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The Law of Last Resort

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INTRODUCTION

A financially distressed individual or corporation employs the bankruptcy process only as a last resort. The study of bankruptcy law, however, need not, and should not, be an afterthought. The traditional bodies of law that compose private ordering are the laws of property, contract, and tort. Property law establishes private entitlements that can be specifically enforced against the world. Contract law permits individuals to exchange obligations and thus invest one another with entitlements. Tort law creates its own set of entitlements and imposes

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* Professor of Law, New York University. This brief Article shares its title with a bankruptcy law monograph that the author is preparing. The Article is adapted from that monograph. This Article, in its current form, has benefited greatly from comments given at the Vanderbilt University Law School Symposium, "Convergence on Delaware: Corporate Bankruptcy and Corporate Governance," for which it was prepared. Special thanks to Bob Rasmussen, who helped me present the paper, to Alan Schwartz, who served as commentator, and to Henry Hansmann, who provided comments at the Symposium and afterward.

liability for unwanted interference with those or other entitlements. These bodies of law are often presented as complete, either unto themselves or in combination with the others.[1] Few might recognize these laws as part of bankruptcy law, even broadly defined. But the issues of bankruptcy law are inextricably intertwined with the rest of private law.

The world is not so orderly that entitlements, obligations, or duties are meaningful simply because the law intends them to be so. In reality, property rights often matter only because obligations conflict, while obligations are breached and duties disregarded because the obligor or transgressor simply lacks the capacity to comply. Where such conflict or incapacity exists, bankruptcy law fills the breach, not fully to resurrect all the impaired claims—this would be impossible—but to choose among them. There are two points here. First, the classic bodies of private law can best be seen, in part, as bankruptcy law (broadly defined). Second, if one imagines that private individuals transact in the shadow of the law, that shadow is cast no less by bankruptcy law than by the classic law of property, contract, and tort, or by derivatives thereof such as corporate law. The content of bankruptcy law, as much as the distinct features of other bodies of law, can be expected to influence the activity of individuals, not merely after the fall, but from the outset.

This approach to bankruptcy law is nontraditional in the United States (and, as far as I know, anywhere in the world). Although, as I hope to illustrate, bankruptcy law, properly understood, is an inevitable part of private law, the traditional focus of bankruptcy law has been on special law drafted into a code. Such special bankruptcy law has been in place continuously in the United States since 1898. This law, and the law for the next eighty years, was narrow and purely reactive, as was the scholarly perception of bankruptcy law over that period. Both the original Bankruptcy Act of 1898 and the New Deal reforms that followed were, at least in part, a reaction to a public outcry for relief from debt's burden on individual debtors, in each case offered as a substitute for inflationary monetary policy.[2] For corporate debtors, a different public outrage was at work, but again

1. *See, e.g.*, Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1 (1985). For a recent discussion of important functional distinctions within and among these bodies of law, however, between property rights and liability rules, e.g., see Ian Ayres & Paul M. Goldbart, *Optimal Delegation and Decoupling in the Design of Liability Rules*, 100 MICH. L. REV. 1, 75-79 (2001) (supplementing the analysis in Guido Calabresi & Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1089-93 (1972)).

2. *See* DAVID A. SKEEL, JR., DEBT'S DOMINION 107 (2001).

focused on the postfailure world. The primary contribution of the New Deal's Chandler Act, for example, was a response to the condemnation by government investigators, most notably William O. Douglas. These investigators decried the perceived abuses by large banks, such as J.P. Morgan, who, it was believed, took advantage of smaller investors whenever a corporation attempted to reorganize.[3] The Chandler Act placed independent trustees, rather than creditors, in control of corporate reorganizations. The academic debate of the time, led by Douglas and his contemporaries, mirrored this preoccupation with a debtor's postinsolvency affairs,[4] with hardly a whiff of broader policy or of consequences for debtors who were not then in financial distress. This narrow approach to bankruptcy law became the standard entrenched for generations.

Myopia about bankruptcy law diminished somewhat with the Bankruptcy Reform Act of 1978 and the attention this reform brought to the topic. The law itself remained focused on financial crisis, a retooling of the old act's mechanics, but scholars began to broaden their outlook. Most notable in this regard was the publication in the mid-1980s of Thomas Jackson's book, *The Logic and Limits of Bankruptey Law*.[5] Jackson suggested that the bankruptcy laws can best be understood as a hypothetical creditors' bargain.[6] Jackson argued that at the time they lend, creditors as a group, in anticipation of insolvency, would prefer a collective debt-recovery process to a race among individual creditors.[7] Bankruptcy law calls off such a race, which, Jackson contended, would waste resources both in the aggregate transaction costs of individual collection and through piecemeal liquidation of viable business concerns.[8] Thus, as compared to prior scholarship on bankruptcy law, Jackson took an ex ante approach. He imagined how creditors' anticipation of a debtor's financial crisis would shape the creditors' preferences for bankruptcy law. But Jackson's approach, while an important advance, was still too narrow. Jackson looked for bankruptcy issues only in, or as reflected by, the Bankruptcy Code, as

3. *Id.* at 109-13.

4. *See, e.g.*, George G. Battle, *The Enactment of the New Bankruptcy Law Will Check the Tendency Toward Currency Inflation*, 19 VA. L. REV. 340 (1933); William O. Douglas, *Protective Committees in Railroad Reorganizations*, 47 HARV. L. REV. 565 (1934); Robert T. Swaine, *"Democratization" of Corporate Reorganizations*, 38 COLUM. L. REV. 256 (1938); *sce also* SKEEL, *supra* note 2, at 73-127 (collecting authority).

5. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986).

6. *Id.* ch.1.

7. *Id.*

8. *Id.*

opposed to elsewhere in law, and he assumed the presence of debt as a starting point for his analysis.[9]

The ideal analysis of bankruptcy law is not so limited in scope or time. One cannot see the full picture of bankruptcy law unless one considers more fundamental decisions about the allocation of property rights and the creation of obligations or duties with respect to property or person, decisions that may precede the issuance of debt. Elements of property, contract, and tort law raise issues that would be familiar to any bankruptcy lawyer or scholar, but may be overlooked by one with her nose buried in the Bankruptcy Code. An opportunity for cross-discussion and analysis is thus lost. Bankruptcy issues, moreover, may be relegated to characterization as "specialized," which often means less than centrally important. But to the contrary, bankruptcy issues, properly understood, are general and thus central.

There is, moreover, an additional failing of an approach to bankruptcy law that starts with the Bankruptcy Code and its treatment of debt obligations. Such analysis overlooks the fact that debt is nothing more than a particular sort of obligation. Debt is constructed of at least two components—namely, fixed payment and the right of the holder individually to collect. Debt is not a primitive. Its components can be constructed differently or adopted in part only. This observation is critical, as so much of what appears a quintessential part of bankruptcy law *given* debt disappears in the absence of debt. Perhaps ironically, then, this second shortcoming of the traditional approach to bankruptcy works counter to the first. Once one looks beyond debt, much of what is now associated with bankruptcy law appears less central, less significant. Further, once one disaggregates debt, and allows once seemingly important issues to drop away, it becomes possible to gain a clearer focus on first principles of financial distress.

A brief elaboration of these ideas follows. Part I newly defines bankruptcy law in its essence as any law, from whatever source, that governs or permits insupportable obligations. Where such obligations are necessarily inconsistent, the law provides a resolution. This is bankruptcy law. Another common conception of bankruptcy law, one that I accept here, is as relief provided to an overburdened individual

9. In a paper prepared contemporaneously with this one, Alan Schwartz notes that Jackson's approach, which Schwartz labels as "traditional," begins after a firm experiences financial distress, which includes a conflict among creditors. *See* Alan Schwartz, The Law and Economics Approach to Corporate Bankruptcy (Feb. 2002) (unpublished manuscript, on file with author). My suggestion, explained below, is that one should not begin analysis with the assumption that there is debt. It necessarily follows, of course, that one should not begin analysis with the assumption that there is conflict among creditors.

debtor. To the extent that law provides such relief, even where contract does not and where a debtor could otherwise satisfy all her obligations, the law permits an obligation to go unsatisfied. This too is bankruptcy law at a basic level.

Part II questions whether there are any other basic elements of bankruptcy law. The discussion suggests that no extensive set of special procedural rules, traditionally understood as bankruptcy law, is necessary or desirable given alternatives to debt as a form of obligation. The objective here is to greatly diminish what Jackson described as the logic and limits of bankruptcy, which he viewed primarily as a process of debt relief. The gain from such an approach is that potentially superior alternatives to bankruptcy as process emerge as a means to address financial distress in the absence of debt.

The next part of the Article, Part III, further disaggregates the accepted notion of "bankruptcy law" and moves to another set of issues commonly referred to as bankruptcy issues. When investors provide capital in the form of debt, the Bankruptcy Code governs the distribution of assets in bad-state outcomes. As Part II demonstrates, were business investment, typically in a corporation, to take some other form, the bankruptcy process would be unnecessary or irrelevant. Still, social welfare depends importantly on investment incentives that are based on anticipation of distributions in bad-state outcomes. Analysis of these incentives and distributions is important, and such analysis is offered, even as isolated from bankruptcy as a process. The analysis concentrates on two topics that I have addressed in prior work—the absolute priority rule and the accelerated resolution of financial distress. The debate about what is commonly called absolute priority turns largely on whether holders of junior claims or interests should receive any return from an insolvent debtor if holders of senior claims are not paid in full. Anticipation of a payment to juniors, even where high-priority claims are not fully satisfied, can in some cases lead the juniors to behave as better agents for investors collectively, while in other circumstances the effect can be quite the opposite. This tradeoff, though contentious, is well established. Relatively neglected, by contrast, is the role of accelerated resolution of financial distress, which has the potential to cut the Gordian knot and provide the benefits of absolute priority deviations with few of the potential costs. Analysis of these topics reveals that the prospect of financial distress as a consequence of fixed obligations can be fundamental to an optimal capital structure even though debt itself is not. Other matters of corporate debtors as well as the treatment of individual debtors are left for the larger project of which this Article is a part.

