THE LOGIC AND LIMITS OF CONTRACT BANKRUPTCY†

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Corporate reorganization under chapter 11 of the Bankruptcy Code is the current focus of heated debates among bankruptcy scholars. Recent commentary is filled with calls from neolibertarian bankruptcy scholars arguing for the privatization of business insolvency proceedings. These theorists argue that private-law bankruptcy alternatives are preferable to legislation on freedom-of-contract grounds. They emphasize the efficiency of contract-based bankruptcy rules and contend that the shift from public to private rules would substantially reduce enforcement costs. Based on an economic analysis, these commentators argue that federal bankruptcy law is unnecessary and costly and that private contracts, subject only to common-law rules of property and contract, are sufficient to resolve financial common pool problems. Finally, these theorists argue that bankruptcy law should seek to maximize distributions to creditors, but should not seek any redistributive purposes. They criticize current bankruptcy law for improperly incorporating redistributive goals more appropriately addressed through tax laws.

Traditional bankruptcy scholars have criticized these theorists on numerous grounds. They argue that private bankruptcy contracts do not create the appropriate ex ante incentives for the affected parties and permit a redistribution of wealth from weak to strong creditors. Finally, these traditionalists question the claim that private contracts would reduce enforcement costs.

In this article, Professor Block-Lieb argues that current commentary on both sides of the debate fail to address the issue of private action in a meaningful manner. She argues that the choice between mandatory bankruptcy legislation and contract bankruptcy must consider implementation costs and ex post effects as well as ex ante incentives and enforcement costs. The article analyzes the choices among

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bankruptcy rules in terms of the broad institutional choices they implicate and seeks to refute the neolibertarian contention that private action is preferable to legislation in the context of bankruptcy.

I. INTRODUCTION

Modern libertarians admit of few exceptions to their preference for private ordering.[1] Consistent with this narrow vision of the proper role for legislation, neolibertarian scholars would repeal federal and state environmental regulations,[2] the regulations governing health care providers,[3] and employment discrimination law.[4] According to this perspective, the laws regulating corporate governance involve wrong-headed interference with private contracts,[5] as does most of the regulation of cyberspace.[6]

Neolibertarian scholars also would prefer contract bankruptcy to corporate reorganization under chapter 11 of the Bankruptcy Code. Recent commentary is filled with calls to "privatize" business insolvency

1. *E.g.*, RICHARD A. EPSTEIN, PRINCIPLES FOR A FREE SOCIETY: RECONCILING INDIVIDUAL LIBERTY WITH THE COMMON GOOD (1998) [hereinafter EPSTEIN, PRINCIPLES FOR A FREE SOCIETY]; RICHARD A. EPSTEIN, SIMPLE RULES FOR A COMPLEX WORLD (1995) [hereinafter EPSTEIN, SIMPLE RULES]. I describe Epstein as a neolibertarian in that his brand of libertarianism does not categorically reject consequentialist concepts of justice and social welfare. Indeed, he explicitly attempts in his more recent work to reconcile deontological natural rights theory with consequentialist utilitarian theories. EPSTEIN, SIMPLE RULES, *supra*, at 30.

> Although I have from time to time been of different minds on this proposition, I have now made peace with myself and believe that these consequentialist theories—that is, those which look to human happiness—offer the best justificatory apparatus for demarcating the scope of state power from the area of individual choice.

EPSTEIN, PRINCIPLES FOR A FREE SOCIETY, *supra*, at 11 (setting forth the goal of "push[ing] the connections between the individual and the common good in both private and public law settings"). "True" libertarians hold utilitarian theories as irreconcilable with their own. ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 41 (1974) ("Utilitarian theory is embarrassed by the possibility of utility monsters who get enormously greater gains in utility from any sacrifice of others than these others lose. For, unacceptably, the theory seems to require that we all be sacrificed in the monster's maw, in order to increase total utility.").

2. *E.g.*, TERRY L. ANDERSON & DONALD R. LEAL, FREE MARKET ENVIRONMENTALISM (1991); EPSTEIN, SIMPLE RULES, *supra* note 1, at 275–305.

3. *E.g.*, RICHARD A. EPSTEIN, MORTAL PERIL: OUR INALIENABLE RIGHT TO HEALTH CARE? (1997).

4. *E.g.*, RICHARD A. EPSTEIN, FORBIDDEN GROUNDS: THE CASE AGAINST EMPLOYMENT DISCRIMINATION LAWS (1992); EPSTEIN, SIMPLE RULES, *supra* note 1, at 170–93.

5. *E.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1–39 (1991); EPSTEIN, SIMPLE RULES, *supra* note 1, at 246–75; RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 292–93 (2d ed. 1977); NICHOLAS WOLFSON, THE MODERN CORPORATION: FREE MARKETS VERSUS REGULATION 75–107 (1984); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976).

6. *E.g.*, PETER HUBER, LAW AND DISORDER IN CYBERSPACE: ABOLISH THE FCC AND LET COMMON LAW RULE THE TELECOSM 3–9 (1997); Frank H. Easterbrook, *Cyberspace and the Law of the Horse*, 1996 U. CHI. LEGAL F. 207, 213–16 (1996); I. Trotter Hardy, *The Proper Legal Regime for 'Cyberspace'*, 55 U. PITT. L. REV. 993 (1994); Lawrence Lessig, *The Path of Cyberlaw*, 104 YALE L.J. 1743 (1995).

proceedings.[7] These free market theorists insist that business bankruptcy legislation imposes net social costs—costs that voluntary contractual arrangements would avoid. Some of these bankruptcy commentators argue that contract law provides an efficient substitute for chapter 11.[8] Others argue that the law of secured and securitized[9] transactions largely subsumes corporate reorganization law.[10]

Why should business entities be allowed to enter into enforceable contractual arrangements in lieu of the processes and protections contained in current bankruptcy legislation? Neolibertarian bankruptcy theorists explain their preference for contractual bankruptcy resolutions in several ways.[11] They argue that private-law bankruptcy alternatives are preferable to legislation on freedom-of-contract grounds. They also emphasize the efficiency of contract-based bankruptcy rules—efficient both because private agreements are better suited than public regulation to create the proper ex ante incentives for affected parties, and because legislative rules can improperly incorporate redistributive goals that are better addressed through tax laws. Finally, these commentators contend that the shift from public to private bankruptcy rules would reduce the substantial enforcement costs found under current legislation.

7. Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1851 (1998) ("This Essay's central claim is captured in a variation on a trendy slogan: Privatize bankruptcy.").

8. *E.g.*, Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107 (1994) [hereinafter Adler, *Finance's Theoretical Divide*] (arguing that Chameleon Equity would better resolve financial distress than bankruptcy legislation); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) [hereinafter Adler, *Financial and Political Theories*] (same); Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343 (1997) [hereinafter Adler, *Theory of Corporate Insolvency*] (same); Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811 (1994) [hereinafter Adler, *World Without Debt*] (same); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992) (arguing that excessive bankruptcy costs undermine justification for chapter 11, and proposing conditional equity as private-law substitute); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992) (arguing that bankruptcy law should be viewed as "default rule" that parties can contract around); Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343, 343 (1999) ("If the rule against contracting for a preferred bankruptcy system were relaxed, parties would write 'bankruptcy contracts' that would induce a borrowing firm to choose the system that would be optimal for it and its creditors were it to become insolvent."); Schwartz, *supra* note 7, at 1850 (arguing that parties should be able "to contract for the bankruptcy system that they prefer").

9. Article 9 of the Uniform Commercial Code governs secured and securitized transactions. "Securitized transactions," also referred to as "structured finance transactions," "asset-back arrangements," and "asset securitization," are defined as a "structured process whereby loans and other receivables are packaged, underwritten, and sold in the form of securities." JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 3 (1988); *see also, e.g.*, Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101 (1997); Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061 (1996); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994); Steven L. Schwarcz, *Structured Finance: The New Way to Securitize Assets*, 11 CARDOZO L. REV. 607 (1990).

10. *E.g.*, Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992); Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515 (1999).

11. *See infra* text accompanying notes 24–34.

Thus far, criticism of this private-law bankruptcy scholarship proceeds from a suspicion of its origins in an economic analysis of bankruptcy law.[12] Critics argue that neolibertarian theory misstates the normative premises of bankruptcy law. They take issue with the assumptions that underlie the empirical case against chapter 11. They argue that bankruptcy contracts would permit a redistribution of wealth from weak to strong creditors. Critics question the accuracy of the claim that shifting from a legislative to a contractual bankruptcy resolution would promote the correct ex ante incentives for a firm's management, and the claim that a contract-bankruptcy regime would result in a net savings of bankruptcy-related administrative costs. Indeed, some question the feasibility of the bankruptcy contracts that have been proposed.

Critics' focus on administrative and other costs has resulted in no clear basis for accepting or rejecting private-law bankruptcy alternatives. Existing estimates of legislative bankruptcy costs vary widely,[13] and there is no way to project the benefits or costs of a contractual regime that does not yet exist.[14] Moreover, critics' outright rejection of an economic analysis of bankruptcy law permits private-law advocates to ignore this critique on ideological grounds.[15] Readers are left with the uneasy impression that the choice between bankruptcy legislation and these private-law alternatives is indistinguishable from the choice between economists' contention that bankruptcy rules should maximize wealth, and not seek to accomplish distributive purposes, and traditionalists' contention that bankruptcy laws should attempt to redistribute wealth among debtors and creditors, even if creditor welfare is not maximized as a consequence. And yet the case for private-law bankruptcy alternatives rests not only on arguments favoring efficiency, but also on the libertar-

12. *See infra* text accompanying notes 48–58.

13. *E.g.*, Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067 (1984); James S. Ang et al., *The Administrative Costs of Corporate Bankruptcy: A Note*, 37 J. FIN. 219 (1982); Sanjai Bhagat et al., *The Costs of Inefficient Bargaining and Financial Distress: Evidence from Corporate Lawsuits*, 35 J. FIN. ECON. 221 (1994); David M. Cutler & Lawrence H. Summers, *The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation*, 19 RAND J. ECON. 157 (1988); Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 335–38 (1990); Jerold B. Warner, *Bankruptcy Costs: Some Evidence*, 32 J. FIN. 337 (1977); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 289 (1990); Michelle J. White, *Bankruptcy Costs and the New Bankruptcy Code*, 38 J. FIN. 477, 483–84 (1983).

14. Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317, 333 (1999).

15. *See* Adler, *World Without Debt*, *supra* note 8, at 825–27 (identifying criticisms of Chameleon Equity); Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1111 ("The notion that contract can better provide any incentive forms the theoretical divide . . . between critics of and defenders of bankruptcy law."); Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 575 (1999) (describing contradictory axioms that divide modern bankruptcy scholarship, and concluding that these axioms "stem not from different political beliefs but rather from radically different views of the underlying normative bases of the role of bankruptcy law and the aims of legal scholarship"); Schwartz, *Bankruptcy Contracting Reviewed*, *supra* note 8, at 363 (contending that what most separates him from LoPucki is that LoPucki "is suspicious of all contractual schemes that deal with bankruptcy").

ian contention that individual autonomy exceeds democratic principles in importance. A critique of contract-bankruptcy rules that is premised solely upon a rejection of their wealth-maximizing utilitarian underpinnings does not refute this libertarian logic.

The choice between mandatory bankruptcy legislation and contract bankruptcy should consider ex ante incentives and reduced enforcement costs. It should also consider enhanced implementation costs and ex post effects. To focus on ex ante incentives but not ex post effects, to emphasize enforcement costs but ignore decision-making costs, presents an incomplete case for or against contract-bankruptcy proposals. In the same way as one blind man feels the trunk of an elephant and describes a serpent, while another feels the elephant's massive side and describes a rough wall, proponents and critics have made narrow cases for or against these private-law bankruptcy alternatives. When choosing a system of bankruptcy rules, whether these are rules of property, contract, or legislation, we should consider the social losses caused by a firm's financial distress as well as the social costs of implementing and enforcing the legal rules that are adopted to resolve this failure.[16]

The proposed analysis permits comparison, not only comparison of the various contract-bankruptcy proposals, but also comparison between contract-bankruptcy proposals and the mandatory legislative regime they would replace. The choice between mandatory bankruptcy legislation and contractual bankruptcy rules involves a comparison of imperfect decision-making institutions—namely, the choice among the market, legislature, and judiciary.[17] Throughout this article, I consider the choices among bankruptcy rules in terms of the institutional choices that they implicate. Comparative institutional analysis is favored on the grounds that these institutions are all imperfect decision makers, and current bankruptcy legislation and the proposed private-law alternatives all provide imperfect resolutions. Neolibertarian scholarship confuses argu-

16. *See* Schwartz, *supra* note 7, at 1814 ("[A]n efficient bankruptcy system maximizes the value that firms have in, and as a consequence of, the system and minimizes the costs of realizing that value."); *cf.* JAMES M. BUCHANAN & GORDEN TULLOCK, THE CALCULUS OF CONSENT 44 (1962) ("If we wish to compare collective organization with private organization, and especially if we want to analyze various collective decision-making rules, we need, even at the conceptual level, some means of comparing the *net* direct gains or the *net* direct costs of collective action with the *costs of organization* itself . . . ."); GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 26 (1970) ("I take it as axiomatic that the principal function of accident law is to reduce the sum of the costs of accidents and the costs of avoiding accidents."); EPSTEIN, SIMPLE RULES, *supra* note 1, at 32 ("[T]he social function of law is to minimize the sum of the administrative (including error) costs and the costs associated with the creation of poor incentives for individual action.").

17. *See generally* NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS AND PUBLIC POLICY (1994); NEIL K. KOMESAR, LAW'S LIMITS: THE RULE OF LAW AND THE SUPPLY AND DEMAND OF RIGHTS (forthcoming 2001); Neil K. Komesar, *Exploring the Darkness: Law, Economics, and Institutional Choice*, 1997 WIS. L. REV. 465; Neil K. Komesar, *In Search of a General Approach to Legal Analysis: A Comparative Institutional Alternative*, 79 MICH. L. REV. 1350 (1981). For a review of Komesar's book, and his reply, see Thomas W. Merrill, *Institutional Choice and Political Faith*, 22 LAW & SOC. INQUIRY 959 (1997), and Neil K. Komesar, *The Perils of Pandora: Further Reflections on Institutional Choice*, 22 LAW & SOC. INQUIRY 999 (1997).

ments that contractual arrangements plausibly could resolve the financial distress of a business entity with the contention that these contracts always should be preferred over bankruptcy legislation. Comparison of competing institutions allows us to choose among these alternatives because, in the context of a specific rule, the strengths and weaknesses of one institution may prevail over the relative strengths and weaknesses of the others.

Through application of a comparative institutional framework, this article seeks to refute neolibertarian theorists' contention that private action is preferable to legislation in the context of bankruptcy, and concludes that legislation fares far better than these theorists admit. It finds that the case for favoring contractual over legislative bankruptcy rules is incoherent in at least three ways. First, the neolibertarian claim that appropriate ex ante incentives for corporate actors are best realized by enforcing private agreements confuses substance with form. A firm's incentives are more likely to be affected by the content of the bankruptcy rule than whether it is forged in the legislature or the market. Second, theorists' emphasis on the importance of individual autonomy is empty rhetoric. Many of the contractual bankruptcy resolutions offered by neolibertarian theorists would covertly bind nonparties—a result completely contrary to principles of freedom of contract.[18] Finally, despite assertions to the contrary, many of the proposed private-law bankruptcy substitutes would create immense decision-making costs, and all of the bankruptcy contract proposals would impose enforcement costs of a magnitude both substantial and comparable to the legislative rules these contracts are meant to replace. In short, there are no simple contractual solutions for complex business bankruptcies.[19]

I divide the remainder of this article into four sections. In part II, I describe this free market bankruptcy commentary and the response of critics in greater detail. In part III, I focus on the proper goals of business bankruptcy law. Prior commentary has extensively debated the topic of normative purposes. On one side, theorists who apply an economic analysis embrace efficiency as the sole normative purpose of bankruptcy rules, argue that bankruptcy law should seek only to maximize creditors' collective wealth, and criticize redistributive bankruptcy laws and reform proposals as inefficient. On the other side, the so-called traditionalist commentators reject wealth maximization as an appropriate

18. Boston Ice Co. v. Potter, 123 Mass. 28, 30 (1877) (defining "freedom of contract" as the freedom "to select and determine with whom he will contract, and [he] cannot have another person thrust upon him without his consent").

19. This article does not reject outright all private-law bankruptcy alternatives. In some instances, multiparty agreements to opt out of default bankruptcy legislation could achieve desirable cost savings without creating undesirable distributive or incentive effects and without undermining individual autonomy, especially if the default-rule proposal were coupled with statutory protection for creditors incapable or unlikely to adjust to the contractual alternative to bankruptcy. Bebchuk and Fried refer to these as "nonadjusting creditors." *See* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1995).

goal for bankruptcy legislation, contending that this law should seek to temper the harsh effects of a debtor's insolvency and redistribute losses so as to protect those least able to protect themselves in the marketplace. I attempt to reconcile these purposes, and, as noted above, argue that bankruptcy law should seek to minimize both the social losses caused by a debtor's financial distress and the costs of implementing and enforcing the legal rules adopted to resolve them. This section is mostly definitional. It describes the direct and indirect losses resulting from the financial distress of a business debtor. It also differentiates between the decision-making and enforcement costs of bankruptcy rules, including both external and internal decision-making costs. Describing the purpose of business bankruptcy law in terms of minimizing the social losses and costs of financial distress encourages comparison of the incentives and effects of current bankruptcy legislation to those of the proposed private-law alternatives. It also permits examination of the tension that exists among the goals of efficiency, individual autonomy, and parsimony in administration.

In part IV, I raise, and seek to answer, questions regarding the proper structure of the legal rules governing the financial distress of a firm. Although there may be other possibilities, part IV compares the implementation of three types of bankruptcy rules that could define rights in the event of the debtor's financial distress:[20] private individual action involving an agreement between the debtor and a single creditor; private collective action through an agreement among all or significantly all affected persons; and public collective action through legislation. Comparisons are made according to the loss and cost minimization goals established in the prior section.

Part IV is divided into several subparts. The first of these, section A, compares the ability of contractual and legislative resolutions to minimize bankruptcy losses across society. Loss minimization is a complex goal in any context, particularly when applied broadly rather than just to specified subgroups. Welfare economists have long sought to determine how distinct losses should be balanced, one against the other, when one group's loss occurs as a result of another group's gain. Much depends upon broadening our understanding of the concept of social welfare. Section A attempts this for the bankruptcy context.

Section B of part IV considers the goal of cost minimization, and differentiates among ex ante external and internal decision-making costs and ex post enforcement costs. External decision-making costs measure a rule's impact on the individual autonomy of entities bound by the rule.

20. Although I call them "bankruptcy rules," I view the first and second of these rules as private-law alternatives to bankruptcy legislation. That is, as to both, I assume that current prohibitions against agreements not to file bankruptcy are overridden. Private individual action includes secured and securitized transactions, as well as two-party bankruptcy waiver agreements. Private collective action would include Adler's Chameleon Equity and other procedure agreements proposed by bankruptcy theorists as private-law replacements for bankruptcy legislation.

Libertarian thinkers generally view the external decision-making costs of legislation as greater than those associated with contractual resolutions, but this supposed truism presumes that the entities bound to the contract voluntarily and knowingly consented to its binding effect. This presumption would not hold true for several of the contractual bankruptcy alternatives promoted by neolibertarian bankruptcy theorists. Subpart 1 of section B, thus, exposes the freedom-of-contract claims made by these commentators as having exaggerated the individual autonomy that would be protected under their proposals.

Subparts 2 and 3 of section B examine neolibertarian contentions that the administrative costs associated with private-law bankruptcy alternatives would be less than those associated with the current Bankruptcy Code. This section first questions the assertion that the costs of implementing contract-based bankruptcy rules—their internal decision-making costs—would be, or at least over time become, manageable, particularly where multiparty contractual agreements are envisioned. It also criticizes commentators' focus on the costs of enforcing legislative bankruptcy rules, although not on the grounds that the costs of these judicial assessments have been inflated by these scholars. The magnitude of enforcement costs in bankruptcy court is an empirical question, and I have no new data to offer. Instead, I argue that their emphasis is misplaced because it presumes wrongly that the enforcement of contractual bankruptcy resolutions would be nominal. Both private- and public-law mechanisms for resolving a firm's financial distress would engender substantial litigation as, under both, incentives exist for strategic interpretation of the governing rules. Accordingly, there is little basis for concluding that contract rules are always less expensive to enforce than legislative ones.

One final note before proceeding. This article assesses commentators' claims that business bankruptcy legislation should be replaced, either completely or on a case-by-case basis, with prebankruptcy contracts. Nonetheless, my hope is that this critique of neolibertarian commentary, while focused on the claim that business bankruptcy legislation should be replaced by private contracts governing parties' remedies in the event of a business debtor's insolvency, might also find application outside the bankruptcy context. The basic framework adopted in the article—the argument that the choice between contractual and legislative rules of law should consider both social losses and the cost to society of implementing and enforcing whatever rule is adopted to address the loss—is general enough that it can be tailored to apply to nearly any area of the law.

