, that although as between themselves in regard to equitable assets the creditors are all equal, and are to share in proportion pari passu, yet as between them and legatees the creditors are entitled to a priority and preference, and that legatees are to take nothing until the debts are all paid."). As noted, this adheres to the just/generous principle. *See id*. at 569 ("The ground of this decision is that it is the duty of every man to be just before he is generous; and no one can well doubt the moral obligation of every man to provide for the payment all his debts."); *see also supra* notes 119 (discussing the concept of absolute priority in bankruptcy), 460 (discussing the just/generous principle).

[627] Bankruptcy Act, 1542, 34 & 35 Hen. 8, c. 4, § 1 (Eng.).

[628] Bankruptcy Act, 1570, 13 Eliz. c. 7, § 2 (Eng.).

[629] 76 Eng. Rep. 458; 2 Co. Rep. 25a (K.B. 1584).

distribution of the bankrupt's goods against the creditors."[630] Applying this concept, the court invalidated the preferential transfer as against the bankrupt's commissioners, by reason that if a bankrupt debtor "may prefer one (who per adventure hath least need) and defeat and defraud many other poor men of their true debts, it would be unequal and unconscionable, and a great defect in the law . . . if the law should credit him to make distribution of his goods to whom he pleased . . . ."[631]

It is worth emphasizing that the court objected to the preferential transfer on the theory that, if the debtor could favor one creditor over others in this way, this might well result in the payment of a creditor who "hath least need." As we shall see, this concept is important, but also must be placed in context. The Bankruptcy Act of 1570 applied only to merchant traders during an era in which, as discussed previously, credit markets were fragile and the failure of one merchant could easily spell disaster for others who depended on the debtor's payment of his debts in order to pay their own.[632] The major creditors of a merchant trader were likely to be other merchant traders, and generally all of relatively equal "need" for some recovery to help settle their own accounts, particularly during times of economic constraint when bankruptcy was especially likely to occur. In this sense, the Act of 1570 supplied a debt-collection mechanism to help keep other merchants afloat, and the concept of "need" as used in *The Case of Bankrupts* should be understood in context to refer to the interests of other merchants seeking to avoid their own failure.

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[630] *Id.*, 76 Eng. Rep. at 465-467; 2 Co. Rep. at 26a.

[631] *Id*. at 473.

[632] *See supra* at 218-19; *supra* notes 409, 411, 458, 581.

The subsequent English Bankruptcy Act of 1623 took this concept much further, providing that, even though a creditor held a debt evidenced by some form of specialty or secured by some kind of attachment or lien, the creditor was entitled to no greater share of the debtor's estate than others unless the creditor had actually executed on his lien or attachment prior to the debtor's bankruptcy and thereby obtained possession of his collateral.[633] Likewise, through the Act's "reputed ownership clause," the law also avoided non-possessory interests in the debtor's property, such as unexecuted liens and the like, permitting the commissioners to sell the property free and clear of such interests.[634] Once again, the basic idea embedded in these provisions was to maintain equality of distribution.[635] Subsequently, in *Worseley v. Demattos*, William Mansfield

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[633] Bankruptcy Act, 1623, 21 Jac. 1, c. 19, § 8 (Eng.).

[634] *Id.* § 10. A "non-possessory" interest refers to the interest of a creditor that does not have possession of the relevant collateral, such as an unexecuted attachment or judgment lien.

[635] Hostility toward non-possessory interests appeared with a particular vengeance in the decision of the Court of Star Chamber in Twyne's Case, 76 Eng. Rep. 809; 3 Co. Rep. 80b (Star Ch. 1601), in which a creditor sought a judgment to enforce a claim against the assets of the debtor, Pierce, that has been transferred previously to another creditor, Twyne. Prior to the suit, Twyne and Pierce had negotiated an absolute deed of gift to Twyne of all of Pierce's goods in return for the cancellation of Pierce's indebtedness to Twyne. Under their arrangement, however, Twyne permitted Pierce to retain possession of his sheep, which represented the majority of Pierce's assets. Pierce sold some of the sheep, sheared some, and marked them with his mark, suggesting to the world that he still owned them notwithstanding the deed of gift. When the sheriff tried to seize the sheep to satisfy Pierce's obligation to the first creditor, Twyne (through his agents) resisted the sheriff by force, claiming he actually owned the sheep. The court concluded that Twyne's deed of gift constituted a fraud because, among other things, Pierce retained possession of the sheep even though the deed of gift imposed no conditions qualifying Twyne's ostensible ownership. In other words, Twyne was convicted of criminal fraud essentially because the transaction documents did not evidence the actual arrangement between the parties. *See id.*, 76 Eng. Rep. at 810-813; 3 Co. Rep. at 81a-81b. Notably, because Pierce actually owed a debt to Twyne, Pierce's transfer of his sheep in satisfaction of the debt was not technically a fraudulent conveyance, but rather a preference. *See* Clark, *Duties*, *supra* note 336 at 513 (making this point). What appeared

applied this principle in voiding the transfer of an insolvent debtor's assets made with intent to defeat equality of distribution, reasoning in particular that the debtor's preferential intent would be inferred where (1) the transaction took place close in time to a traditional "act of bankruptcy" (such as defaulting and then fleeing to parts unknown), and (2) the transaction encumbered most or all of the debtor's assets in favor of a particular creditor.[636]

In the United States, the same concept of equality of distribution, and likewise a profound distaste for preferences, found their way into the Bankruptcy Act of 1800, which like its English predecessors also applied only to merchant traders.[637] First, the Act provided expressly for the recovery and redistribution of the debtor's preferential payments made after the debtor became bankrupt.[638] Second, it provided generally for ratable distribution to creditors based on the same concept of equality of distribution that animated the earlier English statutes, also ignoring non-possessory interests in the debtor's property arising from unexecuted attachments and the like.[639] On the other

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to particularly offend the court was the secret nature of the transaction. The court commented that those seeking to undertake a transaction of the kind must make it "in a public manner, and before the neighbours, and not in private, for secrecy is a mark of fraud." *Twyne's Case*, 76 Eng. Rep. at 814; 3 Co. Rep. at 80a.

[636] 96 Eng. Rep. 1160, 1168; 2 Keny. 218, 238 (K.B. 1758); *see also id.* 96 Eng. Rep. at 1165; 2 Keny. at 231 ("There is a great difference between conveyances of all, and of part only[.] [T]he latter may be public, fair and honest . . . but a conveyance of all must be either fraudulent . . . or an immediate bankruptcy must ensue.").

[637] *See supra* note 581.

[638] *See* Bankruptcy Act of 1800, ch. 19, § 28, 2 Stat. 19 (1800) (repealed 1803).

[639] *See id*., §§ 27, 29, 30, 31 (section 27 followed the "reputed ownership" clause of the prior English statute; section 29 provided for an interim dividend to be paid to creditors "in proportion to their several and respective debts"; section 30 provided for a second and final distribution, also on a pro rata basis; and section 31 directed pro rata distribution

hand, the Act of 1800 also set up three types of priorities permitting certain claims to be paid ahead of others, specifically (1) debts owed to the United States,[640] (2) debts owed to any of the States,[641] and (3) the administrative expenses of the commissioners who supervised the process and the assignees responsible for liquidating the debtor's property.[642] In addition, the Act provided for the non-impairment of liens on the debtor's real estate or chattels if those liens were "existing at the date of this act."[643] Liens arising after the date of enactment, however, were disregarded and the claims of creditors holding them were subject to the provisions directing pro rata distributions—an early form of "lien-stripping."[644]

Subsequent U.S. Bankruptcy Acts expanded the preference provisions, and likewise added to the list of priorities, creating further exceptions to the concept of strict

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without regard to attachments and the like); *see* Harrison v. Sterry, 9 U.S. 289, 301 (1809) (explaining that "[b]y the bankrupt law of the United States, [the attaching creditors'] priority, as to the funds of the bankrupt, is lost" and that [t]hey can only claim a dividend with other creditors"); Harmon v. Jamesson, 11 F. Cas. 555 (C.C.D.C. 1806) (No. 6079) (avoiding attachment lien).

[640] *See id*., § 62. The Supreme Court has explained the rationale for this priority in the following terms: "[t]he importance of securing adequate revenues to discharge national obligations justifies the extraordinary priority accorded federal tax liens . . . ." United States v. Kimbell Foods, Inc., 440 U.S. 715, 734 (1979); *see* Barbara K. Morgan, *Should the Sovereign Be Paid First? A Comparative International Analysis of the Priority for Tax Claims*, 74 AM. BANKR. L.J. 461, 463 (2000) (discussing the priority for debts owed to the United States in the Act of 1800).

[641] *See* Bankruptcy Act of 1800, ch. 19, § 62, 2 Stat. 19 (1800) (repealed 1803).

[642] *See id.*, §§ 29, 46.

[643] *See id.*, § 63. This savings provision was added apparently out of concern for the Fifth Amendment's prohibition against uncompensated retrospective takings of property.

[644] *See supra* note 639. The concept of "lien-stripping" in bankruptcy refers to the removal of liens from collateral. *See* Dewsnup v. Timm, 502 U.S. 410 (1991) (discussing lien-stripping in bankruptcy).

equality of distribution. In particular, the Bankruptcy Act of 1841 provided expansively for the avoidance of any conveyance made by a debtor "in contemplation of bankruptcy and for the purpose of giving any creditor . . . any preference or priority over the general creditors," and stipulated further that any debtor making "such unlawful preferences . . . shall receive no discharge under the provisions of this act."[645] Transactions occurring more than two months prior to the debtor's bankruptcy, however, were excluded from avoidance, so long as the recipient had no notice of any act of bankruptcy by the debtor or knowledge of the debtor's intention to "take the benefit of this act."[646] Thus, for the first time, the Act of 1841 expressly extended the avoidance of preferences to the pre-bankruptcy period—previously the bankruptcy statutes had only expressly avoided post-bankruptcy preferences.

In turn, the Act of 1841 expanded the list of debts entitled to priority ahead of other claims to include (1) obligations owed to the United States, (2) debts owed to sureties of the debtor entitled to priority under other federal laws, and (3) wages due to persons who performed services for the debtor within six months prior to the debtor's bankruptcy, not exceeding twenty-five dollars in amount.[647] Notably, the Act was not

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[645] Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440 (1841) (repealed 1843); *see also* 32 & 33 Vict., ch. 71, § 92 (1869) (Eng.) (providing that any payment by a debtor to a creditor within three months of the bankruptcy "with a view of giving such creditor a preference over the other creditors shall . . . be . . . void as against the trustee of the bankrupt").

[646] Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440 (1841) (repealed 1843).

[647] *See id*., § 5; *see also* C. Scott Pryor, *The Missing Piece of the Puzzle: Perspectives on the Wage Priority in Bankruptcy*, 16 AM. BANKR. INST. L. REV. 121, 127-28 (2008) (discussing the addition of the wage priority in the Act of 1841). The priority for debts owed to sureties was apparently to induce sureties to continue to bond various individuals liable to the United States for such things as the collection and remittance of customs duties and the like.

limited to merchant traders, but applied more broadly to all kinds of individual debtors (with some limitations).[648] In addition, the Act introduced for the first time the idea of a debtor's voluntary bankruptcy filing—bankruptcy relief previously had been available only on an involuntary basis through the filing of a petition by creditors.[649] Given the expanded class of debtors eligible for bankruptcy relief, and the prospect that a debtor might file for bankruptcy to avoid certain kinds of obligations, the Act's distribution scheme could no longer focus exclusively on equality of distribution to facilitate loss-sharing among the commercial creditors of merchant traders. Instead, it established a new tradition of distinguishing and prioritizing different kinds of claims based on differences in the circumstances of the claimants—in essence, their relative "needs."

The current Bankruptcy Code likewise provides for the avoidance and recovery of preferential payments.[650] It also prescribes a list of priorities that is considerably broader than under the Act of 1841.[651] In particular, the Code provides for the priority treatment of (1) most secured claims, (2) unpaid domestic support obligations, (3) administrative

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[648] *See supra* note 581. Some persons were excluded from becoming a bankrupt under the Act, such as those who owed debts as a result of defalcation as a public officer. *See* Bankruptcy Act of 1841, ch. 9, § 1, 5 Stat. 440 (1841) (repealed 1843).

[649] *See id.*

[650] *See* 11 U.S.C. §§ 547 (2000 & Supp. 2006) (providing for the avoidance of certain preferential payments), 550 (2000 & Supp. 2006) (providing for the recovery of preferential payments); Central Virginia Comm. College v. Katz, 546 U.S. 356, 372 (2006) (discussing the history of the preference provisions of the Bankruptcy Code); Union Bank v. Wolas, 502 U.S. 151, 154-55 (1991) (discussing preference law); Begier v. IRS, 496 U.S. 53, 58 (1990) (same); *see also* Countryman, *Concept*, *supra* note 258 at 714-25 (discussing the history of preference law); *see also* Bankruptcy Act of 1898 (as amended by the Chandler Act), ch. 575, § 60(b), 52 Stat. 870 (providing for the avoidance of preferential payments).

[651] *See, e.g.,* 11 U.S.C. §§ 507 (2000 & Supp. 2006), 725 (2000 & Supp. 2006), 726 (2000 & Supp. 2006).

expenses, (4) certain wage and benefit claims, (5) certain contribution obligations to employee benefit plans, (6) certain claims of farmers against debtors operating certain storage or processing facilities, (7) certain consumer deposit claims, (8) certain taxes, (9) certain capital-maintenance claims asserted by federal depository institutions, and (10) certain tort claims arising from the debtor's operation of a motor vehicle or other vessel while intoxicated.[652] The larger question becomes: from the perspective of equity, are these priority and preference-avoidance provisions beneficial?

