THE WASHINGTON UNIVERSITY INTERDISCIPLINARY CONFERENCE ON BANKRUPTCY AND INSOLVENCY THEORY

WHAT IS RIGHT ABOUT BANKRUPTCY LAW AND WRONG ABOUT ITS CRITICS

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WHAT IS RIGHT ABOUT BANKRUPTCY LAW
AND WRONG ABOUT ITS CRITICS

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I. INTRODUCTION

My comments in this paper focus on the papers in this Symposium by Professors Barry Adler;¹ James Bowers;² and Philippe Aghion, Oliver Hart and John Moore (Aghion-Hart-Moore).³ I argue that the central points of these papers are gravely mistaken because they completely misunderstand the character of the bankruptcy caseload and procedures, they ignore some important purposes of bankruptcy reorganization, and they misstate the success rate for reorganizations. I have chosen these papers for comment for two reasons: they recommend radical changes in bankruptcy law, and they are based on the thinnest knowledge of bankruptcy practice. Incidentally, they also all take an economics approach to law.

My perspective differs from that of these principal authors in two respects (apart from no longer being a full-time law professor). First, I am a bankruptcy judge in the Central District of California,⁴ which in 1993 received 10.6% of the nation’s bankruptcy cases (92,396 cases), including 12.5% (2504 cases) of the Chapter 11 cases. My docket at the end of 1993 contained 6229 cases, which included 2208 Chapter 7 cases, 390 Chapter 11 cases, and 3631 Chapter 13 cases. During 1993 I was assigned 5094 new cases, including 2621 Chapter 7 cases, 150 Chapter 11 cases, and 2323 Chapter 13 cases. During nearly nine years on the bench in this district, I have handled nearly 40,000 cases, including nearly 2000 Chapter 11 cases. I think that this perspective provides a fair view of the bankruptcy

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* United States Bankruptcy Judge, Central District of California.
4. One of the papers is written by Professor Jack Ayer, see John D. Ayer, Through Chapter 11 With Gun or Camera, But Probably Not Both: A Field Guide, 72 Wash. U. L.Q. 883 (1994), who does have experience as a bankruptcy judge. Indeed, he was my predecessor on the bankruptcy bench in the Central District of California, where he served for one year, 1982-83, while on sabbatical from the University of California at Davis. The bankruptcy caseload in my district has increased by 172% since his departure, while the size of the bench has increased by only 75%.
world as it actually exists in the United States.

Second, I teach bankruptcy law in Eastern Europe. Last March I taught a week of seminars in Romania, and a year earlier I taught a week-long seminar for bankers in Hungary. Although our Constitution and Bill of Rights traditionally have been our most important legal exports, Chapter 11 of our Bankruptcy Code has become the next most important in recent years. Bankruptcy reorganization is an idea that is especially popular in Eastern Europe, including Russia.

II. THE BANKRUPTCY UNIVERSE

Although the title of this Symposium is The Interdisciplinary Conference on Bankruptcy and Insolvency Theory, many of the papers are limited to a discussion of corporate reorganizations under Chapter 11 of the Bankruptcy Code. Some papers are limited to a much smaller portion of the bankruptcy universe, and at least two are confined to a portion that is minuscule. I begin with a sketch of the universe, so that we can see the importance of the articles to the bankruptcy world if their recommendations are adopted. As we shall see, some would make little difference at all.

Even though the bankruptcy system directly controls a substantial segment of the economy, there is a severe shortage of scientifically collected empirical data. In consequence, to a substantial extent we have no better information than the impressions of the most central participants in the system. This is the principal motivating factor in the initiation of the Chapter 11 research project described by Professors Warren, Westbrook, and Sullivan in this Symposium.5

In this section, I examine the total number of bankruptcy filings under various chapters. I then estimate the number of corporate filings, which were made principally under Chapter 11, and the success rate for Chapter 11 cases (of which I presume that corporate debtors have their proportionate share).

A. Total Bankruptcy Caseload

In 1993 there were 875,170 bankruptcy cases filed in the United States, which were distributed under four chapters of the Bankruptcy Code as

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follows:

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Number</th>
</tr>
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<tbody>
<tr>
<td>7</td>
<td>602,980</td>
</tr>
<tr>
<td>11</td>
<td>19,174</td>
</tr>
<tr>
<td>12</td>
<td>1,243</td>
</tr>
<tr>
<td>13</td>
<td>251,773</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>875,202</strong></td>
</tr>
</tbody>
</table>

In addition, there were a handful (the number of which is unreported) of Chapter 9 cases, and another handful (the number of which is also unreported) of ancillary proceedings to foreign bankruptcy cases filed under Bankruptcy Code § 304. Apparently, the total number of ancillary proceedings and Chapter 9 cases was 32 (the difference between the total in Table 1 and the sum of the other numbers).

B. Corporate Filings

There are some striking gaps in our knowledge about corporate Chapter 11 filings. For example, there are no statistics on the number of Chapter 11 cases filed by corporations. This is surprising because a number of the papers in this Symposium apply only to corporate Chapter 11 cases, and the number of corporate Chapter 11 cases directly affects the significance of these papers. We can determine whether the recommendations made by these authors to repeal or amend the Code are worthwhile only if we know whether corporate Chapter 11 cases are a significant part of the bankruptcy universe.

I have two sets of data from which to make a ballpark estimate of the number of Chapter 11 cases filed by corporations in 1993. The first is my list of pending Chapter 11 cases, which I compile from Chapter 11 petitions forwarded from the clerk’s office. It shows that I have 43 Chapter 11 cases assigned to me in 1994 that are still pending as Chapter 11 cases. Of the 43 cases, 14 (33%) are corporate debtors.6 Second, my colleague, Judge Lisa Fenning, has recently published a study of the Chapter 11 cases assigned to her for the calendar years 1992 and 1993, which principally

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6. This number is imperfect because it excludes the cases originally filed under Chapter 11 but subsequently dismissed, converted to another chapter, or transferred to another judge or court.
focuses on the real estate cases. I counted the number of corporate debtors in her 1992 data base, and found that 44 of 160 petitions (27.5%) were filed by corporations. There are no other known data on this subject.

Averaging these two numbers, I conclude that approximately 30% of the Chapter 11 cases (perhaps 5750 cases) were filed by corporations in 1993. Thus, the universe of corporate Chapter 11 cases is 0.657% of the bankruptcy caseload, or about one case in 152.

I have somewhat better data (although a bit old) on the number of Chapter 7 cases filed by corporations. I have a list of all cases filed in Los Angeles in the last half of 1987, which we used to assign cases to six new judges who were appointed to my court in 1988. I examined a sample of 1000 Chapter 7 cases, and found that 16 (1.6%) were filed by corporations. It is probably a good assumption that the distribution of corporations in the Chapter 7 caseload is nearly the same today. It is a bit more of a stretch to assume that the nationwide rate is similar to that in the Central District of California, but the figure is probably close, since the Central District of California’s 1993 filings were 10.6% of the nation’s bankruptcy caseload. Thus, I conclude that approximately 10,000 of the 602,980 Chapter 7 cases filed nationwide in 1994 were filed on behalf of corporations.

To summarize, in 1993 there were approximately 5750 corporate Chapter 11 cases filed, and another 10,000 corporate Chapter 7 cases, for a total of approximately 15,750 corporate bankruptcy cases. These cases constituted 1.80% of the total bankruptcy filings for 1993. Surprisingly, only 86 of these cases were filed by publicly held corporations, and probably only 16 were listed on the New York or American Stock Exchange.

We should be very careful about recommending changes in bankruptcy law that are designed to correct alleged faults affecting such a small percentage of bankruptcy cases. Even if we limit our changes to Chapter 11 cases, we must not inadvertently change the law applicable to the remaining 70% of the Chapter 11 cases filed by noncorporate debtors, unless there are reasons not disclosed in these papers that support such changes.

8. We should have much better statistics on the filing rate of corporate debtors at the conclusion of the study described by Professors Sullivan, Warren, and Westbrook in their papers, supra note 5.
9. This figure is based on the data collected by Bradley and Rosenzweig, which produced 162 corporations listed on the New York and American Stock Exchanges that filed bankruptcy petitions under Chapter 11 in the decade ending in 1989, for an average of 16 filings per year. Michael Bradley & Michael Rosenzweig, The Untenable Case for Chapter 11, 101 YALE L.J. 1043, 1059 (1992).
C. Success Rate in Chapter 11

There is a basic misconception about the success rate of Chapter 11 cases. It is true that only approximately 17% of Chapter 11 cases result in the confirmation of a plan, and that perhaps a third of these plans are liquidation plans. Indeed, there are a fairly large number of plans, perhaps 30% or 40%, that do not pay out according to the proposal approved by the court. From these numbers, one could conclude that the success rate of Chapter 11 cases is less than 10%. Such a conclusion, however, is clearly false, and draws its appeal from a perversely narrow view of the nature of Chapter 11 success.

Defining success in Chapter 11 requires much more analysis and debate than it has heretofore received. As a first approximation, I propose that success be defined as the achievement of the results sought, or the avoidance of the results unwanted, by the debtor at the time of filing. For example, the debtor may want to sell the business, because the debtor cannot make it profitable. After the filing, a sale is arranged and the case is dismissed. Alternatively, the debtor may be attempting to avoid foreclosure by the principal secured creditor on the principal real estate asset in the bankruptcy estate. The loan is restructured, or a sale is arranged to a better-financed purchaser, and the case is dismissed.

Results of this kind are common in Chapter 11 cases, and frequently occur in single-asset real estate cases, even though they do not comply with bankruptcy theory. However, such cases are all excluded from the tally of successful Chapter 11 cases, according to the conventional counting method.

The real success rate for Chapter 11 cases is probably in the range of 40%. This estimate is based on my experience with nearly 2000 Chapter 11 cases that have been on my docket: no data have been collected on this

10. See, e.g., Bowers, supra note 2, at 963.

11. Indeed, such success stories are even more common in Chapter 12 and Chapter 13 cases, which have eluded the study of most bankruptcy scholars, with the exception of Professors Sullivan, Warren, and Westbroook, in recent years. Professors Sullivan, Warren, and Westbrook have published the main results of their large consumer bankruptcy study in book form: TEREZA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA (1989). See also Teresa A. Sullivan et al., Folklore and Facts: A Preliminary Report From the Consumer Bankruptcy Project, 60 AM. BANKR. L.J. 293 (1986); Teresa A. Sullivan et al., Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981-1991, 68 AM. BANKR. L.J. 121 (1994) (providing a preliminary update ten years after their first empirical study of consumer bankruptcy debtors).
III. THE PURPOSES OF BANKRUPTCY

I do not intend to explore in detail the purposes of bankruptcy law in this article. However, I do devote some attention to two important purposes of bankruptcy law that often escape the attention of bankruptcy commentators: first, bankruptcy is essentially reorganization, even for cases filed under Chapter 7; second, bankruptcy functions as a safety net to avoid a meltdown of the economy. Before discussing these important purposes of bankruptcy, it is necessary to describe the typical bankruptcy case.

