CONTRACTING OUT OF BANKRUPTCY: AN EMPIRICAL INTERVENTION

Elizabeth Warren and Jay Lawrence Westbrook

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Data drawn from a large and recently updated database of business bankruptcy cases challenge the central factual premises implicit in contractualism, a term that encompasses a number of proposals to replace the current business bankruptcy system with private bargains that would govern a debtor's property and affairs following a default. The most prominent contractualist schemes assume a relatively small cohort of claimants in most business bankruptcies and also assume that all or nearly all of those creditors would be able to negotiate a bankruptcy regime with a debtor or to adjust their prices and other contractual terms to reflect the bankruptcy regimes negotiated with the debtor by other parties. Data from the Business Bankruptcy Project show that, contrary to the assumptions of the contractualists, there are many claimants in business bankruptcy cases and many of them are poorly adjusting creditors who would be unable to negotiate or adjust their prices. These findings point toward substantial inefficiencies and costs arising from the contractualist proposals, and severely undermine the case for a contractual bankruptcy system.

INTRODUCTION

Academic debates often seem to circle the same issues again and again for years, until the combatants grow bored with the clash of shopworn abstractions and move on. Bankruptcy law presents no exception. For nearly a decade, one idea has dominated the academic stage — the privatization of bankruptcy, a proposal that would permit a business and its creditors not only to select their interest rates and

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loan collateral, but also to choose the legal regime that will be in place if the debtor-business fails.[1] After some years of sharp clashes at a high level of generality, this debate threatens to grow stale. In this Article, we seek to refresh it with a dose of fact.

Bankruptcy law, as currently formulated, is a mandatory system. A debtor in trouble may file for bankruptcy following a predetermined set of federal rules; most courts will not enforce prebankruptcy contractual agreements not to file, nor will they permit the parties to vary the applicable rules.[2] A number of scholars have recently suggested various schemes by which businesses[3] might agree ex ante to a bankruptcy regime other than the current federal system.[4] An answering chorus has vigorously responded that any such scheme is completely unworkable.[5] Those scholars who promote schemes of bargained bankruptcy, a group that may be called "contractualists," have filled the law reviews with claims and objections, most of them fact-free.[6] In this Article, we offer data that cast substantial doubt on the claimed efficiency of the contractualist proposals.

Although contractualists have various approaches, the common thread is that parties should be free to bargain in advance for a set of

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[1] We describe this as an entirely theoretical debate because there is currently no apparent interest in Congress to consider making such a move. Of course, not so long ago a debate over means testing would also have been described as entirely theoretical by such criteria. Now both the House and the Senate have passed bills featuring complex means-testing devices. *See, e.g.*, Bankruptcy Abuse Prevention and Consumer Protection Act, S. 1920, 108th Cong. (2004); Bankruptcy Abuse Prevention and Consumer Protection Act, H.R. 975, 108th Cong. (2003).

[2] *See, e.g.*, *In re* Pease, 195 B.R. 431, 433–34 (Bankr. D. Neb. 1996); *In re* Madison, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995); Farm Credit of Cent. Fla., ACA v. Polk, 160 B.R. 870, 873–74 (M.D. Fla. 1993); *In re* Sky Group Int'l, Inc., 108 B.R. 86, 88–89 (Bankr. W.D. Pa. 1989). *But see, e.g.*, *In re* Atrium High Point Ltd. P'ship, 189 B.R. 599, 607 (Bankr. M.D.N.C. 1995); *In re* Cheeks, 167 B.R. 817, 818–19 (Bankr. D.S.C. 1994).

[3] These proposals are generally limited to the defaults of legal entities like corporations. Our discussion includes both corporations and individual entrepreneurs, but we too exclude consumer bankruptcy. To date, as far as we know, no one has suggested that Visa or Wal-Mart be allowed to include a bankruptcy system on the back of that credit card application it gives to Suzy or Jimmy.

[4] *See, e.g.*, Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 319–24 (1993); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations,* 101 HARV. L. REV. 775, 776–77 (1988); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 117 (1992); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1850–51 (1998).

[5] *See, e.g.*, Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503, 504–08; Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216, 2246–47 (2000) [hereinafter LoPucki, *Cooperative*]; Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999) [hereinafter LoPucki, *Contract*].

[6] We may be guilty of coining "contractualist" as a generic description of these authors. For a summary of the contractualist proposals, see ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 1029–42 (4th ed. 2001).

rules that will govern their rights in the event of bankruptcy. Their bargains should be permitted to override the rules of bankruptcy, presumably rendering the bankruptcy system applicable only as a default arrangement for those who make no private bargains. It has been suggested that the contractualist approach be extended to govern international insolvencies as well.[7]

The principle of party choice has ample precedent in commercial law. Indeed, party autonomy is at the core of contract law and is the central rationale for government enforcement of contracts. But mandatory rules are equally part of the norm in commercial law. Parties cannot, for example, decide privately on the basic rules governing foreclosure of a loan.[8] Those governing rules are mandatory and unwaivable. The question is not whether party autonomy or mandatory rules are better. Our commercial law system employs both quite successfully. The question is *when* one approach is preferable to the other.

The stakes in private versus public bankruptcy schemes are substantial. Bankruptcy law is the final arbiter of who gets what when a company fails. Nearly all businesses that file for bankruptcy have some value, either in liquidation or as going concerns. The contest for those assets may be the final game played out among the parties. Those who do not recover in the bankruptcy distribution are forced to absorb losses, which can be quite substantial. The bankruptcy system also has powerful nonbankruptcy effects, setting the framework for negotiations with a troubled debtor as each party negotiates with a sharp eye on what the party's rights will be if the debtor files for bankruptcy. Even the initial lending decision or the structure of the deal may be shaped in part by the rules that will apply if one party should find itself in bankruptcy.[9]

The 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 concerned. This is accomplished by shrinking the collection rights of the most

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[7] *See* Robert K. Rasmussen, *A New Approach to Transnational Insolvencies*, 19 MICH. J. INT'L L. 1, 4–5 (1997).

[8] *See, e.g.*, U.C.C. § 9-602 (2000) (listing nonwaivable rules in the enforcement of secured debts). This is also true for real estate. *See, e.g.*, RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 3.1 (1996); LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 59 (4th ed. 2003) ("[T]he requirement that collateral be exposed to public sale as part of the foreclosure process generally cannot be varied by contract.").

[9] *Cf.* Ethan S. Bernstein, All's Fair in Love, War & Bankruptcy?: Corporate Governance Implications of CEO Turnover in Financial Distress 5 (n.d.) (unpublished manuscript, on file with the Harvard Law School Library) (discussing the effects of bankruptcy rules on prebankruptcy behavior).

powerful creditors in order to achieve somewhat greater distribution among *all* those who have a stake in the debtor. Parties who are best able to negotiate for protection outside bankruptcy in the form of security interests and greater default rights often resist seeing their contractual rights diminished in bankruptcy to produce a benefit for other creditors who did not obtain such prebankruptcy protection. The academic debate over a contract-based system of bankruptcy is a debate to determine whether powerful creditors will be able to increase their share of the assets distributed when a debtor collapses or whether a balanced and predictable system of mandatory rules will continue to prevail.

Thus far, the debate over whether parties should be able to contract out of bankruptcy has been entirely theoretical. Using a first-principles approach that rests upon the presumed efficiencies arising from party autonomy, supporters of a new regime argue that multiple methods of dealing with debtor collapse would permit parties to tailor a default system to their specific needs.[10] Critics respond from a different perspective, arguing that efficiencies must be demonstrated, not merely presumed,[11] and that the multiparty nature of bankruptcy, affecting many creditors who have different bundles of legal rights created over different time periods, requires a non-opt-out rule to assure protection for all parties.[12]

Although the contractualists present several different proposals,[13] those proposals share certain basic characteristics. First, each assumes that a bankruptcy regime negotiated in the marketplace will be far more efficient than the standardized "contract" provided by Congress in the Bankruptcy Code. This point apparently requires no further evidence, but survives on assertion alone. Second, the contractualists are vague about how their schemes will be implemented and how they will work, leaving two central questions unanswered.[14] Would the proposed schemes be redistributional and therefore likely to create in-

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[10] *See, e.g.*, Rasmussen, *supra* note 4, at 53–55; Schwartz, *supra* note 4, at 1850–51.

[11] *See, e.g.*, Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 AM. BANKR. L.J. 509, 543–50 (2000).

[12] *See, e.g.*, Block-Lieb, *supra* note 5, at 508–09; LoPucki, *Cooperative*, *supra* note 5, at 2243–51; LoPucki, *Contract*, *supra* note 5, at 339–42.

[13] *See infra* Part I, pp. 1204–07.

[14] We have repeatedly prodded those in our field who consider themselves theorists to put forward testable hypotheses, assuring them we would be glad to gather data to test them. *See* Elizabeth Warren & Jay Lawrence Westbrook, *Searching for Reorganization Realities*, 72 WASH. U. L.Q. 1257, 1287 (1994). Our suggestions have been ignored, so we have to push the proposed theories into testable hypotheses ourselves by identifying the factual premises on which the theories necessarily rest. We do that here. The analogue is of course physical science, where the theorists generate testable hypotheses and the experimentalists test their predictions. *Id.*

efficiencies of their own?[15] Would these schemes create transaction costs that would exceed any claimed efficiencies resulting from marketplace bargaining?[16] The data suggest that the answer to both of these questions is "yes."

Because the first of these two questions breaks into two parts, there are actually three factual issues to explore. First, the contractualist proposals would be redistributional and inefficient if they shifted costs from the debtor and the other contracting party to creditors who could not fully adjust to the risks created for them by the new system.[17] This inability might arise from characteristics of the creditor (for example, a tort victim) or from characteristics of the creditor's claim (for example, a small claim). Second, if there are few such creditors in business bankruptcies, then contractualism's cost-shifting effects may be of relatively little concern. But if there are many of these creditors in business bankruptcies, then the resulting inefficient redistribution of risks may swamp any efficiencies that are claimed to arise from a bankruptcy bargain with other creditors. Third, the separate issue of transaction costs arises even if all parties can negotiate or fully adjust to the bargains negotiated by other parties. If there are relatively few creditors who will come to the table to negotiate a bankruptcy system, the costs of contracting will be low. If, however, there are many creditors, the resulting negotiation and information costs may exceed the benefit from bargaining efficiencies.[18]

With our data, we explore these issues. We draw on information we have collected from thousands of failed businesses that initially filed for bankruptcy in twenty-three federal districts around the country in 1994,[19] harnessing those data in an effort to inform the current debate. We examine the types of claims creditors assert in business bankruptcy cases, the number of such claims, and the individual and collective dollar values of those claims. We are currently analyzing updated data from a supplementary study of cases filed in 2002, and our preliminary results indicate that our findings from the original sample remain robust.

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[15] *See* Block-Lieb, *supra* note 5, at 539, 548–49; LoPucki, *Cooperative*, *supra* note 5, at 2243.

[16] Block-Lieb, *supra* note 5, at 548–49; LoPucki, *Cooperative*, *supra* note 5, at 2245.

[17] *See* Block-Lieb, *supra* note 5, at 537–48; LoPucki, *Cooperative*, *supra* note 5, at 2243; *cf.* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 864, 881 (1996) [hereinafter Bebchuk & Fried, *Uneasy*] (discussing how rules giving priority to secured creditors can create redistributional inefficiencies); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279, 1286–88 (1997) [hereinafter Bebchuk & Fried, *Uneasy #2*] (showing how creditors can use secured interests to bind third parties to new bankruptcy rules).

[18] *See* Rasmussen, *supra* note 4, at 100, 114–16.

[19] For a detailed discussion of the procedures employed to gather and report the 1994 data and some supplementary data from cases filed in 2002, see *infra* Part II, pp. 1207–13.

These data stand as a stark reminder that in virtually every bankruptcy case the rights of a broad range of parties are resolved in a single court proceeding. Whether through a confirmed plan of reorganization or a liquidation of the debtor's assets, the parties claiming from the now-bankrupt estate represent a wide variety of circumstances in their dealings with the debtor — from novice to sophisticate, from a seller of $500 worth of hand tools to a working capital lender, from a mega-corporation to the hapless driver who was waiting at the stoplight behind the company's truck when it discharged four tons of wet cement.

Our data show that a substantial proportion of the creditors listed in business bankruptcies would likely be unable to negotiate for or adjust fully to a new bankruptcy regime, tending to confirm the hypothesis that there would be substantial redistributive implications from any private bankruptcy system that gave strongly adjusting creditors additional opportunities to shift losses to maladjusting creditors. We document the presence of substantial numbers of creditors who have little meaningful opportunity to negotiate with their debtors or adjust their prices to reflect risks. We also show that even if all creditors were fully adjusting, the large number of claims makes it likely that a system dependent upon private bargaining would generate substantial transaction costs, making it difficult for any supposed efficiencies to produce a net reduction in costs.

In commercial law, the practical often informs the theoretical. This Article represents an effort to test three intertwined factual assumptions that underlie the proposals for contracting out of bankruptcy, but the findings ultimately take us back to the theoretical debate about the essential nature of bankruptcy. The data presented here are consistent with a vision of bankruptcy that emphasizes its multiparty aspects, rather than a vision of bankruptcy as a process governed by a series of two-party agreements.

In this Article, our focus is on efficiency, not fairness. To the extent that bankruptcy laws have deliberate policy objectives — such as the protection of employees or the subordination of misbehaving creditors — only non-opt-out rules can achieve those ends.[20] The contractualist proposals necessarily embrace the possibility of redistribution of assets away from those who currently enjoy special protection or toward those who currently forfeit certain advantages in bankruptcy. These are concerns we take very seriously, and we recognize that many policymakers would regard upsetting these policy objectives as disqualify-

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[20] *See, e.g.*, 11 U.S.C.A §§ 507(a), 1129(a) (West 2004) (providing some of the mandatory terms that structure bankruptcy law). For a discussion of the distributional objectives embodied in protections for general unsecured creditors, see Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 352–61 (1993).

ing. For this analysis, however, we set those concerns aside to concentrate on efficiency. So, for example, we discuss the circumstances of employees not from the policy perspective that they deserve greater protection in bankruptcy, but from the efficiency perspective that as creditors they may be poorly positioned to adjust fully to changes in their employers' bankruptcy regimes.

Because our data show that a large number and variety of claims are presented in most business bankruptcy cases, it becomes apparent that a mandatory rule that governs in all cases — and for which parties spend no time or money negotiating — produces substantial efficiencies of its own. In the mix of mandatory and opt-out schemes that characterize commercial law, the data presented in this Article suggest that the collective nature of bankruptcy makes it a particularly unsuitable candidate for an opt-out approach.

I. THE CONTRACTUALIST POSITION

The contractualists present several variations on their theme.[21] One may be called "automated bankruptcy," in which a system of priorities and options is built into a series of financial instruments. Upon default, the ownership and control of a business passes to the owners with the priority appropriate to the business's financial condition. Courts would play little or no role in the process.[22] Another is a "menu" system, in which a debtor chooses from a menu of perhaps five bankruptcy regimes with varying provisions and embeds them in its articles of incorporation, unchangeable without the approval of all of its creditors.[23] A third may be designated the "evergreen" regime, in which the debtor negotiates bankruptcy contracts with a succession of creditors, with the last such contract before default as the one that is controlling.[24]

Automated bankruptcy rests on the idea that it would be useful to separate the purely economic aspects of bankruptcy from its litigation

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[21] This discussion draws heavily on the description in our casebook, which provides more details and useful quotes. *See* WARREN & WESTBROOK, *supra* note 6, at 1029–36. The contractualists often do not concern themselves with the details, and one has to read all, or at least a large part, of an article to discern that an author is contending *X* or *Y*.

[22] *See* Adler, *supra* note 4, at 323–33; Bebchuk, *supra* note 4, at 781–88.

[23] *See* Rasmussen, *supra* note 4, at 100–11.

[24] *See* Schwartz, *supra* note 4, at 1833–36. Another group of contractualist proposals can be grouped under the heading "waiver." *See, e.g.*, Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515 (1999) (proposing the enforcement of certain waivers in bankruptcy). Unlike the other proposals, this approach focuses on creditors contracting with debtors after they have already fallen into financial distress. The proposal is to enforce waivers of the automatic stay and other bankruptcy provisions in exchange for new credits that might enable the business to survive without bankruptcy. The waiver approach involves some substantially different issues than the others, and we do not address it in this Article.

aspects, so that a business could be rapidly and inexpensively liquidated, sold, or placed under new management, without the cost and delay associated with litigation over issues such as fraud, mismanagement, or lender liability. The theory derives from an article by Professor Lucian Bebchuk.[25] His proposal has two central components: the courts would enforce absolute contractual priority in both liquidation and reorganization, and a sort of "bidding-in" by existing creditors or equity holders would determine control over the deployment of the assets of a firm in general default. Each class of equity or debt (predefined by contract) could either purchase all the interests above it at face value or forfeit the interests of the class. Any class that elected to purchase would own the company. If no lower class were able to purchase all the interest above it, the highest class of debt would own the company. The owner would then decide whether to sell the assets or continue operation of the business. In Professor Bebchuk's original conception, the execution of an automated bankruptcy would be accomplished with no involvement by the courts. The process would be completely controlled by creditors.