Consistent with the principle of restraint—equity follows the law—the Code's statutory priority for secured claims aligns with the general practice in traditional equitable administration that equity will respect the priority of enforceable liens and other encumbrances. As Story explained, the equality norm comes into play only *after* legally valid liens and other encumbrances are accounted for, at least with respect to specifically encumbered collateral.[653] The basic idea is that legally enforceable liens and other encumbrances have a usefulness outside the insolvency setting, and legal regulation modifying their priority in bankruptcy, or eliminating them altogether, is a step equity should take only with the greatest reluctance and caution.[654]

On the issue of administrative expenses, equity has long recognized the priority for the necessary costs incurred in running an administration, and bankruptcy law has

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[652] *See id.* §§ 507, 725, 726.

[653] *See supra* at 305-06; *see also* Chemical Bank New York Trust Co. v. Kheel, 369 F.2d 845, 848 (2d Cir. 1966) (Friendly, J., concurring) ("Equality among creditors who have lawfully bargained for different treatment is not equity but its opposite").

[654] *See also* JACKSON, LOGIC, *supra* note 8 at 59-65 (arguing that eliminating a secured creditor's priority in bankruptcy would create a variety of undesirable problems).

likewise long adopted the same concept.[655] If a priority for administrative expenses were not recognized, no one would be willing to take on the assignment of gathering, liquidating, and distributing the debtor's assets.[656] The payment of administrative expenses is thus a necessary and unavoidable cost of the process itself.

Turning to the priority for certain governmental claims, it is the sovereign that makes the process of bankruptcy relief available, and thus facilitates the benefits that bankruptcy law confers. In this light, it would hardly seem inequitable for the sovereign to prefer the payment of its own claims in order to enjoy at least some of the benefits of its own procedures. This at least helps explain the priority of tax obligations, and likewise the priority for certain capital-maintenance claims asserted by a federal depository institution that the government typically insures.[657]

With respect to the Code's other basic priorities, as suggested above, each involves a type of claim that carries with it a certain kind of "need" in the general sense of vulnerability to financial loss as recognized implicitly in *The Case of Bankrupts*. As noted, the impetus behind the Act of 1570 that the court construed in that case was the protection of the collective interests of the creditors of bankrupt merchant traders, who were typically merchant traders themselves. During the sixteenth century, hard currency was scarce, and there were no established banks of the kind that exist today, no insurance companies, and no other similar financial institutions that could stabilize and facilitate

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[655] *See, e.g.*, 11 U.S.C. §§ 503 (2000 & Supp. 2006), 507 (2000 & Supp. 2006).

[656] *See, e.g.*, JACKSON, LOGIC, *supra* note 8 at 153 (observing that the "rationale for administrative expense priority derives from the realities of getting suppliers (and others) to deal with an insolvent enterprise").

[657] *See also supra* note 640 (discussing the government's priority for obligations owed to it).

credit or the diversification of commercial risk. Creditors large and small were vulnerable in relatively equal measure. Failure was also common and distributed among all classes of society.[658] In such a setting, strict equality of distribution among a relatively homogeneous group of creditors was understandably thought to be equitable in response to their collective "need."

In contrast, with the expansion of eligibility for bankruptcy relief in the Act of 1841, together with the emergence of a vastly different economic system, the concept of "need" in the sense of vulnerability to financial loss had a fundamentally different meaning. Many financial creditors of the era could and did take advantage of a variety of commercial strategies designed to diversify their risk taking. By definition, however, many other creditors could not, including employees who are characteristically unable to hedge against their employer's potential default by simultaneously pursuing multiple forms of employment. Hence the priority for wage claims in the 1841 Act and likewise the current Code.

Even more so than laborers, dependents holding claims for unpaid domestic support obligations are also particularly vulnerable: they cannot readily diversify their exposure to the risk of the debtor's nonpayment. Just as the ecclesiastic procedure in administration proceedings might prefer the claim of the widow to her settlement from the decedent's estate over the claims of unpaid creditors, bankruptcy law today grants priority for unpaid alimony and child support liabilities. The remaining basic Code priorities recited above are of a similar character.

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[658] *See supra* note 411.

A particular priority worth special mention is the one for certain tort claims arising from the debtor's operation of a motor vehicle or other vessel while intoxicated. The priority bears special comment not only for its inclusion on the statutory list, but also because it highlights the absence from the same list of tort liabilities generally. From an equitable perspective, the explanation lies in the concept of "marshalling" and the availability of insurance as an alternative means of recovery.

In equity, the doctrine of marshalling permits a court to direct a claimant with two potential sources of recovery—one exclusive to the claimant and the other common with other claimants—to look first to the exclusive source.[659] In the case of tort claims generally, the debtor's available liability insurance often represents an exclusive fund to satisfy the claims of the debtor's tort victims, but not other kinds of obligations. In the special case of a debtor's tort liability for operating a vehicle or vessel while intoxicated, however, the debtor may not have insurance. In enacting the priority, Congress may well have had reason to fear that debtors who engage in such reckless conduct will fail to maintain appropriate coverage, or that it might not be available at all. Because the victims of these kinds of torts are particularly vulnerable, they are protected by the Bankruptcy Code's priority regime.

As formulated, the Bankruptcy Code's system of priorities cannot be expected to work perfectly in all cases. For example, in any given matter, a debtor's liability insurance may be woefully inadequate to pay the claims of all general tort creditors,

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[659] *See* 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 570. As Story explained, "where there exist two or more funds, and there are several claimants against them, and at law one of the parties may resort to either fund for its satisfaction, but the others can come upon only one, there Courts of Equity exercise the authority to marshal (as it is called) the funds, and by this means enable the parties whose remedy at law is confined to one fund only to receive due satisfaction." *Id*.

either because their claims exceed the available coverage or insurance is otherwise unavailable. Yet there is no general priority to protect them in the absence of insurance. The priority scheme is based on general assumptions regarding the typical case, and there is always the possibility that the scheme could be improved through more rigorous calibration. This perhaps suggests the possibility of permitting judges who administer the Code some leeway in applying its priority provisions. One historic weakness of traditional mechanisms of equity, however, is that they have tended to vest too much discretion in the judges applying them, giving some cause to Selden's famous criticism.[660] The cure in bankruptcy has been to codify the relevant equitable principles to make their application more certain and predictable and, correspondingly, less arbitrary.[661] Doing so must inevitably sacrifice the kind of flexibility that might otherwise generate results that are more closely tailored to fit the circumstances. This concern aside, however, the priorities of bankruptcy would seem to be generally beneficial from an equitable perspective in addressing the problem of claims mediation.

This leaves the question of the desirability of the Code's preference provisions as a means to address the problem of payment discriminations. Like the rules governing the avoidance and recovery of fraudulent transfers, the preference rules must distinguish different factual situations to avoid inequitable outcomes. For example, it is one thing for preference law to avoid and recover a preferential transfer between an insolvent firm and one of its creditors made shortly before the firm filed for bankruptcy where (1) the manager of the firm responsible for making the payment also personally guaranteed the

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[660] *See generally supra* note 453.

[661] *See supra* at 232.

firm's obligation to the creditor, (2) the creditor hounded the manager to make the transfer, and (3) the manager did so to avoid personal liability under his guaranty. Under such circumstances, the creditor should hardly be heard to complain of any inequity in having to disgorge the payment so that the funds might be distributed more equitably among the firm's other creditors, including perhaps the victims of its torts.[662]

On the other hand, it would be another thing for preference law to avoid a preferential transfer between an insolvent individual and one of his creditors where (1)

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[662] *See supra* at 130-31 (discussing this kind of situation). It is sometimes argued that there is a virtue in permitting an insolvent firm making a preferential payment to stay afloat. *See* Schwartz, *Normative Theory*, *supra* note 9 at 1230 (arguing that assuring the payment of preexisting unsecured debts through a preferential transfer may be beneficial "so that financially distressed firms could borrow more easily"); *supra* note3 253, 256 (discussing Schwartz's argument). A similar argument was made by the debtor's lawyers in Harman v. Fishar, 98 Eng. Rep. 998; 1 Cowp. 117 (K.B. 1774). Before absconding, the debtor in Harman instructed his agent to prefer one creditor out of gratitude and loyalty. In the subsequent suit, William Mansfield (1705-1793) held the transfer void. Mansfield established the principle that, in order to be a preference, the debtor was required to have had the intent to prefer the particular creditor for some inappropriate reason, such as merely to defeat the claims of other creditors. Thus, where the creditor actually pressed for payment, and the debtor obliged, the payment would not be wrongful and therefore not preferential. In Mansfield's words, "if a creditor threatens legal diligence, and there is no collusion, or begins to sue a debtor, and he makes an assignment of part of his goods, it is a fair transaction . . . ." Alderson v. Temple, 96 Eng. Rep. 384, 385 (K.B. 1768). In Harman, the debtor's conduct was wrongful because he intended to prefer one creditor over others out of personal affection and loyalty, rather than commercial necessity. *See also* Fidgeon v. Sharpe, 128 Eng. Rep. 800; 5 Taunt. 539 (K.B. 1814) (no preference where the debtors did not intend to commit a fraud on the bankruptcy process). Mansfield's conception of a preference was rejected in the United States, and the chief architect for its repudiation was Joseph Story. *See* Arnold v. Maynard, 1 F. Cas. 1181 (C.C.D. Mass. 1842) (No. 561) (reasoning that, so long as the debtor knew he was insolvent when he paid the creditor, the law would infer the preferential intent). The U.S. Supreme Court subsequently adopted Story's approach. *See* Toof v. Martin, 80 U.S. (13 Wall.) 40, 48 (1871) ("The transfer, in any case, by a debtor, of a large portion of his property, while he is insolvent, to one creditor, without making provision for an equal distribution of its proceeds to all his creditors, necessarily operates as a preference to him, and must be taken as conclusive evidence that a preference was intended, unless the debtor can show that he was at the time ignorant of his insolvency").

the debtor made the payment on time in the ordinary course just as he had in prior years, (2) the creditor exerted no unusual pressure on the debtor to obtain the payment, and (3) the creditor was not even aware that the debtor was in any kind of financial straits. Unsurprisingly, preference law generally provides for the recovery of the transfer in the first scenario outlined above, but not in the second.[663]

As one court has observed, the general purposes of the preference provisions are twofold: "to discourage creditors from racing to the courthouse to dismember the debtor during its slide into bankruptcy and to further the prime bankruptcy policy of equal distribution among similarly situated creditors."[664] But there is another, deeper purpose also at work here. By discouraging preferences that a debtor might make as part of his plan to avoid debt-collection activities (e.g., appeasing creditors by stringing them along with just enough payments to keep himself afloat), bankruptcy law encourages deeply insolvent obligors to seek bankruptcy relief sooner rather than later. In other words, preference law helps with the initiation problem by discouraging creditors from seeking and accepting out-of-the-ordinary course payments that play along with the insolvent debtor's game.[665] As noted previously, insolvent debtors (including firms) tend to wait

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[663] *See, e.g.*, Charles J. Tabb, *Panglossian Preference Paradigm?*, 5 AM. BANKR. L. REV. 407, 410, 412 (1997) [hereinafter Tabb, *Panglossian*] (observing that "[f]or centuries, a creditor who simply got paid for an outstanding debt did nothing wrong, and in the interest of repose and justice, was allowed to keep the payment" and that "[t]he idea that only abnormal prebankruptcy grabs should be avoidable, entrenched for several hundred years, apparently is here to stay").

[664] In re Bullion Reserve of North America, 836 F.2d 1214, 1217 (9th Cir. 1988); *see also* Union Bank v. Wolas, 502 U.S. 151, 154-55 (1991) (discussing the policies of the preference law).

[665] *See supra* at 87-90 (discussing the initiation problem). This was Senator Daniel Webster's point in 1840 made during the debates prior to the passage of the Bankruptcy Act of 1841. He complained that "[w]e hear daily of honorary debts, and we hear

far too long to file for bankruptcy relief.[666] By discouraging unusual payment and debt-collection activities on the part of insolvent debtors and their creditors, preference law prompts resort to earlier relief to avoid and remediate the problems of insolvency more efficaciously.

As the foregoing suggests, preference law is not an end unto itself. It descends from the statutory prohibition against the making of post-bankruptcy transfers that violate the equality norm as extended into the immediate pre-bankruptcy period, during which time insolvent debtors are likely to engage in all kinds of wasteful machinations to avoid the inevitable, including making preferential payments to hounding creditors who nonetheless play along for their own advantage. By discouraging these kinds of transactions, preference law encourages resort to the bankruptcy process as part of a larger, highly-calibrated system that aims to make bankruptcy attractive enough so that it can be effective in addressing the problems of insolvency, but not so attractive that it generates significantly deleterious *ex ante* effects.

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reproaches against those who, being insolvent, have yet pushed on, in the hope of retrieving their affairs, until, when failure does come . . . they have not enough left to discharge these honorary obligations. Now, at the bottom of all this is preference. The preference of one creditor to another, both debts being honest, is allowed by the general rules of law; but it is not allowed by bankrupt laws." CONG. GLOBE, 26th Cong., 1st Sess. 814 (1840). One scholar has argued, however, that the sanctions that bankruptcy law imposes for the payment and acceptance of preferential payments are not significant enough to deter the debtor from making them. *See* John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 263-65 (1981). But as discussed above, this criticism seems to miss the larger point of preference law as part of a complex and coordinated response to the problems of insolvency. Preference law should not be viewed in isolation. It generates merely one of several different kinds of incentives designed to facilitate effective resolution of the problems of insolvency. Thus, although preference law by itself may not be sufficient to deter the debtor from preferring one creditor over another, the real question is whether, in combination with the other features of bankruptcy law, it is helpful in ameliorating the problems of insolvency.

