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An Evolutionary Theory of Corporate Law and Corporate Bankruptcy

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An Evolutionary Theory of Corporate Law and Corporate Bankruptcy

David A. Skeel, Jr.

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In this Article, Professor Skeel argues that the important recent literature exploring historical and political influences on American corporate law has neglected a crucial component of corporate governance: corporate bankruptcy. Only by appreciating the complementary relationship between corporate law and corporate bankruptcy can we understand how corporate governance operates in any given nation.

To show this, the Article contrasts American corporate governance with that of Japan and Germany. America's market-driven corporate governanee can only funetion effectively if the bankruptcy framework incudes a manager-driven reorganization option. The relational shareholding that characterizes Japanese and German corporate governance, by contrast, requires a much harsher bankruptcy regime. Drawing on recent insights in corporate finance, the Article contends that a permanent change in the corporate governance approach (such as the increase in relational governance in the United States that some commentators have advocated) would lead to a corresponding change in corporate bankruptcy, and vice versa.

In order to understand why American corporate governance differs so dramatically from that of Japan and Germany, the Article explores the evolution of corporate governance in the three countries in historical and political terms. Based on an analysis of interest group activity, as well as structural and ideological factors, the Article predicts that corporate governance patterns will remain surprisingly stable in each of the three countries, despite the increasing internationalization of markets.

An Evolutionary Theory of Corporate Law and Corporate Bankruptcy

David A. Skeel, Jr.[*]

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I. INTRODUCTION

The current decade has witnessed the rise in corporate law scholarship of a new, political account of corporate law. Like most existing corporate law scholarship, the new account focuses on the characteristic dilemma in American corporate governance: the fact that shareholders of publicly held firms are often too widely dispersed to effectively monitor the firm's managers. This separation of ownership and control, which was most famously documented by Adolph Berle and Gardiner Means in the early 1930s,[1] has long been attributed to economic necessity. In the traditional account, firms' need for enormous amounts of new capital at the end of the nineteenth century required them to attract the savings of vast numbers of investors, who necessarily delegated control to a professional class of managers.

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1. *See* ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

The great contribution of the new wave in corporate law scholarship has been to demonstrate that the characteristic pattern we see in U.S. corporations stems as much from political factors as from economic necessity. By carefully exploring the historical development of American corporate law, Mark Roe and others have shown that legislative restrictions on banks and other financial institutions have played an important role in fragmenting the ownership of American firms.[2] In their comparative mode, these scholars have pointed out that large shareholders actively monitor the managers of Japanese and German firms, underscoring the possibility that things might have developed differently in the United States.[3]

This new scholarship has already offered enormous insights into American corporate governance, yet it has almost completely neglected a critical component of corporate law: the role of corporate bankruptcy.[4] Only by considering the relationship between corporate law and corporate bankruptcy can we fully understand how corporate law functions in the United States, and why American corporate law differs so dramatically from its counterparts in Japan, Germany, and other nations.

Based on this insight, this Article attempts to develop a more complete explanation of the mechanisms of corporate law than the existing literature offers.[5] The analysis will operate, in a sense, at two different levels. At an abstract level, the Article will develop a general theory of corporate law, which takes into account both corporate governance—broadly construed to include political as well as legal factors, and the way managers and other constituencies respond to them[6]—and corporate bankruptcy. In particular, it will argue that

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2. Roe, who has been the most prominent exponent of the political account, recently published an influential book based on a series of earlier articles. *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS (1994) [hereinafter ROE, STRONG MANAGERS].

3. The occasion for much of this analysis has been the increasing concentration of American stock in the hands of institutional investors, and the question whether institutional investor activism will alter the traditional pattern of strong managers and passive shareholders. For further discussion and citations to the literature, see *infra* notes 247-53 and accompanying text.

4. The neglect is especially puzzling with Mark Roe, given that he wrote several important articles on bankruptcy issues earlier in his career. *See, e.g.*, Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983).

5. For earlier works by the Author emphasizing the importance to corporate law of corporate bankruptcy, see David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992) [hereinafter Skeel, *Nature*]; David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994) [hereinafter Skeel, *Rethinking*].

6. This Article will focus on the institutional environment as a whole, or what Lance Davis and Douglass North have characterized as "the set of fundamental political, social and

corporate governance and corporate bankruptcy complement one another, such that changes in firms' characteristic approach to corporate governance in any given country will provoke changes in corporate bankruptcy, and vice versa.[7]

To show this, the Article will focus on corporate governance patterns in the United States, on the one hand, and in Japan and Germany on the other, which stand at opposite ends of the corporate governance spectrum.[8] In the United States, corporate governance is characterized by relatively passive shareholders,[9] well-developed managerial labor markets, and market correctives such as hostile takeovers, combined with a bankruptcy framework that permits the managers of distressed firms to attempt a reorganization. I refer to this approach as an *"ex post"* system, due to the after-the-fact nature of the correctives. In Japan and Germany, by contrast, large shareholders such as banks, rather than hostile takeovers, typify corporate governance, managerial labor markets are comparatively thin, and managers are immediately displaced if a firm files for bankruptcy. I refer to this approach as an *"ex ante"* system.[10]

The argument that corporate law and bankruptcy are complementary suggests that if U.S. governance combined active takeover markets with a bankruptcy law that, as in Japan and Germany,

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legal ground rules that establishes the basis for production, exchange and distribution." LANCE E. DAVIS & DOUGLASS C. NORTH, INSTITUTIONAL CHANGE AND ECONOMIC GROWTH 6 (1971).

The Article will sometimes use "corporate law" as a synonym for corporate governance—that is, to connote not just the background laws, but also the governance patterns the parties adopt. Also, although I distinguish throughout the Article between corporate governance (or corporate law) and corporate bankruptcy for expositional purposes, the larger point is, of course, that corporate bankruptcy is a component of corporate governance.