Subsequent proposals advocate that creditors could be allowed to vote on proposed plans.[26] Professor Barry Adler's automated approach would simply extinguish all of a firm's equity as soon as it was unable to pay any of its fixed obligations, giving equity ownership to the highest-priority class of creditors that could not be paid on time.[27] Financial instruments would be crafted to permit all of this to happen automatically, without court involvement in most cases. He also suggests many alternative approaches to the priority arrangements, and outlines solutions to some, but by no means all, of the numerous problems of detail that would arise from his approach.[28] Overall, Professor Adler's proposal envisions a wide-open, unconstrained role for whatever contractual arrangements the parties may want to make. He explains that his proposal would be difficult or impossible to adopt because it would require changes in many areas of the law and would be opposed by various self-interested groups despite its greater efficiency.[29]

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[25] Bebchuk, *supra* note 4.

[26] *See* Adler, *supra* note 4, at 327.

[27] *See id.* at 324. However, in a more recent article, Professor Adler and Professor Ian Ayres seem to suggest a quasi-auction approach that falls somewhere between Professor Adler's earlier proposals and Professor Bebchuk's "payoff" approach. *See* Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE L.J. 83, 140–48 (2001). Throughout Professor Adler's writing runs the argument that many distressed firms, if not most, should be liquidated but are kept alive because management, equity, and many creditors prefer continuance. *See, e.g.*, Adler, *supra* note 4, at 360–63.

[28] *See* Adler, *supra* note 4, at 324–32.

[29] *See id.* at 341–44.

Professor Robert Rasmussen approaches contractualization by suggesting a "bankruptcy menu" from which a firm would choose the bankruptcy provisions that best served the firm and its creditors. The choice would be made at the inception of the firm and would be included in its corporate charter. Additionally, the choice would be, with certain exceptions, unalterable unless the debtor obtained the agreement of all creditors. Thus, each creditor would know from the start the bankruptcy regime that would apply to the debtor, and would extend credit priced accordingly. The firm could decide to what extent it wished to exchange future bankruptcy protection for lower present interest costs, producing the most efficient result. Professor Rasmussen admits that tort victims or other completely involuntary creditors would require special protection under his proposal, thus conceding that parties unable to protect themselves by contract should be the beneficiaries of mandatory rules. In the process, he also concedes that, absent such protections, his bankruptcy regime would "encourage consensual creditors to shift the costs of insolvency onto nonconsensual creditors," with the result that "their rights would most likely be nonexistent."[30]

Professor Alan Schwartz identifies a potential problem with Professor Rasmussen's menu approach. He observes that a debtor's circumstances change over time, and therefore the most efficient choice of bankruptcy regime at inception of the firm may not be the most efficient choice at a later point in its development.[31] He argues that Professor Rasmussen's approach of requiring the approval of all creditors for an amendment of the menu choice would be expensive and cumbersome, so Professor Schwartz proposes that there be a rolling readjustment in the bankruptcy regime to reflect the changes in the debtor's circumstances. In his proposal, each new creditor would negotiate a bankruptcy bargain with the debtor. If the new bargain were different than the one made with the first creditor, the first creditor would automatically shift to the new bargain.

Professor Schwartz asserts that the principal obstacle to adopting the most efficient choice of bankruptcy solutions (for example, liquidation versus reorganization) is the "private" benefit that managers of bankrupt businesses may gain from the less efficient choice (for example, by prolonging the business a manager may retain her own job, even when liquidation would result in a higher payout to the stakeholders).[32] This private benefit may motivate those in control to

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[30] Rasmussen, *supra* note 4, at 67.

[31] *See* Schwartz, *supra* note 4, at 1811 ("[B]ecause the optimality of a bankruptcy system is state-dependent, it also can be time-dependent. Put more simply, time may render a company's charter solution outmoded . . . .").

[32] *See id.* at 1824–25.

choose a strategy that is suboptimal for the firm's creditors. He proposes therefore that a payment to those in control be provided as part of the bankruptcy bargain. One of his critics, Professor Lynn LoPucki, characterizes this payment as a "bribe."[33]

Professor Schwartz's analysis is based on the premise that the only goal of business bankruptcy law should be to reduce the cost of debt capital, which is best accomplished by maximizing the debt investors' insolvency-state payoff. He argues that a mandatory bankruptcy system increases a borrowing firm's cost of capital over the cost that would obtain in a world in which the firm and its creditors could contract for an alternative bankruptcy system. Thus, if the rule against contracting were relaxed, parties would write "bankruptcy contracts" that would permit a borrowing firm to choose the system that would be optimal for it and its creditors were it to become insolvent.[34]

Although there are a number of differences among these approaches, common to all is the belief that private choice of bankruptcy systems yields greater efficiency. Each would bind all creditors, except perhaps tort victims, to the bankruptcy bargain, either by negotiations or by some form of "deemed" acceptance through notice of the system adopted by the debtor.

II. BUSINESS BANKRUPTCY STUDY

Contractualism promises to produce a net improvement in efficiency, but its proponents have offered little in the way of concrete evidence of its claimed savings or its costs. We identify some of the costs of contractualism by marshalling data from a large national study of business bankruptcy. The Business Bankruptcy Study is an empirical research project that has created an extensive, original database consisting of data about businesses that file for bankruptcy. We offer a brief summary of the design of the database and a profile of the bankrupt businesses about which it contains information.[35]

Bankruptcy records are collected and stored in each individual federal judicial district, making it impossible to create a perfectly representative national sample without visiting every single district in the United States. Like other researchers before us, we have studied only a subset of the districts. In our case, generous funding made it possible to collect data from twenty-three districts, two from each of the eleven circuits in the United States, plus an additional district from the very large and very diverse Ninth Circuit. By sampling from each of

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[33] LoPucki, *Contract*, *supra* note 5, at 322.

[34] *See* Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343, 344–48 (1999).

[35] For a more detailed discussion of the methodology, see Warren & Westbrook, *supra* note **, at 499–517.

the judicial circuits, we attained geographic diversity. In addition, we deliberately sampled both high-filing and low-filing districts within each circuit in order to ensure that different kinds of local economies and legal cultures were represented in the study.[36]

The twenty-three districts we studied represent about 40% of all the business cases filed in the United States in 1994. Our sample cases alone comprised about 6% of all business filings in the country.[37] The cases for the basic sample were filed during 1994 and followed longitudinally for six years, with data collection concluding in 2001.

Within the mix of business cases, we sampled from those initially filed in Chapter 7, Chapter 11, and Chapter 13, using a consistent series of protocols to identify the individual or corporate entity as a business.[38] Debtors in the sample are a mix of human beings, partnerships, corporations, and other forms of legal entities. All, however, including the debtors who are natural persons, indicate in their legal records that they are (or recently had been) operating businesses.

In addition, we updated our findings by creating a supplemental database of new Chapter 7 and Chapter 11 business cases filed during 2002. Limited funding for the 2002 study permitted us to collect data for the Chapter 11 cases from only eight of the original twenty-three districts.[39] The PACER system created special difficulties for separat-

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[36] The districts chosen because they had the highest number of business filings in their respective circuits in 1993 were the District of Massachusetts, the Southern District of New York, the District of New Jersey, the District of Maryland, the Northern District of Texas, the Eastern District of Michigan, the Northern District of Illinois, the District of Minnesota, the Central District of California, the District of Colorado, and the Middle District of Florida. The districts chosen because they had the lowest business filing rate in 1993 in their respective circuits, *and* had at least fifty Chapter 11 bankruptcies, were the District of New Hampshire, the District of Connecticut, the District of Delaware, the Eastern District of North Carolina, the Eastern District of Louisiana, the Western District of Tennessee, the Eastern District of Wisconsin, the District of Nebraska, the Western District of Oklahoma, the District of Hawaii, and the Middle District of Georgia. The additional district was the Western District of Washington, which we added as representative of a Twelfth Circuit that some have suggested might be carved out of the Ninth Circuit. If so, it would likely be the high-filing district in that new circuit. These choices depressed the number of business Chapter 13 cases in the sample because districts with low Chapter 11 filings often have even lower numbers of business Chapter 13 filings. For more information on sample selection, see Warren & Westbrook, *supra* note **, at 512–13.

[37] *See id.*

[38] The designations came from the face sheets of the petitions. Cases were deemed "business cases" if any of the following indicia was present: "(1) the lawyer checked 'business' in the business/nonbusiness box on the face sheet of the petition; (2) the petitioner's name had a business style (e.g., 'Corp.,' 'Inc.,' 'Co.'); or (3) the petitioner had a designation of 'doing business as,' 'formerly doing business as,' or 'also known as,' if the latter designation was a business style." *Id.* at 512.

[39] The eight districts in the 2002 supplemental sample were chosen from the twenty-three in the basic sample. The districts used in the update are the Central District of California, the Northern District of Illinois, the Southern District of New York, the District of Massachusetts, the District of Nebraska, the District of Colorado, the Northern District of Texas, and the Western District of Washington.

ing Chapter 7 business cases from Chapter 7 consumer cases, requiring substantially more time and effort to select a sample than was required for the Chapter 11 cases.[40] For that reason, we had to limit ourselves to four districts for those cases. To maintain comparability between the 1994 and 2002 data, we adjusted the Chapter 7 sample, doubling the weight of each Chapter 7 case.[41]

We maintained geographic diversity in the Chapter 11 update sample by selecting from eight different circuits. We also maintained some economic and cultural diversity by selecting from largely urban districts such as the Southern District of New York, largely rural districts such as Nebraska, and several mixed districts that included both cities and their surrounding rural areas. We used the same protocols to draw the basic sample and the same methods to record certain key variables from cases in the eight districts.[42] The supplemental sample is neither as large nor as detailed as the basic sample, but it is useful for determining whether the story told by the data persists over time.

A total of 3201 cases form the core original sample,[43] with an additional 450 making up the supplemental sample. Both samples include court record data, and the original sample also draws from telephone interviews for those debtors we could reach. The original database has more than 200 variables describing each case, although in some cases data for specific variables are missing from the records.

We could analyze these cases in thousands of different ways, but an overall picture emerges. As Table 1 shows, most businesses that filed

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[40] There are, of course, many more consumer Chapter 7 cases than consumer Chapter 11 cases, so picking out the business Chapter 7 cases was like finding oysters with pearls inside.

[41] That process assumed that the four unexamined districts would have had the same relevant characteristics as those we did sample. Once again, we aimed for geographic diversity, a mix of urban and rural, and districts reputed for having extensive or limited business bankruptcy practices. The Chapter 7 districts sampled were the Central District of California, the Northern District of Illinois, the District of Massachusetts, and the District of Nebraska.

[42] The one significant change was that, rather than going to the courthouses with our copying machines, we used the PACER system to access electronic dockets. Because 2002 was a transition year in some districts, some cases were not fully available online. The generous judges and their very helpful staff assistants, mentioned *supra* note **, provided copies of those case files. Although this approach was far cheaper than going around the country from courthouse to courthouse, it was still expensive, so that the grant from the American College of Bankruptcy was crucial to our efforts.

[43] Our initial plan called for 150 business cases per district — fifty each in Chapter 7, Chapter 11, and Chapter 13. Because some districts did not produce even fifty business cases in Chapter 11 or Chapter 13, and because some courts were unable to locate files for cases in our sample, the final number of business cases was 3201 rather than the projected 3450. The protocols for the Business Bankruptcy Project are set out in greater detail in Warren & Westbrook, *supra* note **, at 503–17. The preliminary report in *Financial Characteristics* shows a useable sample size of 3121 cases. When those data were drawn, some courts were unable to locate the court records for some of the debtors in the initial sample. As a result, we had no useful data about those cases. After publication of *Financial Characteristics*, however, we were able to recover data from additional cases in the initial sample, increasing the useable sample size to 3201 cases.

for bankruptcy were relatively modest in size, although Chapter 11 cases had substantially more assets and debt than did Chapter 7 or Chapter 13 cases.[44] There is also wide variation in the likelihood that the business was balance-sheet insolvent at the time of filing. About 8% of the Chapter 7 liquidations claimed to have assets in excess of liabilities, while more than a third of the Chapter 11 and Chapter 13 cases claimed to be solvent when they filed. The difference, of course, suggests that as a group, businesses in better relative shape are attempting to reorganize through bankruptcy.

TABLE 1. SUMMARY DATA FOR BUSINESSES FILING FOR BANKRUPTCY, 1994 (NOMINAL DOLLARS)

	Ch. 7 Median	Ch. 7 Mean	Ch. 11 Median	Ch. 11 Mean	Ch. 13 Median	Ch. 13 Mean	Median Total	Mean Total
Assets	25,850	132,367	350,900	1,935,413	92,385	127,404	90,090	671,397
Debts	118,617	339,937	529,982	2,491,109	103,167	141,241	153,430	919,087
% Claim Solvent	7.96	N/A	35.45	N/A	35.35	N/A	24.84	N/A
Solvency Ratio	0.302	0.727	0.721	1.516	0.813	1.095	0.591	1.079

Source: Business Bankruptcy Project

About a third of all the businesses in bankruptcy had no employees by the time they filed.[45] The remaining two-thirds, however, averaged about 106 employees per case. Not surprisingly, those employees were concentrated in the biggest businesses, with some employing ten thousand or more workers. But even in the small Chapter 7 and Chapter 13 cases, more than half the businesses had at least one paid employee other than the owner, and three-quarters of all the businesses in Chapter 11 cases had at least one paid employee. Altogether, about two million people were employed by businesses that filed for bankruptcy in 1994.[46]

Notwithstanding the fact that we collected extensive data about the businesses that filed for bankruptcy, we had to delve even deeper into the bankruptcy court records to answer questions about the creditors in the cases. To do this, we examined a subsample of the cases in greater detail. In addition to the summary data on secured claims,

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[44] *See id.* at 538 tbl.8, 539 tbl.9.

[45] *See id.* at 544, 545 tbl.11, 546–49.

[46] The estimate is based on extrapolation from the sample. The details of the extrapolation techniques are reported in *id.* at 546–47 n.83.

priority unsecured claims, and general unsecured claims for all the cases in the sample, for this report we reexamined a subset of cases to categorize each separate unsecured creditor and the dollar amount listed for each separate unsecured claim. The subset was taken from cases originally filed in Chapter 7 or Chapter 11, about 2100 cases in all. We reexamined every fifth Chapter 11 and Chapter 7 business case, recording the type and amount of each unsecured claim listed in the files. This created a subsample of 386 business cases from around the country that, together with our supplemental data, formed the basis for this Article.[47]

We identified twenty-two categories of claimants for which we collected additional, detailed data:

Secured creditors[48]
Judgment lien creditors
Attorney priority creditors
Attorney nonpriority creditors
Other priority creditors
Banks/institutional lenders
Bonds
Credit card issuers
Employee priority creditors
Employee nonpriority creditors
Insurance companies
Individuals, specified loans
Landlords
Medical care providers
Plaintiffs, personal injury
Plaintiffs, unspecified lawsuits
Taxing authorities (priority claims)
Taxing authorities (nonpriority claims)
Trade creditors
Utilities
Business entities, unspecified
Individuals, unspecified

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[47] Because of some missing data, our subsample started at 405 cases. After excluding consumer Chapter 11 cases that were not part of the core business sample, we were left with 386 business cases in Chapter 11 and Chapter 7. Of those, forty had no unsecured claims of a specified amount listed, other than priority tax claims. That is, they either failed to list any unsecured claims or they listed such claims without specifying the amount of any single claim. All but one of these cases had only secured claims, tax claims, or a combination of the two, and therefore appear as "zero-unsecured" cases in the subsample. One case listed no claims at all.

[48] Our coders did not sample more detailed information from the secured claims in the subsample, and we do not have detailed information about those claims. We have only summary data about the nature and amount of the secured claims.

The categorization of the claims involved some judgment calls, and debtors were not always consistent in providing the information necessary to categorize their claims or even all the information required by the statute. To promote consistency, we used only two trained researchers who completed all coding themselves.[49] The two worked in close contact with each other and in direct consultation with us. Ultimately, they coded detailed data for 7959 general unsecured claims for the subsample to supplement the data that had already been coded for the secured and priority claims for the entire sample.[50]

Because we had limited funding for this aspect of the database, we developed the additional data for the Chapter 11 and Chapter 7 business cases only, despite our realization that the smaller business cases filed in Chapter 13 were also important. This means that the enhanced claims database is not representative of the whole sample; it represents only those business cases initially filed in Chapter 11 or Chapter 7. The effect of omitting Chapter 13 cases is to shift the subsample to overrepresent corporate cases, because even small corporations are ineligible for Chapter 13.[51] Elimination of Chapter 13 business cases also tilts the subsample toward larger cases, because of the debt limits imposed on Chapter 13 filers.[52]

In addition, we sampled equal numbers of Chapter 7 and Chapter 11 business cases, despite the fact that Chapter 7 cases outnumber Chapter 11 cases by approximately two to one.[53] We could, of course,

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[49] Scott Kirwin, Harvard Law School Class of 2001, was the lead coder. He worked closely with Catherine Ellis, Columbia Law School Class of 2004, who also coded cases in the sample. We worked with both coders to determine the initial categories and coding protocols, and any questions that arose during the coding were resolved in consultation with both of us.