[666] *See supra* at 87-90, 144-45; *supra* note 275.

Certainly there are other complexities and challenges in connection with the formulation and application of preference law. We need not, however, resolve all of these at this juncture to conclude that, from the general perspective of equity, bankruptcy law's solutions to the problems of claims mediation and payment discrimination are generally beneficial as compared to outcomes under non-bankruptcy law. Of course, this should come as no great surprise given that the relevant equitable concepts that these solutions embody are essentially internal to bankruptcy law itself.

EFFICIENCY AND PAYMENT PRIORITIZATION

Once again: although the debt-adjustment features of bankruptcy law may be equitable, are they also efficient? Once more, the answer is generally yes. The problems that the debt-adjustment features of bankruptcy law address—namely, claims mediation and payment discrimination—are unavoidable challenges that arise as a consequence of a debtor's insolvency owing to the reality that not all claims may be paid in full and losses must be allocated in some way. As explained above, bankruptcy law responds to this challenge with remedies that (1) prioritize claims in certain ways and (2) avoid and recover certain transfers so these may be redistributed in accordance with bankruptcy law's priority scheme. The question becomes: from an efficiency standpoint, are these distributional remedies worth having? The answer is that the debt-adjustment mechanisms of bankruptcy law are beneficial so long as the costs of these mechanisms are less than the costs they avoid, and it seems generally true that this requirement is satisfied.

From the perspective of efficiency, the key virtue of bankruptcy law's system of priorities is that it seeks to channel losses toward creditors who are the cheapest avoiders

of the problems of insolvency, and away from creditors who are poor loss spreaders.[667] The key benefit of placing a loss on the cheapest cost avoider is that it creates an incentive to avoid the loss on the party best suited to do so.[668] It likewise helps prevent someone responsible in some way for a loss from "externalizing" the costs onto someone else who is not.[669] In addition, one of the key benefits of loss spreading is that it helps those who must bear a particular loss to avoid their own bankruptcies.[670] On the whole, bankruptcy law's debt-adjustment mechanisms take beneficial advantage of these principles.

In turn, the key virtues of bankruptcy law's preference rules are that, by avoiding and recovering preferential transfers for distribution in accordance with bankruptcy's system of payment priorities, these rules promote the process of channeling losses toward creditors who are the cheapest cost avoiders and away from those who are poor loss

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[667] *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW 4.1, 4.5 (2d ed. 1977) (arguing that, in order to facilitate an efficient allocation of resources, contract law should place the risk of loss arising from some event on the party best able to protect against the loss); Guido Calabresi & Jon T. Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L.J. 1055, 1060 (1972) (in the context of conducting a "cost-benefit analysis," it is necessary to make "a decision as to which of the parties to the accident is in the best position to make the cost-benefit analysis between accident costs and accident avoidance costs and to act on that decision once it is made"); *see also* Guido Calabresi, *Concerning Cause and the Law of Torts: an Essay for Harry Kalven, Jr.*, 43 U. CHI. L. REV. 69, 73-76 (1975) [hereinafter Calabresi, *Concerning Cause*] (discussing loss spreading).

[668] *See* Ronen Perry, *Relational Economic Loss: An Integrated Economic Justification for the Exclusionary Rule*, 56 RUTG. L. REV. 711, 745 (2004) (discussing how "[t]ort law provides incentives for behavioral change that may reduce the loss of social welfare caused by human interactions").

[669] *See* CALABRESI, COSTS, *supra* note 53 at 73-74 (discussing this function of accident law).

[670] *See* Calabresi, *Concerning Cause*, *supra* note 667 at 75 (observing that limiting damages through calibrated proximate cause evaluations is linked to lessening the burden on a potentially liable party "in order to avoid being bankrupt by a large liability").

spreaders. They also generally help avoid certain of the other problems of insolvency, such as the debtor's incentives to engage in wasteful debt-collection avoidance activities and the creditors' incentives to engage in debt-collection free-for-alls, by discouraging unusual debt-collection efforts and encouraging resort to bankruptcy relief. Certainly preference law is not perfect, and likewise generates costs of its own in terms of its administration and other effects.[671] Nonetheless, it appears on balance to be efficient.

In particular, bankruptcy law seeks to lessen the costs of its several debt-adjustment remedies in two significant ways: (1) by prioritizing secured claims to preserve their non-bankruptcy utility and avoid having bankruptcy relief become a means to ignore otherwise beneficial liens, and (2) by calibrating its preference rules to avoid the potentially negative *ex ante* effects associated with an overly invasive preference law. On balance, these limits appear to be generally adequate. This does not mean, of course, that bankruptcy law's debt-adjustment devices cannot be improved. It simply means that, from an efficiency standpoint, they generate beneficial results when compared to outcomes under non-bankruptcy regimes.[672]

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[671] *See, e.g.*, Tabb, *Panglossian*, *supra* note 663 at 410 (offering some criticisms and suggestions for reform).

[672] As noted previously, the desirability of recognizing the priority of secured claims in bankruptcy is highly contested. *See, e.g.*, Bebchuk & Fried, *Uneasy Case*, *supra* note 210 at 921-26 (1996) (arguing that permitting secured creditors fully priority in bankruptcy may be inefficient in some cases and offering a proposal for reform); LoPucki, *Unsecured*, *supra* note 210 at 1920-24 (challenging the efficiency of the secured creditor's priority); Jackson & Schwartz, *Vacuum*, *supra* note 238 (arguing that the efficiency of security interests has not been demonstrated); White, *Efficiency*, *supra* note 238 (arguing that security interests are generally efficient); Schwartz, *Continuing Puzzle*, *supra* note 238 (disputing White's account); Vern Countryman, *Code Security Interests in Bankruptcy*, 75 COM. L.J. 269 (1970) (criticizing the secured creditor's priority in bankruptcy); *see also* Warren, *Making Policy*, *supra* note 210 at 1379-83 (arguing for the reformation of Article 9 and the treatment of a secured creditor's priority); Klee, *Barbarians*, *supra* note 210 at 1467 (arguing that the case for full priority

The cheapest cost avoiders of the problems of insolvency typically include in significant measure a debtor's financial creditors. Because of the Antonio problem and other biases and deficiencies in the planning capabilities of debtors, financial creditors are often in a much better position to prevent over-spending because of their often superior ability to evaluate how much indebtedness their potential obligors can actually handle. As noted previously, the reasons for this include (1) that creditors do not characteristically suffer from the Antonio problem in extending credit; (2) they frequently deal with large volumes of repeat transactions and therefore acquire a comparatively superior experience in evaluating credit risk; and (3) they have access to sophisticated predictive models, information, and other underwriting tools to assist them in making credit decisions.[673] Nonetheless, many financial creditors routinely increase their debtors' risk of insolvency, or deepen their debtors' already existing insolvent states, by offering credit they know (or should know) their debtors cannot tolerate without materially enhanced risk of failure, and likewise on terms that often accelerate serious financial crisis upon default. A credit card company that issues credit indiscriminately and charges a standard interest rate of eighteen percent—and then on top of that stipulates a default interest rate of thirty-percent or more—not only frequently imperils from the outset the financial health of many of its borrowers, but also exacerbates the problems of

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remains unproven); *supra* notes 210,238 (citing other criticisms and defenses). But given that the secured lending market represents a multi-trillion-dollar juggernaut, it seems unlikely that security interests and mortgage liens will be eliminated as structural financing options in the near term.

[673] *See supra* at 221.

insolvency when trouble comes.[674] To be sure, debtors play a vitally cooperative role in incurring these kinds of obligations, for which they bear some of the blame. But in addressing the problem of claims mediation, the question is whether *other* creditors—such as the debtor's employees or tort victims—should pay for this, or whether the loss should be channeled toward creditors who are more likely to be complicit in the debtor's downfall and in a better position to help avoid it through more provident lending practices. In other words, the question becomes: should the debtor's non-financial creditors bear the externalized cost of the poor lending practices of certain of the debtor's financial creditors?

Because financial creditors are often the cheapest cost avoiders, it is efficient for bankruptcy law to prioritize the claims of non-financial creditors, such as certain tort victims, employees, taxing authorities, and dependents to whom the debtor owes

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[674] As a partial means of avoiding the impact of excessive rates of interest in the bankruptcy setting, bankruptcy law characteristically provides that the accrual of interest generally ceases upon the debtor's commencement of a bankruptcy case. *See, e.g.*, Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 160, 163 (1946) (observing that "[a] purpose of bankruptcy is to administer an estate as to bring about a ratable distribution of assets among the bankrupt's creditors" and that "[t]he general rule in bankruptcy and in equity receivership has been that interest on the debtor's obligations ceases to accrue at the beginning of the proceedings"). Historically, the continued accrual of interest in bankruptcy was thought to be a form of penalty and was prohibited as inequitable because creditors asserting higher rates that continued to accrue would thereby hold larger and larger claims, and receive greater dividends in bankruptcy, at the expense of other creditors. In addition, the prohibition avoided "the administrative inconvenience of continuous recomputation of interest causing recomputation of claims." *Id*. at 163-64. A statutory exception is made for certain "over-secured" claims, meaning claims secured by collateral that has a value in excess of the amount of the debt owed to the secured party. *See* 11 U.S.C. § 506(b) (2000 & Supp. 2006); Craig H. Averch, et al., *The Right of Oversecured Creditors to Default Rates of Interest from a Debtor in Bankruptcy*, 47 BUS LAW. 961 (1992) (discussing the right of an over-secured creditor to recover interest on its claim in bankruptcy); Walter J. Blum, *Treatment of Interest on Debtor Obligations in Reorganizations under the Bankruptcy Code*, 50 U. CHI. L. REV. 430 (1983) (discussing the treatment of interest rates in business reorganization cases).

domestic support obligations. In addition, some of the reasons for prioritizing these claims align with the arguments in favor of granting the debtor a discharge, including that prioritization may (1) help certain individual creditors compensate for the risks associated with their inability to diversify their own investment of their human capital (e.g., employees who are typically unable to take on multiple jobs simultaneously to hedge against a loss of wages); (2) lessen dependence on other forms of public assistance that may be less efficient, such as welfare benefits; and (3) help safeguard the interests of those who may rely on the debtor for their support and well-being.[675]

But what if the debtor's financial creditors are secured? As discussed below in the context of the relative entitlements of secured and unsecured claims, the virtue of most secured lending is that it is typically offered on terms that are much cheaper than unsecured credit, and therefore relatively favorable to the debtor and less likely to foment financial ruin. This generalization, however, is not universally true, and it may well be that some forms of secured lending should be scrutinized rigorously in bankruptcy and excepted from the general rule that favors the priority of secured claims. In the typical case, however, secured claims will not fall into this suspect category.

In sum, when evaluated from the perspective of efficiency, bankruptcy law's debt-adjustment solutions in the form of its special procedures that prioritize claims and avoid and recover preferential transfers appear to be wealth-enhancing solutions to the problems of claims mediation and payment discrimination. Bankruptcy law's debt-adjustment mechanisms are generally efficient because they are specifically designed to address these problems without generating offsetting costs that are greater than the costs

[675] *See* JACKSON, LOGIC, *supra* note 8 at 225-52 (making these arguments in favor of the debtor's discharge); *supra* at 291-92.

they avoid. Once again, there may be specific challenges that arise in applying these devices in specific settings that undermine their efficiency and perhaps require some degree of operational refinement and qualification. But we need not resolve the details of all of these issues in order to conclude that bankruptcy's debt-adjustment mechanisms outlined above are generally desirable from an efficiency standpoint.

ENTITLEMENT AND THE PRIORITY OF PAYMENT RIGHTS

Because all creditors hold legally valid entitlements in the form of their respective claims against the debtor and the debtor's property, crafting and applying the debt-adjustment mechanisms of bankruptcy law entail an unavoidable clash of interests. In sorting out the relative priority of these interests from an entitlement perspective, the question becomes: who has the greater rights? As noted previously, to be a person is not only to have rights, but also to have legal responsibilities,[676] and in prioritizing rights we may consider not only the nature of the interests they protect, but also the manner in which they are used (or abused).

In general, a creditor's interest in recovering a debt will be protected by a package of rights that will typically include an assortment of property and liability rules, and it may also be protected by an inalienability rule in some cases. In turn, certain interests are more protected at law than others, such as the interests of creditors holding claims for wages, domestic support obligations, and tax liabilities.[677] We may gather from this that, on the whole, those who possess such highly protected interests have greater rights that

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[676] *See* KAHN, REIGN, *supra* note 222 at 35 ("[t]o be a person is to have legal rights and responsibilities").

[677] *See supra* at 312-13, *infra* at 339-40 (discussing these claims and the ways in which they are protected).

should be respected in any priority scheme in bankruptcy. After all, regardless of whether doing so would be efficient, these creditors have strong claims as a matter of basic principles of distributive justice.[678] In this sense, it is unsurprising that the current Bankruptcy Code includes on its list of priorities claims of this kind.