7. As discussed in much more detail in Part II.C, I borrow the concept of complementarity from important recent work in the corporate finance literature. *See, e.g.*, Paul Milgrom & John Roberts, *Complementarities and Fit: Strategy, Structure and Organizational Change in Manufacturing*, 19 J. ACCT. & ECON. 179 (1995).

8. Although I focus on the United States, Japan, and Germany both because of my own familiarity with American corporate law and because Japan and Germany offer a vivid contrast, the analysis is intended to be general in application. I elaborate on this, and offer brief comments on Canada, France, and Great Britain in the conclusion to the Article.

9. I say "relatively" because institutional shareholders have taken a more active stance in recent years.

10. The terms *"ex post"* and *"ex ante"* roughly parallel what some commentators have characterized as "market-centered" and "bank-centered" systems. *See, e.g.*, Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 328 (1996). For evidence that other aspects of Japanese regulation also have an *ex ante* focus as compared to the U.S., see Hideki Kanda, *Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan*, 12 U. PA. J. INT'L BUS. L. 569, 584-85 (1991) (*ex ante* emphasis of Japanese administrative law).

My use of the term "system" is meant to be metaphorical only. I do not attribute intentional qualities to the systems, as some recent scholars have done in other contexts. *See, e.g.*, Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 3 (1996) (discussing the liability "system").

immediately displaced managers, the managers of healthy firms would have an incentive to encourage investors to acquire large, stable stakes in American firms, and investors could expect profits from assembling such stakes. Similarly, if Japanese and German firms shifted toward American shareholding patterns, we could expect to see an analogous shift in their bankruptcy regimes.

As this description suggests, my theory does not assert that lawmakers will necessarily alter the *legal* frameworks of corporate law and corporate bankruptcy at the same time and in complementary fashion. Instead, it suggests that firms' overall approach to corporate law, including both the regulatory background and managers' and investors' responses to it, is integrally related to the nature of the corresponding bankruptcy regime.

One way to test this framework will be to see if its predictions hold true in the future—that is, if changes in a nation's corporate governance are accompanied by changes in corporate bankruptcy and vice versa. The best way to shed light on *why* American corporate goveruance looks so different from the approaches in Japan and Germany, however, and to make predictions about *whether* we can expect to see substantial change, is to explore the historical antecedents of the patterns we see now. Once the general theory has been developed, the Article moves to this second, more particularized level of analysis.

The Article focuses in most detail on the institutional factors—interest group activity, structural constraints, and ideology—that have helped to produce the characteristic pattern of U.S. corporate governance: the Berle-Means corporation in corporate governance and manager-driven, negotiated reorganization in bankruptcy. On the corporate law side, much of this story has been told in the important recent work described at the outset of the Article. What has not been explained is how corporate reorganization emerged in this country, and how its emergence relates to the development of corporate law.

As with the Berle-Means corporation, it was not at all inevitable that U.S. law would evolve toward a manager-driven, reorganization-based bankruptcy regime. Until the railroad failures of the nineteenth century, financial distress routinely meant liquidation. Reorganization might never have developed if institutional factors had not prevented Congressional intervention. Railroad failures prompted the creation of a judicial reorganization technique known as equity receivership, which only later gave way to legislative regulation of corporate reorganization. Legislative regulation occurred in

two very different steps during the New Deal and took its current form as a result of a series of events beginning in the 1950s.[11]

In each of these accounts, the story is one of adaptive evolution. Changes in the relevant legal regimes have been central, but managers' and investors' responses to these changes prove equally salient.[12] From the interplay between the parties and the institutional context in which they operate, we see the characteristic patterns of *ex ante* (in Japan and Germany) and *ex post* (in the United States) governance develop.

After describing the emergence of *ex post* governance in the U.S., the Article offers a more concise account of the developments responsible for the very different *ex ante* approaches that characterize Japanese and German corporate governance. The discussion suggests that historical and political influences have played similarly important roles in both Japan and Germany.

The historical analysis leads to several additional issues. One is the question of whether the American *ex post* approach and the *ex ante* systems in Japan and Germany are likely to be stable; or whether we can expect them to converge over time. Although some commentators predict that the continued expansion of international markets will blur the existing distinctions in corporate governance, this Article's analysis of various institutional factors suggests that the respective systems will remain surprisingly stable.

This is not to say that one of the two systems is now and will continue to be superior to the other. Both approaches appear generally to be efficient and to have characteristic biases. For instance, *ex ante* governance eliminates the costs of a manager-driven, *ex post* reorganization process and may enhance the information exchange between managers and shareholders, but it can also chill managerial risk-taking and adaptation to changing technologies. *Ex post* governance encourages risk-taking, but may also lead to excessive risk and related problems, such as inadequate investment by

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11. Interestingly, and in contrast to the political history of corporate governance, the single most important interest group in American bankruptcy law has been lawyers. Throughout the equity receivership period, reorganization practice was centered on a small, elite segment of the Wall Street bar. One of the most dramatic effects of the New Deal bankruptcy reforms was te transform the nature of bankruptcy practice in ways that continue to resonate.