As a contribution for discussion at a symposium, this short Article can hardly be comprehensive within its broad scope. My goal here is merely to provide a framework for a more comprehensive analysis (that will in due course form a monograph). Some components of such analysis already exist, provided by my own earlier work and by that of others. Citations are provided along the way, but I suffer no illusion that I have been complete, and I apologize in advance to those whose work has been omitted.

As a final observation by way of introduction, I want to comment briefly on the place of this work in the Symposium for which this Article was prepared: "Convergence on Delaware: Corporate Bankruptcy and Corporate Governance." The symposium title represents a broad concept that I have liberally interpreted as an observation about connections between bankruptcy law and corporate law, the latter so closely identified with Delaware. This piece takes (what I perceive as) an invitation to draw connections and attempts to draw them down to the most basic levels of private law and then, to a limited extent, to trace them back up the complexity hierarchy.

I. BANKRUPTCY AS FUNDAMENTAL LAW

Viewed from the appropriate perspective, bankruptcy can be seen as part of the law's most basic fabric. Many important property, contract, and tort topics are essentially bankruptcy topics.

Before I provide some illustrations, I will take some license with the terms "bankruptcy" and "bankruptcy law." For specialists, "bankruptcy" refers to a set of federal procedures codified in title 11 of the United States Code. To others, "bankruptcy" means a debtor with insufficient assets to repay his obligations (what specialists refer to as "insolvency"). I want to adopt a different definition. Unless otherwise specified, when I refer generically to "bankruptcy," as in a "bankruptcy issue," I mean to refer to any law that affects the distribution of assets in satisfaction of mutually incompatible obligations or any law that relieves an obligation that could otherwise have been satisfied. The term would thus include state procedures that would govern insolvency in the absence of the federal process as well as the state substantive priority laws on real estate mortgages and on security interests in personal property. Even these are not the limit of "bankruptcy," however, as I mean the term.

The goal is to strip away traditional labels and common understandings to reach underlying substance. In doing so, I also hope that I have met the challenge (or will in a fuller treatment of this work) posed by Alan Schwartz, who commented on an earlier draft of this

Article at the Convergence Symposium. Schwartz accepted the taxonomy that I propose but asked for an explanation of how the new categorization scheme contributes to academic discourse.

My claim of a contribution is two-fold. First there is a pedagogical advantage to the common classification of like concepts. That is, good classification makes difficult problems easier to solve. Second, a recharacterization of a problem may spark a new or at least a more lucid and more productive approach to that problem. So, for example, there is an analysis below of the contract doctrine on substantial performance and material breach. This analysis characterizes the doctrine as a bankruptcy doctrine and, as such, one that can be tested against a standard *bankruptcy* metric of over- and underinvestment incentives, something that, to my knowledge, no prior scholarship has attempted.[10] The claim is not that I have provided here any particularly innovative analysis of insolvency-driven investment incentives. Rather, the point is that standard contract analysis of the substantial performance and material breach doctrine overlooks these incentives because the standard analysis treats the doctrine as one devoted to a determination of excuse from performance rather than, properly, as bankruptcy doctrine.

A. Property Law as Bankruptcy Law

The central legal concept for a capitalist economy is that of private property. This premise is reflected, for example, in the public discussion of the move from communism to capitalism by the former Soviet republics and related states. What these nations need, it is often said, is private property. What is meant, I believe, is not merely that an individual should have a right to exclude others from her home and possessions. This aspect of property undoubtedly offers significant enhancements to human dignity but would not of itself create an engine of development. Instead, what is meant primarily in this context by a need for private property is the need to provide assurances that individuals can capture for themselves the benefits of effort. Private property serves simply when it, for example, prevents government confiscation of a crop.[11]

In a market economy, property law plays another, subtler but essential role as well. Property law not only holds barbarians at the gate, it is also an arbiter among innocents. Every first-year law stu-

10. At least my recent search of the law literature and the economics literature revealed nothing on point.

11. In an economy that includes taxation—that is, in all economies—even this simplest form of private property is not pure, but rather one of degree.

dent is familiar with one or another case of a landowner who conveys the same parcel to two different buyers.[12] The question presented is who owns the land. The answer is (typically) the first to file in the public real estate records. Unsaid, or at least underappreciated, is that this paradigmatic property law case is, in essence, a paradigmatic *bankruptcy* case. The outcome is interesting if, perhaps only if, the original landowner is unable fully to satisfy the conflicting obligations she has created. Otherwise one buyer would receive the land while the other would receive alternative compensation. There would be no harm. The rule that awards the land to the first publicly to file—along with the Uniform Commercial Code's similar rule for conflicting security interests in personalty—is important because the rule allows a purchaser who has provided public notice to count on her ownership interest even if she cannot rely on the seller.

This resolution of such a conflict is important, in particular, for a modern economy. As Karl Llewellyn said in a somewhat different context, "sane" law must go beyond mere notions of passing "title" to property and account for the fact that a modern transaction rarely "resembles that of three hundred years ago: where the whole transaction can be accomplished at one stroke, shifting possession along with title, no strings being left behind—as in a cash purchase of an overcoat worn home."[13] Although he did not say so, the "sane" law that Llewellyn called for to address the strings left behind is, at its heart, sane *bankruptcy* law.

In more recent scholarship, there has been an interesting discussion about the meaning of property law. Tom Merrill and Henry Smith, for example, champion the "in rem" nature of property rights as salient and observe, as I have here, that property law is essential in its ability to foster reliance.[14] Henry Hansmann and Reinier Kraakman focus particularly on the role of notice in property law,[15] as I have here, and in a related context argue that corporate law—long considered a set of contract default rules—serves primarily the property law

12. *See, e.g.*, Lessee of Ewing v. Burnet, 36 U.S. 41 (1837), a principal case found in CHARLES M. HAAR & LANCE LIEBMAN, PROPERTY AND LAW (2d ed. 1985).

13. Karl N. Llewellyn, *Through Title to Contract and a Bit Beyond*, 15 N.Y.U. L. REV. 159, 167 (1938).

14. *See* Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773, 783-89 (2001); Thomas W. Merrill & Henry E. Smith, *What Happened to Property in Law and Economics?*, 111 YALE L.J. 357, 360-66 (2001).

15. *See* Henry Hansmann & Reinier Kraakman, Property, Contract, and Verifiability: Understanding the Law's Restrictions on Divided Rights (Sept. 2002) (unpublished manuscript, on file with author).

function of asset segregation in the face of inconsistent claims.[16] These are generally helpful developments. These developments are also specifically helpful to my theme here, as the conception of property law advanced is a conception of property law as bankruptcy law.

B. The Contract-Bankruptcy Interface

Another example from a first-year law course illustrates the interface between contract and bankruptcy. Consider the doctrine of substantial performance and material breach. Where this doctrine is applicable, a party to a contract who substantially performs can demand performance, or an expectation remedy, from her counterparty. An insubstantial breach entitles the counterparty to damages, but not to walk away from the contract. By comparison, if a party materially breaches (does not substantially perform), the counterparty is free to disregard the contract and may withhold his own performance with impunity.

The line between substantial and insubstantial performance—or between immaterial and material breach—is not a bright one, and courts struggle over the distinction. If a party anticipates that what is in fact only a minor breach will relieve her counterparty of any obligation under the contract, she may invest too much in precaution to prevent breach or invest too little in reliance on the counterparty's performance. Precaution and reliance are central economic justifications for contract enforcement.[17] Thus, there can be much at stake.

Section 241 of the *Restatement (Second) of Contracts* describes factors that courts consider when determining whether a breach is material. The first factor listed is not surprising: "the extent to which the injured party will be deprived of the benefit which he reasonably expected."[18] This factor may not be particularly helpful, as anyone who speaks English would implicitly know that a greatly injurious breach is likely to be a "material" one, but the relevance of the factor is straightforward. The second factor listed may require more thought: "the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived."[19] Why, one might ask, does the availability of compensation matter in a determination of whether a breach is or is not "material"? One might imagine

16. *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 390-93 (2000).

17. *See, e.g.*, Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 646-50 (1988).

18. RESTATEMENT (SECOND) OF CONTRACTS § 241 (1979).

19. *Id.*

that the question of materiality would be prior to that of compensation. If a material breach is a greatly injurious breach, as the *Restatement's* first factor suggests, then compensation could be available, or not, for either a material or an immaterial breach. Preanalytic intuition might suggest that it is unfair to favor a breaching party who will not make good on his end of bargain, but the law does not generally cancel obligations owed to those who cannot repay debts. Therefore, it is not immediately apparent why an insolvent party should be singled out for unfavorable treatment under a definition of materiality.

This conundrum evaporates once one recognizes that the doctrine of substantial performance and material breach is in large part a bankruptcy doctrine. To see this, consider the consequences of a contract rule that *never* released a party from her obligation, absent her counterparty's permission, regardless of how egregious the counterparty's breach. Where damages from breach would be fully compensatory, this rule could be ideal, as it would protect the parties' respective reliance interests and thus yield proper investment (at least to the extent that expectation damages can generally do so). That is, the breaching party would have to pay for her breach as well as any subsequent breach but could count on the return performance for which she contracted. Even if an initial breach portended future breaches, therefore, the victim of breach ultimately would be made whole and both the victim and party in breach would receive the benefits of their bargain. In reality, however, even if damages awards are, or could be made, fully compensatory on average, the risk of insolvency is a natural part of life's variability. The law can address, but cannot eliminate, such variability. A rule that permitted an insolvent party to demand performance despite its incapacity or unwillingness to perform in turn could pervert investment incentives in various ways, one of which would be an insolvent party's incentive to continue a contractual project even if such continuation is inefficient.

The insolvent party's perverse continuation incentive would stem from her hope that the product of her counterparty's performance would restore the party to solvency. In that event, however unlikely, the party could then pay the counterparty in full for such performance and retain any excess value. The insolvent party would, by necessity, otherwise renege, at least in part. Under these conditions, an insolvent party would favor the continuation of even poor projects. In contrast, a fully solvent party to a contract for a project that had a negative net present value would be more likely to repudiate the contract rather than commit itself to pay for its counterparty's performance, a commitment that, by hypothesis, it could and would have to satisfy.