[50] The figure 7959 includes the claims of lien creditors, because these creditors presumably began their credit relationships with the debtor as unsecured creditors. *See infra* note 92. Excluding lien creditors, the total number of unsecured claims is 7898.

[51] *See* 11 U.S.C. § 109(e) (2000).

[52] *See id.*

[53] Because we selected fifty cases per district per chapter for the original sample, we did not reflect the proportion of Chapter 7, Chapter 11, or Chapter 13 cases either in the district or in the country. In 1994, for example, the Administrative Office of the United States Courts (the AO) reported 52,374 business cases, comprised of 29,689 Chapter 7 business cases, 12,508 Chapter 11 cases, and 9238 Chapter 13 cases. L. RALPH MECHAM, ADMIN. OFFICE OF THE U.S. COURTS, JUDICIAL BUSINESS OF THE UNITED STATES COURTS: 1994 REPORT OF THE DIRECTOR app. 1 at A-100 tbl.F-2. While we have raised questions about the accuracy of the AO's classification of business cases, *see* TERESA A. SULLIVAN, ELIZABETH WARREN & JAY L. WESTBROOK, AS WE FORGIVE OUR DEBTORS 16–17, 40–41 nn.1–2 (1989), these figures are nonetheless the closest approximations of the national distribution of business cases. Like all other researchers, we must rely on them for general outlines. *E.g.*, Teresa A. Sullivan, *Methodological Realities: Social Science Methods and Business Reorganizations*, 72 WASH. U. L.Q. 1291, 1298 (1994). Our business bankruptcy sample, by comparison, has three roughly equal parts: business cases filed in Chapter 7 (1150), business cases filed in Chapter 11 (986), and business cases filed in Chapter 13 (986). The sample is comprised of approximately 36% Chapter 7 cases, 32% Chapter 11 cases, and 32% Chapter 13 cases.

weight the data to correct for this distortion, but we concluded that reducing the impact of Chapter 7 liquidation cases may be appropriate for this analysis. Larger corporate cases seem to be the chief interest of contractualists,[54] so a random sample from a pool that better approximates those interests may be more appropriate.

Although the subsample comprises only about 18.3% of the Chapter 7 and Chapter 11 cases in the overall sample,[55] by itself it represents a very large amount of total debt. The total debt, secured and unsecured, in the subsample is approximately $374 million,[56] an average of approximately $970,000 per case.[57] The total unsecured debt in the subsample is more than $133 million, an average of approximately $372,000 per case.[58] Thus, the unsecured claims represent a little more than a third of the total debt in the subsample cases.

The subsample provides a much more detailed view of the creditors who find themselves listed in a business bankruptcy. By shifting attention from the debtor to the creditor, this expanded subsample offers the opportunity to determine which creditors would be affected by a privatized bankruptcy regime.

III. TESTING THE THEORY

The central feature of any proposal that calls for parties to contract 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. The claimed benefits of a contracting scheme are that when parties can provide for different rules to govern in the event that a debtor defaults, those parties can adjust their behavior and prices to create efficiency gains. In effect, they can tailor their prices to reflect different liquidation schemes that suit them better than a one-size-fits-all bankruptcy law. If all creditors can adjust perfectly to different amounts of risk, then the parties can tailor bankruptcy regimes that

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[54] Indeed, some scholars indicate a certain disdain for cases that are less than mega. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 752, 788–89 (2002).

[55] Notwithstanding the omission of Chapter 13 cases, the subsample, like the larger sample of Chapter 11 and Chapter 7 cases, includes both natural persons and legal entities filing business bankruptcies. In the Chapter 11 cases, about one-quarter of the cases were filed by human debtors and about three-quarters were filed by legal entities. In the Chapter 7 cases, the proportions are reversed: approximately three-quarters of the business liquidations were filed by individuals. Warren & Westbrook, *supra* note **, at 532. Note that the chapter designations in our data apply to the chapter of initial filing, ignoring any later conversions to other chapters.

[56] We often round as an act of kindness to our readers and ourselves. We round up from .5.

[57] As usual, the median is considerably lower, at about $162,000.

[58] The median unsecured debt per case is about $75,000. These figures do not include priority tax debt for reasons explained later. *See infra* p. 1250. Cases with no unsecured debt remain in the sample. *See supra* note 47.

best reflect their own preferences and allocations of risk. But if there are creditors who were absent from the bargaining table and cannot adjust behavior or prices to reflect each distinct risk profile, 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. In this Article, we call these creditors "maladjusting creditors."

Contracting creditors can be expected to negotiate for a system that benefits themselves, not the parties who are absent from the negotiating table. For that reason, all contract-bankruptcy schemes depend upon some form of "deemed" acceptance by nonparties. If the absent parties could learn (without cost) about the different rules that would apply upon default, and adjust their behavior (without cost) to reflect the changes in risk associated with the new default regime, then any such proposal for party autonomy would preserve the efficiencies claimed by its proponents.[59] Moreover, it would have no overtly redistributional effects. But if some affected creditors are unable to adjust at all to schemes that offer more or less protection of their interests, then the proposal has a redistributional effect. The value gained by a negotiating creditor arises in part from a loss imposed upon the nonadjusting creditor.[60] In the absence of a policy justification for this reallocation of risk, the proposal is prima facie inefficient. Other creditors may be able to make a partial adjustment to a change in the bankruptcy rules. For example, these maladjusting creditors may not be able to price the change differentially to each particular debtor, but can raise their prices overall to reflect the increased costs. The effect may be to undercharge one particular customer while overcharging the others. Once again, the adjusting creditors will be pushing the risk of loss onto other parties, in this case the customers of the maladjusting creditors, resulting in a corresponding loss in efficiency.[61]

To make the example more vivid, it is useful to consider a contracting creditor and debtor who agree to Bankruptcy Regime *A*: upon default the debtor will have full access to bankruptcy and to the preservation of the going-concern value[62] of the business. (This describes the current bankruptcy system.) Another contracting creditor and debtor

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[59] Such a scheme might have other adverse social effects, such as a reduction in the availability or an increase in the cost of credit from the absent groups, or injury to some group important to social welfare, such as small entrepreneurs. We put these questions aside for present purposes.

[60] *See* LoPucki, *Contract*, *supra* note 5, at 338; Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1916 (1994) [hereinafter LoPucki, *Bargain*].

[61] *See* Bebchuk & Fried, *Uneasy*, *supra* note 17, at 864, 881; Bebchuk & Fried, *Uneasy #2*, *supra* note 17, at 1313–14.

[62] Going-concern value is the amount obtainable by selling the business as a whole and as an ongoing enterprise. *See generally* Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 811 & n.52 (2004) and sources cited therein.

agree to Bankruptcy Regime *B*: the debtor will have no access to bankruptcy and will immediately turn all of its assets over to the contracting creditor. (This describes what happens now if a secured party has a blanket lien and the debtor does not file for bankruptcy.) In Bankruptcy Regime *B*, a default triggers the immediate removal of property from the business to benefit the contracting creditor and will result in the collapse of the debtor's business. The benefit gained by the contracting creditor in Bankruptcy Regime *B* would come at the expense of the parties who might have benefited from both the wealth-enhancing and the distributional aspects of the otherwise-applicable Bankruptcy Regime *A*. In Bankruptcy Regime *A*, for example, noncontracting parties might have profited from continuation of the business and preservation of its going-concern value because the noncontracting parties would have been paid in full if the business had survived, but will be paid nothing if the business is immediately liquidated instead.[63] If noncontracting parties cannot fully adjust their behavior to reflect the decreased risk associated with Bankruptcy Regime *A* and the increased risk associated with Bankruptcy Regime *B*, then there will be an involuntary wealth transfer from maladjusting parties to the contracting party and a resulting pricing inefficiency in the system.

In order to tout the benefits of negotiated bankruptcy regimes, the contractualists assume there would be little or no redistributional effect or, to be more explicit, that all or most parties would be able to adjust their bargains (price and other terms) to reflect the effects of the proposed contractual approaches.[64] If the other creditors are not fully adjusting, then the contractualists' claim of efficiency encounters a serious problem. They can no longer claim benefits from their proposals without offsetting losses. Instead, the presence of substantial inefficiencies associated with contractual proposals means that without some evidence of the size and scope of the purported efficiencies, the proposals are neither theoretically nor factually justifiable.

The inefficiencies in the contractualist approaches spring from the fact that some parties whose relationships with potential debtors may be founded on contract are extremely unlikely to engage in predefault negotiations that reflect differences in pricing based on the bankruptcy scheme selected. Employees and utility companies may fall into this category. In addition, some parties can never be present because their claims are not based in contract. For example, creditors whose claims

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[63] There is a substantial debate as to how often a favored creditor may or may not sell the assets in a way that benefits the maladjusting creditors, but few can deny the risk that the maladjusting creditors may be worse off in some cases because their interests differ from those of the favored creditors. *See generally* LoPucki, *Bargain*, *supra* note 60; Westbrook, *supra* note 62.

[64] *See, e.g.*, Schwartz, *supra* note 4, at 1834.

arise from personal injury or fraud will have no chance to negotiate for any financial consideration in advance of the harms they suffer. Because bankruptcy constitutes a final liquidation of the debtor's assets or a complete financial reorganization of the business, the point of any bankruptcy scheme is to deal with *all* the parties to whom the debtor owes obligations — not just the parties who negotiated in advance for special treatment after default. In this Article, we identify and quantify the types of creditors who are unlikely to be able to contract for a privileged position in an individually bargained bankruptcy system.

There are four types of claimants in bankruptcy that might be unable to adjust fully to a change in bankruptcy rules arising from a contract between a debtor and a third party: involuntary creditors, quasi-involuntary creditors, unsophisticated creditors, and creditors with small claims.[65] They are among the maladjusting creditors. Involuntary creditors are typified by tort claimants.[66] Quasi-involuntary creditors include taxing authorities and many utilities that are prohibited by law from adjusting their charges to reflect subtle changes in financial risks.[67] Unsophisticated creditors may voluntarily contract with a debtor for large or small amounts, but they lack the expertise required to discover and evaluate differing bankruptcy terms.[68] Finally, creditors that have relatively small contracts with a particular debtor may discover that the size of their potential claims does not justify incurring the information or negotiation costs associated with a full adjustment.[69] These four categories show that maladjusting creditors may include creditors large or small, sophisticated or unsophisticated, voluntary or involuntary. All these creditors are united by a single thread: they are not in a position to adjust their behavior (or prices) to account for the different bankruptcy rules that their debtors may have negotiated with other creditors.

The contractualist proposals therefore raise many of the same issues that have arisen in the great debate over the efficiency of secured credit,[70] in which critics have argued that secured credit is inefficient

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[65] *See* Bebchuk & Fried, *Uneasy*, *supra* note 17, at 882–91; Bebchuck & Fried, *Uneasy #2*, *supra* note 17, at 1296–1304; LoPucki, *Bargain*, *supra* note 60, at 1896–97.

[66] *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 53, at 294; Bebchuk & Fried, *Uneasy*, *supra* note 17, at 882–83; LoPucki, *Bargain*, *supra* note 60, at 1893.

[67] *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 53, at 297; Bebchuk & Fried, *Uneasy*, *supra* note 17, at 884.

[68] *See* LoPucki, *Bargain*, *supra* note 60, at 1916.

[69] *See* Bebchuk & Fried, *Uneasy*, *supra* note 17, at 885.

[70] *See generally* Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993) (justifying the perseverance of secured finance); Richard L. Barnes, *The Efficiency Justification for Secured Transactions: Foxes with Soxes and Other Fanciful Stuff*, 42 U. KAN. L. REV. 13 (1993) (arguing that secured credit can be justified only if it produces gains to all players); James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27 (1991) (questioning

because of the presence of maladjusting creditors.[71] Many of the most cogent criticisms of secured credit law are based on the assertion that secured credit captures gains for the secured creditor and the debtor at the expense of maladjusting unsecured creditors.[72] The same critique applies to contractualism generally.

Because of the existence of secured credit, it must be conceded that the existing bankruptcy system permits private contracts to change bankruptcy results, creating the same sorts of losses from maladjustment of claims. Secured creditors shift some of the insolvency risk onto other creditors when they collect substantial amounts, while the tort victims and maladjusting contract creditors are left with small recoveries because they have little opportunity to adjust their "prices" to reflect credit risks. Adoption of a contractualist system would risk a substantial increase in those losses for three reasons. First, without the restraints of bankruptcy's mandatory rules, the strongly adjusting creditors would naturally negotiate the best possible terms for themselves, exacerbating the redistributive effects. Second, to the extent that contractualist proposals have not provided for a notice system akin to Article 9 perfection requirements, the information costs facing maladjusting creditors would be even greater and therefore their ranks would grow larger. Third, to the extent that a contractualist proposal

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whether bankruptcy actually accomplishes efficient results if secured creditors are involved); F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986) (using efficiency theory to explain the incentive to use secured credit); David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179 (1994) (attempting to prove that security interests can theoretically be efficient); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979) (discussing the efficiency of the UCC's Article 9 priority rules); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985) (defending secured credit financing); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982) (discussing the monitoring role of secured creditors); Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J. 1 (1997) (reconciling the use of unsecured lending in small businesses with existing theories of secured credit); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992) (discussing whether secured credit can minimize creditor misbehavior); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986) (suggesting that secured lending supports a beneficial relationship between borrower and lender); Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989) (criticizing the economic evaluation of secured transactions); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992) (analyzing the purported benefits of secured debt); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984) (arguing that secured credit is good for society).

[71] One of us has gone further to argue that contractualism necessarily requires a system of dominant security interests in favor of the contracting party to provide the necessary control over the debtor's assets. *See* Westbrook, *supra* note 62, at 855–57. That position is wholly consistent with the arguments made here, but not necessary to them.

[72] *See* Bebchuk & Fried, *Uneasy*, *supra* note 17, at 870; Block-Lieb, *supra* note 5, at 541; LoPucki, *Bargain*, *supra* note 60, at 1897–98.

would embrace a large number of alternative bankruptcy schemes, it would further increase the information costs for other creditors and thus add to the number of maladjusting creditors.

Even if all creditors were fully adjusting, a contractualist approach would generate an increase in transaction costs, including information costs, arising from negotiation of contract-bankruptcy schemes or from price differentiation based on such schemes — costs avoided by the existence of a standardized system represented by the Bankruptcy Code. The contractualists assume that the increase in efficiency associated with private bargaining will exceed the costs of negotiation.[73] That assumption can be challenged, however, if there are many creditors who would insist on coming to the bargaining table. The transaction costs involved in such a multiparty negotiation would be very substantial. To the extent that those costs would lead to a battle of standardized contracts — a very plausible result — they would also increase related litigation after default. Thus, the presence of a substantial number of creditors is problematic for contractualism, even if a number of the creditors could negotiate and price differentially in each case.

If unsecured creditors got little or nothing in bankruptcy cases under the present system, one could argue that these theoretical inefficiencies do not matter, because a change to a contract-bankruptcy system would not reduce unsecured creditors' recoveries or increase their risks. In fact, unsecured creditors do recover substantial amounts in a number of cases under the present system. While there is some evidence that Chapter 7 liquidations pay little,[74] at the other end of the spectrum are the larger Chapter 11 cases. New data show that the current bankruptcy system generates promises for payments for general unsecured creditors that average about 78% of their original claims in confirmed plans.[75] The typical Chapter 11 cases probably lie somewhere between these extremes, but for the millions of creditors listed in business bankruptcy cases, these data suggest that losses from the inefficiencies just discussed would be significant.

The effects of any change in the rules that disadvantages one group would be felt not only in cases of bankruptcy, but also whenever troubled companies arranged workouts or other debt consolidation plans. Any workout with a troubled company takes place with a careful eye

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[73] *See, e.g.*, Rasmussen, *supra* note 4, at 66.

[74] As many as 95% of Chapter 7 cases may have no payouts for general unsecured creditors, although the data mix together business and consumer debtors. Michael J. Herbert & Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed During 1984–1987*, 22 U. RICH. L. REV. 303, 310–11 (1988).

