Rethinking Freedom of Contract: A Bankruptcy Paradigm

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> *"On these conditions following: . . . that Mephistophilis [the Devil's minister] shall be his servant and be at his command [and] shall do for him and bring him whatsoever [he asks] . . . ., I, John Faustus, of Wittenberg, doctor, by these presents, do give body and soul to Lucifer, Prince of the East [the Devil, after] four and twenty years being expired . . . ."*[2]

> *"Mephistophilis [twenty four years later, to Dr. Faustus]: What, weep'st thou? 'Tis too late. Despair! Farewell! Fools that will laugh on earth must weep in hell."*[3]

This Article tests the limits of private contracting by examining what it means to contract about bankruptcy. Bankruptcy law is governed by a statutory code that defines the relationship between debtors and creditors when a debtor enters the

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2 . CHRISTOPHER MARLOWE, THE TRAGICAL HISTORY OF THE LIFE AND DEATH OF DR. FAUSTUS act II, sc. 1, l. 94-106 (1588).

3 . *Id*. at act V, sc. 2, ll. 94-95.

bankruptcy regulatory scheme. May debtors and creditors contract in advance to change that relationship? Or would these contracts be "Faustian" bargains that the state should not enforce? Both courts and scholars are in conflict, yet the answer is critical because it affects not only bankruptcy costs but also the structuring of corporate reorganizations and securitization transactions. I maintain that the threshold question, what freedom should parties have to contractually override a statutory scheme, has not yet been adequately addressed in this context. I first examine the principles by which parties should or should not be allowed to contractually alter statutory schemes. I then apply those principles to a model of prebankruptcy contracting by taking into account the policies underlying the bankruptcy code and also by analyzing the extent to which, under contract law, externalities should render a contract unenforceable. I conclude that, within defined limits, bankruptcy law should be viewed as default provisions and not as mandatory rules. Finally, I show that my model of prebankruptcy contracting can have important applications, not only to making corporate reorganizations and securitization transactions more efficient but also to understanding when parties should be allowed to contract about statutory schemes generally and when externalities should override freedom of contract.

. Introduction

In recent years, bankruptcy courts have given conflicting answers to the question of whether a prepetition debtor[4] contractually may waive bankruptcy protections.[5] More recently, scholars have entered this debate by asking not only whether debtors should be allowed to waive these protections but also whether parties should be allowed to contract for bankruptcy procedures that are different from those supplied by the state.[6] Some scholars argue that bankruptcy law should

4 . By prepetition, I mean a debtor, or company, that is not subject to a bankruptcy case at the time of contracting. If the prepetition debtor and the debtor's estate in bankruptcy are completely separate legal entities, then one could not contractually bind the other. That "separate entity" theory, however, has been largely discredited. *See infra* note 57 and accompanying text. Furthermore, this Article advances arguments as to what the law should be and is not limited to the current state of the law.

5 . *Compare In re* Atrium High Point Ltd. Partnership, 189 B.R. 599 (Bankr. M.D.N.C. 1995), *In re* Jenkins Court Assocs. L.P., 181 B.R. 33 (Bankr. E.D. Pa. 1995), *In re* Powers, 170 B.R. 480 (Bankr. D. Mass. 1994), *In re* Cheeks, 167 B.R. 817 (Bankr. D.S.C. 1994), *In re* Club Tower L.P., 138 B.R. 307 (Bankr. N.D. Ga. 1991), and *In re* Citadel Properties, Inc., 86 B.R. 275 (Bankr. M.D. Fla. 1988) (all recognizing, in dicta or the holding, that a prepetition debtor may waive the automatic stay), *with* Brown v. C.I.L., Inc., No. 94-C-1479, 1996 WL 164294 (N.D. Ill. Apr. 1, 1996), *In re* Pease, 195 B.R. 431 (Bankr. D. Neb. 1996), Farm Credit of Cent. Fl., ACA v. Polk, 160 B.R. 870 (M.D. Fla. 1993), *In re* Sky Group Int'l, Inc., 108 B.R. 86 (Bankr. W.D. Pa. 1989) (all refusing to enforce the waiver of the automatic stay).

6 . *See* Edward S. Adams & James L. Baillie, *A Privatization Solution to the Legitimacy of Prepetition Waivers of the Automatic Stay*, 38 ARIZ. L. REV. 1 (1996); Daniel B. Bogart, *Games Lawyers Play: Waivers of the Automatic Stay in Bankruptcy and the Single Asset Loan Workout*, 43 UCLA L. REV. 1117 (1996); Rafael Efrat, *The Case for Limited Enforceability of a Pre-Petition Waiver of the Automatic Stay*, 32 SAN DIEGO L. REV. 1133 (1995); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 97-101 (1995); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEXAS L. REV. 51 (1992) [hereinafter Rassmussen, *Debtor's Choice*]; Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807

not be a mandatory regime because a single set of rules cannot meet the requirements of all the parties affected by a bankruptcy. Depending on the circumstances of a given bankruptcy case, some parties will profit and others will be harmed.[7] The ability to structure their private arrangements in the bankruptcy process more creatively therefore may benefit the parties.

The debate also is important because its outcome will affect the way that debtors and creditors act in debt negotiations and workouts that always precede, and often can circumvent, the costly bankruptcy process.[8] The National Bankruptcy Review Commission, for example, recently observed that "lenders increasingly are including contingencies in loan documents, indentures, and workout, forbearance, and settlement agreements that waive certain [bankruptcy] rights of the borrower upon filing for bankruptcy. The possible enforceability of pre-bankruptcy waivers is having a pervasive effect on a wide range of private negotiations between lenders and borrowers."[9] In addition, the

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(1998) [hereinafter *Schwartz, Contract Theory Approach*]; Alan Schwartz, *Contracting About Bankruptcy*, 13 J.L. ECON. & ORG. 127 (1997) [hereinafter Schwartz, *Contracting About Bankruptcy*]; Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301 (1997); Robert K. Rasmussen, Free Contracting in Bankruptcy At Home and Abroad (_____, 19__) (unpublished manuscript, on file with the *Texas Law Review*) [hereinafter Rasmussen, Free Contracting in Bankruptcy]; *see also* Michael St. Patrick Baxter, *Prepetition Waivers of the Automatic Stay: A Secured Lender's Guide*, 52 BUS. LAW. 577 (1997); Bruce H. White, *The Enforceability of Pre-Petition Waivers of the Automatic Stay*, 15 AM. BANKR. INST. J. 26 (Jan. 1997).

7 . *See* Rasmussen, *Debtor's Choice*, *supra* note 5, at 52-53.

8 . Bankruptcy costs can be considerable. *See* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 464 (1992). *See generally* VICTOR BRUDNEY & WILLIAM W. BRATTON, BRUDNEY & CHIRELSTEIN, CASES & MATERIALS ON CORPORATE FINANCE 149 (4th ed. 1993). Bogart noted that "[p]ractically every loan modification or business workout agreement drafted today contains a series of boilerplate 'bankruptcy waiver' provisions." Bogart, *supra* note 5, at 1128 n.21 (quoting Jefferey W. Warren & Wendy V.E. England, *Pre-Petition Waiver of the Automatic Stay Is Not Per Se Enforceable*, AM. BANKR. INST. J., Mar. 1994, at ____.).

9 . Report of the National Bankruptcy Review Commission, Chapter on Business Bankruptcies 24-25 (1997).

outcome of the debate is critical to the structuring of hundreds of billions of dollars of securitization[10] transactions each year which focus primarily on whether the parties have achieved a "bankruptcy remote" structure,[11] and also may influence choice of law issues in transnational bankruptcy cases.[12]

Moreover, the debate raises issues that, I argue, go well beyond bankruptcy to the very essence of freedom of contract. To that extent, I use prebankruptcy contracting as a model for exploring those broader issues.

Although the debate is complex, its essence is easy to grasp by example. A troubled debtor, not yet in bankruptcy,[13] may want relief from a default on its loan agreement or may need additional credit to survive a market downturn. The lender agrees to waive the default, or to extend the credit, but in return demands that the debtor contractually waive one or more of its rights under bankruptcy law, such as its right to

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10 . TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES (1991 & Supp. 1994); STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (2d ed. 1993) Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061 (1996); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994) [hereinafter Schwarcz, *Alchemy*].

11 . A structure is bankruptcy remote if an issuer of securities and the financial assets transferred from the debtor to that issuer are unlikely to be adversely affected by the debtor's bankruptcy. *See* Schwarcz, *Alchemy*, *supra* note 9, at 135. *Compare* Peter V. Pantaleo, et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 172 n.45 (1996) (considering, *inter alia*, whether contract law alone can be used to determine whether a sale occurs under 11 U.S.C. § 541). I discuss the application of prebankruptcy contracting to securitization transactions *infra* subpart IV(C).

12 . *See* Robert K. Rasmussen, A New Approach to Transnational Insolvencies (___ __, 1997) (unpublished manuscript, on file with the *Texas Law Review*) (arguing that multinational firms should be allowed to select their own insolvency rules from a menu of options).

13 . The federal Bankruptcy Code ("Code") governs bankruptcy law in the United States. *See* Bankruptcy Code, 11 U.S.C. 101-___ (19__).

the automatic stay.[14] If bankruptcy later occurs, the lender will be able to enforce its claim notwithstanding that the debtor's other creditors, who are not parties to the contract ("nonconsenting creditors"), will be stayed from enforcing their claims. Preferential enforcement thus may prejudice nonconsenting creditors by permitting the lender to recover first from the debtor's assets. If those assets are essential to the debtor's business, preferential enforcement also may impair the debtor's ability to reorganize under bankruptcy law as a viable company. The idea that parties can override bankruptcy law by contract, which I refer to as a "prebankruptcy contract,"[15] therefore conflicts with the traditional view that bankruptcy law is a form of public law, imposing mandatory rules to preserve distributional and rehabilitative interests.[16]

But bankruptcy law today is not composed entirely of mandatory rules: a certain type of prebankruptcy contract, unrecognized as such,

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14 . The automatic stay provides, in relevant part, that "a petition filed under [the Code] ... operates as a stay, applicable to all entities, of ... any act to obtain possession of property of the [bankrupt debtor's] estate or of property from the estate or to exercise control over property of the estate." *Id*. § 362(a)(3). The lender may ask the debtor for other bankruptcy law waivers, but waiver of the stay is the most common.

15 . The term prebankruptcy contract, which refers to a contract made in advance of bankruptcy with the intention of overriding a portion of the bankruptcy statutory scheme, differs from the term "prepetition contract," which could refer to any contract made in advance of bankruptcy, irrespective of the contract's purpose.

16 . In this context, public law compares to commercial law, which provides that "[t]he effect of provisions of [the Uniform Commercial Code] may be varied by agreement, except as otherwise provided in this Act." U.C.C. § 1-102(3)(1995). Nonetheless, even U.C.C. rules may not be contracted around in ways that adversely impact third parties. *See, e.g.*, *id*. §1-102 cmt. 2 ("The rights of third parties under Section 9- 301 when a security interest is unperfected, for example, cannot be destroyed by a clause in the security agreement."). The U.C.C. also articulates caution for amendments entered into by distressed debtors: "The default situation offers great scope for overreaching; the suspicious attitude of the courts has been grounded in common sense." *Id*. §9-503 cmt. 4 §9-503 (explaining the rationale for U.C.C. §9-501(3)'s limitation on waiving the state-law rights of a debtor in default). Prebankruptcy contracting raises these same cautions to the extent that it adversely impacts third parties (the nonconsenting creditors) and affects distressed debtors.

has long been a permissible private law exception. Whenever a company gives collateral to a creditor, it enters into a prebankruptcy contract in the form of a security agreement, which prefers that creditor at the risk of prejudicing nonconsenting creditors and impairing the company's ability to reorganize.[17] Of course, the existence of this exception to bankruptcy's mandatory rules neither validates the expansion of that exception nor proves that the exception was justified in the first place. I will show, however, that the theoretical basis for enforcing security agreements would appear to be the same as that for enforcing prebankruptcy contracts.[18]

A fundamental normative question will arise in the analysis: When should the law enforce contracts, such as waiver contracts, that may, and in fact sometimes do, harm third parties? This question cannot be answered without addressing the "major conceptual" problem of "[d]etermining which [externalities] are to count in constraining the ability of parties to contract with each other."[19] I devote a significant portion of the analysis in attempting to solve this problem in the context of prebankruptcy contracting.[20]

The analysis begins with the normative justifications for private contracting around public statutory schemes.

Scope and methodology.

I examine what I believe are the two representative kinds of prebankruptcy contracts: contracts, such as waivers, desired by creditors to limit the debtor's bankruptcy protections ("waiver contracts"); and contracts desired by debtors to seek alternatives to bankruptcy procedures or even to the bankruptcy process itself ("procedure contracts").[21] In a typical waiver contract, the debtor waives its

17 . *See infra* notes 328-333 and accompanying text (explaining why a security agreement is a form of prebankruptcy contract).

18 . *See infra* note 332.

19 . MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 20 (1993). The word "externalities" as used in the quotation above and in my Article means negative externalities.

20 . *See infra* section III(B)(1).

21 . Procedure contracts, like waiver contracts, therefore entail the waiver of rights, but they arise in a different context.

protection under the automatic stay in bankruptcy[22] against a particular creditor's debt collection actions.[23] In exchange, that creditor gives the debtor new credit or waives the debtor's default under a loan agreement.[24] Although both the debtor and potentially that creditor is waiving rights, the creditor is merely waiving a contract right, whereas the debtor is waiving a right under bankruptcy law.

In a procedure contract, on the other hand, the debtor, on its own initiative, attempts to negotiate with its creditors to contractually change the statutory procedures that would apply in the event the debtor subsequently goes bankrupt.[25] Under existing law, contracts bind only their parties. Therefore, a procedure contract cannot bind creditors that fail to sign the contract, and those non-signing creditors potentially can force the debtor to use the statutory bankruptcy procedure. Thus, a debtor wants all of its creditors to agree to the procedure contract. Rarely, however, can a debtor obtain unanimous creditor agreement. Some creditors may refuse to agree and other creditors, such as involuntary tort claimants, may not even be known to the debtor. Procedure contracts therefore are less likely than waiver contracts to have practical application without implementing legislation.[26] Accordingly, my analysis focuses more heavily on waiver

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22 . *See* Bankruptcy Code, 11 U.S.C. § 362(a) (19__).

23 . Although the debtor conceivably could waive its protection under the automatic stay in bankruptcy against the debt collection actions of all of its creditors, I later argue that such a broad waiver could thwart the fundamental bankruptcy policy of debtor rehabilitation and therefore should be presumed to be invalid. *See infra* note 357. Accordingly, I focus on waivers in favor of one, or at most a limited number, of a debtor's creditors.

24 . I refer to defaults that are sufficiently material to enable the lender, as a matter of law, to accelerate payment of its loan.

25 . The different procedures may be less costly than the statutory bankruptcy procedures. For examples of procedure contracts, see Rasmussen, Free Contracting in Bankruptcy, *supra* note 5, at __, and Schwartz, *Contracting About Bankruptcy*, *supra* note 5, at __.

26 . *See infra* subpart IV(D) (arguing that statutory implementing legislation, perhaps inspired by prepackaged bankruptcies under §1126(b) of the Code, may be necessary in order to make procedure contracts practical), Schwartz, *Contracting About Bankruptcy*, *supra*

contracts.

I also limit the analysis to business bankruptcies in which the *contracting* parties are sophisticated and represented by bankruptcy counsel.[27] These limitations, however, should not significantly limit the practical scope of my Article. Most prebankruptcy contracts can be expected to be negotiated in a business context; indeed, all of the decided cases on prebankruptcy contracting have involved business bankruptcies.[28] Moreover, business entities generally are presumed to be sophisticated[29] and typically are represented by counsel. My analysis makes no assumptions, however, as to the sophistication or legal representation of noncontracting parties (i.e., nonconsenting

note 5, at 143 (arguing that nonsigners should be bound "to the bankruptcy contract to which a majority of the debt holders (in amount) agreed"). Of course, one of the main drawbacks of waiver contracts—their potential negative effect on creditors of the debtor who are not parties to the contract— would not arise if all of a debtor's creditors are parties to a procedure contract. *See infra* section III(B)(1) (discussing that procedure contracts are unlikely to cause externalities).

27 . Nonbusiness bankruptcies, such as those involving consumer-debtors, could raise issues that would fundamentally distort the analysis. For example, consumer-debtors may be unable to afford counsel to advise them on prebankruptcy contracts. And even if a consumer-debtor does retain counsel, the fee paid may not motivate the lawyer to devote as much time to the client as in a business context, when larger amounts of money are likely to be at stake.

28 . *See supra* note 4 (listing cases).

29 . Consumer protection laws do not, for example, protect unsophisticated businesses. A presumption of sophistication minimizes the cost of adjudicating the issue of sophistication. *See, e.g.,* Steven L. Schwarcz, *A Fundamental Inquiry Into the Statutory Rulemaking Process of Private Legislatures*, 29 GA. L. REV. 909, 939 n.107 (1995). *But cf*. Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1949-58 (1994) (arguing that a substantial number of small-business debtors may be unsophisticated and criticizing arguments for contrary treatment). This Article does not attempt to address whether small-business debtors always should be deemed to be sophisticated for purpose of prebankruptcy contracting.

creditors).[30]

Finally, this Article generally takes a normative approach, examining not merely what the law is but what it ought to be. For example, there is little question that bankruptcy law *can* trump a freely entered-into contract. Chief Justice Hughes concluded, for example, that "when contracts deal with a subject matter which lies within the control of Congress, they have a congenital infirmity. Parties cannot remove their transactions from the reach of dominant constitutional power by making contracts about them."[31] My Article is about whether bankruptcy law *should* trump a freely entered- into contract.[32]

A normative approach to prebankruptcy contracting nonetheless faces the quandary that "[b]ankruptcy scholars are profoundly divided over the proper direction of bankruptcy law."[33] Some scholars, referred to as "free marketers," claim that bankruptcy should pursue only the goal of economic efficiency; others, referred to as "traditionalists," respond that the Code in fact pursues other goals.[34] I combine these

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30 . Those matters are irrelevant to the analysis of externalities suffered by those parties. *See infra* sections III(A)(2), III(B)(1) (analyzing externalities).

31 . Norman v. Baltimore & O.R.R., 294 U.S. 240, 307-08 (1935). Professor Rogers put it even more bluntly: "One simply cannot contract out of the bankruptcy power." James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 995, 994-95 (1983).

32 . An obvious limitation to the Article's scope is that it addresses only United States bankruptcy law. Nonetheless, as a matter of curiosity, I had seven foreign graduate law students examine the bankruptcy and insolvency laws of their respective countries to determine whether any of those laws contemplated prebankruptcy contracting. None of those laws addressed the issue.

33 . Donald R. Korobkin, *The Role of Normative Theory in Bankruptcy Debates*, 82 *Iowa L Rev.* 75, 76 (1996).

34 . Free-marketers generally focus on "what bankruptcy law should be." Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 99 (1984). Traditionalists distrust normative

perspectives by acting as a free marketer in inquiring whether prebankruptcy contracting can make the bankruptcy system more efficient but as a traditionalist in recognizing that political realities constrain the extent to which prebankruptcy contracting may be allowed to impinge on the Code's fundamental policies. This hybrid approach to examining economic efficiency within a traditionalist framework has respectable antecedents in bankruptcy scholarship.[35]

My analysis nonetheless addresses each of these perspectives separately before combining them. In this way, doctrinaire free marketers and doctrinaire traditionalists can, if they wish, focus on their own perspectives.[36] More significantly, however, addressing these perspectives separately allows a reader who wishes to apply my analysis outside of a bankruptcy context—for example, contractually overriding a statute other than the Code—to do so merely by substituting in my analysis another statute's policies for the Code's policies.[37]

Before beginning my substantive analysis, I provide a framework by summarizing and commenting on the current judicial and scholarly debates over prebankruptcy contracting.

. The Current Debate.

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theory as neither useful nor necessary and focus instead on what bankruptcy law actually does. *See* Korobkin, *supra* note 32, at 92, 95. *See also* Schwartz, *Contract Theory Approach*, *supra* note 5, at _ (arguing that the traditionalist "response is a mistake because the appropriate response to an 'ought' claim is an 'ought not' claim, not an 'is' claim").

35 . *See, e.g.*, Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 776-77 (1988) (taking "as given the existence (and significant use) of" the bankruptcy reorganization process and avoiding the debate whether liquidation is preferable to reorganization—focusing instead on finding, "as long as reorganizations remain, the best method for dividing the reorganization pie").

36 . I would, however, regard their narrow perspectives to be incomplete.

37 . Likewise, one who disagrees with the Code's policies (or with my description of those policies) could use my analysis merely by substituting her choice of policies. *Cf. infra* note 164 (discussing other formulations of bankruptcy policies advanced by scholars).

. *The Judicial Debate*

The judicial debate has been heated. Most of the decided cases have arisen in the context of clauses in loan agreements requiring debtors to waive the automatic stay in the event of their subsequent bankruptcy. Six courts have recognized in dicta or holding that the automatic stay may be waived.[38] Four courts have refused to recognize a waiver of the stay.[39] Although arguments can be made that these judicial decisions reflect *ex post* pragmatic judgments more than normative rationale,[40] courts have at least attempted to justify their decisions by principles that go beyond the immediate case at hand.

The cases that support waiver of the stay fall into two categories. Some courts reasoned that a debtor simply has bargained away its right to protection of the stay. *In re Atrium High Point Ltd. Partnership*[41] is representative of this argument. As part of a modification agreement entered into between the debtor and a bank creditor in connection with the debtor's original bankruptcy case, the bank reduced the interest rate and extended the maturity of its loan in return for the debtor's promise not to "oppose any motion filed by Lender . . . seeking relief from or modification of the automatic stay of 11 U.S.C. § 362(a) in any subsequent [bankruptcy] case of [debtor]."[42] A year later, the debtor filed for bankruptcy again and the bank moved for relief from the automatic stay. The court reasoned that

> [a]lthough an order of this court granting relief from stay may debilitate the Debtor somewhat, the Debtor accepted that risk when it agreed to the prepetition waiver of the automatic stay. . . . The agreement not to object to the motion to lift stay was bargained

38 . *See supra* note 4 (listing cases).

39 . *See supra* note 4 (listing cases).

40 . *See, e.g.*, Baxter, *supra* note 5, at 579 (arguing that "if one looks past the judicial rhetoric to the facts of each case, it becomes apparent that the results of the cases are reconcilable on the basis of the [bankrupt] debtor's likelihood of reorganization"). Irrespective of whether the cases could be reconciled by an *ex post* examination of the effect of prebankruptcy contracting, I argue that the enforceability of such contracting should be determinable *ex ante*. *See infra* notes 379-___ and accompanying text.

41 . 189 B.R. 599 (Bankr. M.D.N.C. 1995).

42 . *Id*. at 603.

for under . . . this Debtor's first confirmed plan of reorganization.[43] The Debtor received a lower interest rate and a five-year extension of the loan. . . . Enforcing the Debtor's agreement under these conditions does not violate public policy concerns.[44]

Other courts asserted that permitting parties to contract about bankruptcy promotes the public policy of debtor rehabilitation by encouraging out-of-court restructurings. *In re Club Tower L.P.*,[45] for example, involved a forbearance agreement entered into between a debtor and its single creditor after the debtor had defaulted on a loan agreement. The creditor agreed to forbear for a period of time from exercising its rights and remedies as a secured creditor in return for which the debtor, among other things, agreed to waive the stay in the event of a subsequent bankruptcy. The debtor, which had no employees and only a few unsecured creditors, each holding de minimis claims, later filed for bankruptcy. The court ruled that "[p]re-petition agreements regarding relief from stay are enforceable in bankruptcy,"[46] reasoning that "[w]orkouts and restructurings should be encouraged among debtors and creditors."[47]

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43 . Although one technically can distinguish this case on the ground that the waiver of stay was included in a confirmed plan of reorganization, the reasoning of the court does not appear to depend on that fact.

44 . *In re Atruim High Point*, 189 B.R. at 607 (dictum). *Accord*, *In re Powers*, 170 B.R. 480, 483 (Bankr. D. Mass. 1994) ("[p]re-petition agreements waiving opposition to relief from the automatic stay may be enforceable in appropriate cases."). The court in *In re Atrium High Point*, however, was "not convinced that [the bank's] arguments concerning the Debtor's waiver of its right to object can overcome the legitimate objections of the other creditors in the case" and therefore denied the motion for relief from the stay. *In re Atrium High Point*, 189 B.R. at 608.

45 . 138 B.R. 307 (Bankr. N.D. Ga. 1991).

46 . *Id*. at 311. The court alternatively held that "because the Debtor filed this bankruptcy case in bad faith, [the creditor] is entitled to relief from the automatic stay to exercise its rights and remedies as a secured creditor." *Id*. at 310.

47 . *Id*. at 311. Although the court noted that this reasoning "particularly" applies in single asset cases, the court's rationale is not limited to those cases: "To hold otherwise [*i.e.*, not enforce the prebankruptcy contract] could make lenders more reticent in attempting workouts with borrowers outside of bankruptcy." *Id*. at 312.

The cases opposing waiver of the stay fall into several categories. Some courts simply concluded that waiving the automatic stay violates the policies underlying bankruptcy law.[48] For example, in *Farm Credit of Central Florida, ASA v. Polk*,[49] the lender agreed to extend the date of a foreclosure sale in exchange for an agreement by debtor not to contest a motion for relief from the stay in the event debtor filed for bankruptcy. Debtor subsequently filed for bankruptcy, and the bankruptcy court refused to enforce the waiver. On appeal, the federal district court, which viewed "the automatic stay [as] a key component of federal bankruptcy law,"[50] affirmed that ruling, observing that "the Bankruptcy Court's holding that prepetition agreements providing for the lifting of the stay are 'not per se binding on the debtor, as a public policy position,'[51] is consistent with the purposes of the automatic stay to protect the debtor's assets, provide temporary relief from creditors and promote equality of distribution among the creditors by forestalling a race to the courthouse."[52]

Courts also have reasoned that the debtor, acting on its own, may not waive the automatic stay because the stay protects creditors as well

See also In re Cheeks, 167 B.R. 817, 819 (Bankr. D.S.C. 1994) ("Perhaps the most compelling reason for enforcement of the forbearance agreement is to further the public policy in favor of encouraging out of court restructuring and settlements.").

48 . I later argue that prebankruptcy contracts do not always violate such policies. *See infra* section II(B)(2).

49 . 160 B.R. 870 (M.D. Fla. 1993).

50 . *Id*. at 873.

51 . Of course, that does not mean such waivers are per se invalid either.

52 . *Id*. at 874. The court distinguished existing case-law precedent by asserting that, unlike the facts in the case before it, "[a] review of the underlying facts of [court] cases [upholding stay waivers] . . . does confirm that in each case the Bankruptcy Court, expressly or impliedly, determined that the debtor could not effectively reorganize" irrespective of whether the stay was waived." *Id.* at 872.

as the debtor. For example, in *In re Sky Group International, Inc.*,[53] a debtor had acquired a hotel in part by assuming the debt of its prior owner, a bankrupt company. As part of the assumption agreement, the new debtor consented to relief from the automatic stay in any future bankruptcy. After bankruptcy, however, the court refused to enforce the waiver, stating that "[t]he legislative history makes it clear that the automatic stay has a dual purpose of protecting the debtor and all creditors alike."[54] In particular, the legislative history to which the court referred finds that

> [w]ithout [the automatic stay], certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally.[55]

Relying on that finding by Congress, the court determined that routinely granting relief from the stay based on the debtor's waiver would ignore the purpose of protection and equal treatment of creditors.[56]

Finally, at least one court held that waivers are per se unenforceable for both technical and policy reasons.[57] From a technical standpoint, the court argued that a prepetition debtor is a separate and

53 . 108 B.R. 86 (Bankr. W.D. Pa. 1989).

54 . *Id*. at 88.

55 . H.R. REP. NO. 95-595, at 340 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963, 6296-97, *quoted in In re Sky Group*, 108 B.R. at 89.

56 . *In re Sky Group*, 108 B.R. at 89; *cf. In re* Atrium High Point Ltd. Partnership, 189 B.R. 599, 607 (Bankr. M.D.N.C. 1995) (deciding that a debtor may waive the automatic stay, but that "[a] waiver by the debtor cannot bind third parties").

57 . *See In re* Pease, 195 B.R. 431, 432-33 (Bankr. D. Neb. 1996) ("The apparent trend in decisional law, particularly in the context of single asset cases, is to enforce contractual waivers of the automatic stay. . . . With due respect for existing decisional law, I conclude that the pre-bankruptcy waiver of the automatic stay . . . is unenforceable, per se . . . .").

distinct legal entity from a postpetition "debtor in possession"[58] and

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58 . *Id*. at 433. The court observed:

> Upon the commencement of a Chapter 11 bankruptcy case, the debtor becomes a "debtor in possession" with a fiduciary duty to creditors and rights and obligations under federal law. Those rights include the enforcement of the automatic stay, which protects the debtor in possession and property of the bankruptcy estate. . . . In this sense, the Chapter 11 debtor is a separate and distinct entity from the pre-bankruptcy debtor.

Id. (citations omitted). This argument is weak, having been discredited by the Supreme Court and most commentators and other courts. *See, e.g.*, NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) (rejecting the "new entity" characterization); Thomas G. Kelch, *An Apology for Plain-Meaning Interpretation of the Bankruptcy Code*, 10 BANKR. DEV. J. 289 (1994) (showing that the separate entity doctrine has been discredited) [hereinafter Kelch, *Apology*]; Thomas G. Kelch, *The Phantom Fiduciary: The Debtor in Possession in Chapter 11*, 38 WAYNE L. REV. 1323, 1334 (1992) (observing that the new entity theory "is near death and is being replaced by a less occult conceptual model of the debtor in possession"); Stephen McJohn, *Person or Property? On the Legal Nature of the Bankruptcy Estate*, 10 BANKR. DEV. J. 465, 466 (1994) (reviewing the decline of the separate entity doctrine); Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 235-36 (1989) (asserting that judicial wariness of the new entity theory "is likely correct because the notion of a `new entity' not bound by the contract conflicts with the trustee's duty to pay damages for rejecting the contract"). *See also, e.g.*, United States v. Gerth, 991 F.2d 1428, 1435 (8th Cir. 1993) ("Whether the 'different entity' theory is still viable in any context is questionable."); *In re* Allen, 135 B.R. 856, 868 (Bankr. N.D. Iowa 1992) ("[T]he language of *Bildisco* is unambiguous and intended to put a stop to the rather artificial and fictitious distinctions between the debtor-in-possession and the debtor."); *In re* Ontario Locomotive & Ins. Ry. Supplies, 126 B.R. 146, 147 (Bankr. W.D.N.Y. 1991) ("In [*Bildisco*], the Court would appear to have laid to rest the 'separate entity' doctrine for all time."). Nonetheless, some courts still appear to follow the new entity doctrine. *See, e.g.*, *In re* West Elec. Inc., 852 F.2d 79, 83 (3d Cir. 1988) ("[I]n the context of the assumption and assignment of executory contracts, a solvent contractor and an insolvent debtor in possession going through bankruptcy are materially distinct entities."); *In re* DeLuca, 142 B.R. 687, 691 (Bankr. D.N.J. 1992) ("The filing of a bankruptcy petition creates the bankruptcy estate which is a new and different entity from the debtor."); Small Bus. Admin. v. Gore (*In re* Gore), 124 B.R. 75, 78 (Bankr. E.D. Ark. 1990) (holding that, in defeating a setoff, "a distinction must be made between a prepetition debtor and a debtor-in-possession, the separate entity that therefore has no capacity to bind it.[59] From a policy standpoint, the court reasoned that "the comprehensive nature of the Bankruptcy Code and its underlying purpose of providing a nationally uniform collective remedy to debtor and creditors" shows that "the Bankruptcy Code extinguishes the private right of freedom to contract around its essential provisions."[60] State debtor-creditor law, said the court, is based on the notion of "first in time is first in right"[61] and therefore both "rewards the belligerent liquidator and provides a disincentive to forbearance."[62] As a result, "[t]he resolution of disputes between a debtor and creditors under state law often involves a multiplicity of lawsuits and high transactional costs."[63] But "[t]he Bankruptcy Code substantively alters the rights and remedies of both debtors and creditors

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is created after the filing of [the bankruptcy] petition").

59 . *See In re Pease*, 195 B.R. at 433 ("I conclude that the pre-bankruptcy debtor simply does not have the capacity to waive rights bestowed by the Bankruptcy Code upon a debtor in possession, particularly where those rights are as fundamental as the automatic stay.").

60 . *Id*. at 434. The court also cautioned that upholding the waiver "would encourage institutional lenders to adopt standardized waiver terms in form loan agreements," which "would substantially undercut the relief Congress intended to provide debtors under the Bankruptcy Code." *Id*. at 435. I discuss the transactional application of prebankruptcy contracting to loan agreements *infra* subpart IV(B).