A. The Typical Bankruptcy Case

The typical bankruptcy case in the United States involves a dispute between a debtor and the debtor's principal secured creditor. Such a case is filed because the principal secured creditor is trying to foreclose on the only real property owned by the debtor. Other creditors are bit players in this game, and any benefits that they may receive are incidental. This scenario applies to the vast majority of bankruptcy cases filed under all chapters of the Bankruptcy Code.

The most critical hearing in a typical bankruptcy case is the relief from stay hearing, which is the most common kind of proceeding in a bankruptcy court. I typically have nearly one hundred such hearings a week. At issue is whether the debtor's house (or other single asset real estate) continues to enjoy the protection of the automatic stay. If the court grants relief from stay, the bankruptcy case usually ceases to have any purpose for the debtor.

12. Presumably this lack of information will be filled in with the results of the Chapter 11 project that Professors Sullivan, Warren, and Westbrook are undertaking. See Warren & Westbrook, supra note 5; Sullivan, supra note 5.

13. For such a discussion, see generally Elizabeth Warren, Bankruptcy Policy, 54 U. CHI. L. REV. 775 (1987).


15. One should not assume that the secured creditor who obtains relief from the automatic stay under § 362 completes a foreclosure. The statistics in Los Angeles County suggest that actual foreclosures occur in less than 10% of the cases in which relief from stay orders are granted. Secured lenders continue to do deals after obtaining relief from stay: they do not want the property, and are not in the business of managing such property profitably. Their business is lending money and obtaining payment in return so that they can lend it again. Lenders figure that it is a good year if they have not taken a loss on foreclosed property.
Professor Baird is one of the few participants in this Symposium who recognizes what a typical Chapter 11 case looks like. The typical firm in financial difficulty has a simple capital structure, he recognizes, which includes a single secured creditor (usually undersecured) with a security interest in all of the firm’s assets, and a small group of unsecured trade creditors. Noncorporate debtors have a similar debt structure.

Baird also correctly perceives that creditors often control both the debtor’s decision to file and the timing of such filing. As Baird notes, the single large secured creditor frequently makes this decision. In addition, tax collectors precipitate a substantial number of bankruptcy filings by taking action such as levying on a debtor’s bank account or garnishing a paycheck. Debtors usually do not voluntarily file bankruptcy: it is not strategic behavior to gain an advantage over creditors, except in very isolated instances. Debtors file because they are pushed into bankruptcy either by their principal (and frequently only) secured creditor who threatens to foreclose on their only piece of real estate, or by the taxing authorities.

B. Bankruptcy as Reorganization

1. Present cases

Reorganization is a pervasive feature of bankruptcy. In addition to Chapter 11 cases, which constitute 2.2% of the bankruptcy caseload, Chapter 13 cases for individual debt adjustment constitute 28.8% of the bankruptcy caseload, and Chapter 12 cases add 0.1% more. Thus, 31.1% of bankruptcy filings are specifically intended as reorganization cases.

Chapter 7 cases, like those under the other chapters of the Code, are filed principally to reorganize the debtor’s secured debt. Like debtors filing under other chapters, Chapter 7 debtors file to save their real estate from foreclosure by their secured creditors. Indeed, saving homes is the primary goal of most consumer bankruptcy cases, both under Chapter 13 and Chapter 7. In contrast, liquidation is a quite unusual purpose for filing a bankruptcy petition under any chapter of the Bankruptcy Code, even under Chapter 7.

17. Id. at 915.
18. Id. at 926.
19. See supra table at p. 831.
2. Reorganization History

The use of bankruptcy to restructure secured debt is not a new development in reorganization law. Indeed, reorganization has focused largely on secured creditors from its outset.

Reorganization as we know it grew out of the railroad receiverships of the nineteenth and early twentieth centuries, largely in state court and without the benefit of unifying federal law. Because state law was inadequate to deal with railroad insolvencies, railroad reorganization provisions were among the first reorganization provisions added to the Bankruptcy Code.\(^\text{20}\)

C. Bankruptcy as an Economic Safety Net

Bankruptcy reorganization served another role when it was first introduced, and may still serve this role today. One of the unrecognized policies of bankruptcy law is to provide a safety net for the national economy. It prevents secured creditors from collectively starting a downward spiral of foreclosures and bank failures that could result in the failure of the entire economy, as it nearly did in 1933.

Picture a country where nearly 25% of the working population is unemployed.\(^\text{21}\) For many Americans, their only food is a piece of bread and a bowl of broth handed out after a wait in a long line. The stock market has lost almost 85% of its value.\(^\text{22}\) Denied reelection, the president is preparing to move out of the White House on his last day in office. He had promised that prosperity was just around the corner, but there were no corners to be found. The new president in a few days will close down the banking system, and nobody knows whether the banks will ever reopen. Something appears about to happen to the economy, and total collapse is the most likely prospect.\(^\text{23}\)

Cleaning off his desk, the president comes across the last bill to arrive

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22. On October 1, 1929, before the October crash of 1929, the Dow Jones Industrial Average closed at 342.57. On March 3, 1933, Herbert Hoover’s last day in office, the average was 53.84, a decrease of 84%. DOW JONES & CO., INC., THE DOW JONES AVERAGES 1885-1990 (Phyllis S. Pierce ed., 1991).
23. For a discussion of the last days of the Hoover administration, see SUSAN ESTABROOK KENNEDY, THE BANKING CRISIS OF 1933 129-51 (1972).
from Congress, a substantial revision of the bankruptcy law, which will add reorganization provisions for farmers, railroads, and individuals (especially guarantors).\textsuperscript{24} Signing the bill is the president’s last chance to do some good for the economy.

Much about the causes of the Great Depression was not understood in early 1933. Congress did understand a piece of it, however. It had watched the banks foreclose on real estate in a down economy, and had watched the banks themselves disappear, taking with them the life savings of many people when the banks could not resell the foreclosed properties at a sufficient price to cover their loans. Left to their state-law rights, it appeared that the banks had nearly closed down the economy and put a quarter of the nation’s workers out of work. Congress crafted a law to stop this process. In his last official act,\textsuperscript{25} President Herbert Hoover signed the bill that gave us bankruptcy reorganization.\textsuperscript{26}

The 1933 amendments to the Bankruptcy Act provided for the reorganization of individual debtors,\textsuperscript{27} farmers, and railroads.\textsuperscript{28} The amendments, enacted three days before the new President Franklin D. Roosevelt closed the entire banking system,\textsuperscript{29} are generally considered to be the first introduction of reorganization into bankruptcy law. Two 1934 amendments added § 77B for corporate reorganizations\textsuperscript{30} and § 80 for municipal debt


\textsuperscript{25} See Signs Bankruptcy Bill, N.Y. Times, March 4, 1933, at 2.

\textsuperscript{26} For a collection of Hoover administration bankruptcy policy statements, see Ray Lyman Wilbur & Arthur M. Hyde, The Hoover Policies 486-94 (1937). See also S. Doc. No. 65, 72d Cong., 1st Sess. (1932) (reprinting a message from the President on, inter alia, bankruptcy); H.R. Doc. No. 522, 72d Cong., 2d Sess. (1933) (same).

\textsuperscript{27} Id. at 1467-70. As a reorganization provision, § 74 of the Bankruptcy Act, authorizing “compositions and extensions” was rudimentary, and probably contemplated only a redivision of distribution by vote of the creditors, or a delay in payment. It was in many respects similar to § 12 of the original Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, 549-50 (repealed 1938), and to the 1874 amendment to the 1867 Bankruptcy Act as well, Act of June 22, 1874, ch. 390, 18 Stat. 178, 182-84 (repealed 1878). On the 1874 amendment, see Charles J. Tabb, The Historical Evolution of the Bankruptcy Discharge, 65 Am. Bankr. L.J. 325, 360-61 (1991).

\textsuperscript{28} Act of March 3, 1933, ch. 204, Pub. L. No. 72-420, 47 Stat. 1467 (repealed 1938).

\textsuperscript{29} President Franklin D. Roosevelt closed the banks on March 6, 1933. When the banking system was closed, nobody knew whether the banks would ever open again. See Kennedy, supra note 23, at 158. In fact, they began to reopen 7 days later. Id. at 180. I have heard people who remember the occasion say that it was the most dramatic event in their lifetimes, surpassing the end of the Second World War, the first human walk on the moon, and the fall of the Berlin wall.

adjustments. The 1933 amendments federalized railroad reorganization practice, which had previously occurred principally in state courts. The farmer reorganization and corporate provisions were also a clear departure from earlier bankruptcy law, as was the corporate reorganization provision added by the 1934 amendment. The provision for individual reorganizations, on the other hand, was not remarkably different from provisions in existing bankruptcy law.

An economic safety net is one of the features of bankruptcy reorganization that makes it a powerful idea, particularly in weaker economies like Hungary, Romania, and Russia. Their markets are far from perfect. Our markets are also far from perfect, especially in a weak economy. Chapter 11 protects vital businesses, protects jobs and communities, gives debtors an opportunity to wait out an economic downturn, and avoids a catastrophic destruction of economic values. In short, bankruptcy reorganization is part of the safety net that prevents secured creditors in a weak economy from collectively precipitating a downward spiral leading to a total economic collapse.

IV. THE SYMPOSIUM PAPERS

Let us now look at some of the papers in this Symposium in light of the foregoing comments.

A. Cases to Which Papers Are Applicable

The foregoing analysis of the kinds of bankruptcy cases sheds light on the impact of the recommendations of some of the papers in this Symposium. For some of the papers, the impact is remarkably small.

The most striking paper in this respect is that of Professor Adler, both in the breadth of his conclusions and in the limited number of cases actually affected by his analysis. First, his conclusions: he unabashedly states, "I do think it is wise, in principle, to do away with bankruptcy law." It appears that he recommends the repeal of the entire Bankruptcy Code, although he explains in a footnote that his arguments apply only to corporate debtors. It further appears that his arguments apply only to

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32. Adler, supra note 1.
33. Id. at 811 (emphasis in original).
34. See id. at 811 n.3.
debtors in Chapter 11 cases. In addition, Professor Adler's analysis is limited to those corporate debtors who have issued fixed obligations to a large number of investors. He proposes to solve problems relating to at most a handful of cases in which debtors have issued contractual obligations in fixed amounts to a large number of creditors. Professor Adler proposes to substitute "chameleon equity" for such debt, and thus to eliminate the need for bankruptcy law.