[75] Lynn M. LoPucki, The Myth of the Residual Owner: An Empirical Study apps. B & C at 34–37 (July 28, 2004) (unpublished manuscript, on file with the Harvard Law School Library).

to what the payouts would have been in bankruptcy. Any debtor who had already agreed to a bankruptcy regime that would give a preferred creditor free rein if the company got into trouble would be unlikely to offer some payment to the maladjusting creditors. Whenever the rights of creditors are stripped in bankruptcy, those creditors will recover substantially less in nonbankruptcy workouts as well.

Thus, it is reasonable to anticipate that there are potentially large costs arising from these threatened inefficiencies in both workouts and bankruptcy proceedings. If there were many maladjusting creditors, then the costs of contract proposals would be substantial and the contractualists would bear a heavy burden to show that the greater efficiencies they claim arise from the contracting process would outweigh those costs.[76] If there were many adjusting creditors, and their number drove up transaction costs, the contractualists would also bear a heavy burden to show net efficiencies. The data show that there are likely to be many creditors in both categories and that the costs of departing from a single bankruptcy system would likely be very substantial.

IV. THE SPECIFIC HYPOTHESES — WHAT WE CAN TEST

The most directly useful thing empirical research can do is to establish whether specific factual hypotheses or premises are inconsistent with the facts. We set out to test the three factual propositions that are implicit in the various bankruptcy contract schemes, creating the testable hypotheses that contractualists have failed to generate:

Hypothesis #1: A contracting scheme will have little or no redistributive effect because few creditors will be in circumstances in which they cannot fully adjust to changes in risk that may be imposed on them by the contracts of others.

Hypothesis #2: A contracting scheme will have little or no redistributive effect because almost all creditors will have claims large enough to justify the cost of adjusting to the changes in risk imposed by such a scheme.

Hypothesis #3: A contracting scheme will impose low transaction costs because there will be relatively few creditors in each case.

These are the empirical assumptions that underlie the contractualists' claims that they can generate substantial efficiencies without creating new inefficiencies. We use the data to test each in turn.

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[76] This point is especially true because they have to date made virtually no effort to show any specific savings.

A. Creditors in Circumstances That Make Them Unlikely To Adjust

Hypothesis #1 is inconsistent with the data. Some creditors are unlikely to adjust to the different risks imposed upon them by a variety of bankruptcy schemes because of the nature of the relationship each has with the debtor. In fact, the model of one fully informed debtor sitting at a table negotiating terms of the credit relationship with one fully informed creditor fails to capture reality for many of the creditors who end up as claimants in bankruptcy.

The idea of an involuntary or reluctant (quasi-involuntary) creditor was the subject of a chapter in our 1989 book, *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America*.[77] After drawing a sample of individual (not corporate) debtors filing bankruptcy in Chapter 7 and Chapter 13, we discovered that 72.5% of the cases in the sample listed debts to entities we classified as "involuntary or reluctant creditors."[78] We defined such creditors as those who had no contractual relationship with the debtor (for example, a tort victim or tax authority) and those who attempted to stay on a cash or near-cash basis but were sometimes forced by circumstances to extend credit (for example, many utility companies and health care providers).[79]

Professor LoPucki introduced the notion of involuntary or reluctant creditors to the debate over the efficiency (or inefficiency) of secured credit.[80] He observed that many "unsecured creditors do not consent to their status in any meaningful sense."[81] He argued that secured creditors can lend for less than unsecured creditors because they have the power to "victimize involuntary creditors."[82] The secured creditors "expropriate for themselves value that, absent the agreement, would go to involuntary creditors."[83]

In 1996, Professors Bebchuk and Fried made a similar distinction among business creditors, focusing on three categories of creditors: involuntary nonadjusting, voluntary nonadjusting, and perfectly adjusting.[84] They argued that the case for declaring secured credit efficient is "at best problematic" and that systems for preferring secured creditors at the expense of all nonadjusting and weakly adjusting claimants

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77 SULLIVAN, WARREN & WESTBROOK, *supra* note 53, at 293–301.

78 *Id.* at 295 tbl.16.1.

79 *See id.* at 299.

80 *See generally* LoPucki, *Bargain*, *supra* note 60.

81 *Id.* at 1896.

82 *Id.* at 1897.

83 *Id.* at 1897–98.

84 *See* Bebchuk & Fried, *Uneasy*, *supra* note 17, at 864–65 (noting that in addition to adjusting creditors and involuntary nonadjusting creditors, there is also a class of voluntary creditors who will fail to adjust to new credit arrangements because their claims are "simply too small" or are extended on fixed terms).

"generate a number of inefficiencies."[85] These nonadjusting and weakly adjusting creditors are those we call collectively "maladjusting" creditors.

There are various ways to infer whether a creditor is the sort of claimant that would have been able to protect itself either with a prebankruptcy contract or with a prebankruptcy price adjustment that reflected the risks imposed if the debtor used a bankruptcy distribution scheme that was different from the system currently in place. None is perfect. We offer a list in our 1989 work.[86] Professor LoPucki identifies a similar list in his work,[87] and Professors Bebchuk and Fried offer several examples.[88] All approaches include some of the same claimants. Personal injury claimants are at the top of everyone's list as the prototype of a creditor unable to negotiate for compensation pegged to the credit risk of the tortfeasor, and taxing authorities appear on all three lists. Professor LoPucki notes that his list is not exclusive: "Regardless of where one draws the line among these creditors, involuntary unsecured credit clearly exists in substantial amounts."[89] Professors Bebchuk and Fried take a position befitting less empirically oriented scholars. They state that their conclusions about transferring risks to maladjusting creditors do not depend on documenting the existence of tort or government creditors, instead asserting simply that nonadjusting creditors "invariably exist."[90]

Alas, we are involved in the factual business of trying to identify these maladjusting creditors, which required us to develop some selection criteria. We focused on the prebankruptcy circumstances of dif-

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[85] *Id.* at 859. An empirically based criticism of the Bebchuk-Fried position is stated by Professor Claire Hill. *See* Claire A. Hill, *Is Secured Debt Efficient?*, 80 TEX. L. REV. 1117, 1160–62 (2002). She does not deny the existence of maladjusting creditors, but argues that secured lenders are so sensitive to the additional financial risk such creditors represent that the secured parties require high-risk debtors to purchase adequate amounts of insurance, presumably to cover personal injury claims. *Id.* However, Figure 1, *infra* p. 1224, shows that 22% of the cases in our sample had insurance debts, many of which were presumably unpaid premiums, which suggests to us that the insurance coverage in those cases may have been lacking.

[86] The list was aimed at consumer cases and included tort victims, former spouses and children with unpaid support orders, government agencies, educational lending agencies, health care providers, tax authorities, landlords, and utilities. *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 53, at 294–98.

[87] Professor LoPucki concentrated on business cases, identifying personal injury claims, business activities that subject companies to civil or criminal liabilities, environmental claims, tax claims, other government claims, and utility provider claims. *See* LoPucki, *Bargain*, *supra* note 60, at 1896–97.

[88] They identified tort claimants, government agency claims, tax claims, trade claims, and claims too small to be worth negotiating. *See* Bebchuk & Fried, *Uneasy*, *supra* note 17, at 882–88.

[89] LoPucki, *Bargain*, *supra* note 60, at 1897.

[90] Bebchuk & Fried, *Uneasy*, *supra* note 17, at 865. A collateral benefit of this Article is that by showing the existence of maladjusting creditors it goes a long step toward quantifying the Bebchuk and Fried claims and thus makes them more cogent in the debate about the efficiency of secured credit.

ferent creditors listed in business bankruptcies, using as our test whether the parties had a meaningful opportunity before bankruptcy to negotiate with the debtor businesses. We assumed that those creditors who did negotiate were able to assess the risks and adjust their prices accordingly — or walk away from the unattractive proposals and accept the desirable contracts. Those creditors who did not have an opportunity to make debtor-by-debtor adjustments represent the class of potential claimants who would simply be required to absorb the costs imposed upon them when the other creditors negotiated for their preferred bankruptcy arrangements. We divided and subdivided the creditors, and ultimately settled on five categories of creditors that are most likely to include maladjusting creditors: tort victims, utilities, taxing authorities, employees, and nontrade natural persons.

We recognize that by using general categories, our assessment of the negotiating opportunities facing any particular creditor within a category may be wrong. Nonetheless, we think the generic descriptions are sufficiently accurate to advance our understanding of the balance between strongly adjusting and maladjusting creditors. Any questionable inferences should be obvious in the discussion. We realize, of course, that others may wish to draw different conclusions from these data, so we make every effort in this Article to explain enough about the data and their derivations to permit alternative analyses.

1. The Initial Presumptions. — We begin this analysis with a factual assertion: secured creditors are strongly adjusting creditors. We assumed that any creditor sophisticated enough to get a security interest or mortgage has both the opportunity to negotiate in advance with the debtor and the savvy to understand something about repayment risk. We realize that secured creditors may differ in their individual capacities, and that banks, family members, car dealers, and inventory suppliers may not have identical opportunities to assess and deal with risk. Nonetheless, as a group, secured creditors are best situated to cope with risk. Not surprisingly, in the business bankruptcy cases, these creditors hold the most debt. By dollar value, about 61.2% of all the debt listed in business Chapter 11 and Chapter 7 cases is secured.[91] This means that those who negotiated for collateral to secure the amounts they were owed claimed well over half of all the dollars demanded in business bankruptcy cases. We assumed that these are the creditors most likely to negotiate for bankruptcy contracts that favor their interests.

Our focus in this Article is on what happens to the remaining 40% or so of the debt listed in bankruptcy — debt that is not backed by a

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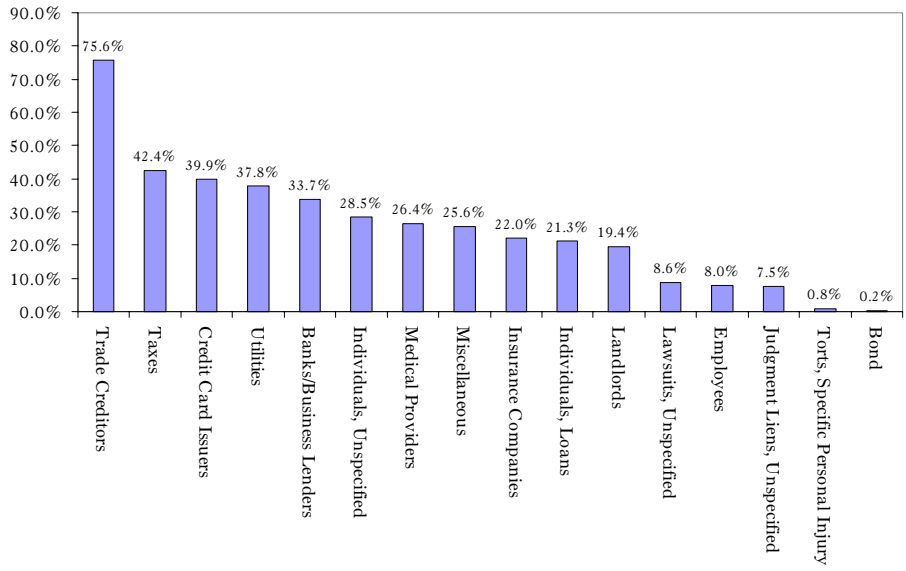
[91] According to the debtors' schedules, about 50.8% of all debt is backed by collateral and about 10.4% of all debt is the unsecured portion of an otherwise secured loan.

prenegotiated security interest. Among the unsecured creditors may be some very sophisticated lenders. For example, banks and other institutional lenders, credit card lenders, landlords, and creditors holding unsecured bonds all end up with unsecured debt in bankruptcy, presumably for a price that reflects the risks they took. But not all the unsecured creditors are so sophisticated or well positioned. Therefore, we made an effort to disaggregate the unsecured creditors to test for the presence of sizeable subgroups of creditors who are unable to make appropriate risk adjustments.

2. The Claimants. — We began by sorting the unsecured creditors by type. Figure 1 lists groups of unsecured creditors by the proportion of Chapter 11 and Chapter 7 business bankruptcy cases in which they appear.[92] Trade creditors are the most ubiquitous in bankruptcy, showing up in three-quarters of all business cases. At the other end of the continuum, bond creditors are the least frequent, listed as creditors in less than 1% of the business bankruptcy cases.

[92] For the purposes of Figure 1, we omitted details on four creditor groups and combined two other groups to shrink the initial list of twenty-two types of creditors about whom we collected detailed data to sixteen categories. We omitted secured creditors on the assumption that they, by definition, could contract in advance for priority of repayment. We omitted attorney claims, priority and nonpriority, on the assumption that attorneys are highly adjusting creditors who know they are dealing with a troubled debtor or who usually have extensive opportunity to negotiate with their clients. We consolidated priority and nonpriority employee claims, in part because the number of nonpriority employee claims was miniscule and in part because priority status does not matter greatly to the discussion of the ability of the creditor to adjust. Priority and nonpriority tax claims are also combined. We omitted the remaining priority claims because there were too few to aggregate in any meaningful way. We have retained reports on judgment lien creditors, even though their debts were presumably secured at the time of the bankruptcy filing, because they were originally unsecured creditors. Although they may have been more aggressive at the enforcement stage than other unsecured creditors, we assume they were in similar negotiating positions at the time the debt was incurred.

FIGURE 1. PROPORTION OF BUSINESS BANKRUPTCY CASES LISTING UNSECURED CREDITORS, BY CATEGORY



Source: Business Bankruptcy Project, Claims Subsample
N = 386

About one in four businesses listed at least one claim that fits into no discernible category, either because the category was too rare (for example, one computer business listed "veterinarian bill") or because too little information was provided (for example, some companies listed the generic "unsecured debt").[93] But for three-quarters of the businesses, every single debt could be categorized. Overall, the number of unclassifiable debts was modest, about 5.3% of all claims.

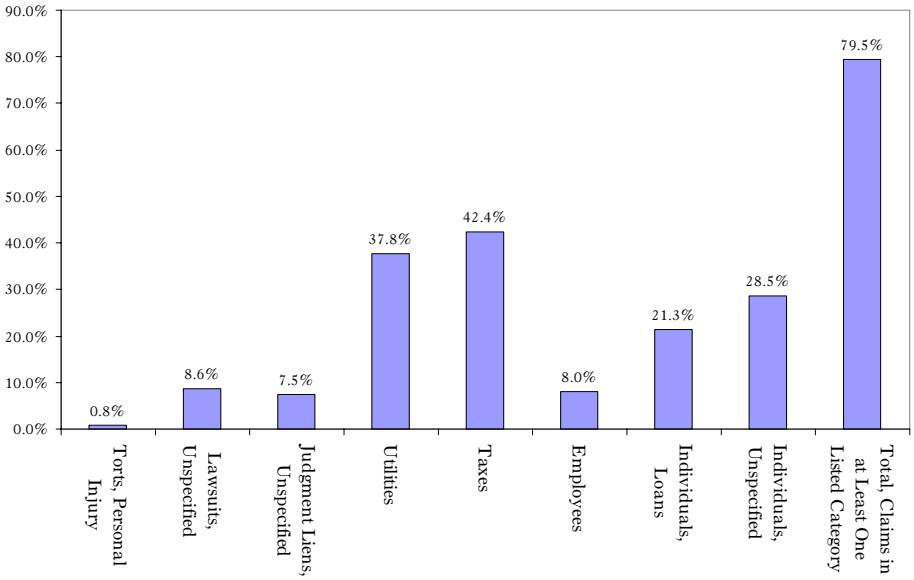
As we develop our analysis in this Article, we examine some of these categories in greater detail, but Figure 1 remains available to put this analysis in context.

For this analysis, we focus specifically on those unsecured claimants for whom the strongest argument can be made that, as a group, they are least likely to have a meaningful opportunity to adjust their behavior (or their prices) to reflect increased risks imposed upon them by the contractual arrangements of others. Accordingly, we concentrate specifically on five groups: personal injury claimants, utility companies, taxing authorities, employees, and individual (rather than

[93] Even for these businesses, however, most of the debt could be classified.

corporate) creditors.[94] We also include a discussion of creditors who show up on the bankruptcy schedules merely as plaintiffs or judgment lien creditors, making some calculated guesses about their circumstances. Data on these creditors are presented in Figure 2, in the order in which we discuss them in the upcoming sections.