II. THE GREAT DIVIDE IN BANKRUPTCY THEORY

The contention that bankruptcy legislation best resolves business debtors' financial distress is hotly contested among scholars applying an economic analysis to bankruptcy law. Early economic theories of bank-

ruptcy law argued that legislation is necessitated by the common pool problem faced by creditors of a financially distressed debtor.[21] This common pool problem was said to arise because self-interested creditors have every incentive to collect as many of the debtor's assets as quickly as they can—creditors who are first to collect suffer none of the deleterious effects of their collection actions. Despite the economic focus of this analysis, it did not point to the marketplace as the proper institution for resolution of a debtor's financial distress. It was, instead, a contractarian model of bankruptcy law, implicitly characterizing creditors' common pool problems as impediments to marketplace resolution and hypothesizing that creditors would consent to the liability rules in bankruptcy legislation in order to resolve this common pool problem to their collective benefit. According to this economic account, bankruptcy law should maximize distributions to creditors,[22] but seek to achieve no other distributive purposes on the grounds that (most) redistributive bankruptcy laws create improper incentives for commencement of a bankruptcy case.[23]

The new bankruptcy law and economics rejects the need for legislative bankruptcy rules. Adopting a libertarian approach, these commentators argue that bankruptcy legislation is unnecessary to resolve financial common pool problems; that rules of contract or property are sufficient, and some would argue preferred, methods of resolution.[24] Ar-

21. *See* DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS AND MATERIALS ON BANKRUPTCY LAW 20–30 (3d ed. 1995) [hereinafter BAIRD & JACKSON, CASES, PROBLEMS AND MATERIALS] (discussing "creditors' bargain" theory of bankruptcy law); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 228–48 (1986) [hereinafter JACKSON, LOGIC AND LIMITS] (same); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987) [hereinafter Baird, *Loss Distribution*] (explicating limited normative goals for bankruptcy law); Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173, 183–84 (1987) [hereinafter Baird, *World Without Bankruptcy*] (same); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 858–71 (1982) [hereinafter Jackson, *Bankruptcy, Non-Bankruptcy Entitlements*] (creating simple creditors' bargain model of bankruptcy law based on comparison of creditors' collection choice to prisoner's dilemma); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 178 (1989) (creating "expanded creditors' bargain model" of bankruptcy).

22. Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 101–09 (1984); Baird, *Loss Distribution*, *supra* note 21, at 822–24; Baird, *World Without Bankruptcy*, *supra* note 21, at 173.

23. *But see* Jackson & Scott, *supra* note 21, at 164–69 (subsequently expanding "creditors' bargain" model to justify downstream redistributions among creditors—reallocations of creditor wealth from high priority creditors to low priority creditors intended to spread the risk of loss from a debtor's insolvency). *See also* Baird, *supra* note 15, at 589–93 (differentiating between "traditionalists" and "proceduralists" in that "traditionalists" believe that consideration of ex post effects of bankruptcy matter more than its ex ante effects, whereas "proceduralists" contend that ex ante effects matter most).

24. *E.g.*, Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1111–31 (contending that financial distress of corporate debtors is more efficiently resolved by means of contract than through bankruptcy legislation); Adler, *Financial and Political Theories*, *supra* note 8, at 323–33 (describing Chameleon Equity as efficient substitute for law of corporate reorganization); Adler, *World Without Debt*, *supra* note 8, at 811–12 (expanding upon his argument that "there is no collective action problem"

guments for the deregulation of corporate bankruptcy law proceed on two levels.

First, these neolibertarian theorists argue that private-law substitutes for bankruptcy legislation are theoretically plausible. They question the assertion that a debtor's financial distress presents a common pool problem for its creditors.[25] If there is no financial common pool problem, then there is no market failure to justify the existence of bankruptcy legislation, and only manageable impediments to negotiations about the contingency of financial distress. These commentators reject the metaphor of the common pool because they reject the contractarian view that creditors would voluntarily agree to the enactment of bankruptcy legislation.[26] Instead, they "attempt to devise a bankruptcy system which mirrors the set of contractual rules that a firm would establish with its consensual creditors at the time these creditors initially decide to lend money to the firm."[27]

Second, neolibertarian bankruptcy commentators argue that private-law resolutions are preferable to legislative ones. In terms of theory, these commentators begin from the premise that bankruptcy law should seek to promote economic efficiency, and that economic efficiency is best realized through consensual agreements among private parties.[28] They question "whether bankruptcy law should trump a freely

and, therefore, "in principle no need for corporate bankruptcy"); Bradley & Rosenzweig, *supra* note 8, at 1078–88 (contending that chapter 11 reorganization provisions of Bankruptcy Code should be replaced with preinsolvency contractual provisions they call contingent equity); Picker, *supra* note 10, at 649–53 (discussing resolution of financial common pool problems by means of Article 9 security interests); Rasmussen, *supra* note 8, at 55–68, 100–11 (describing law of corporate reorganization as default rule and advocating adoption of "menu" approach to such law by which owners of firm would make ex ante bankruptcy choice; "no bankruptcy" among options on menu); Schwarcz, *supra* note 10, at 534–90 (contending that parties should be allowed to enter into multiparty and two-party contractual arrangements that supplant bankruptcy); Schwartz, *supra* note 7, at 1851 (arguing that bankruptcy law should be "privatized" and replaced with contractual agreements among a debtor and the majority of its creditors).

25. *E.g.*, Adler, *World Without Debt*, *supra* note 8, at 811 (contending that "there is no collective action problem"); James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097, 2104 (1990) (questioning existence of financial common pool problems); Picker, *supra* note 10, at 679 (arguing that "[t]he common pool need not arise"); Rasmussen, *supra* note 8, at 59 ("Bankruptcy law is not the term that creditors would agree upon amongst themselves so as to increase their expected return; rather, it is the term that the firm would offer the creditors to maximize *its* expected return.").

26. For example, Barry Adler questions the contractarian premises of Jackson and Scott's "expanded creditors' bargain" model, refuting the possibility that their risk-sharing theory "offers investors a better bargain than the carefully integrated actual bargain that reallocation alters" and concluding that "this refutation leaves much of current bankruptcy law without theoretical justification." Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 441–42 (1992); *see also* Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1108, 1111. Adler also questions the premise that bankruptcy law is necessary to resolve financial common pool problems on the grounds that the law of contract could satisfactorily do the job. *Id.* at 1111–31; Adler, *Financial and Political Theories*, *supra* note 8, at 314, 323–33; Adler, *World Without Debt*, *supra* note 8, at 818.

27. Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 2.

28. *E.g.*, Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1111 (contending that contractual-bankruptcy rules should be preferred to legislative ones); Baird, *supra* note 15, at 582 ("The mission of

entered-into contract."[29] They also find contract bankruptcy preferable on pragmatic grounds. According to this line of argument, bankruptcy legislation imposes improper administrative and enforcement costs because it resolves a debtor's financial distress only after the fact, through judicially enforced legal rules.[30] It also creates improper ex ante investment incentives and imposes distributional costs on minority creditors,[31] by recognizing a new value exception to the rule of absolute priority[32] and by granting favored creditors, such as employees and retirees, priorities in distribution and other benefits.[33] These commentators view private-law alternatives preferable on the grounds that they would avoid the enforcement and distributional costs associated with bankruptcy legislation.[34]

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bankruptcy is to ensure that firms do not fail simply because they have creditors they cannot pay. . . . [T]hat the capital structure of a firm includes debt as well as equity should not change the view that the market in the end decides which firms fail."); Rasmussen, *supra* note 27, at 2 (describing bankruptcy law as attempting to mirror consensual prebankruptcy agreements among debtor and its creditors); Schwartz, *supra* note 8, at 343 ("Requiring parties always to use the mandatory state system increases a borrowing firm's cost of capital over the cost that would obtain in a world in which the firm and its creditors could contract for an alternative bankruptcy system.").

29. Schwarcz, *supra* note 10, at 523. Steven Schwarcz consciously rejects labeling himself as a neolibertarian "free marketer."

> I combine these perspectives by acting as both a free marketer in inquiring whether prebankruptcy contracting can make the bankruptcy system more efficient and as a traditionalist in recognizing that political realities constrain the extent to which prebankruptcy contracting may be allowed to impinge on the Code's fundamental policies.

Id. at 523. He treads the line between "free marketers" and "traditionalists" by proposing that prebankruptcy contracts that neither violate bankruptcy policies nor create externalities with a material secondary impact should be enforceable. *See id.* at 579. He concludes that externalities would have a material impact if they would result in class Pareto inefficiency—a concept he defines as existing whenever the "overall gains to an individual class exceed the losses to that class even if some members of the class individually are harmed." *Id.* at 563. Moreover, he identifies three fundamental policies underlying bankruptcy law: equality in distribution; debtor rehabilitation; and efficient bankruptcy administration. *Id*. at 542, 576–84.

30. For efforts to quantify the direct and indirect costs of bankruptcy, at least for public corporations, see *supra* note 13.

31. For example, Alan Schwartz contends that any attempt to redistribute wealth through bankruptcy legislation is simply "bad public policy." *See* Schwartz, *supra* note 7, at 1817 n.45. Robert Rasmussen rejects redistributive bankruptcy laws as unjustified by John Rawls' "difference principle." *See* Rasmussen, *supra* note 27, at 1 (arguing "that the economic approach to bankruptcy law is fully compatible with social justice as defined by philosopher John Rawls"). Christopher Frost argues against bankruptcy redistributive policies on the grounds that the judiciary is inherently incapable of implementing them. Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75, 138–39 (1995).

32. For discussion of the new value exception to the absolute priority rule, see *Bank of America National Trust & Savings Ass'n v. 203 N. LaSalle St. Partnership*, 526 U.S. 434, 444–49 (1999).

33. *E.g.*, 11 U.S.C. § 507(a)(1)–(8) (1994) (setting forth eight priorities in distribution), § 1113 (formatting special treatment for assumption or rejection of collective bargaining agreements in reorganization cases), and § 1114 (providing special protection for health and medical benefits of former employees in reorganization cases).

34. *E.g.*, Adler, *Theory of Corporate Insolvency*, *supra* note 8, at 353 ("Automatic conversion of the lowest-priority fixed-obligation class to common equity, and the survival of the higher-priority classes, would accomplish a reorganization of an insolvent firm without the expensive imbroglio that is often a consequence of the current bankruptcy reorganization process."); Bradley & Rosenzweig, *supra* note 8, at 1052–53 (describing suboptimal managerial decisions as a major component of the social costs of court-supervised chapter 11 reorganizations); *see also* James W. Bowers, *The Fantastic Wis-*

Neolibertarian bankruptcy theorists mean different things when they argue that contracts could and should provide a substitute for mandatory bankruptcy legislation. The most radical of these proposals contends that all or some of business bankruptcy law should be repealed, because private collective action would provide an efficient substitute for that legislation. For example, Barry Adler describes in detail the form that these prebankruptcy contractual arrangements might take.[35] He envisions a world without business bankruptcy law, state collection law, or debt, in which "Chameleon Equity" remediates financial distress by triggering conversion rights automatically upon default. Michael Bradley and Michael Rosenzweig propose a similar, but distinct, private-law substitute for the law governing corporate reorganization.[36] Bradley and Rosenzweig would not eliminate debt and the state law governing the collection of debt, but, like Adler, would advocate repeal of the law of corporate reorganization and issuance of "contingent equity" that automatically cancels upon default.[37]

Others agree that private contracts would provide an efficient substitute for bankruptcy legislation, but instead propose that the Bankruptcy Code be retained as a "default rule."[38] This default rule legislation would apply only if the debtor and its creditors have not reached an ex ante agreement regarding their rights in the event of subsequent financial distress. Robert Rasmussen proposes that the default rules contained in the Bankruptcy Code consist of a "menu of bankruptcy options" that businesses could choose from and elect to include in their corporate charters.[39] Creditors who subsequently contract with the corporate debtor would be on notice of the bankruptcy option identified in the charter document and would be presumed to consent to the proposed bankruptcy option.[40] Alan Schwartz also argues that business bankruptcy law should be viewed as a default rule.[41] He contends that a debtor and

consylvania Zero-Bureaucratic-Cost School of Bankruptcy Theory: A Comment, 91 MICH. L. REV. 1773 (1993) (emphasizing the enforcement costs associated with mandatory bankruptcy legislation).

35. For discussions describing and refining Adler's concept of "Chameleon Equity," see Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1111–31; Adler, *Financial and Political Theories*, *supra* note 8, at 311; Adler, *Theory of Corporate Insolvency*, *supra* note 8, at 350–57; and Adler, *World Without Debt*, *supra* note 8, at 817–25.

36. Bradley & Rosenzweig, *supra* note 8, at 1078.

37. *Id.* at 1078–79.

38. Rasmussen, *supra* note 8, at 55–68. For the Bankruptcy Code to act as a default rule, current common-law invalidation of a debtor's contractual waiver of bankruptcy protections would have to be overridden.

39. Rasmussen, *supra* note 8, at 100.

40. *Cf.* Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1825–29 (1989) (arguing that principles of efficiency and fairness both support the contention that parties should be free to choose corporate governance terms in the initial charter, but that these same principles contradict the desirability of charter amendments).

41. Schwartz, *supra* note 7, at 1839 ("No one disputes that the state should supply parties with a default bankruptcy procedure if they do not contract for one. Parties who feel themselves unable to

its creditors should be permitted to enter into multiparty contracts regarding their respective remedies in the event of financial distress. He builds a complex economic model to argue that these sorts of contracts could be drafted, despite problems of numerousity, informational asymmetries, intertemporal coordination and conflicts of interest.[42] Similarly, Steven Schwarcz contends that there should be significantly greater freedom to contract around bankruptcy law.[43] He agrees with Alan Schwartz and Robert Rasmussen that multiparty "procedure" contracts provide one such mechanism, but suggests that two-party "waiver" contracts provide a more practical alternative for parties who would like to opt out of the default rules in the Bankruptcy Code.[44] Specifically, Steven Schwarcz argues that prebankruptcy waiver agreements should be enforceable when reached either in the context of a postdefault workout arrangement[45] or in a structured finance transaction.[46]

Commentators have criticized contract-bankruptcy proposals.[47] Many question the underlying assumptions and normative foundations

foresee future events well enough to write bankruptcy contracts could use the default procedure while the others would not.").

42. *Id.* at 1822–26. Although Schwartz purports to have developed a set of bankruptcy contracts that would resolve each of these problems, Lynn LoPucki contends that Schwartz has "fail[ed] to prove bankruptcy contracting feasible." LoPucki, *supra* note 14, at 379.

43. *See* Schwarcz, *supra* note 10, at 534–36.

44. *Id.* at 521–22 (describing "two representative kinds of prebankruptcy contracts"—waiver contracts and procedure contracts—but focusing on waiver contracts because procedure contracts are less likely to have practical application).

45. *Id.* at 590–93. Steven Schwarcz's endorsement of certain waivers of the automatic stay builds on an expanding literature debating whether these sorts of waiver agreements ought to be enforceable. *E.g.*, Edward S. Adams & James L. Baillie, *A Privatization Solution to the Legitimacy of Prepetition Waivers of the Automatic Stay*, 38 ARIZ. L. REV. 1 (1996); Daniel B. Bogart, *Games Lawyers Play: Waivers of the Automatic Stay in Bankruptcy and the Single Asset Loan Workout*, 43 UCLA L. REV. 1117 (1996); Rafael Efrat, *The Case for Limited Enforceability of a Pre-Petition Waiver of the Automatic Stay*, 32 SAN DIEGO L. REV. 1133 (1995); Mark F. Hebbeln, *Prepetition Waivers of the Automatic Stay in Bankruptcy: The Economic Case for Nonenforcement*, 115 BANKING L.J. 126 (1998); Thomas G. Kelch & Michael K. Slattery, *The Mythology of Waivers of Bankruptcy Privileges*, 31 IND. L. REV. 879 (1998); Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301 (1997). Even among free-market commentators, however, contractual waivers of the automatic stay are controversial. *Compare* Bogart, *supra*, at 1130 (arguing on game theoretic grounds that waivers of automatic stay should not be enforced), Hebbeln, *supra*, at 141 (same, on economic grounds), *and* Schwartz, *supra* note 7, at 1850 (arguing that "[t]he automatic stay rule in many cases appears necessary to the integrity of a bankruptcy system"), *with* Schwarcz, *supra* note 10, at 590–99 (arguing that automatic stay waivers in workout agreements and securitization transactions should be enforced, but questioning the wisdom of enforcing similar waivers contained in original loan agreements). In addition, commentary on the desirability of contractual waivers of other bankruptcy procedures is still developing. *See* Schwartz, *supra* note 7, at 1844–49 (tentatively concluding that ipso facto and antiassignment clauses should be enforced); Yeon-Koo Che & Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules*, 15 J.L. ECON. & ORG. 441, 462–63 (1999) (same).

46. Schwarcz, *supra* note 10, at 597–99. Steven Schwarcz is not alone in suggesting that secured or securitized transactions act as bankruptcy contracts. *See* Picker, *supra* note 10, at 645–49, 679 (contending that creditors' common pool problems associated with a debtor's financial distress could be resolved ex ante through the creation of broad Article 9 security interests, and concluding that "we must therefore reconsider the mission of the bankruptcy laws since the parties themselves can and do keep this problem from arising in the first place").

47. *See* Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669 (1993); Lynn M. LoPucki, *Strange Visions in a*

favoring "free market" bankruptcy resolutions.[48] They also contend that contract bankruptcy would impose distributive costs on involuntary creditors, such as tort victims, unsophisticated creditors, and creditors whose small claims would not justify the cost of these complicated contractual remedies.[49] Despite claims about the cost-saving effect of con-

Strange World: A Reply to Professors Bradley and Rosenzweig, 91 MICH. L. REV. 79 (1992) [hereinafter LoPucki, *Strange Visions*]; LoPucki, *supra* note 14; David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465; Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159 (1994); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992). Because "the theoretical basis for enforcing security agreements would appear to be the same as that for enforcing prebankruptcy contracts," Schwarcz, *supra* note 10, at 520, criticism of contract-bankruptcy proposals overlaps in important ways with critiques of the economic analysis of Article 9 secured transactions. *E.g.*, Bebchuk & Fried, *supra* note 19, at 859–64 (arguing that the grant of full priority to secured claims distorts negotiations between debtors and their secured creditors because full priority ignores the presence of "nonadjusting creditors"—private and public involuntary creditors, voluntary creditors with small claims, and prior voluntary creditors—and concluding that, because these nonadjusting creditors cannot increase the interest rate at which they extend credit to account for the presence of a security interest, secured transactions permit transfers of "bankruptcy value" from nonadjusting creditors to secured creditors); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279, 1282–83 (1997) [hereinafter Bebchuk & Fried, *Further Thoughts*] (same); Jesse M. Fried, *Taking the Economic Costs of Priority Seriously*, 51 CONSUMER FIN. L.Q. 328, 330–31 (1997) (same); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1895 (1994) [hereinafter LoPucki, *Unsecured Creditor's Bargain*] (arguing that security interests are prevalent, not because they are efficient, but because they "facilitate[] the exploitation of involuntary creditors or of voluntary creditors who failed to react to security"). It also finds parallels in scholarship that contends that asset securitizations create the potential for imposing distributional effects on nonadjusting creditors. *E.g.*, Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 24–25 (1996) [hereinafter LoPucki, *Death of Liability*] (describing securitization as one among several nonbankruptcy methods of avoiding liability); LoPucki, *supra* note 14, at 333–39 (same); Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595, 598 (1998) [hereinafter Lupica, *Asset Securitization*] ("Securitization's structure is designed to divert value away from the originator, in the absence of any compensating controls on either the consideration received in exchange for the asset sale, or the debtor's behavior. The originator enjoys the benefits of this distributional inefficiency, at the expense of its unsecured creditors."); Lois R. Lupica, *Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization*, 33 CONN. L. REV. 199 (2000) [hereinafter Lupica, *Statutory Institutionalization*] (same).

48. Warren, *supra* note 47, at 467 (arguing that "Bradley and Rosenzweig's work rests on the premise that bankruptcy has a single goal: preservation of value for public shareholders and bondholders," rejecting their limited view, and arguing that bankruptcy law should "serve[] to redistribute value" at the same time as it "functions to preserve value in faltering businesses and to enhance the return to all those who have an interest in the business"); Korobkin, *supra* note 47, at 729 (finding Bradley & Rosenzweig's proposal to be premised upon "the specific normative commitment to the goal of maximizing the value of the firm to its investors," and remaining dubious that a firm's interests will conflate during periods of financial distress). In addition, Elizabeth Warren and Lynn LoPucki criticize the "perfect market" assumptions that underlie the Bradley/Rosenzweig proposal. LoPucki, *Strange Visions*, *supra* note 47, at 97–133; Warren, *supra* note 47, at 475.