The doctrine of substantial performance and material breach—like the related doctrine of adequate assurance[20]—mitigates this tendency, which the finance literature calls an insolvent party's overinvestment incentive, i.e., the incentive to continue a risky project despite its negative net present value.[21] (Furthermore, because ex ante investment incentives reflect anticipated ex post outcomes, the substantial performance and material breach doctrine may promote efficient ex ante investment.) To the extent the doctrine turns on the breaching party's insolvency, it essentially grants the victim of breach a priority interest in her own performance, which she can withhold unless the insolvent party's performance is proffered as a substitute security. This priority scheme limits the insolvent party's ability to gamble with other people's money in much the same way that priority for early ordinary lenders limits a debtor's ability to gamble with other people's money. The latter limitation is one that Alan Schwartz, alone and with Yeon-Koo Che, has explained in the context of traditionally understood contests among creditors for bankruptcy priority.[22] The analysis of contract law here, then, is an illustration of contract law as bankruptcy law.

The doctrine of substantial performance and material breach, when combined with an individual's right to discharge under bankruptcy law, can also illustrate a different aspect of the contract-bankruptcy interface. Imagine that an individual breaches a contract in a manner that is arguably, but not clearly, material. As described above, policy would support a determination that this breach (or any breach) is immaterial but for the risk that the party in breach could not fully compensate the victim of breach. If the party who breaches is an individual, bankruptcy law (now used in the narrow, traditional sense) affects the likelihood that the victim will be fully compensated, as bankruptcy law affords individual debtors a nonwaivable discharge of obligations.

20. A party who has reason to be insecure about her counterparty's performance can, under some circumstances, withhold her own performance until she receives adequate assurance of her counterparty's performance.

21. This use of "overinvestment" is traditional in finance literature, which directly addresses insolvency issues and which I am here attempting to integrate into contract analysis. This use of the term is not standard for the contract literature, which reserves "overinvestment," or its counterpart "underinvestment," for investment prior to the realization of a state that will determine whether performance of a contract is efficient. What I call overinvestment in this example, the standard contract literature would call inefficient ex post performance. There is no substantive distinction, however.

22. *See* Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 214-18 (1989); *see also* Yeon-Koo Che & Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 J.L. ECON. & ORG. 441, 441-46 (1999) (describing inefficient investment incentives under anti–ipso facto provisions of the Bankruptcy Code).

There are benefits from the discharge of one's obligations in bankruptcy. Such discharge can be described as an insurance policy for which the debtor pays in the form of higher interest rates, and insurance is valuable to risk-averse individuals.[23] But there are costs as well, as insurance gives rise to moral hazard. In the bankruptcy context, moral hazard is typically described as insufficient incentive to expend effort.[24] The present example illustrates a broader moral hazard problem, as an insolvent party to a contract may choose not to repudiate the contract, even where it is efficient to do so, in the hope that the other party will remain obliged to perform. But for the available discharge in bankruptcy, the insolvent party might be forced to internalize the cost of continuation and would repudiate the contract if this nonperformance were optimal from a social welfare perspective. When one considers the concomitant effects of bankruptcy law and contract law on the incentives of parties to an executory contract, there is a greater than commonly understood cost to the availability of a bankruptcy discharge and the fact that the right to exercise such discharge cannot be waived under law.

This point can be extended and generalized. The inefficiency described stems from a party's limited liability. In the last example, the bankruptcy discharge was the source of the limitation. If the party were a corporation, however, the limited liability of investors under corporate law would be the source. The inefficiency described, moreover, is a result of a party's insolvency-driven overinvestment incentive to continue with an inefficient contractual project in order to attract investment from a counterparty. This perverse incentive can be seen as the flip side of a party's insolvency-driven underinvestment incentive to discontinue an efficient contract in order to avoid the party's own further investment, a phenomenon described, in separate works, by George Triantis and by Jesse Fried.[25] Their observations are, as I hope I have illustrated, only a part of the more general interrelationship between bankruptcy and contract law.

C. The Tort-Bankruptcy Interface

There is one well-known bankruptcy aspect of tort law. That is, tort victims are not afforded a high priority in a contest with a debtor's

23. *See* Barry Adler, Ben Polak & Alan Schwartz, *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL STUD. 585, 589-91 (2000).

24. *Id.*

25. *See, e.g.*, Jesse M. Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, 46 DUKE L.J. 517 (1996); George G. Triantis, *The Effects of Insolvency and Bankruptcy on Contract Performance and Adjustment*, 43 U. TORONTO L.J. 679 (1993).

consensual investors. Not only do tort victims merely share bankruptcy priority with unsecured creditors, they are also junior to secured creditors. If the debtor is a corporation, moreover, under corporate law, shareholder liability is limited to the assets invested in the corporation. There is a strong argument that at least pure tort victims—victims of released toxins, e.g., as opposed to victims of medical malpractice—should have a higher priority than any consensual creditor, as only the latter can negotiate over the assumption of risk. Current law permits debtors to externalize the cost of potentially hazardous conduct, and society might expect too much such conduct as a result.[26] There have thus been calls—by Hansmann and Kraakman, for example—to eliminate limited liability for shareholders.[27]

Less well understood, perhaps, is that the significance of priority in the tort regime has parallels in the discussion of contract law above. When an insolvent party to a contract induces overinvestment in a project at the expense of her counterparty, as described above, she acts similarly to a tortfeasor who overinvests in activity at the expense of an unwilling victim. In each case, the ability to gamble with someone else's property, life, or limb creates perverse incentives, and the law, whether formally contract, tort, or bankruptcy, either addresses these incentives or fails in this regard. Success or failure does not depend on the labels. The connection between contract and tort incentives is well established. Bob Cooter, for example, talks of the "unity" of contract and tort.[28] This unity has an important bankruptcy component as well.

There are still other aspects to the tort-bankruptcy interface. Consider another rule familiar to every first-year law student. One who intentionally inflicts harm on another cannot raise a defense of contributory negligence.[29] As a result, the tort law's disincentive for malicious action is, not surprisingly, undiminished by any role the victim might play in the injury inflicted. The law expresses no concern either for overdeterrence of the tortfeasor's activity or for underdeterence of the victim's. For example, a bully will pay full damages for a battery even if a victim foolishly wanders into the bully's path. This rule sensibly follows a determination by society that malicious behav-

26. To prevent negative externalities, mandatory insurance laws can substitute for unlimited liability. The voluntary purchase of insurance, moreover, limits the externalization of costs. But mandatory insurance laws are not pervasive and would leave a residual amount of negative externality, as would voluntary insurance.

27. See Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

28. *See generally* Cooter, *supra* note 1, at 2.

29. *See* PROSSER AND KEETON ON TORTS 462 (5tb ed. 1984).

ior should be discouraged without the imposition of any needless burden on potential victims. Although this tort rule does not necessarily raise a bankruptcy issue, bankruptcy law, here meant in the narrow sense, does support the tort rule. Bankruptcy generally discharges the obligations of an individual debtor but does *not* discharge liability for malicious acts.[30] (Many nonspecialists are aware of this rule by virtue of their inquiries about whether O.J. Simpson can use bankruptcy to discharge his wrongful death liability; he cannot.) But for this rule, bankruptcy law would to some extent undermine the tort law's reasonable insistence on the fullest possible liability for malicious acts.

The malicious liability example may not of itself be terribly important, but it is another illustration of how bankruptcy law is broadly intertwined with the rest of private law in small ways as well as large.

II. THE LIMITED LOGIC OF BANKRUPTCY

The vision I have described of bankruptcy law as fundamental is a vision of a limited institution. There is only a single function bankruptcy law must serve: the reconciliation of mutually insupportable obligations. This function, a logically necessary component of law that permits the creation of such obligations, is central to bankruptcy and central in the illustrations above, particularly to the account of property law as bankruptcy law. Bankruptcy law serves a second function, one that many view as necessary to a beneficent society: provision of a fresh start to individual debtors.

This latter function of bankruptcy is controversial, as a mandatory provision of a fresh start through the discharge of obligations is also a mandatory burden on debtor borrowing. As described above, the discharge option can be envisioned as an insurance policy, and debtors can be expected to pay the premium for such a policy. One might question whether the law should require debtors to purchase insurance against debt burden any more than individuals should be forced to purchase other forms of insurance, such as theft insurance. But the desirability of mandatory insurance is not implausible, particularly where an uninsured person or her dependents might become burdens on society. In any case, I do not wish to enter this debate here, and the illustrations above include the fresh start as a component of bankruptcy law at a basic level.

To those steeped in the intellectual discussion of bankruptcy law, the striking omission from my short list of bankruptcy's essential functions is the omission of bankruptcy as a *process*, one that solves

30. *See* 11 U.S.C. § 523(a)(6) (2000).

the collective-action problem among creditors. As noted in the introduction above, Thomas Jackson's work, *The Logic and Limits of Bankruptcy*, transformed the analysis of bankruptcy law into an analysis of a collective-action problem. Creditors, Jackson reasoned, would collectively lose from an unconstrained race, effectuated by individual legal action, to grab an insolvent debtor's assets. The transaction costs of a race could be wasteful—much as the cost of military production is often characterized as wasteful in an arms race—and, more significantly for business debtors such as corporations, self-interested individual creditors could, to the creditors' *collective* detriment, dismember or otherwise destroy a financially burdened but economically viable going concern. To avoid such a race, Jackson concluded, creditors would, if only they could, agree in advance of financial distress to call off the race in favor of a collective-debt collection process.

The bankruptcy process, in Jackson's view, reflects a hypothetical bargain among creditors, who, Jackson assumes, are functionally and temporally too disparate to reach an actual collective bargain in advance of financial distress and may be too greedy to reach one after. Douglas Baird, a frequent Jackson coauthor, and codeveloper of many ideas contained in Jackson's book, has identified an entire school of bankruptcy thought as one devoted to the process of collective action.[31]

The hypothetical bargain among creditors is, in essence, a thought experiment about how holders of debt would design the ideal bankruptcy system. There is an alternative thought experiment, however, one I want to substitute here. Although there are some parallels between consumer and business debtors, I want to focus on how entrepreneurs or business firms—both "firms" for purposes of this Article—would structure ideal investment instruments, perhaps to the exclusion of debt, to perform the collective-action function that Jackson places at the heart of bankruptcy law. This thought experiment yields a conclusion different from Jackson's: The sole essential element of bankruptcy law is resolution of conflicting, mutually insupportable obligations. Because firms can, through investment design, both retain the benefits of debt *and* avoid the collective-action problem (except in the atypical case of substantial tort liability), firms need not issue obligations that will conflict, even contingently. Thus, a collective-action process need not be an element of bankruptcy law at all, much less the central element. A firm that issued debt alternatives would not resolve financial crises in the same way that a debt-laden firm would, but this

31. *See* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 576-80 (1998).

fact does not mean that such a firm would necessarily benefit from a bankruptcy process. Indeed, given the options available to firms, the collective-action problem among creditors may be seen as a solution rather than a problem.