12. This Article's emphasis on managers' and investors' response te an existing legal regime illustrates an important distinction between evolutionary theory in biology and in law. Legal evolution is less "random," since human actors can consciously reflect on the institutional environment to which they are responding. *See generally* E. Donald Elliott, *The Evolutionary Tradition in Jurisprudence*, 85 COLUM. L. REV. 38 (1985). *See also* Larry E. Ribstein, Politics, Adaptation and Change in Corporate Law 4-6 (1998) (unpublished draft, on file with author). As will become clear, intentionality plays a crucial role in the evolutionary theory of this Article.

employees in firm-specific human capital. This Article argues that the two approaches (and variations between these poles) are best seen not as efficient or inefficient, but as alternative mechanisms for enhancing going-concern value.[13]

This Article's conclnsions as to the stability and respective merits of the two systems have important implications for the recent calls for U.S. lawmakers to emulate Japanese and German-style governance, and for Japan and Germany to adopt aspects of the American system. Most obviously, adjustments to one element of corporate governance—such as inducements for relational shareholding in U.S. firms or the adoption of U.S.-style corporate reorganization in Germany—are unlikely to take hold absent corresponding changes to the remainder of the system. Therefore the efforts in recent years by teams of lawyers and academics to export aspects of American corporate or bankruptcy law are unlikely to be successful. On the other hand, cross-fertilization of this sort has on occasion produced fruitful results, and failed efforts are often more ineffectual than harmful.

The Article proceeds as follows: Part II describes the political account of American corporate governance and the very different governance patterns in Japan and Germany, and develops my theory as to the complementarity of corporate law and corporate bankruptcy; Parts III and IV provide a historical analysis of how *ex post* governance emerged in the United States, whereas firms in Japan and Germany gravitated toward *ex ante* governance—focusing in particular on the development of an *ex post* bankruptcy regime in the United States; and Part V considers the stability of the respective systems and the question of whether one or the other is superior.

II. THE CORPORATE LAW/BANKRUPTCY SYSTEM

The standard economic account of American corporate law characterizes the publicly held corporation as a nexus of contracts.[14] This account has encouraged theorists to focus less on the corporate

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13. This is a good place to noto an important caveat. It remains unclear how large an effect any given corporato governance framework has on economic performance. Technological changes and external shocks almost certainly play a greater role. Thus, the efficiency effects of a nation's corporato governance approach will often be on the margin.

14. The nexus of contracts perspective dates back to Ronald Coase's seminal work, Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937), but it did not become widely influential until the more recent work of Eugene Fama and others. *See, e.g.*, Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

entity as an "entity," and more on the wide array of contractual relationships into which the firm enters. While much of corporate law theory examines the relationship between the managers of the firm and its shareholders, contracts with other suppliers of capital, employees, and consumers also play an important role.

In contrast to the earlier literature, which tended to view these contracts solely in economic terms, recent scholars have begun to pay close attention to historical, political, cultural, and regulatory influences on corporate contracting.[15] What has emerged is a far more nuanced explanation of corporate governance, one that has already paid enormous dividends. Rather surprisingly, however, this literature regularly ignores corporate bankruptcy. In this Part, I argue that, by adding bankruptcy to the analysis, we can develop a more complete theoretical account of corporate governance than currently exists.

The analysis proceeds in two steps. The first step describes recent developments in our understanding of corporate governance. The second step adds bankruptcy to the analysis in order to develop a more complete theory of the evolution of corporate law—a theory that casts new light on the differences between American corporate governance and the frameworks in place in Germany and Japan.

A. The Political Account of Corporate Governance

As economic theorists have explored the nexus of contracts that comprise a corporation, they have returned again and again to a single issue: the role of agency costs.[16] Simply put, agency costs are the costs that arise due to conflicts of interest between a principal and her agent. If the managers (the agents of shareholders and the corporation) pursue their own interests—such as leisure or perks, or their own prestige—rather than the interests of shareholders (the principal), shareholders suffer the consequences. Much of corporate

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15. The most recent work in this vein has asked whether the evolution of corporate law is "path dependant" and thus potentially inefficient. *See, e.g.*, Gilson, *supra* note 10, at 329; Michael Klausner, *Corporations, Corporate Law and Networks of Contracts*, 81 VA. L. REV. 757, 815-25 (1995); Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 641 (1996).

16. Jensen and Meckling popularized the term "agency costs" in an article whose importance is difficult to overstate. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Jensen and Meckling defined the total agency costs arising from a principal-agent relationship as the sum of "(1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, (3) the residual loss." *Id.* at 308.

law and of the parties' own contractual arrangements can be seen as efforts to minimize these agency costs.

The principal focus throughout the Article will be on the conflicts of interest between the managers and the shareholders of a corporation—that is, managerial agency costs. However, there are two additional kinds of perverse incentives that will also come into play. The first stems from shareholders' incentives. If a firm's capital structure includes debt, shareholders may encourage the firm's managers to pursue excessively risky strategies, due to the fact that shareholders will receive all of the benefits of a successful gamble but will share the costs of a failure with the firm's debtholders.[17]

Second, to the extent creditors influence corporate governance, they too may have perverse incentives. Just as shareholders have an incentive to encourage too much risk, debtholders prefer that the firm take too little risk—that is, that it eschew even some risks where the benefits exceed the costs.[18]

The standard history of corporate law centers on managerial agency costs. In the early 1930s, Berle and Means inaugurated modern corporate law scholarship by showing that the rise of the publicly held corporation in America had produced a deep separation

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17. In the corporate finance literature, perverse incentives of this sort are referred to as an "overinvestment" problem. *See generally* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977) (discussing perverse incentives).

Consider a simple example. Suppose that Firm's current assets are worth $100; it owes $80 to Creditor; and Shareholder's steck is worth $20. Firm must decide whether to spend its $100 of assets on a business opportunity with a 10 percent chance of success. If the opportunity is successful, Firm will be worth $800, but if it fails, Firm's value will drop te $10. A moment's reflection makes clear that Firm should forgo the opportunity. The opportunity has an expected value of ($800)(.10) + ($10)(.90) = $80.90. Since it would cost $100, Firm should not pursue it. Shareholder will see the opportunity quite differently however. Although tbe opportunity reduces the value of Crediter's interest, it increases the value of Sbareholder's interest from $20 to $72. (The expected value of Shareholder's interest if the opportunity succeeds is ($800 - $80)(.10) = $72, and the expected value in the event of failure is $0 (with the $10 firm value going te Creditor)). Shareholder therefore will encourage Firm's managers to pursue the opportunity.