But what of secured claims? For example, it is hard to argue that secured claims are more important than, say, domestic support obligations—at least from a perspective of distributive justice. Yet bankruptcy law affords secured claims a higher priority, at least with respect to the secured party's collateral. How is this consistent with the relative importance of the interests at stake?

In equity, non-possessory encumbrances on collateral such as liens, attachments, and the like, were not treated as property *per se*. As Story explained, "[a] lien . . . is not, strictly speaking, . . . a property in the thing itself, nor does it constitute a right of action for the thing."[679] Rather, a lien "more properly constitutes a charge upon the thing."[680] There are, of course, many ways to impose a "charge" upon a debtor's property, including through the imposition of judicial liens obtained in the process of execution. In this way, virtually any debt can ripen into a secured claim. It is all only a matter of timing, and bankruptcy law has traditionally eschewed preferring creditors on a first-come, first-served basis. But there is more to the analysis.

In general, secured creditors pay for their priority by charging reduced rates of interest, and some scholars have contended that protecting their priority is not only their

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[678] *See* Calabresi & Melamed, *Property Rules*, *supra* note 5 at 1098-1101 (discussing the assignment of rights based on principles of distributive justice).

[679] 2 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 554.

[680] *Id.*

just desserts, but also confers significant micro- and macroeconomic benefits. For example, Homer Kripke has offered an interpretative historical analysis making such claims. To begin with, he has explained that advances in manufacturing following the Industrial Revolution gave rise to the widespread availability of relatively expensive durable goods, such as cars, appliances, and the like, and a corresponding need for purchasers to pay for them over time:

> [a] decision to purchase such goods involves a commitment to purchase several years of satisfactions in advance. For example, purchase of an automobile may be compared to the purchase of a bus ticket good for five years, or the purchase of a washing machine may be likened to contracting for a person's laundry service for five years. There would be relatively few instances in which a buyer could afford to buy this long-lasting package of satisfactions at once. The installment payment contract is a device for permitting the user to pay for the satisfactions more closely to when they are realized.[681]

Kripke observed, however, that, for a variety of reasons, most consumer debtors are relatively bad credit risks:

> [i]n the case of consumer credit, the consumer is seldom a good balance-sheet risk. Her principal assets are household goods, which would be almost worthless on an execution sale and in many states are exempt from execution sale except in purchase money situations. The consumer's principal other 'asset' is her job. One can check on the existence and duration of the job by telephone, but this gives no assurance that the job will continue. The lender places additional reliance on the salvage value of the goods sold subject to the security interest.[682]

One way to compensate for the risk of the purchaser's default would be for the seller or lender who financed the purchaser's acquisition of the goods to charge a relatively high rate of interest. Kripke maintained, however, that doing so encounters at least three problems. First, it increases the transaction costs for the buyer, making the

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[681] Kripke, *Law*, *supra* note 238 at 941.

[682] *Id*. at 947.

purchase much more expensive, often prohibitively so: "[t]here are limits to the amount of interest that a debtor can pay before a loan arrangement becomes impractical both for financial reasons and for legal reasons such as usury laws."[683] Second, it is costly to set a rate that appropriately compensates the lender for the risk of default associated with any particular debtor because of the amount of information and analysis required in the underwriting process: "passing credit in the absence of security would be a time-consuming and expensive job."[684] Third, in the absence of security, the time it would take to underwrite the extension of credit would delay the transaction: "Our enormous manufacturing system for equipment and consumer goods depends on a distribution system that permits rapid sales on credit at the point of distribution without extended delays involved in the passing of credit and incidental legal matters."[685] By using cheap and certain forms of security devices, such as a lien on the item to secure the purchaser's obligation to pay for it, the seller or lender could more easily make a rapid credit decision, reduce the parties' transaction costs, and charge a lower rate of interest:

> [t]he lender's risk is reduced by the taking of security. If the loan is properly structured with a down payment adequate to overcome the depreciation that occurs when a new object becomes used and to keep ahead of future wear and tear, the risks to the seller or lender on most items of durable goods will be relatively small, given the resale value that can be realized readily on repossession. This reduced risk is taken into account in determining whether to make the loan and in establishing the amount of the down payment, the length of the period of credit, and the extent of the credit investigation.[686]

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[683] *Id.* at 954-55.

[684] *Id.* at 947.

[685] *Id.* at 946.

[686] *Id.*

In conjunction with the rise of secured consumer debt financing of the kind described above, small businesses also found themselves in need of financing to facilitate their acquisitions of inventory—for example, the goods they sold to consumers on installment payment plans. According to Kripke, secured lending (or its economic equivalent) also facilitated this financing. For example, suppose an automobile dealer sold a car to a consumer under a five-year installment plan with the seller retaining a security interest in the car to secure the customer's payments under the plan. Under this arrangement, the customer typically would not finish paying for the car for five years. In order to purchase new inventory to replace the car he had sold, the dealer usually needed a way to convert the consumer's five-year installment contract into immediate dollars, and for this he basically had two options: (1) sell the customer's installment contract to a factor at a discount for cash (say, 95% of the face amount of the contract), or (2) borrow funds from a bank or finance company using the customer's installment contract as collateral.[687] Under either scenario, what made the installment contract attractive to the financing entity (either to purchase or to lend against) was the fact that it was secured by a lien on the automobile such that, if the customer defaulted, the car could be repossessed and sold to cover the unpaid debt.

For large businesses, secured lending also facilitated an expansion of the distribution of goods. Kripke observed that, as a general rule of discretion, "[a] manufacturing company should appropriately borrow not more than thirty-five to fifty percent of its capitalization."[688] Accepted leverage ratios, however, are much higher for

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[687] *Id*. at 944.

[688] *Id*. at 945.

certain kinds of assets, particularly accounts: "[b]y segregating the [accounts] into a separate subsidiary, thus giving lenders the first claim to them, manufacturers can obtain vastly greater sums."[689] Once again, according to Kripke, secured lending supported the growth of the durable goods distribution system by making more capital available to fuel its expansion.

Kripke observed that all of this depended on the willingness of those with capital in the marketplace to invest it in the ways described above.[690] Financial capital, Kripke argued, will go where it will: "it need not necessarily be engaged in loans to finance the distribution of goods" but rather "can be invested in the securities or commodities markets, used to develop real estate, or used to engage in any other business activity."[691] Kripke contended that, where capital is used "in financing the distribution of goods, lenders can largely dictate the terms to which both debtors (manufactures or dealers) and suppliers, who are the bulk of unsecured creditors, have to agree."[692] And, Kripke claimed, the terms the lenders often demanded included the provision of security.

For a number of reasons, scholars have contested whether Kripke's historical account demonstrates the efficiency of security interests,[693] but they do not generally contest the historical accuracy of the account itself. Kripke's argument supports the notion that secured creditors have particularly strong entitlements because recognizing

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[689] *Id.*

[690] *Id.* at 944.

[691] *Id.*

[692] *Id.*

[693] *See, e.g.*, Jackson & Schwartz, *Vacuum*, *supra* note 238 (arguing that Kripke has not shown the efficiency of security interests).

the rights they hold maximizes social welfare.[694] But what of the rights of other creditors who have strong claims in distributive justice, such as those holding domestic support obligations? Does economic efficiency in the form of wealth-maximization trump the concerns of social justice? Under traditional equity analysis, the just/generous principle would supply an answer, at least to the relative priority of domestic support obligations as compared to secured claims: "if a man indebted were allowed to divest himself of his property in favor of his wife or children, his creditors would be defrauded."[695] But this answer is unsatisfying, and the conflict is taken up again in further detail below in the discussion on prioritizing the various debt-collection, debt-forgiveness, and debt-adjustment remedies of bankruptcy law.

In the meantime, regardless of whether security interests and mortgage liens are efficient or their priority comports with principles of distributive justice, and irrespective of such concerns as whether the debtor's other creditors benefit from the lower interest rates that secured parties charge (thus perhaps justifying imposing some of the costs of secured credit on these other creditors), security interests and mortgage liens occupy a priority status from an entitlement perspective both inside and outside of bankruptcy. Of course, as noted previously, not all secured lenders pay for their priority by charging reduced rates of interest, and perhaps liens of this kind should be scrutinized more rigorously in bankruptcy and excepted from priority treatment. Overall, however, the priority treatment of secured claims would appear to be beneficial from an entitlement

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[694] *See* Calabresi & Melamed, *Property Rules, supra* note 5 at 1093-98 (discussing the assignment of rights based on efficiency considerations).

[695] 1 STORY'S EQUITY JURISPRUDENCE, *supra* note 444 at 363.

perspective, at least as compared to outcomes under non-bankruptcy regimes in which security interests are also given priority.

From an entitlement perspective, the preference law is also beneficial. As in the case of fraudulent conveyances, whenever a preferential transfer is avoided and recovered, two expectations are defeated in order to vindicate the creditor's recoveries: the expectation of the debtor that the transfer would be effective, and the similar expectation of the transferee of the preference. In the circumstances in which preferential transfers are characteristically avoided and recovered, however, the expectations of the debtor and the transferee tend to be normatively weak. For example, it is difficult to say that a creditor who extracts payment from an insolvent firm by threatening to sue the firm's manager on his personal guaranty has a particularly strong right to retain the payment it has extracted on the eve of bankruptcy. There are, of course, circumstances in which the normative merits of avoidance will be far less clear.[696] But once again, the necessity of drawing lines to distinguish preferential transfers that are properly avoidable from those that are not is inevitable. From the perspective of the creditors who receive enhanced recoveries in bankruptcy in accordance with their normatively superior priorities, and likewise to the extent that preference law has the effect of avoiding at least some of the problems of insolvency by encouraging debtors to file for bankruptcy sooner rather than later, the remedy appears to be ameliorative.

In sum, bankruptcy law's debt-adjustment solutions to the problems of claims mediation and payment discrimination would appear to be beneficial from the perspective

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[696] *See supra* at 317-19.

of entitlement analysis. Accordingly, entitlement analysis joins with equity and efficiency analysis in demonstrating the desirability of these solutions.

PRIORITIZING THE FUNCTIONS OF BANKRUPTCY LAW

The discussion so far has focused primarily on evaluating the individual merits of bankruptcy law's distinct debt-collection, debt-forgiveness, and debt-adjustment mechanisms in terms of whether each resolves in beneficial ways the various debt-collection, debt-forgiveness, and debt-adjustment problems of insolvency to which they correlate and respond. As we have seen, bankruptcy law's debt-collection solutions are generally beneficial in addressing the debt-collection problems of (1) deadweight collection and monitoring costs, (2) gratuitous transfers, and (3) debt-collection free-for-alls because bankruptcy's solutions make use of procedures that reduce or avoid the costs of these problems, such as mechanisms for the collectivization of enforcement activities, the more orderly disposition of the debtor's property, and the recovery of fraudulent transfers. In addition, although perhaps not perfect, these mechanisms incorporate generally adequate safeguards to reduce the costs of their own implementation, such as by limiting the reach of the fraudulent transfer provisions to avoid intruding unnecessarily on legitimate commercial expectations.

Similarly, bankruptcy law's debt-forgiveness solutions are generally beneficial in addressing the debt-forgiveness problems of (1) an insolvent debtor's incentives to engage in wasteful debt-collection-avoidance activities, such as delay, deception, and inappropriate risk taking, and (2) the waste associated with stagnating and overburdened assets, including an insolvent debtor's human capital, because these solutions, too, make use of procedures that reduce or avoid the costs of these problems, in particular

bankruptcy's discharge and exemption features. Moreover, although they also might be improved, these mechanisms likewise incorporate generally adequate limitations designed to reduce the costs of their implementation, such as by restricting the scope of discharge and exemption relief to avoid making bankruptcy an attractive nuisance.

Finally, bankruptcy law's debt-adjustment solutions are generally beneficial in addressing the debt-adjustment problems of (1) claims mediation, and (2) payment discrimination because these solutions likewise make use of procedures that reduce or avoid the costs of these problems, in particular bankruptcy's prioritization and preference provisions. Although these procedures are also imperfect, they nonetheless incorporate generally adequate limitations to reduce the costs of their implementation, such as by preserving the priority of secured claims and restricting the reach of the preference-avoidance provisions. On the whole, these various debt-collection, debt-forgiveness, and debt-adjustment solutions produce outcomes superior to those generated by non-bankruptcy systems—although again that hopefully should not be too surprising because that is what these solutions are for.

Putting aside the question of how well the different mechanisms of bankruptcy law address the particular problems of insolvency to which they correlate as compared to non-bankruptcy outcomes, the next challenge is to analyze more closely how these various mechanisms appropriately interrelate with each other as an organic whole—if for no other reason than to support (or undermine) the analysis so far. The consolidated deployment of bankruptcy law's debt-collection, debt-forgiveness, and debt-adjustment mechanisms engenders two major conflicts: (1) a creditor-versus-debtor conflict arising

between the solutions of debt-enforcement and debt-forgiveness, and (2) a creditor-versus-creditor conflict arising out of the prioritization of claims.

In evaluating these conflicts, equitable concepts take us only so far. The principle of restraint directs that legally enforceable obligations should be recognized and enforced in equity. But as we have seen, that is only the starting point. Even before Parliament effectively channeled bankruptcy procedures to available statutory mechanisms in 1623, the Privy Council supplied formidable equitable bankruptcy relief that had the effect of suspending, modifying, or reducing the petitioning debtor's obligations, depending on the case. Thereafter, bankruptcy law evolved to incorporate procedures that permitted a discharge of obligations. As noted previously, consideration of the relevant procedures from an equitable perspective helps illuminate the issues and norms that animate bankruptcy law. But equity is only of limited use in prioritizing these norms as a matter of internal relations. For example, the relevant maxims that steer its application often point in different directions and there is no overarching principle to instruct which maxim to select in a particular situation, requiring reliance instead on tradition, conscience, practical expediency, and legislative intervention.