FIGURE 2. PROPORTION OF BUSINESS BANKRUPTCY CASES LISTING LIKELY MALADJUSTING CREDITORS



Source: Business Bankruptcy Project, Claims Subsample
N = 386

For the purposes of pinning down a more clearly maladjusting group of creditors, we eliminated the trade creditors and landlords from the analysis, but we remain conscious that we have thereby seriously skewed our findings. We omitted trade creditors and landlords because these categories include a widely divergent mix of creditors and circumstances, some maladjusting and some fully adjusting. In-

[94] For this analysis, we omitted the health care providers. They are nearly always involuntary or reluctant creditors, and they were prominently included in our analysis of consumer bankruptcies. Furthermore, we were astonished to see that they appear in more than one in four business bankruptcies. We omitted them nonetheless because they appear almost exclusively in the entrepreneur bankruptcies instead of the corporate bankruptcies. The debtors were running a business, but this debt seemed deeply personal. That said, these data should make clear that any decision affecting small businesses will have substantial fallout in unexpected places.

cluding categories so large and so diverse would have diluted the probative value of the data. But there is every reason to believe that a substantial portion of the trade creditors would have a difficult time adjusting their prices to reflect the differential bankruptcy systems of currently paying customers. Many trade creditors are eager to make sales; they often fear that harsh credit terms or delivery delays while credit investigations take place will send some customers elsewhere. More generally, these creditors are often unsophisticated and unlikely to have the capacity to adjust their prices and contract terms in reaction to relatively esoteric variables like a bankruptcy system.[95] Moreover, trade credit is expected to be repaid relatively quickly, further undercutting the incentives to determine whether a customer uses one bankruptcy regime or another.[96] The fact that many sellers offer standardized credit terms to all their customers indicates an inability to take on the burden of differentiating among customers based on credit risk.[97] To assume, as the contractualists must, that these trade creditors could adjust their prices differentially to reflect the impact of various bankruptcy regimes requires an extraordinary optimism about business practices that seems inconsistent with the circumstances in which these businesses find themselves. Trade creditors are especially important because they account for a substantial majority of the claims in business bankruptcies and are listed as unpaid creditors in 75.6% of all the business bankruptcy filings.[98] This significant group of creditors will be powerfully affected by any shift of legal presumptions that favors those creditors who can negotiate for advantage or adjust their prices to reflect changing risks.

Even without trade creditors and landlords, the remaining group of maladjusting creditors — personal injury claimants, utility companies, taxing authorities, employees, and individual creditors — forms a significant cadre in the bankruptcy courts. The overall picture is startling: nearly four out of every five business cases in our subsample — 79.5% — list at least one of these maladjusting creditors. Of course, many of the claimants overlap; that is, one case may have several different maladjusting creditors.[99] Below we discuss each of the five

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[95] Many trade creditors are natural persons. For a discussion of the proportion of natural persons in our business sample, see *infra* pp. 1233–35.

[96] Trade creditors are included in the analysis in sections IV.B and IV.C, along with other creditors engaging in small transactions that cannot support a full adjustment, and other creditors so numerous that transaction costs rise.

[97] Businesses are likely to make an exception for customers who have a history of default. When the risk presented by a customer is evident from a past business relationship, trade creditors may adjust their credit practices, but there is little evidence that they currently make differential credit decisions among customers. *See* Bebchuk & Fried, *Uneasy #2*, *supra* note 17, at 1299–1300.

[98] Not only are trade claims found in the vast majority of the cases, as Figure 1 shows, but we found that they constitute more than half of all the general unsecured claims, a total of 4474.

[99] The plaintiffs in unspecified lawsuits and the judgment lien creditors overlap with the most categories: in every single case in which they appear except one, another creditor from the list —

groups of claimants, describing their collective circumstances and the frequency of their appearance in business bankruptcy cases.

(a) Tort Claims. — In the academic debates, as in life, the paradigmatic nonadjusting creditor is the tort victim. These are the cases for which we can say with the greatest certainty that the creditors were unable to negotiate in advance for a risk-adjusted premium or for a liquidation scheme that would protect their interests. If a debtor and creditor negotiate to shift risks to unsecured creditors generally, a tort creditor will absorb those risks fully — with no additional compensation to offset the increased financial hazard. It is on behalf of tort victims that much of the resistance to contract-based bankruptcy has been argued.[100]

In our subsample of 386 cases, we could clearly identify only three debtors with personal injury claims filed against them. As Figures 1 and 2 illustrate, this is a small fraction of the debtors, a little less than 1%.

This statistic, however, represents the minimum possible number of tort claims in our sample; there are likely more. Tort claims are difficult to identify in the bankruptcy files. There is no box on the bankruptcy forms that asks a creditor if a claim is grounded in tort. We used whatever information was available in the files, such as a debtor's voluntary identification of a claim based on a personal injury. We recognized, however, that such statements were not systematic — that is, the absence of such statements in other cases did not mean that the debts were not also personal injury claims, but merely that the debtor did not identify any claims as such. To try to locate unidentified tort claims, we looked for other markers of an involuntary relationship between the debtor and the claimant. We acknowledge that such markers are imperfect because they either undercount tort claims or contain a mix of tort and nontort claims. Our only other option, however, was to curse the darkness. With that caveat, we offer a few data runs that hint at the presence of more cases with involuntary creditors.

We began expanding the list of possible involuntary creditors by examining all claims identified as lawsuits. About 8.8% of the business cases listed lawsuits outstanding at the time of filing, while 7.5% of businesses listed judgment liens against their property, presumably from lawsuits that had been completed before the businesses filed for

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personal injury claimant, employee, etc. — is also listed. This means the total number of cases involving maladjusting creditors would remain essentially unchanged if we did not count judgment lien creditors or unspecified lawsuits.

100 *See, e.g.*, LoPucki, *Bargain*, *supra* note 60.

bankruptcy.[101] Claims other than personal injury lawsuits may also involve involuntary relationships. Property damage claims, slander, libel, unfair competition, and fraud are among the many grounds on which someone may sue a business. These claims would also involve an injury to maladjusting creditors. Like personal injury lawsuits, victims of these claims would have no preinjury opportunity to negotiate. The problem, of course, is that some lawsuits against a business debtor may be grounded in breach of contract, such as failure to pay a debt or some other court action taken after a contract relationship went sour. As a result, the generic heading "lawsuit" may include monies owed to both voluntary and involuntary creditors.

In addition to the lawsuits, claims may be listed in bankruptcy that would form the basis for a lawsuit even though no suit had been filed at the time the bankruptcy was initiated. It is also possible that not all pending lawsuits were clearly identified as such; debtor's counsel might simply list the name of the filing party or the name of the party's attorney without specifying that a lawsuit has been filed. For collection suits against the debtor, the amount of the claim is likely to be known; that is, the creditor is likely to sue for a very specific amount, even if the creditor hopes to add on attorneys' fees or court costs. But a debtor facing injury-based lawsuits-in-progress, whether filed or not, would typically list the amount of the claim as "unknown" or "unliquidated." Such listings could include contract debts, of course, but such designations would be most likely for tort claims or similar actions in which the damages are not easily known before a jury verdict. In our subsample, 5.4% of debtors listed one or more debts to individuals for an amount that was "unknown" or "unliquidated." Another 3.4% listed one or more debts to other businesses for amounts that were "unknown" or "unliquidated." These cases suggest a possible expansion of the injury-based claims category.[102]

For a few bankruptcy cases, such as those involving companies with substantial asbestos or other product liability exposure, the per-

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[101] *See* Figure 2, *supra* p. 1225. The grounds for both types of suits were unspecified, and each listed only the name of the lawyer handling the case or the name of the plaintiff.

[102] In addition to these "unknown" debts, 21% of the businesses listed one or more debts to insurance companies. These debts may be for unpaid premiums, for the return of money mistakenly paid to the debtor company by its insurance company, or for the reimbursement of claims paid by a victim's own insurance company. Other, more complex arrangements having to do with loss recoveries may also explain some of the filings. The average debt is about $6100, and 19.8% of the debts listed are either greater than $10,000 or listed as "unknown" in amount. The high proportion of debtor businesses that owe money to insurers suggests yet another place where tort debt may be represented, although not identified as such. Because of the highly speculative nature of this part of the analysis, we omitted these data from the compilation of possible maladjusting debt, but we recognize that in doing so we are once again understating the role such debt plays in business bankruptcies.

sonal injury claimants may number in the tens of thousands.[103] For routine cases, such as those that show up in this sample, however, we could not specifically identify a substantial number of such claims. Whether other involuntary creditors, such as victims of employment discrimination or unfair trade practices, are listed in the bankruptcy cases in substantial numbers is also hard to pin down.

Although we cannot ascertain with precision the number of cases involving an action against the debtor that is based on an involuntary relationship, we can use these data to create a range. At one extreme, if none of the unidentifiable lawsuit claims, judgment liens, or unknown debts involved any sort of injury, then only about 1% of the cases listed in bankruptcy had any such involuntary claimants. At the other extreme, if at least one of the unidentified lawsuits and unspecified claims for each debtor was based on an involuntary relationship, which is admittedly unlikely, then about 25.5% of the cases would involve such a claim.[104] Reality lies between these boundaries.[105] As such, the data show that the paradigmatic nonadjusting creditor is

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[103] The RAND Corporation has documented the rising number of asbestos claimants, citing estimates that a million people could claim injuries, with costs totalling $145–210 billion. STEPHEN J. CARROLL ET AL., RAND INST. FOR CIVIL JUSTICE, DOCUMENTED BRIEFING 397-ICJ, ASBESTOS LITIGATION COSTS AND COMPENSATION: AN INTERIM REPORT 77–78 (2002). Those companies affected by asbestos litigation include companies that have confirmed a plan of reorganization, such as Johns Manville; companies that have liquidated in bankruptcy, such as Fuller Austin; and companies with pending bankruptcies, such as W.R. Grace, Owens Corning, and Federal Mogul. Other defendants in product liability cases, such as Dow Corning (breast implants) and A.H. Robins (Dalkon Shield), have also taken to the bankruptcy courts in order to resolve pending tort issues. In all of these cases, personal injury claims numbering into the tens of thousands have been the principal reason for filing. The subsample does not include any such mass tort cases.

[104] To arrive at this aggregated number, we included all cases in which any claim was in the category of Schedule D Lien Creditor Debt, Lawsuit Debt (P.I.), Lawsuit Debt (Non-P.I.), or Lawsuit Debt (uncertain), and all cases for which there was an unknown claim in the category of Debts to Individuals (uncertain) or Misc. Debt.

We did not include claims owed to insurance companies because the information about the nature of the debt seemed too ambiguous. *See supra* note 102. Using just the listed categories, 25.5% of all cases included at least one debt that might be classified as "involuntary."

[105] The number of claims, rather than the number of cases with at least one claim of this type, offers another perspective on the data. The high proportion of certain kinds of claims (for example, trade debt) produces some distortions in the data. From among the 7959 claims that we categorized, only seven claims in three cases were clearly identifiable as personal injury claims. Additionally, 68 pending lawsuits, 61 judgment liens, and 64 claims owed for unspecified reasons in unspecified amounts (34 claims owed to individuals and 30 to businesses) were listed, for a total of 193 claims. If all the obligations in those categories were in fact involuntary, then an additional 193 claims — about 2.4% of all claims — were involuntary. We have included judgment liens because those creditors began unsecured and acquired a lien only after suing the debtor and obtaining a judgment in court.

Although a third analysis might involve evaluating the claims by dollar amount, the high proportion of claims for an "unknown" or "unliquidated" amount would make meaningful comparisons impossible.

present in 1% to 25.5% of bankruptcy cases, although the size of the shadow such a creditor casts is difficult to determine.

(b) Debts Owed to Utilities. — Tort victims are not the only creditors who may have a difficult time adjusting their behavior to reflect changing credit risks of their debtors. A utility is another example of a maladjusting creditor that shares some of the same limitations. Because a utility's profits are carefully regulated by law, it must either absorb losses passed to it by a less favorable bankruptcy regime or pass those losses on to all of its customers in the form of higher rates. Either way, the purported gains from allowing parties to contract for multiple bankruptcy schemes are lost whenever the company cannot price discriminate to account for differential risks.

Most public utilities make some effort to protect themselves from risk of loss by requiring deposits prior to initiating service and by threatening to cut off service if the debtor becomes delinquent.[106] But utilities are sharply constrained by statutes and regulatory rules in their ability to deny service or to charge higher rates to those customers that they deem higher credit risks.[107] It is the inability of the utility to price differentially — to charge one price to a customer employing Bankruptcy Regime *A* and a different price to a customer employing Bankruptcy Regime *B* — that makes the utility a maladjusting creditor. Instead, the utility is bound to charge a single price reflecting a single bankruptcy-risk calculation, thereby creating pricing inefficiencies by overcharging or undercharging its customers in a contract bankruptcy system.

While utilities may use deposits and threats of shutoff to induce payments, the bankruptcy data demonstrate that these tactics have not been entirely successful in securing payment in full. As Figure 2 illustrates, about 37.3% of the business debtors were delinquent on one or more utility bills[108] at the time of the bankruptcy filing.[109] In more than a third of the cases, a utility had to rely on whatever protection the default bankruptcy system provided in order to recover for services provided to a now-bankrupt business.

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[106] *But see, e.g.*, Wash. Gas Light Co. v. Pub. Serv. Comm'n, 334 F. Supp. 1062, 1062–64 (1971) (upholding a regulatory agency order prohibiting a utility from demanding an initial deposit from a customer until it ran a credit check).

[107] *See* 14 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 6681 (rev. vol. 2003) (emphasizing "[t]he general rule proscribing unreasonable discrimination in rates between those customers receiving the same kind and degree of service").

[108] The mean amounts outstanding were modest but not insignificant — about $5123 per debtor.

[109] The proportion of claims is smaller. There were 398 claims filed by utility companies, about 7.5% of all the claims filed.

(c) Tax Obligations. — Taxing authorities are another example of maladjusting creditors. Neither the Internal Revenue Service nor a local municipality can adjust ex ante the tax rate imposed on a business based on its assessment of the business's creditworthiness.[110] Taxing authorities are typically paid at the end of the assessment period or after the transaction that triggers the tax obligation, and are thus forced into an involuntary debtor-creditor relationship. Taxes remain the same regardless of the bankruptcy system adopted by a particular taxpayer.

While taxing authorities can be quite vigorous in their collection efforts, the bankruptcy data demonstrate that a substantial number of debtors file for bankruptcy with an outstanding tax obligation. In at least some cases, the taxing authority had already secured a lien against some of the debtor's property, making the legal protection of the taxing authority similar to that of a secured creditor. For purposes of this analysis, we omitted such tax debts from our calculation, because fixing a lien on the debtor's property is a good sign, albeit not a guarantee, that the taxing authority will be repaid in full. Even in cases in which the taxing authority claims a lien against specific property, however, the taxes owed may exceed the value of the property. In those cases, the taxing authority will have only a general unsecured claim for the remainder. By eliminating all the tax cases in which a lien was listed, we necessarily cut out some portion of unsecured tax debt.

For this analysis we focus only on the tax debts that are not supported by a lien. As Figure 2 illustrates, nearly half of the businesses filing for bankruptcy — 42.4% — listed a general obligation to one or more taxing authorities. These cases were ones in which the taxing authority had a claim for which it did not already have a lien against the debtor's property. In the overwhelming majority of these cases, the debtor listed the tax claim as a priority claim, meaning that it was eligible to be paid as a priority ahead of other general unsecured claims — albeit behind secured creditors and others who negotiated for payment priorities.[111] A total of 39.1% of the cases were filed by debtors who owed a priority tax debt, while 6.7% of the cases were

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[110] These authorities usually can impose penalties for nonpayment, but only after default.

[111] In the current bankruptcy system, taxing authorities enjoy an advantage over most other unsecured creditors. If the taxing authority has not secured a lien by the time the debtor files for bankruptcy, the bankruptcy priority system provides that most tax debt will receive a repayment priority. *See* 11 U.S.C.A. § 507(a)(8) (West 2004). This means that most tax debts must be paid in full before any general unsecured creditor receives a penny of distribution. In general, unpaid tax claims that are more than three years old (one year for property taxes), and on which the government has not yet secured a lien, lose their priority status. A small amount of tax debt is neither secured nor priority debt and stands in line with the other general unsecured creditors.

filed by debtors who owed nonpriority tax debts. About 3.6% of the debtors owed both priority and nonpriority tax claims.

Altogether, taxing authorities in more than 40% of all bankruptcy cases were forced to rely on whatever protection the current bankruptcy system provided in order to recover unpaid taxes from a now bankrupt business.

(d) Employee Debt. — Although few employees might describe themselves as such, they are nearly always creditors of their employers. Employees are typically owed money for work completed before payday. Some companies have made commitments to provide severance pay, postretirement insurance, or long-term disability payments, putting the employee in the position of a long-term creditor. In addition, the practice of funding pension plans with future promises rather than current cash also can turn employees into long-term creditors. Federal law imposes some constraints on the ability of employers to delay their current pension obligations, but as a number of recent large bankruptcies have demonstrated, a significant number of employees will nonetheless find that the bankruptcy of their employer means that there will be little left for the employees' retirement.[112]

Because employees deal voluntarily with their employers, they are not involuntary creditors. They may, however, be maladjusting creditors. Employees can protect themselves from the risk of their employer's insolvency by investigating the company's financial condition and either seeking employment elsewhere or demanding higher wages to reflect that risk, but that possibility is more theoretical than real for most rank-and-file employees. The substantial sophistication and the high transaction costs required to obtain the necessary information present significant barriers. Moreover, the costs of moving from one employer to another can be quite onerous for those employees who are building seniority, who have uniquely matched job skills, or who are geographically pinned down by a working spouse, homeownership, or children in local schools. Similarly, although most creditors have the option of spreading their risks by extending credit to several customers, this option is not available to employees, who are unlikely to work for more than a single employer. Expecting these employees to adjust their wage demands or employment decisions based on their employer's bankruptcy regime seems highly unrealistic. Employees in these circumstances might fairly be described as maladjusting creditors.