In addition to the overinvestment problem, shareholder decision making may be subject to an "underinvestment" or "debt overhang" problem if the firm becomes insolvent. The problem is that shareholders may forgo even positive present-value opportunities if their interest would remain underwater even in the event of a successful outcome. *See id.* at 149-54.

18. As in the example given in the previous footnoto, assume that Firm owes Creditor $80 and its assets currently are worth $100. This time, however, assume that Firm must decide whetber to spend the $100 to pursue an opportunity with 50 percent probability of success, and whose values are $200 if successful and $50 if unsuccessful. Because the overall value of the opportunity is $125, Firm should pursue it. If Creditor were making tbe decision, however (and Shareholder could not offer a side payment te Creditor), Creditor would eschew the opportunity, since it diminishes the value of Firm's obligations to Creditor from $80 te $65. (This is because there is a 50 percent cbance Creditor will be paid the full $80—if the prospect is successful—and a 50 percent cbance of receiving only $50; thus, ($80)(.50) + ($50)(.50) = $65.)

between ownership and control.[19] Although shareholders theoretically owned the corporations, shareholdings in large corporations were so widely scattered that shareholders exerted little influence. Because of shareholders' inability to coordinate—which now would be described as a "collective action problem"—managers had free rein to run the corporations however they saw fit.[20]

Subsequent commentators have assumed that the Berle-Means corporation is economically inevitable. They reason that shareholdings will become increasingly dispersed as corporations grow in size because shareholders wish to limit their holdings in any given firm in order to diversify their interests.

Certainly the most intriguing development in recent corporate law scholarship is the suggestion that the Berle-Means corporation, with its separation of ownership and control, may owe its existence as much to politics and history as to economics. Mark Roe and others have argued that the peculiarities of American regulation of financial intermediaries played a pivotal role in the emergence and survival of the Berle-Means corporation.[21]

1. Politics, Finance, and the Berle-Means Corporation

The political account begins by considering how American corporate governance could plausibly have developed away from the Berle-Means model of powerful managers and passive shareholders. As capital demands intensified and firms grew in size, financial institutions and other intermediaries could have acquired large blocks of stock and played an active role in corporate governance. Some institutions did in fact take precisely these steps in the 1920s. DuPont held twenty-five percent of General Motors' stock, and J.P. Morgan and Company effectively controlled several railroads and other corporations.[22]

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19. *See* BERLE & MEANS, *supra* note 1, at 129.

20. *See id.*

21. *See, e.g.*, ROE, STRONG MANAGERS, *supra* note 2; Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); John Pound, *Proxy Voting and the SEC*, 29 J. FIN. ECON. 241 (1991); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991) [hereinafter Roe, *A Political Theory*].

22. *See* Roe, *A Political Theory*, *supra* note 21, at 15; *see also* RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 224 (1990) (describing Morgan's role in restructuring General Motors).

Economists have recently begun reconsidering this era, and addressing the effect large stockholders such as Morgan had on firm value. For evidence that Morgan had a beneficial effect, see Bradford DeLong, *Did J.P. Morgan's Men Add Value? An Economist's Perspective on Financial Capitalism*, *in* INSIDE THE BUSINESS ENTERPRISE 205 (Peter Temin ed., 1991).

Yet the United States did not follow this alternative path. Legislators repeatedly have taken steps to prevent financial intermediaries from holding significant equity positions in, and exerting influence over, industrial corporations. A variety of regulatory measures have limited the size of banks and their ability to hold stock.[23] Legislators have similarly discouraged insurance companies from holding stock,[24] and mutual funds from acquiring significant blocks in individual companies.[25] Pension funds face fewer restrictions of this sort, but they too have good reason to limit their influence.[26] Far more than economics alone, this mind-numbing web of regulation has assured the preeminence of the Berle-Means model of corporate governance in America.[27]

Why have legislators worked so hard to limit the influence of financial intermediaries? Mark Roe has identified three factors as particularly important. The first is ideological commitments such as populism. Although commentators often discount the relevance of ideology to political decision making, Americans have long been suspi-

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23. The fragmentation of banks goes back to the National Bank Act of 1863 and the National Bank Act of 1864, ch. 106, 13 Stat. 99 (1864) (codified as amended at 12 U.S.C. § 38 (1994)). *See* ROE, STRONG MANAGERS, *supra* note 2, at 54. Congress has reinforced the limitations on bank size and power in this century through the McFadden Act of 1927, ch. 191, 44 Stat. 1224 (1927), which gave states the authority to limit branching within the state; the Glass-Steagall Act of 1933, ch. 89, 48 Stat. 162 (1933) (codified as amended in title 12 of the United States Code), which separated commercial and investment banking; and the Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133 (1956) (codified as amended at 12 U.S.C. §§ 1841-50), which limited bank holding companies to activities related te bankruptcy and prohibited them from holding more than five percent of the voting stock of a non-banking firm. *See* ROE, STRONG MANAGERS, *supra* note 2, at 94-99. In addition, the advent of deposit insurance in 1933 enhanced small banks' ability to compete with larger banks for deposits. *See id.* at 96.

24. The leading state for insurance law, New York, prohibited insurance companies from holding common stock after the Armstrong Investigation of 1905 created a scandal within the industry. *See* ROE, STRONG MANAGERS, *supra* note 2, at 69-70. New York eased these restrictions in 1951, but insurers have continued to limit their holdings of steck. *See id.* at 82.

25. Although mutual funds hold enormous amounts of common stcck, they are discouraged from concentrating their holdings and acting as active monitors by the Investment Company Act of 1940 and the tax laws, which penalize insufficiently diversified funds. *See id.* at 103-10.