The specificity of Adler's proposal necessarily limits his universe to a very small subset of bankruptcy cases. There probably are fewer than 100 Chapter 11 cases filed by publicly held corporations each year, and only a portion of those qualify for "chameleon equity." In the nearly 2000 Chapter 11 cases that have crossed my docket in nine years on the bench, I do not think that I have ever had such a case, and certainly I have not had as many as ten.

Let us generously suppose that there are 25 cases a year nationwide that fit into this category. Obviously, these 25 cases would not create the "debtless world" and the disappearance of the need for corporate bankruptcy (let alone all bankruptcy) that Adler believes would result from the adoption of his proposal. Clearly, the repeal of the entire Bankruptcy Code for the supposed benefit of 25 corporations per year, and to the detriment of more than 875,000 other debtors who file bankruptcy cases, is unwarranted.

Professor Bowers' analysis applies to an even smaller subset of the bankruptcy universe than that of Professor Adler. His analysis applies only to Chapter 11 cases filed by corporations listed on the New York or American Stock Exchanges, which typically amounts to 16 cases per year. If bankruptcy reorganization is bad for such companies, Congress could easily amend § 109 to exclude them from eligibility for Chapter 11, and the bankruptcy world would proceed with little change.

35. Id. at 815.
36. Id. at 816.
37. Id. at 816-17.
38. For example, the yearly average of Chapter 11 bankruptcies in the Bradley and Rosenzweig study is 16. Bradley & Rosenzweig, supra note 9, at 1059.
39. Bowers, supra note 2, at 966; see supra note 38.
41. Indeed, from 1938 to 1978 the Bankruptcy Act, which preceded the Bankruptcy Code, provided a separate Chapter, Chapter X, for corporate bankruptcies. See 11 U.S.C. §§ 501-672 (1976) (repealed 1978). Corporations were also permitted to file for reorganization under Chapter XI, 11 U.S.C. §§ 701-799 (1976) (repealed 1978), and Chapter X was little used.
Bowers' failure to consider the limited application of his analysis leads Bowers to overstate his conclusions. He states:

The most widely replicated finding in the empirical literature about bankruptcy reorganization is that equity in filing firms loses a huge proportion of its value relative to the market in an astonishingly short period surrounding the bankruptcy filing date. There are no such data, except for the minute subclass of publicly traded firms. It would be very foolhardy to develop bankruptcy policy or to revise bankruptcy law based on such a thin slice of bankruptcy life.

The papers by Rasmussen and Aghion-Hart-Moore apply to a somewhat broader number of bankruptcy cases. The Rasmussen paper would apply to the 5750 corporate reorganization cases, and the Aghion-Hart-Moore paper would include these cases plus the 10,000 Chapter 7 corporate cases. This is still a rather thin slice of the bankruptcy pie.

B. Noncontractual Debt

There are two principal types of noncontractual debt that play a large role in the bankruptcy process: tax and tort debts. A substantial number of bankruptcy cases, both under Chapter 11 and under other chapters, result from the failure to pay the fisc. In addition, a number of cases involve tort debts, such as environmental cleanup obligations. While tort debts are relatively uncommon, tort creditors are usually dominant in cases involving such claims.

The advocates of market solutions to insolvency do not deal adequately with noncontractual debt. Adler's and Bowers' papers are clearly limited to bondholder debt, and Rasmussen's paper also appears to be limited to such debt. While somewhat broader, the Aghion-Hart-Moore paper is limited to contract debt and ignores tax and tort debts.

While tax and tort debt is not substantial in more than half of the Chapter 11 cases, there is an important minority of cases in which such debt is overriding. To be fair, the present bankruptcy statute also does not deal with environmental

42. Bowers, supra note 2, at 968-69.
43. There are no data on the number of bankruptcy cases filed in response to tax problems. I know from my docket, however, that the number is substantial, perhaps in the range of 5-10% of all cases.
45. Baird, supra note 14, at 915 n.2.
contamination in an acceptable fashion: a legislative solution is needed. On the other hand, the provision for tax debt, which permits the debtor to stretch it out over six years with or without the consent of the taxing authority, is workable in most cases.

There is another vice in the view that a bankruptcy system should respect contractual rights and priorities. Tort claimants are disadvantaged by such a system, because they have no opportunity to protect their position against contractual claimants. Tax claimants, in contrast, are protected for the most part in comparison with contract claimants, but only because they enjoy a statutory priority for payment under Bankruptcy Code § 507(a)(8). Indeed, tort claimants with unliquidated claims in the A.H. Robins and Manville cases firmly believe that they received much less favorable treatment than the contract claimants, even under present bankruptcy law. Except for Professor Adler, whose paper espouses the view that tort claimants should be paid ahead of all other creditors (even those with secured claims), this problem appears to inhere in all of the papers under discussion here.

C. Bankruptcy and Consensual Remedies for Insolvency

Adler takes the position that parties should be permitted to contract for their remedies in the event that a party becomes insolvent, and that such consensual provisions should make bankruptcy law unnecessary. This is not a new or untried proposal: we have vast experience with it, and we have bankruptcy law because it does not work.

Parties have always been free to contract for their rights in the event of insolvency, absent statutory or case law limitations. In the history of the United States, for example, parties were free to contract on this subject unrestricted by bankruptcy law before 1898, except during those brief periods when federal bankruptcy legislation was in effect.

49. Adler, supra note 1, at 826.
50. See id. at 821.
51. While the Constitution from its outset authorized Congress "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States," U.S. CONST. art. I, § 8, cl. 4, this power lay dormant for most of the nineteenth century. The first bankruptcy law was enacted on March 4, 1800, and repealed on December 19, 1803; the second was enacted on August 19, 1841, went into
When we look at contracts from those eras when there was no federal bankruptcy law, we do not find that contracting parties negotiated for better rights than we now provide under bankruptcy law. In fact, we adopted bankruptcy law in large part to remedy the failure of contracting parties to negotiate adequate solutions to insolvency problems. In simple terms, we have bankruptcy law because it provides much better solutions to these problems than the parties are able to provide on their own, in the vast majority of cases.

Indeed, the secured creditor community does a good job of protecting its interests by contract and by state legislation outside of bankruptcy: it does such a good job that bankruptcy law is needed to protect insolvent debtors from the secured creditor industry. Secured creditors write their own remedies, including the right to foreclose on their security upon default and the right to collect attorney fees from their borrowers.

Bankruptcy law has always been conceived as an involuntary impairment of contract rights. As the United States Supreme Court has stated:

[T]here is, as respects the exertion of the bankruptcy power, a significant difference between a property interest and a contract, since the Constitution does not forbid impairment of the obligation of the latter. The equitable distribution of the bankrupt’s assets, or the equitable adjustment of creditors’ claims in respect of those assets, by way of reorganization, may therefore be regulated by a bankruptcy law which impairs the obligation of the debtor’s contracts. Indeed every bankruptcy act avowedly works such impairment. While, therefore, the Fifth Amendment forbids the destruction of a contract it does not prohibit bankruptcy legislation affecting the creditor’s remedy for its enforcement against the debtor’s assets, or the measure of the creditor’s participation therein . . . .

Many countries in the world today have no bankruptcy law or have only liquidation bankruptcy provisions. If an economy is better off without a bankruptcy scheme, we would expect to find that those countries that lack bankruptcy law would have a more functional economy and a competitive advantage in comparison with the United States. Similarly, we would expect to find that those with only liquidation bankruptcy law would have more functional economies and competitive advantages compared to the

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effect on February 2, 1842, and was repealed on March 13, 1843; the third bankruptcy law was enacted on March 2, 1867, and repealed effective June 7, 1878. See F. Regis Noel, A HISTORY OF THE BANKRUPTCY CLAUSE OF THE CONSTITUTION OF THE UNITED STATES OF AMERICA 124-56 (1918). Except for these periods totalling 15 years, there was no federal bankruptcy law in the United States for more than 100 years after the adoption of the Constitution.

United States.

The reality is exactly the reverse. Notwithstanding a bankruptcy law that has been continuously in force in the United States for almost a century, and reorganization law that has been in force for more than sixty years, the United States has one of the healthiest economies in the world.

Furthermore, bankruptcy law, and especially reorganization bankruptcy, is one of the most important exports of legal ideas from the United States. Many nations, such as Germany, the United Kingdom, and Canada, have recently adopted or are seriously considering the adoption of a reorganization system like our Chapter 11.

Bankruptcy reorganization is an idea that is especially popular in Eastern Europe, including Russia. Both Hungary and Russia have recently adopted reorganization laws, and such proposals are under consideration in Romania and Estonia. One of the largest economic hurdles facing these countries is the need to privatize former state-owned industries and to convert these entities into economically viable businesses. Liquidation is not a feasible alternative: in Romania, for example, 90% of the economy belongs to formerly state-owned industries, and 70% of their debts are owed to the government. Thus, liquidation would return the assets to the government and reverse the privatization effort.

D. Swapping Debt for Equity

Professor Adler adopts the recommendation made famous by Bradley and Rosenzweig that reorganization should be accomplished by swapping debt for equity. While Adler’s proposal is somewhat different, it shares certain basic deficiencies.

The debt-equity swap advocated by Professor Adler (and by Bradley and Rosenzweig) would be a disaster in the typical business reorganization case. Banks, which would receive the equity in most cases, usually do not have the background and experience needed to run the businesses that they finance: this is not their area of expertise.

Furthermore, the systematic conversion of debt into equity will imperil the banking system in the same way that it was imperiled in the Great Depression, because banks would lose the cash flow necessary to pay out deposits and to make new loans. For this reason, we adopted a system of regulation in the 1930s that prohibits banks and insurance companies from

holding significant amounts of stock in nonbank firms.54

Furthermore, neither Adler nor Bradley and Rosenzweig have given any reason why default should trigger the elimination of all debt. Even reorganization rarely accomplishes this, and it appears that there is little to recommend such a result.

E. The Alleged Mixed Problems of Reorganization

The paper by Professors Aghion, Hart and Moore55 is simply wrong in its principal thesis. The main point of Aghion-Hart-Moore is that Chapter 11 is flawed because it mixes two different issues: the determination of who should get what in the reorganization and the decision of what should happen to the bankrupt company.56 As an empirical matter, their supposition is false for most Chapter 11 cases. In consequence, the drastic solution that they propose is unnecessary, and would radically alter the character of reorganization available under Chapter 11.

Apparently Aghion-Hart-Moore believe that Chapter 11 mixes these two issues because they are unfamiliar with the Chapter 11 process as it works in actual cases. They apparently assume that both of these issues are determined in the plan formulation process, and that they must both be resolved in plan negotiation. For most Chapter 11 cases, this is not true.