49. Korobkin, *supra* note 47, at 732–33 (arguing that Bradley and Rosenzweig's automatic cancellation rule shifts distributional decisions from bankruptcy courts to firms' managers and contract creditors); LoPucki, *supra* note 14, at 339 (arguing that contract bankruptcy has "the potential to redistribute wealth from noncontracting parties to contracting parties"); Skeel, *supra* note 47, at 485–86 (concluding that automatic cancellation proposals made by Adler and by Bradley and Rosenzweig create incentives for strategic behavior in which creditors divert value from shareholders to themselves or strike collusive deals with management); Warren, *supra* note 47, at 472–74 (noting that substitution of contract-based priority system for chapter 11 would disadvantage claimants who either have no contract, such as tort victims, discrimination and harassment complainants, and antitrust plaintiffs, or whose bargaining power is unlikely to produce advantageous results, such as rank-and-file employees,

tract bankruptcies, commentators are dubious that contractual substitutes will be less costly than the current bankruptcy process.[50] In fact, Lynn LoPucki questions whether certain contract proposals would be effective at all.[51] Others stress that any potential savings in the ex post costs of administering a statutory bankruptcy case would be overpowered by costly ex ante decision-making costs and misincentives that contract rules would create for firms.[52]

Robert Rasmussen elaborates on these ex ante misincentives.[53] According to Rasmussen, incentives exist for the shareholders of insolvent or nearly insolvent firms to invest in projects with a negative net present value, or to fail to invest in projects with a positive net present value,[54]

pensioners, and trade creditors). The argument that contract-bankruptcy proposals could redistribute wealth from noncontracting to contracting parties refers to a similar contention that Article 9 security agreements can redistribute wealth from nonadjusting to adjusting unsecured creditors. *See* Bebchuk & Fried, *supra* note 19, at 859–67; Bebchuk & Fried, *Further Thoughts*, *supra* note 47, at 1281–84; Fried, *supra* note 47, at 328–29; LoPucki, *Unsecured Creditor's Bargain*, *supra* note 47, at 1891–92. Asset securitizations also have been criticized on distributional grounds. *E.g.*, LoPucki, *supra* note 14, at 333–39 (arguing that "both types of bankruptcy contracting currently in wide use—asset securitizations and stay waivers—have the potential to redistribute wealth from noncontracting parties to contracting parties"); LoPucki, *Death of Liability*, *supra* note 47, at 23–30 (same); Lupica, *Asset Securitization*, *supra* note 47, at 659 (same); Lupica, *Statutory Institutionalization*, *supra* note 47, at 232–36 (same).

50. Korobkin, *supra* note 47, at 720–21 (detailing substantial ex ante implementation and ex post enforcement costs likely to occur under Bradley and Rosenzweig's automatic cancellation proposal); Skeel, *supra* note 47, at 482 (noting that "the costs of negotiating a capital structure in advance [of financial distress] could outweigh, and at the least would reduce, the ex post benefits"); Warren, *supra* note 47, at 476–77 (arguing that reorganization of Federated Department Stores would have taken six years and four months under Bradley/Rosenzweig proposal).

51. *See* LoPucki, *supra* note 14, at 340 ("[T]his Essay demonstrates that the elegant mechanism by which [Schwartz's model generates a contract that is optimal on the model's assumptions] cannot operate in a world in which creditors lend at different times or under different circumstances. . . . [T]he theoretical case for welfare-maximizing contractual bankruptcy remains unproven."). For a reply and sur-reply to LoPucki's Essay, see Schwartz, *Bankruptcy Contracting Reviewed*, *supra* note 8; Lynn M. LoPucki, *Bankruptcy Contracting Revised: A Reply to Alan Schwartz's New Model*, 109 YALE L.J. 365 (1999).

52. *See* Korobkin, *supra* note 47, at 711–21 (arguing that the disruption costs of the Bradley/Rosenzweig proposal outpace corresponding disruption costs under current law, defining disruption costs broadly to cover the disruption from both default and near-default scenarios); Rasmussen, *supra* note 8, at 98–100 (arguing that automatic cancellation proposals, such as those put forward by Adler and by Bradley and Rosenzweig, would aggravate asset substitution, underinvestment and agency cost problems by creating improper ex ante incentives); Skeel, *supra* note 47, at 487 (arguing that, at least in closely held contingent/Chameleon Equity firms, the automatic cancellation rule would "undermine the use of secured credit and, as a result, significantly increase monitoring and thus overall credit costs").

53. *See* Rasmussen, *supra* note 47, at 1190–1200. It is somewhat confusing to group Rasmussen together with other critics of contract bankruptcy, as he is also a proponent of his own brand of contract bankruptcy. *See* Rasmussen, *supra* note 8. In the later article, *supra* note 47, Rasmussen critiques the automatic cancellation proposals put forward by Bradley and Rosenzweig, *supra* note 8, and Adler, *Financial and Political Theories*, *supra* note 8.

54. *See* Rasmussen, *supra* note 47, at 1174. He argues that two of the agency costs of debt—asset substitution and underinvestment—cannot effectively be prohibited by contract. *Id.* at 1170–72 ("Asset substitution occurs when a firm exchanges assets with a stable value for assets with a fluctuating value. . . . Underinvestment occurs when a firm's capital structure causes it to bypass projects that have a positive net present value."). He also argues that there are agency costs associated with the separation of ownership and control, because "shareholders are unconcerned with the value of the

which cannot be altered effectively by most contract-bankruptcy proposals.[55] Rasmussen views proposals involving an automatic cancellation of equity, such as the Chameleon Equity scheme proposed by Adler, as creating improper ex ante incentives for shareholders and management to focus most intently on the cash flow consequences of a project.[56] In addition, Rasmussen argues that these sorts of automatic cancellation proposals aggravate asset substitution problems because they increase incentives to engage in voluntary liquidation to avoid default.[57] Finally, he contends that these proposals would exacerbate equity agency costs because "[m]anagers might shy away from any project which entails a substantial risk for fear that the new owners of the firm would not conclude that the managers made the correct ex ante decision."[58]

To date, criticism of contract-bankruptcy proposals has been limited—particularly limited in discussions of more recent work.[59] Moreover, neolibertarian theorists criticize this commentary on the grounds that it fails to offer a competing normative justification for legislative resolution of a firm's financial distress.[60] In the next section, I develop a generalized framework for comparing legislative to contractual bankruptcy rules.

firm once the firm becomes insolvent," whereas "managers are unconcerned with firm value once the firm's condition deteriorates to the point at which it must be liquidated." *Id.* at 1174.

55. Barry Adler argues that contracts could be drafted to counteract the ex ante misincentives these commentators identify, but does not explain why these contractual provisions are preferable to the legislation he would have them replace. *See* Adler, *Finance's Theoretical Divide*, *supra* note 8; Adler, *World Without Debt*, *supra* note 8. Adler contends that contract could solve this underinvestment problem, conceiving of a corporate charter or other initial contract granting management the right to cause the company to issue limited-discount, high-priority debt conditioned upon retirement of then-existing equity interests. Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1116. But the contractual resolution Adler suggests would not solve the underinvestment problem that Rasmussen and Korobkin identify. Adler's proposal is directed at insolvent or nearly insolvent firms' incentives to underinvest in positive net present value projects. It does not address the even greater disincentive to invest in such projects for fear of triggering default and automatic cancellation of equity—a disincentive that could exist under Adler's proposal although the debtor was firmly solvent—because the proposed fix would condition issuance of the high-priority debt upon the cancellation of equity. Adler's proposal is not intended to encourage the shareholders of solvent, but cash-strapped, firms to invest additional capital. Indeed, he explains that the cancellation of equity is necessary to his proposed fix "[s]o as not to encourage excessive investment while the firm remained solvent." *Id.*

56. *See* Rasmussen, *supra* note 47, at 1194 (concluding that automatic cancellation proposals would create significant underinvestment problems).

57. *Id.* at 1196–97.

58. *Id.* at 1200.

59. Donald Korobkin and Elizabeth Warren discuss only the Bradley/Rosenzweig proposal. *See* Korobkin, *supra* note 47; Warren, *supra* note 47. Robert Rasmussen and David Skeel do not limit their commentary to Bradley/Rosenzweig, but their articles predate more recent efforts by Alan Schwartz, *supra* note 7, and Steven Schwarcz, *supra* note 10. LoPucki alone critiques Alan Schwartz's contract-bankruptcy proposal, and, then, primarily to argue that Schwartz's model does not show that his private-law bankruptcy alternative would be feasible. *See* LoPucki, *supra* note 14.

60. *See supra* note 15.

III. THE GOALS OF BANKRUPTCY

Much of the controversy that separates bankruptcy scholarship involves disagreement on the proper goals of a system of bankruptcy rules.[61] Commentators applying an economic analysis view bankruptcy as a "collectivized debt-collection device" and argue that bankruptcy should maximize wealth either by enhancing distributions to creditors in bankruptcy or facilitating credit availability in the marketplace.[62] Critics of this economic account contend that bankruptcy law affirmatively should seek to accomplish other policy purposes, including those requiring redistributions among classes of creditors or between creditors and their debtor.[63]

Both sides could learn from the other. If an economic analysis of the law has any merit, it is as applied to the commercial law governing sophisticated business entities. An economic analysis of commercial bankruptcy law carries added intuitive appeal in that both economics and bankruptcy law address how best to allocate scarce resources among strategic actors. Moreover, whether or not they have "claims" against the debtor in the sense contemplated under the Bankruptcy Code, the members of a society care about a firm's failure largely because they have a monetary interest in the firm's success.

Nonetheless, bankruptcy rules should maximize collective welfare, not simply the collective welfare of creditors.[64] Creditor welfare offers too narrow a perspective from which to judge bankruptcy law and policy.

61. *E.g.*, Baird, *supra* note 15, at 575 (describing bankruptcy commentators' competing axioms as stemming "not from different political beliefs but rather from radically different views of the underlying normative bases of the role of bankruptcy law and the aims of legal scholarship").

62. Rasmussen, *supra* note 27, at 2 ("Arrayed on one side of the debate are those who view bankruptcy law in solely economic terms. For these scholars, the goal of bankruptcy law is wealth maximization.").

63. *E.g.*, KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM 248–49 (1997) (conceiving of bankruptcy "as a vehicle for social change" because it "provides an opportunity to deal with a social problem immediately, not in the sense of creating a global solution but in terms of resolving an actual situation"); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 722–25 (1991); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 795–97 (1987).

64. Although Baird, Jackson and Scott describe the purposes of bankruptcy in creditor-focused terms, subsequent economic analysis has focused, as I do, on a comparison of the social costs and social benefits of this system. *E.g.*, Adler, *Theory of Corporate Insolvency*, *supra* note 8, at 344 (discussing relative social costs and benefits of current rule, market-based reforms of current rule, and contractual alternatives); Bradley & Rosenzweig, *supra* note 8, at 1048–49, 1089 (referring repeatedly to enhancement of "social welfare" as the normative purpose of bankruptcy law); Rasmussen, *supra* note 47, at 1207 ("The goal is to pick the institution which can best minimize the sum of the deadweight cost to society arising from the substantive rule itself and the transaction costs of implementing the rule."); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 86 (1995) ("The economic analysis of bankruptcy law focuses on devising a set of rules which will increase overall social welfare."); Schwartz, *supra* note 7, at 1850 ("The major goal of business law is to maximize social wealth."); Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 3 (1981) (exploring efficiency of priority accorded to secured transactions in bankruptcy in terms of "net social costs"). However, my analysis pays more than lip-service to the goal of maximizing social welfare.

A bankruptcy system should maximize the welfare of all the parties affected by the debtor's financial distress—not only the welfare of creditors, equity holders, employees, and other parties with standing to appear and be heard in the bankruptcy case; but also, more broadly, the remainder of society affected by the financial failure of the firm.[65]

Consideration of the collective effects of a bankruptcy rule need not neglect to consider its impact upon affected individuals, particularly individuals who dissented or were omitted from the decision-making process. No bankruptcy rule—whether contractual or legislative—will unequivocally improve the lot of society at large. Determinations as to whether collective welfare was enhanced by the shift toward a private-law bankruptcy alternative constitute unanswerable empirical, and therefore judgmental, questions.[66] An assessment of these judgment calls is improved by consideration of whether groups of individuals or entities are more likely to prevail under one rule or another—an assessment of the distributional effects of the rule choice, even though these intrusions into individual autonomy would not, in the end, undermine the welfare-enhancing effects of the determination.[67]

Choosing to minimize both the losses caused by the financial distress of a business, and the costs of implementing and enforcing a rule to contain those losses, carries with it an inherent tension. Cost and loss minimization attempts to maximize social welfare given that business failures are an unavoidable aspect of a credit economy. To claim that bankruptcy law should maximize society's (not just creditors') welfare

65. *See* Warren, *supra* note 47, at 467–68 (contending that social welfare impact of bankruptcy law considers business activity of all affected members of society); *see also, e.g.*, GROSS, *supra* note 63, at 19–24, 193–231 (arguing that bankruptcy legislation should be amended to take account of community interests in reorganization setting); Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994) (criticizing creditors' bargain model for failing to include community interests in bankruptcy decision making); Nathalie D. Martin, *Noneconomic Interests in Bankruptcy: Standing on the Outside Looking In*, 59 OHIO ST. L.J. 429 (1998) (exploring alternative methods for providing voice to noneconomic stakeholders in corporate bankruptcy cases); Lawrence Ponoroff, *Enlarging the Bargaining Table: Some Implications of the Corporate Stakeholder Model for Federal Bankruptcy Proceedings*, 23 CAP. U. L. REV. 441, 472–86 (1994) (contending that business bankruptcy affects a broad range of constituencies whose interests should be taken into account in allocating losses resulting from financial collapse).

66. *E.g.*, EPSTEIN, PRINCIPLES FOR A FREE SOCIETY, *supra* note 1, at 4.

> Every social rule must take into account its consequences for all the people it governs. In principle, we should strive for a rule that leaves everyone at least as well off after its implementation as before. Since the practical impediments to achieving this individual-based account of social welfare are immense, its systematic pursuit must proceed by proxy and indirection.

Id.

67. Epstein puts this balancing of interests in the following terms:

> [I]t is necessary to estimate first the gains of the parties to voluntary transactions, and then determine their spillover effects, both positive and negative, on all third parties. No one can claim that this approach will yield the right results in all cases. Nor should anyone have to meet such a burden in order to defend any principle of social organization against its rivals. Oftentimes, the first goal of a legal system is negative—to advert the social disasters done in the name of the common good. The second is to strive to facilitate incremental improvements in the operation of the system.

Id.

invites consideration of its distributive effects. This is not to say that distributional goals should define bankruptcy policy to the exclusion of every other possible policy purpose. It merely recognizes that bankruptcy, and the choice among bankruptcy rules, have unavoidable distributive consequences, the effects of which must be included in contemplating the sum of the benefits and costs of a bankruptcy-related system.[68] By including external decision-making costs among the costs that should be minimized, this framework seeks also to protect against encroachments upon individual autonomy. Welfare maximization, distributive justice, and individual autonomy sit uneasily together in a single framework, but the tension exists within any efficiency analysis adopted to support a neolibertarian thesis.[69]

Welfare maximization implies more than a minimization of the losses to society from business failures. Depending upon how bankruptcy law is structured, these rules can be more or less costly to create and enforce.[70] A bankruptcy system should minimize society's losses due to a debtor's financial distress, as well as the costs of implementing and enforcing the bankruptcy rules designed to minimize these losses. Loss minimization and cost minimization are both considered in this formulation because they are equally important.

A. Minimizing Losses from Financial Distress

Bankruptcy is an innate cost of a credit economy.[71] It is neither desirable nor achievable to seek to prevent all financial and economic distress.[72] Bankruptcy rules should minimize the loss to society from the financial distress and collapse of a firm, because there will be bankruptcy losses regardless of the structure of the governing legal regime.

The financial distress of a business can cause loss to society both directly and indirectly.[73] These direct losses include creditors' claims that

68. Changes in bankruptcy distributions may not impose costs, and only confer benefits, if there is no right or entitlement to the status quo that is altered. *See* Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?*, 70 N.Y.U. L. REV. 993 (1995).

69. *See supra* note 1.

70. *See supra* note 16.

71. GROSS, *supra* note 63, at 100; JACKSON, LOGIC AND LIMITS, *supra* note 21, at 7; Rasmussen & Skeel, *supra* note 64, at 85.

72. *Cf.* CALABRESI, *supra* note 16, at 18 ("Since we are not committed to preserving life at any cost, the question is the more complex one of how far we want to go to save lives and reduce accident costs.").

73. I refer to the direct and indirect losses occasioned by the financial distress of a business with some trepidation, because an expanding literature seeks to quantify the "costs" of bankruptcy and distinguishes between direct and indirect bankruptcy costs. *See supra* note 13. In these articles, "direct bankruptcy costs" are defined in the same way that "enforcement costs" are defined here. *Compare* Weiss, *supra* note 13, at 285–86 ("Direct costs encompass the legal and administrative fees, including the costs of lawyers, accountants, and other professionals involved in the bankruptcy filing."), *with* the text accompanying *infra* notes 90–93. The bankruptcy cost articles define "indirect bankruptcy costs" to include the lost opportunity costs and lost profits a business is expected to suffer as a result of a

are discharged and equity holders' interests canceled. Indirect losses consider the indirect effect of the firm's financial distress both on the debtor and on the market as a whole, and include such factors as increases in the cost of credit and diminution in competition in the debtor's industry.[74] They also include opportunities lost to those who will no longer deal with the debtor in the future—suppliers who lose business prospects, employees who lose jobs and are dislocated, communities who suffer a decrease in their tax base.[75] Although the losses that occur ex post are most evident, the occurrence and nature of these losses also are affected by actions and investments occurring ex ante—well before the onset of financial distress.[76]

B. Minimizing the Costs of Implementing and Enforcing Bankruptcy Rules

Bankruptcy losses are distinct from the costs of implementing and enforcing a bankruptcy rule. The following section differentiates between these two types of costs.

1. Decision-Making Costs

Decision-making costs are the costs that individuals (and society) can expect to incur when attempting to minimize the losses due to a debtor's financial distress by creating and adopting some means for its resolution.[77] Decision-making costs refer to the costs of implementing

bankruptcy filing. Weiss, *supra* note 13, at 286. These "indirect bankruptcy costs" closely resemble the "indirect losses" resulting from financial distress referred to above.

74. For literature attempting to quantify these indirect bankruptcy costs, see *supra* note 13.

75. *See supra* note 13.

76. *E.g.*, Adler, *Theory of Corporate Insolvency*, *supra* note 8 (contrasting ex post to ex ante approaches to corporate insolvency); Phillipe Aghion et al., *Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849, 852 (1994) (arguing that "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) . . . [and] should give managers the right ex ante incentives to avoid bankruptcy"); Rasmussen, *supra* note 47, at 1163 ("Advocates for change must show that the ex ante effects of their proposal on firm behavior are better—or at least no worse—than the ex ante effects of current law."); Schwartz, *supra* note 7, at 1820 ("That bankruptcy law must be concerned with ex post efficiency cannot of itself imply the irrelevance of ex ante efficiency as a policy goal.").

77. Buchanan and Tullock first considered the "external" and "internal" decision-making costs of individual and collective action in their Nobel-prize winning book, THE CALCULUS OF CONSENT. BUCHANAN & TULLOCK, *supra* note 16. There, Buchanan and Tullock contend that legal rules should be adopted in a democratic society when they enhance the utility of individual members of society. *See id.* at 43–46. They argue that an individual's utility from collective action may be maximized when his share of the associated costs is minimized. *See id.* at 43–44. They define decision-making costs as "costs which the individual expects to incur as a result of his own participation in an organized activity." *Id.* at 45. They are careful to exclude the "purely private cost of reaching decisions." *Id.* By decision-making costs they refer only to the costs of social interaction inherent in individual or collective choice. *See id.* at 45–46 ("We shall define *decision-making costs* to include only the estimated costs of participating in decisions when two or more individuals are required to reach *agreement*.").

individual action, as well as the costs of organizing collective action.[78] Whether individual or collective action is at issue, decision-making costs involve both external and inherent costs.

The external costs of decision making are the costs suffered by one or more as a result of others' decision making.[79] Private individual action can impose external costs on nonparties who are negatively affected by this two-party arrangement.[80] Private collective action that involves *n*-party agreements is free from these external costs "[s]ince individuals will not voluntarily agree to decisions contrary to their own interests . . . ."[81] Public collective action—that is, legislation—generally imposes external decision-making costs on the individuals who are outvoted.[82] Only when a rule of unanimity or virtual unanimity is adopted will public collective action be free from external decision-making costs.[83]

Inherent decision-making costs are the costs incurred in reaching an agreement or taking political action; they arise because these processes involve time and effort.[84] Inherent decision-making costs increase with increases in the size of the group seeking to reach agreement. As a result, the inherent decision-making costs associated with individual action

78. Buchanan and Tullock distinguish between two types of decision-making costs—"the costs of organizing voluntary contractual arrangements" and "the costs of organizing collective action." BUCHANAN & TULLOCK, *supra* note 16, at 48. Buchanan and Tullock recognize that decision making is not costless, and go on to note that "if the costs of organizing decisions voluntarily should be zero, all externalities would be eliminated by voluntary private behavior of individuals regardless of the initial structure of property rights." *Id*. at 47–48 ("There would, in this case, be no rational basis for state or collective action beyond the initial minimal delineation of the power of individual disposition over resources."). They do not explicitly refer to this as the Coase Theorem, but of course, it is. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

79. BUCHANAN & TULLOCK, *supra* note 16, at 63–68.

80. *Id.* at 65.

81. *Id.* at 52.