26. Private pension fund activism is stymied to some extent by the "prudent investor" doctrine under the Employee Retirement Income Security Act of 1974 ("ERISA"), and still more by managers' control over the choice of a firm's fund manager. Public pension funds face fewer restrictions. *See id.* at 125-26.

27. Several commentators have recently questioned the political account. Tom Smith, for instance, has argued that the desire of "customers" such as insurance policy holders and mutual fund investers to minimize risk, rather than politics, explains institutional investors' reluctance to become actively involved in corporate governance. *See* Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1, 2-8 (1997). Smith's emphasis on risk aversion seems more compelling with respect to the customers of some kinds of institutional investors—indexed mutual funds and insurance companies, for instance—than others, such as non-indexed mutual funds, which are designed to be less cautious.

cious of big business and large concentrations of capital.[28] Financial institutions have frequently borne the brunt of this distrust. Periodic investigations into financial institution misbehavior have stoked the concern that financial institutions be kept in check. Three of the most prominent were the Armstrong investigation of insurance companies in 1905, and the Pujo and Pecora investigations of banks in 1911-12 and in the early 1930s, each of which fueled legislative reforms.[29]

The other two factors limiting the influence of financial intermediaries, interest group influence[30] and federalism, have tended to reinforce one another, particularly in banking regulation. The most important proponents of banking restrictions were the small banks scattered throughout the country.[31] Small banks lobbied hard for the geographical restrictions that have long limited banks' ability to branch across state lines, since fragmentation prevents megabanks from putting local banks out of business. Small banks were equally enthusiastic about deposit insurance, which diminishes depositors' incentive to keep their money in large, stable money center banks.[32]

By themselves small banks are only a single interest group, but federalizm's decentralization of power has served to magnify their influence, since each given state is likely to have a group of locally important banks. The broad-based influence of local banks—enhanced by the support of farmers and small businesses—stands in striking contrast to the geographical concentration of the money center banks that have been targeted by financial reform, and translates particularly well in our federal system.[33]

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28. *See* Roe, *A Political Theory*, *supra* note 21, at 32-36.

29. *See id.* at 36-38. In addition te providing a crucial catalyst for change, the investigations put several well-known figures on the political map. Charles Evans Hughes catapulted to prominence as a result of the Armstrong investigations, and Ferdinand Pecora was an unknown before taking over the Pecora hearings early in Franklin Roosevelt's administration.

30. Interest group theory is a branch of public choice analysis. For present purposes, its central insight is that concentrated interest groups tend to have disproportionate influence over the political process because they, unlike more diffuse groups such as general voters, participate actively in various ways. I have described interest group analysis and the public choice literature in much greater detail elsewhere. *See, e.g.*, David A. Skeel, Jr., *Public Choice and the Future of Public Choice-Influenced Legal Scholarship*, 50 VAND. L. REV. 647 (1997) [hereinafter Skeel, *Public Choice*].

31. *See* Roe, *A Political Theory*, *supra* note 21, at 45.

32. *See* ROE, STRONG MANAGERS, *supra* note 2, at 96-97. Interestingly, Morgan and other prominent banks lent their support to deposit insurance, in large part because they thought this concession would help them head off the Glass-Steagall proposal to separate commercial and investment banking. The strategy backfired when both reforms were passed.

33. *See* Roe, *A Political Theory*, *supra* note 21, at 49. The Senate, especially, facilitates the influence of federalism because every state, no matter how small, has the same number of senators.

In sum, populist ideology, the influence of small banks and farmers, and federalism have worked together to minimize the role of financial institutions in corporate governance.[34] Interestingly, managers appear to have played little role in the fragmentation of financial intermediaries.[35]

2. Relational Governance in Japan and Germany

From politics and history, the political account turns to comparative corporate governance to further underscore the contingency of the Berle-Means model. Exhibits A and B in this part of the account are Japan and Germany, both of whose approaches to corporate governance look strikingly different from the road taken in American governance.

In contrast to large U.S. corporations, whose shareholders have traditionally been dispersed and passive, their German and Japanese counterparts are characterized by concentrated shareholdings, thin managerial labor markets and relational governance.[36] In Germany and Japan, banks play a particularly prominent role as shareholders, and non-financial firms also are much more likely to hold significant blocks of shares in other corporations than they do in the United States.

In Germany, large corporations often have three or more bank shareholders, each of which holds roughly ten percent of the firm's stock.[37] While this alone gives bank shareholders a substantial stake, they have even more leverage in practice. Not only do the banks serve as major lenders and underwriters for the firm, but German banks can also vote the stock they hold in a depository or trust capacity unless the beneficial owners of the stock affirmatively withdraw this authority. Banks often exercise their influence formally through representation on the firm's supervisory board and informally through their ability to step in whenever necessary.[38]

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34. This Article will use a similar typology in explaining the emergence of *ex post* corporate governance in this country and *ex ante* governance in Japan and Germany in Parts III and IV, *infra*, with one important difference. Rather than focusing on federalism alone, the Article considers the role that structural constraints in general have played in the evolutionary process.

35. *See* Roe, *A Political Theory*, *supra* note 21, at 45-46. Roe speculates that managers would, however, actively oppose efforts to retreat from the reforms. *See id.* at 46.

36. *See* ROE, STRONG MANAGERS, *supra* note 2, at 169-86; Mark J. Roe, *Some Differences in Corporate Structures in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1936-48 (1993) [hereinafter Roe, *Some Differences*].

37. *See* ROE, STRONG MANAGERS, *supra* note 2, at 172.

38. *See id.* at 172-77.