Aghion-Hart-Moore see the decision on what should happen to the debtor as a choice between two alternatives: reorganization or liquidation. While the alternatives are frequently limited, especially for single asset real estate cases, there are usually additional alternatives in larger cases that the Aghion-Hart-Moore model apparently cannot accommodate. However, it is easier to show the falsity of the Aghion-Hart-Moore assumption using the bipolar model.

The issue of whether to liquidate or reorganize is normally resolved relatively early in the case, and rarely is decided in the context of the adoption of a plan. This issue is brought before the court on a motion to convert to Chapter 7, which may be brought by the United States Trustee or by any party in interest at any time.57 Such a motion is frequently brought (and granted) early in a case, if the debtor does not meet the requirements of the United States Trustee (these requirements typically

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55. Aghion et al., supra note 3.
56. Id. at 850.
include reporting financial transactions in weekly and monthly reports, establishing debtor-in-possession bank accounts, and providing evidence of insurance). After several months a creditor may make a motion to convert for failure to make progress toward proposing a plan or to take appropriate steps toward reorganization. If a case is still under Chapter 11 at the time that a plan is proposed for negotiation, this usually is because reorganization is a viable alternative that should be pursued, rather than an open question to be negotiated in the plan itself.

The plan, in contrast, poses the issue of who should get what in the case. Curiously, Aghion-Hart-Moore want to take the power to negotiate this issue away from the parties, and impose a legislative solution similar to the statutory distribution provision for Chapter 7 cases. Instead of a comprehensive distribution scheme, however, they propose a simplified program in which there are no priorities or security interests: all creditors receive a single type of asset, equity, which varies only in amount. While the Chapter 7 priority system is certainly open to criticism, the simplistic program of Aghion-Hart-Moore does not appear to be an improvement.

Furthermore, we have historically thought it better to permit the parties to negotiate a deal between themselves rather than to impose a distribution scheme on them. In fact, Aghion-Hart-Moore's proposal is at odds with their own position that "in an ideal world," debtors and creditors would anticipate the possibility of default and specify as part of their initial contract what should happen after default.

Aghion-Hart-Moore recognize that their scheme will transfer the assets of a debtor to the bank in the typical Chapter 11 case. We do not need a complicated new scheme to accomplish this result: Chapter 7 accomplishes it quite efficiently. Aghion-Hart-Moore fail to take notice that this was the problem to be solved by introducing reorganization in the first place in

59. It is far from clear why a world would be ideal in which debtors and creditors have to specify what should happen after default. It would at least be better, in my view, to provide a standard resolution to such problems (along the model of the Uniform Partnership Act), and to save the enormous transaction costs of negotiating these features in every contract. The more interesting question is whether the parties should be permitted to contract out of the standard solutions, or whether they should be mandatory (as in the present Bankruptcy Code).
60. I am sure that Aghion-Hart-Moore think that an ideal world is one without transaction costs. Such a world is imaginary, but it is not ideal in any sense, except for those who do not want to think about the costs of transactions.

60. Aghion et al., supra note 3, at 850.
1933. We needed an alternative to turning the equity over to the banks, and we made it illegal for banks to own equity for any length of time.\textsuperscript{61}

\textbf{F. Efficient Markets}

Much recent bankruptcy commentary is animated by the assumption that there are efficient markets in an ideal world available to solve bankruptcy problems. For example, Bowers states:

"In summary, markets seem to be the only available devices which really do solve the problems of financial distress. . . . [M]arkets are efficient and bankruptcy procedures are not. That is the lesson of the only systematic and rigorous theory that has been applied to the problem, and the implications of the only scientific empirical evidence.\textsuperscript{62}"

This statement is simply incorrect. The empirical evidence shows that most markets are far from efficient: we have bankruptcy law in large part because of this problem. Debtors need an opportunity to suspend the rights of creditors because markets are so inefficient.\textsuperscript{63} Similarly, markets do not solve the problems of financial distress.

Adler similarly appears to assume only perfect markets: at least his analysis is unencumbered by substantial transaction costs.\textsuperscript{64} Rasmussen and Aghion-Hart-Moore, on the other hand, attempt to address a world in which markets are imperfect and transaction costs must be paid. As Rasmussen states, "It is easy to show that any system of laws fails when compared to an ideal world. Given the complexities of the real world, it takes little imagination to demonstrate that the current state of affairs is not perfect."\textsuperscript{65}

Bankruptcy is overwhelmingly a result of imperfect markets and high transaction costs. Permitting the functioning of imperfect markets is much of what Chapter 11 is about. Virtually no market in which bankruptcy operates is a perfect market. Waiting out an imperfect market, of course,

\textsuperscript{61} See Gilson & Vetsuypons, supra note 54, at 1005.

\textsuperscript{62} Bowers, supra note 2, at 976-77.

\textsuperscript{63} Bowers gets it exactly backward in insisting that bankruptcy law defenders offer a theory that measures up to his standards before granting anyone the point that current bankruptcy law is worth having. Bowers, supra note 2, at 977. It is convenient to say, "I am right until someone proves me wrong, to my satisfaction." However, burdens of proof do not work that way. It is hornbook law that the burden of proof falls on the Bower's of the world—those who want to change the status quo—rather than on those who defend it. Those who seek change must shoulder the burden of showing that their vision of the world is better than the present system. See, e.g., 2 CHARLES T. MCCORMICK, McCORMICK ON EVIDENCE 428 (John William Strong ed., 4th ed. 1992).

\textsuperscript{64} See, e.g., Adler, supra note 1, at 817.

\textsuperscript{65} Rasmussen, supra note 47, at 1163.
has its hazards. It is difficult to determine in advance that a buyer will appear to make a debtor profitable and perhaps save a community. If a buyer does not appear, the delay may impose substantial costs on both secured and unsecured creditors. Nobody knows whether, on balance, the economy is better off because bankruptcy permits debtors to try to wait out imperfect markets: the data has not been collected.

G. Choice of Bankruptcy Regimes

Rasmussen ends his paper by recommending that Congress establish a menu of choices of bankruptcy regimes from which an entity can choose.\textsuperscript{66} In fact, Congress has already done this. Except for those entities that are ineligible for bankruptcy altogether,\textsuperscript{67} any debtor except a railroad or a municipality may choose Chapter 7.\textsuperscript{68} Any debtor eligible for Chapter 7, except a stockbroker or commodity broker may choose Chapter 11.\textsuperscript{69} Individuals who meet the debt limitation ceiling and who have regular income may choose Chapter 13.\textsuperscript{70} Farmers who meet the debt ceiling limitations may file under Chapter 12.\textsuperscript{71}

More than one-third of corporate bankruptcy cases, ranging from very large to very small, are filed under Chapter 11. The “one size fits all” approach to corporate reorganization is certainly open to criticism. Congress recently considered (and rejected) legislation that would have added to the Code a new Chapter 10 for small businesses.\textsuperscript{72} Perhaps as Rasmussen suggests, more chapters should be added to the Code, to provide more alternative ways of reorganizing: the proof of the wisdom of this idea lies in its elaboration, which Rasmussen does not provide.

V. Conclusion

In this paper I show that the demographics of the bankruptcy caseload are quite different from the assumptions made by theoretical economists who criticize the effectiveness of the Bankruptcy Code, and particularly

\textsuperscript{66} Rasmussen, \textit{supra} note 47, at 1208.
\textsuperscript{67} 11 U.S.C. \textsection 109(b) (1988) (excluding from bankruptcy all banks, savings and loan associations, and insurance companies).
\textsuperscript{68} \textit{Id.}
\textsuperscript{69} 11 U.S.C. \textsection 109(d) (1988).
\textsuperscript{70} 11 U.S.C. \textsection 109(e) (1988).
\textsuperscript{72} The final version of H.R. 5116, 103d Cong., 2d Sess. (1994), which was signed by the President on October 22, 1994, deleted the separate Chapter 10 provision that was written into an earlier Senate draft, and included certain of its provisions under Chapter 11.
Chapter 11. While Professors Adler, Bowers, and Aghion-Hart-Moore, who represent this point of view in this Symposium, assume that corporate cases (particularly under Chapter 11) represent the essence of bankruptcy, only approximately 15,750 of the 875,202 cases filed in 1993 were on behalf of corporations and only approximately 5,750 of them were under Chapter 11. Furthermore, the universe of corporate bankruptcies of interest to Professors Adler and Bowers is limited to a very small subsection of corporate bankruptcies. Even if their views on the treatment of these cases in the bankruptcy system are correct, these views have little to do with the universe of bankruptcy cases. They also incorrectly assume a lower success rate for Chapter 11 cases than is actually the case.

Furthermore, these authors fail to understand that bankruptcy is essentially reorganization, under all chapters of the Bankruptcy Code. They also fail to grasp one of the essential purposes of bankruptcy law—to provide an economic safety net for an economic system under stress. Consensual remedies for insolvency are simply unable to deal with these problems.
IMPROVING BANKRUPTCY PROCEDURE

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I. Introduction

There is a widespread dissatisfaction with bankruptcy procedures throughout the world. Bankruptcy reform is being actively considered in the United Kingdom and France and is in the air in the United States. East European countries that must select a bankruptcy law for their new capitalistic economies have had a hard time making the choice and in some cases, dissatisfied with their original decisions, are already making changes.\(^1\) Russia has recently implemented a bankruptcy law that seems complex and apparently suffers from many of the disadvantages of Western procedures.\(^2\)

We believe the reason for this unsettled state of affairs is that bankruptcy law has developed in a fairly haphazard manner, as a series of attempts to solve perceived immediate problems. There has been relatively little effort to step back and ask what the goals of bankruptcy procedure should be, or to consider how one would set up an optimal bankruptcy procedure if one were starting from scratch. To put it another way, economic analysis—which has been applied with such great success to other aspects of law in the last thirty years—has, with a few notable exceptions, not been used to shed light on optimal bankruptcy procedure.\(^3\)

\(^1\) An example is the case of Hungary. In the original Hungarian bankruptcy law, the debtor was obliged to announce a reorganization or bankruptcy procedure after 90 days of failure to pay any of its debt. This triggered a huge wave of bankruptcies, and in mid-1993 an amendment to the bankruptcy law abolished the mandatory announcement of bankruptcy. See INSTITUTE FOR EAST-WEST STUDIES, ENTERPRISE BANKRUPTCY IN RUSSIA: CRITICAL RECOMMENDATIONS FOR MICROECONOMIC RESTRUCTURING (1993).

\(^2\) See id.