A. A World Without Debt

The supposed benefits of bankruptcy as a solution to a creditor collective-action problem can be explained with a simple syllogism. Debtors benefit from the issuance of debt to multiple creditors. The benefits of such issuance are threatened by a creditor collective-action problem. A solution to the collective-action problem such as that provided by the bankruptcy process, corporate reorganization in particular, is beneficial to debtors. This syllogism is simple, but false. Although it is possible to characterize my objection to this syllogism in a number of ways, I will focus here (for now) on the first premise: that debtors benefit from the issuance of debt to multiple creditors.

Debtors may benefit from the issuance of fixed obligations to multiple *investors*, but these fixed obligations need not be *debt* obligations. Functionally, debt is composed of two parts: the debtor's obligation to pay a sum certain at a time certain, and the debtholder's right to enforce such obligation with an individual collection remedy. In the standard account of debt and bankruptcy, the first component of debt—fixed obligations—is a benefit, while the second component—individual enforcement—is a harm. So my thought experiment begins with a concededly simpleminded question: If debt consists of beneficial fixed obligations and a harmful individual enforcement right, and if bankruptcy law exists to remedy the harm of the individual enforcement right, then why can a firm not simply issue fixed obligations without an individual enforcement right and thus save itself the potential trouble of a bankruptcy process? That is, why issue the bitter with the sweet? Although this question is straightforward, there does not seem to be a satisfactory answer, at least not one that favors the bankruptcy process as a solution to a collective-action problem.

To elaborate,[32] a firm may rationally issue fixed obligations because those obligations may simultaneously allow managers to hold a significant portion of a firm's residual claim and discipline managers, who face the consequences of payment default, perhaps including dismissal. The result may be harder working managers.[33] A firm may ra-

32. For an account that tracks this section and then expands the discussion, see generally Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811 (1994).

33. This account is a simplification of a complicated issue. *Compare* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership*

tionally issue its fixed obligations to a large number of investors because no single lender would be willing to provide all financing at all times. (This supposition might be true of large firms.) Or a firm might rationally prefer to have multiple financing sources so as not to vest in any lender the opportunity to behave strategically with respect to subsequent loans that only an existing lender, given better information, could efficiently provide.[34]

The world I envision, therefore, 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 a fixed-obligation claimant individually to collect. This one feature is significant because it is *the* feature of debt that creates the collective-action problem and the purported need for a bankruptcy process.

My approach is simple. The justification for bankruptcy is the need to prevent individual creditor collection. I imagine a world in which firms issue obligations like debt in every respect except the one that creates the need for bankruptcy. I then ask what might be gained and what might be lost. What might be gained is the avoidance of bankruptcy expense, or other restructuring expense, for firms that issue fixed obligations to multiple investors. This expense can be sub-

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Structure, 3 J. FIN. ECON. 305, 312-20 (1976) (noting the residual claimant's incentive to maximize wealth), *with* Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 653 (1984) (suggesting that managers who have a substantial investment in their firms may be reluctant to invest the firm's assets wisely if the investment in question is risky). Moreover, the market for corporate control, while costly, can substitute, at least to some extent, for debt as a disciplinary device. *See, e.g.*, Peter Dodd, *The Market for Corporate Control: A Review of the Evidence*, 1 MIDLAND CORP. FIN. J. 6 (1983); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983). Suffice it to say here that it *may* be rational for *some* firms to invest their managers with a substantial residual interest and to have those managers face the risk of financial ruin for failure to meet fixed obligations.

34. Virtually all bankruptcy scholarship assumes that large firms have many lenders. As Douglas Diamond illustrates, this assumption is not theoretically inevitable. *See* Douglas W. Diamond, *Corporate Capital Structure: The Control Roles of Bank and Public Debt with Taxes and Costly Bankruptcy*, FED. RES. BANK OF RICHMOND ECON. Q., Spring 1994, at 30-31 (describing circumstances under which bank debt is preferable to public debt). Even a large firm could borrow from a single institution, which could in turn have diversified investors. It is plausible, nonetheless, to assume that many large firms will efficiently have multiple sources of debt capital, perhaps because a single institutional lender to a large firm would have large administrative expenses. *Id.* at 30. Moreover, a single lender or its managers, like a large shareholder or its managers, exert a powerful influence over a debtor, one that might not be in the debtor's best interests. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 826-27 (1992) (describing conflicts of interests facing institutional money managers); *cf.* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 261 (1994) (arguing that the presence of multiple parties with power can reduce side payments to any one such party); Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1, 1-3 (1996) (arguing that multiple creditors may minimize strategic management default).

stantial, at least under current bankruptcy law, which divides an insolvent firm's value through claimant negotiations that more than occasionally deteriorate into a litigated imbroglio.[35] Given the desire to protect insolvent but viable firms, it is not clear that anything significant might be lost from the elimination of individual collection rights.

Elimination of debt, and with it the individual creditor's right to collect, might cost little because there is an alternative *collective* remedy of which fixed-obligation claimants could avail themselves. In earlier work, I have argued that, absent legal and other impediments, a firm could replace debt with a financial instrument analogous to preferred equity.[36] This substitution could create what I call a "Chameleon Equity" firm. Such a firm would retain the benefits of fixed obligations but would avoid the negative consequences of creditor coordination failure—notably postdefault dismemberment of a viable firm—by eliminating individual creditor collection.

In the simplest Chameleon Equity firm, insolvency and uncured default would eliminate the preinsolvency common-equity class and would convert the lowest priority fixed-obligation class to common equity. This transformation might follow a grace period during which a firm's outside directors could replace management in an attempt to cure the default that triggered conversion.[37] A Chameleon Equity transformation would not occur, then, until the capital market signaled a firm's insolvency through a refusal to refinance.[38] Posttrans-

35. For an estimate of bankruptcy reorganization's direct costs, see Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 285 (1990) (estimating that the direct costs of bankruptcy average three percent of the firms' book value of debt plus the market value of the equity). For what is likely the limiting estimate of reorganization's indirect costs, from one prominent case, see David M. Cutler & Lawrence H. Summers, *The Costs of Conflict Rcsolution and Financial Distress: Evidenee from the Texaeo-Pennzoil Litigation*, 19 RAND J. ECON. 157 (1988) (estimating costs in the billions of dollars). The magnitude of these costs, particularly the indirect costs, is debated. *See, e.g.*, Gregor Andrade & Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Beeame Distressed*, 53 J. FIN. 1443 (1998). There is little question, however, that the costs of reorganization are more than trivial, at least for any firm that is both economically and financially distressed.

36. *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323-33 (1993).

37. Such a grace period would limit the risk of collusion between the managers and the pretransformation junior creditor class, which otherwise might, on the side, bribe the managers to have even a solvent firm default.

38. If neither the old managers nor the newly charged special-purpose managers could cure a triggering default, then the most likely reason would be insolvency, which would justify the transformation. Consequently, managers of a Chameleon Equity firm might not have sufficient incentive to transform a firm *early enough*. But managerial desire to avoid default until the last possible moment, a desire that can be mitigated by covenants with investors, or through preference rules, as described in Part III of this Article, would not distinguish a Chameleon Equity firm from a traditional firm under the current bankruptcy regime.

formation, any remaining preferred equity class would survive unaffected. At any given time, management would represent the then-current common equity class and could be summarily replaced by that class.[39] Investors could adopt the Chameleon Equity structure *actually*, rather than hypothetically, through their choice to invest in a firm that has enforceably eschewed traditional debt, perhaps by initial charter.[40]

Thus, for a simple firm, with one class of common equity and one class of general creditors, the general creditors would become the equity class and *automatically* receive securities worth the firm's entire going-concern value. The general creditors collectively, as the new equityholders, or purchasers therefrom, would also have control of the firm, which they could operate or liquidate as they wished. (Perhaps, a common first step would be to replace the managers that had just so spectacularly failed the prior equity class.) There would be no need for a court to provide a collective remedy because there would be no individual remedy in the first place. Nothing else would have to change.

In a more complex firm, one with a variety of fixed obligation priority classes, even after a default triggered a Chameleon Equity transformation, no judicial intervention would be required to preserve the highest priority obligations (which could include asset-based secured obligations). After the firm, relieved of its most junior obligations, cured any payment default on its senior obligations, the senior obligations would retain their priority and would survive complete with fixed claims of original maturity. This process would free the firm to adopt a tiered hierarchy of "onion skin" priority classes that would keep the firm almost eternally solvent and almost eternally subject to

39. This insight, to the extent it is an insight, is built on a discussion of collective action among bondholders in Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 239-40 (1987).

40. Others have seen that a debtor corporation serves as a nexus for agreement among creditors. *See, e.g.*, Robert A. Haugen & Lemma W. Senbet, *Bankruptcy and Agency Costs: Their Significance to the Theory of Optimal Capital Structure*, 23 J. FIN. & QUANTITATIVE ANALYSIS 27, 29-31 (1988) (stating that, in the abstract, impediments to restructuring are easily eliminated through inclusion of simple provisions in corporate charters and bond indentures); Robert C. Merton, *The Financial System and Economic Performance*, 4 J. FIN. SERVICES RES. 263, 283-85 (1990) (suggesting tbat options could eliminate the need for bankruptcy); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 647-48, 669-75 (1992) (arguing that secured credit mitigates the collective-action problem); Roe, *supra* note 39, at 232, 250-69 (arguing that prohibition under section 316(b) of the Trust Indenture Act restricts contractual resolution of financial distress). But none of these contributions has recognized the potential completely to solve the collective-action problem without a substantial restriction on the capital structure flexibility available to firms that rely on the bankruptcy process to cure any collective-action problem. For example, an all-equity capital structure solves the collective-action problem but does not preserve tbe advantages of fixed obligations. This observation is not meant to diminish the contributions of others, but simply to note an advance. *Cf. infra* note 43.

significant fixed obligations. In the end, every claimant would get the priority for which it contracted. (Tort law could award tort victims a Chameleon Equity obligation, rather than a creditor's claim, of any priority, including the highest.) Although there would be questions of default and liability, as there are now in traditional firms, there would be no postinsolvency restructuring expense. A Chameleon Equity firm would have to bear the initial transaction cost of adopting the Chameleon Equity structure. But it is difficult to imagine that this cost would be more than a trivial addition to the current cost of contracting for corporate charters and bond covenants.[41] Corporate bankruptcy, then, seems unnecessary, at least in terms of this simple thought experiment.