The details of Japanese corporate governance differ in important respects, but reflect a similar concentration of shares in the hands of active shareholders. Prior to World War II, Japanese corporate governance featured a small group of *zaibatsu*—vast, interconnected, family-run enterprises that included extensive cross holdings and the presence of a single financing bank.[39] Since World War II and the dismantling of the *zaibatsu* by American occupation forces, the *keiretsu* have emerged as the principal organizational feature of Japanese corporate governance.

The *keiretsu* are small groups of closely interconnected firms.[40] Perhaps in part because the United States foisted much of its financial and securities regulation on Japan after World War II, including our limits on bank stock holdings, *keiretsu* firms generally have a small group of significant shareholders, rather than a single, dominant shareholder.[41] These shareholders include one principal bank, the "main bank," which holds roughly five percent of the stock and also serves as the primary lender, together with four or five other large stockholders, each of which holds a similarly large block of stock. Collectively, these shareholders hold twenty to twenty-five percent of the firm's stock and a seat at the periodic Presidents' Council meetings where managers meet informally with the firm's important shareholders.[42]

The effect of concentrated shareholding in Germany and Japan is to encourage relational governance, rather than the atomized, market-driven governance one sees with U.S. firms. The large shareholders tend to hold their shares on a long-term basis and often act as lenders or suppliers to the German or Japanese firms.[43]

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39. *See* Roe, *Some Differences*, *supra* note 36, at 1963; *see also* Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871, 882-83 (1993) [hereinafter Gilson & Roe, *Overlaps*]. Although the *zaibatsu* are often described as dominating Japanese corporate governance prior to World War II, Okazaki offers evidence that many large Japanese firms were not part of a *zaibatsu*. Tetsuji Okazaki, *The Japanese Firm under the Wartime Planned Economy*, *in* THE JAPANESE FIRM: THE SOURCES OF COMPETITIVE STRENGTH 350, 351-52 (Masahiko Aoki & Ronald Dore eds., 1994) [hereinafter THE JAPANESE FIRM] (only 10 of 60 largest mining and manufacturing firms were *zaibatsu*-related).

40. *See* Roe, *Some Differences*, *supra* note 36, at 1939.

41. The emergence of powerful institutional shareholders in Japan, despite its adoption of many of the reforms that produced fragmentation in the United States, is powerful evidence of a theme that runs throughout the Article—that laws by themselves can be a misleading indicator of a nation's corporate governance or corporate bankruptcy.

42. *See* Roe, *Some Differences*, *supra* note 36, at 1939-48. Whether the Presidents' Council meetings play a meaningful role in Japanese governance is debatable, but the large shareholders themselves clearly do.

43. This is particularly true in Japan. For a description and an argument that cross-holdings help to discourage "stable" shareholders from opportunistically selling their shares, see

Proponents of the political account point out that these relationships may facilitate a valuable long-term perspective and the exchange of confidential information between a firm and its shareholders. The presence of friendly shareholders appears to chill market correctives such as hostile takeovers, and the shareholders are well positioned to intervene and to remove managers or take other steps in the event of a crisis.[44]

In short, German and Japanese corporate governance provide a vivid counterpoint to the Berle-Means corporation in the United States. The pattern in both countries of active shareholders with substantial stakes strongly reinforces the argument that the American model of fragmented shareholding reflects more than economic necessity alone.

B. Completing the Governance Puzzle: The Role of Corporate Bankruptcy

The political account has prompted a wide-ranging reconsideration of our assumptions about the Berle-Means corporation. Yet nearly all of the existing analysis omits a crucial piece from the corporate governance analysis: bankruptcy. This Part introduces that piece and develops an evolutionary theory of the dynamic between corporate governance and corporate bankruptcy. The Article will continue to focus on the United States, Japan, and Germany, but the theory should apply to corporate governance in any developed nation.

The governance framework of the United States, with relatively dispersed shareholdings and active securities markets, relies in important part on hostile takeovers to address managerial agency costs.[45] Poorly run firms may be subject to a takeover and the threat of takeovers has an important deterrent effect. But hostile takeovers are a blunt instrument and frequently they misfire. A firm that must

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Paul Sheard, *Interlocking Shareholders and Corporate Governance*, *in* THE JAPANESE FIRM, *supra* note 39, at 310, 325-33.

44. *See* ROE, STRONG MANAGERS, *supra* note 2, at 169-86; Roe, *Some Differences*, *supra* note 36, at 1936-48. For a criticism of the view that relational shareholding emerged in Japan at least in part as a conscious effort by managers to chill takeover activity, see J. Mark Ramseyer, *Colombian Cartel Launches Bid for Japanese Firms*, 102 YALE L.J. 2005, 2009 (1993).

45. A prescient article by Henry Manne anticipated the role that takeovers would play in subsequent corporate governance. Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). The most prominent recent commentators on the role of takeovers in addressing managerial agency costs are Frank Easterbrook and Daniel Fischel. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 109-44 (1991).

shoulder an enormous new debt load, as many takeover targets did in the 1980s, may face immediate disaster in the event of an unexpected shock.[46] Moreover, firms that are not taken over but whose managers issue substantial new debt in order to discourage actual or potential bidders face precisely the same risk.[47]

To the extent a firm's failure reflects problems with its capital structure rather than with the business itself, destruction of its going-concern value would entail a significant social cost.[48] In view of this, one might suspect—and one certainly would hope—that a governance system relying on active markets and the uncertain corrective of takeovers, would also include a mechanism for keeping existing management in place and preserving going-concern value when an otherwise healthy corporation fails.

In theory, liquidation-oriented bankruptcy could serve this function.[49] Several bankruptcy commentators have in fact defended such an approach, arguing that financially distressed businesses should be sold at auction.[50] However, there are a variety of reasons why liquidation might prove ineffective as a means of preserving going-concern value. If a firm's failure comes during a general indus-

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46. One reason for the precariousness of takeovers is that state anti-takeover laws and takeover defenses make hostile bids much more expensive than they might otherwise be. For a discussion of these factors and a survey of the empirical evidence on takeover profits, see Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119 (1992).