Efficiency analysis can take us at least a bit further. As we have seen, it is generally efficient to provide an insolvent debtor with a discharge of most kinds of debts, as well as some modest amount of exempt property.[697] Doing so, however, necessarily and unavoidably competes with the creditors' interests in the enforcement of their claims. What is particularly relevant in evaluating this conflict from an efficiency perspective is that, in the insolvency setting, the benefits of enforcement are typically low, while the

[697] *See supra* at 286-92; *supra* notes 72, 73, 76, 334 (discussing the discharge and exemption features of bankruptcy law).

costs are typically high. [698] As a result, the unbridled enforcement of claims against insolvent debtors begins to look like merely a form of wealth transfer rather than an exercise in wealth-maximization.

This conclusion is bolstered considerably by the fact that debtors typically *pay* for the benefits of discharge and exemption relief, in part by the interest and other charges that creditors collect. When financial creditors and commercial sellers calculate the price of the credit they offer (whether in the form of a loan of funds or an agreement that goods sold may be paid for over time), they understand that at least some of their debtors will become insolvent and unable to pay their debts, and that some of these will, in turn, seek bankruptcy relief. As a result, these creditors build into their prices the anticipated costs associated with the uncollectability of some portion of their claims, and they thus effectively spread their losses in this way. Because in general these creditors do not know for sure who will default at some point in the future and be unable to pay, the additional charges they add to the price of credit can be thought of as a type of insurance—essentially a fund these creditors create for themselves to compensate for anticipated losses.[699] Because in this way debtors essentially pay for the benefits of discharge and exemption relief, it is generally efficient that they receive what they pay for.

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[698] *See supra* at 137-55, 162-74, 286-92.

[699] *See, e.g.*, Rasmussen, *Debtor's Choice*, *supra* note 9 at 82. As Robert Rasmussen has explained in the context of business reorganization proceedings, "[t]he less that creditors expect to receive in the event that a firm ends up in a bankruptcy proceeding, the more they will charge for the loan in the first instance by increasing the interest rate. Looked at in these terms, bankruptcy redistribution is a type of insurance . . . ." *Id*.; *see also* Jackson & Scott, *Nature of Bankruptcy*, *supra* note 23 at 168 (drawing the same analogy).

It is certainly true that the greater the number of debtors who file for bankruptcy relief, the more financial creditors will charge to cover their anticipated losses, thus increasing the costs of credit. But creditors have themselves to blame to the extent they lend indiscriminately or on terms that exacerbate the likelihood of default and insolvency. Correspondingly, to the extent bankruptcy law forces creditors to internalize the costs of improvident lending, this may result in more efficient extensions of credit and an overall reduction in prices. In addition, as discussed previously, it is unlikely that debtors will increase their risk taking based on the prospect of discharge and exemption relief in bankruptcy. So long as bankruptcy remains generally discouraging and debtors continue to underestimate their risk of default and insolvency (which seems likely), these forms of relief are unlikely to have much of an impact on general risk taking habits.[700]

Of course, not all creditors are able to spread their losses in this way. For example, those who hold claims for domestic support obligations are not generally able to diversify their risk of nonpayment across multiple domestic partners or collect interest and other charges from multiple sources to compensate for losses they may sustain. As a result, these creditors do not benefit from the kind of collection "insurance" that financial creditors may establish for themselves. Taking this into account, it should come as no surprise that domestic support obligations are excepted from discharge in bankruptcy.[701] Also excepted from discharge are a variety of other kinds of similarly situated claims, including those for (1) death or personal injury caused by the debtor's operation of a

[700] As Rasmussen has put it, there is a very large "copayment" required with a debtor's collection of bankruptcy "insurance" because the debtor bears a significant portion of the loss. Rasmussen, *Debtor's Choice*, *supra* note 9 at 114.

[701] *See* 11 U.S.C. § 523(a)(5) (2000 & Supp. 2006) (excepting from discharge "a domestic support obligation").

motor vehicle while intoxicated, (2) willful and malicious injury, and (3) a variety of intentional frauds.[702]

From an efficiency perspective, the debt-forgiveness mechanisms of bankruptcy law would appear to be more important as a general matter than its debt-collection devices, with the kinds of exceptions noted above for certain nondischargeable obligations. The relative efficiency, however, of enforcing domestic support obligations as compared to protecting an individual debtor's use of his own human capital (i.e., protecting his productive autonomy) is harder to evaluate. But that is because the value of these competing interest is inherently difficult to quantify for purposes of efficiency analysis.[703] As discussed below, however, entitlement analysis suggests that domestic support obligations are of exceptional importance, and sufficiently so to justify the burden on individual human capital.

But what of secured claims? In general, the priority of secured claims is recognized in bankruptcy, but a secured creditor may not hold a lien on an individual debtor's human capital. A secured creditor may only hold a lien on certain of the

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[702] *See, e.g.*, 11 U.S.C. §§ 523(a)(9) (2000 & Supp. 2006), 523(a)(6) (2000 & Supp. 2006), 523(a)(4) (2000 & Supp. 2006). Among other reasons, these types of claims also may not be covered by insurance. In addition, their avoidance would tend to trigger moral condemnation. As a general matter, in order for society at large to accept bankruptcy law as just, bankruptcy law must maintain a certain degree of sensitivity to the vindication of particularly compelling legal norms. *See* CALABRESI, COSTS, *supra* note 53 at 294-300 (offering a moral framework for evaluating accident law, including the extent to which it may offend general concepts of fairness). At the very least, to the extent bankruptcy law promotes outcomes that may be perceived as unjust on a comparative basis, its advocates must explain persuasively why these outcomes are justified for bankruptcy reasons.

[703] *See supra* at 242-48 (discussing some of the weaknesses of efficiency analysis).

debtor's personal and real property.[704] Although the secured creditor may retain its interest in the relevant property through bankrutpcy, the debtor's personal liability is generally discharged through bankruptcy law's debt-forgiveness mechanisms.[705]

Turning to the creditor-versus-creditor conflict that arises in the prioritization process, efficiency analysis once again supports channeling losses toward creditors who are the cheapest cost avoiders and away from those who are poor loss spreaders. Because unsecured financial creditors are typically cheap cost avoiders and good loss spreaders, while creditors holding domestic support obligations are neither, it makes sense that bankruptcy law would prioritize the latter over the former. Moreover, given that financial creditors may take advantage of a type of "insurance" that creditors holding claims for domestic support obligations do not usually have access to, this further supports elevating the latter's priority in bankruptcy.

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[704] Outside of bankruptcy, a creditor may in some jurisdictions obtain a writ of garnishment attaching an individual's wages—perhaps the nearest thing to a lien on human capital. There are various state and federal protections that limit the effect of garnishment in those jurisdictions that still permit it. *See, e.g.*, 15 U.S.C. § 1671, et seq. (setting forth federal garnishment restrictions); Long Island Trust Co. v. U.S. Postal Service, 647 F.2d 336 (2d Cir. 1981) (discussing statute and its purpose); Irwin M. Fletcher, *I Can't Have My Wages Garnished!*, 50 S. CAROLINA L. REV. 525 (1999) (discussing federal and other limits on garnishment). Once a debtor files for bankruptcy, garnishment typically does not reach wages earned after the commencement of the bankruptcy case. *See* 11 U.S.C. § 552(b); Local Loan Co. v. Hunt, 292 U.S. 234, 243-45 (1934); In re Mirando Soto, 667 F.2d 235, 237 (1st Cir. 1981) ("The question of whether a wage assignment gives rise to a continuing lien is well settled. The accepted rule is that the assignment of future wages as security for a present debt does not constitute a lien within the meaning of the Bankruptcy Code") (citing cases); In re Rumker, 184 B.R. 621, 627-28 (Bankr. S.D. Ga. 1995) (citing cases). Thereafter, if the underlying liability is discharged, the creditor cannot use garnishment to collect it. *See* Local Loan Co. v. Hunt, 292 U.S. 234, 243-45 (1934) (observing that garnishment is not available to recover discharged debt).

[705] *See* 11 U.S.C. § 524(a)(2) (2000 & Supp. 2006) (providing that a discharge in bankruptcy operates to relieve the debtor of personal liability for an obligation).

The analysis becomes more challenging, however, when the claims of financial creditors are secured. Because secured financial creditors are also much better cost avoiders and loss spreaders than creditors holding domestic support obligations, and likewise may benefit from a type of "insurance" funded by the interest they charge, this suggests that they, too, should be subordinated to domestic support obligations and similar claims. One problem with this idea, however, is that doing so might create a remedy susceptible to systemic manipulation and abuse.

For example, suppose a woman borrows funds on a secured basis to purchase a home and likewise borrows on a secured basis to purchase her car. Suppose also that the house and car are titled in her name. Suppose that the woman's husband loses his job and the couple fall far behind financially. If domestic support obligations had priority in bankruptcy over secured claims, the couple could divorce, enter into a settlement agreement requiring the wife to pay a large sum to the husband and then, after filing for bankruptcy, claim that the unpaid support obligations had priority over the mortgage and secured car loan. In other words, the couple might essentially manipulate the domestic support obligation priority to convert their equity status into a priority creditor position.

This concern aside, it must be conceded that there may well be situations in which it would be efficient to grant priority to some obligations over secured claims in bankruptcy. On the other hand, secured financing is a multi-trillion-dollar industry that arguably benefits society as a whole in a number of ways and tampering with the secured creditor's priority is something to be approached with caution.

From an entitlement perspective, the debt-forgiveness mechanisms of bankruptcy law would also appear to be more important as a general matter than its debt-collection

devices, again with the kinds of exceptions noted above for certain nondischargeable obligations. At this point, however, financial creditors (who have taken something of a beating so far) might interrupt and complain loudly that, as a matter of entitlement, (1) their rights to payment are not less important than those of any other creditor; (2) lending facilitates commerce, which provides significant benefits; and (3) a debtor's obligation to pay a financial debt is no less a duty than any other freely entered into. They might continue that, to the extent debtors are able to dishonor their obligations to financial creditors, this will tend to erode trust and confidence in commercial markets and only make financing more expensive, generating significant social costs. Such was certainly the view of Thomas Hobbes.

With his highly pessimistic view of human nature, Hobbes stated the arguments in favor of the enforcement of contracts in an extreme form, using the utility of vindicating the creditor's expectation of trust in extending credit as the central justification for his grand conception of social and political authority. The coercive power of the state, he contended, was needed to "compel men equally to the performance of their Covenants, by the terror of some punishment greater than the benefit they expect by the breach of their Covenant."[706]

In understanding Hobbes's argument, it is important to note that he distinguished "contract" from "covenant" in a manner uncharacteristic of modern usage. In Hobbes's conception, a "contract" typically involved a simultaneous exchange that did not require any meaningful extension of trust, such as the sale and immediate delivery of a tangible item for cash. In contrast, trust was central to the idea of a "covenant," which Hobbes

[706] THOMAS HOBBES, LEVIATHAN 202-03 (C.B. MacPherson ed. 1968) [hereinafter HOBBES, LEVIATHAN].

defined as "where there is a credit given either to one or both" based on an obligation or obligations yet to be performed in the future, such as a loan or an agreement for the sale of an item that required future payment, future delivery, or both.[707] Hobbes's view of a covenant is thus aligned with the modern conception of most kinds of executory contracts—those contemplating future performance of some kind at the time of contracting. In Hobbes's view, the terror of punishment was necessary to facilitate the kind of trust necessary for these contracts to be viable.[708]

For our purposes, Hobbes's view has a number of weaknesses. To begin with, in claiming that debtors and creditors need to be forced to trust each other, he offered a rather unusual notion of the concept of trust. As Immanuel Kant observed, one of the general challenges of living in modern society is dealing with its general climate of "unsocial sociability."[709] From this perspective, Hobbes's view on the need to coerce trust seems equivalent to the cynically humorous slogan: "the beatings will continue until morale improves." At least from a Kantian standpoint, the real issue is not how to compel "trust" any more than it is how to compel "love," but rather how best to deal with

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[707] THOMAS HOBBES, DE CIVE 126 (B. Gert ed. 1972); *see also* HOBBES, LEVIATHAN, *supra* note 706 at 193 (with a covenant, "he that is to performe in time to come, being trusted, his performance is called Keeping of Promise, or Faith").

[708] Hobbes (1588-1679) thus held a relatively uncompromising view of authority. His view was unpopular with many of his era precisely because he emphasized it at the expense of more cooperative models of sociability. *See supra* at 281; *supra* notes 409-11.

[709] Immanuel Kant, *Idea for a Universal History from a Cosmopolitan Point of View* (1784) reprinted in ON HISTORY 15 (L. Beck trans. 1963). Kant (1724-1804) argued that "[t]he character of the species, as is well known from the experience of all times and all nations, is as follows[: human beings] cannot be without peaceful coexistence, and yet they cannot avoid continuous disagreement with one another." IMMANUEL KANT, ANTHROPOLOGY FROM A PRAGMATIC POINT OF VIEW 249 (V. Dowdell trans. Illinois 1978).

the problems of unsociability that interfere significantly with productive social activities. In this sense, to the extent the lending practices of financial creditors contribute to the problems of insolvency, they should be discouraged, not promoted through coercive vindication in a context in which doing so would only exacerbate the costs of these practices.