As I have noted previously, I am not so naive as to believe that abolition of bankruptcy or firm selection of a Chameleon Equity structure is imminent or even possible. In my original article on Chameleon Equity, I described a list of legal and other impediments to a Chameleon Equity structure. These barriers include tax, commercial, corporate, and tort law. In addition, I offered a public choice explanation for the persistence of these impediments.[42] Nevertheless, absent artificial constraint, a world without debt or bankruptcy, and with contractual solutions to the collective-action problem, seems a potentially efficient world. At the very least, such a world need not include Jackson's conception of what is essential about bankruptcy.[43]

41. I discuss this point in Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107, 1118-19 (1994). In Donald R. Korobkin, *The Unwarrantcd Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669, 720 (1993), the author descrihes these costs as "immense," because he neglects the possibility that the contracts could become standard form much like bond covenants are under the current regime.

42. *See* Adler, *supra* note 36, at 333-41.

43. Others have seen the potential for transferring equity in satisfaction of debt or transforming debt into equity. *See, e.g.*, Merton, *supra* note 40, at 263, 283-85 (suggesting a debtor's option to pay claims and retain equity in underlying assets); Note, *Distress-Contingent Convertible Bonds: A Proposed Solution to the Excess Debt Problem*, 104 HARV. L. REV. 1857, 1869-77 (1991) (recommending a gradual transformation of debt into equity as the value of a firm declines).

None of these proposals, however, attempts to decompose debt into its fixed-obligation and individual-collection parts, and each thus fails to recognize the potential of financial instruments stripped of individual collection rights to mimic any other feature of debt, including multiple priorities, through simple decoupling. In the Merton article cited above, which was published while my original Chameleon Equity paper was in draft, Merton suggested that a holding company rather than an operating company might issue junk bonds so as to insulate the operating company from the burdens of such debt. If the holding company failed to purchase the bonds for the amount owed (i.e., pay the debt), the bondholders would take the equity interest in the operating company. The operating company would thus be spared the risk of liquidation or the need for reorganization. But Merton did not express a broader vision of this mechanism. He noted, for example, that the operating company would itself be subject to trade debt and that such debt

To be sure, Chameleon Equity is not the only contractual arrangement through which investors could provide for the disposition of a firm that fails to meet its fixed obligations. As Alan Schwartz observes in his role as commentator for this Article, one can view the reorganization provisions of the Bankruptcy Code as a set of contract default rules that, in effect, removes what is merely an ostensible incompatibility among traditional debt obligations issued by a firm that becomes insolvent. Thus, the reorganization provisions can serve the same primary function as Chameleon Equity.

Schwartz's observation is perfectly correct and supports my bankruptcy taxonomy. Schwartz's reference to default rules recognizes that the Bankruptcy Code's reorganization provisions can be seen as *contractual*, albeit implicit, terms that avoid inconsistent obligations. As such, the reorganization provisions are not a response to any collective-action problem too stubborn for contract to solve, as Jackson's conception holds. Jackson sees bankruptcy law as a classic *regulatory* response to a collective-action problem, which Jackson believes can yield inevitably conflicting obligations. That is, in Jackson's conception, the Bankruptcy Code's reorganization provisions serve a function similar to the property law, discussed above, which resolves ownership disputes between two innocent buyers who have purchased from a fraudulent seller. In contrast, my view of bankruptcy law, like Schwartz's comment, recognizes that there is no collective-action problem. Thus, solution to a collective-action problem cannot be an essential element of bankruptcy law. The realization that neither traditional debt nor current bankruptcy law is inevitable allows one to consider perhaps superior alternatives to traditional debt and the Bankruptcy Code's response thereto. Such consideration is the essence

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would not be jeopardized by the leverage of the holding company, but he offered no alternative to such trade debt priority, which would exist by necessity of the scheme. To be sure, Merton might have imagined a tiered set of holding companies, each owning another, with debt in each that would correspond to desired priorities. These could be used to replicate a multiple-priority Chameleon Equity firm, but Merton's objective was simply to show that junk bonds need not present a liquidation risk to an operating company, and so he did not even intimate that such a tiered structure was possible. Similarly, given his narrow purpose, Merton did not address the potential advantages, or disadvantages, of Chameleon Equity, or any other ex ante approach, over an ex post arrangement such as an auction. These potential advantages, along with potential disadvantages, described below, make up a substantial part of my own earlier work on the topic. The student note cited above, for its part, alters the nature of a fixed obligation, with a gradual conversion of debt to equity altering priority and with it debt's disciplinary benefits.

Ironically, a reform proposal often described as roughly equivalent to Chameleon Equity, presented in Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992), lacks the essential element of Chameleon Equity, namely the elimination of individual creditor collection. *See* Adler, *supra* note 36, at 332-33.

of Chameleon Equity, described from the start as a thought experiment, one that continues below.

B. Ex Ante Resolution of Financial Distress

Bankruptcy as an essential collective process can be dispatched with a simple decoupling of debt's components and an elimination of the individual collection right. The removal of individual collection rights means that discordant creditors pose no threat to an integrated set of debtor's assets. This does not mean, however, that no additional remedy for financial distress is ever appropriate. Robert Rasmussen, for example, has called for a menu of options debtors might adopt,[44] and Alan Schwartz has repeatedly counseled against attempts to fashion any single set of rules for varied firms.[45] Firms could simply abolish debt, as I suggest, but there are alternatives, the status quo included.

Start with the status quo. Bankruptcy law need not, in my view, include a collective process, but in the United States, and elsewhere, it does. The particular process adopted in the United States, and in a growing number of countries, is one of structured negotiations backed by judicial valuation. In brief, a debtor's bankruptcy petition stays individual creditor collection and invites the debtor's managers (or, in rare cases, a trustee) to propose a reorganization plan. The managers then seek approval from the creditors. If all creditors accept, the plan is confirmed, and the debtor emerges from bankruptcy. If some but not all classes of creditor claims accept, the bankruptcy judge can confirm the plan only if she is satisfied that the dissenters will be compensated under the plan in accordance with "absolute priority," that is, with no compensation for low-priority claims unless high-priority claims are compensated in full.[46] In a reorganization from which the debtor is to emerge as a going concern, compensation under the plan typically takes the form of new claims against or interests in the reorganized firm. Therefore, for a judge to determine whether a plan comports with absolute priority, she ordinarily must determine the value of the firm.

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44. *See* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 100-07 (1992).

45. For Schwartz's most recent admonishment, see Schwartz, *supra* note 9.

46. This description of the bankruptcy reorganization process is oversimplified in some respects. For example, the described protection afforded high-priority creditors who dissent is in fact afforded only to classes of creditors who fail to approve a plan by supermajority vote. Neither this nor other details of the bankruptcy reorganization process are relevant to the current discussion, however.

The most common suggestions for bankruptcy reform involve replacing judicial valuation with a market-based mechanism. These proposals rest on at least two key assumptions. The first is that absolute priority matters. A more extended discussion of absolute priority follows in Part III of this Article. For now, merely note that absolute priority likely matters because absolute priority is largely based on contracts among investors (with tort claims an exception). Presumably there is a reason that parties create different priority classes, or every firm would be financed simply with common equity. Consider, for example, an insolvency resolution that granted creditors no greater compensation than shareholders. Investors and managers would anticipate this outcome, and the fixed-obligation benefits described above would be lost. The result would be that the debtor would face a higher cost of capital. The second assumption that supports market-based reform is that markets value capital assets at least as well as individual judges. These assumptions are at least plausible, except perhaps with respect to the smallest firms in the thinnest markets, and there has thus been substantial interest in market alternatives to judicial valuation.

The simplest market reform would be for the bankruptcy court to conduct a cash auction for the assets of the debtor. Holders of the debtor's prebankruptcy claims and interests would then divide the proceeds according to absolute priority. The new owners, free from prebankruptcy conflicts, would decide the firm's fate. This idea has been developed by, and become associated with, Douglas Baird.[47] In an earlier variant of Baird's proposal, Mark Roe suggested that a full-scale auction is not necessary. He recommended that bankruptcy law provide instead for the sale of a small portion of new interests in the firm.[48] The purchase price from such a sale would serve as the basis for the issuance of additional new interests in exchange for prebankrutpcy claims and interests.

Market alternatives can be more elaborate as well. Lucian Bebchuk followed Roe with his own issue-of-securities, market-valuation solution. He proposed a bankruptcy process in which each holder of a claim or interest would be granted a conditional option, exercisable in ascending order of priority. The option would entitle the holder to buy a ratable portion of all higher priority claims or interests

47. *See* Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633, 633-35 (1993); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 145-47 (1986). The idea was also mentioned in William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS. 13, 38 (1977).