47. Although increasing a firm's debt load increases the risk of bankruptcy, it may also have desirable effects. As Michael Jensen has pointed out, for instance, debt constrains managers' discretion by reducing free cash flow and can, in consequence, substantially reduce managerial agency costs. *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

48. One can perhaps imagine firms designing their capital structure in such a way that failure is likely to reflect non-viability. For an argument along these lines, see Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343 (1997). However, the text assumes that capital structure and viahility may not be correlated, as is the case under existing American law. *See id.* at 344.

49. It might also appear that private renegotiation could preserve going-concern value in the absence of state-sponsored reorganization. But collective action problems would impede renegotiation, and in the United States existing legal restrictions would impose further obstacles. *See* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 232 (1987) (effect of prohibition against binding bondholders by majority vote).

50. Douglas Baird was the first to suggest auctions as an alternative to corporate reorganization. *See* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986). He later considered the benefits and limitations of such an approach in thoughtful detail. *See* Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633 (1993). Several other proposed alternatives to Chapter 11 rely on more elaborate auction procedures. *See, e.g.*, Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523 (1992) (options-based auction); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988) (same). For a review and critique of these and other proposals, see David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465 [hereinafter Skeel, *Brave New World*].

try downturn, for instance, the firm's competitors, who often are the most likely bidders, may not be able to participate in the bidding.[51]

More importantly, the prospect of liquidation would influence managerial behavior in ways that would transform the corporate law side of U.S. corporate governance.[52] If managers expected to lose their jobs in the event of bankruptcy, they would face the combined threat of hostile takeovers, on the one hand, and on the other, displacement in bankruptcy if the firm failed after the managers took steps such as issuing new debt in order to protect themselves against the takeover threat. Rather than simply accept this lose-lose regime, managers would have an incentive to reduce the firm's debt and to seek out large, stable shareholders that would implicitly promise not to tender into any outside tender offer.[53] Alternatively, an increase of the number of firms that failed following hostile takeovers would lead to pressure by their managers for a more flexible bankruptcy regime.[54] Either way, if we consider both the background regime and managers' likely responses to it, it quickly becomes clear that liquidation-based bankruptcy is unlikely to coexist with active markets and hostile takeovers.

Although U.S. bankruptcy law includes a liquidation option, it looks to another mechanism for preserving going-concern value: corporate reorganization. In a corporate reorganization under Chapter 11 of the Bankruptcy Code,[55] a firm's constituencies engage in an often extended negotiation process, whose goal is to confirm a reorganization plan that will address the financial difficulties that landed the firm in bankruptcy.

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51. *See* Skeel, *Brave New World*, *supra* note 50, at 477-79 (citing Andrei Shliefer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343 (1992)). There may also be other reasons for preferring reorganization to an auction, such as the benefits to competition of preserving the troubled firm as an intact entity.

52. For an analysis of the likely effects of the liquidation-based bankruptcy reforms on pre-bankruptcy behavior, see Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159 (1994).

53. If managers persuaded the legislature to eliminate hostile takeovers the ultimate effect would be similar. Under these circumstances, investors would have an incentive to acquire concentratod stakes, as discussed in more detail in Part II.C., *infra*.

54. Notice that a move to flexible bankruptcy may in fact be in shareholders' (not just managers') interests in a world with active takeover markets and fragmented ownership. The benefit of manager-led reorganization is that it helps to coordinate scattered shareholders in the event of financial distress. For a similar peint about managers' role in respense to takeover bids, see, e.g., Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 502 (1991) (criticizing Easterbrook and Fischel's proposal te prevent managers from resisting takeover bids as "depriv[ing] shareholders of a negotiator at precisely the time when they need one most").

55. Provisions of the current Bankruptcy Code, 11 U.S.C. §§ 101-1330 (1994), will be cited hereafter as "Bankruptcy Code § ___."

Notice again the importance of managers' perspectives. If managers were inevitably displaced in the event of bankruptcy, they would treat the framework like a liquidation regime, even if it theoretically included a reorganization option, since for *them* bankruptcy would be the end of the road. It is therefore crucial to the U.S. approach that managers retain at least some control over the bankruptcy process.[56]

To underscore the importance of managers' perspectives, this Article characterizes each nation's corporate bankruptcy regime as either "manager-driven" or "manager-displacing." The U.S. approach typifies manager-driven corporate bankruptcy. In "manager displacement" regimes, by contrast, managers lose their jobs if the firms file for bankruptcy, and bankruptcy generally entails piecemeal liquidation (even if the bankruptcy laws ostensibly include a reorganization option).[57]

The characteristics of U.S. corporate goveruance—active markets, relatively passive, often scattered shareholders, and a well-developed managerial labor market, combined with manager-driven reorganization in bankruptcy—not only developed together, but also comprise the complementary facets of a single system. A permanent change in corporate governance would require a different approach to corporate bankruptcy, and vice versa. Alteruative arrangements would be inherently unstable.

Throughout the Article, I will refer to the kind of approach we see in the United States as an *ex post* governance system. The system has an *ex post* perspective in at least two respects. First, on the corporate governance side, hostile takeovers can be seen as an *ex post* mechanism for reducing managerial agency costs, since takeover bidders emerge after managers have failed to run the firm effi-

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56. In particular, Chapter 11 assumes that a firm's managers will continue to run the firm, Bankruptcy Code §§ 1101, 1107 (assuming continued operation by the "debtor-in-possession"), and it gives the debtor-in-possession the first crack at proposing a reorganization plan, Bankruptcy Code § 1121 (120-day exclusivity period during which only the debter-in-possession may propose plan).