82. *Id*. Buchanan and Tullock's groundbreaking work on the external decision-making costs of legislative action paved the way for modern public choice theory, which contends that rational self-interested legislators tend to enact legislation that favors organized interests to the detriment of social welfare. For a general discussion of public choice theory, see, for example, DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE (1991). For application of public choice theory to bankruptcy law, see BRUCE G. CARRUTHERS & TERENCE C. HALLIDAY, RESCUING BUSINESS: THE MAKING OF CORPORATE BANKRUPTCY LAW IN ENGLAND AND THE UNITED STATES (1998); Susan Block-Lieb, *Congress' Temptation to Defect: A Political and Economic Theory of Legislative Resolutions to Financial Common Pool Problems*, 39 ARIZ. L. REV. 801 (1997) [hereinafter Block-Lieb, *Political and Economic Theory*]; Susan Block-Lieb, *The Politics of Privatizing Business Bankruptcy Law*, 74 AM. BANKR. L.J. 77 (2000) [hereinafter Block-Lieb, *Politics of Privatizing*]; Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47 (1997). For application of public choice theory to the law of secured transactions, see Edward J. Janger, *Predicting When the Uniform Law Process Will Fail: Article 9, Capture and the Race to the Bottom*, 83 IOWA L. REV. 569 (1998); Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436 (1997); Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995); Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783 (1994).

83. BUCHANAN & TULLOCK, *supra* note 16, at 53 ("Only if the unanimity rule is dictated for [public] collective decisions will this second element, which represents a particular sort of external cost, be absent.").

84. *See id.* at 68 ("If two or more persons are required to agree on a *single* decision, time and effort of another sort is introduced—that which is required to secure agreement."). Economists often refer to these costs as transaction costs.

are less than those relating to collective action because individual action involves fewer parties.[85] Moreover, private collective action generally involves greater inherent decision-making costs than public collective action because *n*-party agreements are binding only upon unanimous consent,[86] while legislation usually is binding upon a vote of the majority.[87] The size of the group is just one among many factors likely to affect inherent decision-making costs. Other impediments to negotiated and political resolution include informational asymmetries[88] and incentives for strategic action.[89]

2. *Enforcement Costs*

Enforcement costs are considered separately from decision-making costs. Decision-making costs are incurred ex ante, at the time the bankruptcy resolution is implemented. Enforcement costs are instead incurred ex post, in the event actors fail to comply with the bankruptcy rule that has been adopted.[90] Enforcement costs include attorneys' fees and the fees of other professionals such as accountants and investment bankers, as well as costs associated with judicial or other institutional enforcement. They also take account of real and opportunity costs associated with efforts to monitor for compliance with the chosen bankruptcy

85. *E.g.*, Armen A. Alchian & Harold Demsetz, *The Property Rights Paradigm*, 33 J. ECON. HIST. 16, 22 (1973) (describing the shift to property rules as having "significantly reduced the cost of carrying on transactions among those possessing rights of use").

86. BUCHANAN & TULLOCK, *supra* note 16, at 68–69. Consequently, they consider a rule of unanimity as the most inherently costly form of collective action. *See id.* at 105–09 (comparing the individual's decision-making costs under the rule of unanimity as the size of the group increases to the individual's decision-making costs as the proportion of the group required to reach agreement increases). For refinement of the argument that the size of the group negatively impacts the group's likelihood to resolve its collective problems, see MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION 53–65 (1974).

87. It would be plausible to make public collective action binding only upon unanimous agreement. In this event, public collective action would be as costly as private collective action. BUCHANAN & TULLOCK, *supra* note 16, at 58 ("[I]f the collective decision-making rule should be that of unanimity (or approximately this), *g* would surely not diverge appreciably in value from some hypothetical *b* which would represent the costs of private contractual arrangements.").

88. For a discussion of the effect of asymmetries in information on legislative action, see, for example, *id.* at 38; Jonathan R. Macey, *Public Choice: The Theory of the Firm and the Theory of Market Exchange*, 74 CORNELL L. REV. 43, 52–56 (1988). For a discussion of their effects on private action, see, for example, Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979).

89. *E.g.*, DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW (1994) (discussing ability of game theory to analyze strategic incentives and their impact upon legal rules); ERIC RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY (1989) (detailing game theoretic models of strategic action).

90. James Krier and Stuart Schwab similarly emphasize the significance of "assessment costs"—which they define as the costs of judicial enforcement—to the choice between property and liability rules. James E. Krier & Stuart J. Schwab, *Property Rules and Liability Rules: The Cathedral in Another Light*, 70 N.Y.U. L. REV. 440, 453–54 (1995).

rule. Enforcement can involve private[91] or public action,[92] but either sort of enforcement requires both monitoring and punishment. Enforcement costs increase as the size of the group increases and as the informational asymmetries facing the group members increase, and also depend upon the incentives for strategic action (or inaction).[93]

IV. THE STRUCTURE OF BANKRUPTCY RULES

If bankruptcy rules were costless to implement and enforce, it would not matter how they were structured.[94] Parties would costlessly resolve their financial difficulties, one way or another.[95] Law and economics scholarship generally contends that property rules are preferable where the costs of implementing and enforcing these rules are low, and that liability or regulatory rules are better where these costs are high,[96] but this truism oversimplifies a complex balance of interests. Decision-making costs may be low and enforcement costs high (or vice versa).[97] Alternatively, the high distributive costs of a property rule may tip the scales toward another form of rule, although its costs of implementation and enforcement are otherwise low.[98]

In this section, I consider the question of how best to structure the bankruptcy rules by reference to the goals stated earlier in part III. Specifically, I question whether contract bankruptcy would minimize both the losses to society from a debtor's financial distress and the cost to society of implementing and enforcing legal rules for minimizing these losses. I also comparatively assess whether bankruptcy legislation could accomplish the same loss- and cost-minimization goals. Loss minimiza-

91. Private enforcement action involves self-help.

92. Public enforcement generally involves civil judicial or administrative enforcement, but might also involve criminal enforcement action.

93. For game theoretic discussion of the effect of group size and other factors upon the likelihood of cooperative solutions to strategic incentives, see, for example, ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984); MICHAEL TAYLOR, THE POSSIBILITY OF COOPERATION 8–30 (1987).

94. *See* Coase, *supra* note 78, at 19; LoPucki, *Strange Visions*, *supra* note 47, at 97–106; *see also* A. Mitchell Polinsky, *Controlling Externalities and Protecting Entitlements: Property Right, Liability Rule and Tax-Subsidy Approaches*, 8 J. LEGAL STUD. 1 (1979); A. Mitchell Polinsky, *Resolving Nuisance Disputes: The Simple Economics of Injunctive and Damage Remedies*, 32 STAN. L. REV. 1075, 1105–06 (1980).

95. But, as Elizabeth Warren and Lynn LoPucki have noted, it is strange to conceive of a world in which there is default and financial distress but costless negotiation and rule enforcement. LoPucki, *Strange Visions*, *supra* note 47, at 97–133; Warren, *supra* note 47, at 474–75.

96. *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1106–10 (1972).

97. *See supra* note 16.

98. *E.g.*, Calabresi & Melamed, *supra* note 96, at 1110.

> We should also recognize that efficiency is not the sole ground for employing liability rules rather than property rules. Just as the initial entitlement is often decided upon for distributional reasons, so too the choice of a liability rule is often made because it facilitates a combination of efficiency and distributive results which would be difficult to achieve under a property rule.

Id.

tion is considered first. Discussion of cost minimization follows, including both ex ante external and inherent costs of bankruptcy decision making and ex post costs of enforcing bankruptcy rules.

A. Bankruptcy Losses

Bankruptcy rules should be designed to minimize the losses that inevitably result from financial distress, no matter how a rule is structured to address these losses. The financial distress of a business can create direct and indirect losses throughout society. Minimizing the losses from financial distress should look beyond losses to creditors. Loss minimization requires consideration of both the ex ante and ex post effects of a proposed rule.

Attempting to maximize social, not just creditor, welfare and taking into account both the ex ante and ex post effects of a rule, neolibertarian bankruptcy scholars argue several points. First, they argue that bankruptcy law should maximize social welfare by minimizing the cost of commercial credit to the marketplace. Second, they argue that the choice between contractual and legislative bankruptcy rules depends upon consideration of the ex ante incentives created by these rules. They justify a preference for private-law bankruptcy resolutions on the grounds that only strict compliance with the absolute priority rule creates the proper ex ante incentives,[99] and assert that absolute priority is more likely to be followed in contract bankruptcy than bankruptcy legislation. Third, they argue that bankruptcy law should not favor consideration of ex post effects. They contend that attempts to minimize harmful ex post effects, by espousing a preference for rehabilitating businesses, saving jobs, or accomplishing a redistribution of wealth from strong to weak creditors, are inefficient, unless pursued through nonbankruptcy laws such as the laws governing a progressive tax system or job training program.

In the sections that follow, I question whether minimizing the cost of credit would maximize social welfare, and find that credit cost minimization primarily considers the welfare of creditors. I also argue that emphasis on the supposed ex ante misincentives created by legislative bankruptcy rules hides an attack on the substantive content of the Bankruptcy Code—an attack now virtually moot given changing Supreme Court doctrine on the absolute priority rule.[100] Even if commentators' critique of the content were appropriate, they have not shown a unique relationship between structure and substance. Finally, I argue that neolibertarian

99. Strict compliance with the absolute priority rule is most often emphasized in the contract-bankruptcy literature. Earlier economic accounts of business bankruptcy law instead emphasized the importance of strict adherence to prebankruptcy entitlements, more generally. *E.g.*, JACKSON, LOGIC AND LIMITS, *supra* note 21, at 89–150.

100. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 457–59 (1999).

scholarship overstates the inefficiency of addressing the ex post effects of financial distress in bankruptcy legislation.

1. Would Contract Bankruptcy Maximize Social Welfare by Minimizing Credit Costs?

Neolibertarian bankruptcy theorists support their preference for private-law bankruptcy reforms on the grounds that contract bankruptcy would decrease the cost of credit.[101] Indeed, Alan Schwartz goes so far as to contend that "[t]he only goal of a business bankruptcy law should be to reduce the cost of debt capital."[102] Originally, economic analysis of bankruptcy law asserted that bankruptcy should maximize distributions to creditors; any other policy purpose was said to diminish its welfare-enhancing function.[103] Critics complained that this conception of the normative purposes of bankruptcy law was narrow, and that the interests of creditors were distinct from the interests of society at large.[104] Perhaps in reaction, neolibertarian commentators emphasize the social costs of bankruptcy legislation and the social benefits of a contract-bankruptcy regime, rather than the costs and benefits to creditors.[105] The shift in rhetoric appears to accept that bankruptcy law should maximize the welfare of society as a whole, rather than simply creditor welfare. According to the new economic analysis of bankruptcy law, social welfare is maximized where the cost of credit is minimized because, in competitive markets, these credit-cost savings are passed on to borrowers and their customers.

In support of their claim that business bankruptcy law should have no goal other than to minimize the cost of debt capital, neolibertarian theorists characterize credit-cost minimization as beneficial throughout society and competing bankruptcy goals as redistributive.[106] Through this lens, there would seem to be little basis for disagreeing with the contention that a bankruptcy rule that provides wide-spread social benefits should be preferred over a bankruptcy rule that favors one small subgroup of society at the expense of another. But this perspective both magnifies the social benefit of reductions in the cost of debt capital and

101. *E.g.*, Bradley & Rosenzweig, *supra* note 8, at 1088 n.108; Rasmussen, *supra* note 27, at 23–25; Schwartz, *supra* note 8, at 343.

102. Schwartz, *supra* note 8, at 343.

103. *See supra* text accompanying notes 21–23.

104. *See supra* note 65.

105. *See supra* note 64.

106. Traditionalists are, in part, to blame for the rhetoric that describes bankruptcy protections as "redistributive." *E.g.*, Donald R. Korobkin, *Value and Rationality in Bankruptcy Decisionmaking*, 33 WM. & MARY L. REV. 333, 335 (1992) (arguing that "bankruptcy law exists to create a context in which the economic and noneconomic values of all those affected by a financial distress may be expressed and sometimes recognized"); Warren, *supra* note 47, at 467 ("Bankruptcy functions to preserve value in faltering businesses and to enhance the return to all those who have an interest in the business, but it also serves to redistribute value.").

exaggerates the absence of socially beneficial effects for bankruptcy provisions that protect specific creditor groups.

If only interest rates are considered,[107] minimizing the cost of credit would seem to provide benefits throughout society. Who can argue with the proposition that lower interest rates should be preferred to higher interest rates? Moreover, lowered credit costs seem to benefit debtors and their customers, more than lenders. Not only would existing borrowers enjoy reduced costs for debt capital, but also additional firms would enjoy access to sources of credit rendered affordable by the shift toward contract bankruptcy. In competitive markets, borrowers' reductions in the cost of credit would have ripple effects; these reductions in the cost of doing business would create pressure to reduce the cost at which goods and services are provided throughout the marketplace, redounding to the benefit of all consumers.

Notwithstanding the above, minimizing the cost of commercial credit may not maximize social welfare. The contention that business bankruptcy should minimize the cost of commercial credit does not alter, in any meaningful way, earlier assertions that bankruptcy law should maximize distributions to creditors. Both statements of normative purpose embrace a creditor-oriented focus for bankruptcy because, in the main, commentators contend the reductions in the cost of credit are best realized through enhanced distributions to creditors. Neolibertarian theorists argue that the shift toward private-law bankruptcy alternatives would reduce the cost of debt capital because creditors would avoid costly bankruptcy proceedings;[108] reduced enforcement costs would enhance distributions to creditors, thus, permitting creditors to decrease credit costs. They argue that contractual bankruptcy rules would reduce the cost of debt capital because these contracts would not contain inefficient redistributions to employees and others;[109] diminished distributions to priority claimants would enhance overall distributions to creditors, thus, permitting a concomitant reduction in the cost of credit. They contend that prebankruptcy contracts would reduce the cost of debt capital because, unlike current bankruptcy legislation, contractual bankruptcy

107. Economists often consider the effect of a variable *ceteris paribus*—that is, all other things being equal—but this analytic tool can be both unrealistic and misleading. Reductions in the cost of commercial-debt capital would not occur in a vacuum, however. The shift toward a contract-bankruptcy system might minimize commercial borrowing costs but also cause other direct and indirect changes in the marketplace. *See generally* R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1957); Richard S. Markovits, *Second-Best Theory and Law & Economics: An Introduction*, 73 CHI.-KENT L. REV. 3 (1998). The determination to permit actors to adopt private-law alternatives to mandatory bankruptcy legislation may well create social benefits; just as assuredly, however, this determination would come at a cost to society. At the very least, the shift to a contract-bankruptcy regime would create decision-making costs that may exceed the enforcement costs it permits society to avoid. For discussion of these decision-making and enforcement costs, see *supra* text accompanying notes 77–93.

108. *See supra* text accompanying notes 30, 34.

109. *See supra* text accompanying note 31.

resolutions would not permit deviation from the absolute priority rule.[110] Strict enforcement of the absolute priority rule would cause a diminution in the cost of debt capital, in part, because it would increase distributions to creditors.[111] To argue that business bankruptcy law should minimize the expense of borrowing for commercial entities is no different from arguing that "what's good for creditors is good for society as a whole."

Moreover, neolibertarian analysts are wrong to describe bankruptcy provisions, such as those that protect employees' labor claims, retirees' claims for medical and health benefits, and state and federal environmental claims, as having no public policy purpose other than the redistribution of bankruptcy losses from favored creditors to general unsecured creditors. Bankruptcy provisions such as these represent social and political determinations to protect broad-based policy interests in a bankruptcy case. In some instances, like those involving pension, labor and environmental claims, these public policy determinations are not unique to the Bankruptcy Code, but previously were identified in other federal legislation.[112] These protections should be viewed, not as provisions intended to redistribute wealth among creditors affected by a firm's bankruptcy, but as provisions reinforcing in bankruptcy important cultural, social and political interests that have been identified outside of bankruptcy.[113] Thus, even when bankruptcy protections of this sort can be said to increase the cost of commercial credit, it is in no way clear that the failure to minimize debt-capital costs represents a failure to maximize social welfare. With many bankruptcy protections, the failure to minimize the cost of credit means only that the maximization of social welfare involves a complex balancing of society's competing interests.

2. *Are Ex Ante Misincentives Caused by the Structure or the Content of a Rule?*

Neolibertarian commentators contend that traditionalists ignore the importance of ex ante incentives to bankruptcy policy-making.[114] They

110. *See supra* text accompanying note 32.

111. In addition, neolibertarian theorists argue that strict enforcement of the absolute priority rule would reduce the cost of credit because it would create appropriate ex ante incentives for a firm and its management.

112. *E.g.*, Employer Retirement Income Security Act, 29 U.S.C. §§ 1001–1191c (Supp. IV 1998); National Labor Relations Act, 29 U.S.C. § 141 (1994); Comprehensive Environmental Response Compensation and Liability Act, 42 U.S.C. §§ 9601–9675 (1994).

113. Another way to think about this complex balance of interests is to realize that the goal of minimizing the cost of credit is not absolute. However socially beneficial it may be to reduce the cost, and increase the availability, of debt capital, social interests in credit cost minimization should be limited by bodies of law outside bankruptcy law, such as labor or environmental law. Bankruptcy trustees and debtors-in-possession have abiding obligations to comply with applicable nonbankruptcy laws, even though distributions to creditors would be enhanced, and the cost of credit reduced, if they were not so obligated.

114. Baird, *supra* note 15, at 589 ("That the traditionalists do not even discuss ex ante effects directly shows how unimportant they think ex ante effects are. . . . The traditionalists believe that bank-

argue that existing bankruptcy legislation exacerbates incentives facing corporate debtors and their management for underinvestment, asset substitution, and other agency costs;[115] that the proper ex ante incentives would exist only where debt enjoys full priority over equity—that is, where the absolute priority rule is strictly enforced. These theorists prefer contract bankruptcy to mandatory bankruptcy legislation because the former is "designed to ensure that contractual priority remains intact."[116]

The argument that private-law alternatives should be preferred to bankruptcy legislation, because only under the former would the absolute priority rule find respect, confuses the substance of current bankruptcy legislation with questions of the inherent ability of legislation to create proper ex ante bankruptcy incentives. If the substance of the legislation creates the problem, then changing the substance—for example, by constricting the new value exception—should resolve the problem. Indeed, the Supreme Court recently did just that. In its decision in *203 North LaSalle Street Partnership*, the Court significantly limited the new value exception to the absolute priority rule.[117] Declining to decide whether Congress intended to incorporate a "new value" exception to § 1129(b)(2)(b)(ii)'s absolute priority rule,[118] the Court held that chapter 11 plans violate the absolute priority rule if they grant equity interests to the former owners of a reorganizing debtor "without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan."[119]

Neolibertarian theorists' preference for contract bankruptcy on the grounds that contracts would create appropriate ex ante incentives neglects the comparative institutional question: When would contractual rules provide better ex ante incentives than legislative ones, and vice versa? Some contract-bankruptcy proposals presume judicial enforcement of the absolute priority rule, but the presence of a prebankruptcy contract may not alter incentives to deviate from absolute priority that

ruptcy law can largely ignore ex ante effects and that it can push parties in beneficial directions in which they would not otherwise go.").

115. *See supra* note 76. Critics, in turn, argue that some of these private-law alternatives themselves create improper ex ante incentives. *See supra* text accompanying notes 53–58. I say that these commentators criticize only some of the private-law proposals on this ground because Korobkin's critique focuses exclusively on the Bradley/Rosenzweig proposal. Skeel and Rasmussen comment on a broader range of deregulatory proposals but criticize only the Bradley/Rosenzweig and Adler proposals along these lines. Rasmussen contends that his own "menu" proposal provides the proper ex ante incentives for business debtors and their management.

116. Rasmussen, *supra* note 54, at 1177; Schwartz, *supra* note 8, at 352–60.

117. Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 457–59 (1999).

118. *Id.* at 454–55. Courts of appeal are divided on this issue. At least one has held that "the doctrine remains a vital legal principle." Bonner Mall P'ship v. U.S. Bancorp Mortgage Co. (*In re* Bonner Mall P'ship), 2 F.3d 899, 907 (9th Cir. 1994), *cert. granted*, 510 U.S. 1039, *case dismissed as moot after settlement, but motion to vacate Ninth Circuit decision denied*, 513 U.S. 18 (1994). Others have questioned its continuing vitality, but declined to rule on the issue. *E.g.*, Travelers Ins. Co. v. Bryson Props. XVIII (*In re* Bryson Props. XVIII), 961 F.2d 496 (4th Cir. 1992).

119. *203 N. LaSalle St. P'ship*, 526 U.S. 434, 454 (1999).

exist under a legislative bankruptcy regime.[120] Incentives to waive application of the absolute priority rule may exist in either legislative or contractual bankruptcy rules. Even though a debtor and its creditors have agreed not to deviate from the absolute priority rule, parties will continue to face incentives to waive strict application of the rule from time to time and courts will continue to be called upon to relax absolute priority. With closely held corporate debtors, parties may negotiate around literal enforcement of the absolute priority rule in order to retain the unique management or operational skills of certain equity holders, whether absolute priority is governed by legislation or contract. In other instances, parties may relax their enforcement of absolute priority in order to avoid a costly valuation hearing as valuation costs are not unique to a legislative absolute priority rule. Parties bound by a contract-based bankruptcy rule could face costly valuation procedures if both equity holders and junior creditors were to receive distributions of stock in the reorganized corporate entity. Junior creditors could contest the distributions to shareholders as violative of the absolute priority rule, but shareholders could defend them as consistent with application of that rule to a solvent entity. Similarly, valuation procedures could arise under a contractual bankruptcy arrangement if equity holders were to receive no stock in the reorganized entity. Shareholders may argue that the absolute priority rule does not permit creditors to be paid more than in full, even in a contractual setting; only after a valuation of the reorganized corporation could creditors refute equity's objection.