61 . *Id*. at 434. For example, the first creditor to obtain a judgment and levy on the debtor's assets is the first that obtains a judicial lien. *Id*. The Uniform Commercial Code priority scheme also is based on first in time, first in right. *See* U.C.C. § 9-312(5) (stating that the order of priority of secured creditors ordinarily is determined by order in which they file a financing statement or perfect).

62 . *In re Pease*, 195 B.R. at 434.

63 . *Id*.

in a most fundamental way."[64]

The cases are therefore split on the fundamental issue of whether prebankruptcy contracts are ever permitted, much less whether waivers of the stay are permitted.[65] Although cases acknowledge that

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64 . *Id*. Virtually the only other cases addressing freedom of contract are those holding that a debtor's right to file a bankruptcy petition is absolute. *See, e.g.*, Fallick v. Kehr, 369 F.2d 899, 904 (2d Cir. 1966); *In re* Weitzen, 3 F. Supp. 698, 698 (S.D.N.Y. 1933); *In re* Madison, 184 B.R. 686, 690-91 (Bankr. E.D. Penn. 1995); Artinian v. Peli (*In re* Peli), 31 B.R. 952, 956 (Bankr. E.D.N.Y. 1983); Johnson v. Kriger (*In re* Kriger), 2 B.R. 19, 23 (Bankr. D. Or. 1979). But see *United States v. Royal Business Funds Corp*., 724 F.2d 12 (2d Cir. 1983), in which a company licensed by the Small Business Administration ("SBA") appealed the stay of its Chapter 11 bankruptcy filing. The SBA, as consideration for a new loan to the troubled business which was already in default under an existing SBA loan, had obtained a stipulation granting the SBA "exclusive power" to collect and administer the company's assets under nonbankruptcy court supervision. *Id*. at 14. The court dismissed the Chapter 11 filing, reasoning that if the SBA could not rely on the agreement, it "will never again provide new loans to a company in . . . financial straits and [thus] receivership designed to resuscitate financially troubled [small business investment companies] will be much less feasible." *Id*. See also *In re NBI, Inc.*, 129 B.R. 212 (Bankr. D. Col. 1991), in which the court held void a prebankruptcy agreement granting a debtor's bankruptcy counsel a substantial nonrefundable fee retainer covering postpetition legal services because the agreement "impermissibly circumvent[ed] the explicit and implicit requirements of the Bankruptcy Code and Rules [authorizing] the compensation of professionals . . . only for actual and necessary legal services and related costs." *Id*. at 222-23. Although the court felt that the provisions of the Code governing fee arrangements are meant to "protect against the danger that a prospective debtor, willing to do whatever necessary to secure the counsel of its choice, may bargain away more than is reasonable," *id*. at 222, that logic suggests a distinction on which I later focus. Once a debtor retains and is advised by bankruptcy counsel, its naivety may be compensated for by its counsel's sophistication and experience. *See infra* text accompanying notes 149-150, 188-190. My Article is limited to situations in which the contracting debtors are sophisticated and represented by bankruptcy counsel. *See supra* text accompanying note 26.

65 . Indeed, it could be argued that those cases which enforced waivers found facts sympathetic to enforcement but those which refused to enforce waivers faced less sympathetic facts. Each court could have narrowed its holding by focusing on particular facts.

prebankruptcy contracting can enhance public policy by promoting out-of-court restructuring, judges also are concerned that debtors or creditors may be prejudiced or that bankruptcy policies may be violated.[66] The following discussion, which describes and critiques the scholarly debate, shows that scholars are also divided.

. *The Scholarly Debate*

The scholarly debate appears to have started when Professor Robert Rasmussen, after pointing out the "increasing uneasiness in the academy" over Chapter 11, suggested that the "failure to reach a consensus [on Chapter 11] stems from a basic flaw contained in all of the theories of corporate-reorganization law offered to date."[67] The flaw was the assumption that bankruptcy law must be a mandatory rule.[68] Rasmussen suggested that viewing bankruptcy law as inherently a set of mandatory rules is anomalous because most rules in contract law are default rules.[69] Arguing that "one must provide a justification for

66 . I later address these concerns. *See infra* section III(B)(2) and text accompanying notes XX-XX, (arguing that debtors that receive reasonably equivalent value should not be prejudiced, and that limited forms of prebankruptcy contracting are consistent with bankruptcy policies), and *infra* section III(B)(1) and text accompanying notes XX-XX (arguing that nonconsenting creditors would not be prejudiced by bankruptcy contracting that is class Pareto efficient).

67 . Rasmussen, *Debtor's Choice*, *supra* note 5, at 52.

68 . A mandatory rule is a rule that a government imposes and parties are not free to change; in contrast, a default rule is a rule that government imposes but parties are free to change by agreement. *Id*. at 53 ("[A]ll theorists assume that bankruptcy law is a mandatory rule; it is a rule set in place by the government that cannot be altered by those whom it affects."). Given that assumption, Rasmussen argued that scholars inevitably will reach "differing assessments of the impact of the bankruptcy regime on the groups—creditors, shareholders, workers, or members of the community at large—in whom the [particular] scholar is interested." *Id*. at 52-53.

69 . *Id*. at 53, 61-62. Rasmussen argued that because the interest rate on a loan will depend in part on the anticipated recovery in bankruptcy, "bankruptcy law is an implied term of the contract between a creditor and the firm" and therefore "at a fundamental level [is] no different from the myriad of rules that the law implies to flesh out the

invoking mandatory rules,"[70] Rasmussen proposed that "it is time for bankruptcy scholarship to address the question of who should decide whether a firm is eligible for corporate reorganization under the auspices of the Bankruptcy Code."[71]

Rasmussen's arguments have generated a lively debate. Agreeing that prebankruptcy contracting is an important subject for scholarly inquiry,[72] Professor Alan Schwartz examined a model in which, similar to current law, an insolvent debtor can choose one of two bankruptcy

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bargain between contracting parties." *Id*. at 58-59. Of course, that a statutory provision affects the bargain between parties does not necessarily turn the statute itself into contract law. Even presuming that some of bankruptcy law's normative foundations may be contractarian, *see generally* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988), bankruptcy law itself is neither contract law nor a subset of contract law but an independent statutory scheme in which the state, not private parties, plays a dominant role.

70 . Rasmussen, *Debtor's Choice*, *supra* note 5. at 63 (citing Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87 (1989), for the proposition that mandatory rules are generally viewed as the exception and not the rule). That most contract rules are default rules does not, however, prove that all mandatory rules must be justified.

71 . *Id*. at 53. Rasmussen went on to propose a menu approach to corporate bankruptcy. The need for default rules increases proportionally to the number of parties and situations covered by the rule. Corporate bankruptcy covers a wide range of companies and creditors, making a one-size-fits-all rule inefficient and "strongly suggest[ing] that a default-rule approach is superior to the law's current prescription of a mandatory rule." *Id*. at 63. A menu of standardized bankruptcy options, selected by a firm when it is formed, would respond to this problem and reduce the transaction costs and the strategic action problem of allowing unlimited options. *Id*. at 66. He would impose mandatory rules, however, to protect nonconsenting creditors. *Id*. at 67. The nature of those rules, however, is beyond the scope of his article.

72 . *See* Schwartz, *Contracting About Bankruptcy*, *supra* note 5, at 130-31 ("[C]ontracting issues in bankruptcy are worthy of study.").

procedures.[73] Although an "efficient bankruptcy procedure will maximize the sum of monetary returns [to creditors] and private benefits [to the debtor],"[74] neither of the two posited procedures is assumed always to do this.[75] Instead, because creditors are legally entitled to the monetary return when the debtor is insolvent, the debtor will prefer the bankruptcy procedure that maximizes its private benefits irrespective of the monetary return to creditors.[76] Schwartz pointed out that creditors could always bribe the debtor to choose the more efficient procedure.[77] However, if creditors believe *ex ante* that they may have to pay a bribe, that would add to the cost of credit and reduce investment in positive-value projects.[78] Thus the current mandatory rule is inefficient. Schwartz then showed that prebankruptcy contracting could lead to an optimal bankruptcy procedure because the parties, in order to reach agreement, effectively will have to balance the debtor's private benefits with the creditors' monetary return.[79]

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73 . Under the Code, a business debtor generally chooses either to reorganize under Chapter 11 or to liquidate under Chapter 7.

74 . Schwartz, *Contracting About Bankruptcy, supra* note 5, at 129. By private benefits, Schwartz meant benefits, such as salaries, that the debtor's owners and managers derive from continuing to operate the debtor. *See id*. at 133.

75 . For example, if a debtor has a temporary liquidity crisis but otherwise is a sound business, the reorganization procedure may be better economically even though creditors might prefer a quick liquidation to get their money and avoid risk. But if the debtor's business is inherently unsound, liquidation may be better economically even though the debtor's managers may wish to preserve their jobs by keeping the business running at the creditors' expense. *See id*. at 132.

76 . *Id*. at 129.

77 . *Id*. at 130.

78 . *Id*. at 130.

79 . FA. Rasmussen referred to this as negotiating for "an ex ante bribe set in the contract." Rasmussen, Free Contracting in Bankruptcy, *supra* note 5, at 5. Schwartz dismissed the collective action problem as a bar to prebankruptcy contracting, observing that "[c]ollective action

Nonetheless, Schwartz cautioned that disagreement among the creditors themselves can be an obstacle to prebankruptcy contracting.[80] Senior creditors may prefer liquidation in order to be paid, but trade creditors may prefer that the debtor's business continue to operate so they can earn profits by continuing to provide the debtor with goods and services.[81] Thus, he concluded "there is a serious question whether contracting about bankruptcy issues is feasible."[82]

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problems . . . sometimes yield to contractual solutions." Schwartz, *Contracting About Bankruptcy*, *supra* note 5, at 128. He contemplated that a contractually-chosen procedure could "best solve these parties' particular collective action problem." *Id*. The collective action problem is that absent a bankruptcy procedure, creditors will act in their individual interests, increasing the risk that an inherently viable but temporarily troubled debtor will be liquidated. FA.

80 . *Id*. at 140-43.

81 . FA. Trade creditors who supply goods and services postpetition usually will be paid during the pendency of a Chapter 11 case. *See* Bankruptcy Code, 11 U.S.C. §§503(b), 507(a)(1). Schwartz suggested that "[t]he appropriate legal response to this source of conflict, however prevalent, is to bind nonsigners to the bankruptcy contract to which a majority of the debt holders (in amount) agreed." Schwartz, *Contracting About Bankruptcy*, *supra* note 5, at 143. He reasoned that a trade creditor who dissents from a bankruptcy contract is merely attempting to redistribute wealth inefficiently from the majority to itself and that Chapter 11 now bans that strategic behavior by letting the majority determine the choice of a reorganization plan. *Id*. *Cf*. 11 U.S.C. § 1126(b)-(d) (governing class acceptance of plan and deemed acceptance or rejection of a plan in prepackaged bankruptcies, which are binding on all creditors under existing bankruptcy law); *infra* Part IV.D (analyzing the relationship between prepackaged bankruptcies and procedure contracts).

82 . *Id*. at 128. He identified three obstacles: a firm's creditors may have different preferences over bankruptcy procedures, the firm often has many creditors, and the creditors usually lend at different times. *Id*. He later showed that having many creditors who lend at different times would not matter if all creditors had the same preferences. FA in Schwartz. The obstacles noted by Schwartz obtain only in contracts to which all creditors must agree. Therefore, the type of prebankruptcy contract that is most common, waivers by the debtor of such rights as the automatic stay, would not face the obstacles that Professor Schwartz identified. *See infra* text accompanying notes 106-107

In a more recent article,[83] Professor Schwartz probed more deeply into the meaning of mandatory bankruptcy rules and economic efficiency. He argued that a mandatory rule is justifiable for two reasons only: it is necessary to protect the integrity of the system itself or it enhances *ex post* efficiency when the parties themselves cannot reach the efficient outcome on their own.[84] Because "[b]ankruptcy systems create mechanisms to facilitate Coasean bargaining,"[85] parties will be able to reach efficient outcomes on their own, and therefore redistributional mandatory bankruptcy rules should not be needed. Schwartz acknowledged that certain mandatory rules, which he calls "structural rules," may be needed to protect the integrity of the

(comparing the need for creditor agreement under procedure and waiver contracts). Also compare *infra* notes 456-467 (arguing that, in the context of procedure contracts, prepackaged bankruptcy may be a model to overcome Professor Schwartz's obstacles). Schwartz ultimately made five tentative recommendations: parties should be free to contract for the bankruptcy procedure they like; the state should create a set of bankruptcy procedures as defaults; every procedure should include absolute priority; creditors who do not agree to a bankruptcy procedure should be required to use the procedure contracted for by a majority of the debtor's creditors; and because contracts seem feasible in bankruptcy contexts, "deeper justifications are needed for the mandatory rules in the current Bankruptcy Code." Schwartz, *Contracting About Bankruptcy*, *supra* note 5, at 144. These recommendations were tentative because Professor Schwartz acknowledged that his analysis has two major limitations: it ignored involuntary creditors, and it made three "strong" assumptions— that the managers are, or are faithful to, the owners; that creditors do not form coalitions to collude against other creditors; and that creditors are symmetrically informed about the relevant variables. *Id*. at 144.

83 . Schwartz, *Contract Theory Approach*, *supra* note 5.

84 . FA. According to Schwartz, "[P]olicy analysis should be done on the assumption that maximizing the ex post value of insolvent firms is the only defensible goal of a business bankruptcy law." *Id*. at 1817.

85 . *Id*. at 1809. Under Coasean bargaining, "the initial location of a property right, as set by mandatory rules, is irrelevant to efficiency" in the absence of transaction costs. *Id.* In reality, of course, there always are transaction costs.

bankruptcy system itself.[86] Other than structural rules, however, mandatory rules are inefficient because parties would have to rely on renegotiation to induce the optimal bankruptcy choice.[87] Contracts dealing with bankruptcy, on the other hand, "would generate higher expected values for creditors,"[88] and thereby permit more projects to be funded.

Whereas Rasmussen and Schwartz focused primarily on procedure contracts, other scholars have expanded the scope of the debate by focusing on waiver contracts. Professor Marshall E. Tracht argued that

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86 . *Id*. at 1839. He identified the automatic stay as such a rule:

> In many cases, some form of stay is essential to the existence of an efficient bankruptcy system. . . . If the collateral is worth more to the firm than to the market, preventing foreclosure would maximize the ex post value of the estate. Hence, to let secured creditors . . . foreclose before the value issue is resolved would vitiate the reorganization process.

Id. at 1840-41. I agree with the proposition that an automatic stay is generally necessary to protect the value of the debtor's property. I later argue, however, that contractual waivers of the stay that, on a case-by-case basis, are *ex ante* unlikely to reduce such value actually would maximize *ex post* overall value and therefore should be allowed. *See infra* subpart III(B). *Cf.* Tracht, *supra* note 5, at 317-18 (arguing that bankruptcy sometimes is so costly that creditors and debtors would be better off without it, even if bankruptcy solves a collective action problem of creditors racing to the courthouse to attach a debtor's assets).

87 . Schwartz, *Contract Theory Approach*, *supra* note 5, at 1831. *See generally id*. at 1826-36.

88 . *Id*. at 1831. Schwartz illustrated his point by examining several mandatory rules in the Code. For example, *ipso facto* clauses, which are clauses canceling or modifying a contract upon the occurrence of bankruptcy, are generally unenforceable. *See* Bankruptcy Code, 11 U.S.C. §365(e)(1) (____). Yet their enforcement, he argued, would not generally reduce *ex post* efficiency. They therefore should be enforceable unless "the estate's gain from performance [of the contract] would exceed [the non-bankrupt] party's loss." Schwartz, *Contract Theory Approach*, *supra* note 5, at 1809, 1842-49 (arguing based on Kaldor-Hicks efficiency). *Cf. infra* notes 262-271 and accompanying text (discussing whether Kaldor-Hicks efficiency should be the appropriate test of efficiency in the context of prebankruptcy contracting); *infra* notes 385-387 and accompanying text (discussing *ipso facto* clauses as a type of prebankruptcy contract).

prebankruptcy contractual waivers, especially of the automatic stay, should be presumed to be valid.[89] After questioning whether some courts' refusal to enforce bankruptcy waivers reflects "a belief that private parties lack the information or ability to determine, at the time of the waiver, whether a subsequent bankruptcy proceeding would be worth the cost,"[90] he countered that "firms and their creditors may be better than bankruptcy judges at predicting the likely costs and benefits of bankruptcy."[91] Tracht further suggested that "waivers may play an important role in encouraging consensual resolutions that would otherwise fail due to information asymmetries."[92] "[C]reditors may reject effective workout proposals because they cannot be distinguished from ineffective ones. Management needs a signal that will assure creditors that management really believes in its workout scenario. A

89 . *See* Tracht, *supra* note 5, at 311-13 (describing how many courts enforce these waivers based on the public policy of encouraging out-of-court restructurings).

90 . *Id*. at 328.

91 . *Id*. at 329. In examining whether bankruptcy waivers will prejudice unsophisticated unsecured creditors or tort creditors, Tracht argued that contractual unsecured creditors can demand disclosure of prebankruptcy waivers through a filing system, such as the U.C.C. recording system for security interests, and could try to obtain covenants limiting such waivers. *See id*. at 338; Rasmussen & Skeel, *supra* note 5, at 100 (suggesting a filing system for prebankruptcy waivers); *infra* note 331, (comparing U.C.C. and prebankruptcy filing systems). He acknowledged that involuntary creditors, such as tort creditors, could not require such protection but argues that "the risk to these parties is minimal" and that unsecured creditors would "benefit . . . in part . . . through a reduced risk of insolvency." Tracht, *supra* note 5, at 335-36. Although I agree that unsecured creditors, including involuntary creditors, *could* benefit through a reduced risk of bankruptcy, I later show that unrestricted bankruptcy contracting does not necessarily benefit unsecured creditors. *See infra* notes XX-XX and accompanying text (analyzing effect of prebankruptcy contracting on unsecured creditors).

92 . Tracht, *supra* note 5, at 335.

bankruptcy waiver provides such a signal."[93]

Professor Daniel Bogart extended the debate to include game theory.[94] In opposition to prebankruptcy contracting, he argued that although signaling is the apparent justification for waivers of the stay,[95] "[b]ad borrowers are desperate to see their loans worked out, if only temporarily, and are often willing to signal as well."[96] Good and bad debtors therefore will compete to signal their success, driving up the cost of signaling.[97] Indeed, "in actual practice," the good signal is

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93 . *Id*. at 345. Tracht further argued that there should be a strong presumption of enforceability because "[i]f waivers are commonly voided, creditors will refuse to give substantial value in exchange for them." *Id*. at 352-53.

94 . *See* Bogart, *supra* note 5. Bogart's arguments are limited by their exclusive focus on the "small slice" of single-asset real estate loan workouts. *Id*. at 1119. When a debtor has only one asset, the waiver of the stay would amount to liquidation, eliminating any possibility of rehabilitation. Bogart's arguments therefore would not apply generally to typical debtors only certain of whose assets are encumbered.

95 . *See id*. at 1182. According to Bogart

> The waiver of stay provision might be seen as a signal that Borrower is confident that it controls a good project and is worth the effort of a loan workout, presuming that only a borrower convinced that it will not need to file for bankruptcy would waive its most substantial protection.

Id. To this extent, Professors Bogart and Tracht agree that, from the perspective of asymmetric information, a good debtor by agreeing to waive its right to the automatic stay can signal to its creditors that a proposed workout will be successful. *See supra* text accompanying note 92.

96 . Bogart, *supra* note 5, at 1176.

97 . *See id*. at 1176-77. Cost will rise because

> bad borrowers will grant concessions to lenders, making the process of distinguishing between good and bad borrowers difficult. The only option available to the good borrower, then, is to adopt even more costly strategies of signaling the lender. . . . [T]his process of signaling leads to inefficient results. The constant confusion of signals, with attendant costs, is an externality forced upon good borrowers by the

"copied by bad troubled borrowers."[98]

Clearly prebankruptcy contracting raises complex issues about which scholars are divided. Although some justify prebankruptcy contracting on signaling grounds,[99] I agree with Professor Bogart that it cannot be so justified. Waivers actually may send a negative signal to noncontracting creditors, suggesting the debtor is in trouble.[100] The underlying problem is that only very strong, or very desperate, debtors are likely to give waivers, and there is often no way to distinguish them. Furthermore, even if the waiver signals to the contracting creditor that the debtor believes it will succeed, that creditor more tangibly can rely on the substantive protection provided by the waiver. Thus, the signal sent by the waiver may be mixed and the very creditor who receives the positive signal may not need it.

Other scholars have justified prebankruptcy contracting as maximizing economic efficiency.[101] I later question, however, whether economic efficiency alone should drive bankruptcy rulemaking[102] and argue that fundamental bankruptcy policies, which foster distributional and rehabilitative goals beyond mere economic efficiency, also should

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behavior of bad borrowers.

Id.

98 . *Id*. at 1183. Bogart does not cite the basis of his knowledge of "actual practice."

99 . *See supra* text accompanying note 92.

100 . Telephone Interview with Arthur Steinberg, Bankruptcy Partner at Kaye, Scholer, Fierman, Hays & Handler (June 10, 1997) (on file with ___).

101 . *See supra* notes 69-92 and accompanying text.

102 . *But see* Schwartz, *Contract Theory Approach*, *supra* note 5, at 1809 (arguing that bankruptcy systems only "function to maximize the monetary value of the estate"). Schwartz admitted that limiting the goals of a bankruptcy system to maximizing the monetary value of the estate is not uncontroversial. *Id*. at 1809-10. *But see* Korobkin, *supra* note 32, at 118 (arguing that unless we are persuaded that maximizing estate value "reflects some authoritative ideal—an overriding good or one of our deepest commitments as persons"—we still face the problem of normativity).

be taken into account.[103] Furthermore, I question whether the traditional tests of economic efficiency are suited to analyzing prebankruptcy contracting and propose an alternative test that takes into account the impact of prebankruptcy contracting on nonconsenting creditors.[104]

Finally, some scholars have flatly opposed prebankruptcy contracting.[105] I argue instead that limited forms of prebankruptcy contracting may well be appropriate.[106]

. Analysis

I begin the analysis by asking the threshold question: what freedom should parties have to contractually override a statutory scheme? I attempt to answer this question within the context of the bankruptcy statutory scheme. Because the analysis is lengthy, I start by providing a summary.

I first examine the restrictions that generally should be imposed on attempts to waive provisions of a federal statute such as the Code. Absent specific statutory prohibitions, waivers are permitted if they do not thwart the legislative policies underlying the statute. I then attempt to identify the legislative policies underlying the Code.

Next, I examine the restrictions that contract law additionally would impose: should the Code's provisions be viewed, under contract law, as mandatory rules that may not be changed by agreement, or as default rules that parties may contract to change? There are two justifications for mandatory rules: paternalism and externalities. In the context of this Article's exclusive focus on sophisticated contracting parties represented by bankruptcy counsel, I conclude that paternalism alone would not justify viewing the Code's provisions as mandatory. In contrast, I show that externalities could well serve as a justification for imposing mandatory bankruptcy rules.

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103 . *See infra* text accompanying notes 336-376. *Cf. supra* text accompanying note 34 (explaining that I argue as a free marketer in inquiring whether prebankruptcy contracting can make the bankruptcy system more efficient but as a traditionalist in recognizing that political realities constrain the extent to which prebankruptcy contracting can impinge on fundamental Code policies).

104 . *See infra* Part III.

105 . *See supra* notes 93-97 and accompanying text.

106 . *See infra* subparts III(B), III(C), IV(A), and IV(C).

Having established a context in which to analyze the enforceability of prebankruptcy contracts, I first address procedure contracts. Because contracts generally do not bind noncontracting parties, a procedure contract, at least under present law, would not be binding unless the debtor and all of its creditors agree to it. In the case of such unanimous consent, there would be no externalities because no rational party would agree to be harmed. But because unanimous consent is usually impractical, procedure contracts are unlikely to have widespread use without implementing legislation establishing a supermajority voting procedure.[107]

Waiver contracts, to which only the debtor and (typically) a single creditor are parties, are much more likely than procedure contracts to have widespread use. They are, however, also more likely to cause externalities and to interfere with bankruptcy policies. Waiver contracts that do not materially harm nonconsenting creditors[108] should not cause externalities sufficient to render the contract unenforceable. In the event of a bankruptcy, however, waiver contracts often could harm nonconsenting creditors. Should they be enforced?

I use a law-and-economic analysis to help answer that question. I argue that even though some nonconsenting creditors inadvertently may be harmed, waiver contracts that *ex ante* are unlikely to harm nonconsenting creditors should make those creditors *as a class* better off[109] by providing liquidity to troubled debtors. Therefore, enforcing such contracts would be consistent with the normative basis for legislation—evaluating the effects of proposed rules on classes of persons rather than on particular, identifiable individuals. Moreover, enforcement also would be consistent with the normative argument for freedom of contract—voluntary assent on the part of all parties—because even creditors who, in retrospect, are harmed would want those contracts, viewed *ex ante*, to be enforceable. Waiver contracts that are likely to harm nonconsenting creditors,[110] however, would make those creditors worse off as a class and therefore should not

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107 . *See infra* Part IV(D) (discussing a supermajority voting proposal and analyzing its relation to voting for prepackaged bankruptcies).

108 . Or, in my terminology, have a secondary material impact on those creditors.

109 . Or at least no worse off.

110 . Or, more technically, waiver contracts that are *not unlikely* to harm nonconsenting creditors.

be enforced.[111]

Finally, I analyze whether otherwise enforceable waiver contracts would violate bankruptcy policies.

. *What Principles Govern Whether a Person Should Have Freedom to Contract About a Statutory Scheme?*

This question raises two issues: what restrictions generally should be imposed on contracting to alter a statutory scheme, and what restrictions does contract law additionally impose? Because the Code is federal law, I analyze these issues from the standpoint of the federal statutory scheme.

. *What Restrictions Generally Should Be Imposed on Contracting to Alter a Federal Statutory Scheme?* Waivers of a federal statute generally are permitted unless they would thwart the legislative policies the statute was designed to effectuate[112] or Congress specifically precludes them, as through an anti-waiver provision:

> Rather than deeming waiver presumptively unavailable absent some sort of express enabling clause, we [the Supreme Court] instead have adhered to the opposite presumption. . . . [A]bsent some affirmative indication of Congress' intent to preclude waiver, we have presumed that statutory provisions are subject to waiver by voluntary

111 . One of my colleagues has suggested that non-enforcement versus full enforcement should not be the only possible outcomes. Often the law internalizes a cost by allowing a party to act but making that party liable for the consequences of its actions. Although cost internalization may be theoretically possible, I think its enforcement would be difficult because prebankruptcy contracting potentially affects a multitude of parties and one cannot assume that the contracting creditor has the financial wherewithal to satisfy those parties' claims. Neither can the debtor satisfy those claims; if the contract is ever tested, it will be in bankruptcy.

112 . *See, e.g.*, Barrentine v. Arkansas-Best Freight System, Inc., 450 U.S. 728, 740 (1981) (holding that rights under a federal statute "cannot be abridged by contract or otherwise waived" if doing so would "'nullify the purposes' of the statute and thwart the legislative policies it was designed to effectuate"); *infra* subsection III(A)(1)(2). Waivers also may be precluded by "overriding procedural considerations." 21 CHARLES ALAN WRIGHT & KENNETH W. GRAHAM, JR., FEDERAL PRACTICE AND PROCEDURE § 5039, at ____ (1977).

agreement of the parties.[113]
Because the Code has relatively few antiwaiver provisions,[114] I focus on

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113 . United States v. Mezzanatto, 513 U.S. 196, 200-01 (1995). *Accord* Shutte v. Thompson, 82 U.S. (15 Wall.) 151, 159 (1873) ("A party may waive any provision, either of a contract or of a statute intended for his benefit.").

114 . Most of the provisions in the Bankruptcy Code, 11 U.S.C. §§ 101-___ (1994), including the automatic stay, are not expressly precluded from being waived. Only certain bankruptcy waivers are specifically prohibited. The provisions in prepetition contracts—called *ipso facto* clauses—terminating the contract in the event of the debtor's bankruptcy, insolvency or financial condition are not enforceable. *Id*. § 365(b)(2). Similarly, contract provisions waiving exemptions or related avoiding powers are not enforceable. *Id*. § 522(e). The Code places limits on the right of debtors to waive their dischargeability rights. *Id*. § 524(c). Provisions terminating a debtor's interest in property in event of debtor's bankruptcy, insolvency or financial condition—another type of *ipso facto* provision—are not enforceable). *Id*. § 541(c). In addition, post-petition waivers by the debtor of defenses, such as statutes of limitations or fraud, usury, and other personal defenses, are not binding on the estate. *Id*. § 558. A debtor also cannot waive its one-time right to convert a case from Chapter 7 to Chapter 11 or 13. *Id*. § 706(a). The Code further grants the debtor an unwaivable opportunity to redeem personal property from a lien securing a dischargeable consumer debt. *Id*. § 722. An attorney employed to represent a creditors' committee is prohibited from representing another entity that has an adverse interest in the case: under the legislative history, that prohibition cannot be waived. *Id*. § 1103(b). Finally, a waiver of a debtor's right to convert the case to another chapter of the Code or to dismiss a personal bankruptcy case prior to conversion of the case to another chapter of the Code is not enforceable. *Id*. § 1307(a), (b). One bankruptcy court has refused to enforce a prebankruptcy contract in analagous circumstances. *See In re* Howe, 78 B.R. 226 (Bankr. S.D. 1987) (refusing to enforce an assignment fee in an executory contract in light of language in 11 U.S.C. §365(f) that a bankrupt debtor may assign an executory contract "notwithstanding a provision . . . that prohibits, restricts, or conditions the assignment"). There nonetheless may be an argument, illogical as it may appear, that "an express waiver clause may suggest that Congress intended to occupy the field and to preclude waiver under other unstated circumstances." *Mezzanatto*, 513 U.S. at 201. *But see* Johnson v. Home State Bank, 501 U.S. 78, 87 (1991) (holding that because Congress had expressly prohibited certain types of serial filings elsewhere in the Code, "[t]he absence of a like prohibition on serial

whether waivers would thwart the Code's policies, first by examining the case law on thwarting a statute's policies and then by identifying the policies that the Code was designed to effectuate.[115]

. *Case law on thwarting a statute's policies*Courts appear reluctant in most cases to find that a waiver thwarts a statute's policies. The cases in which waivers have been found *not* to thwart a statute's legislative policies surprisingly include waivers of constitutional

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filings of Chapter 7 and Chapter 13 petitions . . . convinces us that Congress did not intend categorically to foreclose the benefit of Chapter 13 reorganization to a debtor who previously has filed for Chapter 7 relief"). Because the Supreme Court has not adhered to a consistent textualist approach in interpreting the Code, I do not attempt to predict the significance, if any, of the existence of specific Code prohibitions on waiver. *See, e.g.*, Kelch, *Apology*, *supra* note 57, at 294 (concluding that "[t]he outline of the 'plain-meaning' rule that emerges from analysis of these [Court] cases is anything but uniform and nothing that can be called a 'theory'"); Charles Jordan Tabb & Robert M. Lawless, *Of Commas, Gerunds, and Conjunctions: The Bankruptcy Jursidprudence of the Rehnquist Court*, 42 SYRACUSE L. REV. 823, 879-81, 891 (1991) (noting that the Court's ad- hoc approach, or "textualist drift," has resulted in a lack of consistent jurisprudence in statutory interpretation).

115 . Recently, however, the National Bankruptcy Review Commission, a group of nine individuals appointed by Congress to review the Code, by a five-to-four vote recommended the adoption of a proposed new § 558 providing, in relevant part, that "except as otherwise provided in title 11, a clause in a contract or lease or a provision in a court order or plan of reorganization executed or issued prior to the commencement of a bankruptcy case does not waive, terminate, restrict, condition, or otherwise modify any rights or defenses provided by title 11." NBRC Recommendation No. 2.4.5 (Prebankruptcy Waivers of Bankruptcy Code Provisions) (October 1997). Most of the NBRC's proposals have been highly controversial:

> [T]he National Bankruptcy Review Commission on Oct. 20 unveiled a 1,300-page report to Congress on how to fix the nation's bankruptcy laws. And its 172 proposals managed to please . . . almost nobody.
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> . . .
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> Even within the commission, deep divisions led four of the nine members—mostly private lawyers and federal judges—to issue a scathing dissent.