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[112] *See* Gretchen Morgenson, *Market Watch: Lopsided 401(k)'s, All Too Common*, N.Y. TIMES, Oct. 5, 2003, § 3, at 1 (discussing how many retirement plans are underdiversified and thus tied to a company's financial status); Mary Williams Walsh & Micheline Maynard, *A Plan To Postpone Pension Financing at United Airlines*, N.Y. TIMES, Nov. 20, 2003, at A1 (discussing United Airlines' plan to postpone pension contributions to allow the airline to come out of bankruptcy).

The number of debtors listing outstanding obligations to employees was quite modest. As Figure 2 illustrates, only 8.0% of the businesses in bankruptcy listed employee obligations on their schedules.[113] The majority of those debtors listed employees as priority debt claimants, suggesting that the employees were seeking wages and pension payments.[114] Another six debtors listed nonpriority employee claims. These may have been for wage or retirement fund payments that exceeded the statutory maximum or for other liabilities, such as a promised payment to settle a grievance between employer and employee.

The relatively modest proportion of businesses in bankruptcy listing outstanding employee obligations might seem surprising. After all, more than half of the Chapter 7 businesses and more than three-quarters of the Chapter 11 businesses in the overall sample had one or more employees at the time of filing, suggesting ongoing operations and outstanding paychecks.[115] Among Chapter 7 businesses with employees, the mean number of employees was fifteen.[116] For the Chapter 11 businesses with employees, the mean number was 216.[117] Failure to list any employees as creditors in more than 90% of these cases suggests that employers are generally meeting their payrolls as they come due. This may be the result of maladjusting employees' other form of leverage: if their paychecks are not ready on time, they can quit working.

On the other hand — and there is always another hand in bankruptcy — the impact of employee claimants in some cases is likely to be great. For the employees counting on wages or pension contributions for work already completed, ending up as an unsecured creditor, even a priority unsecured creditor, in bankruptcy cannot be good news. Employees may have built claims over many years — promises for sick pay and health insurance, or retirement checks based on seniority — and the endangerment of those claims in bankruptcy likely means a sharp cutback in their own lives. For the employees of one in every twelve businesses in bankruptcy, these outstanding obligations can be devastating.

(e) Natural Persons as Creditors. — Besides employees, there are a fair number of voluntary contract creditors who simply lack the sophistication to adjust their contract terms to a variable as complex as

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113 One hundred twenty-four employee claims were for priority repayment, and nine were for repayment as general unsecured creditors.

114 *See* 11 U.S.C.A. § 507(a)(3)–(4) (West 2004). The amount owed to employees was generally modest. If we total the employee claims for each debtor, the mean amount claimed was $7186 and the median was $4242.

115 *See* Warren & Westbrook, *supra* note **, at 544.

116 *Id.* at 548 tbl.12.

117 *Id.*

contractually established bankruptcy systems.[118] These creditors may have the theoretical ability to price in relation to risk, but they are simply not in a position to evaluate the risks arising from a given contract-bankruptcy system. Their only response must be to raise overall price levels in the hope of recouping potential losses. If they cannot do so, then they must simply absorb the losses. We cannot identify lack of sophistication in a statistical study, but we predict that we will find more such unsophisticated creditors in the class of natural persons than on the corporate side.

In a sample of business bankruptcy cases, we had expected that, with the exception of employee obligations and debts owed to trade creditors, there would be few voluntary debts owed to individuals as opposed to legal entities. We were wrong. After separately classifying involuntary debts, lawsuits and unexplained debts, employee debts, trade debts, debts owed to attorneys, and medical debts, we were left with a residual category of debts owed to individuals listed as general unsecured creditors. The first category of such debts consisted of loans from individuals to the debtors. As Figure 2 illustrates, about one in five of the bankrupt businesses — 21.3% — owed money to an individual based on what the debtor characterized as "loans." We confess to being somewhat surprised by the proportion of businesses borrowing from individuals. We were also surprised to discover that corporate debtors were *more* likely to have borrowed from individuals than their individual debtor counterparts, although the difference was not significant. Among the corporate debtors, one in four — 25% — listed one or more outstanding unsecured loans from individuals, while only 17% of entrepreneurs had unsecured loans from natural persons. While we assumed that owners lend to their own businesses, our coders found no substantial evidence that the individual creditors listed were equity owners. Instead, it appears that many or most of these creditors were third parties. We found that the corporate businesses had borrowed money from individuals in a substantially higher proportion than they had tapped banks on an unsecured basis. Presumably these were all voluntary relationships; the debtor's description of "loan" suggested a willingness to transact, even on an unsecured basis.

In addition, a surprising number of debtors owed money to individuals in transactions that were not characterized as "loans." More than one in four business debtors — 28.5% — owed money to an individual who was identified only by name. It is possible, of course, that some of these individuals were tort claimants, employees, trade creditors, lenders, or health care providers. The debtors provided no clues, except by negative inference — they listed no business name, no pro-

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[118] *See* LoPucki, *Bargain*, *supra* note 60, at 1918, 1954–56.

fessional association, and no title such as "Dr." These claims listed a human being and what appears to be a home address, with little additional information. It is not possible to tell from the records whether the claims of these individuals were based on negotiated or involuntary relationships. If we could question the debtors, we might discover that some of the debts owed to individuals rightly belong in one of the preceding categories, such as trade debt or tort debt, while others may be outright loans from individuals.

When we bring together these various categories, it turns out that nearly half — 46.5% — of businesses in bankruptcy listed one or more unsecured debts to individuals whose relationship to the debtor was either an employee, lender, or unspecified.[119] There were some overlaps, with some debtors owing individuals in more than one of these categories. The largest group was comprised of undifferentiated obligations to individuals (28.5%), followed by loans by individuals (21.3%), obligations to employees (8.1%), and lawsuits filed by individual claimants (6.3%).

With the limited amount of data available, it is not possible to assess the circumstances that would permit these individuals to adjust rates or price as a function of differences in creditworthiness or of whether a debtor had adopted Bankruptcy Regime *A* or Bankruptcy Regime *B*. It is nonetheless intriguing to discover the high proportion of individuals who were listed as general unsecured creditors in bankruptcy, which suggests a line of inquiry into another possible category of maladjusting creditors.

3. The Importance of Maladjusting Creditors. — The claims of efficiency for contract bankruptcy are seriously undermined by the presence of significant numbers of maladjusting creditors. Each maladjusting creditor represents the possibility of substantial inefficiencies; as their numbers grow, the likelihood increases that these inefficiencies will overwhelm any purported efficiency gains from a contract bankruptcy system. The magnitude of the obstacle presented by the maladjusting creditors can be measured in different ways.

First, it is possible to identify how many bankrupt debtors have at least one creditor that can be classified as maladjusting. Collectively,

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[119] Perhaps the most surprising finding is that when all the categories are combined, the data hint that corporations may be more likely than human debtors to owe money to individuals. We found that more than half of the corporate debtors — 52.5% — and less than half of the individual debtors — 42.7% — listed one or more claims to individuals, but the difference is not statistically significant ($p = 0.055$). The difference does, however, approach statistical significance and may have reached the level of significance if the sample had been larger. We recognize that some of these loans in corporate cases may have been made by owners investing additional capital in the form of loans to their companies. In any case, the data strongly suggest that both corporations and human debtors owe money to human creditors when they file for bankruptcy.

79.5% of the business cases in the sample listed at least one creditor that can be classified as maladjusting.[120]

A second way to measure the impact of maladjusting creditors is to reanalyze the sample to determine what proportion of all claims is potentially maladjusting. Instead of analyzing the data on a debtor-by-debtor basis, this approach focuses on all the claims filed by all the unsecured creditors in the sample to determine what proportion of these claims was filed by maladjusting creditors. This analysis reveals that about one in every seven claims filed in bankruptcy — 15.2% of all claims — was filed by a potentially maladjusting creditor.

A third way to measure the importance of maladjusting creditors in the bankruptcy system is to examine the total dollar amount of debt such claims represent. This involves comparing all the claims filed in bankruptcy with each other, rather than conducting a debtor-by-debtor analysis. Here the impact of maladjusting creditors is even greater. More than a quarter — 28.4% — of all the unsecured debt listed in business bankruptcy cases was owed to maladjusting creditors. The average claim for maladjusting creditors was more than twice as large as the average for other claimants.

These three approaches are summarized in Figure 3.

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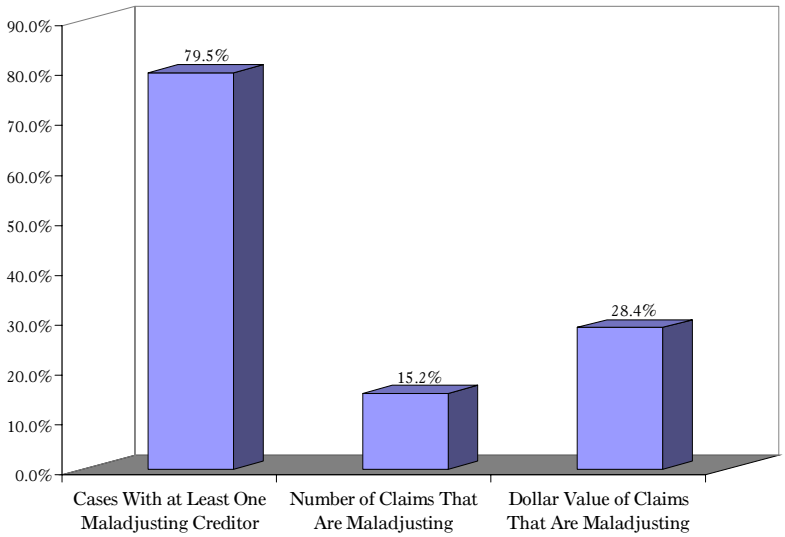
[120] For this combined calculation, we used the most restrictive definition of tort claimant — only those three cases in which the debtor clearly identified the claim as one for a personal injury. If we used the least restrictive definition, including all possible lawsuits, the number of debtors with one of these claims would increase by only one debtor — a statistically insignificant change. The reason, of course, is that many of these debtors identified claims within more than one of the maladjusting categories.

FIGURE 3. LIKELY MALADJUSTING CREDITORS IN BUSINESS BANKRUPTCY CASES



Source: Business Bankruptcy Project, Claims Subsample
N = 386

The importance of the maladjusting creditors also persisted over time. The data reported here were part of a longitudinal study of cases initially filed in 1994.[121] As we noted earlier, to update our report we drew a second sample of cases filed in 2002 to see if the findings reported here continued over time.[122] We discovered that they did. In 2002, 76.7% of the cases had at least one likely maladjusting creditor, a number that is close to the 79.5% reported for 1994. The two data points suggest that the proportion of cases in which a debtor will have at least one maladjusting creditor has remained quite high.

The proportion of claims that are maladjusting increased from 1994 to 2002. In 1994 about 15.2% of all the unsecured claims could be classified as maladjusting. By 2002, the proportion had more than doubled to 35.2%. This suggests that over time the bankruptcy system has been called on to deal with a growing share of maladjusting creditors.[123]

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[121] *See supra* pp. 1207–08.

[122] *See supra* pp. 1208–09.

[123] This finding is particularly interesting because the total number of claims — both adjusting and maladjusting — rose sharply. Even as the number of total claims increased, the proportion of those claims that should be classified as maladjusting grew.

In 1994, more than one in every four dollars of claims listed in bankruptcy was owed to a maladjusting creditor. By 2002, the absolute dollar amount of claims had risen for all creditors — adjusting and maladjusting. Growth was larger for adjusting creditors, so the proportion of dollars claimed by maladjusting creditors fell to about 13.6%. But as so often happens, the comparison is complicated by a new development: a much higher number of maladjusting creditors in 2002 had claims of "unspecified" amounts.[124] If the quantified claims were similar to the unquantified claims, we estimate that the dollar value of maladjusting claims in 2002 was 19.7% of all claims.[125] That is more modest than the 28.4% in 1994, but it nonetheless represents a meaningful slice of the bankruptcy claims. Based on the 2002 projection, about one-fifth of the dollar amount of claims in bankruptcy is held by creditors that could be classified as maladjusting.

The 2002 update confirms the continuing significance of maladjusting creditors in the bankruptcy system. These creditors continue to appear in nearly 80% of cases, they represent about one in three unsecured claims, and they seek about one in five of the unsecured dollars claimed for repayment.

No matter how the data are analyzed, the same point rises to the surface: maladjusting creditors are an important part of the bankruptcy system. The 2002 data generally support the findings from the original sample, which showed that maladjusting creditors appear in most of the cases, they constitute a significant number of all the debts, they hold a substantial proportion of all money claimed, and they are owed more on average than their better-adjusting counterparts.

We recognize that some of the creditors identified in these categories are only *candidates* for classification as maladjusting creditors; the information about them is too sketchy to permit a confident evaluation of their prebankruptcy readjustment capacities. Conversely, we have omitted whole categories of creditors who, on closer examination, might properly belong among the maladjusting creditors. For example, trade creditors are the single largest group of unsecured creditors listed in bankruptcy and undoubtedly include substantial numbers of

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[124] In 1994, the number of claims with no dollar amount specified was a modest 6.4%, with the nonresponses fairly closely split between the maladjusting (7.5%) and adjusting creditors (6.2%). The nonresponse rate rose for adjusting creditors in 2002, coming in at about 11.5%, but the number of maladjusting creditors who listed no specific dollar amount soared to 51.0%. The inequality in the proportion of claims that list no dollar values means that when dollar values are combined, the maladjusting creditors are significantly underrepresented in the 2002 data.

[125] The projection necessarily assumes that the quantified claims and the unquantified claims were alike. It is possible that the unquantified claims were different. If more of the unquantified claims were pending personal injury claims, for example, then the ultimate amounts owed to maladjusting creditors could be much larger. Of course, the unquantified claims could be smaller as well.

maladjusting creditors, but we treat them as adjusting creditors in this analysis.

The data show that maladjusting debt plays a substantial role in the current bankruptcy system. Without more information, we cannot specify the precise number of maladjusting creditors or the exact dollar value of their claims; but these data demonstrate the existence of a large set of creditors that is highly likely to contain substantial numbers of maladjusting creditors.[126] The presence of so many creditors in the categories we have identified strongly suggests that any effort to move to a contract-determined bankruptcy system will very likely produce substantial inefficiencies.

We can further document the importance of maladjusting creditors in bankruptcy by reversing foreground and background. Financial creditors — banks and other institutional lenders who offer everything from lines of credit to business credit cards — play a surprisingly modest role in the *unsecured* debt extended to troubled businesses. Our data show that half of all business bankruptcy cases have *no* unsecured financial creditors at all.[127] Instead, trade creditors and other nonfinancial creditors absorb most of the unsecured losses listed in most of the business bankruptcy cases. The nonfinancial creditors are a group heavily populated with maladjusting creditors. Collectively they extend most of the unsecured credit listed in bankruptcy.

The presence of maladjusting creditors in so many bankruptcies strongly suggests that the promised gains from a bankruptcy contracting system will be obliterated by the inability of some creditors to adjust their pricing to reflect different bankruptcy regimes. Whether the creditor alone suffers the loss (the tort claimant) or the creditor passes it along to all customers indiscriminately (the utility claimant), the outcome is the same: negotiating creditors can push losses and the resulting inefficiencies off onto other parties who cannot adjust for these shifting bankruptcy regimes.

B. Creditors Too Small To Adjust

Hypothesis #2 — that a contracting scheme will have little or no redistributive effect because few creditors will have claims too small to justify the investment necessary to adjust to any changes in risk im-

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[126] Logically, the argument has this structure: If observation or argument suggests that a group of *X*s is likely to include a substantial, although unquantified, percentage of *Y*s, then observation of a large group of *X*s implies the existence of a substantial number of *Y*s. Thus, if sales of ice cream generally include a substantial amount of vanilla and one demonstrates sale of a large amount of ice cream, it becomes highly likely that a large amount of vanilla was sold.

[127] If unsecured bank debt, business loans, and credit card debt are grouped together as financial debt incurred for business, the median case (that is, at least half the cases in the sample) has no such debt. Even on average, the mean case has only 0.6 bank and business-loan debts and less than two credit card debts.

posed on them by a debtor's choice of bankruptcy regime — is also inconsistent with the data.