Other contract-bankruptcy proposals would not rely on judicial enforcement of the absolute priority rule. For example, Barry Adler's Chameleon Equity proposal posits the issuance of debt that would automatically convert to equity under a debtor's default.[121] More than simply enforce the absolute priority rule, the automatic conversion function of Chameleon Equity would alter the absolute priority rule in important ways. Chameleon Equity looks to implement the absolute priority rule without the need for judicial involvement, thus eliminating the possibility for nullification of the rule through judicial discretion. It also looks to limit parties' ability to nullify strict enforcement of the rule through waiver, as unanimous or near-unanimous agreement would be needed to modify the terms of Chameleon Equity. Whether or not these substantive changes are viewed as desirable,[122] there is nothing that would pre-

120. *See* Schwartz, *supra* note 8, at 352–60 (discussing the implicit assumption in his model of contract bankruptcy that courts will enforce absolute priority rule).

121. *E.g.*, Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1111–31; Adler, *Financial and Political Theories*, *supra* note 8, at 323–33; Adler, *Theory of Corporate Insolvency*, *supra* note 8, at 350–57.

122. For a discussion of the improper ex ante incentives that automatic conversion would create for the management of a corporate equity issuing Chameleon Equity, see Korobkin, *supra* note 47, at 711–21; Rasmussen, *supra* note 47, at 1190–1200; Skeel, *supra* note 47, at 487; *see also supra* text accompanying notes 53–58.

clude the realization of these goals through legislative rather than contractual means.[123] Chameleon Equity does not resolve the comparative institutional question as to whether contractual bankruptcy rules should be preferred to legislative ones.[124]

3. *Should Consideration of Ex Ante Incentives Predominate Concern for Ex Post Effects?*

Neolibertarian bankruptcy theorists assert that ex ante efficiency is more important than an interest in alleviating untoward ex post effects of a contract-bankruptcy regime.[125] This focus upon ex ante incentives to the exclusion of ex post effects is revealing about the assumptions that underlay their analysis. It might be appropriate to ignore ex post effects if actors were assumed to be rational actors who enjoy equal access to information about the risk of a firm's financial distress and equal ability to set credit terms that incorporate that information. In this case, actors' ex ante incentives are all that matters because ex ante price determinations accurately account for all foreseeable ex post effects. But different actors enjoy distinct access to such information and disparate abilities to craft credit terms that take such information into account.[126] Tort and other involuntary creditors cannot be expected to have entered into contracts that reflect an assessment of their debtor's risk of default because they will not have contracted with the debtor at all.[127] Nor are these premises generally accurate as applied to the voluntary creditors who, for

123. Adler's Chameleon Equity proposal presumes the absence of business bankruptcy law, state collection law, and debt. In making these assumptions, Adler admits that contract alone could not accomplish an issuance of Chameleon Equity. He envisions legislative changes to the Bankruptcy Code, the Internal Revenue Code, and state laws governing corporations, creditors' rights, and tort. *See supra* text accompanying note 35.

124. Indeed, implicitly conceding this comparative institutional critique of his contract-bankruptcy proposals, Adler, together with his co-author, Ian Ayres, propose a market-oriented dilution mechanism to market test application of the absolute priority rule in chapter 11 reorganization cases after *203 N. LaSalle Street*. Barry E. Adler & Ian Ayres, A Dilution Mechanism for Valuing Corporations in Bankruptcy (unpublished manuscript) (on file with the *University of Illinois Law Review*).

125. *E.g.*, Adler, *Theory of Corporate Insolvency*, *supra* note 8, at 375–80 (arguing that investors would prefer ex ante to ex post solutions for financial distress of firm); Rasmussen, *supra* note 47, at 1163 ("Ex post inefficiency involving the relatively few firms that file for bankruptcy should not come at the expense of ex ante inefficiency for all firms in the economy."). Adler elaborates on this idea as follows:

> Bankruptcy law or an alternative means of firm protection may save firms that are viable ex post, despite the ex ante likelihood of inviability. But the cost of screening must be borne by investors in all insolvent firms. The occasional successful rescue of a viable firm may not justify this ubiquitous cost.

Adler, *Theory of Corporate Insolvency*, *supra* note 8, at 345.

126. *E.g.*, Bebchuk & Fried, *supra* note 19, at 864; LoPucki, *Strange Visions*, *supra* note 47, at 106–10; Warren, *supra* note 47, at 474.

127. Prejudgment interest is, in all likelihood, unavailable. Postjudgment interest, to the extent available, will be set by statute and, thus, will not differ depending upon the financial risk that the firm presents.

one reason or another, would not adjust their credit terms to account for the shift to a private-law alternative.

The premise that creditors would make such adjustments rests, in part, on assumptions about the rationality of lenders in that market. Recent psychological and behavioral economics scholarship questions the premises of a rational actor model of economic conduct.[128] Behavioral economists find that people sometimes act inconsistent with their self-interest—they opt for fair results,[129] exhibit greater risk aversion for loss than preference for gains of the same size,[130] exhibit a status quo bias,[131] underestimate risks associated with events over which they are in control, and overestimate uncontrolled risks of equal size.[132] This experimental work undercuts claims that the shift toward a contract-bankruptcy regime would result in savings in the cost of credit. Robert Rasmussen admits as much, but argues that banks' internal mechanisms should counteract for the excessive optimism, status quo bias, and other irrationalities of its loan officers.[133] Whether or not Rasmussen is right about bank creditors, his argument concedes the devastating impact of behavioral economics as it pertains to nonbank creditors.[134] Certainly involuntary creditors would not be influenced by a shift to a private-law bankruptcy regime to increase "credit" availability; given the findings of behavioral economists, it is also unlikely that small, noninstitutional creditors, such as suppliers and employees, would pass on the cost savings of private resolutions to their debtors.[135]

128. *E.g.*, Elizabeth Hoffman & Matthew L. Spitzer, *Experimental Law and Economics: An Introduction*, 85 COLUM. L. REV. 991 (1985); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); Symposium, *Behavioral Approaches to Law and Economics*, NAT'L BUREAU ECON. RES. REP., Winter 1997–98, at 18; Symposium, *The Legal Implications of Psychology: Human Behavior, Behavioral Economics, and the Law*, 51 VAND. L. REV. 1499 (1998).

129. *E.g.*, Ernst Fehr et al., *Does Fairness Prevent Market Clearing? An Experimental Investigation*, 108 Q.J. ECON. 437, 438 (1993); Werner Guth et al., *An Experimental Analysis of Ultimatum Bargaining*, 3 J. ECON. BEHAV. & ORG. 367, 384 (1982); Richard H. Thaler, *The Ultimatum Game*, *in* THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE 21 (1992).

130. *E.g.*, Amos Tversky & Daniel Kahneman, *Loss Aversion in Riskless Choice: A Reference-Dependent Model*, 106 Q.J. ECON. 1039, 1039 (1991).

131. *E.g.*, Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583 (1998); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 611 (1998); William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7 (1988).

132. *E.g.*, MAX BAZERMAN, JUDGMENT IN MANAGERIAL DECISIONMAKING 37–39 (3d ed. 1994); Daniel Kahneman & Amos Tversky, *Conflict Resolution: A Cognitive Perspective*, *in* BARRIERS TO CONFLICT RESOLUTION 44, 46–50 (Kenneth J. Arrow et al. eds., 1995).

133. *See* Robert K. Rasmussen, *Behavioral Economics, the Economic Analysis of Bankruptcy Law and the Pricing of Credit*, 51 VAND. L. REV. 1679 (1998) (examining assumption that creditors pass on cost of inefficient bankruptcy regime to their debtors in light of findings in behavior economics and concluding banks' internal mechanisms may provide effective guards against excessive optimism and status quo bias).

134. *Id.* at 1690 ("It may well be the case that if the law allowed debtors to select the operative bankruptcy rules, small creditors would not adjust their lending rates based on the choice that the debtor made.").

135. *E.g.*, Bebchuk & Fried, *supra* note 19; Bebchuk & Fried, *Further Thoughts*, *supra* note 47; Korobkin, *supra* note 47; LoPucki, *supra* note 47; Warren, *supra* note 47.

4. *Is Concern for Ex Post Effects Always Inefficient?*

A belief that, in the event of conflict, ex ante incentives should trump ex post effects leads neolibertarian theorists to ignore ex post effects altogether. Commentators such as Alan Schwartz, Robert Rasmussen, and Christopher Frost criticize bankruptcy legislation that seeks to counteract ex post effects on the grounds that these redistributions are inefficient.[136]

Alan Schwartz argues that "attempting to protect employees and communities in bankruptcy is bad public policy" on both efficiency and equity grounds.[137] On efficiency grounds, he finds that legislative protections interfere with benefits that inure in the marketplace such as the cost of credit.[138] On equity grounds, he contends that bankruptcy protections unfairly impose costs on creditors that are more fairly spread among all taxpayers.[139] Robert Rasmussen similarly argues that bankruptcy law should not pursue distributive goals.[140] He characterizes efforts to redistribute through bankruptcy law as "ad hoc, and grossly imprecise" and concludes that, "[i]n the end, an efficient bankruptcy regime, by promoting business activity, will more likely help the worst-off members of society than will a bankruptcy system geared toward redistribution, even in a world of imperfect social justice."[141] According to Rasmussen, redistributive bankruptcy policies increase the cost of credit for the entire market, not simply for those embroiled in a bankruptcy case. Christopher Frost makes comparable arguments,[142] arguing that distributional preferences are better resolved through tax or directed spending programs on the grounds that the judiciary are inherently incapable of making these sorts of redistributive decisions.[143]

136. For a critique of this neolibertarian scholarship, see Edward J. Janger, *Crystals and Mud in Bankruptcy: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. (forthcoming 2001).

137. Schwartz, *supra* note 7, at 1817 n.45.

138. *Id.* at 1817–19. For a similar argument made outside the context of bankruptcy, see, for example, Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713 (1996); Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821 (2000); Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient Than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994). For a refutation of this argument, see Chris William Sanchirico, *Deconstructing the New Efficiency Rationale*, 86 CORNELL L. REV. (forthcoming 2001); Chris William Sanchirico, *Taxes Versus Legal Rules as Instruments for Equity: A More Equitable View*, 29 J. LEGAL STUD. 797 (2000).

139. Schwartz, *supra* note 7, at 1817–19.

140. Rasmussen, *supra* note 27 (applying John Rawl's *Theory of Justice* and concluding that bankruptcy law justly does not pursue distributional goals, whether Rawl's "difference principle" views consensual creditors, shareholders, the surrounding community, employees, or tort victims as the least advantaged participants in this scheme).

141. *Id.* at 41.

142. Frost, *supra* note 31, at 113–22 (concluding that "[p]redicting the effects of redistributive policies will be an extraordinarily inexact undertaking").

143. Frost questions the capability of the judicial process to accomplish redistributional goals in bankruptcy both because of the polycentric nature of the issues in bankruptcy, and because of the pro-

Contending that redistributive bankruptcy legislation is inefficient, these commentators argue that a contract-bankruptcy regime should always be preferred to mandatory legislation. But the issue is not simply whether bankruptcy legislation contains provisions intended to redistribute wealth among creditors, debtors, and debtors' shareholders. It does, although I would not have focused on the provisions favoring these sorts of weak creditors as the worst examples of interest group influence in the bankruptcy political process.[144] The more important question is whether the choice between legislative, contractual, and property bankruptcy rules has distributive implications.[145] Would prebankruptcy contracts be less likely than mandatory legislation to attempt to redistribute property in a bankruptcy context?[146]

The answer to the comparative institutional question depends critically upon the nature of the contractual arrangement. With multiparty contracts among all or substantially all of the parties affected by the firm's financial distress, distributions favoring one creditor or group of creditors would be unlikely because the preferential treatment would be effective only upon consensus.[147] With two-party contracts between a debtor and its creditor, by contrast, the debtor and contracting creditor

cedural limitations confronting bankruptcy judges. *Id.* at 124–35. For a rejoinder to Frost, see Janger, *supra* note 136.

144. *See* Block-Lieb, *Political and Economic Theory*, *supra* note 82.

145. Others stress that unintended redistributive effects are especially likely to follow from the assignment of property rights and the private individual action that follows. For example, Carol Rose and Gary Libecap independently have argued that property rights exhibit especially high distributional costs for the losing nonowners. *See* GARY D. LIBECAP, CONTRACTING FOR PROPERTY RIGHTS 5 (1989) ("Because property rights involve the assignment of exclusive decision making over valuable resources, some parties will be harmed by the new definition of wealth and political power."); Carol M. Rose, *Rethinking Environmental Controls: Management Strategies for Common Resources*, 1991 DUKE L.J. 1, 22 ("Shall we have an auction, or a giveaway to existing fishers, or some other allocation scheme? . . . [I]t matters a great deal to those who want to fish; oldtimers are likely to want the rights allocated to themselves, whereas newcomers might prefer an auction or lottery."); *see also* CAROL M. ROSE, PROPERTY AND PERSUASION: ESSAYS ON THE HISTORY, THEORY, AND RHETORIC OF OWNERSHIP (1994).

146. According to Calabresi and Melamed, society sets initial entitlements and should choose among protective legal rules to facilitate a combination of efficiency, distributive and other justice results. Calabresi & Melamed, *supra* note 96, at 1093, 1098, 1106–10. Twenty-five years later, Guido Calabresi reiterated the importance of distributional considerations to choices among legal rules. Guido Calabresi, *Remarks: The Simple Virtues of* The Cathedral, 106 YALE L.J. 2201, 2204 (1997).

> [T]he article was a way of saying that we can look at a situation and consider whether one rule is more appropriate than another in terms that go beyond efficiency and allow decisionmakers to respond, for example, to distributional desires as well. It is for this reason that I have relatively little patience with the debate over which is more efficient, a property rule or a liability rule when transaction costs are high or low. This debate is certainly worth having, but it is not as interesting as the question of when we want to use one remedy rather than another for broader reasons.

Id.

147. I am not contending that these sorts of preferences would never occur, however. Contracting well in advance of default or financial distress vaguely resembles Rawlsian contracting, and, thus, suggests that redistributive contractual provisions are plausible. Holdouts might also be bribed to contract if offered favored status under the agreement.

might easily agree to treat the contract creditor more favorably than the debtor's other creditors.[148]

Both legislative and contractual rules can contain redistributive provisions. Thus, equating redistributions with inefficiencies does not answer the comparative institutional question as to whether contract bankruptcy should be preferred to mandatory bankruptcy legislation. Libertarian theory prefers contractual to legislative arrangements, in large part, because it presumes that contracts would permit only voluntary redistributions.[149] This presumption may be misplaced with majority rule and two party contracts that bind even nonparties, however.[150] I return to this topic below, when considering the extent to which freedom of contract would in fact exist under a contract-bankruptcy regime.

B. Bankruptcy Costs

Part 1 of this section discusses the impact of various bankruptcy rules on parties' individual autonomy, an impact I measure in terms of the external decision-making costs of a rule. Although neolibertarian bankruptcy commentators emphasize "freedom of contract," some of these private-law substitutes would bind nonparties. These scholars purport to justify the binding effect of nonconsensual bankruptcy contracts on several grounds. First, they argue that practical difficulties prevent unanimous agreement among affected entities. Second, they describe objections raised on behalf of nonconsenting parties as demands for inefficient redistributions of property or other wealth. Finally, they characterize all loss that would be suffered by these dissenters as externality ef-

148. Because legislation is comparable to a multiparty contract in which dissenters are bound by the vote of the majority, I would expect the occurrence of redistributive provisions in both to fall somewhere between their occurrence in multiparty and two-party contracts. Contractual redistributions are likely to favor entities with market power, while legislative redistributions are likely to favor entities with political power. There is a great deal of overlap between the two, but market and political power are subtly distinct. *See* CARRUTHERS & HALLIDAY, *supra* note 82, at 149. Legislation may prove greater opportunity for redistributive provisions than contracts governed by a majority rule because legislation is more likely to be enacted through the vote of representatives, creating agency costs and other issues as noted by public choice theorists.

149. LoPucki, *supra* note 14, at 341 ("The case for freedom of contract rests squarely on the assumption that each party chooses the contract because the contract makes that party better off. Because each party is better off, all parties are better off in the aggregate. That aggregate becomes a proxy for 'social welfare.'"); Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1714 (1989) ("[T]he argument for contractual rule making is simple but powerful . . . . Contractually created rules will tend strongly to be pareto-superior rules: they will make one or both parties better off, and neither party worse off.").

150. LoPucki, *supra* note 14, at 340–41.

> Failure of secured creditors to include unsecured creditors in the contracts for stay waivers in workouts suggests that the contracting parties are attempting to appropriate the expectancies of the unsecured creditors rather than to maximize social welfare. Failure to protect the future creditors of the originator in asset-securitization contracts suggests that redistribution of wealth may be the motivating force in those transactions as well. These tendencies of real-world bankruptcy contracting to seize on opportunities for redistribution do not bode well for the future of bankruptcy contracting.

Id.

fects, whose harm is outweighed by the beneficial effects of the proposal on the marketplace as a whole. I find each rationale for deviation from principles of individual autonomy to provide unconvincing support for contract-bankruptcy proposals to bind nonparties.

Subparts 2 and 3 of this section discuss the implementation and enforcement costs of various bankruptcy rules. The privatization of corporate bankruptcy law has been justified by comparing the costs of negotiations to the costs of judicially enforcing statutory bankruptcy rules. Ex ante, commentators find manageable impediments to negotiations between debtors and their creditors, while, ex post, they contend that there are substantial costs associated with the enforcement of bankruptcy-focused liability rules. I argue that this explanation both understates the inherent decision-making costs associated with the private resolution of a debtor's financial distress, and overstates the enforcement costs of judicial enforcement.

1. External Decision-Making Costs

Neolibertarian bankruptcy theorists cloak their analysis with the mantle of freedom of contract. Alan Schwartz dubs his "*A Contract Theory Approach to Business Bankruptcy.*"[151] Steven Schwarcz rethinks "*Freedom of Contract*" using bankruptcy as a paradigm.[152] Barry Adler also consciously describes his proposal as contractual in nature.[153] Robert Rasmussen and others describe bankruptcy law as a "default rule"[154]—a term invariably used in conjunction with contract remedies.[155] Contract-based bankruptcy rules, they argue, maximize entities' individual autonomy, and, thus minimize external decision-making costs.[156]

151. Schwartz, *supra* note 7, at 1807.

152. Schwarcz, *supra* note 10, at 515.

153. *E.g.*, Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1111 (concluding that, "despite the ingenuity of recent scholarship on the complexity of contractual relationships, contract, not special legal rules, can in principle best provide for even daunting contingencies such as insolvency"). Alder elaborates on the freedom-of-contract underpinnings of his analysis as follows.

> Intuition suggests that the most efficient legal rules are those that enforce contracts in as straightforward a manner as possible. . . . Thorough analysis, however, reveals that intuition can be robust despite complexity. In the case of corporate insolvency, simple rules that honor absolute priority are likely the best response to elaborate circumstances.

Id. at 1150.

154. Rasmussen, *supra* note 8, at 53.

155. *E.g.*, Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 611 (1998).

156. Many commentators would agree that unanimous agreement among a business debtor and all its creditors about possible financial distress is, in principle, an improvement upon legislative rules on the same topic. *E.g.*, Schwarcz, *supra* note 10, at 600 (agreeing that when a debtor and all of its creditors agree to a procedure contract "there is little question that the contract should be enforced"). Most would also concede that unanimous consent is so difficult to achieve in practice as to render the principle virtually illusory. *See id.* (finding unanimous consent implausible, concluding that procedure contracts will exist only if "the law imposes a consensus mechanism that substitutes for unanimity" and that, even if the law were to adopt such a procedure, "the obstacles to procedure contracts are not in the concept but in the implementation").

Despite this freedom-of-contract rhetoric, the specifics of the contractual arrangements proposed by these scholars belie their emphasis on individual autonomy. Alan Schwartz focuses his attention on multiparty procedure contracts among a debtor and its creditors. Unlike other commentators who have written on the topic of private-law bankruptcy substitutes,[157] Schwartz contends that these contracts should be binding upon the majority vote of affected parties.[158] Because practical difficulties prevent unanimous agreement among affected entities, he argues that a majority of the debtor's creditors should be able to bind a minority of dissenters in order to prevent them from engaging in "inefficient holdout behavior."[159] Fully aware that his proposal would intrude on dissenters' individual autonomy, Schwartz contends that "[t]he freedom to contract should not be used to prevent efficient contracting."[160] He justifies the move to majority-rule contracts by noting that under chapter 11 of the Bankruptcy Code a dissenting minority of creditors can be bound to a plan of reorganization by the vote of the majority.[161] But his contractual proposal would appear to contain none of chapter 11's protections for dissenting individual creditors.[162] He would bind dissenters on the agreement of a majority in the amount of outstanding debt,[163] whereas the Bankruptcy Code binds dissenters only upon the vote of "at least two-thirds in amount and more than one-half in number."[164] Moreover, the Code applies this super-majority rule on a class-by-class basis, permitting only "substantially similar" claims to be classed together.[165] The statute also protects dissenting members of a class by means of a substan-

157. *See generally* Adler, *Financial and Political Theories*, *supra* note 8; Bradley & Rosenzweig, *supra* note 8; Rasmussen, *supra* note 8.

158. Schwartz, *supra* note 7, at 1838. In his later paper, Schwartz clarifies that the "proposal was to permit the preferences of a majority in amount of the firm's debt to control." Schwartz, *supra* note 8, at 360 n.28.