Dean Foust & Debra Sparks, *Bankruptcy Reform: Everybody's Mad—And That's Fine*, BUS. WK. 154 (Nov. 3, 1997).

rights,[116] federal rules of criminal procedure,[117] and anti-discrimination laws.[118] In *United States v. Mezzanatto*,[119] for instance, the Court upheld waivers of the exclusionary provisions in Rule 410 of the Federal Rules of Evidence and in Rule 11(e)(6) of the Federal Rules of Criminal Procedure.[120] The Court reasoned that since "evidentiary stipulations are a valuable and integral part of everyday trial practice" and "[b]oth the Federal Rules of Civil Procedure and the Federal Rules of Criminal Procedure appear to contemplate that the parties will enter into evidentiary agreements during a pretrial conference," congressional silence on the matter did not constitute an "implicit rejection of waivability."[121] Similarly, the Court held in *Gilmer v. Interstate/Johnson Lane Corp.*[122] that the right to bring claims in federal court under the Age Discrimination in Employment Act[123] (ADEA) could be waived, and the claims subjected instead to

116 . *See, e.g.*, Cohen v. Cowles Media Co., 501 U.S. 663, 665 (1991) (ruling that the First Amendment did not bar a promissory estoppel claim); Snepp v. United States, 444 U.S. 507 (1980) (involving freedom of expression); D.H. Overmyer Co. v. Frick Co., 405 U.S. 174, 187 (1972) (holding that a cognovit clause is not a per se due process violation).

117 . *See, e.g.*, *Mezzanatto*, 513 U.S. at 197 (1995) (validating a waiver of plea-statement exclusionary provisions).

118 . *See, e.g.*, Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 23 (1991) (upholding a waiver of the right to bring a claim in federal court); *see also* Alford v. Dean Witter Reynolds, Inc., 939 F.2d 229 (5th Cir. 1991) (denying the defendant's motion to dismiss the case, compelling the plaintiff to submit her Title VII claim to arbitration, and noting that, in light of *Gilmer*, some Title VII rights may be waived).

119 . 513 U.S. 196 (1995).

120 . *Mezzanatto*, 513 U.S. at 197.

121 . *Id*. at 203, 204.

122 . 500 U.S. 20 (1991).

123 . 29 U.S.C. §§ 621-634 (1994).

compulsory arbitration.[124] One of the primary policies of the Act was "to prohibit arbitrary age discrimination in employment,"[125] and Congress sought to effectuate this policy by making it unlawful to "fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual . . . because of such individual's age."[126] The ADEA is to be enforced by private suits[127] as well as by the Equal Employment Opportunity Commission.[128] The Court noted: "[S]o long as the prospective litigant effectively may vindicate [his or her] statutory cause of action in the arbitral forum, the statute will continue to serve both its remedial and deterrent function."[129] Because arbitration permitted an individual to pursue his cause of action, it was deemed an adequate remedy, and therefore the right to bring suit in federal court could be waived.[130] The upholding of waivers of constitutional rights, criminal procedure, and antidiscrimination legislation suggests that no statute—not even the Code—is too sacred to be waived.

Nonetheless, courts sometimes do strike down waivers that are

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124 . *Gilmer*, 500 U.S. at 23.

125 . 29 U.S.C. § 621(b).

126 . *Id*. § 623(a)(1).

127 . *Id*. § 626(c).

128 . *Id*. § 626(b) (noting that the EEOC should attempt to gain compliance and eliminate discrimination before bringing an action).

129 . *Gilmer*, 500 U.S. at 28 (quoting *Mitsubishi MotorsCorp. v. Soler Chrysler-Plymouth, Inc*., 473 U.S. 614, 637 (1985)) (alterations in original).

130 . *Cf. infra* notes ___-144 and accompanying text (discussing cases where the waiver was stricken). I express no independent view on whether the Court should have found that the arbitration clause in *Gilmer* thwarted the policies underlying the ADEA. For a cogent argument that those policies were thwarted, *see* Paul D. Carrington & Paul H. Haagen, *Contract and Jurisdiction*, 1996 SUP. CT. REV. 331, 369, 369-71 ("[The Court] failed to observe the large difference between mandatory, binding arbitration . . . and voluntary, non-binding conciliation of the sort envisioned by ADEA.").

found to thwart the policies underlying federal laws.[131] In *Alexander v. Gardner- Denver Co.*,[132] for example, the Court held that the selection of a purportedly exclusive arbitration procedure under a collective-bargaining agreement does not constitute an enforceable waiver of the right to sue under Title VII of the Civil Rights Act of 1964.[133] The arbitrator had ruled that there was just cause for discharging the petitioner from his job. Petitioner subsequently sued under Title VII, alleging racial discrimination. Although the lower courts held that petitioner was bound by the arbitral decision, the Supreme Court reversed.[134] It reasoned: "In submitting his grievance to arbitration, an employee seeks to vindicate his contractual right under a collective-bargaining agreement. By contrast, in filing a lawsuit under Title VII, an employee asserts independent statutory rights accorded by Congress."[135] The Court explained that although "the arbitrator's task is to effectuate the intent of the parties `by interpreting' the collective-bargaining agreement . . . in accordance with the 'industrial common law of the shop,'" the arbitrator "has no general authority to invoke public laws that conflict with" the contracting parties' intent.[136] Yet, the "broad language [of Title VII] frequently can be given meaning only by reference to public law concepts."[137] The Court therefore struck the waiver because its enforcement would have thwarted the

131 . *See, e.g.*, Barrentine v. Arkansas-Best Freight Sys., Inc., 450 U.S. 728, 740 (1981), Brooklyn Sav. Bank v. O'Neil, 324 U.S. 697, 704 (1945) (both addressing the Fair Labor Standards Act); Duncan v. Thompson, 315 U.S. 1 (1942), Philadelphia, Baltimore & Wash. R.R. v. Schubert, 224 U.S. 603 (1912) (both addressing the Federal Employers' Liability Act).

132 . 415 U.S. 36 (1974).

133 . 42 U.S.C. §§ 2000e - 2000e-17 (1994).

134 . *Alexander*, 415 U.S. at 42-43.

135 . *Id*. at 49-50.

136 . *Id*. at 53.

137 . *Id*. at 57.

statutory policy under Title VII.[138]

Similarly, in *Barrentine v. Arkansas-Best Freight System*,[139] the Court held that minimum wage claims under the Fair Labor Standards Act[140] (FLSA) are not precluded by prior submission of the issue to a joint grievance committee, a form of arbitration required by the union's collective bargaining agreement. The FLSA was passed in "recognition of the fact that due to the unequal bargaining power as between employer and employee, certain segments of the population required federal compulsory legislation to prevent private contracts [from imposing substandard wages and excessive hours] which endangered national health and efficiency."[141] The Court was concerned that "[b]ecause the arbitrator is required to effectuate the intent of the parties, rather than enforce the statute, he may issue a ruling that is inimical to the public policies underlying the FLSA."[142]

These cases, however, do not necessarily create a bright line by which to distinguish, in the context of prebankruptcy contracting, between a waiver that thwarts a fundamental statutory policy and one that merely significantly impairs that policy.[143] Bankruptcy judges

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138 . *Id*. at 59-60. In addition to an employee being able to pursue a remedy, rendered non-exclusive by the Court, under the grievance-arbitration clause of a collective-bargaining agreement, the Court thought "that the federal policy . . . can best be accommodated by permitting an employee to pursue . . . his cause of action under Title VII." *Id*.

139 . 450 U.S. 728 (1981).

140 . 29 U.S.C. §§ 201-219.

141 . Brooklyn Sav. Bank v. O'Neil, 324 U.S. 697, 706 (1945).

142 . 450 U.S. at 744.

143 . In the two cases in which waivers were struck down, *Alexander* and *Barrentine*, the waiver in question would have prevented the application of an entire public law regulatory scheme. The cases do not reveal, however, how waivers of specific statutory provisions would be viewed.

might find it equally difficult to distinguish these cases.[144] I therefore apply a margin of error in my analysis by assuming that a prebankruptcy contract that significantly impairs a fundamental bankruptcy policy could be treated like one that thwarts that policy, and therefore should not be enforced.[145] In order to analyze whether prebankruptcy contracting would significantly impair bankruptcy policies, I need to identify those policies, which I do in the next section.

So far, however, my analysis implicitly assumes that prebankruptcy contracting would satisfy the basic standards for the enforceability of any commercial waiver, whether or not of a federal statute. I therefore first need to examine those standards. In the leading case of *D.H. Overmyer Co. v. Frick Co.*,[146] the Supreme Court applied the standards for waiver in a criminal proceeding—that the waiver be "voluntary, knowing, and intelligently made"[147]—to commercial waivers. The issue was whether to uphold the validity of a cognovit provision under which Overmyer consented in advance, should it default on a promissory note, to Frick's obtaining a judgment without notice or hearing. The Court reasoned that these standards were satisfied: the provision was voluntary because the parties, being business entities, had roughly equal bargaining power; the provision was knowing because the parties understood the

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144. This difficulty may actually explain certain of the lower court bankruptcy decisions. *See supra* subpart II(A) (discussing lower court decisions refusing to enforce prebankruptcy contracting because of harm to bankruptcy policies). Impairing bankruptcy policies also would appear to explain the line of cases holding that the right of a debtor, under 11 U.S.C. § 301, to voluntarily file a petition for bankruptcy cannot be waived. *See supra* note 63 (listing cases). Preventing a debtor from filing for bankruptcy protection necessarily impairs the realization of bankruptcy policies.

145. My margin of error also compensates for the possibility that certain of the cases on waiver of a federal statute that arise in the arbitration context reflect a bias toward arbitration. *See, e.g.*, Jean R. Sternlight, *Rethinking the Constitutionality of the Supreme Court's Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers, and Due Process Concerns*, 72 TUL. L. REV. 1 (1997) (arguing that the Supreme Court has been biased in favor of arbitration).

146. 405 U.S. 174 (1972).

147. 405 U.S. at 185.

significance of the cognovit provision; and the provision was intelligently made because Overmyer received value—a waiver of defaults and a release of mechanic's liens—in exchange therefor.[148]

Waivers contained in prebankruptcy contracts[149] also would appear to satisfy these standards. The waiver would be "knowing" because parties to a prebankruptcy contract, negotiated after default with the help of bankruptcy counsel,[150] should be well aware of its significance. The waiver would be voluntary because business entities represented by bankruptcy counsel[151] should have roughly equal bargaining power.[152] Finally, the waiver would be intelligently made because the debtor in a prebankruptcy contract should receive value in the form of new credit or a waiver of default.[153]

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148 . 405 U.S. at 186-87. The Court cautioned, however, that "where the contract is one of adhesion, where there is great disparity in bargaining power, and where the debtor receives nothing for the cognovit provision, other legal consequences may ensue." *Id*. at 188.

149 . I refer here to the types of prebankruptcy contracts that I argue should be enforceable.

150 . I later suggest that prebankruptcy waivers should be negotiated after default. *See infra* subpart IV(B).

151 . *See supra* text accompanying note 26 (limiting my Article to business bankruptcies in which the contracting parties are sophisticated and represented by bankruptcy counsel).

152 . *Accord* Edward L. Rubin, *Toward A General Theory of Waiver*, 28 U.C.L.A. L. Rev. 478, 490 (1981) (observing that "[w]aivers pose few dangers in such cases [of companies represented by counsel] because . . . equal parties are likely to reach mutually acceptable agreements on their own," as opposed to the troublesome situation in which "the person making the waiver is a consumer, patient, or employee—in other words, an amateur"). *See also id*. at 556 (arguing that "[t]he presence of a lawyer at the [waiver] negotiations is not essential, . . . but it does provide strong evidence of an acceptable bargaining process").

153 . *See* text accompanying notes XX-XX, *supra*. Scholars appear to agree with the result in *Overmyer*. *See Id*. at 556 (discussing the *Overmyer* case with approval); Sternlight, *supra* note 144, at 56. Scholars have argued, however, that waivers should not be enforced

Prebankruptcy contracting therefore should not violate any basic waiver principles. I next turn to the question whether it would significantly impair any fundamental bankruptcy policies.

. *Bankruptcy policies that would be implicated by prebankruptcy contracting*Three fundamental policies appear to underlie bankruptcy law: equality of distribution among creditors; debtor rehabilitation; and, to a lesser extent, economical administration of the bankruptcy process.[154] Equality of distribution ensures an equitable distribution of the debtor's assets amongst its creditors.[155] It also promotes collective debt enforcement when collection by one creditor may not be in the interests of the creditors as a whole,[156] thereby making it less likely that individual creditors will start a "run" on the

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unless the waiving party has obtained the functional equivalent of the right being waived. *See, e.g.*, Rubin, *supra* note 151, at 537. A prebankruptcy contract that enhances a debtor's ability to rehabilitate outside of bankruptcy would appear to be the functional equivalent of the automatic stay, which furthers a debtor's ability to rehabilitate in bankruptcy.

154 . *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1, at 75 (1973). Although I act as a traditionalist in describing the policies underlying the Code, I am not suggesting those policies are immutable. Furthermore, my analysis can be adapted to any set of bankruptcy policies. *See supra* note 36, (observing that one who disagrees with the Code's policies could use my analysis merely by substituting her choice of policies); *infra* note 164 (discussing other formulations of bankruptcy policies advanced by scholars).

155 . *See* H.R. DOC. NO. 93-137, pt. 1, at 75 (specifying the special goals of bankruptcy policy). It also "continue[s] the law-based orderliness of the open credit economy in the event of a debtor's inability or unwillingness generally to pay his debts." *Id*. at 71. The "open-credit"
economy refers to the role of private credit generally in the country's economy.

156 . *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7-19 (1986).

debtor.[157] Debtor rehabilitation recognizes that a primary purpose of reorganization is "to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders."[158]

The third policy is to administer the bankruptcy process in an efficient manner. Debtor rehabilitation and equality of distribution are not to be achieved at any cost. Minimizing fees and administrative expenses will maximize the value of the bankruptcy estate.[159] Thus, the administration of bankruptcy proceedings should, to the extent

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157 . *See, e.g.*, *In re* Elcona Homes Corp., 863 F.2d 483, 484 (7th Cir. 1988). In economic terms, equality of distribution addresses the so-called collective action problem. Previous commentators, however, have not viewed this problem as fatal to prebankruptcy contracting. *See supra* notes 78, 85.

158 . H.R. REP. NO. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6179. For individual debtors, the equivalent policy—usually referred to as "fresh start"—recognizes that the purpose of the bankruptcy laws is "to convert the assets of the bankrupt into cash for distribution among creditors and then to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." Williams v. United States Fidelity & Guar. Co., 236 U.S. 549, 554-555 (1915). Although the first courts to recognize the fresh start policy applied it to individuals and not to corporations, *see* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934), later authorities recognize debtor rehabilitation as an important policy even for corporate debtors, *see, e.g.*, Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 AM. U. L. REV. 337, 424 (1993) (showing that "Congress sought to . . . facilitate the rehabilitation of financially troubled business debtors"). My Article focuses on corporate, and not individual, debtors.

159 . *See* Otte v. United States, 419 U.S. 43, 53 (1974) (noting that there is "an overriding concern in the Act with keeping fees and administrative expenses at a minimum so as to preserve as much of the estate as possible for the creditors").

practicable, be "prompt"[160] and "speedy."[161] Indeed, one goal of the Bankruptcy Reform Act of 1978,[162] the statute creating the Code, was to modernize the process and make it more efficient.[163] By promoting out-of-court settlements, prebankruptcy contracting would make the bankruptcy process more efficient by reducing its cost.[164]

I now test these policies[165] by examining whether they also

160 . Katchen v. Landy, 382 U.S. 323, 328-29 (1966) (quoting *Ex parte* Christy, 44 U.S. (3 How.) 292, 312 (18__)).

161 . *Ex Parte* Woollen, 104 U.S. 300, 301(1881).

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163 . *See* H.R. REP. NO. 95-595, at 340, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963, 5965. In reviewing bankruptcy law preceding the Code, the Commission on the Bankruptcy Laws of the United States was concerned that the cost of decisionmaking in many bankruptcy cases was disproportionate to the amount of money involved. *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1, at 82 (1973).

164 . *Cf. supra* notes 44-46 and accompanying text (discussing a case that upheld a waiver because out-of-court restructuring promotes the policy of debtor rehabilitation). In the context of bankruptcy reorganization, Professor Bebchuk identified the following three goals: preserving the participants' non-bankruptcy entitlements, maximizing the value of the reorganized company, and reducing costs of the reorganization process. *See* Bebchuk, *supra* note 34, at 780-81. His first goal is effectively the same as equality of distribution, which attempts to preserve in bankruptcy the relative priorities of non-bankruptcy entitlements. *See infra* text accompanying notes 166-168. His second goal, by assuming a company can maximize its value by reorganizing in bankruptcy, is consistent with debtor rehabilitation. And his third goal is identical to economical administration.

165 . Some scholars have proposed different articulations of bankruptcy's policy goals. Professor Warren argued that there are four principal goals of a business bankruptcy system: to enhance the value of the failing debtor, to provide for equality of distribution (except for deliberate deviations from equality), to constrain externalization of business losses to parties not dealing with the debtor, and to create

underlie the Code's automatic stay provision, on which my Article significantly focuses. The purposes of the stay have been described as "permit[ting] the debtor to attempt a repayment or reorganization plan."[166] That reflects the policy of debtor rehabilitation. The stay

reliance on private monitoring. *See* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 343-73 (1993). Professor LoPucki argued that four of the problems addressed by Chapter 11 are as follows: liquidity, so that assets are not disposed of at bargain prices; communication and coordination among all interested parties; relief from contract provisions that depress the value of the estate; and oversight of the shifts in control that accompany insolvency. See Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79, 100-06 (1992). I believe, however, that these goals are included within the general policies and considerations that I have identified. Professor Warren's first goal, enhancing the value of the failing debtor, is included in my policy of debtor rehabilitation because Chapter 11 presumes that a rehabilitated debtor is worth more than one in liquidation, but nonetheless mandates liquidation over rehabilitation when the rehabilitated debtor would be worth less. *Compare* Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75, 78 (1995) ("Chapter 11 is premised on the notion that keeping the assets together will result in an increase in value over that obtainable in a liquidation."), *with* Bankruptcy Code, 11 U.S.C. § 1129(a)(7)(ii) (1994) (providing that a plan of reorganization may be confirmed only if creditors receive at least the value that they would receive if the debtor were liquidated instead). Her second goal is included in my policy of equality of distribution, her third goal is included in my goal of minimizing externalities, *see infra* section III(B)(1), and her fourth goal is neutral to my analysis. Indeed, Professor Warren acknowledged that her list of policy goals is deliberately flexible, stating that "[a]nother reader might divide the list more finely from four items to six or eight or recombine them to two or three." Warren, *supra* at 340. Professor LoPucki's first and third problems are addressed by my condition that an enforceable prebankruptcy contract be one that is unlikely to result in a secondary material impact, *see infra* text accompanying note 230, and his second and fourth problems are neutral to my analysis. In any event, those who may disagree with my choice of bankruptcy policies still could find my Article useful by substituting their policies for the policies I discuss. *See supra* note 36.

166 . H.R. REP. NO. 95-595, at 340, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6297; S. REP. NO. 95-989, at 54, 55 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5840-41.

also freezes the priorities among creditors[167] in order to prevent creditors "who acted first [from obtaining] payment of the claims in preference to and to the detriment of other creditors."[168] "By preventing this race the stay promotes the stated policy of equal treatment" of creditors.[169] Thus, the stay also reflects the policy of equality of distribution. Finally, the stay "channel[s] all actions and proceedings against the debtor into the bankruptcy court . . . [thereby] reduc[ing] the time, trouble, and costs of bankruptcy administration,"[170] reflecting the policy of economical administration of the bankruptcy estate. The same policies that underlie the Code, therefore, also underlie the automatic stay.[171]

Before analyzing whether prebankruptcy contracting would impair any of these policies,[172] however, I will finish constructing the framework for analysis by examining whether contract law should place any additional restrictions on a person's freedom to contractually override statutory provisions.

. *What Additional Restrictions Should Contract Law Place on a Person's Freedom to Contractually Override a Statutory*

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167 . DAVID G. EPSTEIN, ET AL. BANKRUPTCY §3-1, at 60 (1993) ().

168 . H.R. REP. NO. 95-595, at 340, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6297 (quoted with approval in EPSTEIN, ET AL., *supra* note 166, §3-1, at 61).

169 . EPSTEIN, ET AL., *supra* note 166, §3-1, at 61.

170 . *Id*. §3-6, at 69.

171 . *Accord*, ROBERT L. JORDAN & WILLIAM D. WARREN, BANKRUPTCY 303 (4th ed. 1995) (justifying the automatic stay as "a fundamental protection for both debtors (safeguard against dismembering the bankrupt's estate) and creditors (insuring ratable distribution)"); Farm Credit of Cent. Fla., ACA v. Polk, 160 B.R. 870, 874 (M.D. Fla. 1993) (stating the "purposes of the automatic stay" are "to protect the debtor's assets, provide temporary relief from creditors and promote equality of distribution among the creditors by forestalling a race to the courthouse"); *In re* Sky Group Int'l, Inc., 108 B.R. 86, 89 (Bankr. W.D. Pa. 1989) (the automatic stay provides an orderly liquidation procedure which treats all creditors equally).

172 . *See infra* section III(B)(2).

Scheme? Because contract law presumes that parties will not consensually enter into a contract unless each party perceives a net benefit,[173] courts enforce contracts absent good reasons not to do so. Violating the policies underlying a statute would constitute such a reason.[174] To that extent, contract law is consistent with, and would be analyzed the same as, federal case law.[175]

The presumption of contract enforceability also is rebuttable if the contract harms contracting parties or impinges on the rights of noncontracting parties. The doctrine that protects the contracting parties is called "paternalism."[176] The infringement of rights of

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173 . Describing normative economic analysis, Professor Trebilcock notes:

> [The] predilection [of neo-classical economists] for private ordering over collective decision-making is based on a simple (perhaps simple-minded) premise: if two parties are to be observed entering into a voluntary private exchange, the presumption must be that both feel the exchange is likely to make them better off, otherwise they would not have entered into it.

TREBILCOCK, *supra* note 18, at 7.

174 . *See* RESTATEMENT (SECOND) OF CONTRACTS § 178(1) (1979) (stating that a "promise or other term of an agreement is unenforceable on grounds of public policy if legislation provides that it is unenforceable or the interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms"). Other reasons include lack of capacity, mutual mistake, frustration, impossibility, fraud, misrepresentation, and the limitation on liquidated damages. These reasons need not be discussed in this Article because they no more would be likely to arise in the context of prebankruptcy contracting than in any other contracting context. Moreover, the analysis of these issues, if they did arise in connection with a prebankruptcy contract, would be no different than in any other context.

175 . *See supra* subsection III(A)(1)(2) (describing cases stating that contracts thwarting policies underlying a federal statute should not be enforced); *see also infra* section III(B)(2) (analyzing whether prebankruptcy contracting would impair bankruptcy policies).

176 . *See* Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 Yale L. J. 763, 763-64 (1983) ("In general, any legal rule that prohibits an action on the ground that it would be contrary to the actor's own welfare is paternalistic.").

noncontracting parties is referred to as an "externality."[177] Rules that may not be contractually modified are referred to as mandatory rules.[178] Rules that may be contractually modified are called default rules.[179] The

177 . *See, e.g.*, Ayres & Gertner, *supra* note 69, at 88 (citing I. Macneil, Contracts: Exchange Transactions and Relations 346-47 (1978); Kronman, *supra* note 175, at 763; Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1093 (1972)). Rasmussen, *Debtor's Choice*, *supra* note 5, at 63 ("Contract theorists generally agree that mandatory rules can be justified either by society wanting to protect the contracting parties themselves (paternalism) or by society wanting to protect third parties (externalities)"); *see also* Cass R. Sunstein, *Legal Interference with Private Preferences*, 53 U. CHI. L. REV. 1129, 1130 (1986) ("It may generally be agreed that if actions that gratify private preferences produce 'harm to others,' governmental intervention is appropriate."). The economic definition of externalities means "the indirect effect of a consumption activity or a production activity on the consumption set of a consumer, the utility function of a consumer, or the production function of a producer." 2 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 263, 263-65 (John Eatwell et al. eds., 1987). Legal commentators, however, usually define externalities as harm (or costs) to third parties. *See, e.g.,* TREBILCOCK, *supra* note 18, at 58; Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1436-41 (1989); Richard A. Epstein, *Surrogacy: The Case for Full Contractual Enforcement*, 81 VA. L. REV. 2305, 2325-26 (1995); Richard A. Posner, *Blackmail, Privacy, and Freedom of Contract*, 141 U. PA. L. REV. 1817, 1818-19 (1993). Third parties theoretically may even include the public at large. I later show, however, that only legally recognized third parties, meaning holders of claims against and holders of interests in the debtor, should be considered in the case of prebankruptcy contracting. *See infra* text accompanying notes 245-247.

178 . Mandatory rules sometimes are referred to as immutable. *See* Ayres & Gertner, *supra* note 69, at 87 ("The legal rules of contracts and corporations can be divided into two distinct classes. ... [T]he smaller, but important, class consists of 'immutable' rules that parties cannot change by contractual agreement.") (citations omitted). Ayres and Gertner offered the U.C.C. duty to act in good faith as an example of an immutable, or mandatory, rule. *See id*.

179 . *See id*. ("The larger class consists of 'default' rules that parties can contract around by prior agreement."). Ayres and Gertner offered the U.C.C. warranty of merchantability, which parties may waive by

specific question is, then, whether in the context of bankruptcy, paternalistic concerns or externalities warrant the use of mandatory bankruptcy rules.[180]

. *Paternalistic concerns*Paternalistic concerns are expressed in contract law defenses that are based on information asymmetry, unconscionability, or duress.[181] Information asymmetry, in the context of this Article, means that one party to a contract has significantly greater information than the other party about the subject of the contract. Information asymmetry by itself should not provide a basis for restricting the type of prebankruptcy contracting discussed in this Article.[182] The parties to a prebankruptcy contract are the debtor and one or more of its creditors. In a waiver contract, although both the contracting creditor and the debtor would be waiving their rights,[183] paternalistic concerns normally focus on a creditor taking advantage of a debtor and not the other way around. Asymmetric information therefore would be troublesome only if creditors have more information about the debtor than the debtor itself has.

Such asymmetry appears unlikely, however. The debtor should know at least as much as, if not more than, the creditor about its own

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agreement, as an example of a default rule. *See id*.

180 . *See id*. at 89.

181 . FA.

182 . Information asymmetry is not itself a contract defense. An information asymmetry, however, may undermine some prerequisite to enforceability—for example, by casting doubt on whether there is meaningful consent. *See* FA (such as the unenforceability of antenuptial contracts in which one prospective spouse does not disclose her assets to the other). By doing so, it provides a normative rationale to justify limiting freedom of contract. My point, though, is that the very *existence* of information asymmetry is unlikely in the context of the type of prebankruptcy contracting discussed in this Article.

183 . *See infra* note XX, and accompanying text (discussing that creditors would be waiving their rights and remedies in default). Debtors, of course, would be waiving certain of their rights in bankruptcy.

ability to succeed.[184] There are, though, two cautions. The first is the distinction between the amount of information the debtor possesses and the debtor's appreciation of that information. Sometimes a troubled debtor—desperate to avoid bankruptcy and overconfident of its ability to succeed—may know more than the creditor about its prospects, but may be unable to judge the information in an objective context and therefore may overestimate the likelihood of success.[185] A financially robust debtor also may not always appreciate the significance of a prebankruptcy contract provision included as boilerplate in its loan agreement.[186] Secondly, creditors usually are repeat players in the bankruptcy game and may have better information about the consequences of bankruptcy. Although these cautions would be mitigated by the experience level of the debtor's bankruptcy counsel,[187]

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184 . *See* Bogart, *supra* note 5, at 1123 ("Workouts are games of asymmetric information: Borrowers have a far greater sense of whether they are capable of successfully reorganizing than does the lender."). *Cf. supra* text accompanying note 85, (describing Tracht's view of waivers as a signalling device in the presence of information asymmetry). Recall that I limit the analysis to sophisticated contracting parties represented by bankruptcy counsel. *See supra* text accompanying note 26.

185 . There are two relevant types of information: the likelihood of rehabilitation and the consequences of the prebankruptcy contract (or waiver). The debtor may overestimate the likelihood of rehabilitation and underestimate the consequences of the waiver.

186 . *See infra* subpart IV(B) (discussing prebankruptcy contracts included in original transactional documentation). To mitigate this concern and a related concern over agency costs, I later suggest that a debtor should not enter most prebankruptcy contracts prior to default. *Id*.

187 . Practical criteria should determine whether a prebankruptcy contract has been negotiated by the debtor's "bankruptcy counsel." Law firms that specialize in bankruptcy work are well known and bankruptcy lawyers themselves are affiliated with a number of professional organizations, such as the American Bankruptcy Institute, the National Bankruptcy Conference, and the American College of Bankruptcy. The American Board of Bankruptcy Certification also certifies bankruptcy law specialists. My proposal that prebankruptcy contracts be unenforceable unless the contracting parties are represented by bankruptcy counsel takes into account the insistence by some

their existence may help to explain the coolness of some courts and commentators to waiver contracts—particularly those that appear in original loan agreements[188] for which the debtor has not engaged bankruptcy counsel and may not appreciate the gravity of the concession it has made.

Information asymmetry also should not provide a conceptual basis for restricting procedure contracts. Because both the debtor and its creditors would be agreeing to alternative procedures, both may be waiving their rights. Asymmetric information would be troublesome if creditors have more information about the debtor than the debtor itself or vice versa. That appears unlikely for the reasons discussed above. Asymmetric information also would be troublesome, however, if one side has more information about the *bankruptcy process*. As discussed above, creditors may have more information about the process because they likely are repeat players in the bankruptcy game: an institutional creditor especially will have seen numerous debtors go bankrupt. Nonetheless, a sophisticated debtor that is advised about the process by experienced bankruptcy counsel should overcome what would otherwise be a serious information asymmetry.[189]

The paternalistic defense of unconscionability is based on the premise that there may be certain extreme situations when, as a matter of equity, a contracting party must be protected against his own weakness.[190] Dr. Faustus's contract with the Devil may well be

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sophisticated parties negotiating with consumers that the consumers be represented by counsel. *Cf*. Bankruptcy Code, 11 U.S.C. § 524 (c), (d) (providing that individual debtors who agree to reaffirm discharged debts either must be represented by counsel or seek court approval of the agreement).

188 . *Cf*. *infra* subpart IV(B), (proposing that, with limited exceptions, only prebankruptcy contracts entered into by a debtor after default should be enforceable).

189 . *Cf*. Harry DeAngelo et al., An Empirical Investigation of The Relation Between Accounting Choice and Dividend Policy in Troubled Companies (___ ___, 1990) (unpublished manuscript, on file with the Texas Law Review) (presenting evidence that distressed firms use their superior information to influence the perceptions of creditors, thereby improving the firm's terms in debt renegotiations).

190 . *See* Donald P. Arnavas, *Unconscionability Under UCC § 2-302: How It Applies to Commercial and Government Contracts*, 12 U.C.C. L.J. 48, 49 (1979).

unconscionable under that standard.[191] Is a prebankruptcy contract an unconscionable, or Faustian, bargain that should not be enforced as a matter of contract law? The following analysis shows that when the contracting parties are sophisticated and represented by bankruptcy counsel,[192] unconscionability is unlikely.

Tracht concluded that prebankruptcy contracts are not per se unconscionable, because in many cases it is rational for debtors to enter into them.[193] I agree with his conclusion but for different reasons. The purpose of the unconscionability doctrine is to prevent unfair surprise

191 . However, law and economics purists may question even that:

> And even if the court holds the contract unenforceable, it may require the party who broke the contract to make restitution to the other party of the value of the latter's performance. . . . But how could Faustus have restored Mephistophilis the value (with interest!) of the goods and services that Mephistophilis had provided over the twenty-four years that the pact was in force? Penance would be of no benefit to Mephistophilis—quite the opposite. Of course, despite these nice legal points, no court would enforce a pact with the devil, in any circumstances; and it would detract from Faustus's grandeur—and blasphemy—if he were *legally* bound to the contract with Mephistophilis. All that my [Posner's] analysis suggests is that it was not unjust in a legal sense to hold Faustus to his bargain.

RICHARD POSNER, LAW AND LITERATURE: A MISUNDERSTOOD RELATION 101 n.45 (1988). Posner appears to be saying that as a technical legal matter he would hold Faust to this type of bargain, although no court would enforce a contract—any contract -- in favor of the devil.

192 . Recall that this Article is limited to business bankruptcies and assumes that the contracting parties are sophisticated and represented by bankruptcy counsel. *See supra* text accompanying note 26. I also will assume the prebankruptcy contracts are not adhesion contracts.