More important, the concept of duty underlying contractual obligations is not monolithic. As Holmes explained, the law does not typically call upon the coercive power of the state to compel a debtor to perform a breached contractual promise. Rather, most civil obligations are properly understood to require either the performance of the relevant duty or, failing that, the payment of some monetary equivalent.[710] Some liabilities, of course, are sufficiently important that they are, in fact, backed rigorously by the coercive power of the state. These include domestic support obligations. Notably, although courts will not throw a debtor in jail for breaching an ordinary contract, they *will* throw a debtor in jail for failure to pay child support, which further supports the relative priority of this kind of liability in bankruptcy. But in general, most civil debts are simply reducible to money damages, and the ability to collect money damages from a debtor is typically freighted with many conditions, protections, obstacles, and restraints designed to preserve norms of social existence that compete with the creditor's interest in recovering a debt. Simply put, the Hobbesian perspective is not the law's perspective;

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[710] *See* HOLMES, COMMON LAW, *supra* note 5 at 236; *see also* Warren, *Bankruptcy Policy*, *supra* note 10 at 778 (making this point). An exception is the remedy of specific performance available in certain circumstances. *See* Schwartz, *Specific Performance*, *supra* note 335 at 275-78 (arguing that the difficulty in placing a value on certain obligations is one justification for the doctrine of specific performance).

the reality is far more complex and not beneficially susceptible in most cases to narrow, coercive resolution.

Even from an entitlement perspective that takes into account the importance of enforcing claims as a matter of corrective justice, the collection of claims must give way to solutions designed to address the problems of insolvency, including those of debt-forgiveness designed to vindicate important considerations of distributive justice, such as those that find expression in cherished principles of autonomy and self-direction.[711] Likewise, similar concerns underlie recognition of the greater "need" of some creditors over others in the prioritization of claims—again, a concept of distributive justice.[712] Ultimately, the beneficial allocation of scarce resources—including the assets of an insolvent debtor—is more important than the bare payment of claims. It requires sorting the claims to ensure that assets are allocated among claimants in the most beneficial way.

THE BANKRUPTCY MARKET

Up to this point, this chapter has been devoted to explaining the desirability of the various debt-collection, debt-forgiveness, and debt-adjustment mechanisms of bankruptcy law. Collectively, it seems fairly obvious that these mechanisms require coordination and administration. The initial question arises: for purposes of organizing them, what conceptual framework best captures an appropriate organizational structure?

As summarized in Chapter 1, the Bankruptcy Code coordinates bankruptcy law's various debt-collection, debt-forgiveness, and debt-adjustment devices by providing that, upon the commencement of a bankruptcy case, the debtor's property is vested in a special

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[711] *See supra* at 35 (discussing these competing considerations of corrective justice and distributive justice).

[712] *See id.*

bankruptcy estate; the claims of creditors are exchanged for equitable shares in the estate (and are sometimes traded in a unique distressed-debt submarket); most debt-collection activity is curtailed in favor of court-supervised oversight of the debtor's affairs; and the debtor's liabilities are thereafter sorted, altered, negotiated, and extinguished under the auspices of a special regulatory system that effectively supplants non-bankruptcy mechanisms.[713] As a positive matter, these various mechanisms work together in a way best described as a special "bankruptcy market" designed to address what is to be done with the person, property, and liabilities of insolvent debtors. In addition, the bankruptcy market is essentially "corrective" in nature because, as explored previously, its purpose is to remediate the problems of insolvency so that, among other goals, insolvent debtors and their property may once again return to, and participate fully in, ordinary non-bankruptcy markets unburdened by the waste, inefficiency, and distorted decision-making incentives that insolvency generates.

This particular conceptualization of bankruptcy law as creating a corrective market is also normatively vital because it best describes what bankruptcy law *should* be doing. Bankruptcy law should be functioning as a corrective market because, as a tool for resolving the problems of insolvency, only a corrective market is sophisticated enough to orchestrate all of the desirable functions of bankruptcy law. Settling on this

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[713] *See, e.g.,* 11 U.S.C. §§ 541 (2000 & Supp. 2006) (providing for the creation of a bankruptcy estate), 362 (2000 & Supp. 2006) (providing for the automatic stay), 501 (2000 & Supp. 2006) (permitting creditors to file proofs of claim), 502 (providing for the allowance and disallowance of claims), 510(c) (2000 & Supp. 2006) (providing for the equitable subordination of certain claims), 524(c) (2000 & Supp. 2006) (providing for reaffirmation), 727 (2000 & Supp. 2006) (providing for the discharge of claims in Chapter 7 cases), 1123(b) (2000 & Supp. 2006) (providing for the classification of claims in Chapter 11 cases in a plan of reorganization); *see also supra* notes 72-76, 171, 240-41, 244 (discussing these and other aspects of the bankruptcy process).

label, however, does not end the matter, and in fleshing out more precisely the beneficial contours of the bankruptcy market, a number of additional issues arise.

First, there is a question of access. Among other things, should solvent debtors be entitled to take advantage of the remedies of bankruptcy law? Second, there is a question of procedural economy. Which is more important: accuracy in resolving the various problems that bankruptcy law addresses, or speed? Third, if bankruptcy law makes use of courts, should they be traditional dispute-resolution courts or problem-solving courts? Fourth, in the case of an insolvent firm, what procedure should bankruptcy law recognize for determining whether the firm should be liquidated or reorganized? Finally, if the assets of a bankrupt firm are not to be sold, how should value be distributed among creditors where there are no cash proceeds from an actual sale? The details of the answers to these questions are important.[714] Although the list of questions explored here is not exhaustive, it is representative of those that are the most significant.

ACCESS

Because the purpose of bankruptcy law is to respond to the problems of *insolvency*, it seems rather obvious that bankruptcy relief should be limited to insolvent individuals, firms, and other kinds of debtors, such as municipalities. Bankruptcy relief is powerful medicine. Recognizing this, most judges unceremoniously eject solvent debtors from the bankruptcy forum, and this is entirely appropriate.[715]

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[714] In order to avoid outright rejection by society, bankruptcy law must, among other things, take care to avoid abuse of its mechanisms and likewise avoid procedures that offend general principles of responsibility, cause and effect, individualized treatment, and the like. *See* CALABRESI, COSTS, *supra* note 53 at 294-300 (arguing that any system of law must pay attention to such concerns if it is going to be accepted as fair).

[715] *See supra* note 105 (citing cases).

Bankruptcy law must also be scrupulous in avoiding the use of its procedures for fraudulent purposes and otherwise to prevent bankruptcy relief from sheltering abusive misconduct.[716] This does not mean, however, that our bankruptcy law should adopt extensive screening mechanisms that attempt routinely to scrutinize minutely the causes of a debtor's financial ruin. As the Supreme Court has noted, the "vast majority" of debtors who file for bankruptcy relief fit the "honest but unfortunate" paradigm.[717] Burdening the system with complicated tools of inquisition designed to ferret out such things as the moral dimensions of an insolvent debtor's financial downfall would be simply a waste of time. Moreover, except in cases of outright fraud or other egregious misconduct, it is often difficult (i.e., costly) to determine the causes of insolvency in any particular case.[718] This difficulty is often exacerbated in the context of insolvent firms. A firm's insolvency often presents a complex pattern of causation, and one might well ask whether the cost of the inquiry is worth the expense when the debtor's resources

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[716] *See* Bank of Marin v. England, 385 U.S. 99, 103 (1966) (bankruptcy law must be exercised in a way that avoids inequity); Pepper v. Litton, 308 U.S. 295, 304-05 (1939) (recognizing the responsibility of a bankruptcy court to exercise its jurisdiction so that "fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done").

[717] *See* Marrama v. Citizens Bank of Mass., 549 U.S. 365, 374 (2007) (observing that "[t]he class of honest but unfortunate debtors" who file for bankruptcy "includes the vast majority of the hundreds of thousands of individuals who file Chapter 7 petitions each year"); *see also supra* at 267.

[718] In the case of most individuals, inquiry into the relative culpability of the debtor is almost certainly not worth the cost. Even assuming that one might conclude that the debtor's insolvency is the result of excessive risk taking, typically the most important question (given that most insolvency cases are of the no-asset variety) is what should be done with the debtor's human capital. Even assuming the debtor's responsibility for his or her condition, continuing the debtor's debt burden is at once likely to be both a pyrrhic victory for creditors and excessively costly to the debtor (as well as others). Moreover, since the costs of the inquiry regarding the debtor's culpability are likely to be unrecoverable, the analysis is simply likely to generate further deadweight costs.

might be directed more fruitfully elsewhere.[719] Although bankruptcy law should guard jealously the gates of the bankruptcy market, it should not inflict additional wounds on those who approach them for essential relief.[720]

ACCURACY VERSUS SPEED

In administering bankruptcy relief, bankruptcy law must also take account of procedural economy—i.e., how best to balance accuracy versus speed. Specifically, it must balance (1) concluding bankruptcy proceedings as expeditiously as possible in order to, among other things, reduce its costs; and (2) ensuring the fairness of the proceedings,

[719] By analogy, one would not routinely envision the need for a formal judicial inquiry into the abilities of the managers of a solvent firm just because the firm was faring poorly. Typically, the equity holders would simply decide to continue the retention of the managers or not. Managers are sacked every day in a variety of contexts and no one argues that every sacking should be preceded by a formal judicial inquisition to determine the cause of the firm's poor performance.

[720] In some rare cases, of course, it may be important to identify in detail the cause of the debtor's demise. For example, if the debtor's management has engaged in massive fraud, it will often be important to identify the fraud in order to replace the management as quickly as possible. In the overwhelming majority of cases, however, it will be pointless to attempt to prove that poor decision making is to blame for the debtor's demise for the purpose of attempting to "prove" that management is incompetent to make decisions. For example, the debtor's financial demise may be the result of management's decision to invest in a particular project that turns out poorly. In the typical case, however, there is little utility in engaging in an expensive fact-finding and causation inquiry simply for the purpose of documenting each misstep. Time and resources will often be better spent in attempting to salvage the debtor and decide what is to be done with the assets. Among other reasons, a bankruptcy system that systematically devotes resources to investigating management under a presumption that financial demise is typically the result of wrongdoing will discourage management from seeking bankruptcy protection when bankruptcy protection might do the most good. Instead, management will move likely engage in avoidance strategies if for no other reason than to avoid an investigation of their conduct. The question when and how to replace management should be left to procedures akin to those employed in replacing management outside the bankruptcy context. It is a decision best left for those with the best incentives to make it appropriately, rather than courtroom drama.

including the accurate determination of claims, and otherwise the prevention of abuse and unfairness.[721]

For example, creditors holding claims against the debtor's bankruptcy estate prefer to recover whatever they can as quickly as possible. Unlike fine wine, delinquent debts do not tend to improve with age, and delay typically reduces the value of any eventual recovery. At the same time, however, it is important to have a fair procedure that separates meritorious claims from those that are not (e.g., claims that are inflated or altogether fraudulent).[722] In addition, at the time of the commencement of the debtor's bankruptcy case, the amount of many claims may be unknown. For example, a victim of the debtor's wrongdoing may not yet have commenced a lawsuit asserting his claim, and it may take years to either settle or liquidate the controversy. Until the amount of the claim is known and the debtor's liability fixed, it may be impossible to allocate the debtor's resources among all claimants with complete accuracy.[723] The question becomes: to what extent should speed give way to accuracy.

Although accuracy and speed are both important, accuracy is more important than speed *so long as* the pursuit of accuracy does not impinge unduly on the more important question of deciding what is to be done with the person and property of the debtor. For example, until the claims of creditors are tallied, it may not be known for sure whether a

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[721] *See* FINNIS, NATURAL LAW, *supra* note 77 at 188-93 (examining the procedural aspects of a just bankruptcy law).

[722] *See, e.g.*, 11 U.S.C. §§ 501 (2000 & Supp. 2006) (permitting creditors to file proofs of claim), 502 (providing for the allowance and disallowance of claims); *see generally supra* notes 16, 241 (discussing the claims-allowance process).

[723] The problem of unmanifested tort claims arises frequently in the bankruptcy context. *See, e.g.*, In re UNR Indus., Inc., 725 F.2d 1111, 1118-21 (7th Cir. 1984) (discussing difficulties in handling such claims); *supra* note 257.

particular creditor is entitled to a voice in the process. In the meantime, decisions may have to be made, including whether to sell the debtor's assets. In such circumstances, speed is often more important.[724]

TRADITIONAL OR PROBLEM-SOLVING COURTS

Given that the mechanisms of bankruptcy law address a great number of disputes, it seems logical that the bankruptcy market would make use of a court system. The question arises: what kind?

The traditional judicial archetype is the classic dispute-resolution court. Courts within this genre have traditionally "functioned as neutral arbitrators, resolving issues of historical facts or supervising juries engaged in the adjudicatory process."[725] Problem-solving courts, on the other hand, are characteristically "specialized tribunals established to deal with specific problems," including problems of rehabilitation of varying kinds.[726] They have generally arisen in response to the failure of traditional court systems to address significant problems, including lack of judicial expertise in handling particular challenges in need of specialized solutions.[727] The success of certain problem-solving courts has led in recent years to their proliferation in some jurisdictions.[728] Without a

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[724] *See supra* notes 74, 92, 588, *infra* note 739 (discussing sales process in bankruptcy).

[725] Bruce J. Winick, *Therapeutic Jurisprudence and Problem Solving Courts*, 30 FORDHAM URB. L.J. 1055 (2002) [hereinafter Winick, *Therapeutic Jurisprudence*].