159. Schwartz, *supra* note 7, at 1838.

160. *Id.*

161. *Id.*

162. Although Schwartz implies that his proposal creates no greater distribution costs than those already in existence under the Bankruptcy Code, he conveniently ignores, for purposes of this argument, the procedural and substantive protections afforded by statute to these dissenting minority creditors. Nowhere does Schwartz describe means for protecting noncontracting creditors from the tyranny of this majority. *E.g.*, 11 U.S.C. §§ 1122 (1994) (restricting classification of claims in chapter 11 plans), 1123 (prescribing required and permissible contents of plan of reorganization), 1124 (defining impairment of claims or interests for purposes of standards of confirmation of reorganization plan), 1125 (requiring presolicitation disclosure to holders of claims and interest), 1126 (defining standards for acceptance of plan), and 1129 (providing detailed standards for confirmation of chapter 11 plan of reorganization); *see also* LoPucki, *supra* note 14, at 330–31 (criticizing Schwartz's majority rule solution on the grounds that it is inconsistent with other segments of his model in that it offers no mechanism for counting changing majorities over time, and "implicitly assumes that the creditors who prefer an efficient liquidation will outnumber those who prefer an inefficient reorganization").

163. Schwartz, *supra* note 8, at 360 n.28.

164. 11 U.S.C. § 1124(c).

165. *Id.* § 1122(a).

tive standard—the "best interest of creditors" test—which Schwartz would appear not to require.[166]

Steven Schwarcz also would undercut individual autonomy with the private-law bankruptcy alternatives he advocates. He contends that parties should be allowed to enter into enforceable agreements that supplant bankruptcy procedures. He focuses most heavily on what he refers to as "waiver contracts"—two-party contracts between a debtor and creditor in which "the debtor waives its protection under the automatic stay in bankruptcy against a particular creditor's debt-collection actions" in exchange for new credit or a waiver of the debtor's default under a preexisting loan agreement.[167] In support of his argument that these waiver contracts should be enforceable, Schwarcz emphasizes the importance of reconceptualizing freedom of contract. He argues that a business debtor and its creditors should be free to enter into two-party waiver agreements, even though these contracts "may, and in fact sometimes do, harm third parties[.]"[168] By describing this harm as an externality effect, Schwarcz is able to describe "the major conceptual problem" he confronts as the determination of "which [externalities] are to count in constraining the ability of parties to contract with each other."[169] After all, Schwarcz remarks, not every indirect negative impact upon non-parties should intrude upon the freedom of a debtor and its creditor to enter into a waiver agreement.

The appeal of Steven Schwarcz's argument to a libertarian theorist depends entirely upon whether the admitted harm that these waiver contracts would export to third parties should be characterized as an externality. If it should, then Schwarcz is right, the question becomes one of line drawing—where to draw the line between tolerable and intolerable externalities.[170] But if instead he advocates the enforceability of waiver agreements entered into between a debtor and creditor but binding upon third parties, then he advocates a position antithetical to libertarian emphasis on the importance of individual autonomy.

Schwarcz is careful to define waiver agreements narrowly so as to support his contention that the third-party harm constitutes an external-

166. *Id.* § 1129(a)(7)(A).

167. Schwarcz, *supra* note 10, at 521.

168. *Id.* at 520.

169. *Id.* at 521 (quoting MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 20 (1993)) (brackets original to Schwarcz).

170. And Schwarcz's attempt to draw the line between permissible and impermissible externalities is, at least ostensibly, far more interested in the distributive impact of the harmful effect than his predecessors. *E.g.*, James M. Buchanan & William Craig Stubblebine, *Externality*, 29 ECONOMICA 371, 371–77 (1962) (arguing that only Pareto relevant externalities should affect policy determinations, and defining Pareto relevant externalities as those that can be removed at a net positive benefit to society); Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 143 (1979) (arguing that concept of externality "is void of any positive content but, on the contrary, simply constitutes a normative judgment about the rule of government and the ability of markets to establish mutually beneficial exchanges").

ity.[171] Specifically, he defines these narrow waiver agreements to involve a debtor's waiver of the automatic stay only as applied to the contracting-creditor. He later notes that a general waiver of the automatic stay should not be enforceable on the grounds that such a general waiver would subvert any possible reorganization of the debtor and, therefore, contradict a fundamental policy goal under the Bankruptcy Code.[172] But even if the statute's preference for business rehabilitation were ignored, the distinction Schwarcz makes between narrow and general waiver agreements is an important one. The attempt of a debtor and one creditor to alter bankruptcy procedure for all of the debtor's creditors is not a mere side-effect of the contract. More than creating an externality, general waiver agreements turn the notion of freedom of contract on its head by permitting contract parties to rob statutory procedural rights from nonparties.

Freedom of contract is undermined with more than just the two-party generalized waiver of the automatic stay that Schwarcz distinguishes, moreover. There is no principled difference between a two-party contract that broadly alters nonconsenting creditors' automatic stay protections and the majority-rule contract that Alan Schwartz advocates. Both purport to bind nonparties. More importantly, both would alter nonconsenting parties' statutory protections.

Parallels also exist between the two-party contract purporting generally to waive the automatic stay and a two-party agreement in which the debtor grants a blanket security interest.[173] Preexisting unsecured creditors are bound by the terms of the security agreement in ways that impact significantly both upon their statutory rights of execution and levy and upon their ability to be repaid in full in the event of the debtor's default. Schwarcz himself concedes the comparison when he contends "that the theoretical basis for enforcing security agreements would appear to be the same as that for enforcing prebankruptcy contracts."[174]

In this way, neolibertarian complaints that redistributive bankruptcy legislation is inequitable and inefficient come back to haunt. Free-market bankruptcy theorists object to statutory provisions that redistrib-

171. Schwarcz, *supra* note 10, at 521 n.22.

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

172. *Id*.

173. The primary difference between bankruptcy waiver agreements and security agreements is that Article 9 generally requires secured creditors to provide public notice of a security interest, while nothing in the literature suggests that enforceability of waiver agreements (or any other pre-bankruptcy contract) should be conditioned upon filing or other public registration.

174. *Id.* at 520. Indeed, Schwarcz applies the same class Pareto efficiency analysis to justify the institution of secured credit as he utilizes to justify prebankruptcy waiver agreements. *See* Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 432 (1997) [hereinafter Schwarcz, *Easy Case*].

ute property in a bankruptcy context because they constitute involuntary takings from those who did not vote for the legislation. The same could be said of some bankruptcy contracts, however. There can be no distinction between legislation that redistributes from the politically weak to the politically strong and majority-rule (or two-party) contracts that redistribute from contractually weak to strong creditors.

The redistributive implications of security agreements that bind nonconsenting unsecured creditors are well understood in the academy. Lynn LoPucki, Lucian Bebchuk, and Jesse Fried argue that the creation of a security interest permits a debtor and its secured creditor to export the risk of financial distress to nonadjusting unsecured creditors, and describe this externalization of risk using explicitly distributional language.[175] Asset securitizations also have been criticized for their potential for similar distributional costs.[176] Although these commentators have been loudly criticized, the criticism primarily has taken issue with the contention that this externalization of risk renders the institution of secured credit inefficient.[177] Critics have not questioned the presence of distributional costs identified by LoPucki, Bebchuk, and Fried; instead, they argue that these costs are outweighed by the social benefits of secured transactions.[178]

175. *E.g.*, LoPucki, *Unsecured Creditor's Bargain*, *supra* note 47, at 1963 ("Article 9 artificially and unjustifiably advantages the institution of security over unsecurity. . . . This bizarre scheme subsidizes the institution of security, causing more secured lending than is optimal."); Bebchuk & Fried, *supra* note 19, at 864 ("[T]he creation of a security interest under the rule of full priority has distributional consequences. In particular, under the rule of full priority, the creation of a security interest diverts value from creditors that do not 'adjust' the size of their claims to take into account the effect of the loan transaction that creates the security interest, including the fact that any security interest given to the secured creditor subordinates their unsecured claims.").

176. *See* LoPucki, *supra* note 14, at 335–40; LoPucki, *Death of Liability*, *supra* note 47, at 23–38; Lupica, *Asset Securitization*, *supra* note 47, at 648–60; Lupica, *Statutory Institutionalization*, *supra* note 47, at 232–36.

177. *E.g.*, David Gray Carlson, *Secured Lending as a Zero-Sum Game*, 19 CARDOZO L. REV. 1635, 1694–1721 (1998) (critically discussing efficiency implications of Bebchuk and Fried's models); Schwarcz, *Easy Case*, *supra* note 174, at 428–29 (arguing that new money secured credit is class Pareto efficient and that, "although Bebchuk and Fried intend to protect unsecured creditors by limiting secured debt, unsecured creditors themselves should want debtors to have access to secured debt").

178. *E.g.*, Steven L. Harris & Charles W. Mooney, Jr., *Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy*, 82 CORNELL L. REV. 1349, 1356 (1997) (arguing that "subordination proposals would materially reduce credit available to distressed businesses, and that the costs of the credit contraction would swamp the benefits of increased distributions in bankruptcy for the promoted classes of creditors"); Schwarcz, *Easy Case*, *supra* note 174, at 486–87 n.266 (making explicit his failure to distinguish between adjusting and nonadjusting creditors because, "[u]nder the logic of the Article, no type of unsecured creditor is likely to be prejudiced by new money liens"). For most, this leaves the debate as an empirical question—an empirical question to which everyone has opinions and few have proof. *E.g.*, Carlson, *supra* note 177, at 1708 (arguing that "Bebchuk and Fried have demonstrated that some security interests are efficient and some are not," but that they make "no attempt to quantify whether the efficient or inefficient security interests predominate"); Harris & Mooney, *supra*, at 1363 (arguing that a "firm's nonadjusting creditors cannot possibly suffer any harm from the new secured credit unless the firm in fact becomes insolvent and fails to pay the creditors' claims in full." The firm "may be exposed to additional risk, but that risk will be converted into harm only as to creditors of debtors that actually fail."). The debate has stalled on the question of which side bears the burden of proof on this empirical question.

The redistributive implications of multiparty, prebankruptcy contracts are less apparent. If truly *n*-party, their external decision-making costs would be nonexistent. But, of course, unanimous agreement is implausible in practice. Some commentators would couple their contract-bankruptcy proposals with statutory protections for creditors who would be unable or unlikely to consent to these private arrangements. Barry Adler, Alan Schwartz, and Robert Rasmussen each remark that their private-law proposals should be coupled with statutory protection for tort and possibly other nonadjusting creditors.[179]

Among contract-bankruptcy proponents, only Steven Schwarcz disagrees. He argues that nonadjusting creditors do not need statutory protection because he does not find that the harmful effect of waiver and procedure agreements would create class Pareto inefficiencies. Nonadjusting creditors need not receive statutory protection under his class Pareto efficiency theory because, as a class, they would do better under private-law alternatives due to enhanced credit availability. Only the tort and other nonadjusting creditors of the small fraction of borrowers who ultimately suffer financial distress would do worse, but they count only as a fraction of a class for purposes of this class Pareto efficiency test.[180]

In the abstract, Schwarcz's class Pareto optimality analysis adds a powerful distributive dimension to a neolibertarian analysis of bankruptcy law. Neolibertarians reluctantly embrace Kaldor-Hicks efficiency—the contention that the move from one legal rule to another is efficient if it would increase social wealth to such an extent that the winners could compensate the losers and still have some left over—because Kaldor-Hicks efficiency sits in tension with libertarian concerns for indi-

Compare, e.g., Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1468 (1997) ("While Warren should bear the burden of proof on her Proposal, the Article 9 reformers should bear the burden of proof on the scope of Article 9 reform."), *and* Elizabeth Warren, *Making Policy With Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1385–86 (1997) ("The question that arises again and again, both in the scholarly literature and public debates, is whether a partial priority system would reduce credit availability. The empirical question quickly turns into the empirical assertion that credit availability would diminish, thereby harming all business interests."), *with, e.g.*, Harris & Mooney, *supra*, at 1349 ("As of yet, however, none of the subordination proponents has addressed [the empirical question] in any detail.").

179. *E.g.*, Adler, *Financial and Political Theories*, *supra* note 8, at 340 ("Ideally, nonconsensual claimants would have highest priority in any sort of firm."); Mark J. Roe, *Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics*, 75 VA. L. REV. 219, 227 (1989) ("A rule of priority for nonbargain creditors seems efficient."); Schwartz, *supra* note 7, at 1810 n.15 ("Tort and environmental victims of the firm's activities do not bargain with the firm ex ante, but do have current bankruptcy claims against it. These claims should be protected in bankruptcy, but just how is beyond this Essay's scope."); *see also* Rasmussen, *supra* note 27, at 33–34 (arguing, first, that Rawlsian difference principle favors "priority for tort creditors coupled with unlimited liability," but later in same page concluding that "those in the original position would opt for the pro rata rule"). Because they provide little in the way of detail, it is difficult to assess the statutory protections they envision.

180. Schwarcz, *Easy Case*, *supra* note 174, at 486–87 n.266 ("The Article does not need to distinguish between tort creditors and other unsecured creditors. Under the logic of the Article, no type of unsecured creditor is likely to be prejudiced by new money liens.").

vidual welfare and freedom of contract.[181] They do so because more traditional libertarian thinking leads ineluctably to Paretian concepts of efficiency and yet, because a shift would only be considered Pareto superior if it left no individual worse off, Pareto efficiency analysis is notorious for its status quo bias.[182]

Like many, Schwarcz is uncomfortable with the marriage of Kaldor-Hicks utilitarianism to libertarian freedom-of-contract analysis and suggests that we assess contract-bankruptcy proposals to determine their class Pareto efficiency precisely to assuage this discomfort.[183] As conceived by Schwarcz, class Pareto efficiency would tolerate the change to a rule that imposes losses on individuals, but only to the extent that these losses are evenly distributed across society and are not imposed on a class of affected persons.[184] "[W]here the group of persons harmed by a particular form of advantage-taking represents a permanently distinct subset of society as a whole,"[185] then the shift to the rule could not be viewed as class Pareto efficient, regardless of the relative size of losers' losses to winners' gains.[186] Thus, in theory, the concept of class Pareto efficiency admirably tempers the harshness of Kaldor-Hicks efficiency analysis, which would accept losses imposed on individuals or classes of individuals so long as those losses were counterbalanced by sufficient offsetting social benefits. At the same time, class Pareto efficiency also imposes useful pragmatic limits on an often times unworkable individually oriented Paretian analysis, which would forgo social benefits, no matter the magnitude, if a single individual were harmed by the proposal.

Despite the enormous potential benefits of his class-based Paretian theory, Schwarcz fails in the end to comment on the redistributive impli-

181. *See supra* note 1.

182. *E.g.*, Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 Yale L.J. 1211 (1991).

183. Although Schwarcz believes that a contract-bankruptcy regime would be Kaldor-Hicks efficient as compared to a system with mandatory bankruptcy legislation, he professes to be unsatisfied with such a conclusion. Schwarcz, *supra* note 10, at 562.

> Even though such prebankruptcy contracting would appear to be Kaldor-Hicks efficient, I am uncomfortable with using Kaldor-Hicks alone to judge the efficiency of prebankruptcy contracting. My uneasiness stems from the apparent unfairness of justifying prebankruptcy contracting by comparing whether the gains to be beneficiary of the contract and to the debtor, which voluntarily contract, exceed the detriment to nonconsenting creditors.

Id. His class Pareto efficiency standard is intended to mitigate precisely this unease. *Id.* at 563.

184. Schwarcz, *supra* note 10, at 557 n.239 (explaining that class Pareto efficiency would permit enforcement of contracts "if each class of affected persons benefits overall (or at least is not harmed) even though some of those individual persons may be harmed" but would not permit enforcement of "contracts that harm a class of affected persons overall").

185. Anthony T. Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472, 487 (1980).

186. Although Kronman does not explicitly discuss class Pareto efficiency, Steven Schwarcz formulates his class Pareto efficiency standard based on Kronman's efforts to import distributive justice into efficiency concepts. Schwarcz, *supra* note 10, at 563–64 n.267; *see also* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 82 (1993) (discussing Kronman's "modified Paretian principle," which "would ask whether the welfare of most people who are taken advantage of in a particular way is likely, in the long-run, to be increased by permitting the kind of advantage-taking in question in the particular case").

cations of prebankruptcy contracts. His application of this theory to contract bankruptcy amounts to little more than a conventional Kaldor-Hicks efficiency analysis draped with a little distributional window dressing. It fails to reach beyond its utilitarian origins for at least three reasons.

First, Schwarcz defines "class" so broadly for purposes of his class Pareto efficiency analysis as to find no class of harmed entities so long as overall the market for credit is improved by enforcement of these prebankruptcy contracts.[187] Schwarcz admits that nonadjusting creditors *are* harmed with these bankruptcy contracts, but contends that nonadjusting creditors' harm does not count for purposes of his class Pareto efficiency analysis because nonadjusting creditors are not a *class* of creditors. He groups all adjusting and nonadjusting unsecured creditors in the same class on the grounds that the Bankruptcy Code does not itself differentiate among unsecured claims that derive from contract, tort, lease, or other nonbankruptcy law.[188] Because all unsecured creditors are treated as a single class for purposes of assessing the fairness of a chapter 11 plan, Schwarcz treats all unsecured creditors as a single class for purposes of assessing the fairness of contract-bankruptcy proposals.

In reaching this conclusion, Schwarcz overstates the statutory prohibition against separately classifying unsecured claims.[189] Courts often uphold plans that differentiate among tort and other unsecured creditors' claims;[190] decisions to the contrary are easily distinguished on the facts.[191] In any event, it is far from clear that the statutory provision governing the separate classification of claims should define the existence of a class for purposes of analyzing the class Pareto efficiency of a contract-

187. Schwarcz, *supra* note 10, at 565.

> My model assumes that the debtor has one secured creditor who seeks a prebankruptcy contract waiving the automatic stay and that all of the debtor's nonconsenting creditors are unsecured. I treat these nonconsenting creditors as a single class because holders of all prepetition unsecured claims—irrespective of whether those claims arise out of loans or breaches of contract or tort—generally have the same priority, and therefore usually are treated alike, in bankruptcy.

Id.

188. *Id.* (citing *In re* Bloomingdale Partners, 170 B.R. 984, 998 (Bankr. N.D. Ill. 1994)).

189. 11 U.S.C. § 1122(a) (providing that "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class").

190. For decisions in which courts have viewed tort claims as sufficiently distinct to justify separate treatment, see, for example, *In re* Jersey City Med. Ctr., 817 F.2d 1055 (3d Cir. 1987) (upholding separate classification of medical malpractice claims against reorganizing health care provider); *In re* Dow Corning Corp., 255 B.R. 445 (Bankr. E.D. Mich. 2000) (upholding classification of personal injury claims into three classes distinct from other general unsecured claims provided for under plan); *In re* EBP, Inc., 172 B.R. 241, 243–44 (Bankr. N.D. Ohio 1994) (tort claim classified separately from other unsecured creditors); *In re* Rochem, Ltd., 58 B.R. 641, 642–44 (Bankr. D.N.J. 1985) (permitting separate classification and distinct treatment of $35 million unliquidated, disputed tort claim when remaining unsecured claims equaled $171,000).

191. The tort claims at issue in *Bloomingdale Partners*, the decision upon which Schwarcz relies, were indistinguishable from the other general unsecured claims in that case in that the dispute regarding this claim had been resolved and the amount of their claim liquidated by bankruptcy court. *Bloomingdale Partners*, 170 B.R. at 998. Often enough, tort claims against a bankruptcy estate remain both disputed and unliquidated at the time for assessing the confirmability of a chapter 11 plan and, thus, are not "substantially similar" to other unsecured claims in the case.

bankruptcy proposal. Class Pareto efficiency assesses basic questions of distributive justice and fairness. Section 1122 of the Bankruptcy Code instead addresses the standard for confirmation of a plan of reorganization.[192] Moreover, the implication of looking to § 1122 to define a class for purposes of class Pareto efficiency analysis is that Congress should be relied upon to identify subsets of society upon whom harmful effects may be imposed by contract. Public choice analysis suggests,[193] to the contrary, that groups too weak in the marketplace to resist the imposition of contractual externalities are also unlikely to muster sufficient political strength for protection.[194]

Second, analysis under a class Pareto efficiency standard is only meaningful if it leads to a different result than a Kaldor-Hicks efficiency analysis.[195] Schwarcz professes to pinpoint the meaningfulness of his class Pareto analysis of contract bankruptcy by claiming to identify prebankruptcy contracts that are likely to result in a secondary material impact[196] as class Pareto inefficient[197] but Kaldor-Hicks efficient.[198] On closer examination, however, there is little to differentiate his Kaldor-Hicks and class Pareto efficiency analyses of these contractual bankruptcy resolutions.

Applying Kaldor-Hicks to assess whether parties should be able to rely on a prebankruptcy contract that was unlikely to cause a secondary material impact but that did, in the end, have such an impact, Schwarcz reasonably concludes that "[i]f the amount of the impact is designated Z, a prebankruptcy contract would be Kaldor-Hicks efficient when the sum of X [the debtor's benefit from the contract] and Y [the contracting creditor's benefit] equals or exceeds Z."[199] He argues that Z is mathematically likely to exceed $X + Y$ whenever the secondary material impact was ex ante unlikely[200] to occur, and applies the following logic to support his claim:

> Given the focus on prebankruptcy contracts for which secondary material impacts are ex ante unlikely, the number of situations in which $X + Y$ turns out to equal or exceed Z would be expected to be significantly greater than the number of situations in which $X + Y$ turns out to be less than Z. Because Z is expected to be immate-

192. 11 U.S.C. § 1122 (1994).