193 . Tracht argued that it could not be the case that "no informed and rational borrower would agree to waive" its bankruptcy rights. Tracht, *supra* note 5, at 343-44. Tracht follows the oft-quoted definition that characterizes an unconscionable contract as one "which no man in his senses, nor under a delusion would make, on the one hand, and which no fair and honest man would accept on the other." Hume v. United States, 132 U.S. 406, 411 (1889) (quoting Earl of Chesterfield v. Janssen, 28 Eng. Rep. 125, 155 (1750)).

or oppression.[194] Courts have used the doctrine primarily to rescue from hard bargains those who are grossly disadvantaged in their dealings with more sophisticated parties.[195] It therefore is questionable whether the doctrine should apply to contracts between sophisticated parties that are represented by bankruptcy counsel.

Furthermore, in almost all cases in which courts have found unconscionability, there have been elements of *both* procedural[196] and substantive[197] unfairness. Neither procedural unfairness nor substantive unfairness alone is generally sufficient to render a contract unconscionable.[198] Unconscionability therefore is rare in commercial

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194 . *See, e.g.,* Doctor, Inc. v. Stuart, 85 F.3d 975, 980 (2d Cir. 1996); David L. Threlkeld & Co. v. Metallgesellschaft Ltd. (London), 923 F.2d 245, 249 (2d Cir. 1991); Pierson v. Dean, Witter, Reynolds, Inc. 742 F.2d 334, 339 (7th Cir. 1984); *see also* U.C.C. § 2-302 (1995) official cmt. 1 ("This section is intended to make it possible for courts to police explicitly against the contracts or clauses they find to be unconscionable. . . . The principle is one of the prevention of oppression and unfair surprise.").

195 . *See* Jane P. Mallor, *Unconscionability in Contracts Between Merchants*, 40 SW. L.J. 1065, 1066 (1986).

196 . Procedural unfairness refers to the circumstances surrounding the formation of an agreement, including whether there is unequal bargaining power or unfair surprise. *See* Jones Dist. Co. v. White Consol. Indus., 943 F. Supp. 1445, 1460-61 (N.D. Iowa 1996); *see also* Arthur Allen Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485, 488 (1967) (introducing the distinction between procedural and substantive unconscionability).

197 . Substantive unfairness refers to the content of an agreement, such as overly harsh or one-sided contract terms or unreasonable and unexpected allocation of risk. *See Jones Dist. Co.*, 943 F. Supp. at 1460; Leff, *supra* note 197, at 488.

198 . *See, e.g.*, Smith, Bucklin & Assocs., Inc. v. Sonntag, 83 F.3d 476, 480 (D.C. Cir. 1996) (holding that an adhesion contract is not per se unenforceable and that other factors must be present in order for the contract to be deemed unconscionable). Substantive unfairness alone has been sufficient to find unconscionability in only a handful of cases, all involving consumer credit contracts. *See* Craig Horowitz, Comment, *Reviving the Law of Substantive Unconscionability: Applying the*

settings because parties are deemed to possess equal bargaining power, rendering procedural fairness unlikely.[199] The law presumes that business people are fully competent to enter into contracts and obligate themselves to perform in any manner they wish: "[T]here is a presumption of conscionability when the contract is between businessmen in a commercial setting."[200]

Some nonetheless may argue that a troubled debtor often may be under duress to choose between entering into a prebankruptcy contract and filing for bankruptcy, and therefore its choice should not be enforced. The defense of duress generally requires that a party's assent be "induced by an improper threat . . . that leaves the victim no

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Implied Covenant of Good Faith and Fair Dealing to Excessively Priced Consumer Credit Contracts, 33 UCLA L. REV. 940, 946-47 (1986). Thus, contracts bargained at arm's length by sophisticated parties with equal information should not be invalidated merely because they turn out to be disadvantageous to one of the parties *ex post*.

199. *See, e.g.,* Consolidated Data Terminals v. Applied Digital Data Sys., Inc., 708 F.2d 385, 392 n.6 (9th Cir. 1983); U.S. Fibres, Inc. v. Proctor & Schwartz, Inc., 509 F.2d 1043, 1048 (6th Cir. 1975); Salt River Project Agric. Improvement & Power Dist. v. Westinghouse Elec. Corp., 694 P.2d 198, 204 (Ariz. 1984); Chemtrol Adhesives, Inc. v. American Mfrs. Mut. Ins. Co., 537 N.E.2d 624, 639 (Ohio 1989).

200. American Dredging Co. v. Plaza Petroleum Inc., 799 F. Supp. 1335, 1339 (E.D.N.Y. 1992). *Accord* WXON-TV, Inc. v. A.C. Nielsen Co., 740 F. Supp. 1261, 1264 (E.D. Mich. 1990) ("[Courts have] no authority to rewrite the terms of a contract because they might feel that it was an unwise agreement for a party to have entered into."). As an effective defense, unconscionability is particularly rare when the parties are large corporations. In these instances, procedural unfairness is highly unlikely as both parties will benefit from extensive contracting experience, advice of counsel, and the availability of alternatives, which enables a party to bargain for balanced terms. Furthermore, contracts will invariably result from extensive negotiations. Courts quite naturally have been reluctant to apply the unconscionability doctrine in these instances. Judge Posner, for instance, has commented that "the defense of unconscionability was not invented to protect multi-billion dollar corporations against mistakes committed by their employees." Northrop Corp. v. Litronic Indus., 29 F.3d 1173, 1180 (7th Cir. 1994) (noting that the unconscionability doctrine "has rarely succeeded outside the area of consumer contracts").

reasonable alternative."[201] A threat may be improper if "what is threatened is a crime or a tort . . . [or] a criminal prosecution."[202] These forms of duress are not relevant here. There is, however, a form of duress that focuses on economic threats.

Economic duress possibly may render a prebankruptcy contract voidable. Although mere "hard bargaining" or the threat to exercise a legal right would not constitute economic duress,[203] an improper threat to use civil process might if the debtor has no reasonable alternative.[204] In the context of prebankruptcy contracting, the debtor arguably would have a reasonable alternative: refusing to enter into the contract[205] and, if necessary, filing for protection under the Code. Irrespective, however, of whether a court always would agree that this constitutes a reasonable alternative, I will assume that, in the business context of this Article, most creditors desiring prebankruptcy contracts will make no threats that exceed their legally appropriate rights and remedies.[206]

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201 . RESTATEMENT (SECOND) OF CONTRACTS § 175 (19__).

202 . *Id*. §176(a), (b).

203 . *See* Bogart, *supra* note 5, at 1160-61 (arguing that a successful argument of economic duress will be difficult for a debtor because "courts typically refuse to find `duress' if . . . [an] agreement simply result[s] from `hard bargaining[]' [or] a lender's threat to exercise a legal right under a contract") (citation omitted).

204 . *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 176(1)(c), 175 cmt. b.

205 . *See id*. § 175 cmt. b (noting that even when the threat of commencing a civil action to enforce a claim to money may be improper, "it does not usually amount to duress because the victim can assert his rights in the threatened action, and this is ordinarily a reasonable alternative to succumbing to the threat"). Put simply, the debtor's choice in prebankruptcy contracting is not between a rock and a hard place but between a rock and a soft place (bankruptcy rehabilitation).

206 . The threat, therefore, would not be deemed improper. *See id*. ("A threat is improper if . . . what is threatened is the use of civil process *and the threat is made in bad faith* . . . .") (emphasis added). Courts similarly are unlikely to find that the debtor had entered into a prebankruptcy contract as a result of undue influence, which is "unfair

Thus, when the debtor is represented by bankruptcy counsel, paternalistic concerns appear insufficient to justify the Code as a set of mandatory rules.

. *Externalities* Externalities are potentially more troublesome than paternalistic concerns; the parties to a prebankruptcy contract may not care whether third parties are affected. The debtor's only interest may be in getting a default waived, and the contracting creditor's only interest may be in getting paid. Thus, nonconsenting creditors could be harmed. Indeed, courts that have refused to enforce prebankruptcy contracts have focused on the potential harm to creditors.[207] Externalities therefore must be taken into account in any analysis of prebankruptcy contracting.[208] But the mere existence of externalities should not defeat contract enforcement. Many contracts create externalities, yet they are enforced. When examining externalities, I therefore focus on understanding which externalities should defeat contract enforcement, and under what circumstances.

A complete identification has now been made of the concerns that could restrict prebankruptcy contracting between sophisticated business

persuasion of a party who is under the domination of the person exercising the persuasion or who by virtue of the relation between them is justified in assuming that that person will not act in a manner inconsistent with his welfare." *Id*. § 177(1). Findings of undue influence generally require a special relationship between the parties such that one party is "peculiarly susceptible to persuasion by the other." E. ALLAN FARNSWORTH, CONTRACTS § 4.20, at 284 (2d ed. 1990). The relationship between a debtor and its creditor, however, is unlikely to satisfy this requirement of domination or a special relationship. *See, e.g.*, Umbaugh Pole Bldg. Co. v. Scott, 390 N.E.2d 320, 323 (Ohio 1979) (refusing to find a special relationship even when the creditor provided financial and business counseling to the debtor). Creditors, for example, generally are under no fiduciary obligation to their debtors. *See, e.g.*, *id*.; Zimmer v. Central Penn Nat'l Bank (*In re* Ludwig Honold Mfg. Co.), 46 B.R. 125, 128 (Bankr. E.D. Pa. 1985); Anaconda-Ericsson, Inc. v. Hessen (*In re* Teltronic Servs., Inc.), 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983), *aff'd*, 762 F.2d 185, 187 (2d Cir. 1985).

207 . *See* subpart II(A) (discussing the reasons given by courts for not enforcing prebankruptcy contracts).

208 . *See infra* section III(B)(1). Ultimately, I show that only externalities that adversely affect classes of person—as opposed to externalities that randomly affect individual class members—should justify the imposition of mandatory bankruptcy rules.

parties: externalities and significantly impairing policies underlying the Code.[209] This framework provides a basis for the following analysis.

. *What Are the Limits of Freedom to Contract About Bankruptcy?*

Under my framework, a court may refuse to enforce a prebankruptcy contract that creates troublesome externalities or that significantly impairs the policies underlying the Code. I start the analysis with externalities.

. *Externalities*As discussed, procedure contracts would be unlikely, under existing law, to cause externalities, because all creditors must agree to the contract and no rational creditor would agree to be harmed.[210] In contrast, it is more realistic that waiver contracts would cause externalities, because the only creditor who must agree to the contract is the one who reaps its benefit. That creditor likely prefers a waiver that allows it more easily to recover its claim than other creditors can recover their claims.

Nevertheless, some types of waiver contracts may be unlikely to cause externalities. A prebankruptcy contract that waives the automatic stay for an individual creditor secured by financial assets[211] will not necessarily affect other creditors. Under commercial law, the secured party's right to the collateral already has priority over claims of other creditors by virtue of the security interest, whether or not the stay is waived.[212] Once the secured party has been paid its claim from

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209 . I exclude paternalistic concerns, in accordance with the foregoing discussion. *See supra* text accompanying note 207.

210 . *See supra* text accompanying note 106. *But cf. infra* subpart IV(D) (discussing possible supermajority voting procedures).

211 . Financial assets are assets, such as accounts receivable or amounts due under loans, that by their terms reduce to cash within a finite period of time. Schwarcz, *Alchemy*, *supra* note 9, at 135 n.7. The United Nations Commission on International Trade Law recently noted that "in developed countries the bulk of corporate wealth is locked up in receivables." Summary of UNCITRAL's Work on Assignment in Receivables Financing (1997) (on file with the author).

212 . *See* U.C.C. §§ 9-301(1)(a), 9-312(5) (1995) (establishing the general rule that the rights of a person who has a perfected security interest in specific collateral are superior to the rights of other creditors with respect to that collateral). I will show that, at least when

the collateral proceeds, the debtor (and therefore nonconsenting creditors by virtue of their claims) is entitled to any remaining collateral value.[213] For example, consider a debtor owing a one-thousand-dollar loan secured by receivables valued at twelve hundred dollars. If foreclosure yields close to twelve hundred dollars, one thousand dollars would be applied to repay the secured creditor and the debtor would receive the two-hundred-dollar surplus. The debtor's value would go down by one thousand dollars but its debt also would shrink by one thousand dollars. Therefore nonconsenting creditors should receive the same distribution they would have received had the stay not been waived.[214]

In the previous example, I assumed that foreclosure on the receivables would yield their value or at least an amount not materially less than that value. That value, of course, may well be less than face value: because the obligors on the receivables may not be creditworthy or because of the debtor's poor financial condition, the receivables may be delinquent or defaulted.[215] So long as the inherent value of the

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foreclosure causes no secondary impact, waiving the automatic stay does not impair equality of distribution. The existence of collateral, however, *does* affect equality of distribution by giving a creditor a higher priority in bankruptcy. *See infra* note XX (referring to the secured credit controversy).

213 . *See* U.C.C. §§ 9-502(2), 9-504(2) (requiring secured parties to "account to the debtor for any surplus" collateral value once the secured party's claim is paid). Of equal importance, every aspect of the foreclosure "including the method, manner, time, place and terms must be commercially reasonable." *Id*. § 9-504(3). Therefore the foreclosure sale cannot be manipulated to destroy surplus value.

214 . *Cf*., Pantaleo *et al., supra* note 10, at 186 (concluding that the distribution to unsecured creditors will be similar whether the debtor sells an asset or uses the asset as collateral to borrow money). It is, nonetheless, possible that the waiver might send a negative signal to the other creditors, perhaps reducing the amount of credit they are willing to extend to the debtor. *See* text accompanying note 99, *supra* (proposing that a waiver of the automatic stay may have a disquieting effect on creditors who are not beneficiaries of the waiver). Such a reduction in credit, if it occurs, could reduce the debtor's value.

215 . *See, e.g.*, LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 63-64 (2d ed. 1998) (observing that accounts receivable may become uncollectible if, among other reasons, dealers decide to withhold payment to protect themselves against a

receivables, no matter how low, is realized, there is no reduction of the amount available to distribute to creditors.[216] Furthermore, any deterioration of collateral value that occurs when a debtor becomes bankrupt is irrelevant to my anlysis because that deterioration would occur in the absence of foreclosure. The analysis needs only focus on whether the foreclosure, *in and of itself*, will materially affect the asset value. The assumption that foreclosure will not materially affect asset value should be reasonable for financial assets that are relatively easy to value.[217]

Non-financial assets that are frequently bought and sold[218] also should be relatively easy to value. A reduction of the amount available to distribute to creditors, however, still could occur when the foreclosure price for these assets turns out to be less than their market price. Allowing foreclosure then diminishes net value. Considerable evidence, for example, indicates that *prepetition* foreclosure prices tend to be

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troubled manufacturer's future failure to provide service or honor warranties).

216 . Thus, if the receivables are home mortgage loans having an aggregate face amount of $1,000,000 but not expected to yield more than $600,000 (on a present value basis), foreclosure on those receivables that yields $600,000 would not constitute a reduction of the amount available to distribute to creditors. With receivables consisting of secured loans, one must of course distinguish between foreclosure on the collateral underlying the loans—such as foreclosure on the homes—and foreclosure on the receivables themselves (*i.e.*, the loans), which could lead to such a reduction. A foreclosure on the underlying collateral, if any, would occur independently from a foreclosure on the receivables.

217 . Financial assets consisting of trade receivables or amounts due under loans or leases would be relatively easy to value when their face amount is known and the obligor's credit can be analyzed. Financial assets consisting of licenses, management contracts, or franchise fees, however, would be difficult to value because their worth would be adversely affected by the debtor's bankruptcy. *See* Schwarcz, *Alchemy, supra* note 9, at 151 n.60.

218 . Such as real estate or, sometimes, inventory.

lower—sometimes considerably lower—than market prices.[219] I do not believe, however, that *postpetition* foreclosure prices would necessarily be lower than market prices. Unlike a prepetition foreclosure sale, when the collateral is sold to the highest bidder irrespective of price,[220] bankruptcy courts can exercise their equitable powers[221] to try to achieve a market price. The evidence that "a good deal of property is sold following UCC repossessions to third parties who are paying something that approximates market value"[222] suggests that a debtor-sensitive bankruptcy foreclosure process may well achieve market value.[223]

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219. The Supreme Court has observed in a mortgage foreclosure context that real property subject to a foreclosure sale may be worth less than it would be worth absent foreclosure. *See* BFP v. Resolution Trust Corp., 511 U.S. 531, 539 (1994). *Accord* LoPucki & Warren, *supra* note 216, at 111 ("Based on what we do know, our judgment is that [the] Article 9 [foreclosure] sale procedure, on the average, yields prices considerably lower than the market value of the collateral sold."); Philip Schuchman, *Profit on Default: An Archival Study of Automobile Repossession and Resale*, 22 Stan. L. Rev. 20 (1969). If the practical universe of assets for which foreclosure is unlikely to result in a reduction of the amount available to distribute to creditors were small, then the social benefits of prebankruptcy contracting would be minimal, and a bright line rule prohibiting prebankruptcy contracting may well be justified.

220. *See* U.C.C. § 9-507(2) (1995) ("The fact that a better price could have been obtained by a [foreclosure] sale at a different time or in a different method from that selected by the secured party is not of itself sufficient to establish that the sale was not made in a commercial reasonable manner.").

221. *See* Bankruptcy Code, 11 U.S.C. § 105(a) (199_) permits a bankruptcy judge to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of Title 11.

222. LoPucki & Warren, *supra* note 216, at 110.

223. Some commentators have advocated that the prepetition foreclosure procedure under commercial law should be made more debtor-sensitive. *See, e.g.,* Donald J. Rapson, *Repurchase (of Collateral?) Agreements and the Larger Issue of Deficiency Actions: What Does Section 9-504(5) Mean?*, 29 Idaho L Rev. 649 (1992-93)

Finally, a reduction of the amount available to distribute to creditors could occur when the foreclosure deprives the debtor of operating equipment or other assets that are essential to running the debtor's business.[224] For example, assume that the collateral in the previous hypothetical is now a customized widget-making machine, valued at twelve hundred dollars, and that the debtor would be unable to manufacture widgets after the foreclosure.[225] Even if the foreclosure would yield the full twelve- hundred-dollar market price[226]—one thousand dollars to repay the secured creditor and a two-hundred-dollar surplus to the debtor—the debtor's value would likely go down by much more than one thousand dollars because, without the widget-making machine, the debtor no longer would be a viable business.[227] The debtor would lose value as a going concern.[228]

(proposing that the foreclosure procedure under U.C.C. § 9-504 be amended to ensure that the collateral is sold at market value).

224 . Of course, any harm would be mitigated if the operating assets were easily replaceable *and* the debtor had funds to purchase such substitute operating assets. These are questions of fact that could be resolved on a case-by-case basis.

225 . I am assuming here that similar machines would not be readily available on the market for the debtor to purchase as a replacement or that, if similar machines were readily available, the debtor would not have the financial wherewithal to purchase a replacement.

226 . A scenario that may be inaccurate. *See supra* notes 220-224 and accompanying text.

227 . Assuming, of course, that the widget machine is essential to operating the business.

228 . Professor Tracht argues, however, that there is “no reason to believe that waivers will generally lead to the gratuitous destruction of value through foreclosure of operating machinery or similar collateral.” Letter from Marshall E. Tracht to the author 3 (July 22, 1987) (on file with the author). His rationale is that the “creditor generally cannot just remove the machine, but must foreclose. And at the foreclosure sale, the debtor may buy the machine—and will do so, if it is worth more to the business than to other bidders . . . and the funds are available.” *Id*. at 2. Because the “foreclosure sale scenario provides a final protection for the [debtor] that compels the creditor to negotiate

I will refer to any prebankruptcy contract that materially reduces the amount available to distribute to creditors as having a secondary material impact.[229] At least from the standpoint of externalities,[230] apparently parties *should* be allowed to make prebankruptcy contracts that do not—but should not necessarily be allowed to make prebankruptcy contracts that do—result in secondary material impacts.[231] This conclusion arguably is consistent with the rationale of existing case law that courts should uphold stay-waiver contracts when

rather than hold out." The situations in which the amount available to distribute to creditors is reduced "should be relatively uncommon." *Id.* at 3. When the debtor has the funds to bid in, I agree with Prof. Tracht's argument.

229. In a foreclosure, reduction of the debtor's net value is a simple way of measuring impingement on the rights of third parties. But an impingement may occur even if the debtor's net value remains constant. For example, if a debtor has only $1,000 in cash and 10 creditors each owed $100, the debtor's investing its cash in a double-or-nothing gamble will not, *ex ante*, change its net worth, but will devalue the claims by 50% because creditors do not share in the debtor's profits. Also, if a prebankruptcy contract only affects a small portion of the debtor's assets, its effect on the debtor's overall value may be immaterial. Still, if prebankruptcy contracts were enforceable, then many such contracts collectively could have a material impact. Therefore, in evaluating whether a particular prebankruptcy contract is likely to cause a secondary material impact, the contract should be viewed as if the assets it affects constitute all of the debtor's assets.

230. I later discuss the limitations imposed on prebankruptcy contracting by bankruptcy policies. *See infra* section III(B)(2). For example, even foreclosure on financial assets may be troublesome when it deprives the debtor of essential working capital. *See infra* text accompanying notes 359-360.

231. For an insolvent debtor, a secondary material impact would necessarily affect the creditors adversely because no excess net value of the debtor exists to cushion the impact. Most debtors in bankruptcy are insolvent. FA. Some, however, may be solvent, in which case a secondary material impact would cause externalities only if it depleted the cushion of excess value, thereby reducing the payments to nonconsenting creditors. *See* Bankruptcy Code, 11 U.S.C. § 301 (199_) (permitting voluntary bankruptcy filings without a requirement of insolvency).

the harm to nonconsenting creditors is immaterial.[232] The conclusion even is consistent with Professor Schwartz's characterization of the automatic stay as a structural rule.[233] Nonetheless, the conclusion is somewhat unsatisfying[234] for two reasons: it does not address whether parties can rely on a particular prebankruptcy contract that later results in a secondary material impact even though, viewed at the time that contract was entered into, such an impact was unlikely;[235] nor does it address when parties should be able to rely on a prebankruptcy contract that is likely to result in a secondary material impact.[236]

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232 . *See, e.g.*, *In re* Club Tower L.P., 138 B.R. 307, 308-09 (Bankr. N.D. Ga. 1991) (holding that a waiver of the automatic stay was enforceable because the debtor had "only a few unsecured creditors whose claims are de minimis").

233 . Professor Schwartz's rationale for that characterization is that "[i]f the collateral is worth more to the firm than to the market, preventing foreclosure would maximize the ex post value of the estate." Schwartz, *Contract Theory Approach*, *supra* note 5, at 1839. To the extent that my requirement of no secondary material impact limits foreclosure to situations in which the collateral is *not* worth more to the firm than to the market, my approach is consistent with that of Professor Schwartz.

234 . Although I later propose an approach that theoretically is more satisfying, I also raise the possibility that a bright line test ultimately may be the best practical resolution. Such a test could include one in which only prebankruptcy contracts that do not result in secondary material impacts should be enforceable. *See infra* note 326.

235 . By "unlikely," I mean not likely to occur, or improbable. In quantifying this term, I later consider an event to be unlikely if its probability is significantly less than 25%. *See infra* text accompanying note 287.

236 . Without the ability to rely on the contract, rational persons might be unwilling to give the debtor value in exchange for the contract, and prebankruptcy contracts would have limited practical application. Justification for finding practical applications of waiver contracts derives from the potential of waiver contracts to provide a debtor with liquidity and encourage out-of-court settlements, thereby enhancing the bankruptcy policies of debtor rehabilitation and economical administration of the bankruptcy estate. *See supra* note

I next answer these questions by addressing the more general question: when should courts enforce contracts that create externalities?[237] I show that the universe of persons that legally should be recognized as being affected by externalities is limited. Furthermore, only material externalities should be allowed to limit contracting. I then use an economic efficiency argument to show that prebankruptcy contracts, or indeed any contracts, that cause externalities should be enforceable[238] *unless their net effect on one or more classes of nonconsenting persons is adverse*.[239] In the case of prebankruptcy contracting, the relevant class of nonconsenting persons would be the debtor's nonconsenting unsecured creditors. Finally, I use an expected value analysis to show that parties should be able to rely on prebankruptcy contracts in only two circumstances: when the contracts *ex post* do not cause secondary material impacts; and when the contracts *ex ante* are unlikely to cause secondary material impacts, irrespective of the *ex post* consequences. Only those types of prebankruptcy contracts would not adversely affect nonconsenting creditors as a class.[240]

. *What constitutes an externality that should defeat enforcement of a contract?*Stated in pristine form, the proposition that courts should not enforce contracts that create externalities cannot be correct, because most contracts adversely affect at least some third

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XX and accompanying text.

237 . My analysis, of course, will be further limited by restrictions imposed by bankruptcy policy. *See infra* section III(B)(2).

238 . At least from the standpoint of externalities.

239 . In other words, contracts should be enforced if each class of affected persons benefits (or at least is not harmed) on a net basis even though some of those individual persons may be harmed. But contracts that, on a net basis, harm a class of affected persons should not be enforced. See text accompanying notes XX-XX, *infra*.

240 . I later show that this same measure of reliance should be justifiable from the standpoint of bankruptcy policy. *See* Part III.B.2, *infra* notes XX-XX and accompanying text (analyzing whether prebankruptcy contracts that *ex ante* are unlikely to, but *ex post* may, cause secondary material impacts should be enforceable from the standpoint of the bankruptcy law policy of equality of distribution).

parties.[241] The more interesting question is not whether a contract adversely affects third parties, but whether it adversely affects third parties, in a way that the law deems intolerable. Unfortunately, "[d]etermining which of these impacts [externalities], if negative, are to count in constraining the ability of parties to contract with each other poses major conceptual problems."[242] An answer to this question requires a determination of the universe of third parties that should be recognized as potentially being affected by externalities. In the context of contractually seeking to override a statutory scheme, that universe may be limited.[243]

Bankruptcy law, the statutory scheme on which this Article focuses, does not recognize that all persons who are injured have recourse under the Code.[244] The Code generally affords rights only to

241 . *See* TREBILCOCK, *supra* note 18, at 20 (["F]ew transactions have no tangible or intangible effects on third parties.") (citing Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 Yale L. J. 1211 (1991)). For example, contracts that create collateral are enforced even though they have the effect of subordinating unsecured creditors.

242 . *Id*.

243 . Of course, there is no legally recognized externality if a person on whom costs are imposed has no right to avoid the costs. *See* JEFFREY L. HARRISON, LAW AND ECONOMICS 42 (1995).

244 . Bankruptcy may affect a broad range of interests, including "employees who will lose jobs, taxing authorities that will lose [a source of tax revenue], suppliers that will lose customers, nearby property owners who will lose beneficial neighbors, and current customers [that will lose established suppliers]. Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World,* 92 MICH. L. REV. 336, 355 (1993). Although these diverse interests obtain no standing to be heard or to support or oppose proposals in a bankruptcy case, *id*., Professor Warren asserted that policy underlying the Code "takes into account the distributional impact of a business failure on parties . . . who have no formal legal rights," *id*. at 354-55. The Code accomplishes this "through provisions that forestall liquidation to permit the business to remain in operation and to reorganize, instead of being shut down by a few anxious creditors." *Id*. at 356.

holders of claims (creditors) and interests (equityholders).[245] Whether or not affected third parties have recourse under other laws—such as employees who want to keep their jobs with the bankrupt company—they have no right to be recognized under bankruptcy law unless they have a claim or interest within the meaning of the Code.[246] Whether or not those other persons *should* be recognized under

245 . *See* Bankruptcy Code, 11 U.S.C. § 501(a) (allowing only creditors or indenture trustees to file claims and only equity security holders to file interests); *id*. § 726(a) (listing the order of distribution of estate property: first, to holders of claims; next, to holders of interests; and finally, any residual to the debtor); *id*. § 1129(a) (only explicitly taking holders of claims and interests into account when confirming a plan of reorganization). It is not unprecedented for law to take into account only certain affected parties. For example, directors who manage a corporation are obligated to corporate shareholders, but are not generally obligated to the corporation's employees who may be equally affected by the directors' actions. *See* Pepper v. Litton, 308 U.S. 295, 306 (1939).

246 . That does not, however, mean that bankruptcy judges must wholly ignore that bankruptcy involves financial distress. Although the Code characterizes claims and interests as the only entitlements, it selectively mandates consideration of public policy concerns in limited situations. *See, e.g.*, 11 U.S.C. §1123(a)(7): (requiring a plan of reorganization to "contain only provisions that are consistent with the interests of creditors and equity security holders *and with public policy* with respect to the manner of selection of any officer, director, or trustee under the plan") (emphasis added). Procedural Rules provide that "a labor union or employees' association . . . shall have the right to be heard on the economic soundness of a plan affecting the interests of the [debtor's] employees," FED. R. BANKR. P. 2018(d), and that a bankruptcy court has discretion to "permit any interested entity to intervene," *id*. 2018 (a). Furthermore, bankruptcy courts on an individual basis have taken public interests into account, as in the Eastern Airlines bankruptcy case in which the court allowed the debtor to spend over $600 million in an unsuccessful attempt to keep the airline in business despite "vociferous" objections by creditors. *See* Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319, 320, 319-20 (1991). The court's rationale was that "the flying public's interest must at all times be taken into account." *In re* Ionosphere Clubs, 113 B.R. 164, 168 (Bankr. S.D.N.Y. 1990).

bankruptcy law is an important issue but not the focus of this Article.[247]

Once the groups of legally recognized third parties—in the case of bankruptcy, holders of claims and holders of interests—are determined, the next step is to define the threshold level at which an adverse effect will be legally recognized. It appears obvious that externalities that are immaterial should not be recognized. For example, in noting that all transactions by a business negatively affect its competitors, the purchase of a car increases pollution, and sale of a rare good deprives others of items they may otherwise have obtained, Trebilcock concluded that "[i]f all these, and similar externalities, should count in prohibiting the exchange process or in justifying constraints upon it,

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247 . For an excellent recent discussion of this issue, see Schwartz, *Contract Theory Approach*, *supra* note 5, at 1818, 1814-19 (arguing that bankruptcy law should protect only parties with current claims because protecting community interests with bankruptcy law allows "the wrong set of firms" to survive). Limited recognition of claims is consistent with the model of bankruptcy as a "creditors' bargain" in which bankruptcy is a response to the problem of collecting claims; therefore only persons with distributive claims against the debtor's assets should be recognized. *See* JACKSON, *supra* note 155, at 1-3, 24-27; Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain,* 75 VA. L. REV. 155, 177-78; Baird & Jackson, *supra* note 33, at 100-01, 103. *But see* Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994) (arguing that bankruptcy law should address the range of social problems that result from both personal and business failures); Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEXAS L. REV. 541, 554-58 (1993) (arguing that bankruptcy is a more general response to the problem of financial distress and that limiting recognition "denies representation to the vital interests of managers, employees, and their dependents, as well as the community at large"); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 732-61 (1991) (characterizing bankruptcy law as a more general "response to the problem of financial distress—not only as an economic, but as a moral, political, personal, and social problem"); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 788 (1987) (arguing that bankruptcy law already indirectly considers the interests of employees, communities, and other business dependents). For a constitutional perspective on this controversy, see Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 491-94, 559-64 (1996) (arguing that bankruptcy law may not give special benefits to third parties holding neither claims nor interests).

freedom of contract would largely be at an end."[248] Litigation over those externalities also would impose an unacceptable burden on the judicial system.[249]

A materiality threshold explains the intuition of focusing on whether a prebankruptcy contract results in a secondary *material* impact, as opposed to any mere impact. Materiality only sets a floor, however, and not a ceiling for determining whether externalities should defeat enforcement of a contract. Measuring that ceiling requires a tool to judge the quantitative impact of the externalities.[250] I propose using economic efficiency. Economic efficiency, of course, is not an uncontroversial goal for resolving social issues.[251] I therefore also go beyond the traditional tests of efficiency to show that, *in the context of the externalities that I argue should not defeat enforcement of a prebankruptcy contract,* even third parties who potentially are harmed by those externalities should nonetheless want the contract to be

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248 . TREBILCOCK, *supra* note 18, at 58.

249 . Curiously, though, the issue of materiality does not appear to be explicitly addressed, but merely assumed in most of the scholarly literature. For example, in commenting on Professor Jeffrey Gordon's argument that opting out of standard corporate charter provisions creates an externality because parties using the standard provision would have fewer precedents to rely on, Professor Lucian Bebchuk observed that "the positive externalities created by standardization seem to be much larger with respect to the features of many technical products—such as VCRs or certain types of communication and computer systems—and still their magnitude does not appear sufficiently substantial to warrant mandatory intervention in these products' features." Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1405 n.46 (1989). Professor Bebchuk also observed that "[i]f significant externalities can be shown to exist, then the case for [mandatory] intervention can be established in a relatively noncontroversial way." *Id*. at 1405.

250 . A general metric would consider the finite chance that a debtor will go bankrupt and that a bankruptcy foreclosure in accordance with the prebankruptcy contract then inadvertently results in a secondary material impact that transfers value from nonconsenting creditors.