48. *See* Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 530 (1983).

at face value unless a holder of a lower priority claim or interest exercised its option to purchase the holder's own claim or interest. The options themselves would be marketable prior to the date of exercise.[49] Philippe Aghion, Oliver Hart, and John Moore specified how the Bebchuk proposal could include a role for the bankruptcy court as a guide, not to valuation, but to the determination of the firm's postreorganization character.[50]

Recently, with Ian Ayres, I suggested that bankruptcy might employ a dilution mechanism to value a debtor. In one simplified version of this mechanism, the court would issue new shares to senior creditors and then just that number of additional shares, if any, to junior creditors such that the seniors would want to sell, but neither the juniors nor any market bidder would want to buy, the seniors' shares at the price of the seniors' aggregate claim. In the end, senior creditors would either own all the shares of the firm—if the debtor were worth less than the aggregate senior claim and thus no additional shares were issued to junior creditors—or the seniors would own shares that, after dilution by issuance to the juniors, were worth precisely what the seniors were owed with the debtor's excess value incorporated into the junior creditors' own shares. Either way, absolute priority would be honored (and the scheme could incorporate shareholders as well were there some chance that the value of the debtor exceeded the aggregate of all claims, senior and junior). We believe our mechanism is an improvement over Bebchuk's in circumstances where junior creditors (or shareholders) face a liquidity crisis, which is possible in thin markets.[51]

Although these proposals differ from one another in various respects, each with strengths and weaknesses (the description of which is beyond the scope of this Article),[52] they share a common trait. Every one of them provides for the division of a financially distressed firm based on a valuation determined *after* the firm has become unable to meet its obligations. In each case, this is the proposed order of events: First, the firm defaults or declares that it will not pay; second, absent a consensual resolution among investors, the willingness of investors or other market participants to buy or sell determines the firm's value;

49. *See* Lucian A. Behchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 781-88 (1988).

50. *See* Philippe Aghion, Oliver Hart & John Moore, *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523, 535 (1992); Philippe Aghion, Oliver Hart & John Moore, *Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849, 861-66 (1994).

51. Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Firms in Bankruptcy*, 111 YALE L.J. 83, 96-112, 140-48 (2002).

52. For a more detailed account, see *id.* at 140-48; Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 347-50 (1997).

and third, either automatically or through judicial intervention, the firm's value is distributed to holders of claims and interests. Bankruptcy reorganization employs a similar order of events, save that in bankruptcy judicial valuation replaces market valuation in the second step. In every case, though, a critical part of the process—satisfying claims and interests—turns on *some* ex post valuation.

Inasmuch as both current bankruptcy law and so many proposals for reform treat valuation as the touchstone of any bankruptcy process, it is not surprising that valuation has come to be considered an essential element of bankruptcy. Recall my claim, however, that the only essential element of bankruptcy is the resolution of inconsistent obligations. Ex post valuation is *one* method of resolution when a debtor cannot fully satisfy its fixed obligations, but it is not the only method. Note that a Chameleon Equity firm, as described above, can include multiple fixed obligations in multiple priority classes and can honor the priority among its investors all without any attempt to accomplish a postdefault valuation. Instead, investors decide, ex ante, at the time they invest, what will happen in the event the firm fails to meet its obligations. Contract, not the court or marketplace, is consulted. The transformation of a Chameleon Equity firm is thus simple and ministerial.

The Chameleon Equity idea, therefore, is different in kind from the market-based proposals that are by far the most common in the bankruptcy reform debate.[53] The difference is as stark as between ex ante and ex post. This is not to say that Chameleon Equity's ex ante approach logically dominates the others; it does not. Chameleon Equity works well when the investors can make accurate ex ante predictions about a firm's value at the time the firm defaults without cure. The approach works less well otherwise. For example, one might imagine a Chameleon Equity firm with a senior and a junior fixed-obligation priority class, each owed $100. If the firm defaults on a mature obligation and cannot cure default within contractually prescribed means, then the senior class would become the sole fixed-obligation class, with the junior fixed-obligation class transformed into the sole common-equity class, while the former common-equity class would be canceled. This transformation comports with absolute priority if, but only if, the value of the firm at the time is between $100 and $200. To the extent a judicial or market ex post valuation could correct any mistaken ex ante prediction of firm value at the time of default, an ex post approach has potential advantages over an ex ante method.

53. *See* Adler, *supra* note 52, at 351-57.

But any such potential advantage comes at a price that makes the advantage *merely* potential.

If information were free, adherence to absolute priority would be trivial as contention over value, and thus over distribution entitlement, would simply vanish. Indeed, many of private law's most difficult, and most interesting, legal issues would disappear. This observation is not limited to bankruptcy questions, though it applies to them as well. For example, as noted above, the design of contract remedy is important because remedy influences investment incentives.[54] Such incentives matter only because investment itself—e.g., in effort level—is often not verifiable, except at a prohibitive expense and is thus noncontractible. Similarly, a firm's valuation may be considered nonverifiable. Valuation depends on many subtle factors, both those specific to the firm and those general to the economy at large. A market process can aggregate information among participants (bidders) but only at some cost.

Sale costs for public offerings are significant, as much as almost 5% of even large public offerings[55] and as much as 20% for smaller offerings[56]—and this substantial cost despite competition among underwriters. The cost may well be attributable to the cost of information generation and distribution, without which (for fear of a lemons problem)[57] bidders would not bid, or would not bid much.[58] For a debtor in bankruptcy, the costs of market valuation might vary with the particular method chosen, but the process would not be costless even assuming, counterfactually, that the valuation result would be perfectly accurate. The valuation cost must be weighed in the balance when one compares market solutions to judicial valuation and to an ex ante solution such as Chameleon Equity, which eliminates ex post valuation entirely.

As mentioned, the claim here is not that an ex ante approach to bankruptcy resolution dominates ex post valuation. There are poten-

54. *See* Craswell, *supra* note 17, at 646-50 and accompanying text.

55. *See* Clifford W. Smith, Jr., *Alternative Methods for Raising Capital: Rights Versus Underwritten Offerings*, 5 J. FIN. ECON. 273, 277 (1977) (analyzing SEC data to compare underwriting costs with rights offerings costs).

56. *See* Jay R. Ritter, *The Costs of Going Public*, 19 J. FIN. ECON. 269, 272 (1987).

57. Compare the discussion on public offerings with the famous Akerlof "lemons" problem. *See, e.g.*, Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 570-72 (1990) (reviewing law and finance literature); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1515-24 (1989) (same); Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 580-83 (1995) (same).

58. *See, e.g.*, Kenneth R. French & Robert E. McCormick, *Sealed Bids, Sunk Costs, and the Process of Competition*, 57 J. BUS. 417, 431-32 (1984) (showing that without information, buyers will purchase at a price that is lower than the expected value of the good).

tial costs and potential benefits to either approach. The commentator for this Article, Alan Schwartz, recommends that these trade-offs be formalized in a model that demonstrates how savings may be realized, and under what conditions, from the various bankruptcy alternatives. This recommendation is a good one and poses a challenge that I will undertake in subsequent work.

The very plausibility of an ex ante approach such as Chameleon Equity demonstrates that ex post valuation is not an essential component of bankruptcy. This distinction between ex ante and ex post is not merely semantic. Insolvency resolution, while significant, may not present the most important challenges to market economies in the United States or in other developed countries because any of the approaches discussed may work tolerably well. In developing countries, however, markets tend to be unreliable and the judiciary perhaps less so. Therefore, an ex ante solution, which requires no market valuation and only ministerial judicial involvement, may uniquely permit the efficient allocation of capital.

C. The Endogeneity of Process and Capital Structure

The debate over the bankruptcy reorganization process and the various reform proposals begins with the premise that there will be *some* opportunity for a collective insolvency resolution. Ex post solutions rely on a stay of individual collection until the debtor's value can be determined and distributed. An ex ante solution, such as Chameleon Equity, requires no stay because there is no individual collection right in the first instance. In either case, a firm will be kept alive at least until those who would benefit from a proper disposition of the firm's assets can make a collective decision. So even if the possibility of an ex ante solution implies that valuation is not an essential bankruptcy element, there remains the impression that collective action is essential—a false impression.

A misapprehension of financial economics gives rise to the intuition that a proper insolvency system must screen firms that should live from those that should die. It is an axiom of finance theory that a firm's financial health—its ability to pay its debts—is not synonymous with the firm's economic health—its ability efficiently to provide goods or services. It is commonly observed, therefore, that a debt-laden firm can suffer financial distress while maintaining economic viability. Thus, if insolvency provided no clue as to a firm's viability, legal rules that permitted a firm's immediate dismemberment at the hands of unconstrained creditors might waste much value. But a firm's insolvency, as signaled by the firm's default on its debt, may provide a *strong* clue as to the firm's viability. Financial distress need not randomly befall good and bad firms alike. Because investors choose an initial capital structure, they may adopt a debt component that renders unlikely the simultaneous occurrence of insolvency and viability. Consequently, investors might well prefer insolvency rules that channel few resources into distinguishing firms that should continue from those that should liquidate, even if the result is routine liquidation.

This observation, taken from my prior work,[59] provides a theory of corporate insolvency that integrates investors' capital-structure and insolvency-rule decisions. A combination of preferred-equity instruments, such as Chameleon Equity, and traditional debt allows dispersed investors to enjoy the advantages of fixed obligations without fear of liquidation while a firm is likely to be viable and permits these investors to benefit from liquidation through creditor competition for assets when the firm is likely to be inviable. Small failures, perhaps from independent exogenous shocks, might impair a viable debtor's common equity or even, eventually, some of its junior Chameleon Equity classes. At some point, however, when the debtor has dissipated all the value contained in its Chameleon Equity classes and defaults on its traditional debt, one might safely assume that the failures are systemic and that the debtor is no longer viable.[60] That is, the size of a financial failure may imply its cause, and so when a firm's capital is impaired beyond a certain point, one might safely conclude that the firm could efficiently dissolve into its creditors' hands.

The bankruptcy reorganization process would interfere with this design by protecting even those firms that should not continue. Alternatives that would protect insolvent firms could similarly interfere. 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. These costs would include the direct or indirect costs of formal reorganization, market valuation, or a potential continuation bias by those who may control a firm and earn private benefits from its existence. No method of insolvency resolution can avoid all these potential expenses. The occasional successful rescue of a viable firm may not justify this ubiquitous cost.

Once one sees insolvency process and capital structure as endogenous choices,[61] it becomes apparent that there may be no need for

59. *See* Adler, *supra* note 52, at 367-75.

60. *See* Michael C. Jensen, *Corporate Control and the Politics of Finance*, 4 J. APPLIED CORP. FIN. 13, 24 (1991) (discussing losses that are exogenous and endogenous to management).