193. *See supra* note 82.

194. For discussion of the overlap and divergence between political and economic power, see CARRUTHERS & HALLIDAY, *supra* note 82, at 149.

195. Schwarcz, *supra* note 10, at 562–63 (noting his unease with Kaldor-Hicks efficiency analysis and constructing class Pareto efficiency standard to mitigate this uneasiness).

196. Schwarcz defines a contract with a "secondary material impact" as one "that materially reduces the amount available for distribution to creditors." Schwarcz, *supra* note 10, at 556.

197. *Id.* at 571.

198. *Id.* at 561–62.

199. *Id.* at 561.

200. Schwarcz defines "unlikely," in this context, as "not likely to occur, or improbable." *Id.* at 556 n.236. He later quantifies the term "unlikely" as pertaining to an event with less than twenty-five percent chance of occurrence. *Id.* at 566 & n.284.

> rial, there also is no reason to believe—even though *Z* itself sometimes could be material—that *Z* would be large enough when material to cause the sum of all *Z*s to exceed the sum of all the *X*s and *Y*s. Thus, in aggregate, the sum of all *X* + *Y*s would be expected to exceed the sum of all *Z*s. It therefore is reasonable to presume, at least in the absence of empirical evidence to the contrary, that prebankruptcy contracting that ex ante is unlikely to result in a secondary material impact would be Kaldor-Hicks efficient.[201]

Thus, like most Kaldor-Hicks analyses, Schwarcz argues that prebankruptcy contracts that are ex ante unlikely to impose a secondary material impact are Kaldor-Hicks *efficient*, even if ex post they do from time to time impose a secondary material impact, because, in the aggregate, the benefits of such contracts will equal or exceed the ex post secondary material impact that results. The implication of this analysis is that prebankruptcy contracts that are ex ante likely to impose secondary material impacts are Kaldor-Hicks *inefficient*.

Whatever one thinks of Schwarcz's Kaldor-Hicks analysis, it is, in the end, indistinguishable from his conclusion that certain prebankruptcy contracts are class Pareto inefficient. Like the earlier Kaldor-Hicks analysis, Schwarcz concludes that prebankruptcy contracts would be class Pareto efficient "when a secondary material impact, viewed ex ante, is unlikely" and that "prebankruptcy contracts that are likely to result in secondary material impacts are not class Pareto efficient."[202] Schwarcz argues that prebankruptcy contracts for which secondary material impacts are ex ante unlikely are both Kaldor-Hicks and class Pareto efficient on the grounds that, in the long run, both borrowers and their creditors (adjusting and nonadjusting, alike) would be better off under a system in which they were enforced. Enforcement would result in more, or cheaper, credit being made available to the marketplace as a whole.[203] In concluding that the admitted losers under this private-law regime should not be viewed as a *class* of losers, Schwartz points only to the size of the pie. But this analysis subverts the supposed purposes of a class Pareto efficiency analysis, exposing it as indistinguishable from its Kaldor-Hicks origins.

Third, Schwarcz's class Pareto efficiency analysis fails to explain why he rejects the need to provide statutory protections for nonadjusting unsecured creditors although most other neolibertarian bankruptcy theorists have accepted the logic of providing statutory protections to creditors who would otherwise inevitably constitute the losers in a contract-bankruptcy regime.[204] Application of a Kaldor-Hicks standard of efficiency would not mandate such compensation so long as nonadjusting

201. *Id.* at 562.

202. *Id.* at 571.

203. For a discussion of the contention that a contract-bankruptcy regime should be preferred because it would reduce the cost of commercial credit, see *supra* text accompanying notes 101–11.

204. *See supra* text accompanying note 179.

creditors' losses did not exceed others' gains from contract bankruptcy, because, by its very definition, actual compensation is not required to find Kaldor-Hicks efficiency.[205] Economists recognize, however, that if losers were compensated for their losses, the resulting compensatory rule would be Pareto superior to the starting point.[206]

Thus, even if Schwarcz properly defines "class" for purposes of his class Pareto analysis, he should explain why compensation to the subgroup of losers in bankruptcy would be class Pareto inefficient. If the loss to nonadjusting creditors is so limited as to justify the failure to view this subgroup as a harmed "class" within the meaning of his class Pareto efficiency analysis, then statutory protection of nonadjusting creditors in the event of their debtor's failure should have only minimal impact in the marketplace. Jules Coleman notes that arguments against compensation of the losers under a Kaldor-Hicks efficient rule emphasize the cost of administering compensation to losers,[207] but concludes that only where the costs of compensation "exceed the difference between the value the higher and lower bidders place on the entitlement" would compensation "defeat the purpose of the rule by promoting a result that is not Pareto optimal."[208] Even where it is assumed that compensation is costly, Coleman argues that a requirement of less than full compensation may be preferable to no compensation.[209] He finds only limited circumstances in which application of Kaldor-Hicks efficiency criterion are to be preferred to Paretian ones, and emphasizes the narrowness of these limited exceptions.[210] Coleman does not conclude that compensation should always be required, but instead recommends against compensation only in the limited circumstances under which Kaldor-Hicks standards are preferable to

205. JULES L. COLEMAN, MARKETS, MORALS AND THE LAW 98 (1988) [hereinafter COLEMAN, MARKETS]; Jules L. Coleman, *Efficiency, Exchange, and Auction: Philosophic Aspects Approach to Law*, 68 CAL. L. REV. 221, 239 (1980) [hereinafter Coleman, *Philosophic Aspects*] ("Were payment transaction costless and full compensation given to the losers, Kaldor-Hicks distributions would be transformed into Pareto-superior ones."); Jules L. Coleman, *Efficiency, Utility and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 513 (1980) [hereinafter Coleman, *Wealth Maximization*] (same).

206. *See* COLEMAN, MARKETS, *supra* note 205; Coleman, *Wealth Maximization*, *supra* note 205.

207. Coleman, *Philosophic Aspects*, *supra* note 205, at 245.

208. *Id.*

209. *Id.* at 245–46.

> When conjoined with the cost of making compensation, a full compensation rule may generate an inefficient allocation. Something less than full compensation, however, need not. That is, requiring compensation up to that amount which, when added to the cost of compensation, is still less than or equal to the price the higher bidder is willing to pay would be a second best option. The result would be a Pareto optimal allocation that involved a close approximation of a Pareto superior move.

Id.

210. *Id.* at 246–47. For example, Coleman argues that changes that remove impediments to competition are Kaldor-Hicks efficient but not Pareto superior—the losers are those who previously have been advantaged by the absence of competition. *Id.* at 247. He justifies application of Kaldor-Hicks standards of efficiency in this case because "those monopolists who have benefited from impediments to competition are not entitled to or do not deserve to be compensated." *Id.* The other limited exception Coleman finds involves a party's costless entry into a market. If this entry enhances efficiency and drives another from the market, compensation is unnecessary due to the costlessness of subsequent entry into the market. *Id.*

Paretian ones. Full compensation of these losers would be Pareto inferior only where the costs of identifying and compensating losers are prohibitively high. In all other cases, though, Coleman argues that compensation would be both Pareto superior and consistent with notions of distributive justice.[211]

The nonadjusting creditors discussed by LoPucki, Bebchuk, and Fried—tort and other involuntary creditors, voluntary creditors with small claims, voluntary creditors who lent before the transaction occurred—are the potential losers in a regime that facilitates the creation of blanket security interests, asset securitizations, and other prebankruptcy contracts that do not provide statutory protections for nonadjusting creditors. Even if it is assumed that these contracts are Kaldor-Hicks efficient, because they either decrease the cost of credit or increase the amount of available credit to such an extent that nonadjusting creditors could be compensated for their losses, legislative protection of nonadjusting creditors may not be inefficient. To be sure, some lenders and borrowers would be made worse off by the protective legislation than they currently are under Article 9. But this is not the only plausible comparison. Compare where these winners and losers were before the law permitted lenders and borrowers to better themselves at the expense of nonadjusting creditors to where they would be under a law that both encouraged prebankruptcy contracting and protected creditors who could not be expected to protect themselves. From this vantage point, legislation protecting nonadjusting creditors could be calibrated to render the beneficiaries of the prebankruptcy contracts better off, and the losers under this system no worse off, than they would have been without laws governing secured and securitized transactions or otherwise authorizing contract bankruptcy. Legislation that enables secured transactions and other contract-bankruptcy proposals, while at the same time protecting nonadjusting creditors, could be Pareto superior to a world without such legislation.

2. *Internal Decision-Making Costs*

Neolibertarian bankruptcy commentators argue that it should be possible to contract about an event of financial difficulty, at least where creditors' claims are the result of consensual transactions, because, by virtue of their consensual relationship, there were only manageable impediments to negotiations in the creation of this relationship.[212] But this seeming truism obscures the full complexity of the transaction costs that a debtor and its creditors would face when attempting to agree ex ante on the procedures to follow in the event of the debtor's financial dis-

211. *See id.*

212. *See* Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1134; Schwartz, *supra* note 7, at 1832.

tress.[213] Private individual action (two-party contracts) imposes fewer internal decision-making costs than private collective action (*n*-party contracts). The internal decision-making costs associated with private action, whether individual or collective, increase with increases in transaction costs.[214]

Transaction costs are high when contracting about a debtor's financial distress, because firms often owe hundreds or thousands or hundreds of thousands of creditors at one time. The sheer number of parties and potential for holdouts makes contracting impractible.[215] The creditors on this list vary from day to day and year to year.[216] In addition, debtors and creditors often face conflicting incentives regarding decisions to borrow and repay.[217] Eventually, a debtor's financial distress presents a common pool problem for its creditors, thus, creating conflicts of interest among its creditors. Ex ante determinations as to whether liquidation or reorganization would be optimal ex post present the same conflict in interests.[218] Multiply this difficult situation times the entire market, for if chapter 11 were repealed as some suggest, then every corporate entity would have to enter into one of these contracts.

Not surprisingly, bankruptcy theorists are often imprecise about the ex ante decision-making costs that would be associated with private collective action. Barry Adler argues that "eventually insolvency provisions could become routine components of corporate provisions."[219] As a result, he contends that the ex ante decision-making costs associated with these agreements "would seem trivial compared to the amount of capital investors placed at risk,"[220] because trade associations and specialized law firms will free-ride on each others' efforts and quickly perfect and repli-

213. *See* Calabresi & Melamed, *supra* note 96, at 1106.

214. *See id.* at 1091–93. Applying the Coase theorem, Calabresi and Melamed similarly understood that the presence of high transaction costs prevent property rules from working efficiently. *Id.* at 1093–98. When transaction costs are low, it does not matter who receives the benefit of an entitlement because the parties will costlessly correct any misallocation in the market. *See id.* When transaction costs are high—if there are either too many parties (resulting in holdout or free rider effects) or too few (leading to a bilateral monopoly), if information is not freely available to the parties, or if the parties face strategic incentives—the parties may be unable or unwilling to exchange property rights. *See id.* Thus, where transaction costs are high, property rules are efficient only if they protect entitlements efficiently allocated in the first instance.

215. Schwartz, *supra* note 7, at 1833 ("One possible obstacle to writing these contracts is that a firm may have many creditors.").

216. *Id.* ("A possibly more serious obstacle is an intertemporal coordination problem because creditors sometimes lend at different times while the parameters that determine which contract would be optimal can be time variant.").

217. *Id.* at 1833 ("Another possibly serious obstacle is that a firm's creditors may have inconsistent preferences concerning bankruptcy systems.").

218. Schwartz, *supra* note 7, at 1823 ("[T]he ex post circumstances and their relation to what an optimal bankruptcy choice would be are too costly to describe in a contract."). On this ground, Schwartz implicitly criticizes Rasmussen's "menu" approach to contract bankruptcy.

219. Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1134.

220. *Id.* at 1135.

cate the transaction.[221] Adler overstates the triviality of these decision-making costs by comparing them to the total value of the market for credit, but the more relevant comparison would contrast the inherent decision-making costs of his contract-bankruptcy proposal to that of the mandatory bankruptcy legislation he would replace.

When Barry Adler replies to critics—for example, Rasmussen's contention that Chameleon Equity would create improper ex ante incentives[222]—he forgets his contention that the inherent decision-making costs associated with his Chameleon Equity proposal, while not nonexistent, would eventually become trivial.[223] For every critique of his proposal, and every beneficial aspect of the bankruptcy process, Adler contends that contractual provisions could be drafted to accommodate the criticism or mimic the benefit. For example, he replies to critics' contentions that his proposal would undermine beneficial monitoring functions of secured transactions by suggesting that Chameleon Equity contracts could be drafted to accommodate asset-specific priority.[224] Adler responds to criticisms that Chameleon Equity firms would be unable to borrow instantaneously and resolve their liquidity demands by arguing that these firms could specify grace periods in their corporate charters.[225] He also responds to arguments that Chameleon Equity would make it difficult to remove management by proposing contractual provisions disenfranchising management in the event of equity cancellation.[226] Chameleon Equity contracts drafted along the lines suggested by Adler would be far more complex and individually tailored than those that did not respond in contract to these criticisms. Consequently, the inherent decision-making costs associated with their implementation would be far

221. *Id.* at 1134. In making this assertion, Adler focuses exclusively on issues of numerousity and factual complexity, and ignores the drafters' strategic interests as an impediment to their negotiations.

222. For discussion of Rasmussen's criticism of Adler's Chameleon Equity proposal on the grounds that it would create improper ex ante incentives, see *supra* text accompanying notes 53–58.

223. For a discussion of Adler's view that the inherent decision-making costs of Chameleon Equity contracts would become trivial, see *supra* text accompanying notes 219–221.

224. Adler, *World Without Debt*, *supra* note 8, at 819–21.

225. *Id.* at 822–23.

226. *Id.* at 823–24. Some of these proposed contractual provisions seem at odds with one another. In a companion article, Adler responds to criticisms that his Chameleon Equity creates incentives for management to incur excessively risky obligations by suggesting that "investors could require managers to hold not equity, or not only equity, but inalienable higher priority interests in the firm." *See* Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1120–21. Similarly, in response to contentions that Chameleon Equity undercuts valuable separation functions, Adler argues that "[i]nvestors in a Chameleon Equity firm could grant a liquidation preference to managers or to each investor class that would begin as or could become a common equity class." *Id.* at 1124. When commentators argue that bankruptcy's disregard for absolute priority lessens perverse incentives to choose "specific projects" that rely heavily on the skills of individual managers, Adler contends that Chameleon Equity firms "could require managers to hold inalienable fixed obligations" that would "guarantee managers a stake in even an insolvent firm." *Id.* at 1125. Each of these provisions contradicts Adler's proposed contractual resolution to the problem of removing incumbent management. Adler, *World Without Debt*, *supra* note 8, at 823–24.

greater, raising additional questions as to Adler's claim that these costs would "trivialize" after time.[227]

Alan Schwartz also recognizes numerous obstacles to preinsolvency contracts of this sort, and, like Adler, is overly eager to find resolution for the straw arguments he raises.[228] First, Schwartz rejects numerousity as a "serious" obstacle to negotiated resolution—"because the firm can offer contracts to creditors, and it would offer to all creditors the efficient contract with respect to bankruptcy."[229]

Schwartz also evaluates the problem of factual complexity, and concludes that "[d]escribing all of the possible facts and their implication in the lending agreement would be costly."[230] He argues, however, that it should be feasible to contract on the basis of some signal that serves as a proxy for detailed description of these factual circumstances, and quickly presumes the existence of an appropriate signal.[231] Simple signals may be available, as Schwartz contends, but, except in unusual cases, the simplest signals will act only as imperfect proxies for detailed factual analysis. Their use will inevitably result in false positives and negatives. More complex signals may also be available, but the better these complex signals serve as proxies for detailed factual analysis, the greater the ex ante decision-making (and possibly also the ex post enforcement) costs will be.

227. In response to Donald Korobkin's characterization of these decision-making costs as "immense," Korobkin, *supra* note 47, at 720, Adler complains that Korobkin "neglects the possibility that the contract could become standard form much like bond covenants under the current regime." Adler, *World Without Debt*, *supra* note 8, at 817 n.20. But it is difficult to comprehend how Chameleon Equity contracts could become standardized given the variation in contractual responses Adler proposes. Tailored contracts are not standardized contracts.

228. For an acerbic debate on the feasibility of Alan Schwartz's contract-bankruptcy proposal, see LoPucki, *supra* note 14; LoPucki, *supra* note 51; Schwartz, *supra* note 8.

229. Schwartz, *supra* note 7, at 1833. Schwartz's solution to the problem of numerousity, given the assumptions of his model, "is a contract in which the parties agree ex ante that whether the firm chooses reorganization or liquidation, the creditors will permit the firm to keep, as a 'bribe,' a percentage [s] of the firm's insolvency monetary return [y]." LoPucki, *supra* note 14, at 322.

230. Schwartz, *supra* note 7, at 1822.

> The contract theory problem is serious, however, because the optimality of a bankruptcy system is state-dependent: Under some values of the ex post economic parameters, it would be efficient to liquidate the firm, while under other values, reorganization would be best. Thus, reorganization might turn out to yield a suboptimal result. A relatively simple contract, apparently, could require the firm to use the "reorganization system" when certain circumstances materialize and to use another system under different circumstances. The difficulty here . . . is describing the circumstances. Litigation over whether firms should be reorganized or liquidated suggests that the decision is fact-specific.

Id.

231. Schwartz, *supra* note 7, at 1823–24.

> The parties, however, can contract on the basis of a signal that correlates with the return the firm would earn under either system. The signal may be the performance of a relevant economic index. For example, a particular firm's returns may have a high positive correlation with the Consumer Price Index (CPI). Hence, if this firm becomes insolvent when the CPI is falling, the firm probably should be liquidated. Parties are assumed to be able to prove the content of the signal in court (the CPI's performance for the most recent quarter, say).

Id.

Schwartz also considers intertemporal coordination among creditors as a potential impediment to negotiation, but again rejects this as a serious problem because he conceives of contracts with automatic conversion terms that will achieve the desired result even though creditors lend at different times.[232] Lynn LoPucki contends that this conversion term is unworkable because "the firm could at least sometimes deceive the initial creditor as to the optimal percentage."[233] Because of the possibility that the debtor would lie to the initial contracting creditor, LoPucki argues that no bankruptcy contracting will occur.[234]

Finally, Schwartz would resolve holdout problems by binding creditors ex ante upon the vote of a majority.[235] While this solution would decrease the inherent decision-making costs of ex ante agreements, it would at the same time create external decision-making costs, as I noted above. Moreover, LoPucki points out that the majority rule is unworkable when combined with the conversion term of Schwartz's model—as of what point in time would such a majority be determined?[236]

Both Adler and Schwartz address numerousity, intertemporal and other coordination problems and informational asymmetries, and largely ignore potential conflicts among the interests of debtors and creditors.[237] In fact, Adler contests the notion that these strategic conflicts of interest would impede private contracting about bankruptcy procedures. Although the predominant metaphor in bankruptcy scholarship compares the creditors of a financially distressed debtor to fishers in a pond they own in common,[238] Adler supports his preference for contract bankruptcy

232. *Id.* at 1833–36.

233. LoPucki, *supra* note 14, at 325.

234. *Id.* at 325–26. In his reply to LoPucki, Schwartz argues that fraudulent conduct by a debtor is inconsistent with the assumptions of his model and, in any event, ruled out by "the desire of most firms to preserve good will." Schwartz, *supra* note 8, at 349. As to Schwartz's contention that his model, like all contract-theory models, assumed that parties would not engage in fraud, LoPucki views the contention as inconsistent with the assumptions made in his original essay and unsubstantiated with a review of other contract theory scholarship. LoPucki, *supra* note 51, at 365–69. LoPucki describes the revised assumptions as "both inconsistent [with other assumptions made in] the original model and implausible." *Id.* at 369.

235. Schwartz, *supra* note 7, at 1838.

> The current Bankruptcy Code binds minority dissenters in a reorganization proceeding to the deal a majority prefer in order to avoid inefficient holdout behavior. For similar reasons, a trade creditor who prefers an inefficient bankruptcy contract should also be bound to the bankruptcy bargain that the ex ante majority prefer. The freedom to contract should not be used to prevent efficient contracting.

Id.

236. LoPucki, *supra* note 14, at 330–33. Schwartz only obliquely responds to this critique. *See* Schwartz, *supra* note 8, at 360 n.28; *see also* LoPucki, *supra* note 51, at 375.

237. Schwartz assumes that conflicts between junior and senior creditors would not exist if the absolute priority rule were strictly enforced. Schwartz, *supra* note 7, at 1837–38. LoPucki disagrees, contending that deviations from the absolute priority rule do not constitute the sole basis for such conflicts. He argues that conflict also stems from junior creditors' preference for ill-advised reorganizations "in which they might get lucky." LoPucki, *supra* note 14, at 328; *see also* LoPucki, *supra* note 51, at 374 (elaborating on this argument).

238. *See supra* note 21.

by questioning the relevance of the common pool metaphor.[239] He argues that bankruptcy legislation is unnecessary, in part, because a debtor's financial distress does not present a common pool problem for its creditors.