251 . *But see* Schwartz, *Contract Theory Approach*, *supra* note 5, at 1809 (asserting that "mandatory bankruptcy rules are justifiable only if they increase ex post efficiency").

enforceable.[252]

. *Economic efficiency*To conclude that something is efficient, one must agree on the standard by which to measure efficiency. The law and economics literature generally defines efficiency as meaning *either* Pareto or Kaldor-Hicks efficiency. Pareto efficiency means, in the context of a prebankruptcy contract, that the contract would make the beneficiary of the contract, and possibly the debtor, better off *but no other creditors worse off*.[253] A prebankruptcy contract therefore would be Pareto efficient only if it had no negative impact on nonconsenting creditors. That, however, raises the same practical dilemma that started my inquiry: parties to a prebankruptcy contract would not be able to rely on the contract's enforceability.[254]

That dilemma ostensibly is solved because economists generally accept Kaldor-Hicks, and not Pareto, as the operating standard of efficiency: "Because the conditions for Pareto superiority are almost never satisfied in the real world, . . . it is pretty clear that the operating definition of efficiency in economics is not Pareto superiority. When an economist says that [something] is efficient, nine times out of ten he means Kaldor-Hicks efficient."[255] Kaldor-Hicks efficiency means, in the context of a prebankruptcy contract, that the aggregate benefit to the debtor and the contracting creditor exceeds any net harm to the

252 . See the discussion of the test of class Pareto efficiency *infra* notes 266-271 and accompanying text.

253 . *See* Jules L. Coleman, *Efficiency, Utility & Wealth Maximization*, 8 HOFSTRA L. REV. 509 (1980); Thomas J. Miceli & Kathleen Segerson, *Defining Efficient Care: The Role of Income Distribution*, 24 J. LEGAL STUD. 189, 192-93 (1995). Although technically the test of Pareto efficiency is whether it makes any other persons, as opposed to merely any other creditors, worse off, for purposes of analysis I assume that only creditors could potentially be made worse off.

254 . Recall that even when a secondary material impact appears at the time of contracting to be unlikely, creditors nonetheless could be prejudiced in individual cases. Yet, the normative justification for enabling parties to rely on prebankruptcy contracts derives from the potential of waiver contracts to provide a debtor with liquidity and encourage out-of-court settlements, thereby enhancing the bankruptcy policies of debtor rehabilitation and economical administration of the bankruptcy estate. *See supra* note XX and accompanying text.

255 . RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 1.2, at 14 (4th ed. 1992).

nonconsenting creditors.[256] The debtor and the contracting creditor clearly expect a benefit; otherwise, they would not have freely entered into the contract. Call the debtor's benefit X and the contracting creditor's benefit Y.

In applying Kaldor-Hicks to the question raised earlier—whether parties should be able to rely on a prebankruptcy contract that *ex ante* is unlikely to cause a secondary material impact[257]—the analysis needs only to focus on contracts that are likely to result in *non*material impacts.[258] If the amount of the impact is designated Z, a prebankruptcy contract would be Kaldor-Hicks efficient when the sum of X + Y equals or exceeds Z.[259] Because parties usually will not incur the transaction costs of contracting unless they expect material gains, the sum of X + Y would be expected to be material. That sum therefore would exceed Z for most prebankruptcy contracts belonging to the limited universe of prebankruptcy contracts on which I focus in which Z is likely to be nonmaterial. Most prebankruptcy contracts belonging to that limited universe therefore would be Kaldor-Hicks efficient.

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256 . *See id*. § 1.2, at 13-14. By "net harm," I mean the harm to the debtor's nonconsenting creditors minus any benefit to them. *See id*. § 1.2, at 14. A transaction is Kaldor-Hicks efficient even if the "winners" (the debtor and the contracting creditor) do not compensate the "losers" (the nonconsenting creditors). *See id*.

257 . See *supra* text accompanying note 236.

258 . I later show that only prebankruptcy contracts that are unlikely to, or that do not, result in a secondary material impact would be class Pareto efficient. See text accompanying notes XX-XX, *infra*. I therefore conclude that only those prebankruptcy contracts should be deemed to be enforceable from the standpoint of externalities.

259 . Judge Posner gave this analysis:

> In the less austere concept of efficiency used in this book—called the Kaldor-Hicks concept or wealth maximization—if A values the wood carving at $5 and B at $12, so that at a sale price of $10 . . . the transaction creates a total benefit of $7 (. . . A considers himself $5 better off and B considers himself $2 better off), then it is an efficient transaction, *provided that the harm (if any) done to third parties (minus any benefit to them) does not exceed $7. . . . The winners [A and B] could compensate the losers [the third parties], whether or not they actually do*."

POSNER, *supra* note 256, § 1.2, at 13-14 (emphasis added).

But what would be the effect of the relatively small percentage of those prebankruptcy contracts that *do* result in a secondary material impact? For those contracts, Z *would* be material, and X + Y could be less than Z. That does not, however, mean that Kaldor-Hicks efficiency is indeterminate. Mathematically, if an event has a greater probability of causing gain than loss, and if the magnitude of the gain and the loss generally would be equal, a statistically large number of such events is likely to result in a net gain. Given the focus on prebankruptcy contracts for which secondary material impacts are *ex ante* unlikely, situations in which X + Y turns out to equal or exceed Z would be expected to be significantly greater than situations in which X + Y turns out to be less than Z. Because Z is expected to be immaterial, there also is no reason to believe—even though Z itself sometimes *could* be material—that Z would be large enough to cause the sum of all Zs to exceed the sum of all the Xs and Ys. Thus, on an aggregate basis, the sum of all X + Ys would be expected to exceed the sum of all Zs. It therefore is reasonable to presume, at least in the absence of empirical evidence to the contrary, that prebankruptcy contracting that *ex ante* is unlikely to result in a secondary material impact would be Kaldor-Hicks efficient.[260]

Even though such prebankruptcy contracting would appear to be

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260 . Some may argue that Kaldor-Hicks efficiency is usually measured *ex post*, with reference to the outcome of a particular transaction, and not *ex ante* as I have proposed. However, when the outcome of an exchange is uncertain or risky, economists measure the efficiency of the exchange *ex ante*. *See, e.g.,* Kenneth J. Arrow & Robert C. Lind, *Uncertainty and the Evaluation of Public Investment Decisions*, 60 AM. ECON. REV. 364 (1970); Milton Friedman & L.J. Savage, *The Utility Analysis of Choices Involving Risk*, 56 J. POL. ECON. 279, 304 (1948) ("[I]ndividuals seek to maximize expected utility . . . ."). The logic is that one cannot use the actual costs and benefits because they are unknown *ex ante*. Because the outcome of any given prebankruptcy contract is uncertain, the general efficiency of such contracts must also be measured *ex ante*. Nonetheless, when there is a risk of different outcomes, economists may factor into the expected outcome a risk premium representing the price one would pay to eliminate the risk. *See* E.J. MISHAN, COST-BENEFIT ANALYSIS 363-65 (3d ed. 1982); Friedman & Savage, *supra*, at 289-90 (arguing that risk-averse consumers will pay to insure against the risk of actuarially fair gambles). The risk premium in the case of prebankruptcy contracting would appear to be small—and therefore would not materially change the analysis—because I have assumed that the expected impact on creditors who do not benefit from the prebankruptcy contract would be non-material.

Kaldor-Hicks efficient,[261] I am uncomfortable with Kaldor-Hicks alone being used to judge the efficiency of prebankruptcy contracting. My uneasiness stems from the apparent unfairness of justifying prebankruptcy contracting by comparing whether the gains to the beneficiary of the contract and to the debtor, which voluntarily contract, exceed the detriment to nonconsenting creditors.[262] I would have less concern if nonconsenting creditors in some transactions acted as secured creditors, or even debtors, in other transactions, but that is not the case.[263] Other commentators are similarly uneasy:

> In terms of Kaldor-Hicks efficiency, the welfare implications of the exchange would entail balancing the costs to third parties [*i.e.* nonconsenting creditors] against the gains to the immediate parties to the exchange. While the individual autonomy of the parties to the exchange may be enhanced by permitting them to exercise their autonomy in this way, that of third parties may well be violated by external impacts of the exchange.[264]

To mitigate this uneasiness, I propose focusing the analysis on balancing the costs to nonconsenting creditors against the gains *to those same parties*. In other words, I analyze whether the net effect of prebankruptcy contracting is to harm nonconsenting creditors.

I perform this analysis by using a methodology, which I have

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261 . See text accompanying notes XX-XX, *infra* (arguing that the classic application of Kaldor-Hicks efficiency to voluntary contracting may be inadequate when the contract causes significant involuntary externalities).

262 . Recall that, under Kaldor-Hicks efficiency, the winners (the debtor and the contracting creditor) need not compensate the losers (the nonconsenting creditors). *See supra* note 257.

263 . Unsecured creditors rarely act as debtors and only infrequently act as secured creditors. And involuntary creditors, such as tort victims, almost never act as debtors or creditors in situations in which prebankruptcy contracting would occur. The justification for Kaldor-Hicks efficiency that nonconsenting persons in some deals would be consenting persons in other deals does not appear to apply; rather, there is systematic discrimination against nonconsenting creditors.

264 . TREBILCOCK, *supra* note 18, at 58. In a general contracting context, Trebilcock states: "The problem of third-party effects from exchange relationships is pervasive and not aberrational. Almost every transaction one can conceive of is likely to impose costs on third parties." *Id*.

elsewhere called "class Pareto efficiency,"[265] that applies Pareto efficiency not to affected individuals but to affected classes. A transaction would be class Pareto efficient if it is Pareto efficient when viewing each separate class of affected persons as a single collective person.[266] Class Pareto efficiency therefore exists whenever, for every affected class, the overall gains to an individual class exceed the losses to that class even if some members of the class individually are harmed.[267] Dean Anthony Kronman has articulated, in another context, a normative basis for such an approach:

> [U]nlike a court, a legislature must evaluate the effects of proposed rules on classes of persons rather than on particular, identifiable individuals. For these reasons, a strictly individualistic interpretation of paretianism [*i.e.*, strict Pareto efficiency] is likely to make the principle unworkable in all but a few cases.[268]

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265 . Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 481 (1997) (defining class Pareto efficiency).

266 . *See id*.

267 . *See id*. at __. Class Pareto efficiency could be described equally well as Kaldor-Hicks efficiency *within each class* of persons affected by a transaction. *See id*., at 482 n.254. Within the class of unsecured creditors, the justification for Kaldor-Hicks efficiency—that non-consenting persons in some deals would be consenting persons in other deals—*would* apply because even unsecured creditors who are harmed in some cases of prebankruptcy contracting would be benefited in other cases. Alternatively, class Pareto efficiency could be described as the application of Pareto efficiency on an *ex ante* basis, without regard for *ex post* consequences. *See id*. (suggesting that some might regard *ex ante* Pareto efficiency as counter-intuitive because one normally thinks of Pareto efficiency as meaning no person will be harmed). *Compare* text accompanying note XX, *infra* (explaining that all creditors *ex ante* would want a class Pareto efficient contract to be enforced even if some creditors, *ex post*, are harmed).

268 . Anthony T. Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472, 487 (1980) (arguing that, "[a]lthough the matter is by no means free from difficulty, one reasonable approach is to interpret paretianism as requiring only that the welfare of *most people* who are taken advantage of in a particular way be increased by the kind of advantage-taking in question" (emphasis in original)). A difference between Dean Kronman's approach and mine is that he applies the approach to disputes between parties to a contract, *id*. at 486-87 (applying the approach to a fraudulent sale of a watch); whereas I would

Furthermore, the normative argument for freedom of contract, voluntary assent on the part of all parties,[269] also justifies a standard of class Pareto efficiency: all creditors *ex ante* would want a class Pareto efficient contract to be enforced even if some creditors, *ex post*, are harmed.[270]

I next apply this approach to the question under analysis: whether parties should be able to rely on prebankruptcy contracts that *ex ante* are unlikely to cause secondary material impacts. I illustrate my analysis by the example of a prebankruptcy contract to waive the automatic stay. Nonconsenting creditors would suffer when foreclosure results in an unanticipated secondary material impact. On the other hand, stay-waiver contracts may create offsetting benefits for those creditors if, in return for waiving the automatic stay, the debtor demands something of value from the contracting creditor. I later argue that the debtor often will receive value in the form of a liquidity

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apply the approach only to externalities, out of concern that applying it to the contracting parties would appear to undercut the consensual nature of their contract. *Accord*, TREBILCOCK, *supra* note 18, at 83 (commenting on Kronman's application of the approach).

269. *See* TREBILCOCK, *supra* note 18, at 7. Although nonconsenting creditors do not have the opportunity to assent, my point is that they would assent if given the choice *ex ante*. Hypothetical voluntary assent also provides a separate economic justification. In purely voluntary exchanges, economic efficiency is measured by examining whether the net effect of the exchange on all parties is positive. But in purely involuntary transactions, such as crimes or accidents, some scholars measure efficiency by examining "whether, if a voluntary transaction had been feasible, it would have occurred." POSNER, *supra* note 256, § 1.2, at 16. Because a prebankruptcy contracting transaction is voluntary for debtor and the contracting creditor *but involuntary for nonconsenting creditors*, efficiency of the involuntary portion of the transaction should be measured by examining whether nonconsenting creditors, if given a choice, would have consented to the transaction.

270. Even though actual creditors are risk averse, this statement need not be qualified to offset creditor risk aversion against the benefits that creditors expect to receive if the contract were enforced. Risk aversion is most applicable when a person is comparing very different risk profiles; for example, comparing a relatively sure thing against a small chance of obtaining a large gain. With prebankruptcy contracting, there is no sure thing. The alternative to entering into the prebankruptcy contract may be bankruptcy.

advance or relief from default,[271] thereby benefitting the debtor by reducing the likelihood of its subsequent bankruptcy. Although no empirical data are available on how increased liquidity will reduce the likelihood of bankruptcy,[272] recent scholarship analyzing liquidity provided by secured lending, a type of prebankruptcy contract,[273] suggests the reduction is likely to be significant.[274] By comparing the expected value of nonconsenting creditors' claims with and without a prebankruptcy contract, I next argue that a reduction in the likelihood of bankruptcy is likely to benefit those creditors in excess of any harm, and that a significant reduction will greatly benefit those creditors.[275]

. *Expected value analysis*In order to calculate the expected value of a claim against a debtor that has a likelihood of bankruptcy, the value of the claim in bankruptcy must be multiplied by the chance of bankruptcy, the value of the claim absent bankruptcy must be multiplied by the chance of the debtor's avoiding bankruptcy, and the

271 . For example, a creditor might extend a new loan to the debtor, modify the debtor's loan covenants to make them less restrictive, or waive a default. I will refer collectively to these and similar means of providing relief to a debtor as "liquidity."

272 . That may be a subject for future empirical study. *Cf.* Michael J. Herbert, *The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2), & (4) of the Bankruptcy Code*, 17 U. RICH. L. REV. 667, 673 (1983) ("The seller who advances credit increases the chances of the buyer's survival much more than the seller who does not. This, in turn, increases the chance that all creditors will be paid.") Philip S. Scherer, *Starting Over, A Guide to Turnaround Management* at __ (1989) (arguing that the availability of capital is important to achieving a successful turnaround).

273 . *See infra* notes 328-333 (analyzing secured lending as a type of prebankruptcy contract and distinguishing secured lending from waiver and procedure contracts).

274 . *See* Schwarcz, *supra* note 266, at 443-49 (discussing increased liquidity resulting from new money loans).

275 . See text accompanying notes XX-XX, *infra*.

results must be added.[276] My model will assume that the debtor has one secured creditor who seeks a prebankruptcy contract waiving the automatic stay and that all of the debtor's nonconsenting creditors are unsecured. I treat these nonconsenting creditors as a single class because holders of all prepetition unsecured claims—irrespective of whether those claims arise out of loans or breaches of contract or tort—have the same priority,[277] and therefore usually are treated alike,[278] in bankruptcy.[279]

I examine this model under what I believe are a representative range of variables, starting with conservative variables.[280] Because I later propose that prebankruptcy contracts generally be restricted under my model to those entered into in default situations,[281] I will assume

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276. *See* VICTOR BRUDNEY & WILLIAM W. BRATTON, CASES AND MATERIALS ON CORPORATE FINANCE 55-56 (4th ed. 1993); POSNER, *supra* note 256, §15.1, at 471-72 & n.1 (both illustrating the expected value computation).

277. *See* Bankruptcy Code, 11 U.S.C. § 726(a)(2), (b) (199_) (providing that general unsecured creditors—whether voluntary or involuntary—get paid on a pro-rata basis).

278. *See, e.g.*, *In re* Bloomingdale Partners, 170 B.R. 984, 998 (Bankr. N.D. Ill. 1994) (holding that, for purposes of classification of claims under 11 U.S.C. § 1122, a tort claim is substantially similar to a contract-based claim because "[t]hey are all unsecured claims with the same bankruptcy priority").

279. Therefore, even if we treated involuntary tort creditors as a separate class for purposes of the class Pareto efficiency analysis, their class would receive the same *pro rata* recovery as all other unsecured creditors.

280. I have selected these variables based on the best available empirical evidence. Furthermore, I later show that the starting variables can be materially changed and still produce a higher expected value in the case of prebankruptcy contracting. See notes XX-XX, *infra*, and accompanying text (describing the effect of modifying one variable at a time and then modifying several variables simultaneously in a Monte Carlo simulation).

281. I propose that, with limited exceptions not relevant here, only debtors in default be permitted to enter into prebankruptcy contracts. *See infra* subpart IV(B).

that the likelihood of bankruptcy absent the liquidity provided by the prebankruptcy contract is fifty percent, a figure that derives from a study of the incentives of financially distressed firms to restructure their debt privately rather than through formal bankruptcy.[282] I also assume that the liquidity resulting from a prebankruptcy contract would reduce the likelihood of bankruptcy by only ten percentage points, to forty percent.[283] Although the amount of this reduction lacks an empirical basis,[284] I later show that my overall conclusions obtain even if the likelihood of bankruptcy is reduced by only seven percentage points.[285] Also, even though my example assumes that a secondary material impact is considered *unlikely* at the time of contracting, I will conservatively use in the calculations a twenty-five percent chance of such an impact inadvertently occurring.[286] I've also assumed a simple

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282 . *See* Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 326 (1990) (finding in a sample of 169 financially distressed companies that 89, or 52.7%, were unable to restructure their debt outside bankruptcy). Furthermore, I later show that my overall conclusions are relatively insensitive to variations in the 50% figure. See *infra* notes XX-XX and accompanying text.

283 . This estimate of the reduction in the likelihood of bankruptcy derives from a Telephone Interview with Peter V. Pantaleo, Bankruptcy Partner at O'Melveny & Meyers LLP (November 4, 1997) (on file with ____).

284 . Empirical evidence for the reduction in the likelihood of bankruptcy does not exist because prebankruptcy contracting is rare, particularly for public companies for which data would be available. Nonetheless, a 10 percentage point reduction appears reasonable, indeed conservative, given that I later show that a rational debtor would be reluctant to enter into a prebankruptcy contract, even assuming a creditor is thereby willing to provide liquidity, *unless* the liquidity would render its chance of bankruptcy unlikely. See text accompanying notes XX-XX, *infra*.

285 . See *infra* note XX and accompanying text.

286 . See note XX, *supra* (defining the term unlikely as meaning not likely to occur, or improbable). My assumption is especially conservative given that the bankruptcy foreclosure procedure is likely to be much more debtor-sensitive than prepetition foreclosure under

debtor-creditor model, which I later varied,[287] in which the debtor has eighteen hundred dollars of assets, the secured creditor's claim of one thousand dollars is secured by all the assets, and the unsecured creditors' claims are one thousand dollars.[288]

I further assume that the foreclosure value of the assets if a secondary material impact occurs is only half of their value,[289] leaving

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commercial law. *See* text accompanying notes XX-XX, *supra* (arguing that bankruptcy courts can exercise their equitable powers to try to achieve a market price for collateral).

287. To ensure that the overall result is not dependent on a particular fact pattern, I computed expected values by varying the debtor's assets and liabilities, but otherwise assuming that its likelihood of bankruptcy is reduced by eight percentage points. The results consistently show that the prebankruptcy contract increases the expected value of the unsecured claims. For assets of $2000, secured claims of $1000, and unsecured claims of $1500, the expected value is $11.11 higher for a prebankruptcy contract. For assets of $1600, secured claims of $1000, and unsecured claims of $1500, the expected value is $76.89 higher for a prebankruptcy contract. And for assets of $2000, secured claims of $1500, and unsecured claims of $1000, the expected value is $81.11 higher for a prebankruptcy contract.

288. The debtor is therefore slightly insolvent, a reasonable assumption for a company in default. FA. If we assumed a solvent debtor, the expected value of the unsecured claims might be higher absent a prebankruptcy contract. Those creditors would likely be paid most of their claims in the bankruptcy reorganization anyway, whereas they would lose part of the value of their claims in the unlikely event of a secondary material impact caused by the foreclosure.

289. An average foreclosure value of assets of 50% appears conservative. *See* TIMOTHY W. KOCH, BANK MANAGEMENT 647 (1995) (stating that banks making loans secured by receivables generally assume 50% to 80% foreclosure values, and that banks making loans secured by raw materials generally assume 40% to 60% foreclosure values); Steven Wechsler, *Through the Looking Glass: Foreclosure by Sale as* De Facto *Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850, 865-66, _____ (1985) (finding in a study of 118 mortgage foreclosures in Onondaga County, New York that the average loss of value in foreclosure was 44.6%); Ronald J. Mann, Strategy & Force in the Liquidation of Secured Debt 50, 62 (July 7, 1997) (unpublished manuscript, on file with _______) (suggesting from a small sampling of six distressed small business loan

nothing to pay the unsecured creditors,[290] but that the bankruptcy nonforeclosure value of those assets is only two hundred dollars less than market value (that is, almost ninety percent of their value).[291] These assumptions reflect that the assets may have greater value in a bankruptcy reorganization than in an ordinary foreclosure where a secondary material impact occurs. Still, the value of the assets in a bankruptcy is assumed to be less than their market value, because some reorganizations fail and the debtor ends up being liquidated,[292] in which case the assets may not realize their market value.[293] And bankruptcy reorganization costs, which must be paid out of asset value before

foreclosures by a single insurance company that the average loss of value could be greater than 50%). *But see Texas Default Study Confirms Loan- Loss Assumptions*, STANDARD & POOR'S STRUCTURED FINANCE, February 1993, at 3 (finding in an empirical study of mortgage foreclosures in Texas in the early 1980's that the average loss of value in foreclosure was less than 40%). I later will show, however, that even reducing the foreclosure value dramatically is unlikely to affect my ultimate conclusion for three reasons: first, the increase in expected value resulting from liquidity would more than offset the loss caused by a lower foreclosure value; second, the lower foreclosure value would apply only in the case of a secondary material impact, which under my model is unlikely); third, and most important, because my model's 50% foreclosure value already wipes out the surplus payable to unsecured creditors, those creditors could not be further impaired by a lower foreclosure value. *See infra* notes __-__ and accompanying text.

290 . That reduction in value also theoretically could harm the secured creditor, but the secured creditor is a party to the prebankruptcy contract and therefore is not the subject of externalities.

291 . Thus, of the $1800 of assets, only $1600 (88.9%) of asset value will remain at the end of the bankruptcy case to pay claims.

292 . JAMES J. WHITE & RAYMOND T. NIMMER, CASES AND MATERIALS ON BANKRUPTCY 664 (3d ed.1996) ("It is not uncommon for a corporate debtor who has filed initially in Chapter 11 to convert to Chapter 7 for liquidation.").

293 . *See* MARK S. SCARBERRY ET AL., BUSINESS REORGANIZATION IN BANKRUPTCY: CASES AND MATERIALS 760 (1996) ("The liquidation value will, in most cases, be much less than going concern values. For example, inventory in the garment industry is often worth no more than one third of its cost in situations where the business is liquidated.").

unsecured creditors are paid, further reduce asset value.[294] I believe my assumption of approximately ninety percent of value is conservative.[295] To be consistent, I also have assumed that any assets remaining after foreclosure will reduce to approximately ninety percent of their value during the bankruptcy case.[296] For example, a foreclosure occurring at the beginning of the bankruptcy case, that does not result in a secondary material impact will yield eight hundred dollars of surplus value at that time, but that surplus value will not be applied to payment of other claims until the end of the case, at which time its value will have reduced to approximately ninety percent of the surplus value, or

294 . *See* Bankruptcy Code, 11 U.S.C. § 507(a) (1994) (requiring the payment of bankruptcy administrative claims prior to unsecured claims).

295 . *See, e.g.*, Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Code Question*, 39 J. FIN. 1067, 1087 (1984) (showing, in a study of 26 firms filing for bankruptcy, that the estimated direct and indirect costs of bankruptcy were between 11 and 17% and that "in many cases they exceed 20% of the value of the firm measured just prior to bankruptcy"); Lynn M. LoPucki, *Virtual Judgment Proofing: A Rejoinder*, 107 YALE L.J. 1413, 1424-25, 1425 n.67 (1998) ("[T]he costs of Chapter 11, direct and indirect, are high. For large public corporations, they are probably in excess of 10% of the value of the company."). For purposes of our computations, Altman's data significantly understates the costs by failing to take into account any reduction of asset values in liquidation, but overstates the costs to the extent that indirect costs of bankruptcy, such as "the opportunity costs of lost managerial energies," *id*. at 1070-71, do not reduce asset values. I separately calculated that, holding all other variables constant, only bankruptcy nonforeclosure values exceeding 91% would lead to a higher expected value in the absence of prebankruptcy contracting. *See infra* notes 306-307 and accompanying text (describing the effect of modifying one variable at a time and then modifying several variables simultaneously in a Monte Carlo simulation).

296 . I use the same rate of reduction, to approximately 90% of value, because an asset's value would appear to reduce in direct proportion to its value at the outset of the bankruptcy case. That certainly would be the effect of selling assets in a liquidation sale. Empirical evidence suggests that bankruptcy costs, which must be subtracted from asset value, *see supra* note 295 and accompanying text, also are proportional to asset value, *see* Altman, *supra* note 296, at 1077 (concluding that the average ratio of direct bankruptcy costs to firm value is "fairly stable").

$711.11.[297] Part of the value gained from prebankruptcy contracting therefore derives from permitting foreclosure on the collateral at the outset of the bankruptcy case, thereby avoiding its loss of value during the case.[298] Although this may appear counterintuitive at first, there is an intuitive explanation. Because I limit enforceable prebankruptcy contracts to those in which the foreclosure is unlikely to result in a secondary material impact, the debtor does not value the collateral more highly than the market does.[299] The buyer in the foreclosure sale may well have a more valuable use for the collateral than the debtor would have.[300]

Ignoring interest costs and assuming that the bankrupt debtor would be insolvent,[301] the following equations apply:[302]

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297 . At the beginning of the case, the surplus derives from the $1800 asset value minus the $1000 secured claim. At the end of the case, the amount available to satisfy the unsecured claims derives from $800 times the ratio of $1600 to $1800, *i.e.*, the amount of surplus at the beginning of the case times the constant percentage of decline.

298 One might expect that a judge would lift the automatic stay, absent a prebankruptcy contract, where early foreclosure would avoid loss of value. However, "[t]here has been a tendency in certain cases to take an extremely mechanical view of stay litigation and to preclude a party who is subject to the automatic stay from seeking relief. This creates an anomalous situation where a party is subject to the automatic stay but is unable to seek relief even if damage may result from its continuance." COLLIER ON BANKRUPTCY, *supra* note , ¶ 362.07, at 362-04.

299 . If the debtor did value the collateral more highly than the market, the foreclosure value could be materially less than the value of the collateral to the debtor, resulting in a secondary material impact. *See* text accompanying notes XX-XX, *supra*.

300 . Foreclosure at the outset of the case also could increase the value of the nonconsenting creditors' claims by eliminating postpetition interest that an oversecured creditor may receive. *See* 11 U.S.C. § 506(b).

301 . *See supra* note 289. On the other hand, I assume that the unsecured creditors ultimately will be paid in full if the debtor is able to avoid bankruptcy. Alternatively, I could have assumed that even if the debtor is able to avoid bankruptcy, the unsecured creditors will be paid

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where:

EV_1 is the expected value of unsecured claims *absent* the prebankruptcy contract.
EV_2 is the expected value of unsecured claims *with* the prebankruptcy contract.
is the likelihood of bankruptcy absent a prebankruptcy contract.
is the reduction in the likelihood of bankruptcy from a prebankruptcy contract.
V is the value of the collateral at the outset of the bankruptcy case.
S is the amount of the secured claim.
U is the amount of the unsecured claims.
is the percentage of original value to which assets deteriorate during bankruptcy.
2 is the chance of a secondary material impact occurring.
F is the foreclosure value of the collateral if a secondary

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less than their full claims. I separately computed that, holding all other variables constant, the average amount recovered by unsecured creditors on their claims, even though bankruptcy is avoided, would have to drop below 87% in order for prebankruptcy contracting to lead to a lower expected value. That large an average loss does not seem likely when bankruptcy is averted. *See* note XX, *infra*.

302. These equations are algebraic expressions of the following equalities: *The expected value of the unsecured claims absent the prebankruptcy contract* is equal to the likelihood of bankruptcy absent the contract x [non-foreclosure asset value in bankruptcy — amount of the secured claim] + likelihood of avoiding bankruptcy absent the contract x amount of unsecured claim (assumes payment in full by avoiding bankruptcy); *Expected value of unsecured claims with the prebankruptcy contract* = likelihood of bankruptcy with the liquidity resulting from the contract x [{chance of an unanticipated secondary material impact occurring x value of the unsecured claims if a secondary material impact occurs}+ {chance that an unanticipated secondary material impact will *not* occur x (asset value assuming no secondary material impact - amount of the secured claim)}] + likelihood of avoiding bankruptcy with liquidity resulting from the contract x amount of unsecured claim (assumes payment in full by avoiding bankruptcy).

material impact occurs.[303]

Using the foregoing numbers in these equations yields a higher expected value of the unsecured claims if prebankruptcy contracting is allowed. For example, if a prebankruptcy contract reduces the likelihood of bankruptcy by ten percentage points, the expected value of unsecured claims would equal $800 *absent* prebankruptcy contracting but $813.66 *with* prebankruptcy contracting.

I acknowledge that critics could argue that this result depends on the particular numbers chosen and therefore interpret its significance cautiously.[304] Nonetheless, it is easy to show that the result remains valid even for smaller reductions in the likelihood of bankruptcy.[305] Furthermore, I have tested the sensitivity of the equation to changes in other starting variables.[306] The results show that prebankruptcy contracting is likely to lead to a higher expected value of unsecured claims even if those variables are significantly changed from the

303 . I assume, of course, that $V - S$, $V - S$, and $F - S$ cannot be less than zero.

304 . See text accompanying notes XX-XX, *infra* (describing the limitations of my quantitative analysis).

305 . The likelihood of bankruptcy can be reduced by almost seven percentage points, rather than the ten percentage points illustrated in the text, before the expected value of the unsecured claims without the prebankruptcy contract exceeds the value with the contract. At a seven percentage point reduction, the value without the contract remains $800, while the value with the contract falls to $799.33.

306 . With the able help of Henry ("Hank") B. Michael, Rita Y.S. Pang, and Steve Lauff, I first modified one starting variable at a time while holding the others constant (single variable manipulation) in order to determine the degree to which the value or probability may be varied and still result in a higher expected value of unsecured claims. Next, with the help of a personal computer spreadsheet and special software (Microsoft Excel and Crystal Ball), we modified several variables simultaneously in a "Monte Carlo simulation," a methodology that allows one to examine the effect of simultaneously varying *several* of the starting values within predetermined ranges. This permitted us, for instance, to examine the effect of simultaneously varying both the likelihood of bankruptcy *and* the likelihood of a secondary material impact. The computations, results, and software are on file with the *Texas Law Review*.

empirically-derived numbers used in this Article.[307]

If, on the other hand, it is assumed that the liquidity provided by the prebankruptcy contract reduces the likelihood of bankruptcy by more than ten percentage points—a reasonable assumption given that I later show that a rational debtor would be reluctant to enter into a prebankruptcy contract, even assuming a creditor is thereby willing to provide liquidity, *unless* the liquidity would render its chance of bankruptcy unlikely[308]—the increase in expected value is even more dramatic. For example, a 15 percentage point reduction in the debtor's likelihood of bankruptcy yields an expected value of unsecured claims equal to $800 *absent* prebankruptcy contracting but $836.67 *with* prebankruptcy contracting.