[726] *Id.*

[727] *See id*. at 1060; *see also* Julian W. Mack, *The Juvenile Court*, 23 HARV. L. REV. 104, 107 (1909) (discussing the establishment of the first juvenile court in Chicago in 1899).

[728] *See* Winick, *Therapeutic Jurisprudence*, *supra* note 725 at 1057 (discussing the success of certain problem-solving courts in helping addicts end their addictions); *see also* Michael C. Dorf & Charles F. Sabel, *Drug Treatment Courts and Emergent*

doubt, bankruptcy courts, as specialized tribunals that handle only proceedings in bankruptcy and that are responsible for supervising such complex matters as the reorganization of business enterprises, are specialized problem-solving courts.[729]

This is appropriate. Bankruptcy cases involve special problems and sometimes require innovative answers. Many bankruptcy cases are unique, particularly large ones. For example, with over $18 billion in debt and innumerable problems that will likely take years to resolve, it is difficult to imagine how bankruptcy law might handle effectively the City of Detroit's recent bankruptcy filing if the presiding bankruptcy court were not a specialized problem-solving court.[730] This role is consistent with bankruptcy's origins in equity and the constitution of bankruptcy courts as equitable tribunals.[731]

LIQUIDATION OR REORGANIZATION

Who should decide the fate of a firm in bankruptcy? Creditors in their role as creditors will typically possess skill at setting and monitoring benchmarks for a debtor's payment performance. For example, secured creditors may have elaborate covenants embedded in their loan documents requiring defined levels of financial achievement to avoid default. Breach of any of these covenants will almost certainly invite greater

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Experimentalist Government, 53 VAND. L. REV. 831, 832 (2000) (discussing rehabilitation ambitions of specialized drug treatment courts).

[729] *See, e.g.,* Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. L.J. 431 (1995) (discussing the role of bankruptcy judges in business reorganization cases).

[730] *See* In re City of Detroit, no. 13-53846 (Bankr. E.D. Mich. 2013).

[731] *See supra* notes 440-41.

scrutiny of the debtor's activities and possibly trigger debt-collection activity.[732] But skill at setting and monitoring benchmarks for the debtor's payment performance does not necessarily encompass competence in actually running the debtor's business, especially where the debtor is insolvent. Nor does a creditor's skill in managing its own commercial affairs necessarily fit the bill.

For example, in the case of a creditor that is an individual, the creditor may have considerable skill and expertise in managing his own business affairs. But that does not necessarily translate into the skill, resources, or expertise necessary to manage successfully the business affairs of *the debtor*, particularly the debtor *in crisis*. Similarly, in the case of a creditor that is a firm, the creditor may likewise have employees who are skilled at running the creditor's business. But these employees are also presumably occupied with that task, and the credit manager in charge of the defaulting debtor's account hardly seems a likely candidate to take charge of the debtor's operations.

In the insolvency context, the preeminent challenge is promoting the intelligent investment of the debtor's resources given the problems of insolvency, not establishing and monitoring benchmarks for that performance based on preexisting loan covenants. By analogy, the fact that a timekeeper stands ready with a watch in hand will be meaningless if there is no one to actually run the race. This is not to say that monitoring and benchmarks are inappropriate or unimportant. Rather, it is to say that they should be kept in proper perspective.

In matching decision-making needs and skills in the insolvency context, what matters is ensuring that those who will make determinations over the disposition of the

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[732] *See supra* at 162-68; *supra* note 283.

debtor's property will have the appropriate incentives *and* competence to do so. Although creditors may have a stake in the outcome, their role in the process should be matched to what, practically speaking, they have to offer toward its resolution, not merely what they hope to receive.

In the case of most insolvent individuals, the key consideration is, once again, the future deployment of the debtor's human capital. That is so because, in most individual bankruptcy cases, the debtor's human capital is likely to be the debtor's most significant asset. In deciding how best to dispose of this asset, creditors are not likely to have much meaningful direct input. Because an individual debtor's human capital cannot be separated from the person of the debtor, it is not something that creditors can direct or dispose of independently. Perhaps one creditor may believe that the debtor should change jobs to earn more money (ostensibly to better satisfy the creditor's claim). Perhaps another creditor might believe that the debtor should go back to school and earn a degree to increase his earnings potential (for the same reason). Still another creditor might conclude that the debtor should not have children on the ground that doing so would be costly.[733] But there is more than an air of unreality to creditors making these kinds of investment decisions.

Similarly, in cases involving small businesses, the value of the firm may be inextricably bound up with the personal skill, expertise, or reputation of the firm's

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[733] *See* David Rowan, *Life After Debt*, EVENING STANDARD, Aug. 17, 2001, available at 2001 WLNR 2667667 (Kim Basinger's bankruptcy "case was of Hollywood proportions, with the producers' lawyers even trying to stop Basinger having children—as this would diminish the sum they might reclaim.").

individual owner-manager.[734] In these instances, divesting the firm of its assets and dividing the resulting value among the creditors encounters many of the same difficulties that arise in the case of handling the human capital of insolvent individuals.

With other kinds of insolvent firms, particularly those that are larger, the considerations are often differently aligned. Here, the interests of creditors are typically more like those of passive investors where the firm itself, its managers, and its owners are functionally separate and distinct (and also separable). The creditors hold claims against the debtor, which entitle them to certain rights. Although the creditors' rights are typically distinct from the rights of equity holders, insolvency changes the equation (discussed previously). Specifically, once the firm becomes insolvent, the duties of the firm's managers shift to encompass the creditors' interests in new ways, and the creditors become the "residual claimants" of the firm.[735] But just as one would not typically view passive equity investors as necessarily the best decision makers to manage a *solvent* enterprise, one would probably not view the creditors of an *insolvent* firm to fulfill this function either. This is likely to be especially true given the generally heterogenous nature of the creditors' rights, interests, and perspectives.[736] Instead, one might well envision retaining managerial responsibilities for the firm with some group of professional managers. Because the firm is in crisis, however, the managers will likely benefit from the assistance of those who are skilled in crisis management, not only to

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[734] *Cf.* Baird, *Uncontested Axioms*, *supra* note 27 at 583 n.34 (observing in the case of a closely-held and managed firm dependent on its owner's human capital that "[t]he problems of this failed firm cannot be separated from the financial or other difficulties of its owner.").

[735] *See supra* notes 119, 280-81.

[736] *See supra* at 156-62.

stabilize the business, but also help evaluate whether it should be liquidated or reorganized.

By analogy, outside the bankruptcy context there are legions of experienced professionals who advise managers every day on choices over asset retentions and sales. The major difference is that the lines of authority are typically clearer outside the bankruptcy setting—the outside professionals answer to the managers, and the managers to the shareholders. Within bankruptcy, the lines of authority tend to be more fluid and nuanced owing to the inherent uncertainty in many instances over who has a voice in selecting the firm's direction based on such questions as the debtor's value.

For example, equity holders might argue that they have a right to a voice in the process on the theory that the debtor is not actually insolvent and they therefore remain the residual claimants. In contrast, unsecured creditors might argue that they are the residual claimants on the theory that there is enough value to pay secured claims in full, but not enough to cover their unsecured claims, rendering equity holders "out of the money." In further contrast, secured creditors might argue that they are the true and exclusive residual claimants on the theory that there is not enough value to pay their claims in full, leaving nothing for either unsecured creditors or existing equity holders. Of course, while these parties squabble, the patient (debtor) may well be bleeding to death. Although it is normatively more important for bankruptcy law to ensure the optimal allocation of the debtor's assets than it is to preserve payment entitlements, creditors involved in any particular case will not necessarily see it that way. And those

who know that they are "out-of-the-money" can be expected to engage in all kinds of strategic behavior to attempt to extract at least something for their claims.[737]

What is necessary is for bankruptcy law to impose a structure that can produce a meaningful decision in spite of these problems and conditions. One alternative might be for the process to employ an autocratic and coercive judge to keep the parties on the "right" decision-making track. But a judge is not typically well-suited to make the actual decisions that will be called for—he is generally well-suited only to supervise the process. The question persists: who should evaluate and decide whether to sell the assets or not?

The best response is that, absent unusual circumstances, the debtor's managers, acting in concert with appropriate outside professionals, should evaluate the question and present their recommendation for the creditors' consideration.[738] In this way, the managers are answerable to the creditors (who will almost always be the residual claimants, notwithstanding the protestations of the existing equity holders based on trumped-up values), and if the creditors cannot agree amongst themselves on a particular course of conduct or managerial direction, they may be compelled to negotiate the resolution of key issues through a form of compulsory mediation designed to achieve a negotiated resolution of the debtor's fate (ideally, in the form of a consensual plan). Here the bankruptcy judge has a particularly important "problem-solving" role to play as

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[737] *See, e.g., supra* at 81-82, *supra* notes 170, 183, 482 (discussing the complexity and uncertainty of some instances of insolvency and the opportunities for exploitation that these create).

[738] There is always the risk that, to keep their jobs, managers will seek to delay liquidation even when a debtor's prospects are hopeless. But that is why, under the current law, creditors typically employ professionals to advise them on the debtor's prospects and the managers' proposals.

essentially the lumberjack who breaks up the log jams. If unusual circumstances are present (e.g., the assets must be sold quickly because they are deteriorating rapidly in the hands of the debtor), then the managers, again acting in concert with appropriate professionals, should decide whether to sell them or not. As a check, it is for the court to evaluate whether unusual circumstances exist to alter the relevant decision-making authority (such as the managers seeking to cut self-serving deals for themselves in violation of their duties). But absent proof of malfeasance, the managers' choice should control.[739]

For example, suppose the debtor is a large airline with a complicated asset and operational structure. Once again, the fact that the debtor becomes insolvent does not mean that the debtor (or rather its management) is necessarily incompetent. More commonly, the root of the debtor's financial demise will involve misfortune of one kind or another (and, in any event, the cost of attempting to figure out whether the debtor's financial demise stems from something other than misfortune will usually not be worth the effort). On the other hand, although it is possible in some cases that the effects of

[739] This is essentially how the law currently deals with these issues. In general, the goal of every business reorganization case is the confirmation of a plan that the creditors have negotiated, voted on, and accepted (or been compelled to accept through "cramdown") that provides for the disposition of the debtor's assets. *See* Bank of America Nat'l Trust & Sav. Ass'n v. 203 North LaSalle St. P'ship, 526 U.S. 434, 440-42 (1999) (discussing plan confirmation process and cramdown requirements). If there is insufficient time to engage in this process, the debtor's assets may be disposed of without the creditors' formal vote, but the debtor's managers must demonstrate that there is good reason to depart from the process of confirming a plan providing for the disposition of the debtor's assets that has been accepted by creditors. *See* 11 U.S.C. § 363(b) (2000 & Supp. 2006) (providing for the sale of the debtor's property other than in the ordinary course of business with approval by the bankruptcy court); In re Lionel Corp., 722 F.2d 1063 (2d Cir. 1983) (in a chapter 11 case, the sale of the debtor's assets outside a plan must be based upon a good business reason). The bankruptcy judge determines whether special circumstances exist sufficient to warrant departure from the normal course.

insolvency may be overcome simply by releasing the debtor from the burden of excessive debt (i.e., the debtor is suffering merely from financial distress), this may be difficult to assess. Sometimes it will be obvious, as in the case of the restaurant that cannot produce edible food. Other times it will not be, as in the case of an airline that has suffered extraordinary losses from unusual events, such as the 9/11 tragedy.

Because optimal asset allocations are more important than preserving payment entitlements, the debtor may retain its assets if that would be the optimal use under the circumstances, or the assets may be transferred in some way to some new owner if that would be optimal.[740] If the best choice is to leave the assets with the debtor, this should be done and the relevant debts discharged in a manner sufficient to negate the problems that excessive indebtedness have with respect to decision making over the use of the assets (i.e., the debt-forgiveness problems of insolvency). Again, as with corporate governance and investment decisions generally, determining which option *is* in fact optimal should be for the managers to decide in the manner outlined above.

The issues are somewhat differently aligned, however, in so-called "single asset cases," involving typically a special purpose debtor (such as a firm organized as a limited partnership or special purpose trust) that owns a single physical asset (such as a hotel, apartment building, office building, or shopping mall).[741] Once again, the fact that the

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[740] *See* Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 922 (2001) ("the central focus of corporate reorganization should not be on priority rights. Instead, as in corporate law generally, it should remain upon how the firm's assets are used and who controls them"); *see also* Baird & Bernstein, *Absolute Priority, supra* note 190 at 1936 (further critiquing traditional focus on absolute priority).

[741] *See* Bank of America Nat'l Trust & Sav. Ass'n v. 203 North LaSalle St. P'ship, 526 U.S. 434 (1999) (involving a single-asset case).

debtor becomes insolvent does not typically demonstrate that the debtor (or, more particularly, its manager) is a poor decision maker over the use of the single asset—say, an apartment building. Further, although insolvent debtors have incentives to use their assets improvidently (such as by gambling with them), the effects of insolvency may be eliminated by releasing the debtor from the grip of excessive debt. At the same time, however, there are many solvent firms skilled in operating apartment buildings, and the operation of a building may not require much asset-specific knowledge. Further, unlike human capital in individual cases or complex combinations of assets in the form of a large business enterprise, a single building is more readily transferable from one owner to the next.