61. Although others have observed a connection between capital structure and potential value, as far as I know no one has made the further connection to insolvency process design.

bankruptcy or any alternative process to provide *any* collective insolvency remedy. I do not believe, as Douglas Baird and Robert Rasmussen apparently do, that important creditor-collection conflicts rarely arise in our modern economy.[62] (Baird and Rasmussen note that firms like Enron, for example, would disappear in an orderly fashion even outside of bankruptcy. But in other recent large bankruptcies, a potential grab race was evident as debtors apparently feared that creditors or lessors would take planes off runways, in Swissair's case, or evict a retailer from its storefronts, in Kmart's case.) Rather my contention is that creditor-collection conflicts can be a solution rather than a problem.

III. FIRST PRINCIPLES OF FINANCIAL DISTRESS

The principles that narrow the usefulness of bankruptcy as a process do not limit the importance of insolvency as a concept. Bankruptcy law need do no more than resolve conflicts among mutually insupportable claims. Contract can provide obligations that address insolvency as a contingency and thus that do not conflict. Nevertheless, contractual resolution might rationally permit conflict that investors could, even from an ex ante perspective, happily leave to a creditor grab race. These are the propositions I hope to have supported thus far (albeit briefly).

There is, however, an important set of issues that I have not addressed. These require one to consider bad-state outcomes and how the allocation of loss from such outcomes affects incentives of investors and their agents. The questions raised are commonly referred to as

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Douglas Diamond has lamented a lack of integration of corporate insolvency theories. *See* Diamond, *supra* note 34, at 11-13. As I have, Diamond discusses the role of ex ante structure in continuation decisions, but Diamond's focus is on whether bank debt or public debt maximizes firm value given the presumably higher cost of, and better continuation decision provided by, the former. There are, in addition, numerous articles that discuss variations in initial capital structure with variations in insolvency costs, including costs from an inefficient continuation decision. *See, e.g.*, Michael J. Alderson & Brian L. Betker, *Liquidation Costs and Capital Structure*, 39 J. FIN. ECON. 45, 47-49 (1995) (collecting and discussing earlier work); D. Bruce Johnsen, *The Quasi-Rent Structure of Corporate Enterprise: A Transaction Cost Theory*, 44 EMORY L.J. 1277, 1354-56 (1995); Oliver E. Williamson, *Corporate Finance and Corporate Governance*, 43 J. FIN. 567, 576-82 (1988) (describing theories of debt and equity). Michael Jensen has suggested that firms adjust their capital structures to reduce the costs of postinsolvency workouts, although he takes as given the rule that would govern absent postinsolvency agreement among creditors. *See* Michael C. Jensen, *Active Investors, LBOs, and the Privatization of Bankruptcy*, 2 J. APPLIED CORP. FIN. 35, 41-43 (1989). My focus here is on the simultaneous ex ante decision concerning capital structure and the rule that would govern absent postinsolvency agreement among investors.

62. Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. (forthcoming 2003) (manuscript on file with author).

bankruptcy questions because they stem from bankruptcy law as it exists as opposed to what it could be in an idealized world where agreement could greatly limit the opportunity for incompatible obligations that are the essential core of bankruptcy. The reason not to tag these questions of incentive with the "bankruptcy" label in the taxonomy I adopt here is that exclusion from such characterization focuses attention on the more universal importance of the questions, which must be answered regardless of whether the allocation of loss is provided by the traditional bankruptcy process or by some contractual alternative that may avoid even the possibility of incompatible obligations. Labels aside, my goal is to isolate incentive questions from process questions so that one may analyze each independently. As I have attempted to show in prior work,[63] an efficient insolvency process, whatever that may be in context, can be adapted to include whatever incentives are desirable.

A vast literature has been devoted to the analysis of ex ante incentives from anticipation of bad-state outcomes. It is not possible in this short Article comprehensively even to survey that literature. Instead, I will identify two areas that either have received much attention or, in my view, should, and I will provide a brief glimpse into the relevant issues. The areas I will discuss are absolute priority, a topic that has attracted great attention, but could afford to be refocused, and the timing of financial distress, a topic that, in my view, deserves more attention than it has received. There is, moreover, a connection between the two topics, as accelerated resolution of financial distress can obviate the need, if any, for payments to holders of junior claims or interests where senior claims are not fully satisfied. Other issues for corporate debtors as well as the treatment of individual debtors, no less fundamental, are left for a broader work.[64]

A. Absolute Priority

There is general agreement that the bankruptcy reorganization process in the United States does not strictly honor absolute priority. Deviations are not always large,[65] but the direct and indirect costs of the reorganization contest over even small amounts can be signifi-

63. *See* Adler, *supra* note 41, at 1109-11.

64. For a description of another issue that confronts a corporate debtor, see, e.g., Barry E. Adler, *An Equity Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993) (arguing that firms might issue general rather than secured debt to reduce the agency costs of the relationship between shareholders and managers). For some ideas on consumer bankruptcy, see, e.g., Adler, Polak & Schwartz, *supra* note 23.

65. *See, e.g.*, Weiss, *supra* note 35, at 294-95 (describing payments to equity where creditors are not paid in full).

cant.[66] In particular, the prospect of even a small absolute priority violation may induce holders of junior claims and interests to push for an inefficient reorganization of an inviable debtor because distributions in reorganizations tend to take the form of new claims or interests, which a judge may mistakenly value in favor of the juniors, while distributions in liquidations tend to be in cash, the value of which cannot be mistaken.[67] Holders of junior and senior claims or interests could, absent transaction costs, settle on an efficient resolution of the debtor's affairs—whether that is continuation or liquidation—whatever the potential or actual judicial resolution. But negotiation difficulty and the prospect of breakdown that may have led the debtor to bankruptcy in the first place can plague settlement after the reorganization and thus favor the judicial outcome of the bankruptcy process. As noted above, moreover, deviations in absolute priority—including those that result from ex post renegotiation—upset initial bargains and thus potentially undermine efficient allocations such as early-investor priority. The result would be an increase in a debtor's ex ante cost of capital. Consequently, many of the bankruptcy reform proposals discussed in the prior part of this Article were devoted to protection of absolute priority.

Although no one argues that bankruptcy law should abandon contractual priority altogether, not everyone is sanguine about the advisability of strict adherence. A substantial contingent of bankruptcy scholars, and many bankruptcy judges, favor liberal reorganization even though they might concede that many debtors could not be reorganized at all were absolute priority inflexibly enforced. These scholars and jurists would argue that reorganizations are socially desirable, even if liquidation would yield a higher return to investors, because reorganization means, at least for a time, continued employment and community preservation. Others would contend, however, that anticipated violations of absolute priority for the protection of inviable firms would lead to an increased ex ante cost of capital, ultimately to the aggregate detriment, not benefit, of employees and their communities.[68] This debate is, in essence, one over the large question of whether markets are agents of social welfare and is therefore not easily settled.

Another argument against strict absolute priority comes from Lucian Bebchuk and Jesse Fried, who suggest that a reduction of pri-

66. *Id.* at 288-90.

67. I have made this point elsewhere. *See* Barry E. Adler, A Simple Game-Theoretic Solution to the Tension Between Cramdown and Holdup in Corporate Reorganization (Feb. 2002) (unpublished manuscript, on file with author).

68. For a further discussion of this debate, see Schwartz, *supra* note 9.

ority for secured claims may be socially desirable because, in their view, secured credit allows debtors to impose risk ex post on "nonadjusting" general creditors, those who cannot react to the priority scheme that subordinates them.[69] The result, according to Bebchuk and Fried, is not that secured credit cheats nonadjusting creditors, at least other than tort victims. Rather, Bebchuk and Fried recognize that any consensual creditor, even one who cannot adjust all its loan terms to a debtor's capital structure, can anticipate subordination and set the price of its loan accordingly. Bebchuk and Fried are concerned, nonetheless, that full priority for secured credit may yield inefficient debtor incentives, as debtors would tend to issue excessive secured debt in order fully to exploit nonadjusting creditors ex post, a tendency that can lead to too much secured credit (which, they explain, is plausibly more costly than unsecured credit in some circumstances). Such excess is inefficient even if consensual nonadjusting creditors anticipate, and charge for, such excess ex ante.[70]

The argument that tort claims should have first priority is presented in Part I of this Article. As I have argued before, however, there is reason to doubt whether any consensual creditor, even a small one, can meaningfully be described as nonadjusting, as it does not take much, for example, to take and perfect one's own security interest and thus avoid even the prospect of subordination.[71] Moreover, the law could (but does not) permit a debtor to bind itself, with entry in a public record, against excessive encumbrance of its assets. Any creditor could then safely deal with such a debtor on terms favorable to the debtor without fear that the creditor's interest later would be trumped. The debtor's negative pledge, then, could be a substitute for excess secured credit.[72] Still, even the use of, or reference to, a mechanical filing system may be beyond the ken of some casual creditors, even significant ones, and the matter is thus not simple.

In any case, the argument against full priority for secured claims is only formally an argument against absolute priority. The benefits of absolute priority are benefits of *contractual* priority. If, as Bebchuk and Fried contend, debtors and nonadjusting creditors can-

69. *See* Lucian A. Bebchuk & Jesse Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 864 (1996).

70. *Id.*

71. *See* Barry E. Adler, *Secured Credit Contracts*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 409 (Peter Newman ed., 1998).

72. *Id.* For an extended version of the debate on this topic, including a discussion of the potential costs of excess secured credit, compare Lucian A. Bebchuk & Jesse Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279, 1304-08 (1997), with Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL L. REV. 1396, 1415-17 (1997).

not freely contract for ideal terms, then the principle that supports absolute priority as a social good is inapplicable.

The role of secured credit aside, there is a more fundamental set of theories that is often mislabeled as an argument against absolute priority (though not necessarily by the theorists themselves). These theories advance the role of contractual concessions to holders of junior interests rather than deviations from contractual priority (and are thus mislabeled). In what he describes as "Contracting About Bankruptcy," Alan Schwartz has argued that it may be in the interest of some firms, though not all, to share even insolvency returns with a debtor's equity interest (shareholders and managers).[73] The idea is to give equity, which is presumed to have private information, an incentive to dispose of the debtor's assets efficiently. That is, with a share of even the insolvent debtor, equityholders will have an incentive to make the correct decision on a matter of primary importance for a financially distressed firm, whether to continue or liquidate. Ideally, this share, or "bribe," would be set so that the owners' stake in the monetary returns from the bankruptcy process would be just large enough for the owners to benefit more from liquidation than continuation where liquidation proved optimal, this despite the higher private benefits the owners would garner from reorganization. With this preordained bribe in place, the owners could not credibly threaten to continue a debtor when liquidation would be the better course because continuation would cost the owners the bribe and the owners would thus suffer with the creditors from inefficient continuation. The contract would thus be "renegotiation proof."