\(^3\) The notable exceptions include Douglas G. Baird, The Uneasy Case for Corporate Reorganizations, 15 J. LEGAL STUD. 127 (1986); Lucian A. Bebchuk, A New Approach to Corporate Reorganizations, 101 HARV. L. REV. 775 (1988); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY
This Article attempts to provide an economic perspective on bankruptcy procedure. In Parts II and III, we discuss the rationale for, and goals of, bankruptcy procedure. Part IV describes how existing procedures fall short of these goals. Our main point is that reorganization procedures like Chapter 11 are flawed because they mix the decision of who should get what with the decision of what should happen to the bankrupt company. In Part V, we turn to a procedure that we have proposed elsewhere, which we believe would improve on existing procedures. In our scheme, debt claims are converted into equity, and the decision about whether to reorganize or liquidate is then put to a vote. The merit of the scheme is that all claimants, once they are shareholders, have a common interest in voting for the efficient outcome. In Part VI, we discuss some practical difficulties concerning our proposal and how they might be resolved. Part VII contains concluding remarks.

II. BACKGROUND

Companies take on debt for many reasons. To mention just a few: they may wish to reduce taxes; they may wish to commit themselves to reduce slack; or they may wish to signal that future prospects are good. Whatever the reason, there will be circumstances, arising perhaps from an unexpected shock, in which the company will be unable to pay its debts. Bankruptcy law is concerned with what should happen in such situations.

The analysis of optimal bankruptcy law is complicated by the following observation. In an ideal world, debtors and creditors would anticipate the possibility of default and specify as part of their initial contracts what should happen in a default state: in particular, whether the company should be reorganized or liquidated and how its value should be divided up among the various creditors. In other words, the parties would provide their own bankruptcy procedure: there would be no need for a state-provided bankruptcy procedure.

In practice, transaction costs are likely to be too large for debtors and creditors to craft their own bankruptcy procedures, particularly in situations where debtors acquire new assets and new creditors as time passes.

Law (1986); and Mark J. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganizations, 83 Colum. L. Rev. 527 (1983).

Instead, parties may prefer to rely on a "standard form" bankruptcy procedure provided by the state. It is a long way from this observation, however, to any conclusions about the nature of such a standard-form procedure. The problem is that the theory of optimal contracting in the presence of transaction costs (the "theory of incomplete contracts") is in its infancy. In particular, we are aware of no formal analysis that both explains why it is rational for parties to leave out of their contract what should happen in a default state and shows how a state-provided procedure can improve matters.\(^5\)

Thus, in what follows we do not derive an optimal bankruptcy procedure from first principles. Instead our approach is to use economic theory to guide us as to the nature of a "good" bankruptcy procedure. In the next section we suggest some goals that an efficient bankruptcy procedure should satisfy. Later (in Part V), we describe a procedure that we believe meets these goals. Although we do not claim that our procedure is optimal, we think that it is practical and avoids some of the pitfalls of existing procedures. Also, the procedure is sufficiently simple and natural that future work may show it to be optimal within a reasonable class of procedures.\(^6\)

It is also worth pointing out that, while we propose our procedure for use by the state, it could, in principle, also be adopted by companies of their own accord. In other words, to the extent that a company can opt out of existing bankruptcy procedures, it may wish to select our procedure—as a mechanism for resolving financial distress—as part of its initial contracts with its creditors.

III. GOALS OF BANKRUPTCY PROCEDURE

As noted, we do not proceed from first principles. However, on the basis of economic theory, we believe that the following are desirable goals for a bankruptcy procedure. As we shall see, some of these goals may conflict.

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\(^{6}\) We do not believe that our procedure should be mandatory. Anybody who wishes to deviate from it and craft their own procedure should be allowed to do so.
First (goal 1), a good bankruptcy procedure should try to achieve an ex post efficient outcome (that is, an outcome that maximizes the total value of the proceeds—measured in money terms—received by existing claimants). The efficient outcome may be to close the company down and sell off the assets for cash, to sell the company as a going concern for cash, or to reorganize the company. Second (goal 2), a good bankruptcy procedure should give managers the right ex ante incentives to avoid bankruptcy. In particular, a good procedure should not favor incumbent managers, although it should not preclude them from retaining their jobs if the bankruptcy was due to bad luck rather than bad management.

Third (goal 3), a good bankruptcy procedure should preserve absolute priority. That is, the most senior creditors should be paid off before anything is given to the next most senior creditors, and so on down the ladder (with ordinary shareholders at the bottom). Finally, as a fourth goal (goal 4), a good bankruptcy procedure should, whenever possible, put ultimate decision-making power in the hands of the claimants rather than in the hands of the judiciary or experts.

Let us briefly discuss the rationale for goals 1-4. Goal 1 simply reflects the idea that, other things being equal, more is preferred to less; in particular, if a procedure can be modified to deliver higher total ex post value, then, given that absolute priority is preserved (i.e., goal 3), everybody will be better off. Goal 2 reflects the idea that debt may have an important role in constraining or bonding managers to act in the interest of claimholders. Managers may have taken on debt at an earlier stage as a way of committing themselves to reduce slack. A bankruptcy procedure that lets managers off too lightly if they fail to pay their debts—for example, by favoring them in the reorganization process—will interfere with the ex ante bonding role of debt.

7. Note that we exclude “external” considerations from our definition of efficiency: that is, we assume that the important benefits and costs have been incorporated into the valuation of the firm. For example, we do not include such items as the external benefit from maintaining employment in the local area. Our view is that if there are external considerations, government action may indeed be warranted, but bankruptcy law is the wrong instrument for dealing with such considerations. It would be better to have a general employment subsidy to save jobs than to distort bankruptcy procedures in order to save bad firms.

8. The use of debt as a bonding device presumably arises because other devices to keep management in check—lender incentives, proxy fights, and takeovers—cannot always be relied upon. The stimulus for the increase in debt might have been a hostile takeover bid that management was trying to resist; or management might have been trying to raise funds from the capital market and found it necessary to issue debt in order to convince the market that it would use the funds wisely. For more on this issue, see Aghion et al., supra note 4.
Absolute priority (i.e., goal 3) is desirable for several reasons. First, it corresponds to what the parties contracted for outside of bankruptcy; that is, if the company were sold outside bankruptcy and there were not enough cash to pay creditors off, senior creditors would be paid off, followed by junior creditors, and so on. If contracts are not upheld within bankruptcy, creditors, particularly senior ones, may be less willing to lend to the company in the first place. In addition, as Jackson has argued, any discrepancy between what a class of claimants receives inside bankruptcy and what it receives outside bankruptcy could lead to inefficient rent-seeking—some people bribing management into deliberately precipitating bankruptcy, and other people attempting to forestall bankruptcy.9

Second, the priority of a company’s capital structure provides an important instrument for constraining management’s ability to raise fresh capital. Under certain circumstances, for example, management may issue senior debt—which mops up earnings from assets in place—in order to restrain itself from raising further capital in the future to fund unprofitable, but empire-enhancing projects. This ability to commit to profitable projects will be weakened to the extent that the seniority of initial claims is not respected, i.e., to the extent that new claims issued at a later date are not treated as junior to existing claims in a bankruptcy procedure.10

Goal 4 simply captures the idea that it is better to put decisions in the hands of claimants who suffer the consequences of those decisions than in the hands of outsiders (judges, insolvency practitioners) who do not. This does not mean, of course, that the advice of experts may not be very useful to claimants when they make their decisions—in fact, they may simply follow this advice (for more on this, see Part V).

Although we believe that goals 1-4 have great appeal, they are not beyond question. Bankruptcy scholars have raised doubts about goal 3 in particular. Critics argue that if equityholders get little or nothing in a bankruptcy proceeding, then management—acting on the equityholders’ behalf—will engage in highly risky, but inefficient, behavior when a company is close to bankruptcy, because while the shareholders gain if things go well, it is the creditors that lose if things go badly.11

9. See Jackson, supra note 3, at 21.
11. See Michelle J. White, The Corporate Bankruptcy Decision, J. ECON. PERSP., Spring 1989, at 129, 149 (1989) ("As long as streamlining the bankruptcy procedure involves compensating creditors according to the [absolute priority rule], then managers will have an incentive to gamble with creditors'
We are skeptical about this argument. It supposes that management acts on behalf of shareholders, an assumption that may be plausible for small owner-managed companies, but which is questionable for large, public companies. The recent theoretical literature on agency costs and capital structure argues that it is more reasonable to suppose that management is self-interested. Under these conditions, there is a case for making bankruptcy procedure less harsh for managers—to prevent them from engaging in highly risky behavior to save their jobs—but this is already covered under goal 2.

Even in the case of small, owner-managed companies, it is far from clear that departures from absolute priority are the best way to soften the blow of bankruptcy. A better method might be to give managers and/or owners a golden parachute in the form of senior debt.

Given the above, we shall assume that goals 1-4 are desirable, ceteris paribus. It is worth noting, however, that the procedure we propose in Part V could easily be modified to allow for departures from absolute priority if this was found to be a desirable goal.

A final important point to make is that some of the four goals may be in conflict. For example, suppose incumbent management has special skills. In that situation, ex post efficiency (goal 1) might call for the incumbent management of a bankrupt company to be retained. However, knowing this, management might have little incentive to avoid bankruptcy, i.e., goal 2 would not be served. In view of this, it is unlikely that any bankruptcy procedure can achieve all of the four goals. The best we can probably hope for is a reasonable balance between these goals—particularly goals 1 and 2. The procedure discussed in Part V is constructed with this in mind. Although we feel that it does a satisfactory job in this respect, the procedure could quite easily be fine-tuned if the balance were felt to be wrong; we return to this point in the conclusion.

12. For a recent survey of this literature, see Oliver Hart, Theories of Optimal Capital Structure: A Managerial Discretion Perspective, in THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE (Margaret M. Blair ed., 1993).
13. In addition, in order to prevent managers from delaying a bankruptcy filing for too long, it may be desirable to give creditors greater powers to push a company into involuntary bankruptcy.
IV. EXISTING PROCEDURES

Although there are many different bankruptcy procedures used around the world, these procedures fall into two main categories: cash auctions and structured bargaining. We discuss these in turn, paying particular attention to their application in the United States and the United Kingdom.

A. Cash Auctions (e.g., Chapter 7 in the United States or Liquidation in the United Kingdom)

In a cash auction, the company is put on the block and sold to the highest bidder. Often the company's assets are sold piecemeal, i.e., the company is liquidated. Sometimes, however, the company is sold as a going concern. Whichever occurs, the receipts from the sale are distributed among former claimants according to absolute priority.

In a world of perfect capital markets, a cash auction would (presumably) be the ideal bankruptcy procedure. Anybody who could make the company profitable would be able to raise cash from some source (a commercial bank, an investment bank, the stock market) and make a bid for the company. Perfect competition among bidders would ensure that the company was sold for its true value.