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307 . For example, by holding all of the variables constant except for the reduction in the likelihood of bankruptcy, we found that prebankruptcy contracting is advantageous under my example to the extent it reduces the likelihood of bankruptcy by over seven percentage points. Irrespective of how we varied the foreclosure value of the assets, we found that the expected value of unsecured claims with the prebankruptcy contract will be higher. (Because the equation conservatively assumes that unsecured creditors will receive nothing if a secondary material impact occurs, a lower foreclosure value only hurts the secured creditor.) We then varied only the bankruptcy nonforeclosure value of the assets and found that the expected value of unsecured claims with the prebankruptcy contract will be higher unless that foreclosure value exceeded approximately 91% of full value. We also considered the situation in which the unsecured creditors are not paid in full following a prebankruptcy contract even though bankruptcy is avoided. The amount recovered by unsecured creditors would have to drop below approximately 87% of their total claims in order for prebankruptcy contracting to lead to a lower expected value. In the Monte Carlo simulations, we first varied both the likelihood of bankruptcy and the chance of a secondary material impact. The mean expected value with the prebankruptcy contract was significantly higher than the mean expected value without the prebankruptcy contract. We then chose different values for the assets as well as for the amount of the secured and unsecured claims. Although the margin was somewhat slimmer, the mean expected value still was higher with, than without, the prebankruptcy contract. Finally, we chose different values for the assets as well as for the amount of the secured and unsecured claims and also assumed that prebankruptcy contracting would reduce the likelihood of bankruptcy by eight percentage points. Once again, the mean expected value was higher with, than without, the prebankruptcy contract.

308 . See text accompanying notes XX-XX, *infra*.

Prebankruptcy contracting therefore appears generally to be class Pareto efficient when a secondary material impact, viewed *ex ante*, is unlikely. Such contracting not only would make the classes of the contract beneficiaries and debtors better off, but also would make non-contracting creditors, including involuntary creditors,[309] better off as a class.[310] Accordingly, even those creditors, viewing the contract *ex ante*, would want it to be enforceable.[311]

However, I still have not answered the question whether parties should be able to rely on prebankruptcy contracts that *are likely* to result in secondary material impacts. I next show those contracts are not class Pareto efficient.[312]

Using the same equations but varying only the likelihood of a secondary material impact, I found that the harm from prebankruptcy contracting's externalities would begin to outweigh the benefit from

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309 . My analysis covers involuntary creditors because the priority of such creditors' claims would be *pari passu* with the priority of all other unsecured creditor claims.

310 . The class at least would not be worse off.

311 . One reviewer of this Article asked whether actual agreement of the unsecured creditors should be required for prebankruptcy contracting. At least for waiver contracts, obtaining such agreement would be impractical. One would have to identify every unsecured creditor, adequately disclose the prebankruptcy contracting transaction and its consequences, and arrange a vote. A debtor in default may be unwilling or unable, however, to wait until that has been accomplished. Trade creditors, for example, may have suspended credit, and institutional creditors may have cross-default provisions with grace periods that are expiring. Even the cost of soliciting and arranging the vote may be prohibitive, particularly when the solicitation must comply with securities laws. Also, future creditors presumably would have to be made aware of the contract's existence before they extend credit, an impractical task for involuntary creditors such as tort creditors. Furthermore, requiring actual agreement of unsecured creditors would encourage rent seeking behavior by holdouts. On the other hand, this type of *ex ante* voting, subject to supermajority voting standards similar to those in § 1126(c) of the Code, is precisely what I am proposing for procedure contracts. *See infra* subpart IV(D).

312 . Indeed, I show that unless a prebankruptcy contract is *unlikely* to result in a secondary material impact, it would not be class Pareto efficient.

increased liquidity when the likelihood of a secondary material impact exceeds approximately thirty percent.[313] Thus, prebankruptcy contracting no longer would be class Pareto efficient when the likelihood of a secondary material impact exceeds thirty percent.[314] Parties therefore should not be able to rely, *ex ante*, on those contracts.

. *Limitations of my quantitative analysis* Any quantitative analysis is no better than its assumptions, and the assumptions of this Article rely on only a limited amount of empirical data.[315] There is, nonetheless, a possible empirical test. Security agreements are a type of prebankruptcy contract presently recognized by law.[316] Therefore, price changes of unsecured corporate bonds brought about by investor reaction to announcements of security agreements might reflect the reaction of nonconsenting unsecured creditors to prebankruptcy contracting generally. With the help of a research assistant,[317] I measured these price changes and found an average increase in unsecured

313 . If 30% represents the chance of an unanticipated secondary material impact occurring, the expected value of unsecured claims equals $800 *absent* prebankruptcy contracting but only $799.11 *with* prebankruptcy contracting.

314 . If, for example, the likelihood of a secondary material impact were 35%, the expected value of unsecured claims equals $800 *absent* but only $784.89 *with* prebankruptcy contracting. For this reason, I have proposed that only prebankruptcy contracts that are unlikely to result in secondary material impacts should be deemed, *ex ante*, to be enforceable.

315 . Game theory teaches that in a continuing game, the losers will try to figure out a way of protecting themselves against being exposed to constantly losing positions. FA. Therefore, a possible test of my argument that the expected value of nonconsenting creditor claims would not (as a class) be impaired is to observe whether creditors will refuse to make loans unless debtors agree not to enter into future waiver contracts. But even that test may not be dispositive. *See* Schwarcz, *supra* note , at 449-52 (showing that the widespread existence of "negative pledge" covenants, which restrict debtors from entering into future collateral contracts, is not indicative of the inefficiency of collateral).

316 . *See infra* text accompanying notes -.

317 . Duke law student Adam Chodos assisted in the project.

bond prices of 0.2% within the 24 hour period and 0.3% within a week after the announcement.[318] These results tentatively suggest that unsecured bondholders may favor security agreements and, by implication, prebankruptcy contracting.[319]

Another limitation may result from the small difference between

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[318] . These data are adjusted for the effect of general corporate bond market performance. Our general methodology was to locate every announcement, published since January 1, 1990 in the *Wall Street Journal* or other major U.S. newspaper, of companies having entered into security agreements. Chodos then excluded any announcements that included other factors (such as profits or losses) that might affect bond prices, and then determined the relevant public bond prices during each day of the week before and after each remaining announcement. The results are on file with the *Texas Law Review*.

[319] . I recognize, however, that this empirical test is imperfect for various reasons. Bond price data are generally available only on a month-end and not a daily or weekly basis. Some companies did not even have bonds outstanding during the relevant period. Therefore, Chodos was able to locate data for only 16 announcements. As a result, the sample may not be statistically meaningful. Also, security agreements may not be a sufficiently representative form of prebankruptcy contract, and public bondholders may not be representative of nonconsenting creditors because only larger companies tend to publicly issue bonds. Furthermore, the data includes announcements of security agreements given for new money loans as well as security agreements given only for waivers of defaults. The new money data showed an average increase in unsecured bond prices of 0.3% within the 24 hour period, and 0.6% within a week, after the announcement; but the non-new money data showed an average increase in unsecured bond prices of only 0.1% within the 24 hour period, and an average *decrease* of 0.1% within a week, after the announcement. *Cf*. Schwarcz, *supra* note , at 433-37 (distinguishing new money security interests). Ultimately, therefore, I rely on the intuitive plausibility of the foregoing arguments as to class Pareto efficiency: that the freedom to engage in prebankruptcy contracting, subject to the limits imposed in this Article, will benefit creditors if the liquidity it creates reduces the probability of bankruptcy sufficiently more than the decreased recovery by such creditors should bankruptcy occur; and that restricting prebankruptcy contracting will harm creditors if the restriction reduces liquidity and hence increases the probability of bankruptcy sufficiently more than the increased recovery to creditors should bankruptcy occur.

expected values with and without prebankruptcy contracting.[320] One may ask whether marginal numbers should drive policy if we know that a default rule will result in individual harm in some cases.[321] One response is that many transactions, each with a small increase in expected value, will result in a significant increase in aggregate expected value. More significantly, the question raises the larger issue of the extent to which economic efficiency should be relied on for policy analysis. That issue has been much debated in other contexts.[322]

A further limitation is that a jurisprudence based on factual inquiry, as opposed to a "bright line" test, would increase the cost of transactions.[323] To ensure class Pareto efficiency, it would be necessary to decide, for each prebankruptcy contract, whether a secondary material impact is *ex ante* unlikely. This theoretically could be done at minimal cost; for example, the debtor and the beneficiary of the contract, acting in good faith and performing appropriate due diligence,[324] could decide prior to entering into the contract whether or

320 . The largest differential in the numbers previously referred to was a $836.7 expected value with prebankruptcy contracting versus a $800 expected value without, and some examples had much lower savings. See text accompanying notes XX-XX, *supra*.

321 . Because individual parties could be harmed by prebankruptcy contracting, one could even argue that the law should not implement a rule that allows such harm without a greater level of proof that unsecured creditors will benefit as a class. That argument is blunted, however, by the observation that, even under a mandatory regime, some parties will benefit and others will be harmed. *See* note XX, *supra*, and accompanying text.

322 . *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW §§ 2.2, 2.3, at 26-31 (5th ed. 1998) (comparing arguments for and against the use of economic efficiency as a basis for rulemaking).

323 . Transaction costs also could arise if parties are confused by a bankruptcy regime that is partly mandatory and partly default rules. I find that less troublesome because most legal regimes combine mandatory and default rules. FA.

324 . In addition to other appropriate due diligence, the beneficiary may want to interview the
debtor's officers about the effect of the prebankruptcy contract. A simple representation and warranty by the debtor that the contract will

not a secondary material impact is unlikely.[325] In actuality, however, allowing the contracting parties to make the determination might prove more costly, particularly if litigation ensues. Because any transaction costs would have to be offset against prebankruptcy contracting's benefits, and the difference between expected values with and without prebankruptcy contracting was not large, significant transaction costs could well outweigh the benefits of prebankruptcy contracting.

One could minimize transaction costs by creating a bright line test: for example, all prebankruptcy contracts, whether or not class Pareto efficient, should be enforceable; or all should be unenforceable.[326] But a bright line test would impose other costs: under the first test,

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have no secondary impact would not appear to be sufficient.

325 . This result would be consistent, for example, with fraudulent conveyance law, which incorporates a "savings clause" that limits the bankrupt debtor's right to avoid transfers when the transferee has acted in good faith at the time of the transfer. *See* Bankruptcy Code, 11 U.S.C. § 548(c) (199_). Although not a precise parallel, this result also would be consistent with a principle of contract law: the adequacy of consideration is determined at the time the parties execute the contract because any other rule would impose substantial uncertainty as to the enforceability of a contract. *Compare In re* Chomakos, 69 F.3d 769, 770 (6th Cir. 1995), Cooper v. Ashley Communications (*In re* Morris Communications NC, Inc.) 914 F.2d 458, 466 (4th Cir. 1990) (both noting that the date for determining reasonable equivalence in bankruptcy cases is the date of the transfer or exchange), *and* 5 COLLIER ON BANKRUPTCY ¶ 548.09[1], at 116 (Lawrence P. King ed., 15th ed. 1984), *with* Crail v. Blakely, 505 P.2d 1027, 1034 (Cal. 1973), Wilson v. Strange, 219 S.E.2d 88, ____ (Ga. 1975), *and* Russell v. Jim Russell Supply, Inc., 558 N.E.2d 115, 120 (Ill. App. 1990) (all stating that the adequacy of consideration for a contract must be determined at the time of entering into the contract).

326 . A possible compromise between these bright line tests would enforce only prebankruptcy contracts that do not, *ex post*, result in a secondary material impact. I actually started with such an approach but concluded that it was somewhat unsatisfying because parties could not rely on a particular prebankruptcy contract that later results in a secondary material impact even though, viewed at the time that contract was entered into, such an impact was unlikely. Without the ability to rely on enforcement of the contract, rational persons might be unwilling to give the debtor value in exchange for the contract, and prebankruptcy contracting would have limited practical application. *See supra* note XX and accompanying text.

transaction costs would be replaced by increased externalities; and under the second test, transaction costs would be replaced by higher bankruptcy administration costs due to fewer out-of-court settlements.[327]

It thus is interesting to observe that a form of prebankruptcy contracting already exists under the Code, and that Congress has chosen the first bright line test by which to apply it. A troubled debtor and one or more of its creditors are permitted to enter into a contract, called a security agreement,[328] whereby the debtor secures the creditor's antecedent debt.[329] Although it is possible to distinguish agreements securing antecedent debt from other forms of prebankruptcy contracting, the distinctions are not necessarily compelling. One might attempt to distinguish them on historical grounds, but a distinction based on the accident of historical usage is not conclusive. Another possible distinction is that, unlike waiver agreements, security agreements create property rights in the form of security interests. Nonetheless, I later argue that property and contract rights are merely part of an overall bundle of rights.[330] Yet another distinction is that security interests are perfected by providing actual or constructive notice to other creditors, but the same could be done for prebankruptcy contracts.[331] Furthermore, like a prebankruptcy contract, a security

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327 . See text accompanying notes XX-XX, *supra* (discussing how prebankruptcy contracting can reduce costs of bankruptcy administration by encouraging out-of-court settlements).

328 . Article 9 of the Uniform Commercial Code, generally adopted as law in all states, FA, empowers debtors to enter into security agreements in order to secure payment or performance of their obligations, *see* U.C.C. § 9-201 (199_) (____).

329 . *See* U.C.C. § 1-2-1(44)(b) ("[A] person gives `value' for rights if he acquires them . . . as security for . . . a pre-existing claim."). I purposely focus on agreements securing antecedent debt, as opposed to agreements securing new money loans. The debtor's consideration therefore would not be new money but, as with prebankruptcy contracts generally, more typically would consist of a waiver of default.

330 . See note XX, *infra*, and accompanying text.

331 . This distinction, however, does not seem to have normative significance. A filing system would be completely irrelevant for involuntary creditors. Filing also would not provide notice to

agreement creates externalities: the secured creditor would be paid prior to the debtor's nonconsenting creditors.[332] Yet security agreements are generally enforceable in bankruptcy.[333] By analogy, then, one could argue that the existence under the Code of a bright line test favoring these security agreements justifies a bright line test favoring prebankruptcy contracting generally. However, because my analysis is normative, I am not making that argument. I am only suggesting that if a bright line test were desirable, there is precedent for it.

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pre-existing creditors; indeed, those creditors, being aware of the possibility of prebankruptcy contracting, would not need specific notice in order to price their credit. Adopting a filing system, however, would impose transaction costs. *See supra* note , (citing articles discussing possible filing systems).

332 . Security agreements, which are entered into between a debtor and one or more creditors prior to bankruptcy, give the secured creditors priority to repayment out of designated assets in the event the debtor later goes bankrupt. *See* Bankruptcy Code, 11 U.S.C. § 506(a) (199_); U.C.C. §§ 9-301(1)(a), 9-312(5). The normative analysis for enforcing security agreements would appear to be the same as that for enforcing prebankruptcy contracts: whether the benefits outweigh the harm to unsecured creditors as a class. *Compare* SCHWARCZ, *supra* note , at 480- 83 (arguing that the normative justification for new money secured credit is its class Pareto efficiency), *with* Bebchuck & Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy* (questioning the legitimacy of security agreements because they create externalities).

333 . A bankruptcy trustee can avoid a security interest in two important situations. If the debtor becomes subject to bankruptcy within 90 days following the transfer of the security interest, the interest may be able to be avoided as a preference. *See* 11 U.S.C. § 547(b) (stating additional requirements and time periods not relevant here). If the debtor grants the security interest with specific intent to hinder, delay, or defraud creditors, the trustee can avoid it. *See id*. § 548(a)(1) (providing that transfers of collateral made with such intent are voidable as fraudulent conveyances). I later discuss these provisions in the context of the parallel between prebankruptcy contracts and contracts to secure antecedent debt. See text accompanying notes XX-XX, *infra* (discussing that parallel under the bankruptcy policy of equality of distribution and noting that prebankruptcy contracts would be subject to preference law) and text accompanying notes XX-XX, *infra* (discussing that parallel under the bankruptcy policy of debtor rehabilitation).

Subject to those limitations, the analysis has suggested that prebankruptcy contracts that do not, or that *ex ante* are unlikely to, result in a secondary material impact should be enforceable from the standpoint of contract externalities. I next examine whether those prebankruptcy contracts also should be enforceable from the standpoint of bankruptcy policies.

. *Bankruptcy Policies* I start the analysis of bankruptcy policies by examining the policy of equality of distribution. Thereafter I examine the policies of debtor rehabilitation and economical administration of the bankruptcy estate.

. *Equality of distribution* Procedure contracts under existing law are unlikely to cause externalities because all creditors must agree to the contract, and no rational creditor would agree to be harmed.[334] For the same reason, the proposed procedure contracts also are unlikely to violate the policy of equality of distribution.[335] Waiver contracts, on the other hand, which are entered into precisely to favor the contracting creditor, are more likely to violate that policy. My analysis of equality of distribution therefore focuses on waiver contracts.

The analysis proceeds in two steps. I first show that rights created by a state law contract should be enforced in bankruptcy unless a federal interest requires a different result. I then argue that the federal interest of equality of distribution should not require a different result so long as secondary material impacts are unlikely.

The enforceability in bankruptcy of state law rights has been addressed by the Supreme Court. In *Butner v. United States,*[336] a unanimous Court adopted a view, already held by the Second, Fourth, Sixth, Eighth, and Ninth Circuits, that property rights are determined by state law and that the involvement of an interested party in a bankruptcy proceeding has no effect on these rights:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed

334 . See text accompanying note XX, *supra*. Thus, a rational unsecured creditor would not voluntarily subordinate the priority of her claim which, absent contractual subordination, would share equally and ratably with other unsecured claims. *See* note XX, *supra* (explaining that unsecured claims have equal priority).

335 . *Cf. infra* subpart IV(D); *infra* text accompanying notes XX-XX (discussing whether procedure contracts based on supermajority voting would violate the policy of equality of distribution).

336 . 440 U.S. 48 (1978).

differently simply because an interested party is involved in a bankruptcy proceeding. . . . The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests . . . .[337]

The Court reasoned that "[u]niform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a [debtor] from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'"[338] Although there are no cases directly on point,[339] the Court's logic appears to apply not only to property rights but also to state law contract rights. Uniform treatment of contracts likewise would reduce uncertainty and would prevent a debtor from receiving a windfall merely by filing bankruptcy to impair rights under those contracts.[340] Furthermore, property is merely a bundle of rights, and it would be inconsistent to treat unbundled rights, such as contract rights, differently from bundled rights for purposes of this analysis.[341]

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337 . *Butner* 440 U.S. at 55 (citations omitted).

338 . *Id*. (quoting Lewis v. Manufacturers Nat'l Bank, 364 U.S. 603, 609 (1961)).

339 . In several cases, though, courts have deferred to state contract law in determining whether a contract was executory under § 365 of the Code. *See, e.g.*, *In re* Columbia Gas Sys. Inc., 50 F.3d 233, 241 (3d Cir. 1995) (deferring to state law in determining whether a class action settlement was a contract and, if so, whether it was executory); *In re* Streets & Beard Farm Partnership, 882 F.2d 233, 241 (7th Cir. 1989) (looking to state law to determine whether the remaining obligations on an installment contract were significant enough to render the contract executory).

340 . The Code does permit a debtor in bankruptcy to terminate executory contracts, subject to becoming liable for a prepetition claim for contract breach. *See* Bankruptcy Code, 11 U.S.C. § 365(a), (g) (199_). Presumably, a well-drafted prebankruptcy contract would not be executory. FA.

341 . On the other hand, bankruptcy law tends to recognize property rights, but often impinges on contract rights. *Compare* 11 U.S.C. § 506(a), *with id*. § 365. That counterargument would not be compelling, however, because the distinction between property and contract increasingly is being questioned by scholars. *See, e.g.*, Saul Levmore, *Obligation or Restitution for Best Efforts*, 67 S. CAL. L. REV. 1411, 1413 (1994) (discussing the linkage between contract and product liability

According to *Butner*, however, even state property rights can be overridden by a federal interest. Although the Court did not define what constitutes such a federal interest, the Code's policy of equality of distribution surely should qualify. Thus, a prebankruptcy contract that is likely to result in a secondary material impact impairing equality of distribution may not be protected under *Butner*. But what about a prebankruptcy contract that is *unlikely* to result in such an impact? While this cannot be answered dispositively in the absence of authorities, my efficiency analysis has shown that enforcing those contracts would economically benefit, overall, the very class of creditors that the policy of equality of distribution is intended to protect—unsecured creditors. This economic benefit arises because prebankruptcy contracting provides a debtor with liquidity and encourages out-of-court settlements, in effect enhancing the federal interests of debtor rehabilitation and economical administration of the bankruptcy process.[342] The enhancement of these federal interests to some extent offsets against any detraction of the federal interest in equality of distribution that prebankruptcy contracting may cause. Indeed, the net effect of prebankruptcy contracting[343] on unsecured creditors as a class already has been shown to be economically beneficial in general.[344] The balance of federal interests thus appears to weigh in favor of prebankruptcy contracting.

Even if a court were to disagree with this balancing, it is far from clear under *Butner* that the federal interest in equality of distribution requires a different result than enforcing prebankruptcy contracts. The dominant expression of equality of distribution under bankruptcy law is

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law); Jay M. Feinman, *The Jurisprudence of Classification*, 41 STAN. L. REV. 661, 664 (1989); Michael W. McConnell, *Contract Rights and Property Rights: A Case Study in the Relationship Between Individual Liberties and Constitutional Structure*, 76 CAL. L. REV. 267, 271 (1988) (arguing that the contracts clause and the takings clause should be interpreted with more flexible concepts of contracts and property).

342 . *See supra* note XX and accompanying text.

343 . Assuming such contracting is unlikely to result in a secondary material impact.

344 . See notes XX-XX, *supra*, and accompanying text (showing that prebankruptcy contracting would be class Pareto efficient after taking into account the losses to nonconsenting creditors should the debtor fail).

found in Section 547(b),[345] the Code's preference provision. Prebankruptcy contracts would be subject to that provision just as would anything else affected by preference law.[346] Thus, a waiver contract could be avoided as a preference if it were made within 90 days of the debtor's bankruptcy.[347] Because the enforcement of prebankruptcy contracts, subject to preference law, would not impair the federal interest in equality of distribution as articulated in the Code, there should be no reason for the federal interest in equality of distribution to require a different result than enforcement.

For still another reason, prebankruptcy contracts should be enforced, notwithstanding their potential impact on equality of distribution. As previously discussed, the Code already permits a form of prebankruptcy contract: agreements securing antecedent debt.[348] Even though such agreements impair equality of distribution by giving newly secured creditors priority over unsecured creditors, the rearrangement of priorities is not deemed to violate bankruptcy policy;

345 . FA. *See* 11 U.S.C. § 547(b).

346 . In other words, I propose that a prebankruptcy contract would be fully subject to preference law even if it were otherwise enforceable.

347 . The preference provision covers transfers of the debtor's interests in *property*. *See* 11 U.S.C. § 547(b) (stating additional requirements and time periods not relevant here). The debtor's waiver of the stay would appear to constitute a transfer of an interest of the debtor in property, property being a bundle of rights within the meaning of that subsection. FA. The Code could be amended, in any event, to clarify that waiver contracts are subject to preference law.

There is an exception to preference law if the debtor receives new value consisting of "money or money's worth in goods, services, or new credit." 11 U.S.C. §§ 547(c)(1), (a)(2). Even though a prebankruptcy contract itself should constitute "value" under fraudulent conveyance law, it would not constitute "new value" under preference law's more limited definition. *Compare id*. § 548(d)(2)(A), *with id*. § 547(a)(2) (both defining the concept of value applicable to the particular section). Furthermore, any attempt to waive the preference provision of Section 547(b) itself would directly violate the policy of equality of distribution and therefore should be unenforceable.

348 . *See supra* text accompanying notes -.

indeed, it is regarded as "fair and equitable."[349] *A fortiori*, prebankruptcy contracts that are unlikely to result in secondary material impacts should be enforceable.

For these reasons, I believe that prebankruptcy contracts that *ex ante* are unlikely to cause secondary material impacts ought to be enforceable, notwithstanding that in individual cases equality of distribution could be impaired.

The analysis next shifts to the effect of prebankruptcy contracting on the debtor itself as I examine the bankruptcy policy of debtor rehabilitation.

. *Debtor rehabilitation*As noted earlier, prebankruptcy contracting can *enhance* the policy of debtor rehabilitation.[350] Now I consider the ways in which prebankruptcy contracting might impair that policy.

Procedure contracts, which debtors themselves seek *on their own initiative* as alternatives to the bankruptcy process,[351] would be unlikely to significantly impair that policy. A rational debtor would not seek to enter into a contract that impedes its rehabilitation. Indeed, the debtor's motivation may well be to increase the likelihood of its rehabilitation. There may, of course, be mistakes: the debtor may not foresee or may miscalculate how an alternative procedure could affect its rehabilitation. The reorganization process under Chapter 11 of the Code, however, is likewise imperfect. There is inherent unpredictability in *any* bankruptcy rehabilitation procedure.[352] It therefore is reasonable to presume that debtors that wish to enter into procedure contracts

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349 . *See, e.g.*, 11 U.S.C. § 1129(b) (requiring a fair and equitable reorganization plan to generally protect the full value of a secured creditor's claim).

350 . *See supra* note XX and accompanying text (observing that waiver contracts could encourage out-of-court settlements and maximize a debtor's liquidity, thereby enhancing the bankruptcy policy of debtor rehabilitation).

351 . *See* text accompanying note XX, *supra* (defining procedure contracts).

352 . Any evaluation of whether procedure contracts generally would advance or impede debtor rehabilitation would require a comparison of the relative likelihood of rehabilitation under procedure contracting and under Chapter 11. But empirical data for that comparison do not presently exist because there are no outstanding procedure contracts from which data can be derived.

should have the flexibility to do so—at least from the standpoint of debtor rehabilitation—so long as such contracts do not manifestly impair their rehabilitation.[353]

Waiver contracts, in contrast, are not sought by debtors on their own initiative. Rather, they are sought by creditors that want the debtor to waive its bankruptcy protections, often without regard to the effect of the waiver on the debtor's ability to rehabilitate.[354] The analysis of the impact of waiver contracts on debtor rehabilitation therefore must take into account the effect of the contract both on the debtor's value and on its efforts to reorganize.[355]

As to the first issue, value, the concept of secondary material impact again is useful. Foreclosure on easy-to-value financial assets, for example, may deprive the debtor of cash collections but would not materially impact the debtor's value.[356] But if the collateral were the customized widget machine, the impact on the debtor of a foreclosure would be as devastating to the debtor as it would be to nonconsenting creditors because, without the machine to operate, the debtor's business

353 . This situation should be distinguished from the cases holding that debtors cannot be compelled to waive their right to file for bankruptcy. *See supra* note (citing cases).

354 . Institutional creditors such as banks and insurance companies typically focus only on recovery of their claims. Trade creditors, on the other hand, may prefer the debtor to continue in business in order to continue the provision of goods and services. *See supra* text accompanying note .

355 . For example, the filing of multiple bankruptcies by a debtor may well suggest that rehabilitation potential is already de minimis. *Cf. In re* Madison, 184 B.R. 686, 689 (Bankr. E.D. Pa. 1995) ("[W]e reject the Debtor's implicit assertion that the sixth filing eradicates any power of this court to examine her conduct in the course of the fifth filing.").

356 . *See supra* notes - and accompanying text. The discussion below shows that if, in individual cases, the debtor needs to use the cash collections in order to preserve its value, it could do so after notice and a hearing by providing adequate protection, most likely in the form of substitute collateral. *See infra* note and accompanying text.

may be destroyed.[357] Therefore, as to value, the analysis is similar to that used for determining whether waiver contracts cause material externalities.

The second issue, the effect of the waiver contract on the debtor's efforts to reorganize,[358] is more difficult to analyze. The impact of the contract on rehabilitation depends on variables that will not be known until the bankruptcy itself. For example, foreclosure on financial assets may deprive a debtor of a source of reorganization financing, which could be troublesome if the debtor lacks other sources of financing.[359] The collateral also may be needed for an effective reorganization of the debtor,[360]a determination that may be difficult to make even at the outset of a bankruptcy case, much less before bankruptcy.[361] Therefore, it is harder to assess in advance the extent to which the policy of debtor rehabilitation will be affected by a particular waiver contract, suggesting that the enforceability of waiver contracts should be judged *ex post*.

If parties to a waiver contract could not determine its enforceability until the debtor was in bankruptcy, however, creditors would be discouraged from offering valuable consideration for the

357 . Thus, waiving the automatic stay for all creditors, not just for the creditor desiring the waiver, would be an imperfect solution. Even though it would enhance equality of distribution, it would impair debtor rehabilitation because creditors then may be able to foreclose on the operating assets.

358 . Reorganization means that the debtor will become a viable business entity and avoid being liquidated.

359 . *See* Pantaleo et al., *supra* note , at 186 ("[T]he financial assets of a business are often a prime source of collateral for debtor-in-possession financing." *But see infra* notes - and accompanying text (discussing that even if the automatic stay is waived, a debtor still may be able to use the financial assets and cash collections thereof by providing the secured creditor with "adequate protection").

360 . *Cf*. Bankruptcy Code, 11 U.S.C. § 362(d) (1994) (permitting a bankruptcy court to grant relief from the automatic stay under various circumstances provided that the "property is not necessary to an effective reorganization" of the debtor).

361 . *See* Telephone Interview with Arthur Steinberg, *supra* note .

contract.[362] That, in turn, would impair a debtor's ability to offer a waiver in exchange for financing or other valuable consideration, thereby making it more difficult for the debtor to reorganize outside of bankruptcy *and impeding the very same policy of debtor rehabilitation*.[363] It therefore is desirable to find an approach that promotes debtor rehabilitation while allowing parties to rely on waiver contracts.

Interestingly, fraudulent conveyance law,[364] the only provision of the Code that both has a basis in the policy of debtor rehabilitation and that might invalidate prebankruptcy contracting, already incorporates a "safe harbor" that allows parties to rely on prebankruptcy contracts.[365]

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362 . *See* Tracht, *supra* note , at 344-45. Also compare text accompanying notes XX-XX, *supra* (arguing, in the context of equality of distribution and externalities, for the importance of an *ex ante* determination of enforceability of prebankruptcy contracts).

363 . In addition to rehabilitation *in* bankrupcy, courts have held that rehabilitation *outside of* bankruptcy also promotes the bankruptcy policy of promoting debtor rehabilitation. *See, e.g.*, *In re* Timbers of Inwood Forest, Ltd., 793 F.2d 1380, 1405 (5th Cir. 1986), *aff'd sub nom.*, United Sav. Ass'n v. Timbers of Inwood Forest, Ltd., 484 U.S. 365 (1988); *In re* Jenkins Court Assocs. L.P., 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995); *In re* Cheeks, 167 B.R. 817, 818-19 (Bankr. D.S.C. 1994); *In re* Hudson Manor Partners, No. 91-81065HR, 1991 Bankr. LEXIS 2145, at *6 (Bankr. N.D. Ga. Dec. 31, 1991); *In re* Colonial Ford, 24 B.R. 1014, 1017-19 (Bankr. D. Utah 1982). The Code also recognizes that it may be appropriate for a bankruptcy court to decline jurisdiction when parties have reached an adequate out-of-court settlement. *See* H.R. REP. NO. 95-595, at ___ (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6281 (providing the legislative history for 11 U.S.C. § 305).

364 . *See* 11 U.S.C. § 548 (permitting the bankruptcy trustee to avoid transfers made or obligations incurred within a year prior to bankruptcy under certain circumstances).