The previous section discussed claimants who were maladjusting because of the nature of the claimants' circumstances. This section addresses an even larger group of claimants who are maladjusting for a different reason: their claims are simply too small to justify adjustment when a debtor adopts a contract-bankruptcy regime. These claimants are primarily voluntary contract creditors and may be large and sophisticated businesses, but their claims are too small to support either individualized negotiations with the debtor or a repricing of their standard-term contracts to reflect the changed risks when a particular buyer has moved from Bankruptcy Regime *A* to Bankruptcy Regime *B*. For this purpose, the definition of "small claim" will vary depending on the circumstances, as explained below.[128]

The situation can be illustrated by a contract under which a very large company, such as Dupont or IBM, agrees to sell $500 worth of products to a debtor. Although these businesses have highly sophisticated contract negotiators on staff and batteries of lawyers, both inside and outside the company, it would make no sense for them to attempt to negotiate the terms of a bankruptcy contract with such a debtor. It would be equally irrational for them to expend resources to discover whether a customer was in Bankruptcy Regime *A* or Bankruptcy Regime *B* and then to respond, either by modifying the standard terms of their contracts to deal with this debtor's choice or by repricing their standard-term contract to reflect any greater risk to their recovery in the event of the debtor's bankruptcy.[129] For a $500 contract, it seems inconceivable the game would be worth the candle. Failing to differentiate risks in one contract may not be serious for a company the size of Dupont, but mispricing a thousand such contracts might have a real effect. And mispricing a million such contracts could impose important inefficiencies. Even sophisticated parties cannot afford the costs of adjusting their responses for small contracts, and the resulting inefficiencies would echo through the economy. Thus, the most important effect of inefficiencies related to small claims would be found ex ante (transactionally) rather than in the bankruptcy proceeding itself.

A multiplicity of options in bankruptcy contracting would increase inefficiencies even more. In order to capture the promised efficiencies that tailoring different bankruptcy regimes might produce, some of the proponents of bankruptcy contracting posit many possible postdefault

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[128] *See infra* pp. 1243–44.

[129] We use the word "bankruptcy" throughout this discussion in the interests of simplicity, but the postdefault procedure adopted under some contractualist legal regime might have no relationship to bankruptcy law and bankruptcy proceedings as they now exist. Inter alia, it might be entirely private.

systems rather than the single, uniform system we have at present.[130] The range of possible contract systems would include allocations of priority and control much more advantageous to the strongly adjusting party than those available under current law. In the debates over the efficiency of secured credit, it has been argued (without much in the way of refutation) that there must be some bankruptcy claimants with smaller claims and that secured credit, by advantaging the secured party, must be redistributional or inefficient as to these claimants, because their claims are too small to support negotiation or repricing.[131] Yet in secured credit the basic options are relatively limited — security and no security. In a contractual bankruptcy regime, the same problem for small creditors would be considerably exacerbated by a multiplicity of bankruptcy bargains and results.

The magnitude of the maladjustment problem in a contract-based bankruptcy system would depend on the type of contractualist proposal adopted. As noted earlier, the contractualist proposals are vague about how they would operate in the marketplace, so some of this analysis must proceed by inference.[132] Each of the proposals bows to the collective nature of the bankruptcy process by offering a method by which one particular bankruptcy contract will be the operative one — binding all the creditors — following the debtor's default. One method is through a scheme embedded in the debtor's financial structure by provisions in its debt instruments.[133] A second puts the bankruptcy contract in the debtor's articles of incorporation, selected from a menu of permitted bankruptcy regimes.[134] A third makes the last bankruptcy contract negotiated before default binding on all.[135]

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[130] *See* Adler, *supra* note 4; Schwartz, *supra* note 4, at 1833–36. Professors Schwartz and Adler both assume that parties will be free to negotiate a variety of terms relating to default and the consequences of default. They do not limit or define those terms, but leave them to the open-ended bargaining of the parties. *See, e.g.*, Adler, *supra* note 4, at 327 (envisioning an open-ended bargaining process for subsequent investor-lenders). It follows that there is an almost infinite number of possible postdefault rules and procedures that might be agreed to in a bankruptcy contract negotiated between the debtor and another party. A third party contracting with the debtor would be forced either to acquire and analyze information about each such contract or to assume the possibility (if not the likelihood) that those terms would be highly unfavorable to itself. It would then be required to try to adjust its price and terms in light of that information or that assumption.

[131] *See* Bebchuk & Fried, *Uneasy*, *supra* note 17, at 885–87, 908–09; Block-Lieb, *supra* note 5, at 548; LoPucki, *Contract*, *supra* note 5, at 340–42.

[132] *See supra* p. 1201.

[133] *See* Adler, *supra* note 4, at 314 & nn. 8–9 (mentioning some of the alternative contractual provisions a firm might adopt concerning default); Bebchuk, *supra* note 4, at 781–88 (proposing a system in which debt instruments contain bargained-for security interests in a reorganized company).

[134] *See* Rasmussen, *supra* note 4, at 53–54.

[135] *See* Schwartz, *supra* note 4, at 1833–36.

The first and third of these proposals seem open-ended in two senses: there is a seemingly infinite number of contractual bankruptcy systems to which parties might agree, and the controlling regime is subject to change whenever the company arranges new financing or negotiates a new bankruptcy contract.[136] The second proposal offers a finite number of options and is more stable, because it is more rigid and difficult to change.[137] The open-ended proposals have the advantage of flexibility among debtors and over time, but greatly increase information costs and the degree of redistribution or overpricing. As the number of options rise, it would become ever more expensive to acquire and analyze the terms of the debtor's chosen bankruptcy regime, so it would take an ever-larger claim to support that cost, raising the threshold at which claims can become adjusting claims. Because there would be no limit on the disadvantages that could be imposed on maladjusting creditors by the bankruptcy bargain between the debtor and a third party, maladjusting creditors would likely assume the worst outcome, thereby driving up costs for all debtors.[138]

A contractualist approach that limits the possible options, such as Professor Rasmussen's menu proposal, reduces the costs imposed on maladjusting creditors and their other customers.[139] But it does so at a significant price. The benefits of contractualism are claimed to arise directly from the efficiencies gained by individualized negotiations in the marketplace. To the extent that a proposal narrows parties' choices to a list of standard contracts, it forfeits much of this potential advantage. These differences in methods reflect a fundamental tension in contractualism. The open-ended approaches provide flexibility for those at the negotiating table and for those who may be able to adjust to a new bargain over time, while raising the threshold of maladjustment by increasing information costs and redistributional effects. A limited-choice approach raises the maladjustment threshold less, but also loses much of the benefit of a contract bankruptcy regime.

The problem of increased information costs would be relatively minor in a world in which there were few small claims in business

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[136] The first proposal might be either open-ended or rigid. If the financial structure of the company were subject to constant change by the issuance of new financial instruments, then the proposal would be open-ended. If the company embedded the structure in its articles of incorporation or in enforceable covenants, then the method might function much like the more rigid menu approach.

[137] Professor Rasmussen would permit most changes in menu choice only with the consent of all creditors. *See* Rasmussen, *supra* note 4, at 117–20.

[138] A more nuanced version would be that the price charged by a party to all customers would have to reflect the various possible default regimes weighted by the party's estimate of the probability of encountering each of them. The substantial transition costs that would arise during the period when parties had no experience on which to base such calculations are no doubt one reason contractualism has attracted little interest outside the academy.

[139] *See* Rasmussen, *supra* note 4, at 66, 111.

bankruptcy cases and therefore only slight inefficiency effects. The problem becomes greater as the number of small claims increases. Thus, a contractualist approach must consider the number and distribution of small claims. All of the proposals are problematic if there are many small claimants found throughout the system. In that case, any contractualist plan must postulate enormous savings from the contract process in order to overcome a great increase in costs from redistribution and overpricing inefficiencies.

We found that the cases in our subsample present a great many small claims. Furthermore, although the number of claims per case varies widely across the subsample, a significant number of cases have a large number of claims, many of which are small in amount. These data suggest substantial costs would be associated with any contract-bankruptcy system.

1. Small Claims. — Understanding the size of the unsecured claims in business cases is an exercise in the difference between means (averages) and medians (middle numbers). The mean claim in the subsample was about $19,000, but that number reflects a small number of truly enormous claims. The median claim in the subsample was a far more modest $905. This means that half of all the unsecured claims listed in Chapter 7 and Chapter 11 business bankruptcy cases are for $905 or less.

Nearly four out of five of the unsecured claims (79%) were for less than $5000. Figure 4 shows the total number of claims in the subsample divided into five categories: under $500, $500 to $999, $1000 to $4999, $5000 to $9999, and $10,000 and over.[140] The average total number of unsecured claims per case is about twenty; the average number of claims under $5000 is about fifteen.[141]

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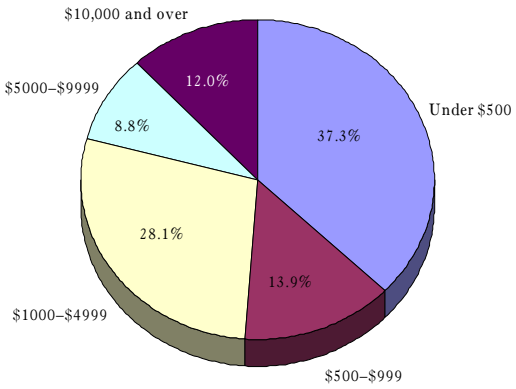
[140] Although we excluded detailed coding of secured debt from the subsample, we note that the average secured debt in the sample as a whole was quite substantial, at $137,088. However, that number is inflated by huge claims. More than 2200 of the 8954 secured claims (about 27%) amounted to $5000 or less, and over 600 (7%) were $1000 or less. (We have excluded claims of unspecified amounts.) Therefore, many secured debts may also present uneconomic subjects for negotiation of a bankruptcy system by contract, but we have not included them in our calculations.

[141] The median for the total number of unsecured claims per case is thirteen. We have twenty as the mean number of claims here, versus nineteen earlier, because this computation includes the unknown claims that we excluded in computing the earlier number.

FIGURE 4. DISTRIBUTION OF UNSECURED CLAIMS BY DOLLAR AMOUNT



Source: Business Bankruptcy Project, Claims Subsample
N = 386

At least as measured at the time of bankruptcy, many of the claims are quite small. We recognize that the initial loan may have been larger and that the amount listed in bankruptcy simply may be what is left after the debtor has made many payments. Of course, the facts may go the opposite way as well: a claim for $5000 in bankruptcy may have involved a transaction for less money initially but is now pumped up with compounded interest, late fees, and processing charges.

The profit margin in a $5000 loan or sale varies from one transaction to another, but it seems hard to believe that any benefit from bargaining about bankruptcy, discounted by the improbability of bankruptcy measured at the time of contracting, would make it worthwhile to negotiate a different bankruptcy system when the amount at stake is less than $5000. Using that as a breakpoint, about 80% of the claims in our sample would be too small to sustain any bankruptcy bargaining. That seems even more certain for the 51% of the claims valued at less than $1000. As to claims under $500, which constitute more than a third of all business bankruptcy unsecured claims (37%), negotiation seems almost a silly suggestion.[142]

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[142] If we were to increase our denominator of total number of claims by including claims of undetermined amount, the percentages would decrease slightly, to 74%, 48%, and 35%, respectively. It seems to us more likely that the claims listed as an unknown amount would be small claims, thus increasing the percentage of small claims if the amounts were known, but we cannot know for sure. Because of that uncertainty, we have excluded claims of unknown amount unless indicated otherwise. There are 513 such claims, approximately 7% of the total number of unsecured claims.

2. Many Cases Have Many Small Claims. — Of course, in any statistical universe distribution can be as important as overall numbers. Are small claims found only in a small number of cases or are they typical of most? The answer is that small claims are found in most cases. More than two-thirds of the cases have one or more claims under $500. If anything under $5000 is a small claim, 87% of the cases have one or more small claims. Furthermore, most of these are not cases with the odd small claim nestled among many large ones. Most are cases with a substantial number of small claims. Figure 5 illustrates the distribution.

Figure 5 shows the distribution of claims at four levels: under $500, $500 to $999, $1000 to $4999, and $5000 to $9999. About 16% of the cases in Figure 5 are in a fifth category in which claims under $10,000 constituted less than 25% of all the claims in each case. The figure illustrates the percentage of cases for which at least one-quarter of the claims are small claims, defining a small claim at each of those levels. This analysis shows that claims ranging from tiny to small are found in substantial numbers in most cases. Collectively, these claims make up a significant portion of the unsecured claims in most of the cases. For example, although a claim under $500 is tiny, such claims made up more than a quarter of the claims in a majority of the cases in the subsample.[143] That is, in most of the business cases in the sample, at least one out of four claims was for less than $500. The notion that each of these holders of tiny claims should have negotiated a bankruptcy system or adjusted its price to reflect the negotiations of others may seem a bit farfetched.

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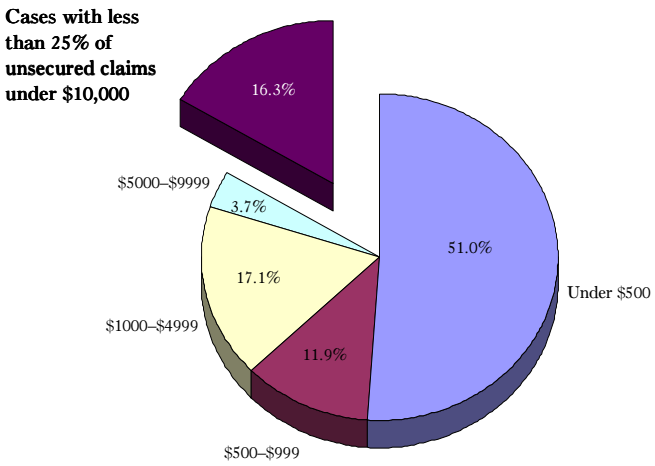
[143] In about two-thirds of the cases, claims under $500 constituted more than 10% of the total number of claims in the case.

FIGURE 5. PERCENTAGE OF BUSINESS CASES WITH SMALL CLAIMS CONSTITUTING 25% OR MORE OF UNSECURED CLAIMS



Source: Business Bankruptcy Project, Claims Subsample
N = 386

If the definition of a small claim — a claim that is too small to make it worth negotiating for a bankruptcy system — is raised to $5000, the great majority of cases include a large proportion of small claims. Claims under $5000 constitute at least 25% of the claims in 80% of the subsample cases.

Although it seemed fairly clear to us that it would not be worth the parties' time to negotiate a contract clause to determine the applicable bankruptcy system for a debt of less than $5000, there are no behavioral or cost data available to identify the point at which more detailed negotiation of low-probability events such as bankruptcy might begin to be plausible. We speculated that $10,000 might be such a point, so we performed some of the same tests at the $10,000 level. If $10,000 is defined as the ceiling for small claims, 85% of the cases had small claims, and in those cases the small claims almost always made up more than 25% of all claims.[144] Whether we use $5000 or $10,000 to define a small claim, the overall picture is clear: a minority of cases (15% to 17%) have no small unsecured claims at all, while the great majority of cases have a high percentage of such claims.

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[144] Only 63 of 386 cases (16%) had no claims under $10,000. Almost all of the cases that did have a claim under $10,000 had a substantial proportion of such claims. In 98% of cases with any claims under $10,000, those under-$10,000 claims constituted a quarter or more of the total number of claims in each case.

We found that sixty-seven cases, about 17% of the total, had no claims under $5000 ("high-claim companies").[145] If $5000 is a proxy for the point at which parties might begin negotiating for a bankruptcy regime, about one in every six companies that end up in bankruptcy might have been dealing exclusively with transactions that would support a negotiation for bankruptcy alternatives. Of course, that still leaves five out of six companies that have at least some claims that were too small to support such bargaining — and in the vast majority of those cases, small claims make up a substantial fraction of the total number of claims.

It is not very helpful for transactional or policy purposes to know that there is a group of cases with fewer small claimants unless some characteristic of such cases can be identified ex ante and used to designate which cases should receive special treatment or be subject to special rules. We attempted to predict which companies would be high-claim companies. So far, we have been unable to find any identifying characteristic. For example, it is plausible that high-claim companies might be disproportionately corporations rather than individual entrepreneurs.[146] The data, however, reveal no statistically significant difference between the presence of claims under $500 or $1000 in business bankruptcies filed by humans and in those filed by corporations. At the $5000 level, small claims remain widespread and important in the bankruptcies of both sole proprietorships and corporate businesses, but a statistically significant difference emerges: claims under $5000 constitute 64% of the total claims made in corporate bankruptcies versus more than 75% of those listed in the bankruptcies of individuals. Although it might be intuitive that corporate debtors would have fewer small claimants than individual debtors, we were surprised to find that almost two-thirds of the claims in corporate bankruptcies are also quite small.

It is often the case that the simplest explanation is the right one. The high-claim debtors may just be businesses that paid most of their smaller bills before filing.[147]

The pattern of many small claims widely distributed throughout bankruptcy cases creates serious difficulties for the contractualist ap-

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[145] About 26% of the cases had no claims under $1000, and less than a third (30%) had no claims under $500. Thus, small claims were found throughout most of the sample.