In practice, there is widespread skepticism about the efficacy of cash auctions. The feeling is that a combination of transaction costs, asymmetric information, and moral hazard makes it difficult for bidders to raise sufficient cash to maintain a company as a going concern (i.e., capital markets are not perfect). As a consequence, there may be a lack of competition in the auction and few bids to keep the company whole. The result will be that some companies are liquidated piecemeal and/or sold at a low price.

It is worth spelling out a transaction-cost reason for imperfect capital markets. Suppose a large public company is put on the block. Someone making a cash bid for the company is, in effect, taking the company private (unless the bidder itself represents a public company). The bidder's intention may well be to take the company public again later. The problem is that in the interim period the bidder is bearing the risk of changes in the company's value. The bidder will, of course, "charge" for this risk-bearing by offering a lower price in the original auction. The consequence of this

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15. We put in the qualification "presumably" because we are aware of no formal derivation of this result.
is two-fold. First, the going-concern bid may lose to a collection of piecemeal bids for the company's assets, since the latter achieve risk-sharing by spreading risk over a large number of bidders. Second, regardless of who wins the auction, the amount of cash raised will tend to be lower.  

The above transaction cost arises because of the difficulty of assembling a suitable group of investors to be risk bearers for the new company. Note, however, that there is a natural group of risk bearers at hand: the former claimants (who were, after all, the previous bidders). Transaction costs would be reduced if bidders could reach this group directly by offering them securities in the postbankruptcy company. This is not allowed for in a cash-only auction like Chapter 7, but is a key feature of the procedure we propose in Part V (and also of Chapter 11).

Neither the above theoretical argument nor the empirical evidence described in footnote 17 provides much indication of the magnitude of the imperfections in capital markets. Given this, any bankruptcy procedure...
adopted should work well both in the case where capital markets are perfect and in the case where they are not. The procedure described in Part V has this flexibility. As we shall see, it consists of an auction in which both cash and noncash bids for the company are allowed. If capital markets are perfect, the company will go to the bidder with the highest willingness to pay—moreover, this bidder can do no better than to offer cash—and thus the outcome will be exactly the same as in a cash-only auction. On the other hand, if capital markets are imperfect, the procedure can deliver an outcome that is superior to that achievable by a cash auction.

B. Structured Bargaining (e.g., United States Chapter 11 or United Kingdom Administration)

Because of the concern about the effectiveness of cash auctions, a number of countries have developed alternative procedures based on the idea of structured bargaining. The basic idea behind these procedures is that the company’s claimants are encouraged to bargain about the future of the company—in particular, whether it should be liquidated or reorganized and how its value should be divided up—according to predetermined rules. The leading example of a structured bargaining procedure in the West is Chapter 11 of the U.S. Bankruptcy Code; however, U.K. Administration is based on similar ideas, as are procedures in France, Germany, and Japan.

The details of Chapter 11 are complicated, but the basic elements are as follows: creditors’ claims are stayed; claimholders are grouped into classes according to the type of claim they have; committees or trustees are appointed to represent each class; and a judge supervises a process of bargaining among the committees to determine a plan of action and a division of value for the company. During the process, incumbent management usually runs the company. An important part of the procedure is that a plan can be implemented if it receives approval by a suitable majority of each claimant class: unanimity is not required.

We remark that U.K. Administration was introduced in the 1986 Insolvency Act as “the British version of Chapter 11.” An important difference between U.K. Administration and Chapter 11 is that the administrator (who is an insolvency practitioner) runs the company during bankruptcy, rather than incumbent management. There are also a number of differences in the voting rules between the two procedures. To date, the

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costs of Administration are such that it has rarely been used.

Chapter 11 has been subject to a great deal of criticism in the last few years. Among other things, practitioners and commentators have claimed that it is time-consuming, that it involves significant legal and administrative costs, that it causes considerable loss in the bankrupt company’s value, that it is (relatively) soft on management, and that the judges who run it sometimes abuse their powers. 19

It would undoubtedly be possible to modify Chapter 11—and procedures like it—to improve matters, and a number of suggestions along these lines have been made. However, we believe there are two fundamental problems inherent in any structured bargaining procedure that no amount of tinkering can solve. These problems are associated with the fact that a structured bargaining procedure like Chapter 11 attempts to make two decisions at once: what to do with the company, and who should get what in the event of a restructuring of claims.

Problem 1. Restructured companies do not have an objective value. Consequently, it is hard to know what fraction of the postbankruptcy company’s securities each group of creditors is entitled to receive. This is true even if there is no dispute about the amount and seniority of each creditor’s claim. As a result, there can be a great deal of haggling.

Problem 2. Perhaps even more serious, there is a danger that the wrong decision will be made concerning the company’s future. The voting mechanism is fixed in advance, which means that those people whose payoff ought not to be affected by the outcome (either because they are fully protected anyway, or because they are not entitled to anything) may end up controlling the pivotal votes.

Problem 1 is well understood, having been discussed at some length in the literature. 20 Problem 2 has also been noted but has been subject to

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20. See, e.g., Rot, supra note 3; Bebchuk, supra note 3. The recent bankruptcy of Macy’s provides a clear example of Problem 1. Senior creditors claimed that the reorganized company was worth little (implying that they should receive a large fraction of it). Junior creditors and shareholders
less analysis. An example may help to illustrate it.

**Example A.** Suppose senior creditors are owed $100, and the liquidation value of the company is $90. Assume that if the company were maintained as a going concern for six months then it would be worth on average $110 (suppose the discount rate is zero). However, there is uncertainty: if things go well, it will be worth $180; if things go badly, it will be worth only $40. (The average of $180 and $40 is $110.) Clearly, the value-maximizing choice is to keep the company going, since $110 exceeds the liquidation value of $90. However, it is not in the senior creditors’ interest to do this. If things go well, and the company is worth $180, the senior creditors get only the $100 they are owed. But if things go badly, they get just $40. The average of these amounts is $70, which is less than the $90 the senior creditors receive from immediate liquidation.

In this example senior creditors may vote to liquidate the company immediately rather than enter into a lengthy negotiation that might lead to the company’s being saved. This is in spite of the fact that there is enough value in the efficient outcome for the senior creditors to be paid off in full: $110 exceeds the $100 senior debt. Had the senior creditors been paid off, and the vote left in the hands of the junior creditors and the shareholders (whose money is at stake), then the junior creditors would have made the efficient decision about the company’s future.

Things may go the other way, though. Consider a variant on Example A:

**Example B.** Assume the same facts set forth in Example A, except that the upside value from continuation is lower—only $120 rather than $180. Thus, the average value from continuation is $80 (the average of $120 and $40).

In Example B, the junior creditors and shareholders are not entitled to anything, since the best that can happen to the company is that it is liquidated for $90, which is less than the senior debt. So the junior creditors and shareholders ought not to be party to the decision over the company’s future. And yet, the rules of Chapter 11 dictate that they do have votes, and as a result, they may be in a position to press for continuation (since they can see the upside potential of $120). 21 If the

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21. This is unless the cram-down procedure is adopted. See Douglas G. Baird & Thomas H. Jackson, Cases, Problems, and Materials on Bankruptcy 676 (1st ed. 1985). Under cram-down, junior claimants’ voting rights are removed on the grounds that they would receive nothing in liquidation. *Id.* (describing the procedure of 11 U.S.C. § 1129(b) (1988)). The cram-down procedure...
junior creditors and shareholders have enough votes to veto a liquidation plan, then at best the senior creditors may have to bribe them to accept it—which would lead to a violation of absolute priority—and at worst the company may be inefficiently kept going. Notice that, had the vote been left in the hands of senior creditors, they would have made the correct decision about the company’s future.22

At this point, it is worth standing back and asking why the various claimants cannot bargain around the inefficiencies described in Examples A and B, i.e., why the Coase Theorem does not solve Problems 1 and 2. Probably the most important reason is that, in the case of large companies, there are often numerous claimants (bondholders, trade creditors, and shareholders), which can make negotiation around a given (inefficient) procedure very difficult and lengthy (due to freerider and holdout problems, combined with asymmetries of information among claimants).

Consider Example A where senior creditors might vote to liquidate the company. This outcome could be avoided if junior creditors and shareholders could bribe the senior creditors not to liquidate, e.g., they could buy out the senior creditors at a price between $90 and $100. However, the more numerous and heterogeneous the junior creditors and shareholders are, the more difficult it is—and the longer it will take—to coordinate such an offer (each junior claimant will want the other junior claimants to bribe the senior creditors). As a result, either an agreement will not be reached or it will require lengthy negotiation (there may be a war of attrition).23

Similar problems arise in Example B, where senior creditors must collectively decide to make concessions to junior claimants to compensate them for not pursuing reorganization. It may be easier to achieve

cannot be relied upon, however; among other things, it requires an accurate judicial evaluation of the company’s liquidation value.

22. The empirical work on departures from absolute priority suggests that junior claimants do indeed have enough power to force concessions from senior creditors, i.e., the problem described in Example B is relevant in practice. See Julian R. Franks & Walter N. Torous, An Empirical Investigation of U.S. Firms in Reorganization, 44 J. Fin. 747 (1989). There is less formal empirical evidence on the problem described in Example A. However, practitioners frequently mention (and write about) this problem, so it would seem to be a mistake not to take it seriously. Also, the conflict between the desire of senior creditors to terminate a bankruptcy proceeding quickly, and that of junior creditors to drag it out on the off-chance that there will be something of value for them, seems to have been a factor in the recent Macy’s bankruptcy. See, e.g., Patrick M. Reilly & Laura Jereski, Media & Marketing: Macy May Seek Shorter Period for Extension, WALL ST. J., Feb. 18, 1994, at B2.

agreement in Example B, however, to the extent that the number of senior creditors is relatively small and the creditors find it easier to coordinate their actions.