365 . Some may question whether fraudulent conveyance law has a basis in the policy of debtor rehabilitation. After all, commentators often describe the purpose of fraudulent conveyance law as creditor protection. *See, e.g.*, William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 102 n.27 ("This duty of creditor protection appears most notably in fraudulent

Contracts securing antecedent debt, a form of prebankruptcy

conveyance law."); Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C. L. REV. 1165, 1169 (1995) ("[W]hen the English courts held that a judgment creditor could disregard a fraudulent conveyance and levy execution on the property transferred, the fraudulent conveyance law became primarily one of creditor protection."). However, creditor protection *per se* is not a fundamental Code policy. The closest policy is equality of distribution to creditors. Does fraudulent conveyance law protect equality of distribution? The answer must be no. Fraudulent conveyance law is not concerned with equal distribution of the debtor's assets to creditors. *See In re* Roscar Steel Scrap and Metals Corp., 12 B.R. 629, 634 (S.D.N.Y. 1981) ("Unlike a preference, which is a violation of the rule of equal distribution among all creditors, a fraudulent conveyance is a deceitful device through which the debtor seeks to secure an advantage for himself out of what in law should belong to his creditors and not to him."). In fact, fraudulent conveyance law specifically permits unequal distribution by defining "value" to include the "satisfaction or securing of a present or antecedent debt of the debtor." 11 U.S.C. § 548(d)(2). Thus, if a debtor with assets of $1000 has three creditors, each with a claim of $1000, its payment in full of one of the creditors, leaving the other two creditors with no assets against which to assert a claim, does not violate fraudulent conveyance law. *See, e.g.*, Irving Trust Co. v. Chase Nat'l Bank, 65 F.2d 409, 410 (2d Cir. 1933) (noting that the "securing or paying of an actual debt, in good faith, without any design injurious to creditors beyond that implied in giving the preference, was not deemed a fraudulent conveyance under the principles of the common law," but that the payment may constitute a voidable preference under 11 U.S.C. § 547, a separate section of the Code that does address equality of distribution). In contrast, it is easy to demonstrate that fraudulent conveyance law protects debtor rehabilitation. By limiting the right of a debtor to transfer assets (or incur obligations) without obtaining reasonably equivalent value as consideration, the law attempts to ensure that the debtor's net assets will be preserved. *See, e.g.*, *In re* Bundles, 856 F.2d 815, 824 (7th Cir. 1987) ("[T]he purpose of section 548's avoiding powers [is] to preserve the assets of the estate."). Fraudulent conveyance law therefore protects *both* debtors and creditors. Indeed, debtor rehabilitation and creditor protection are mirror-image concepts because only creditors have substantive rights against an insolvent debtor. *See, e.g.*, James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 975 (1983) ("Reorganization proceedings are designed to preserve [a debtor's] going concern surplus for the benefit of the enterprise's creditors and investors.").

contracting,[366] are enforceable under fraudulent conveyance law so long as debtors receive value that, at the time of contracting, is seen to be reasonably equivalent to the value of the contract.[367] This promotes debtor rehabilitation by encouraging creditors to provide value that could help the debtor to reorganize. If that value is equivalent to what the debtor gives up, the net impact on debtor rehabilitation is deemed to be neutral. Logically, the same reasoning should apply to waiver contracts: they should be neutral from the standpoint of debtor rehabilitation if the debtor receives reasonably equivalent value.[368]

Still, in individual cases a court might feel uneasy if the debtor's out-of-court rehabilitation failed because the value, even though equivalent when given, was no longer available to the debtor to aid in its rehabilitation.[369] That concern, however, is not a defense to creditor

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366 . *See supra* text accompanying notes -.

367 . Under fraudulent conveyance law, reasonably equivalent value is determined *ex ante*, at the time of contracting. *See In re* Morris Communication, Inc., 914 F.2d 458, 466 (4th Cir. 1990) (noting that the critical time is when the transfer is made).

368 . An alternative way of thinking about this exists. Under fraudulent conveyance law, an insolvent debtor contemplating bankruptcy can grant a security interest in assets in exchange for reasonably equivalent value. Such a transfer can be viewed as a prebankruptcy contract in which a debtor waives its right to avoid transfers made in contemplation of bankruptcy by accepting the value. Although the prebankruptcy contract analogy is not precise because the debtor's waiver is mandatory and not consensual, the policy argument still obtains. I later show that the interpretation of reasonably equivalent value under fraudulent conveyance law would provide an established body of law on the meaning of that term. *See infra* text accompanying notes -.

369 . *See, e.g.*, *In re* Jenkins Court Assoc. Ltd. Partnership, 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995) (denying relief from the automatic stay and noting that, in a single-asset real estate case, enforcement of the waiver would mean that the debtor "will have no realistic opportunity to attempt to formulate a repayment or reorganization plan"). *But cf. In re* Club Tower L.P., 138 B.R. 307, 310 (Bankr. N.D. Ga. 1991) (enforcing a stay waiver because, although the debtor had "little hope of rehabilitation," it still retained most of the core bankruptcy rights, including an automatic stay as to other creditors and therefore still had the opportunity to rehabilitate).

reliance under fraudulent conveyance law—which largely ignores the debtor's subsequent misuse or loss of value[370]—perhaps because the failure of individual debtors is the necessary price of promoting debtor rehabilitation more generally.[371] The dissipation of value, therefore, should not be a defense to creditor reliance on waiver contracts.

In some circumstances, collateral may turn out to be essential to a debtor's ability to reorganize. For example, a debtor that waived the automatic stay prior to bankruptcy might find, if it has no liquidity, that unless it can use financial assets pledged as collateral, it will be forced to default on its payroll and close its doors. This concern can be addressed by distinguishing between waiver contracts that include a waiver of the right to use collateral and those that do not. A waiver of the automatic stay does not, by itself, prohibit the debtor from using the collateral. The Code still allows the debtor to *use* the collateral if it gives the secured creditor adequate protection, typically substitute collateral.[372] If the creditor bargains for a prebankruptcy waiver of the debtor's right to use collateral under Section 363, that waiver would be analyzed separately from the stay waiver and, because of its potentially more severe impact on debtor rehabilitation, would be less likely to be enforced.[373]

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370 . *See supra* note . If the debtor itself controls the use of the value, it should bear the burden of misuse. Even though creditors sometimes are able to impose covenants that monitor the debtor's use of proceeds, even that is imperfect because debtors can ignore the covenants or lose money in bona fide business operations.

371 . *Accord* Kronman, *supra* note , at 489 (arguing that a legislature must evaluate the effects of proposed rules on classes of persons rather than on particular, identifiable individuals).

372 . *See* Bankruptcy Code, 11 U.S.C.. §§ 363(c), (d), 361(2). Adequate protection includes "an additional or replacement lien." *Id*. § 361(2). Although subsection § 363(d) prohibits use that is inconsistent with stay relief ordered by a court, *see id*. § 363(d), contractual stay relief would not appear to prohibit such use. Moreover, unless the debtor's right to use collateral also is waived, a waiver should not prohibit the use. To avoid any doubt, subsection (d) could be amended specifically to permit such use.

373 . Waiver of the stay without waiving the debtor's right to use collateral would not defeat the purpose of the stay waiver because the debtor might not need to use the collateral in bankruptcy. Furthermore, even if the use would be necessary, the creditor's right to foreclose on

There still remains a question of how, under an *ex ante* reasonably-equivalent-value standard, one could value a waiver contract in order to determine if the debtor receives reasonably equivalent value. The problem is that a waiver, unlike an asset transferred by a debtor, is not a commodity with a *market* price. I later address this valuation question in the context of applying the theory.[374]

. *Economical administration of the bankruptcy process* It does not appear that prebankruptcy contracts such as waivers, which are desired by creditors to limit the debtor's bankruptcy protections, would affect the economical administration of the bankruptcy process. Furthermore, procedure contracts, which are desired by debtors to seek alternatives to the bankruptcy process, would be entered into precisely because the debtor wishes to make the process more efficient.[375] Prebankruptcy contracting therefore would not be expected to impair the policy of economical administration of the bankruptcy process.

I next integrate my approach and the foregoing analysis into a thesis and then, in Part IV, apply the thesis to representative transactions in which prebankruptcy contracts are likely to arise. My thesis reflects a dual perspective: acting as a free marketer in inquiring, as a normative matter, whether prebankruptcy contracting can make the bankruptcy system more efficient; but as a traditionalist in recognizing that political realities constrain the extent to which prebankruptcy contracting will be allowed to impinge on the Code's fundamental policies. Thus, the thesis is normative to the extent it views prebankruptcy contracting as a way of maximizing efficiency—redefining efficiency in this context by proposing that Kaldor-Hicks efficiency alone is insufficient, and that nonconsenting creditors be protected by imposing an additional standard of class Pareto efficiency. The thesis is traditionalist to the extent it inquires how the Code's

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the substitute collateral would not be stayed because the waiver would operate with regard to the replacement lien. *Cf. infra* note (discussing how rating agencies would view the difference between a waiver of the stay and a waiver of the debtor's right to use collateral).

374 . *See infra* text accompanying notes -.

375 . *Cf.* Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J. L. & ECON. 595, 595 (1993) ("A private workout ... should Pareto dominate a legal bankruptcy [because] each party could receive the share of the insolvent firm it would expect to get in bankruptcy plus a portion of the savings from avoiding the court.").

policies would limit the scope of efficient prebankruptcy contracting.[376]

. *Thesis*

1. Statement.—Provisions of the Code sometimes should be viewed as default, and not mandatory, rules. A prebankruptcy contract that is unlikely to result in a secondary material impact neither offends the bankruptcy policy of equality of distribution nor creates an externality that should be unenforceable under contract law.[377] This determination can be made *ex ante*, at the time of contracting.[378]

There still remains a risk that the prebankruptcy contract could impair the debtor's ability to rehabilitate. A court could assess that risk by observing *ex post* whether or not the debtor's ability to reorganize in bankruptcy has, in fact, been impaired by the prebankruptcy contract.[379] However, if parties to a prebankruptcy contract can not determine its enforceability until the debtor is in bankruptcy, creditors would be discouraged from offering valuable consideration for the contract, thereby making it more difficult for the debtor to reorganize outside of bankruptcy and impeding the policies of debtor rehabilitation and economical administration. Therefore, an *ex ante* solution to this

376 . My thesis thus contrasts with the approaches of Tracht who would enforce virtually all prebankruptcy contracts and Bogart who would enforce none. *See* Tracht, *supra* note , at 348; Bogart, *supra* note , at 1264-66. The *ex ante* test saves the thesis from being unpredictable. *Cf*. text accompanying notes XX-XX, *infra* (comparing my *ex ante* test with a "bright line" test).

377 . As a corollary, parties should be limited from contracting out of the preference provision of the Code, *see* 11 U.S.C. § 547, and other trustee-avoiding-powers that protect equality of distribution and other fundamental bankruptcy policies, *see e.g.*, *id*. §§ 544-546, 548, 553.

378 . *See* text accompanying notes XX-XX, *supra* (describing how the debtor and the beneficiary of a prebankruptcy contract, acting in good faith and performing appropriate due diligence, could decide prior to entering into the contract whether or not a secondary material impact is unlikely).

379 . The Code delegates broad powers to courts. *See* 11 U.S.C. § 105(a) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code]."). If the delegation is insufficient, the Code could be amended specifically to authorize *ex post* review.

problem is preferable.[380] I have proposed as a solution that prebankruptcy contracts be enforceable only if the debtor receives value that is reasonably equivalent to the value of the contract. This requirement would promote debtor rehabilitation by providing the debtor with value that could help it reorganize and by permitting enforceability to be judged *ex ante,* at the time the prebankruptcy contract is entered into. Therefore, a prebankruptcy contract for which the debtor receives reasonably equivalent value should be enforceable if, viewed *ex ante*, it is unlikely to result in a secondary material impact and does not manifestly impair a debtor's ability to be rehabilitated.

As a corollary of this rule, however, if the debtor does *not* receive reasonably equivalent value, the policy of debtor rehabilitation may be implicated even if the prebankruptcy contract has no secondary material impact. Therefore a bankruptcy court should be able to consider the enforceability of such contracts *ex post* and, as appropriate, enforce them or not based on whether the contract has impaired the debtor's ability to reorganize in bankruptcy. By the same token, if the prebankruptcy contract, at the time of contracting, is likely to (and later does) cause a secondary material impact, it may be unenforceable *even if* the debtor receives reasonably equivalent value. Of course, if the prebankruptcy contract is likely to (and does) cause a secondary material impact, *and* the debtor does not receive reasonably equivalent value, the contract clearly violates bankruptcy policies and should not be enforced.

2. Qualifications.—This Article analyzes, and therefore the thesis only is intended to apply to, prebankruptcy contracts that are either waiver contracts (which waive bankruptcy rights) or procedure contracts (which change bankruptcy procedures). The thesis would not necessarily apply to other conceivable prebankruptcy contracts, such as contracts that purport to grant administrative priority to prepetition unsecured claims or to claims for rejection of executory contracts.[381] Those contracts neither waive rights of a contracting party nor change procedures; rather, they purport to expand the application of substantive rights that arise solely by virtue of statutory

380. *See supra* text accompanying notes 328-333.

381. The Code provides that administrative priority claims have priority over unsecured claims. *See* 11 U.S.C. § 507(a). A claim for rejection of an executory contract is treated as a prepetition claim. *See id*. §§ 365(g)(1), 502(g).

authorization.[382] To the extent that statutory rights affect noncontracting parties, parties to a contract should no more be able to expand those rights than to create them *ab initio*.[383]

In applying the thesis, a distinction must be made between what the law is and what the law, as a normative matter, should be.[384] For example, the Code provides that *ipso facto* clauses, which purport to terminate or modify a contract if bankruptcy occurs, are unenforceable.[385] Although that is the law, it should not necessarily be the law. That Code section arose from a belief that *ipso facto* clauses

382. My thesis, however, may well apply to prebankruptcy contracts that do not purport to expand statutory rights. For example, in the next paragraph of the text, I argue that *ipso facto* clauses, which are neither waiver nor procedure contracts, should be enforceable subject to the limitations proposed in this Article.

383. It sometimes may be unclear whether a particular prebankruptcy contract waives claims or expands statutory rights. A prebankruptcy contract that purports to allow postpetition interest on unsecured claims implicitly waives the debtor's right in bankruptcy not to pay postpetition interest on unsecured claims. *See* 11 U.S.C. § 506(b) (permitting postpetition interest to accrue only on oversecured claims against an insolvent debtor). Under this interpretation, the waiver would be analyzed in accordance with this Article. Alternatively, the contract implicitly expands the application of the substantive bankruptcy right to receive postpetition interest. With this focus, the contract should not be enforced.

384. *See supra* text accompanying notes -.

385. *See* 11 U.S.C. § 365(e)(1) (providing, with exceptions not relevant here, that "[n]otwithstanding a provision in an executory contract [*i.e.*, a contract in which substantial performance is due on both sides such that the breach by one party would excuse performance by the other party], an executory contract . . . of the debtor may not be terminated or modified, and any right or obligation under such contract . . . may not be terminated or modified, at any time after the commencement of the [bankruptcy] case solely because of a provision [called an "*ipso facto* clause"] in such contract . . . that is conditioned on . . . the commencement of a [bankruptcy] case"); *supra* note (discussing the Code's non-enforcement of *ipso facto* clauses in contracts).

subvert bankruptcy policies.[386] *Ipso facto* clauses contained in prebankruptcy contracts, however, would not subvert those policies if they were subject to the limitations I have proposed for prebankruptcy contracting generally. As a normative matter, *ipso facto* clauses entered into after default for reasonably equivalent value that are unlikely to cause a secondary material impact *should* be enforceable.[387]

My analysis so far begs the question whether debtors that can obtain liquidity only through prebankruptcy contracting inevitably will fail, making efforts to delay the failure inefficient. I believe, however, that debtors that receive liquidity through prebankruptcy contracting will *not* inevitably fail. To understand why, assume that a debtor needs liquidity and cannot obtain it except through prebankruptcy contracting, and that its alternative is to file for protection under Chapter 11 of the Code.[388] Debtors that are likely to go bankrupt have strong disincentives[389] against entering into prebankruptcy contracts.[390]

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386 . *See* Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1310 (5th Cir. 1985) (stating that Section 365 "serves the purpose of making the debtor's rehabilitation more likely"). *But see* JACKSON, *supra* note 155, at 40-43 (arguing that the Code's justification for *ipso facto* clauses is unsatisfactory).

387 . *See* Schwartz, *Contract Theory Approach*, *supra* note , at 58-63 (arguing that *ipso facto* clauses should not be banned); Yeon-Koo Che & Alan Schwartz, Section 365 and Mandatory Bankruptcy Rules, (___, ___ 1997) (unpublished manuscript, on file with __________).

388 . *See* Bankruptcy Code, 11 U.S.C. §§ 1101-1174 (199_). For an introduction to Chapter 11 reorganization, see Steven L. Schwarcz, *Basics of Business Reorganization in Bankruptcy*, J. COM. BANK LENDING, Nov. 1985, at 36-44, *revised and updated in* A SPECIAL COLLECTION FROM THE J. COM. BANK LENDING 79 (1988).

389 . FA. Creditors that provide liquidity in the form of new money likewise would have strong disincentives against providing the liquidity. Creditors will not even want to make secured loans unless it helps an otherwise viable debtor avoid bankruptcy because the bankruptcy process has inherent imperfections that would impair the creditor's chance of repayment. Compare note XX, *infra* (discussing these imperfections in the context of rating agency ratings). For example, a secured creditor's collateral might be replaced by substitute collateral that the creditor values less, the creditor may be unable under fraudulent conveyance law to secure its debt by collateral of excessive value, and an oversecured creditor is not always legally entitled to its full collateral

In deciding whether to seek bankruptcy protection, a debtor's officers will want to keep their jobs and therefore will tend to decide in favor of choices that maximize their job security. If the debtor, even after obtaining liquidity, is still likely to go bankrupt, then the liquidity only delays the inevitable. Although delaying the inevitable sometimes can be valuable for managers who wish to retain their positions, the negative consequences of delay could wipe out the benefits of delay in the case of prebankruptcy contracting, because a bankrupt debtor's assets that are the subject of the prebankruptcy contract may be foreclosed on, possibly making it harder for the debtor to ultimately negotiate a successful plan of reorganization.[391] On the other hand, by choosing to file for reorganization under Chapter 11 without risking a prebankruptcy contract, the debtor may have greater flexibility in negotiating, and therefore a higher likelihood of reaching, a plan of reorganization. Although agency costs[392] could distort the decision, officers and directors often stay in their jobs during a reorganization and, if the debtor is successfully reorganized, they might even continue

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cushion. For a complete discussion of these bankruptcy imperfections, see Schwarcz, *supra* note , at 455-58.

390 . While a possible counterargument is that a bankruptcy filing has negative reputational effects for a debtor, those reputational effects are getting smaller as larger and more well-known companies take advantage of Chapter 11 to reorganize. *See infra* note and accompanying text. If the liquidity provided by the prebankruptcy contract would be futile anyway, those reputational effects would merely be delayed, not avoided.

391 . The inability to achieve a plan of reorganization may well lead to the debtor's liquidation. *See* 11 U.S.C. § 1112 (b) (providing that "the court may convert a case under this chapter [11] to a case under chapter 7 . . . for cause, including . . . (2) inability to effectuate a plan" of reorganization); *cf. id.* § 1123 (b)(4) (permitting liquidation of a debtor pursuant to a Chapter 11 plan).

392 . The term agency costs refers to the inherent conflict of interest between a firm and its managers. FA. Managers, for example, want job security and high income whether or not those goals benefit the firm.

as officers and directors of the reorganized company.[393] By maximizing job security, a Chapter 11 reorganization, not an ultimately futile prebankruptcy contract, may be in the outright self-interest of management.[394] Moreover, most business debtors are corporations,[395] which are managed by their boards of directors.[396] Directors generally owe their obligations to the corporation's shareholders.[397] They therefore would have an obligation to choose the Chapter 11 reorganization over a futile prebankruptcy contract, because the

393 . *See* Schwarcz, *supra* note , at notes XX-XX and accompanying text (explaining that the debtor's existing management may continue to manage the debtor during the course of its reorganization case; and arguing that, although two studies report that only a minority of incumbent corporate managers and directors remain in office following a corporate reorganization, even a less-than-50% chance of managers' retaining their jobs may be more attractive than the certainty of losing their jobs if the debtor is liquidated).

394 . An exception may arise when insiders of privately held companies fear the possibility of dividend or salary recapture or that insider loans made to them may be enforced in a bankruptcy. FA. In those situations, insiders might agree to an inappropriate prebankruptcy contract merely in order to avoid, or delay, scrutiny of a bankruptcy court. FA. When prebankruptcy contracts are primarily motivated by such conflicts of interest, I would argue that the debtor is not acting in good faith and the contract therefore should not be enforced. *See* note XX, *supra* (requiring that the parties to a prebankruptcy contract act in good faith).

395 . *See* Susan Block-Leib, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 AM. U. L. REV. 337, 351 n.39 (1993) ("Most often a business debtor will be a corporation, partnership, or other business association. . . .").

396 . The following analysis assumes that, as a matter of the applicable state's corporation law, the prebankruptcy contract would be subject to approval by the company's board of directors.

397 . *See* Pepper v. Litton, 308 U.S. 295, 306 (1939). *See generally* Schwarcz, *supra* note , at 665-68.

reorganization maximizes the likelihood of shareholder recovery.[398]

In individual cases, it nonetheless is possible who managers that wish to avoid Chapter 11 may be unrealistically hopeful in assessing whether the liquidity provided by a prebankruptcy contract will return the debtor to viability.[399] Chapter 11, however, no longer bears its former stigma and increasingly is regarded as an innovative approach to solve troublesome financial problems.[400] Without empirical evidence,

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398 . By entering into a futile prebankruptcy contract, a debtor would reduce its chance of a successful reorganization, yet shareholders tend to be paid more in a reorganization than in a liquidation. That is because shareholders only are entitled to the value, if any, that remains after creditor claims are paid in full in a liquidation. *See* Bankruptcy Code, 11 U.S.C. § 726(a) (199_) (specifying the order of distribution of the debtor's assets in a Chapter 7 liquidation). In a reorganization, however, creditors are motivated to share their recovery with shareholders in order to induce them to agree to a consensual plan. *See* Schwarcz, *supra* note , at 36.

399 . Professor Rose-Ackerman, for example, observes that "[w]hen already in a situation that offers little or no chance of gain [such as the prospect of a bankruptcy *liquidation*, as opposed to a reorganization], people take risks. They gamble on a chance of breaking even, although if things go wrong, they may incur very large losses." Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEG. STUD. 277, 294 (1991) (quoting KENNETH R. MACCRIMMON & DONALD A. WEHRUNG, WITH T.W. STANBURY, TAKING RISKS: THE MANAGEMENT OF UNCERTAINTY 195 (1986)). Professor Rose-Ackerman's observation appears to be based on prospect theory, which predicts that individuals who are performing above the success level that they seek to achieve (their "aspiration level") will prefer lower risk options and, conversely, that individuals who are performing below their aspiration level will prefer higher risk options. *See* Daniel Kahneman & Amos Tversky, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. RISK & UNCERTAINTY 297 (1992); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979) (introducing prospect theory).

400 . Professors Warren and Westbrook have commented on the trend: "Bankruptcy has lost some of its once overwhelming association with failure. . . . The once disreputable 'bully boy' of bankruptcy [Chapter 11] is becoming the 'innovative approach'" ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 830-31 (3d ed. 1996). Respectability, according to Warren

one therefore cannot assume that fear of Chapter 11 will cause unrealistic hopefulness to prevail over rationality in a relatively significant number of cases.[401]

Finally, I am assuming that allowing prebankruptcy contracting under the limited circumstances contemplated in this Article would not make a debtor's managers more likely to engage in risky ventures for the benefit of shareholders. For example, managers might gamble the proceeds of a loan made possible by a prebankruptcy contract in order to maximize shareholder value, even though such a gamble would prejudice involuntary creditors.[402] However, I have argued in another context that directors of a corporation should, and indeed under existing law may well, have a fiduciary duty to creditors as well as shareholders when a risky venture is reasonably expected to prejudice creditors.[403]

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and Westbrook, arose as a byproduct of the highly publicized, successful bankruptcy reorganizations of TOYS "R" US, Texaco, LTV Steel, Wickes Lumber, Zales Jewelers, and Macy's Department Stores. *Id*. at 830. Chapter 11 offers firms the possibility of using "the powerful provisions of the Bankruptcy Code [to] solve serious legal problems." *Id*. at 831.

401 . Even Rose-Ackerman acknowledges a trend toward rationality: "[T]he less painful Chapter 11 is for managers, the more likely they are to select the overall value-maximizing project . . . ." Rose-Ackerman, *supra* note , at 303.

402 . *See* Steven L. Schwarcz, *Rethinking A Corporation's Obligations to Creditors,* 17 CARDOZO L. REV. 647, 674 (1996) (explaining that even though a double-or-nothing gamble by a corporation with assets of $100 and debt of $90 increases shareholder expected value, it cuts the expected value of creditor claims in half because "the debt doesn't share in the upside, and creditors have a fifty percent chance of losing everything").

403 . *Id*. at 677-78 (arguing that "[d]irectors of an insolvent corporation, or of a corporation whose actions have a reasonable expectation of resulting in insolvency, have a fiduciary obligation to creditors as well as shareholders"). I need not assume that a debtor's managers avoid bad faith risky transactions because I propose that only prebankruptcy contracts made in good faith be enforceable. *See* text accompanying notes XX-XX, *infra*.

My assumption would be valid when that duty applies.[404]

. Transactional Application of Prebankruptcy Contracting

Having integrated my approach into a thesis, I now apply the thesis to representative transactions in which prebankruptcy contracts are likely to arise.

. *Debt Workouts.*

Waiver contracts are most likely to arise in debt workouts. In order to avoid bankruptcy, a debtor that has defaulted on its loan agreement tries to renegotiate with its lender the terms and conditions of the loan. Typically, the debtor will seek covenant relief (including waiver of existing defaults under the loan agreement), extension of the loan's maturities, and possibly additional credit. In return, the lender customarily seeks to secure its loan (if the loan is not already secured) and sometimes also seeks to have the debtor waive certain bankruptcy protections, such as the automatic stay. If the debtor grants such a waiver, should the state enforce it?[405]

I have shown that a workout in which the waiver is unlikely to cause a secondary material impact and for which the debtor receives reasonably equivalent value should be enforceable. A typical waiver of the automatic stay is unlikely to cause a secondary material impact with

404 . This assumption also is supported by my previous argument that debtors that are likely to go bankrupt have strong disincentives against entering into prebankruptcy contracts, and that a Chapter 11 reorganization, not an ultimately futile prebankruptcy contract, may be in the outright self-interest of management. *See supra* text accompanying notes XX-XX and XX-XX. Moreover, even though the existence of prebankruptcy contracting theoretically reduces, to some extent, the consequences of default, I believe that managers of the sophisticated debtors discussed in this Article will continue to want to avoid default, which has negative consequences irrespective of whether the default is later cured. A debtor in default may find, for example, that the default triggers defaults in its other credit agreements (so-called "cross defaults") and may dry up trade credit. A public debtor also will want to avoid having to announce its default under SEC disclosure requirements. I therefore assume that prebankruptcy contracting will be exogenous.

405 . This question only needs to be answered in cases where the debtor, notwithstanding the workout, eventually goes bankrupt. A successful debt workout would avoid the debtor's bankruptcy.

respect to some types of collateral.[406] But will the relief sought by the debtor constitute reasonably equivalent value for the waiver?

The question arises because a waiver contract has no obvious market in which it can be valued. That does not, however, mean that reasonably equivalent value fails as a standard in the context of waiver contracts. There is a solution that has both a normative justification and a precedent in existing fraudulent conveyance law.

The essence of a contract is a voluntary private exchange.[407] Ordinarily, therefore, one would expect a debtor that chooses to enter into a waiver contract to value the *quid pro quo* it receives as equivalent or superior to what it gives up. A concern, however, is whether a debtor in default truly can make a voluntary choice. I already have addressed this concern under contract law and concluded that, given the assumptions of this Article, contract law should enforce the debtor's choice.[408] I now address this concern under the bankruptcy law policy of debtor rehabilitation that underlies the reasonably equivalent value requirement.

From the standpoint of debtor rehabilitation, a debtor *should* be allowed to enter into a waiver contract, however imperfect that choice may be. As previously discussed, a debtor in a workout would enter into a waiver contract to obtain some form of liquidity; without liquidity, the debtor will have a higher risk of bankruptcy.[409] The availability of liquidity therefore enhances the debtor's ability to rehabilitate itself outside of bankruptcy. Indeed, liquidity is uniquely valuable to a troubled debtor because, dollar for dollar, it may provide significantly more value to the debtor than an ordinary commercial exchange. For example, a loan that facilitates the debtor's rehabilitation would increase the debtor's value far more than the amount of the loan. Liquidity that allows the debtor to rehabilitate therefore is a great bargain for the debtor. And even if the debtor ultimately fails in its effort to

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406 . *See supra* notes - (discussing that foreclosure on financial assets may not result in a secondary material impact).

407 . *See* TREBILCOCK, *supra* note , at 7 (defining contract as a "voluntary private exchange").

408 . *See supra* text accompanying notes - and accompanying text (discussing the enforceability of prebankruptcy contracts under contract law and analyzing duress and other paternalistic concerns as a defense).

409 . Liquidity may be provided, for example, in the form of new money, a loosening of covenants, or a waiver of default. *See supra* note ; *supra* text accompanying note .

rehabilitate, the mere opportunity to rehabilitate arguably should constitute value.[410] Accordingly, the question is not whether to curtail the availability of liquidity. Instead, the question is: Which person is best able to assess how the liquidity offered is likely to affect the debtor's ability to rehabilitate?[411] That person should decide whether the debtor should enter into the waiver contract in order to obtain the liquidity. That person, of course, is the debtor itself.

I recognize that a troubled debtor may not always make rational choices. The debtor sometimes may be overly optimistic, for example, of its chances for rehabilitation.[412] No other party, however, is better able than the debtor to make that choice *ex ante*. An alternative might be to allow the courts to make an *ex post* reassessment of the debtor's *ex ante* choice. However, liquidity then may dry up because few liquidity providers would be willing to be second-guessed.[413] I therefore propose

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410 . The mere opportunity to receive future economic benefits constitutes value under fraudulent conveyance law. *See, e.g.*, *In re* Chomakos, 69 F.3d 769, 771 (6th Cir. 1995) (holding that a debtor who legally gambles at blackjack receives reasonably equivalent value in the form of the chance to win $3 for every $2 bet). The court reasoned that the opportunity "is not unlike futures contracts purchased on margin. The investor in futures may win big, or his position may be wiped out, but the contractual right to a payoff if the market happens to move the right way at the right time constitutes a value reasonably equivalent to the money at risk." *Id.*; *accord*, *In re* R.M.L., Inc., 92 F.3d 139, 148 (3d Cir. 1996) (stating in dicta that an irrevocable payment for a loan commitment may constitute value even if the loan ultimately fails to be made).

411 . I do not need to worry here about the effect of a failed waiver contract on third parties because I have already addressed that concern in the context of limiting secondary material impacts.

412 . The concern then may be that the enhancement to the debtor's ability to rehabilitate outside of bankruptcy could be outweighed by the harm to the ability of those debtors who go bankrupt anyway to rehabilitate in Chapter 11. *But see supra* notes - and accompanying text (arguing that although a troubled debtor may at times be irrational, a general assumption of irrationality should not be made in the absence of empirical evidence).

413 . An *ex post* reassessment by a court might be analogous to the final cartoon in THE HAPPY HYPOCHONDRIAC, FA, a humorous book I read many years back. After surviving numerous scares and living a

that the debtor itself should be allowed to choose whether to enter into a prebankruptcy waiver contract. There may be occasions, however, when that choice is manifestly unreasonable. If, for example, no reasonable basis for the choice can be discerned, the parties may well be deemed to be acting in bad faith and the contract not enforced.[414] Nonetheless, in order to encourage parties to provide liquidity, the debtor's choice to enter into a waiver contract should create a presumption that the debtor will receive reasonably equivalent value in return. The presumption should be rebuttable only by a showing that at the time of the making of the contract there was no reasonable basis to believe that the debtor's ability to be rehabilitated might be improved as a result of entering into the contract.[415]

This proposal has precedent not only in fraudulent conveyance law but also in the application of that law to agreements securing antecedent debt, which I have shown is a form of prebankruptcy contracting.[416] Under Section 548(d)(2)(A) of the Code, which defines "value" for purposes of fraudulent conveyance law, a debtor that secures or pays an antecedent debt is *deemed to receive* reasonably equivalent value.[417] At first glance, that result seems illogical. The debtor receives nothing tangible by securing or paying its debts; rather, it *gives away* tangible collateral or cash. There are, however, two explanations for this apparent inconsistency. The historical explanation is that fraudulent conveyance law originally was intended to prevent fraud; and

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long life, the poor hypochondriac ultimately succumbs, as do we all. On his gravestone was written the words, "See, I told you I was sick." *Id*. at ___. A court making an *ex post* reassessment of a now bankrupt debtor's *ex ante* likelihood of rehabilitating would be tempted to reach that same conclusion.

414 . Prebankruptcy contracts that are primarily motivated by conflicting interest would typify this category. *See supra* note .

415 . A creditor entering into a waiver contract therefore may wish to consider the due diligence that would be appropriate to show that such a rational basis exists. Appropriate due diligence might include, for example, discussions with the debtor itself about its reasons for entering into the contract.

416 . *See supra* text accompanying notes - (describing agreements to secure antecedent debt as a form of prebankruptcy contracting presently recognized under the Code).