[146] We call legal entities "corporations" most of the time. They usually are corporations, and "legal entity" is a semantic toad.

[147] We tried alternate hypotheses to no avail. For example, one might imagine that small claims would be more common in cases with much unsecured debt and perhaps more rarely associated with debtors who have substantial secured debt. That is not true of our sample. For each case, we compared the percentage of small claims at each level (under $500, under $1000, and under $5000) with the percentage of that case's total debt that was unsecured. There was no relationship even close to statistical significance.

proach. Regardless of the threshold amount for a smaller, maladjusting claim, there are many such claims. Therefore a great deal of redistribution and overpricing would follow from the adoption of a contractualist scheme. The most important impact of this inefficiency would arise outside of bankruptcy.[148] Because it would be too costly for creditors engaged in moderate-size transactions to adjust their prices to the individual bankruptcy regimes adopted by each customer, they would have to raise their prices across the board, imposing a portion of the cost on each customer regardless of the bankruptcy regime to which that customer was subject. This consequence for thousands or millions of transactions would be far greater than the impact in the bankruptcy process itself.

Cases filed in 2002 showed very similar results. We are in the midst of analyzing those data, so we do not have the full range of results. But we were able to compare the 2002 data with what we had found in the earlier data about claims under $5000. By 2002, it took $6070 to purchase what $5000 would purchase in 1994,[149] so we tested for claims that were under $6070. Such claims were 78% of the total number of claims in the sample, almost exactly the same as in our earlier data.[150] In both years, such claims were widely distributed among the cases. In 2002, claims under $6070 constituted at least 25% of all claims for 87% of the cases in the sample. This represents an increase in the percentage of cases with a substantial portion of small claims. Overall, in 2002 small claims were once again a substantial fraction of all claims and were even more widely distributed than were small claims in the cases filed in 1994.

The data show that the second hypothesis, like the first, is false. There are many small claims in bankruptcy, which makes it virtually impossible for many creditors to adjust fully to the risks imposed by different bankruptcy regimes. Without such adjustment, a contract bankruptcy system would produce substantial inefficiencies.

C. Creditors So Numerous That Transaction Costs Rise

Hypothesis #3 — that in a world of fully adjusting creditors, a contracting scheme will have little or no loss in efficiency from transaction

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148 The dollar impact of small claims within bankruptcy cases is significant but far from dominant. Such claims in our sample total about $10 million, about 7% of all unsecured claims. On the other hand, these claims are not duplicative of the maladjusting categories of creditors described earlier. Only about 12% of the small claims are held by these creditors, meaning that the problems that arise for holders of small claims are for the most part in addition to those created by the creditors who are in one of the maladjusting categories.

149 According to the Consumer Price Index. *See* Federal Reserve Bank of Minneapolis, Consumer Price Index Calculator, *at* http://minneapolisfed.org/Research/data/US/calc/index.cfm (last visited Jan. 15, 2005).

150 *See supra* p. 1244.

costs because there will be relatively few creditors in most cases — is also inconsistent with the data.

The analysis thus far has focused on maladjusting creditors, but the contractualist regimes would face a profound difficulty even if all creditors could adjust. We start with the longstanding truth that neither information nor negotiation is free. If there are many claims in bankruptcy cases, even if the circumstances of each party would permit prebankruptcy negotiations and even if the amounts at stake were large enough to justify an investment of resources to make the necessary adjustments, the open-ended proposals would create substantial transaction costs.

The image invoked by most contractualist articles is of a debtor with a few creditors, most of them lenders. In such a scenario, a proposal to have the debtor negotiate a private, postdefault regime by sitting around a table with these creditors may seem plausible. If, however, the reality of business bankruptcy is that most debtors have many claimants and that any negotiations would have to take place in a rented hall, then the efficiency gains from contract bankruptcy quickly fade, overwhelmed by the negotiating costs of dealing with many creditors. As the number of possible bankruptcy options multiplied, the transaction costs would rise exponentially.[151] Regardless of the identities of the individual creditors or the size of their claims, their sheer number will have a powerful impact on whether claimed efficiency gains will result from a contract-based bankruptcy system.

To put the problem in context, note that each negotiation will involve costs to acquire and verify information about bankruptcy regimes to which the debtor has already agreed, and to analyze the effect of those regimes upon the negotiating creditor.[152] Only then can the parties assemble at the bargaining table. Some parties — perhaps most — will avoid those substantial costs by using standardized contracts containing a bankruptcy regime. This approach will save negotiating costs at the price of losing many of the claimed benefits of individual negotiation. It will also result in sophisticated parties having two standardized contracts, because every company is both a debtor and a creditor. As customer it will use its standard debtor-friendly contract, and as supplier it will employ its creditor-friendly contract. Following default, there will be sufficient complex and novel litigation

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[151] The restricted, menu approach would reduce those difficulties but would require approval by a host of contract parties to change the system adopted as the business evolves. *See* Rasmussen, *supra* note 4, at 116–21.

[152] All the contractualist proposals involve these costs, although the menu approach reduces them by reducing the number of choices available. The menu approach also reduces the other difficulties discussed in the text, although at the cost of reducing the benefits of contractualism as well. *See supra* pp. 1241–42.

to delight every law professor and to leave businesspeople in despair. Finally, a third reaction by some parties will consist of adjusting prices only. Even these parties, however, will have to incur the substantial costs of acquiring and analyzing information about the bankruptcy regime applicable to a given debtor so as to price correctly.[153] Thus, substantial costs will arise from any of these approaches if there are numerous parties adjusting to flexible bankruptcy regimes.

In our subsample of 386 cases, the total number of unsecured claims, after excluding priority tax claims, was 7959, of which 513 were listed for an unknown amount, leaving 7446 that could be investigated as to size.[154] That yields a mean of about nineteen claims per case, close to what we found for the whole sample.[155] We have excluded priority tax claims for the purposes of this section[156] because no contractualist has yet suggested that the IRS or the local tax district wants to negotiate a bankruptcy system with each taxpayer. We ignore those claims for the purpose of determining the efficiency of private contracting for bankruptcy, but we recognize that the taxing authority (and the taxpayers it represents) would not be pleased by a contract bankruptcy regime that diminished its priority.

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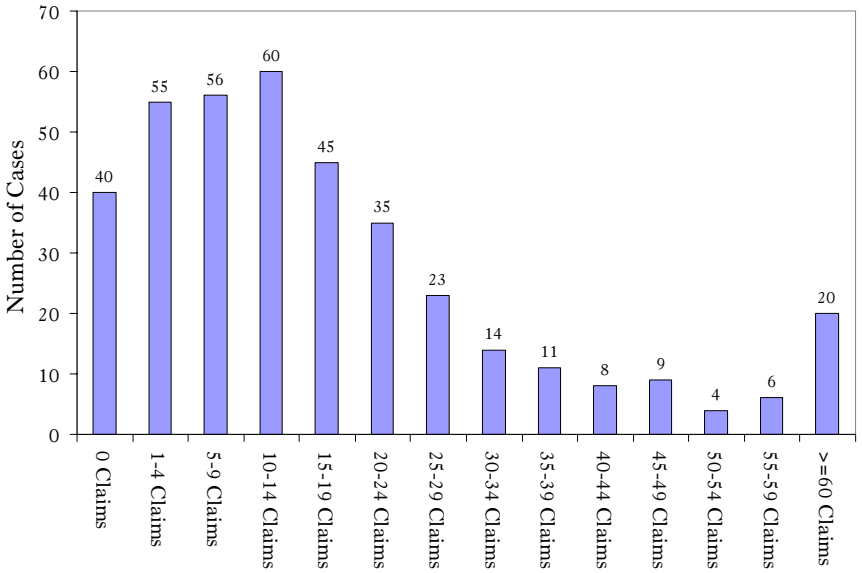
[153] Note that if a creditor concludes that the economics of its contracts will not support any of these approaches, then it is by definition a maladjusting creditor. In this Part, we are assuming, contrary to fact, that all creditors are fully adjusting.

[154] These claims are unsecured, except for those of judgment lien creditors, which are included because they began as unsecured creditors. *See supra* note 92. There were almost 9000 secured claims in the subsample.

[155] *See* Warren & Westbrook, *supra* note **, at 515. If we exclude the cases with no unsecured claims, we get an average number of unsecured claims of 21.5 per case. If we include claims of unknown amount, bringing the total to 7959, we get about twenty-one claims per case. If we include claims of unknown amount and exclude the forty cases with no unsecured claims, the number of claims per case rises to twenty-three. In our overall sample, we found an average of about twenty-two claims per case. *Id.*

[156] We did not exclude claims of reluctant creditors or nontax priority creditors, identified in section IV.A, pp. 1220–22, because some may want to argue that utilities or employees, for example, are potentially negotiating creditors. We should note there were only forty-two nontax priority claims.

FIGURE 6. DISTRIBUTION OF NUMBER OF UNSECURED CLAIMS PER CASE



Source: Business Bankruptcy Project, Claims Subsample
N = 386

Figure 6 shows that many of the business cases have many claims. About 130 cases, roughly one-third of the total, have twenty or more unsecured claims.[157] If we exclude the cases with no general unsecured claims,[158] nearly 40% of the cases have twenty or more such claims. One case, involving a ski equipment manufacturer, topped the subsample at 255 unsecured claims. Note that our subsample includes none of the really large cases in the main sample. Any one of those cases may have thousands of claims, so their chance inclusion would have raised substantially the average number of claims in our subsample.

These numbers identify *new* negotiations imposed on the parties in a contractualist regime if each creditor adjusted fully to the contract bankruptcy regime. In our subsample, these 8000 unsecured credit negotiations would be added to the 9000 secured claims, each of which would continue to be negotiated; but now a bankruptcy system, a pro-

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[157] If the reader should perceive an apparent anomaly between an average of twenty claims and only a third of the cases with twenty or more claims, it is explained by the difference between means and medians. The mean is pulled up by cases with substantially more claims.

[158] Forty of the subsample cases — 10.3% — have no general unsecured claims at all. Except for one anomaly, they are cases with only secured and priority tax claims. *See supra* note 47.

vision potentially far more complex than any normally addressed in a secured financing agreement, would be added to the agenda.

We have trouble envisioning a debtor negotiating twenty or more contracts concerning the conduct of its possible future bankruptcy, or as some proponents suggest,[159] negotiating and renegotiating the bankruptcy regime twenty times as each new creditor signs on. The problem is compounded by the acknowledgment that twenty is merely the minimum number — the number of unsecured creditors who were still around at the time of the filing of the bankruptcy. There would presumably be a number of instances in which the debtor and creditor would negotiate over the bankruptcy system to be implemented only to conclude their relationship before the debtor filed.

Even with high numbers of creditors, transaction costs might be kept under control if certain kinds of debtors consistently had fewer claims. That is, the contractualist approach might be adopted for certain kinds of businesses even if it were not applicable to every kind of business. Including the zero-unsecured cases, there are ninety-five cases, about 25% of the subsample, in which there are fewer than five unsecured claims.[160] We speculated that these cases might fit into identifiable categories, such as certain industries or businesses in the corporate form, but so far we have not discovered a common thread among businesses with few claims that would permit ex ante identification of a business unlikely to have many unsecured claims.[161]

We updated these figures as well. The average 2002 case had eighty-nine claims per case.[162] This 2002 mean is far greater than the mean for our 1994 sample.[163] The median number of claims in 2002 is twenty-two, a number which is not so far removed from our median in 1994, but still 10% greater. These figures indicate that many of the cases filed in 2002 had far more claims than those cases filed in 1994,

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[159] *See, e.g.*, Schwartz, *supra* note 34, at 346–48, 359–60.

[160] There are forty zero-unsecured cases, which list no unsecured claims in a definite amount. *See supra* note 47. In fifty-five cases there is at least one unsecured claim, but fewer than five.

[161] For example, we ascertained that these cases had greater secured debt, but the statistical analysis showed the differences in secured debt between these cases and those with more claims were not statistically significant. Using the face-sheet data about business type, we found that real estate cases were more likely to have fewer claims, and the relationship was statistically significant. This finding is suggestive, but unfortunately, the face-sheet data are simply too unreliable to support a meaningful finding. *See* Warren & Westbrook, *supra* note **, at 529–30. We will have to leave this interesting point for another paper. We probed for a correlation between cases with few claims and a number of other variables, but without success.

[162] Note this number reflects the doubling of Chapter 7 cases. *See supra* pp. 1209.

[163] This increase may reflect in part the greater average size of the 2002 cases, although our analysis of the new data is preliminary. Note that the district we did not include for claims purposes for either Chapter 11 or Chapter 7 was Delaware, because the cases there were so enormous that we did not have the resources to gather the claims data. Inclusion of Delaware would have increased the mean (and perhaps the median) number of claims by a very large, but unknown, amount.

which suggests that the problems numerosity creates for contractualism have been exacerbated over time.

The data thus highlight yet another cost of a contract-based bankruptcy system. Even with the best (and most unrealistic) assumptions about the ability of creditors to adjust perfectly to changing legal regimes that would affect their rights, the sheer number of creditors who would need to react to possible differences in bankruptcy regimes would produce substantial transaction costs that would likely overwhelm any claimed gains.

CONCLUSION

The proponents of contractualism have never explained how their systems would produce efficiencies, other than by reference to a general expectation that privately negotiated arrangements are *always* better than those imposed by law. Such a simplistic view ignores basic economic theory, including the problems of pricing inefficiencies and high transaction costs. Because the efficiencies that would be generated by contractualism remain unspecified, it is difficult to net the substantial costs we have identified against those claimed efficiencies. But these data demonstrate that the costs are substantial. In fact, the data show that the potential costs are so high that until the contractualists can present data demonstrating the magnitude of the gains they claim, their proposals cannot be taken seriously.

Our data show that private bankruptcy systems would shift risks and costs to maladjusting creditors or their customers in a substantial number of cases. Some creditors would never have any meaningful opportunity to negotiate for their place in line if the debtor defaulted. Others would have too little at stake in any individual case to make either negotiations or adjustments feasible, even if they had millions of dollars at stake spread among many different debtors. In both cases, risks would be reallocated to parties who could not adjust their behavior, with resulting efficiency losses.

The data also demonstrate that even if parties were somehow able to adjust perfectly to the risks that more powerful creditors shifted to them, transaction costs would be substantial when an average of twenty additional creditors vied for their projected piece of a limited bankruptcy pie. Substantial information and transaction costs would lead to standardized bankruptcy contracts that would in turn produce considerable battle-of-the-forms litigation. The combined costs would likely swamp any supposed gains from bargained bankruptcy regimes.

The costs imposed by a bankruptcy-by-contract system contrast vividly with the efficiencies of a mandatory regime, particularly because bankruptcy is a multiparty system. When a debtor collapses, creditors of all types and sizes come together for a final accounting of the debtor's assets. A few creditors with multimillion dollar claims

may compete with thousands of creditors with small claims. A creditor that engaged a team of lawyers and accountants to negotiate every aspect of its dealings with the failed debtor may compete for assets with a creditor whose first meeting with the debtor was in a calamitous accident. A dozen or a thousand or a million creditors may all scramble to pick up whatever remains of the debtor's assets. The bankruptcy system is charged with resolving all of their claims with a minimum of cost and a maximum of justice for each of the claimants.

The current bankruptcy system is universal and highly predictable. Most commercial lawyers can give a good account of the likely fate of various transactional structures in case of bankruptcy, and their clients can price their risks accordingly. Over time, credit managers and small business owners have built up experience in the bankruptcy system, making it possible for them to predict outcomes with increasing accuracy. The system is not perfect, and changes come slowly. When they do come, they are likely to be incremental adjustments rather than wholesale revisions. Although critics claim that the current mandated system generates expense and delay, recent evidence suggests that, at least in the big cases, costs are declining as parties become more effective users of the bankruptcy system.[164] While many useful reforms might be proposed, it seems to us a bad idea to abandon the field to a contractual system likely to be closer to Rube Goldberg than Ronald Coase.

Anyone who sees bankruptcy as little more than an accretion of two-party contracts makes the central mistake of looking for standard contract efficiencies in a system that encompasses a great deal more, including multiple contracts obligating a single pool of assets and multiple noncontractual obligations. Bankruptcy is the forum in which our society makes its final decisions about the life and death of a business and who gets what. To that forum come bank lenders and pensioners, tort victims and trade creditors, unpaid doctors and disappointed bondholders, each with a different economic role in society and each with a different economic relationship with the debtor. It is a sort of economic Judgment Day to which society and its members refer as they create those multiple obligations. In the congregation of so many different social and economic relationships, a two-party contract model cannot build an efficient distribution system. The contractualists have given us an entertaining debate, but it is time to move on.

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[164] *See* Lubben, *supra* note 11, at 550; *see also* Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. FIN. 161, 189–90 (1997) (finding that transaction costs are smaller and there is less recurrence of financial distress when firms restructure in Chapter 11 rather than through out-of-court negotiations).