A structured procedure like Chapter 11 reduces the severity of the above bargaining problems by making the majority's will binding on the minority (this mitigates freeriding and holdout behavior). However, even in this case, an efficient outcome may not be reached, e.g., because of asymmetries of information. Suppose, in Example A, junior claimants are unsure whether the company's liquidation value is really $90 as opposed to some lower figure, while senior creditors know the true value. Then junior creditors may quite rationally "low-ball" the senior creditors by offering them less than $90 to compensate them for not liquidating. In this case the senior creditors will turn them down if the true liquidation value is $90, and a valuable going-concern opportunity will be lost.\(^{24}\)

V. AN ALTERNATIVE PROCEDURE

We can summarize the previous discussion as follows. We believe existing bankruptcy procedures are flawed for two reasons: either they assume perfect capital markets (as in Chapter 7) or they mix the decision of what should happen to the company with the decision of who gets what (as in Chapter 11). We now describe a procedure that does not suffer from these defects. The key lies in transforming a group of people with different claims (and therefore different objectives) into a homogeneous class of shareholders, and then putting the company's future to a simple vote. Our proposal also avoids bargaining over the division of the pie, because it uses a mechanical procedure for distributing shares that preserves absolute priority.\(^{25}\)

The philosophy underlying the procedure—and the procedure itself—can be most easily understood in the case of a company with a single class of creditors, who are owed \(D\) by the company. Suppose the company defaults on its debt or for some other reason enters bankruptcy. The presumption is that the company is worth less than \(D\), because otherwise it should have been able to avoid bankruptcy by borrowing or issuing new equity to pay

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24. There is a vast literature on bargaining under asymmetric information. A representative article is Drew Fudenberg & Jean Tirole, *Sequential Bargaining with Incomplete Information*, 50 REV. ECON. STUD. 221 (1983).

25. However, our procedure does not avoid disputes over the amounts and seniorities of claims. Judges and the courts would undoubtedly have a very important role in resolving these disputes under our procedure, just as they currently do.
off existing creditors. Given this, the following bankruptcy procedure seems natural: cancel the company's debts, give all the equity to the former creditors, and let these creditors—as the new owners—decide what to do with the company, i.e., whether it should be sold off for cash or reorganized as a going concern. To this end, let the judge supervising the procedure solicit bids for the company, but permit noncash bids as well as cash bids. In a noncash bid, someone offers securities in the postbankruptcy company instead of cash; thus, a noncash bid embraces the possibility of reorganization and/or recapitalization of the company as a going concern. The following are some examples of a noncash bid:

1. The old managers propose to keep their jobs, and offer claimants a share in the postbankruptcy company;
2. The same financial arrangement might be offered by a new management team;
3. The managers of another company might propose to buy the bankrupt company, offering shares in their company as payment;
4. Management (old or new) might induce some debt in the company's capital structure. One way to do this would be to arrange for a bank to lend money to the postbankruptcy company (the loan is conditional on the bid succeeding), and offer claimants a combination of cash and equity in the (levered) company. Another way would be to offer claimants a combination of shares and bonds in the postbankruptcy company.

Three months are allowed for bids to be made. Finally, after the bids are in, let the new owners—the former creditors—decide by a simple majority vote which bid to select. The company then exits from bankruptcy. (At this point, it may be helpful to consult the time line in Figure 1; some aspects of this time line will be explained later.)

26. The scheme does not depend on this particular time horizon, and adjustments might be desirable. See, e.g., discussion infra pp. 867-68.
Figure 1. Time line of proposed new bankruptcy procedure.

(A) Bids solicited
(B) Rights allocated

Options exercised.
Trade in equity
and options?

<table>
<thead>
<tr>
<th>Months (approx.)</th>
<th>0</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
</table>

Bankruptcy declared.
All debt canceled
⇒ new all-equity company

Bids announced
Vote
Company exits from bankruptcy

Note that, for the bidding process to work well, it is important that potential bidders have reasonably accurate information about the company’s prospects. Part of the bankruptcy judge’s job therefore will be to ensure that bidders have access to the company’s books during the three-month bid solicitation period. Another part of the judge’s job might be to evaluate, and make recommendations about, the bids, possibly with the help of appointed outside experts (e.g., an investment bank). These evaluations and recommendations would not be binding, however, and the creditors would be free to ignore them.

The above is the bare-bones description of the Aghion-Hart-Moore (AHM) procedure. Let us now discuss two elaborations. First, it is possible that the company really is worth more than $D$. This could be the case if the company was being run inefficiently by incumbent management prior to bankruptcy, but will be run efficiently postbankruptcy. Under these conditions, the above scheme overpays creditors—they get equity worth more than $D$—and initial shareholders are short-changed. In order to deal with this possibility, the AHM procedure incorporates an idea attributable to Bebchuk. Each shareholder is given the option to buy out the

27. See Bebchuk, supra note 3.
creditors for the pro rata value of their debts. (That is, a shareholder who held 1% of the equity is given the right to buy back up to 1% of the equity for a price of $D$ per 100%. Note that creditors who are bought out must relinquish their equity—they cannot hold on.) These options are exercised once the bids are in—so that an assessment of the company’s value can be made—but before the vote. An extra month is allowed for this purpose (refer again to the time line in Figure 1 above). In addition, options can be bought and sold (unexercised options expire at month four, and are thus worthless). The point of these options is simple. Any shareholder who thinks former creditors are being overpaid can do something about it; he or she can, on a pro rata basis, pay the former creditors what they are owed and get their equity in return.

Second, companies often have several classes of creditors. The AHM procedure can be extended to this case quite easily, again using Bebchuk options. Suppose, for instance, there are two classes of creditors: senior creditors owed $D_1$ and junior creditors owed $D_2$. Initially, all the equity is given to senior creditors. However, junior creditors are given options to buy equity back from the senior creditors for a price of $D_1$ per 100%, while shareholders are given options to buy equity back from senior and junior creditors for a price of $D_1 + D_2$ per 100%. (The scheme generalizes in a natural way to the case of $n$ classes of creditors.) Again, these options are exercised after the bids are announced, but before the vote.

To see how this process works, suppose first that the best bid is perceived to value the company at less than $D_1$. Then no one will want to exercise their options (the junior creditors will not want to spend $D_1$ to get something worth less; and, a fortiori, the former shareholders will not want to spend $D_1 + D_2$), and the creditors will end up with all the equity. Suppose next that the best bid is perceived to be worth more than $D_1$, but less than $D_1 + D_2$. Then the junior creditors will choose to buy out the senior creditors, but the former shareholders will not want to exercise their options. Finally, if the best bid is perceived to be worth more than $D_1 + D_2$, then the shareholders will buy out both classes of creditors. It should be clear that these options preserve the absolute priority of claims even though there is no objective valuation of the company.

The other important point is that at the time of the vote, all claimholders’ interests are aligned. Whether those voting are former creditors or former shareholders (who have bought out the creditors), they are now all shareholders.

Shareholders who would like larger equity shares a best bid scheme because course, their options are ignored and their $1 as residues concern.

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Notice possible to keep any income prematurity their jol

28. See Bebchuk, supra note 3, at 800.
shareholders and so have an incentive to vote for the highest value bid.

Of course, there may be a divergence of opinion about the value of the
best bid (or indeed about which bid will win). No matter, because the
scheme is decentralized, everyone can act as they wish. The more bullish
people will buy out the creditors above them, and the others will not. For
larger companies, markets may develop (during the fourth month) in which
shares and options could be traded.29

Let us take a look at how our scheme operates in Examples A and B.
In Example A, there are two alternatives: liquidate for $90 or keep the
company going for an average value of $110. The big difference between
our scheme and structured bargaining is that if the former creditors as
shareholders get to vote, they will choose to keep the company going
because they enjoy all of the potential upside gains from continuation.
Of course, in this instance the former shareholders will be eager to exercise
their options, since by spending $1.00 they obtain a share worth $1.10 (we
are ignoring junior creditors). That is, the former creditors will get paid
their $100 in full by the former shareholders, and the former shareholders,
as residual claimants, will vote to maintain the company as a going
corporation. A good company has been saved.

In Example B, the alternatives are to liquidate for $90 or to keep the
company going for an average value of $80. Here, the former shareholders
will not exercise their options, and the former creditors—as the new
shareholders—will vote to liquidate and receive $90. A bad company has
been shut down.

Notice that Problems 1 and 2 have been resolved without eliminating the
possibility of reorganization. In Example A, incumbent managers are able
to retain their jobs even though they may not have the cash in hand, and
any incentive on the part of the creditors to liquidate the company
prematurely is avoided. In Example B, managers are rightly unable to keep
their jobs. In neither example is there room for haggling. And in both

29. At the same time that our proposal was being developed, two other proposals for bankruptcy
reform appeared in the literature. See Barry E. Adler, Financial and Political Theories of American
Corporate Bankruptcy, 43 STAN. L. REV. 311 (1993); Michael Bradley & Michael Rosenweig, The
Ustenable Case for Chapter 11, 101 YALE L.J. 1043 (1992); see also Barry E. Adler, A World Without
Debt, 72 WASH. U. L.Q. 811 (1994). These proposals, like ours, envisage that when a company goes
bankrupt the company’s equity is transferred to creditors. Adler’s proposal removes the right of
individual creditors to foreclose on a bankrupt company’s assets, while Bradley and Rosenweig’s does
not. In both proposals, the company’s debt is not accelerated and no bids are solicited. Also, while
both proposals envisage that the transfer of control to creditors will bring about improved management,
neither is very explicit about how this will happen.
examples, the people who end up voting over the future of the company are the residual claimants (i.e., those who bear the consequences of their actions); as a result, the final outcome is the value-maximizing choice.

VI. FURTHER CONSIDERATIONS

In this Part, we briefly raise some additional issues and discuss a number of practical problems that might arise under our scheme.

A. Treatment of Junior Creditors and Former Shareholders

In our scheme, junior creditors are required, before they receive anything, to buy out senior creditors. A concern may be that junior creditors do not have the cash on hand to exercise their options and, therefore, will be unduly disadvantaged by the need to raise cash.

We have a modification of our scheme that ameliorates this problem. Once the bids are in, the bankruptcy judge will be able to place a lower bound on the value of the company, equal to the size of the best cash bid, $V^c$ (an objective amount). Given this, he or she could proceed as if the firm were worth $V^c$, and distribute shares accordingly. If $V^c$ exceeds the amount owed to senior creditors, the junior creditors will receive a fraction of the shares in the initial distribution. For example, if the senior creditors are owed $100, and the best cash bid that comes in is for $150, then the senior creditors would be issued two-thirds of the shares and the junior creditors would be issued one-third. Of course, there may be a noncash bid that the junior creditors perceive to be worth more than $150, in which case the senior creditors would still be getting too much; but in that case the junior creditors could exercise their options to buy out the senior creditors.

Of course, even with this modification, junior creditors might still be shortchanged. The worst case would be that there is no cash bid; here $V^c = 0$, and all the equity is initially allocated to senior creditors. How bad are things for the junior creditors in such a case? We think not too bad, for at least three reasons.

First, junior creditors do not collectively have to raise the cash to buy out the senior creditors. Each junior creditor can act as an individual. The pro rata cash injection may be quite small (indeed, an individual need not exercise his options in full; he may choose to exercise only a fraction). Second, a market for options may well develop during the bankruptcy process—especially for large firms. (Indeed, the bankruptcy judge might be obliged to establish such a market.) In this case, junior creditors need not come up with cash; they could simply sell their options. Third, even
pany are of their choice.