417 . *See* Bankruptcy Code, 11 U.S.C. § 548(d)(2)(A) (199_).

securing or paying a legitimate debt is not fraudulent.[418] A possible policy rationale, however, is that a troubled debtor may need the flexibility to secure or pay its debts in order to avoid default or reach an out-of-court settlement, thereby facilitating its rehabilitation. Thus, even under fraudulent conveyance law itself, the inability to verify the equivalence of values exchanged is irrelevant to the determination of reasonably equivalent value when the debtor is deemed to take an action that may facilitate its rehabilitation. The treatment of reasonably equivalent value under fraudulent conveyance law thus supports my proposal for allowing a debtor to choose whether to enter into a prebankruptcy waiver contract. The next subpart suggests, however, that the same conclusion may not apply to waivers made outside of a default context.[419]

. *Loan Agreements*

Should waiver contracts that are included in original loan agreements be enforced, assuming they would be enforceable if bargained for as part of a workout agreement? The concern is that absent a default, the debtor may not fully appreciate the significance of the

418 . *See, e.g.*, *In re* Lakeside Community Hosp., Inc., 200 B.R. 853, 857 (Bankr. N.D. Ill. 1996).

419 . An interesting twist on waiver of the automatic stay in a workout occurs when the creditor bargaining for the waiver is unsecured or undersecured. (An undersecured creditor's claim exceeds the value of the collateral; the Code bifurcates the claim into a secured claim for the amount of the collateral's value and an unsecured claim for the balance. *See* 11 U.S.C. § 506(a). If the stay is waived as to the unsecured claim, the creditor would recover from the debtor's assets *before* nonconsenting creditors have been paid, effectively subordinating and therefore having a material impact on their claims. Stay waivers therefore should not be allowed as to unsecured claims. *See In re* Sonnax Indus., Inc., 99 B.R. 591 (D. Vt. 1989), *aff'd,* 907 F.2d 1280 (2d Cir. 1990); *In re* Tristar Automotive Group, Inc., 141 B.R. 41 (Bankr. S.D.N.Y. 1992); *In re* Clark, 69 B.R. 885, *reconsidered*, 71 B.R. 747 (Bankr. E.D. Pa. 1987) (each holding that unsecured creditors are not entitled to relief from the automatic stay except in extraordinary circumstances); *see also In re* FRG, Inc., 114 B.R. 75 (E.D. Pa.), *rev'd*, FRG, Inc. v. Manley, 919 F.2d 850 (3d Cir. 1990) (holding that unsecured creditors would have to satisfy a higher burden than secured creditors in order to obtain relief from the stay).

waiver. At least one court already has expressed this concern.[420]

In a sense, this scenario recalls the Faustian-bargain analogy. Dr. Faustus entered into his contract with the Devil twenty-four years before the contract's troublesome consequences.[421] Human beings discount the significance of future events, especially those far in the future.[422] For additional reasons, waiver contracts placed in original loan agreements may be discounted by the debtor even further.[423] Not only will the troublesome consequence (the waiver) occur in the future

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420 . *See In re* Atrium High Point Ltd., 189 B.R. 599, 607 (Bankr. M.D.N.C. 1995) (noting that "[t]his was not a situation where a prohibition to opposing a motion to relief from stay was inserted in the original loan documents").

421 . *See* MARLOWE, *supra* text accompanying notes -.

422 . FA. *Cf*. Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 525-26 (1991) (arguing that people tend to underestimate the significance of low probability, high loss events). On the other hand, sophisticated counsel can help debtors assess such events more rationally.

423 . New York had a common law rule that refused to enforce a provision in a loan agreement that charged compound interest—interest on defaulted overdue interest. *See, e.g.,* Giventer v. Arnow, 372 N.Y.S.2d 63 (N.Y. 1975); Young v. Hill, 67 N.Y. 162 (1876); Stewart v. Petree, 55 N.Y. 621 (1874). The rule had the same rationale: debtors may not appreciate provisions in loan agreements that take effect only upon default. Courts believed that debtors were unlikely to realize the rate at which compound interest could accumulate. *See Giventer*, 372 N.Y.S.2d at 66; 72 N.Y. JUR. 2D *Interest and Usury* § 12 (1988). However, *after* a debtor defaulted in the payment of interest, courts would enforce agreements to pay compound interest. Debtors then would be more likely to be aware of the geometric rate of increase that results from compounding interest. *See, e.g.*, Newburger-Morris Co. v. Talcott, 114 N.E. 846, 847 (1916); *Young*, 67 N.Y. at 167. Although the New York legislature recently passed a statute to allow a loan agreement provision for compound interest, *see* N.Y. GEN. OBLIG. LAW § 5-527(1) (McKinney 1997), the motivation appeared to be pragmatic: the prohibition on compound interest "put New York at a commercial and financial disadvantage, [and] knowledgeable lenders and borrowers who seek clear authority for their compound interest or interest-on-interest loans often take their business to other states." 1989 N.Y. Laws 2108.

(at the time of the debtor's bankruptcy) but, unlike the inevitable time period facing Dr. Faustus, even the *occurrence* of the triggering event—bankruptcy—is uncertain and, if the debtor is financially robust, unlikely.[424] It is uncertain whether a healthy debtor at the time of the original loan agreement will adequately appreciate the significance of a waiver contract.[425] For this reason, a waiver contract included in an original loan agreement might not satisfy the standard of being "voluntary, knowing, and intelligently made."[426]

I already have argued that this lack of appreciation can be

424 . But should high risk firms be permitted to agree to binding prebankruptcy waivers in their loan agreements? Although they are more likely to appreciate the bankruptcy risks, it may be difficult to draw a line between high and lower risk firms. Furthermore, high risk firms may be subject to the same agency cost concerns described below, *infra* notes XX-XX and accompanying text.

425 . The operation of perceptual biases has been described as follows:

> "Sometimes people's perceptual apparatuses do not work well. They underestimate the chance that certain risks (floods, earthquakes, failures of the products they buy) will come to pass and as a result may not choose rationally when confronted with choices about such risks. ... When a person is confronted with a problem or risk for the first (or only) time in his life, the chance of error is greatest."

Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416, 1434 (1989).

426 . D.H. Overmyer v. Frick Co., 405 U.S. 174, 185 (1972). All contractual waivers must meet this standard. *See supra* notes - and accompanying text. The *Overmyer* Court itself stated that had the cognovit provision in question been included in "the initial contract" or been agreed to in advance of a default by the party executing such provision, the provision would not have been enforceable. *Id*. at 186. In this context, some might ask whether healthy debtors will appreciate the significance of entering into a security agreement, which after all is a type of prebankruptcy contract. They should, because the granting of collateral is significant even to a financially healthy debtor, *see* Schwarcz, *supra* note , at 431, and may involve conscious and deliberate steps by the debtor—*e.g.*, physically pledging the collateral or filing U.C.C. financing statements.

mitigated by the experience level of the debtor's bankruptcy counsel.[427] However, agency costs compound this lack of appreciation in a way that mere retention of bankruptcy counsel cannot solve. Managers of a healthy debtor—for which bankruptcy is viewed as a remote event—have an economic incentive to undervalue the cost of prebankruptcy waivers and, indeed, may perceive the waiver as relatively costless to them. That is because the waiver will not need to be disclosed at the time it is made,[428] and the possibility of eventual disclosure will be discounted by the typical manager who expects to have moved on to other companies well before a bankruptcy occurs.[429]

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427 . See text accompanying notes XX-XX, *supra* (arguing from the standpoint of paternalistic concerns that the failure of a financially robust debtor to appreciate the significance of a prebankruptcy contractual provision included as boilerplate can be mitigated by the experience level of the debtor's bankruptcy counsel).

428 . For a healthy company, the waiver could be viewed as immaterial and therefore not required to be disclosed in the notes to the financial statements or other information about the company. FA.

429 . FA. A survey of executive turnover trends indicates that turnover is significantly greater among firms that are facing bankruptcy. The chief executive officer resigned or was dismissed in the twelve months prior to bankruptcy in 20 of the 45 companies with assets greater than $50 million that filed for Chapter 11 between July 1, 1996 and June 30, 1997. Search of 1 STANDARD & POOR'S REGISTER OF CORPORATIONS, DIRECTORS, AND EXECUTIVES (1997) (supplementary search for chief executives); LEXIS, Bkrtcy Library, Bankruptcy Datasource- Data Pages File (July 15, 1997) (search for records of firms filing for bankruptcy and their chief executive officers); search of LEXIS, News Library, Curnws and Papers Files (July 15, 1997) (search for news reports indicating either that the chief executive officer resigned or was dismissed within the 12 months preceding the bankruptcy filing or that he/she held the position more than a year prior to the filing). In contrast, executive turnover among non-bankrupt corporations is noticeably lower. Chief Executive magazine reported that in 1994 only 39 of the 238 chief executive officers included in its annual CEO compensation survey had changed companies. Lori Grube, *CEO's at Risk*, CHIEF EXECUTIVE, Nov. 1995, at 42. The article also noted a study conducted by scholars at Northwestern University's Kellogg School of Management which indicated that of 413 large corporations (taken from the Forbes and Fortune 500 indexes), only 54 had changed chief executive officers in 1992. *See id*. (referring to James D. Westphal & Edward J. Zajac, *Who*

To counteract this undervaluing, I suggest that, absent actual or incipient default[430] at the time of contracting, waiver contracts generally should be unenforceable.[431]

Entering into a prebankruptcy contract at the original loan stage also may prematurely take away the contract beneficiary's incentive to give valuable liquidity.[432] In the context of prebankruptcy contracts to give collateral in exchange for loans, I have argued elsewhere that debtors have economic incentives not to give the collateral until they

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Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection, ADMIN. SCI. Q., Mar. 1995, at 60).

430 . By "incipient" default, I mean an event that but for the giving of notice or the lapse of time, or both, would constitute a default.

431 . *But see infra* subpart IV(C) (arguing that securitization transactions should be an exception to this general rule). Also, one could argue on a case-by-case basis that a debtor that undervalues a waiver contract does not receive reasonably equivalent value for it. However, it appears better to avoid the cost and uncertainty of litigating this issue for every bankrupt debtor's loan agreement that includes such a contract. This could become especially costly if waiver contracts became boilerplate provisions of loan agreements. The court in *In re Pease*, 195 B.R. 431 (Bankr. D. Neb. 1996), for example, cautioned that upholding a waiver of the automatic stay "would encourage institutional lenders to adopt standardized waiver terms in formal loan agreements," *id*. at 435. For a view that waiver contracts are unlikely to become boilerplate provisions, see Bogart, *supra* note , at 1124 ("[L]enders' counsel continually exhort their colleagues not to overuse the waiver [of automatic stay provision] (for example, by extracting the waiver at the initial loan stage rather than at workout). According to these attorneys, courts may view such behavior as overreaching and refuse to enforce the waiver in all situations."). *Accord*, Bradford F. Englander, "Developments Regarding the Enforceability of Pre-bankruptcy Waivers of the Automatic Stay," Bankruptcy Court Decisions 5, 6 (June 17, 1997) (advising practicing lawyers that "gross overreaching in the use of a waiver can result in unfortunate consequences").

432 . See text accompanying notes XX-XX, *supra* (discussing how prebankruptcy contracting allows a troubled debtor to obtain needed liquidity).

need liquidity and have no other source of funds.[433] That is because borrowing on a secured basis has a cost, which I call theta (), that reflects, among other things, the lost opportunity of having the pledged assets available to use as collateral if the debtor later faces a liquidity crisis. However, whereas the value of is large for collateral, it may be somewhat smaller for other types of prebankruptcy contracts. One of 's components is the reputational cost.[434] That cost may be higher for collateral, which must be recorded as a matter of public record to be perfected,[435] than for prebankruptcy contracts such as waivers of the automatic stay, which are not matters of public record.[436] If is smaller for waiver contracts, debtors may succumb more prematurely to creditor pressure to enter into waivers. Restricting waiver contracts to post-default situations would ameliorate that pressure.

. *Securitization Transactions*

One of prebankruptcy contracting's most important potential applications is to securitization. Described as "becoming one of the

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433 . *See* Schwarcz, *supra* note , at ____.

434 . Of course, the reputational cost of prebankruptcy contracting, depending on the contract, may be greater than the reputational cost of secured debt. *See* discussion of the reputational cost of waiving the automatic stay, *supra* note XX.

435 . *See* U.C.C. § 9-302 (1995) (requiring that a financing statement be filed to perfect a security interest in collateral).

436 . Whether prebankruptcy contracts *should* be recorded as a matter of public record is beyond the scope of this discussion. *See supra* note 90 (referring to arguments by Professors Tracht, Rasmussen, and Skeel regarding the filing of prebankruptcy contracts); *supra* note ___ (examining the normative significance of such a filing system); *see also* Carl S. Bjerre, Secured Financing Inside Out: Reflections On Making Negative Pledge Covenants Perfectible (forthcoming Cornell Law Review) (addressing whether negative-pledge covenants should be recorded). Although a filing system alone cannot address the problem of a creditor extending credit prior to the execution and filing of a later-made waiver, a creditor that wished to restrict its debtor from entering into future waiver contracts could request the debtor to enter into a "negative waiver" covenant. *See* note XX, *supra* (discussing the possibility of enforcing such covenants).

dominant means of capital formation in the United States,"[437] securitization is a financial technique whereby a debtor transfers rights in receivables or other financial assets to a special purpose vehicle ("SPV"), which in turn issues securities to capital market investors and uses the proceeds of the issuance to pay for the financial assets. The investors buy the securities based on their assessment of the value of the financial assets, without concern for the debtor's financial condition.[438] Thus, companies that otherwise cannot obtain financing now can do so; and even companies that can obtain financing now may be able to do so at lower cost.[439]

The success of a securitization transaction depends on the rating that independent rating agencies, such as Standard & Poor's and Moody's, assign to the securities. A higher rating makes it more likely that investors can be found to buy the securities.[440] To obtain a high rating, most debtors need to structure their sale of financial assets to the SPV in a way that will be respected in the event of the debtor's bankruptcy: the so-called "true sale."[441] That structure, unfortunately,

437 . Investment Company Act Release No. 19,105, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85062, at 83500 (Nov. 19, 1992) (provided in connection with the Securities and Exchange Commission's issuance of Rule 3a-7 under the Investment Company Act of 1940).

438 . *See generally* Schwarcz, *Alchemy*, *supra* note , at 141.

439 . *Id*. at 141, 146 (showing that securitization can be less expensive than alternative funding sources and, even if not less expensive, can provide valuable "off-balance sheet" funding).

440 . Inversely, a higher rating lowers the rate of return needed to attract those investors. *See* Hill, *supra* note , at ___.

441 . "True sale" means a sale that bankruptcy courts would recognize, under the Bankruptcy Code, 11 U.S.C. § 541 (creating the debtor's estate in bankruptcy and defining the property constituting it as transferring title to the assets from the debtor to the SPV. FA.

sometimes is difficult,[442] and almost always very expensive,[443] to achieve in a way that preserves the competing economic requirements of the debtor and the SPV.[444]

That difficulty and cost can be greatly minimized, however, by permitting the debtor to enter into a prebankruptcy contract which waives any future application of the automatic stay against the SPV. Absent the stay, the debtor would not need to transfer its financial assets to the SPV as a true sale in a complex two-tier structure, because even if the debtor goes bankrupt, the SPV could continue using the proceeds of the financial assets to pay investors. The securities therefore could be rated close to the level of a true sale[445] and the

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442 . *See* Schwarcz, *Alchemy*, *supra* note , at 141-42 (describing the tension between achieving a true sale for bankruptcy purposes and making the transaction economically viable).

443 . *See* Pantaleo et al., *supra* note at 162 & n.8 (describing a two-tier structure).

444 . Can one simply specify in a prebankruptcy contract that a given transfer of assets constitutes a true sale? After all, property is a bundle of rights, and if all rights can be waived, why can't two parties simply agree that their transaction will constitute a sale? I believe they cannot because ownership rights are not merely what one calls ownership but rather a court's characterization of the bundle of rights that one possesses. If, for example, a transferor of an asset is entitled to the residual value of the asset after the transferee gets its bargained economic return, courts say that the "ownership" of the asset belongs to the transferor irrespective of where the parties say that ownership lies. *Cf*. *id*. at 172 n.45 (raising the possibility of an expansive theory of sale that would give more credence to how the parties characterize the transfer and less credence to the economic incidents of the bargain).

445 . From the standpoint of a true sale, rating agencies consider three issues in deciding whether to assign the highest "AAA" rating, assuming all other criteria (such as the quality of the financial assets) meet the standards of that rating. FA. The first, and most important, issue is whether enforcement would be subject to the automatic stay in bankruptcy. If the stay is waived, that issue goes away. The second issue is whether the collateral is subject to substitution by the debtor. The significance of that issue turns on whether the debtor can offer substitute collateral and whether the debtor's right to use collateral under § 363 has been waived. If it has been waived, that issue also goes away. (Waivers of the debtor's right to use collateral may be harder to justify

debtor would save significant transaction costs.[446] Waiver contracts thus would make it easier and less costly for debtors to use securitization.

Because securitization transactions affect only a debtor's *financial* assets, waiver contracts rarely would be expected to result in a secondary material impact.[447] However, the limitation that waiver

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because then debtors could not use cash collections of financial assets for working capital needs, which might impair debtor rehabilitation. *See* text accompany note XX, *supra*.) The third issue is whether the secured party is entitled to its entire collateral cushion. For example, a rating agency may have required a very high level of overcollateralization in order to ensure that the secured creditor will always be paid even if defaults turn out to greatly exceed the historical default levels. Yet, an oversecured creditor is not always legally entitled to its full collateral cushion because a court, in the exercise of its equitable powers under 11 U.S.C. § 105(a), may decide that some portion of that cushion is unnecessary to protect the creditor. *See, e.g.*, *In re* T.H.B. Corp., 85 B.R. 192, 194-95 (Bankr. D. Mass. 1988) (holding that a debtor may use cash collateral without granting a substitute lien or making cash payments because the remaining collateral constituted a "sufficient 'cushion' of collateral value in excess of the debt," and "the [remaining] collateral value far exceed[ed] the debt"). Thus, a rating agency will be unable to assign a "AAA" true sale rating, but nonetheless may be able to get close to that rating depending on the facts of the particular case. *See* Telephone Interview with Petrina R. Dawson, Managing Director and Associate General Counsel, Standard & Poor's Ratings Services (July 31, 1997). *See also* Solomon B. Samson & Gail I. Hessol, *Ultimate Recovery in Ratings: A Conceptual Framework*, STANDARD & POOR'S CREDITWEEK, Nov. 6, 1996, at 25 (analyzing a new policy for enhancing a security's rating above the issuer's credit rating if virtually full recovery, although delayed, can be anticipated, in the event of a default). These issues, of course, are related to the same bankruptcy imperfections that we previously encountered in the efficiency argument, *supra* note 392.

446 . The debtor has a secondary benefit in structuring the transfer of financial assets to the SPV as a secured loan and not a true sale because, in a secured loan, the debtor is entitled to any surplus value in the financial assets once the SPV were repaid on its loan. *See* U.C.C. §§ 9- 502(2), 9-504(2) (1995).

447 . *See supra* text accompanying notes XX-XX.

contracts be entered into after default[448] would greatly restrict the application of prebankruptcy contracting to securitization transactions, many of which are entered into absent default.[449] But there are reasons why this limitation should not apply to securitization transactions.

I have argued that a healthy debtor may not appreciate the significance of a waiver contract because people discount the significance of future events, especially when the occurrence of the troublesome consequence (the waiver) is unlikely,[450] and that this lack of appreciation is compounded by the problem of agency costs in that managers of healthy companies systematically will undervalue waiver contracts.[451] These concerns, however, are less likely to arise in securitization transactions. Whereas a prebankruptcy waiver merely would be one of the many terms of a loan agreement and perhaps be treated as "boilerplate," it would be at the core of the bankruptcy-remote structure of a securitization and central to its disclosure. That is because the most critical goal of securitization is to ensure that the debtor's bankruptcy will not affect investors in the SPV's securities. Indeed, parties such as rating agencies that scrutinize the transaction start their analysis with the assumption that the debtor *will* go bankrupt.[452] Thus, even a healthy debtor should appreciate the

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448 . *See supra* text accompanying notes XX-XX.

449 . *See* Schwarcz, *Alchemy*, *supra* note , at 137 ("Even an originator [debtor] with an investment grade rating [on its securities] may derive benefit from securitization if the SPV can issue debt securities with a higher investment grade rating and, as a result, significantly decrease the originator's interest costs."). A healthy debtor also can benefit by obtaining capital market debt funding without having to record a liability on its balance sheet. *Id*. at 142-43.

450 . Because its triggering event—bankruptcy of the debtor—may not occur.

451 . *See supra* text accompanying notes - (arguing that systematic undervaluing will occur because waiver contracts are not required to be disclosed and managers expect to move on to jobs at other companies well before a bankruptcy occurs).

452 . *See, e.g.*, Standard & Poor's Structured Finance Ratings, Asset-Backed Securities, Credit Card Criteria (April 1996), at 10: "Standard & Poor's worst-case scenario assumes the bankruptcy or insolvency of each transaction participant that is deemed not to be a

central significance of the waiver. Likewise, waiver contracts should not be systematically undervalued, because their value is clear: they permit the debtor to engage in a securitization without incurring the significant transaction costs of a two-tier structure. Therefore the reasons for restricting waiver contracts to post-default situations—underappreciation and undervaluing—should not apply in securitization transactions.

. *Contracting for Different Bankruptcy Procedures*

Professor Alan Schwartz has shown that procedure contracts can benefit both debtors and creditors.[453] And I have shown that when a debtor and all of its creditors agree to a procedure contract, there is little question that contract should be enforced.[454] But neither Professor Schwartz nor I have provided actual examples of procedure contracts. That is not surprising. Given the requirement of unanimity, procedure contracts are expected to be rare. Indeed, I have been unable to find any evidence of the existence of actual procedure contracts.

That lack of evidence is consistent with Schwartz's observation that procedure contracts may not be feasible because of an "apparent obstacle . . . to the parties' ability to write 'bankruptcy contracts.'"[455] The obstacle is that, as a matter of contract law, a contract cannot bind creditors who refuse to sign.[456] Most debtors have a multiplicity of creditors, and it would be difficult for a debtor to persuade all its

bankruptcy-remote entity or that is rated lower than the transaction."

453 . *See* text accompanying note XX, *supra*.

454 . When there are no nonconsenting creditors, there is no concern with externalities or with the bankruptcy policy of equality of distribution. See text accompanying notes XX-XX and XX-XX, *supra*. Thus, Professor Schwartz was justified in focusing on maximizing the value of the estate *ex post* and ignoring distributional issues. Furthermore, procedure contracts should not impair the bankruptcy policy of debtor rehabilitation. See text accompanying notes XX-XX, *supra*.

455 . Schwartz, *Contracting About Bankruptcy*, *supra* note , at 140.

456 . *See supra* text accompanying note ; *accord*, Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 Yale L.J. 232, __ (1987).

creditors to agree on an alternative process.[457] This problem is compounded because many claims— such as future tort claims—do not even exist at the time the proposed procedure contract would be executed.

Therefore a procedure contract could work, as a practical matter, only if the law were to impose a consensus mechanism that substitutes for unanimity. A similar mechanism actually exists under current bankruptcy law. Subsection 1126(b) of the Code provides as follows: "For the purposes of subsections (c) and (d) of this section [dealing with voting requirements], a holder of a claim or interest that has accepted or rejected the plan [of reorganization] before the commencement of the case under this title is deemed to have accepted or rejected such plan, as the case may be," if solicitation of such acceptance or rejection was in compliance with federal securities law.[458]

The purpose of subsection (b) is to create an actual prebankruptcy consensus voting procedure that substitutes for unanimity.[459] Although the prebankruptcy vote of holders of claims and interests binds those individual holders, the magic is worked through subsections 1126(c) and (d) that, for purposes of accepting a plan of reorganization, bind *all holders* of claims and interests even though fewer than all such holders have voted to accept the plan.[460] In the case of claims, for example, all that is needed is that creditors "that hold at least two-thirds in amount and more than one-half in number" of the claims have voted to accept the plan.[461] The vote then is binding on *all* the creditors.[462]

This supermajority voting procedure forms the basis for "an important, though relatively infrequent, type of bankruptcy called a prepackaged bankruptcy, . . . [a] type of proceeding [which] offers

457 . As a debtor moves closer to bankruptcy, it may be especially difficult to achieve unanimity because creditors may be in conflict as to their ultimate strategies. FA.

458 . Bankruptcy Code, 11 U.S.C. § 1126(b) (1994).

459 . *See* DAVID G. EPSTEIN, et al., BANKRUPTCY, § 11-24, at 837 (1993).

460 . *See* 11 U.S.C. § 1126(c), (d).

461 . *Id*. §1126(c).

462 . *Id*.

savings to debtors and creditors alike."[463] The core element of a prepackaged bankruptcy is the debtor's ability to solicit creditor approval of a reorganization plan, binding non-consenting creditors, *prior* to the filing of its bankruptcy case.[464] Thus, the reorganization plan in a prepackaged bankruptcy is actually an enforceable prebankruptcy procedure contract, substituting statutory supermajority voting requirements for unanimity.

There are, however, practical and conceptual limits on using supermajority voting for procedure contracts. Under current law, for example, debtors seeking confirmation of a prepackaged plan must satisfy certain disclosure requirements, which often means complying with the disclosure provisions of the federal securities laws.[465] Citing the need for creditor protection, courts have rejected prepackaged plans when the time between disclosure and the voting deadline was too short[466] or when the debtor failed to comply with the governing securities laws.[467] As a practical matter, prepackaged plans also can be difficult to implement when much of the debt is composed of trade or employee claims which fluctuate during the prepetition solicitation period.[468] Furthermore, some prepackaged plans have given rise to litigation over classification of claims for voting purposes and identification of the holders of transferable debt instruments, issues that

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463 . Robert K. Rasmussen & Randall S. Thomas, Improving Corporate Bankruptcy Law Through Venue Reform 5 (___, __ 199_) (unpublished manuscript, on file with _____).

464 . *See* COLLIER ON BANKRUPTCY, *supra* note , ¶ 1126.03[2].

465 . *See* 11 U.S.C. § 1126(b). Debtors must follow the disclosure rules of "any applicable non-bankruptcy law, rule or regulation," or if there is no such law, rule or regulation, debtors must disclose "adequate information," *id.*, as that term is defined, *id.* § 1125(a)(1).

466 . *In re* The Southland Corp., 124 B.R. 211, 226 (N. D. Tex. Bankr. 1991).

467 . [cite to be included from Colorado Springs prepackaged bankruptcy.]

468 . *See* COLLIER ON BANKRUPTCY, *supra* note , ¶ 1126.03[2][c]. Prepackaged plans also may not be feasible when the debtor has a large number of creditors which are not represented by a trustee or a committee. *Id.*

become critical in the case of close votes.[469]

Supermajority voting also suffers the potential infirmity that, unlike prepackaged bankruptcies in which prepetition claims are fixed at the date of bankruptcy, there is no point when all creditors will have had the opportunity to vote on a procedure contract.[470] Even after the contract is made, future claims may, and in the case of an ongoing business undoubtedly will, arise. How should creditors holding those claims be treated if the claims arise in numbers that would potentially change the prior vote of their class, or if the claims constitute a new class for which supermajority creditor consent has not yet been obtained?[471] Solutions might include, in the former case, requiring another vote of that class and, in the latter case, requiring a vote of the new class.

Another issue will be the degree of court supervision. Prepackaged plans are pursued under the supervision of the bankruptcy court, and plan confirmation is subject to court approval. Approval may not be given unless the court finds that disclosure was adequate, other solicitation requirements were met, and the protections provided by the Code for nonconsenting creditors have been satisfied.[472] Court supervision therefore gives a substantial measure of protection to nonconsenting creditors. It seems unlikely that Congress would apply

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469 . *In re* The Southland Corp., *supra* note XX, at 220-21.

470 . Most prepetition claims will be known by the date of bankruptcy. Although claims may arise after bankruptcy, postpetition creditors generally are afforded special priority treatment in bankruptcy. *See* 11 U.S.C. §§ 503(b), 507(a)(1).

471 . Until then, the normative justification for binding *newly arising* creditors would appear to be that if representative members of a similarly situated class consent, distributional effects on other members of the class are likely to be small. That same logic would appear to justify ignoring potential distributional effects, such as externalities and nonequality of distribution, on existing nonconsenting creditors. The Code itself implicitly recognizes that logic under Section 1126 by imposing the results of supermajority voting on nonconsenting creditors. *Cf. id.* § 1126(c), (d).

472 . *See* 11 U.S.C. §1129(a) (stating that a court may "confirm a plan only if all of the [specified] requirements are met"). These requirements include a "best interest" test: each non-consenting creditor must receive at least as much as it would have received in a liquidation of the debtor under Chapter 7 of the Code. *See id.* § 1129(a)(7)(A)(ii).

supermajority voting to procedure contracts without subjecting any alternative procedure contemplated by the contract to bankruptcy court supervision.

Perhaps the lesson of prepackaged bankruptcies is that the obstacles to procedure contracts are not in the concept but in the implementation. Further study of actual prepackaged bankruptcies plans therefore may be valuable.

. Conclusion

A. General Results.—In rethinking the debate over prebankruptcy contracting, I have started from the first principles underlying contract and bankruptcy law. After answering the threshold question, what freedom should parties have to contractually override a statutory scheme, I have derived a unifying theory that explains when provisions of the Bankruptcy Code should be viewed as default rules that parties may contract to change and when they should be viewed as mandatory rules that may not be contractually changed. My theory reflects the dual perspectives of inquiring how prebankruptcy contracting can maximize efficiency while recognizing that the Code's policies may well limit the scope of otherwise efficient contracting.

In examining whether harm to third persons, or "externalities," should limit prebankruptcy contracting, I have shown that externalities should not render a prebankruptcy contract, or indeed any other contract, unenforceable if each class of affected persons benefits[473] on a net basis, even though some of those persons individually may turn out to be harmed. This result is consistent with the normative basis for legislation (evaluating the effects of proposed rules on classes of persons rather than on particular individuals), and also is consistent with the normative argument for freedom of contract (voluntary assent on the part of all parties) because even creditors—including involuntary creditors—who, in retrospect, are harmed would have wanted those contracts, viewed *ex ante*, to be enforceable.[474]

My model therefore may be useful outside of a bankruptcy context in solving the more generic problem of determining which externalities are to count in constraining the freedom of parties to contract with each other. Furthermore, the model provides a key to understanding when parties should be allowed to contract about statutory schemes

473 . Or at least is not harmed.

474 . My approach thus may be better adapted to a policy analysis of prebankruptcy contracting than that of traditional economic scholarship, which would determine efficiency by offsetting the benefit to contracting parties against the harm to nonconsenting creditors.

generally: one merely needs to substitute in my analysis another statute's policies for the Code's policies.

B. Specific Recommendation for Bankruptcy Law Reform.

Although my analysis has been largely normative, many of my conclusions are not necessarily inconsistent with existing law; and therefore parties even now could choose to enter into the types of prebankruptcy contracts proposed. Nonetheless, parties often want greater assurance that their contracts comply with the law. The legal uncertainty is compounded by the recent proposal of the National Bankruptcy Review Commission to ban all forms of prebankruptcy contracting.[475] The statutory text proposed below would make it clear that parties could enter into prebankruptcy contracts in accordance with the approaches put forth in this article.[476]

New Section __: (a) Contracts entered into by a debtor prior to the filing of a petition under section 301, 302, or 303 of this title . . . that purport to amend, modify, or waive any of the provisions of this title other than sections . . . shall be enforceable by the parties thereto if, at the time of contracting, the contract does not manifestly impair the debtor's ability to be rehabilitated, the parties to the contract in good faith believe that the contract is unlikely to result in material injury to any other person, and either (x) the debtor had received, at the time of the making of the contract, reasonably equivalent value as consideration or (y) the debtor's ability to be rehabilitated is not materially impaired as a result of the contract.

(b) For purposes of subsection (a), (I) value shall be defined by reference to section 548, provided that a debtor shall not be deemed to have received value for a contract if at the time of the making of such contract there was no reasonable basis to believe that the debtor's ability to be rehabilitated might be improved as a result of entering into the contract, and (ii) a party shall be deemed to have acted in good faith only if that party has undertaken due diligence that is appropriate under the circumstances.

(c) This section __ shall apply only to contracts entered into after default by business parties that are represented by counsel having expertise in federal bankruptcy law. The term "default" shall mean an actual default or an event which with the giving of notice or the passing of time, or both, would constitute an actual default. The condition that such contracts be entered into "after default" shall not apply to

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475 . See *supra* note XX (disclosing the National Bankruptcy Review Commission's divided recommendation to that effect).

476 . My proposed statutory text only addresses waiver contracts. *See supra* subpart IV(D) (arguing that additional study of prepackaged bankruptcies is needed for a full understanding of supermajority procedure contracts).

contracts entered into between the debtor and an issuer of securities if the securityholders' right to payment depends primarily on cash flow from financial assets that are the subject of the contract.

The significance of my Article, however, depends neither on the adoption of the foregoing statutory text nor the implementation of other schemes to permit prebankruptcy contracting. Rather, my broader purpose has been to use prebankruptcy contracting as a model for exploring the larger issue of freedom of contract in the face of externalities and statutory constraints.