Schwartz did not write on a blank slate. Others have advocated similar sharing proposals. Thomas Jackson and Robert Scott, for example, have argued that deviations from absolute priority serve to reduce an insolvent debtor's incentive to gamble with assets that would otherwise go to creditors in bankruptcy.[74] Even so, Schwartz's characterization of sharing as a contractual choice, rather than as a deviation from contract, is an advance as he recognizes that not all debtors would opt for sharing. On the one hand, Schwartz recognizes that equity may unduly favor continuation not merely because of the inherent gamble but because of the private benefits they earn from continuation itself. On the other hand, Schwartz observes that the bribe can, for some firms, be unduly costly from an ex ante perspective, as an-

73. *See* Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1827-30 (1998) (drawing its central model from Alan Schwartz, *Contracting About Bankruptcy*, 13 J.L. ECON. & ORG. 127, 130 (1997)).

74. *See, e.g.*, 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 (1989).

ticipation of the bribe, out of the creditors' share, can unnecessarily increase the debtor's cost of capital. If, for example, ex post renegotiations would cost little, and if creditors expected to capture almost the entire share of surplus from such renegotiation, the debtor could achieve the lowest possible interest rate on a loan without the bribe in place. Absent the bribe, the owners could threaten inefficiently to continue, but the parties would, by hypothesis, negotiate easily to an efficient liquidation, the benefit of which would redound to the creditors, and ultimately to the debtor's original owners.

There is, in Schwartz's work, therefore, a proper ex ante perspective. But he does not tell a complete story (or claim that he does). Schwartz notes, correctly, that an unnecessary bribe to equity would raise the debtor's ex ante cost of capital, but he treats the event of insolvency as exogenous to the insolvency distribution rule. As noted above, much of my own work has been devoted to exploring the *endogeneity* of insolvency and the process through which insolvency is addressed. There is a similar endogeneity between insolvency and the distribution rule. In particular, I have in prior work observed that although a bankruptcy distribution to an insolvent debtor's owners may reduce the insolvent debtor's incentives to take risks, such as continuation itself, anticipation of such a distribution may have the perverse and opposite effect of increasing the owners' incentives to take risks when the debtor is on the verge of insolvency.[75] Others have noted that anticipation of a payoff for an insolvent debtor's owners leaves the owners with less incentive to avoid insolvency, and the owners might thus expend less effort toward that end.[76] So Schwartz's objective to minimize the owners' take consistent with an efficient continuation decision ex post is only part of an ideal optimization strategy. A general account of capital cost requires consideration not only of how insolvent firms deploy assets but also of how solvent firms deploy assets, perhaps on their way to insolvency.

B. Accelerated Resolution of Financial Distress

There is general agreement that, at least in the United States, bankruptcy comes too late rather than too early in the life of a finan-

75. *See* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 473-75 (1992); *see also* Lucian A. Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 J. FIN. 445 (2002).

76. *See, e.g.*, Paul Povel, *Optimal Soft or Tough Bankruptcy Procedures*, 15 J.L. ECON. & ORG. 659 (1999). Povel's conclusions are analogous to the well-known Jensen and Meckling result that outside equity finance reduces managerial incentive as compared with outside debt finance. *See* Jensen & Meckling, *supra* note 33, at 344-51. Sharing makes debt more like equity.

cially distressed firm. Often, by the time a debtor has come under the influence of bankruptcy's collective process much value has already been wasted. For the most part, this fact has been treated as inevitable, like the weather. Unlike the weather, however, late resolution of financial distress could be managed, if not entirely controlled, if the law were favorable.

When a debtor becomes insolvent, its managers may have an excessive incentive to gamble with the firm's assets for reasons now well rehearsed in this Article. As noted above, ex ante sharing contracts with equity can mitigate such perverse incentives, but, as also noted, there are costs to such contracts. Thus, managers may have both the incentive and the discretion to exhaust a debtor's last available dollar before bankruptcy's day of reckoning is at hand. The fact that managers cannot exhaust *more* than the last dollar available, however, presents an underappreciated control opportunity, an opportunity based on an underappreciated provision of current bankruptcy law.

In many instances, a firm can recapture transfers, called voidable preferences, made to creditors within ninety days of the firm's bankruptcy.[77] In *Logic and Limits*, Thomas Jackson explains that preference law "is essentially a transitional rule designed to prevent individual creditors from opting out of [bankruptcy's] collective proceeding once that event becomes likely. It is part of the attempt to ameliorate the effects of a common pool problem that justifies a collective proceeding in the first place."[78]

On close analysis, however, it is not clear that preference law serves the purpose given in this standard justification, which assumes that assets are static. There are few direct or indirect disincentives for creditor collection, and there is thus little reason to believe that preference rules have any significant effect on such activity. As I have argued in prior work, it may be that preference law serves a valuable purpose in its capacity to *diminish* rather than protect a troubled firm's assets.[79] Inasmuch as many firms in financial distress, perhaps most, are most valuable if liquidated, such diminution may serve investors' collective interest.

The story is basically a simple one. Gambles on the eve of bankruptcy may be profitable for managers or equity but not for investors collectively. For an insolvent firm, continuation itself may be of

77. *See* 11 U.S.C. § 547(c) (2000).

78. JACKSON, *supra* note 5, at 125.

79. *See* Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575, 576 (1995).

negative net present value and presumably would, therefore, constitute an investment that equity and creditors as a group would not have agreed to sanction ex ante were it possible to contract for all contingencies. Contracting ex post does not offer an ideal solution to a debtor's risk incentive, because negotiations could consume significant resources or break down and, as discussed above, because anticipation of an ex post bribe to managers or equity could unnecessarily increase the debtor's ex ante cost of capital.

Bankruptcy's voidable preference law discourages negative-net-present-value investment by negating eve-of-bankruptcy pledges of collateral for antecedent debt and by prohibiting the enforcement of promises to allow eve-of-bankruptcy collection of new loans before existing debt becomes due. Negation of these pledges and promises effectively raises a distressed firm's (ex post) cost of capital and thus discourages unduly risky investment. That is, the preference laws make it harder for insolvent debtors to finance their perhaps desperate projects. Bankruptcy thus becomes an attractive, or the only, alternative for managers sooner than would otherwise be the case. This analysis uniquely demonstrates a solution to the puzzle of why preference law should void a creditor's eve-of-bankruptcy improvement of priority, which cannot result in dismemberment. Thus, as compared to the static asset approach, this dynamic view offers a richer explanation of voidable preference law.[80]

There is, moreover, an opportunity for preference rules to do more. Managers of financially distressed firms may urgently seek new capital from new sources to keep equity's options alive. An event that may precipitate such a crisis is a demand for payment by an existing creditor. Current preference law does not prevent, or even discourage, an insolvent debtor from replacing matured low-interest obligations with new high-interest, secured, or relatively short-maturity obligations all at the expense of other, unmatured obligations. This is so because current preference law does not apply to a new or old lender whose new loan delays the debtor's bankruptcy and who then collects on a secured loan at any time prior to bankruptcy, or on an unsecured loan before any preference period begins, or waits out any bankruptcy process for ultimate collection on favorable terms. In response to this

80. This dynamic approach to preference law demonstrates a mechanism through which preference law can hasten financial distress and thus substantiates the observation, made by George Triantis and Ron Daniels, that preference law accelerates the date on which creditors scrutinize the debtor. *See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1093 (1995).

problem, as I have discussed in prior work,[81] Congress could amend the preference rules, or if the law permitted, parties could contractually adopt their own. The applicable rules could provide that a new loan to an insolvent (or otherwise specified financially distressed) firm would be unenforceable to the extent the new loan contained better terms for the lender than those of the old loans the debtor subsequently repaid. To assure that the debtor could not avoid this limitation by offering a lender not a new high-interest or secured loan but a new safe unsecured loan at the expense of other general creditors with loans of long maturities, the law, or contract, could disallow any collection on the new loan prior to the longest maturity of any loan outstanding at the time of the new loan. If a lender were forced by a low interest rate or long maturity on a general obligation to internalize the true risk of the debtor's failure, the lender would balk at a request for a new loan and force the debtor into a collective process.

As noted above, bankruptcy is a less-than-ideal collective process. Alternatives such as Chameleon Equity, described in Part II of this Article, may provide a superior resolution to financial distress. The prospect of such alternatives enhances the value of preference rules as an accelerator of financial distress. If financial distress is accelerated, a debtor's managers may have limited opportunity to misinvest assets prior to a default that triggers a collective process. If that collective process itself restores incentives for proper investment, there is a reduced risk of misinvestment after the onset of crisis. The overall effect could be a more or less continuously proper set of investment incentives and a consequently lower ex ante cost of capital than could be obtained through other methods of incentive optimization such as deviations from absolute priority (or, more precisely, from payments to holders of junior claims or interests even where senior claims are not fully satisfied).

These illustrations of how preference rules can affect investment incentives identify the proper perspective of rules that will govern in the event of financial distress. That perspective must permit examination of a debtor's incentives not only before financial distress, but before investment itself.

CONCLUSION

Bankruptcy law, broadly defined, is fundamental to private ordering, but its essence is much simpler than commonly understood.

81. *See* Barry E. Adler, *Accelerated Resolution of Financial Distress*, 76 WASH. U. L.Q. 1169, 1197 (1998).

Bankruptcy must resolve inconsistent obligations and may serve other functions, such as provision of a fresh start to individuals, but bankruptcy need not provide a collective-action process. The rest of what traditionally goes under the rubric of bankruptcy, including the creation of appropriate investment incentives in the shadow of a bad-state outcome, *is* essential, but is not essentially a bankruptcy function, either in the fundamental or process sense.

Separated into its constituent parts, bankruptcy law becomes easier to see as broadly important—like property, contract, and tort law—and becomes more manageable, no longer an amorphous, indecipherable law of last resort. The proper perspective on a topic does not imply that policymakers will reach good decisions or even agree on an objective, but clear air at least brings potentially desirable objectives into view.