Finally, it is important to realize that the problem facing junior creditors who wish to raise cash in order to exercise their options is quite different from that of a bidder who wishes to make a cash bid for the whole company. Because junior creditors act individually, no junior creditor who exercises her option bears much risk; nor does someone who buys the option and exercises it on her behalf. In contrast, someone who makes a cash bid for the whole company may bear a great deal of risk. Hence, there is no contradiction between supposing on the one hand that capital markets are sufficiently imperfect that noncash bids have a role to play, and supposing on the other hand that junior claimants will be able to obtain a reasonable fraction of the postbankruptcy pie by exercising or selling their options.

B. Claims Disputes

We have so far paid little attention to the question of how the amounts and seniorities of creditors’ claims are established. The adjudication process is complex and forms an important part of any bankruptcy procedure, including our own. It may be argued that our time scale of three months is too short for the purpose of allocating shares and options. There is a way of dealing with awkward claims disputes without jeopardizing our scheme, as long as a reasonable proportion of the claims can be established within the three months: take the claims that can be established, allocate shares and options on the basis of these claims alone.

30. LoPucki and Whitford examined 43 firms that filed for bankruptcy in the United States after October 1, 1979, had declared assets in excess of $100 million, and had a plan confirmed by March 31, 1988. They found that the mean return to unsecured creditors was 49.5 cents per dollar, and that the median return was 38.7 cents per dollar. See Lynn M. LoPucki & William C. Whitford, Bargaining Over Equity’s Share in the Bankruptcy Reorganization of Large, Publicly Held Companies, 139 U. Pa. L. Rev. 125, 142 (1990).

31. See the discussion in Part IV, supra, about the transaction costs of making a cash bid.
carry out the vote, and emerge from bankruptcy with the contentious claims still outstanding. Once these claims have been decided, there could be an appropriate ex post settling up—with the claimants being given securities in the postbankruptcy company.\textsuperscript{32} Notice that the people with contentious claims do not participate in the vote, but this is not too serious, since one may presume that they too would have voted for the value-maximizing bid.\textsuperscript{33}

In other words, we do not agree with those commentators who have argued that the complexity of the adjudication process favors a liquidation procedure like Chapter 7 over a reorganization procedure like Chapter 11 or like ours.\textsuperscript{34} Their point is that if a company is liquidated for cash, then the cash can be held in an interest-bearing escrow account and disbursed when the claims are resolved. We would argue that something similar can be done in the case of a reorganization plan. If a noncash bid is voted in, any subsequent dividends or debt repayments can be placed in an escrow account and distributed, along with fresh equity, once the claims are resolved.

To put it another way, we think that a bankrupt company is not so different from a solvent company that has uncertain claims against it. If there is a threat of a tort claim, a solvent company carries on operating until the tort claim is resolved and ex post settling up occurs. The company is not liquidated just because a tort claim may be established in the future.

C. Urgent Cases

For some kinds of businesses, the worry may be that three to four months is too long a period, rather than too short. This is particularly true of companies with customers and suppliers that, unless the uncertainty is resolved quickly, will shift elsewhere.

There may be a case for granting the bankruptcy judge discretion to speed up the process; that is, to hold the vote sooner. The drawback is that there may be less information available at the time of the vote, and a

32. There are several ways of doing this; one is to give new claimants the same securities that equivalent creditors elected to hold as a result of the bankruptcy process.
33. We are oversimplifying a little here. Those shareholders who think a senior claim may materialize later have an incentive to choose a risky reorganization plan since they gain if things turn out well and do not suffer if they turn out badly. See Example D supra pp. 859-60 for a similar phenomenon.
number of claims may still be outstanding. But, as we have explained above in subpart B, this need not be fatal to the efficacy of our procedure.

To safeguard against abuse, it would probably be desirable to limit the bankruptcy judge’s discretionary powers to cases in which he had clear evidence that the normal timetable would severely jeopardize creditors’ claims or the future of the business.

D. Treatment of Secured Creditors

We propose that a secured creditor’s collateral be appraised. If the appraisal value is greater than the debt, the creditor should simply be treated as if all his debt was senior—i.e., he should be allocated shares, not options. If his debt is less than fully secured, then he is given an appropriate mix of shares and options. We do not believe that secured creditors should have the right to seize collateralized property (unless it can be shown to be unnecessary to the company’s reorganization), since this could lead to an inefficient dismantlement of the company’s assets through a “me-first” grab. Note that this is also the position taken by current U.S. bankruptcy law.35

Of course, we realize that there is a tension between the view that a secured creditor’s rights to seize assets should be restricted and the view, which we also hold, that private contracts should be upheld (the secured creditor’s contract may have included the right to seize assets). In some cases, there may be efficiency gains from letting an outside party exercise its right to seize a specific asset. Note that the parties may be able to achieve something like this arrangement—even under our scheme—by making the outside party the owner of the asset and having the company rent the asset from him. In this case, if the company goes bankrupt, the outside party might be in a stronger position to repossess its property (a bidder for the company could, of course, negotiate with the outside party for the continued use of the asset if this were desirable).36

E. Who Runs the Company During Bankruptcy?

In Chapter 11, incumbent management typically runs the company during bankruptcy. An alternative is for a trustee to run the company, as in old Chapter X of the U.S. Bankruptcy Code. Clearly, this is an important issue

for any bankruptcy procedure. Notice that our procedure can be applied regardless of how this issue is resolved.

F. Debtor-in-Possession Financing

The viability of certain kinds of bankrupt companies (such as retail stores) can depend to a great extent on management being granted debtor-in-possession financing, whereby suppliers' credit is placed ahead of existing (unsecured) senior debt. (Ensuring this financing is often mentioned as an important role played by Chapter 11.) There is no reason why a comparable arrangement could not be used during the four months of our proposed bankruptcy process, with the judge’s approval.

G. Partial Bids

We have implicitly assumed that the bids received are for the entire company. In fact, bids may be for parts of the company. The problem then arises as to how to deal with overlapping or inconsistent bids. Before a vote can be taken, a menu of coherent options has to be assembled.

We think that it makes most sense to leave the matter of assembling "whole" bids in the hands of the judge and his or her appointed agents. It may well be necessary to solicit supplementary bids for parts of the company, in order to package a whole bid. Although this seems messy, it should be noted that a similar difficulty—how to bundle or unbundle the assets of the company so as to maximize cash receipts—is faced in a Chapter 7 proceeding.

H. Voting Procedures

Another issue concerns the voting procedure per se. If there are only two bids, it seems natural to have a simple vote between them. However, with more than two bids, there are many possibilities. Shareholders could cast their votes for their most preferred plan, with the plan that receives the most votes being the winner; or shareholders could rank the plans, with the plan that receives the highest total ranking being chosen; or there could be two rounds, in which shareholders rank the plans in the first round, with a subsequent runoff between the two highest-ranked plans in the second round. One point to note is that the Condorcet Paradox are less likely to arise in the present context, given that shareholders have a common objective: value maximization.

37. Another possibility is to put the onus of assembling whole bids on the bidders themselves, i.e., a bidder for part of the company would have to find someone else to bid for the complementary part.
I. Small Companies

Our scheme is likely to be most valuable in the case of medium to large companies with multiple creditors, for which bankruptcy raises the thorniest problems. However, most bankruptcies relate to small companies, for which a bank is typically the single main creditor. Under our scheme, the bank would get all the equity (presuming that it is not bought out) and could "vote" on whether to liquidate or reorganize the company. In addition, our scheme allows junior creditors—e.g., trade creditors—to buy out the bank; trade creditors might have an incentive to vote to keep the company going because they anticipate profitable trade with the company in the future. In short, our scheme may also have a role to play in the case of small companies.

J. Workouts

Many of the problems of bankruptcy plague company workouts. There is no reason why companies could not, of their own accord, choose our scheme as a vehicle for facilitating such workouts.

VII. CONCLUDING REMARKS

First, it is worth repeating what we see as the main point of this Article. Current reorganization procedures are flawed because they mix the decision of who should get what with the decision of what should happen to a bankrupt company. We have proposed a procedure that separates these two issues.

Second, it may help to say a few more words about the philosophy underlying our procedure. Our view is that a bankrupt company is not fundamentally different from a solvent company that is performing badly. In the case of a solvent company, shareholders elect a board of directors who are entrusted with deciding, on a day-to-day basis, whether to keep the company going, sell it, or close it down. We believe that the same menu of options should be available to the claimants of a bankrupt company. In other words, we do not see why bankruptcy should automatically trigger the termination of a company via a cash sale (either as a going concern or in pieces). We see bankruptcy as an indication that something is wrong with management rather than with the company itself. The appropriate response is to allow new management teams the opportunity to replace existing management. Our scheme does this through the device of a noncash bid. Noncash bids allow for Chapter 11-type reorganization plans.
However, in our scheme, unlike in Chapter 11, the company’s future is decided by a simple vote—a procedure that is standard for solvent companies—rather than by a complex bargaining procedure that is never seen outside bankruptcy.

An interesting insight into how our scheme might work is provided by the recent takeover battle for Paramount. There were two bidders for Paramount—Viacom and QVC—and each put in a bid with a noncash component as well as a cash component. Paramount shareholders chose between the bids—and the option of keeping Paramount independent—by what was in effect a vote. (Viacom won the vote.) Thus the choice Paramount shareholders were asked to make is analogous to the choice claimants would make in our scheme in the presence of noncash bids.

We noted in Part III that a good bankruptcy procedure should balance two goals: one is to achieve an ex post efficient outcome, the other is to be neither too hard nor too soft on incumbent management (so as to encourage the appropriate behavior prior to bankruptcy). We believe that our procedure does a reasonable job of balancing these objectives. Note, however, that the procedure can be modified to be softer or harder on incumbent management (at some probable cost in terms of ex post inefficiency), if that is thought to be desirable. For example, incumbent management could be favored by handicapping other bidders in the auction—e.g., the auction rules could state that an outside bidder has to win more than two-thirds of the votes. (Another way to soften the blow of bankruptcy is to give managers a golden parachute in the form of senior debt in their company.) Conversely, management could be disfavored by a requirement that they must win more than two-thirds of the votes to retain their jobs.

Finally, it is worth repeating a point we made in Part IV. A good bankruptcy procedure should work well both when capital markets are imperfect and when they are perfect. Our procedure has this feature. If capital markets are perfect, the company will go to the bidder willing to pay the highest amount—moreover, this bidder can do no better than offer cash—and thus the outcome will be exactly the same as in Chapter 7. For this reason, while believers in perfect capital markets may not see the merit of our scheme relative to Chapter 7, they should not be strongly opposed to it. In contrast, those with doubts about the adequacy of capital markets should, we feel, find value in the scheme.