Because optimal asset allocations are more important than preserving payment entitlements, the debtor may retain the asset if that would be its optimal use, or the asset may be transferred to some new owner if that would be optimal under the circumstances of the particular case. Once again, the real question is whether leaving the asset with the debtor *is* in fact optimal and, more particularly, who should decide that question. In single-asset cases, the best decision maker is typically going to be someone who is willing to inject capital into the debtor (such as by making an infusion of cash) in an amount that, in combination with the elimination of indebtedness that exceeds the debtor's value, is sufficient to recapitalize the debtor as a financially sound entity.[742] If

[742] In a rough sense, this is similar to the general test that the law currently endorses. *See* In re Bonner Mall Partnership, 2 F.3d 899, 906 (9th Cir. 1993) (holding that the new value doctrine survived the passage of the Bankruptcy Code of 1978 and explaining that under the doctrine "a plan that allowed stockholders in the business that had filed for bankruptcy protection (old equity) to receive stock in the reorganized debtor in exchange for contributions of added capital (new value) could under certain conditions satisfy the

no one is willing to make that contribution in order to reorganize the debtor in its existing ownership configuration, then the asset should be sold to someone other than the debtor, and the proceeds distributed among creditors.

To assist with the reorganization of salvageable business enterprises (such as viable airlines and the like), the reorganization procedures of current bankruptcy law compel a system of controlled negotiations with the expectation that the parties will produce a negotiated plan that resolves the proper disposition of the debtor and its property. Bankruptcy law generally keeps managers in control of the process in most reorganization cases,[743] provides for the appointment of committees to represent different stakeholder constituencies,[744] and authorizes the retention of skilled professionals to guide the process and advise the parties and the court.[745] Secured creditors are generally prevented from foreclosing, while the value of their rights is ostensibly protected by complex rules.[746] All of this sounds costly, but the evidence suggests that it is no more so than other major corporate transactions, such as major mergers.[747]

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absolute priority rule and be considered 'fair and equitable' even though a senior class was not paid in full").

[743] *See* 11 U.S.C. §§ 1101(1) (2000 & Supp. 2006) (defining "debtor in possession"), 1107 (2000 & Supp. 2006) (defining the rights, powers, and duties of a debtor in possession).

[744] *See* 11 U.S.C. § 1102 (2000 & Supp. 2006) (providing for the appointment of creditors' and equity security holders' committees).

[745] *See* 11 U.S.C. § 1103(a) (2000 & Supp. 2006) (providing for the employment "attorneys, accountants, and other agents" by creditors' and equity security holders' committees).

[746] *See supra* notes 16, 74-75, 119, 244, 305, 325.

[747] *See supra* note 154.

One criticism of the current law is that it coddles incompetent management. Ousting management automatically upon the commencement of a bankruptcy case, however, is only likely to be counterproductive. Once again, it does not necessarily follow that, just because a debtor files for bankruptcy, management is incompetent. More important, a rule that automatically ousts management would create a powerful incentive for managers to avoid bankruptcy even if the firm sorely needs it—exacerbating the initiation problem.[748] Further, if management of the firm is incompetent, it may be replaced after the bankruptcy filing has occurred, and the available evidence suggests that, at least in the case of large firms, this often happens.[749] Keeping existing managers at the helm, at least initially, may not be ideal in every sense, but it is better than the alternatives.

DISTRIBUTING VALUE

Finally, there are two other procedural problems that arise routinely as a result of a firm insolvency: (1) determining the value of the firm's assets if the assets are not reduced to readily distributable cash through a sale, and (2) allocating this value among the competing claimants. In the case of a solvent debtor, the managers typically do not need to value the debtor's assets in order to pay claims or make distributions to shareholders, and the task of determining entitlements and allocating value among the creditors and shareholders is generally straightforward. First, creditors simply receive payment of their claims in accordance with their payment entitlements under applicable

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[748] *See supra* at 87-90; *supra* note 184.

[749] *See supra* note 185; *see also* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 156 (2005) (observing that data indicate that companies in bankruptcy that replace old management fare better in bankruptcy than companies that do not).

non-bankruptcy law. Second, shareholders receive dividends as and when determined by the firm's directors.[750] Third, the shareholders' entitlements are generally the same: the members of each class of shareholders have the same rights based on their individual shares, and they each share equally on a per-share basis (unless they agree otherwise). In other words, the rights of the residual claimants of a solvent firm (i.e., the shareholders) are relatively homogeneous and easily determined.

In the case of insolvency, however, the creditors become the residual claimants, and their diverse rights and interests generate unique problems in the allocation of the firm's value. First, allocation problems arise because the claims of creditors are not seamlessly convertible into residual ownership interests. Second, valuation problems arise (often in combination with allocation difficulties) if the debtor's assets are not reduced to readily distributable cash.

Just as it is sometimes useful to sell some of the assets of a thriving business (e.g., those that are not needed for profitable operations) so that their value may be redeployed in other ways, it is often useful to liquidate some or all of the assets of an insolvent debtor.[751] Because under principles of absolute priority the creditors of an insolvent firm are generally entitled to payment of their claims before distributions may be made to

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[750] *See* Gabelli & Co. Profit Sharing Plan v. Ligget Group, Inc., 444 A.2d 261, 264 (Del. Ch. 1982) (stating that "[a] decision to declare a dividend is a matter ordinarily addressed to the discretion of the Board of Directors invoking, as it does, important business considerations"). A hybrid situation may arise in the case of preferred shares, which may have certain features that resemble equity interests, and others that resemble debt instruments.

[751] *See supra* notes 74, 92, 739.

equity holders, the proceeds of any liquidation are generally allocated to creditors first.[752] One question that arises is how to allocate the proceeds among competing claimants who bargained originally for payment of their claims in full, but who must now accept less than what they bargained for, owing to the debtor's insolvency. This is a manifestation of the problem of claims mediation that can become quite complicated in its particulars.

To begin with, the amount of each claim is often different and may not be readily discernible (as in the case of contingent claims).[753] Accordingly, it may be difficult to determine the total amount of the firm's obligations and the precise interest of each creditor. In addition, creditors typically hold different payment priorities (e.g., secured creditors are paid from their collateral before others, and some creditors may be

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[752] *See supra* note 119 (discussing the absolute priority rule). Notably, current Chapter 11 reorganization law does not require the distribution to preexisting creditors of all surplus generated from the preservation of the firm as a going concern. All that it requires is that, unless a creditor consents otherwise, each creditor receive not less than what it would receive if the assets were liquidated. *See* 11 U.S.C. § 1129(a)(7) (2000 & Supp. 2006) (prescribing the "best interest of creditors test" in Chapter 11 cases); *see also* H.R. Rep. No. 95-595, at 224 (1977) (stating that "[t]he bill does not impose a rigid financial rule . . . . The bill only sets the outer limits on the outcome [for preexisting creditors]: it must be somewhere between the going-concern value and the liquidation value."). The current law also directs that certain claimants who might receive nothing outside of bankruptcy must have their claims paid on a priority basis. *See* 11 U.S.C. § 507 (2000 & Supp. 2006) (prescribing general priority rules).

[753] In general, a contingent claim is one as to which the debtor's liability turns upon the occurrence of some extrinsic event, such as a tort claim based on the claimant's exposure to a harmful product but for which the claimant has not yet suffered any damages and may not yet even know of the existence of the claim. *See* In re All Media Properties, Inc., 5 B.R. 126, 133 (S.D. Tex. 1980) (reciting that "claims are contingent . . . if the debt is one which the debtor will be called upon to pay only upon the occurrence or happening of an extrinsic event"), aff'd, 646 F.2d 193 (5th Cir. 1981). Hence, at any particular point in time, the debtor's obligation to pay any amount on the claim may be in question. Similarly, claims may be unliquidated, meaning that the amount of the claim has not yet been ascertained, as in the case of a tort claim that has not yet been reduced to judgment.

contractually subordinated to certain other claims).[754] Thus, in contrast to the interests of the residual claimants of a solvent firm, the rights and interests of an insolvent debtor's creditors are often heterogeneous and may be difficult to fix.[755]

Moreover, in the absence of a sale of the debtor's assets, determining the value of these assets can be problematic because, as one commentator has explained, "[a]ll estimates of value are noisy,"[756] and uncertainty over value can easily lead to disputes over payment entitlements. For example, the inability to fix definitively the value of the debtor's assets (sometimes exacerbated by the inability to determine the aggregate amount of all claims) may call into doubt whether the debtor is truly insolvent. This, in turn, may call into question the identity of the firm's residual claimants and whether the

[754] *See supra* notes 171, 234, 244.

[755] Mechanically, the Bankruptcy Code defines the term "claim" broadly to include any "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5) (2000 & Supp. 2006); *see* In re Udell, 18 F.3d 403, 406 (7th Cir. 1994) (stating that "[b]y fashioning a single definition of 'claim' for the 1978 Bankruptcy Code, Congress intended to adopt the broadest available definition of that term") (citations omitted). As a result, claims in bankruptcy include a broad spectrum of tort, environmental, labor, and other types of obligations. *See* Pennsylvania Dept. of Pub. Welfare v. Davenport, 495 U.S. 552, 555 (1990) (discussing the breadth of the concept of a claim in bankruptcy in a case involving a criminal restitution obligation); Southeastern Sprinkler Co. v. Meyertech Corp. (In re Meyertech Corp.), 831 F.2d 410, 412 (3d Cir. 1987) (breach of warranty claim); In re Altair Airlines, Inc., 727 F.2d 88, 89 (3d Cir. 1984) (claim by a collective bargaining representative for unpaid wages of union members); Newton v. Johns-Manville Corp. (In re Johns-Manville Corp.), 45 B.R. 827, 828 (Bankr. S.D.N.Y. 1984) (claims brought by individuals injured by the asbestos produced by the debtor).

[756] Fischer Black, *Noise*, 41 J. FIN. 529, 533 (1986); *see also* Baird & Bernstein, *Absolute Priority, supra* note 190 at 1942-43 (discussing inherent uncertainties in the valuation process).

managers' fiduciary duties also encompass the interests of creditors.[757] Moreover, disputes over value can call into question whether and to what extent some claims should be eliminated (because there is not enough value to reach them after more senior claims are paid), or reduced (because, although they are entitled to receive some value, there is not enough to pay them in full), and whether they should be converted into equity interests in the reorganized debtor or given other kinds of rights. Obviously, this kind of uncertainty creates opportunities for strategic behavior that may add to the overall cost of resolving a firm's insolvency.[758]

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[757] *See* Baird & Jackson, *Bargaining*, *supra* note 60 at 763 (observing that, in some cases, "the value of the firm may not be clear and we may not know who the residual claimant is").

[758] For example, if there is any room for doubt regarding a firm's solvency, equity holders may be expected to challenge any alleged forfeiture of their status as the firm's residual claimants. In the insolvency context, shareholders may be able to do this in one of several ways. *See* Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1072 (2d Cir. 1983) (Winter, J., dissenting) (arguing that the challenge by the equity security holders' committee to the sale in bankruptcy of a particular asset was simply a delaying tactic designed to extract value from creditors); Skeel, *Nature*, *supra* note 158 at 508 (observing that the equity holders may use their ability to call a shareholder meeting and oust existing management strategically as a bargaining tool to extract value from creditors); J. Ronald Trost, *Corporate Bankruptcy Reorganizations: For the Benefit of Creditors or Stockholders?*, 21 UCLA L. Rev. 540, 545 (1973) (explaining that "[t]he participation of junior creditors and shareholder interests depends upon a finding of value in the business over and above that of the claims of the senior interests. This is where the battle is fought between the stockholders and the creditors."); *cf.* Miller, *Wealth Transfers*, *supra* note 181 at 40-41 (stating that "[c]ourt protection that permits stockholders to work their way out of difficulties and repay their obligations in full . . . gives the stockholders a valuable call option at the expense of creditors, who in effect are compelled to put up the [funds] on terms they would otherwise never accept").

Like a variety of other administrative problems, however, bankruptcy law has evolved to deal with these kinds of issues.[759] In Chapter 7 liquidation cases, value is allocated in accordance with the Bankruptcy Code's prioritized payment allocation rules.[760] In Chapter 11 reorganization cases, value is allocated under the terms of the debtor's confirmed Chapter 11 plan, which accommodates elaborate rules for value distributions combined with flexibility to respond to particular situations.[761] In Chapter 11 liquidation cases, the value of an asset is typically determined by its sale.[762] Although perhaps not perfect, these mechanisms are nonetheless serviceable and help illustrate the necessary complexity of the bankruptcy market.

CONCLUSION

Bankruptcy law responds robustly and beneficially to the problems of insolvency. Its various debt-collection, debt-forgiveness, and debt-adjustment mechanisms are geared to address these problems in fairly complex ways because the problems themselves are complex. The fact that bankruptcy law operates beneficially does not mean, of course, that its mechanisms cannot be improved. It does mean, however, that bankruptcy law is worth having, notwithstanding its itinerant vices. This should come as no surprise—bankruptcy law has been in the making for many centuries and draws together many

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[759] *See* Baird & Bernstein, *Absolute Priority, supra* note 190 (discussing how modern reorganization practice under Chapter 11 of the Bankruptcy Code has evolved to resolve valuation and allocation difficulties).

[760] *See supra* note 75-76, 241, 247 (discussing payment rules in liquidation cases).

[761] *See supra* notes 73-74, 119, 241, 299, 588, 752 (discussing plans of reorganization).

[762] *See supra* note 74, 92, 739 (discussing sales).

traditions and experiences from many legal sources. It is thus the product of a rich heritage and should be understood in this way.

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