Adler argues that the analogy is misplaced because, in a world free of debt and individual collection remedies, there would be no race for a debtor's assets.[240] In this debt-free world, Adler expects corporate debtors to finance their operations by issuing Chameleon Equity.[241] Chameleon Equity resembles debt in that heightened rights spring into action upon the debtor's financial distress.[242] It differs from debt in that these rights do not involve the right to force a sale of the debtor's assets to cover repayment.[243] Upon default, Adler proposes that the lowest rung of Chameleon Equity would "become the equity class and *automatically* hold securities worth the firm's entire going-concern value."[244] Because collection on Chameleon Equity could occur only collectively, Adler argues that it erases the possibility that a debtor's financial distress will create a common pool problem for the holders of Chameleon Equity. He, thus, questions the assumption that bankruptcy legislation is necessary to resolve financial common pool problems, arguing that "pre-insolvency contracts can provide for division of an insolvent firm, and at lower cost than a bankruptcy proceeding."[245] Because he understands that there would be no common pool problem in this world of equity and Chameleon Equity but no debt, Adler concludes that there also would be no need for bankruptcy legislation.[246]

Although he purports to reject the metaphor of the common pool, Adler actually relies on it quite heavily to argue that the law of corporate reorganization should be repealed. By creating a world without debt or individual collection rights, Adler envisions a world in which a debtor's financial distress does not create a common pool problem because the

239. *See supra* note 25 (collecting citations to those skeptical to bankruptcy as a common pool problem).

240. *E.g.*, Adler, *World Without Debt*, *supra* note 8, at 811, 814–18 (explaining why he believes "there is no collective action problem" for creditors of corporate debtors and arguing, as a result, that "there is in principle no need for corporate bankruptcy").

241. *Id*. at 817. Adler first proposed the substitution of "Chameleon Equity" for debt in an earlier article. *See* Adler, *Financial and Political Theories*, *supra* note 8.

242. *See* Adler, *World Without Debt*, *supra* note 8, at 817 (comparing Chameleon Equity to "preferred equity").

243. *Id*. at 816.

> The world without debt that I propose is a world *with* fixed obligations that a firm might issue to numerous investors. I imagine eliminating only a single feature of traditional debt: the right of an individual fixed-obligation claimant to collect. This one feature is significant because it is *the* feature of debt that creates the collective action problem and the need for bankruptcy reorganization law.

Id.

244. *Id*. at 817 (emphasis in original).

245. Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1109.

246. *See* Adler, *World Without Debt*, *supra* note 8, at 817 ("A court would not need to provide the collective remedy because there would be no individual remedy in the first place.").

potential for such a problem has been resolved contractually between the debtor and its Chameleon Equity holders. Once he argues that this potential common pool problem can be resolved contractually, rather than legislatively, Adler concludes that there is no need to retain bankruptcy law. But this is not a refutation of the potential for the assets of a financially distressed debtor to create a common pool problem for the debtor's financiers.[247] It is, instead, a recognition of this potential, and an argument that the common pool problem is better resolved through contract than legislation, at least in certain limited circumstances.

Not every commentator who advocates private-law alternatives to bankruptcy legislation rejects the metaphor of the common pool. Although stating that creditors of insolvent firms face "coordination" problems, the coordination problem that Schwartz describes closely resembles a common pool problem:

> Some insolvent firms cannot earn revenues sufficient to cover nonfinancing costs. The assets of these firms can be put to better uses elsewhere, so the assets should be sold off. Other insolvent firms earn revenues that exceed production costs but that are too low to service the firm's debt. These firms should be continued as going concerns under less leveraged capital structures. As is well known, an individual creditor is not interested in this distinction: The creditor would rather maximize returns by attaching assets sufficient to pay its claim in full. If every creditor attempts to attach assets, the firm will be liquidated piecemeal, whether it is efficient to continue the firm or not.
>
> Creditors as a group would prefer to coordinate their collection actions so that the debtor firm is liquidated piecemeal only when that would raise more money for creditors than continuing the firm—"reorganizing" it—would raise. Creditors are widely believed to have high coalition costs, however . . . .[248]

Despite this reference to the common pool problems of creditors in financial distress, Schwartz contends that these creditors should be expected to enter into preinsolvency contracts with their debtor because, like any other commercial contract, an ex ante agreement "maximizes the parties' ex ante (or expected) utility."[249] He, thus, views common pool problems as infecting only efforts to negotiate postinsolvency

247. *Cf.* TAYLOR, *supra* note 93, at 21–24 (distinguishing between internal and external resolutions to Prisoner's Dilemma games, and arguing that, although "[i]t could be said that in the case where an internal 'solution' is forthcoming, there was no 'problem' there to solve", he rejects this characterization both because internal resolutions solve but do not extinguish Prisoner's Dilemma games, and because an understanding of the limits of internal resolutions is critical to an understanding of the need for external ones).

248. Schwartz, *supra* note 7, at 1807.

249. *Id.* at 1819.

agreements.[250] Although he concedes that bankruptcy legislation is necessary "to facilitate the parties' ability to renegotiate to ex post efficient outcomes,"[251] he argues that the need for bankruptcy legislation to coordinate ex post efficient outcomes does not logically also indicate the need for such a system to achieve ex ante efficiency as a policy goal. In reaching this conclusion, Schwartz assumes that the potential for a financial common pool problem will not influence the parties until after the debtor's financial distress arises. But if creditors are presumed to be negotiating about the potential for financial distress, why should it also be presumed that creditors would ignore the strategic interests that arise in that event?[252] The parties to this prebankruptcy negotiation face collection incentives contrary to the interest of the group. These self-interested incentives do not dissipate when the affected parties sit down to negotiate a way out of a common pool problem.[253] It is more likely that the strategic incentives will create second-order collective action problems and stand in the way of a negotiated resolution.[254]

3. *Enforcement Costs*

Neolibertarian theorists emphasize the high costs of enforcing bankruptcy legislation to support their claim that private-law alternatives should be permitted to replace mandatory provisions.[255] They argue that the marketplace better values reorganizing businesses than courts, as

250. Schwartz writes:

> Bankruptcy law differs from other areas of commercial law because renegotiation after insolvency is difficult. Creditors cannot conveniently coordinate their collection efforts or positions respecting the appropriate disposition of the insolvent firm because there are often many creditors whose interests may diverge. The firm also has no legal power to compel creditors to agree.

Id. at 1820.

251. *Id.*

252. Through a process of backward induction, creditors may anticipate subsequent strategic incentives even before they arise. *E.g.*, BAIRD ET AL., *supra* note 89, at 50–57, 159–65 (discussing backwards induction and its limits in game theory); RASMUSEN, *supra* note 89, at 88–89 (same); Reinhard Selten, *The Chain Store Paradox*, 9 THEORY & DECISION 127, 138 (1978) (discussing backward induction as applied to Prisoner's Dilemma games).

253. *Cf.* Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1465 (1989) ("It is almost impossible to deal adequately with this potential for ex post opportunism by ex ante contracting.").

254. Second-order collective action problems are the collective action problems that impede attempts to resolve collective action problems. *E.g.*, Robert H. Bates, *Contra Contractarianism: Some Reflections on the New Institutionalism*, 16 POL. & SOC'Y 387 (1988); Block-Lieb, *Political and Economic Theory*, *supra* note 82, at 839–47; Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 352 (1997); Carlisle Ford Runge, *Institutions and the Free Rider: The Assurance Problem in Collective Action*, 46 J. POL. 154, 154–55 (1984).

255. *E.g.*, Adler, *Theoretical Divide*, *supra* note 8 (arguing that Chameleon Equity can mimic efficiency gains attributable to current Bankruptcy Code but save costs of bankruptcy proceeding); Bradley & Rosenzweig, *supra* note 8, at 1078 ("Judicially-supervised corporate reorganization imposes on society the expense of compensating those responsible for reorganization plans (judges, lawyers, accountants, and financial advisors) *and* more than likely produces plans that seriously undermine allocative efficiency."). Jim Bowers similarly accuses critics of private-law bankruptcy alternatives of assuming away enforcement costs as trivial. *See* Bowers, *supra* note 34, at 1774 (describing these critics as having inaugurated "the Fantastic Wisconsylvania School of Zero-Bureaucratic-Costs").

courts have only limited access to the information necessary to make valuation decisions and, in any event, generally are not trained to assess this sort of information.[256] For example, Barry Adler contends that firms would benefit from the debt-free Chameleon Equity capital structure he proposes because they would avoid "the expense of restructuring, through bankruptcy or other means."[257]

A number of scholars have attempted to quantify the costs of bankruptcy enforcement, with varying results. Most of this research has focused on large, publicly held debtors and found the average direct costs of bankruptcy enforcement to range between 3.1% and 6.2% of firm value.[258] When small and medium sized bankruptcy cases are instead considered, direct costs similarly are reported to consume 3.5% of total assets in the median chapter 11 case.[259] Regardless of the precise dollar-figure breakdown, it seems clear that bankruptcy legislation involves significant enforcement costs. Debtors' estates pay not only for their own lawyers, accountants, investment bankers, appraisers, public relations personnel, and lobbyists; but also for professionals hired by any official committee of creditors or equity holders. These professionals investigate, litigate, negotiate, and draft voluminous documents. Because years can pass before a chapter 11 plan of reorganization is confirmed, fees can, in the largest cases, reach astronomical figures.

How much, if any, of these expenses would be avoided by private-law alternatives to the current bankruptcy system? Barry Adler admits that enforcement of his proposed Chameleon Equity scheme would not be costless: "Disputes would arise over liability and remedy just as they

256. *E.g.*, Frost, *supra* note 31, at 129–35 (arguing that bankruptcy courts are institutionally incapable of accomplishing effective redistributive bankruptcy laws); Rasmussen & Skeel, *supra* note 64, at 91–96 (questioning efficiency of judicial valuations and other proceedings in bankruptcy).

257. Adler, *World Without Debt*, *supra* note 8, at 816 ("This [bankruptcy reorganization] expense can be significant, at least under current bankruptcy law, which divides an insolvent firm's value through claimant negotiations that often deteriorate into an imbroglio."). Adler expands on this point elsewhere:

> The Chameleon Equity structure would not, of course, eliminate all costs of debt. . . . But without risk of individual collection, there would be no need for bankruptcy's collective proceeding. Without acceleration of all claims against the firm, there would be no need for a judicial or other external valuation of the firm (such as through an auction). Thus, a Chameleon Equity firm could save investors the largest part of bankruptcy reorganization expense.

Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1118–19.

258. *See* Altman, *supra* note 13, at 1078 (finding average bankruptcy costs of approximately 6.2%); Warner, *supra* note 13, at 73–74 (studying railroad reorganization cases and finding average costs of 4.0%); Weiss, *supra* note 13, at 286 (finding average bankruptcy costs of 3.1%); White, *supra* note 13, at 484 (finding average bankruptcy costs of 6.0%).

259. *See* Robert M. Lawless & Stephen P. Ferris, *The Expenses of Financial Distress: The Direct Costs of Chapter 11*, 61 U. PITT. L. REV. 629 (2000) (studying direct bankruptcy costs incurred in chapter 11 cases filed in six districts). For additional studies of the bankruptcy costs incurred in public and nonpublic business bankruptcy cases filed in specified districts, see generally, Robert M. Lawless & Stephen P. Ferris, *Professional Fees and Other Direct Costs in Chapter 7 Business Liquidations*, 75 WASH. U. L.Q. 1207 (1997); Robert M. Lawless et al., *A Glimpse at Professional Fees and Direct Costs in Small Firm Bankruptcies*, 1994 U. ILL. L. REV. 847.

do now with respect to traditional debt and equity contracts."[260] Adler asserts that the "enforcement costs of alternative contracts would be less than current enforcement costs, which include bankruptcy reorganization expense."[261] Alan Schwartz goes further, arguing that even private-law bankruptcy alternatives "should contain mandatory structural rules that protect the integrity of a bankruptcy system but should not contain mandatory rules whose goal is to augment the bankruptcy estate."[262] These mandatory structural rules likely would include rules providing for a claims resolution process,[263] a stay of collection activity pending resolution of this process,[264] and a system for the avoidance of fraudulent and preferential transfers.[265] Statutory protections for nonadjusting creditors also would require enforcement. These functions account for a substantial portion of the enforcement costs incurred under the current bankruptcy system.

Thus, the shift to a private-law bankruptcy system would not eliminate enforcement costs.[266] Private collective action may incur fewer enforcement costs than public collective action, but the enforcement costs of either may be substantial and, to a large degree, unavoidable.[267] Moreover, the move to a private-law bankruptcy alternative may decrease ex post enforcement costs, but increase the ex ante decision-making costs associated with implementing the Chameleon Equity or

260. Adler, *Finance's Theoretical Divide*, *supra* note 8, at 1135. Adler asserts that the "enforcement costs of alternative contracts would be less than current enforcement costs, which include bankruptcy reorganization expense," *id.*, but provides nothing more than raw optimism to support this inequality.

261. *Id.*

262. Schwartz, *supra* note 7, at 1839.

263. Aghion et al., *supra* note 76, at 867 (noting that a process for determining the amount and priority of creditors' claims "forms an important part of any bankruptcy procedure, including our own [conditional equity proposal]").

264. *See* Schwartz, *supra* note 7, at 1839–49 (analyzing four mandatory rules in current Bankruptcy Code):

> the rule automatically staying debt collection while a bankruptcy proceeding is in process; the rule that establishes the disagreement payoff for secured creditors who dissent to a reorganization plan; and the two rules preventing a solvent party from refusing to deal further with a bankrupt contracting partner or that partner's assignee.

Id. at 1839–40. Adler's proposal avoids the need for a stay by repealing state collection law, but this is probably an unworkable solution outside the context of his thought experiment.

265. *Cf.* Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575, 590 (1995) (arguing that voidable preference rules may be efficient because they mitigate overinvestment by insolvent firms).

266. *E.g.*, LoPucki, *Strange Visions*, *supra* note 47, at 99 n.74 ("[Bradley and Rosenzweig] cannot mean that the state courts will remove managers from office after they resolve disputes regarding default, because such removal would be far from 'immediate' as they promised.").

267. *Cf.* John C. Coffee, *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) (evaluating contractarian theories of corporate law and noting the active and indispensable role of courts in monitoring and interpreting corporate governance terms).

other means of private collective action, resulting in questionable net savings.[268]

Enforcement costs are also affected by the stability of the rule. In an earlier article, I argued that bankruptcy legislation may provide an unstable resolution to financial common pool problems.[269] Organized groups have every incentive to lobby for favored treatment in bankruptcy legislation.[270] When coalitions of these groups join together, lawmakers will be tempted to enact the omnibus bankruptcy amendments they promote as consensus legislation.[271] Specifically, lawmakers may enact revisions that exempt favored beneficiaries from the bankruptcy statute, but leave the underlying statute intact.[272] Private-law alternatives may be no more stable than their legislative counterparts, however. Just as there exist incentives to seek revisions to bankruptcy legislation, there are nearly identical incentives to attempt to modify the multiparty agreements that would substitute for bankruptcy legislation. If contract modification is permitted by the agreement of a majority of the affected parties, then, as with the legislative scenario, a majority may favor modification to their benefit and the detriment of the dissenting minority.[273]

V. CONCLUSION

Despite the claims of neolibertarian bankruptcy theorists, there is no clear winner in a comparison of decision-making and enforcement institutions. Courts, legislatures, and the market place each have strengths and weaknesses in their ability to remedy a business entity's financial distress.

Bankruptcy courts are a favorite scapegoat among these commentators. Scholarship is replete with anecdotal and empirical evidence of bankruptcy enforcement costs.[274] Despite this rhetoric, it remains true that no bankruptcy regime—regardless of the private- or public-law origin of its rules—can avoid the judiciary altogether. Private-law bankruptcy alternatives all require judicial enforcement. Courts differ from

268. Donald Korobkin similarly remarks on the Bradley/Rosenzweig proposal:

> Significantly, while the automatic cancellation rule eliminates the court-supervised process, it does not eliminate the function necessary to cancel and transfer ownership. All it does is shift that function forward in time, from the time of financial distress to the point at which the various contracts of the firm are first made.

Korobkin, *supra* note 47, at 720.

269. Block-Lieb, *Political and Economic Theory*, *supra* note 82, at 871.

270. *See id*. at 839–54.

271. *See id.* at 864–67.

272. *Id.* at 850.

> But if we instead assume that *n* lawmakers will vote on the referendum to revise, and that the referendum to this expanded assembly proposes amendments that exempt a majority of the lawmakers from the scope of the resolutive statute (but leave the remaining lawmakers subject to the amended statute), votes for the omnibus amendment bill may well succeed.

Id.

273. *See* Bebchuk, *supra* note 40, at 1859–60.

274. *See supra* notes 13 and 259.

markets and legislatures foremost in that they serve distinct functions: courts enforce the bankruptcy rules that legislatures have, and some argue markets should have, created.[275] As a result, the shift to a private-law bankruptcy system would, at best, merely reduce these unavoidable enforcement costs.[276]

Notwithstanding critical remarks regarding the high cost of judicial enforcement, court involvement can have beneficial consequences. Open access to precedent renders judicial enforcement a public good, which creates positive externalities for both private and public bankruptcy rules.[277] Moreover, courts can be expected to protect minority interests to an extent that neither the marketplace nor a legislature is likely to replicate.[278] As a result, judicially enforced bankruptcy rules can be expected to be comparatively stable, resistant to the self-serving modifications and revisions that can plague contractual and legislative decision making.[279] Finally, by virtue of its frequent ex post focus, judicial enforcement can be cost effective where there are skewed distributions of stakes at issue.[280] Every business debtor in the marketplace presents a risk of financial distress to its creditor body, thus, an assessment of the need for ex ante contracting would occur with every business debtor in the marketplace. Alternatively, the contingency of a debtor's financial distress might be redressed by means of an ex post ruling, applied to the small percentage of debtors for whom the contingent becomes the actual. Where numerous actors face a small risk of some contingency (in this case, financial distress) but relatively few of them ultimately will suffer the consequences of the calamitous contingent event, then an ex post rule may be more cost effective than one that works ex ante.

Market resolutions permit parties to tailor their responses to a debtor's financial distress in ways that legislation cannot. This fit comes at substantial cost, however—namely, the high inherent decision-making costs of implementing agreements for every firm that might suffer financial distress among all of the parties who might be affected. Where fewer than all affected parties are governed by the agreement, external decision-making costs also arise. Enforcement costs may be reduced with these private-law proposals, but not wholly eliminated.

275. In a common-law regime, courts fulfill both a decision-making and enforcement function. Because no one seems to be advocating that we shift toward a common-law bankruptcy regime, I ignore that possibility for purposes of this article.

276. For example, proposed amendments to the Bankruptcy Code would exclude most securitized assets from property of an issuer's bankruptcy estate. *See* S. 220, 107th Cong. § 912 (2001) (amending Bankruptcy Code to exclude assets transferred by the debtor in connection with an asset-back securitization from property of estate); H.R. 333, 107th Cong. § 912 (2001) (same). This amendment would severely limit bankruptcy court scrutiny of structured finance transactions. It would not, however, strip state or federal district courts of jurisdiction to scrutinize these transactions.

277. *See* Coffee, *supra* note 267, at 1689–91.

278. *See* KOMESAR, *supra* note 17, at 150.

279. For a discussion of the effect of (in)stability on the enforcement costs of a bankruptcy rule, see *supra* text accompanying notes 269–72.

280. KOMESAR, *supra* note 17, at 130–38.

Under limited circumstances, private-law bankruptcy resolutions may provide beneficial alternatives to mandatory legislation. Market resolution may permit parties to adopt bankruptcy rules to fit their specific needs, without incurring or imposing unmanageable decision-making costs. Default rule proposals are likely to create fewer inherent decision-making costs than the pure private-law proposals. If statutory protections for nonadjusting creditors were coupled with a default-rule contract-bankruptcy proposal, the distributive effects of these default-options would be minimized.

Legislatures should continue to play an important role in bankruptcy policy-making, even if bankruptcy legislation were viewed as a default rule around which parties might contract. Legislatures best accomplish the complex balance of competing interests and policies that necessarily arise in the business bankruptcy setting, especially where there are both direct and indirect costs and benefits to consider.[281] Legislatures are also better suited to address distributive concerns than the marketplace.[282] Statutory bankruptcy rules need not take the form contained in existing legislation. Indeed, many of the difficulties in current law that theorists point to in support of their private-law bankruptcy proposals can, alternatively, be addressed through legislative amendment or judicial action.

Private-law substitutes for bankruptcy legislation are not as beneficial to social welfare as neolibertarian theorists would have us believe. Despite claims to the contrary, the substance of a bankruptcy rule is more likely than its form to influence ex ante incentives. Moreover, the decision-making costs associated with these private-law proposals are greater than commentators admit. No sort of bankruptcy rule—whether contractual or legislative—is free from distributive or enforcement costs. Contract bankruptcy presents no cheap fix. Tough policy decisions confront us, no matter how bankruptcy rules are structured.

281. *See* Thomas S. Ulen, *Courts, Legislatures, and the General Theory of Second Best in Law and Economics*, 73 CHI.-KENT L. REV. 189, 218 (1998) (arguing that the legislative process, "precisely in the jostling among competing interests that occurs every time legislators propose to take action, offers an opportunity for second-best effects to be incorporated explicitly").

282. *See* Janger, *supra* note 82, at 594–616.