To be sure, managers hardly have free reign in Chapter 11. Recent studies suggest they frequently are replaced before the conclusion of the reorganization. *See, e.g.*, Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholdsrs*, 27 J. FIN. ECON. 355, 356 (1990) (most current managers removed before end of Chapter 11 case). But some do retain their jobs, and Chapter 11 is much more attractive to them than the certain displacement of a liquidation regime.

57. As the text suggests, an important reason for focusing on managers, rather than the distinction between reorganization-based (like the United States) and liquidation-based approaches (like Germany), is that it isolates the single variable that determines how bankruptcy functions in practice (as opposed to the law "on the books"). For instance, although Japan's bankruptcy laws include a reorganization option, they also provide for immediate removal of a firm's managers and invariably lead te liquidation. *See infra* note 60 and accompanying text.

ciently.[58] On the bankruptcy side, Chapter 11 assures that the managers of a firm that encounters financial distress can attempt to reorganize after the fact.[59]

Given the striking differences between U.S. and Japanese or German corporate governance, one also would expect Japanese and German bankruptcy to differ from the American approach. And they do. In both Japan and Germany, the managers of a firm that files for bankruptcy lose their jobs immediately. Although Japanese law purports to provide a bankruptcy reorganization option, there is an extraordinarily strong bias toward liquidation.[60]

Japan and Germany can thus be seen as having adopted an *ex ante* approach to corporate governance. In contrast to American firms, which rely on *ex post* devices such as takeovers to address managerial agency costs, Japanese and German corporations look to existing, long-term shareholders to monitor managerial performance—that is, to "relational" governance.[61] On the bankruptcy side, Japanese and German managers are held to their *ex ante* contractual obligations. If a corporation fails, its managers cannot count on a second chance; quite to the contrary, they face immediate displacement.[62]

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58. This does not suggest that hostile takeovers have only an *ex post* effect. To the contrary, much of their effectiveness stems from their deterrent effect—i.e., the incentive they give managers to run firms efficiently so that the firm will not be taken over. *See* EASTERBROOK & FISCHEL, *supra* note 45, at 173. I characterize takeovers as *ex post* because the takeover mechanism itself operates after the fact.

59. One could also conceptualize the approach in temporal terms. On this view, investers can intervene to correct poor management at various stages, starting with shareholder voting, then moving to debtholders' invocation of default rights, hostile takeovers, and as a final resort, bankruptcy. *See* George G. Triantis, *The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines*, 16 INT'L REV. L. & ECON. 101, 105 (1996). As this time line suggests, investors in an *ex post* regime tend to intervene relatively late, rather than correcting problems early.

60. Japanese corporate bankruptcy law is derived from the Chandler Act amendments to the former Bankruptcy Act. *See infra* notes 218, 221 and accompanying text. The Japanese framework includes an explicit reorganization option but it burdens that option by displacing the managers of a distressed firm with a trustee. As in Germany, the vast majority of firms are liquidated if they file for bankruptcy.

German bankruptcy law provides for straight liquidation and a limited composition option, which permits composition if creditors are likely to recover at least 35 percent of their claims. Even in a composition, however, the principal goal is te liquidate the firm. Germany has adopted a more substantial reorganization option to take effect in 1999, but the presumptive displacement of managers and bias towards liquidation are retained. For further discussion, see *infra* Part IV.

61. *See generally* Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT'L L.J. 3 (1996) (analyzing the Japanese System).

62. In temperal terms, the relational shareholders tend to intervene earlier, prior te bankruptcy, in an *ex ante* governance regime. *See supra* note 59.

As with *ex post* governance, the corporate law and bankruptcy components of *ex ante* governance are integrally and necessarily connected. Consider first the perspective of a bank that acts as a relational monitor. In order to serve as an effective monitor, the bank must have enough leverage over the debtor to implement change if the firm's managers misbehave or the firm performs poorly. Only if it can displace managers in an emergency, and force a restructuring of the firm, will the bank prove effective as a monitor.[63]

The bank acquires this leverage in several ways. The first is through simple voting power. The bank is likely to be a significant shareholder, particularly if it joins forces with other holders of large blocks of stock.[64] Second, in addition to its shareholdings, the bank often serves as a principal source of financing. If managers resist a restructuring, the bank can threaten to cut off the firm's financing. Managers have good reason to respond to this threat because Japanese and German firms have fewer alternative sources of financing than do their United States counterparts,[65] and because the withdrawal of a relational bank—which knows more about the firm than any other party—would send a powerfully negative signal to other potential lenders.

While voting power and control over financing play a significant role in influencing managers' behavior, only by adding bankruptcy to the mix can we appreciate the full extent of the relational monitor's leverage. Managers face dire consequences (i.e. immediate removal) if they resist any changes proposed by the relational monitor and the firm subsequently winds up in bankruptcy. As a result, man-

63. For a discussion of banks' monitoring role in Japan, see Gilson & Roe, *Overlaps*, *supra* note 39, at 879-82. The Japanese government sometimes figures prominently in corporate restructurings in Japan, usually to urge the main bank to bail out a troubled firm. For a discussion of some of the perverse incentives this creates for main banks, see Masahiko Aoki, *The Japanese Firm as a System of Attributes: A Survey and Research Agenda*, *in* THE JAPANESE FIRM, *supra* note 39, at 11, 32.

64. *See* Roe, *Some Differences*, *supra* note 36, at 1943-46 (suggesting relational moniters in Japan and Germany act through coalitions and that no single shareholder has sufficient power to act as a controlling influence).

65. This is less true now than it was in the past, as secondary markets have expanded in both countries, but Japanese and German firms are still much more dependant on bank financing than American firms. Interestingly, as securities markets have expanded in Japan, commercial banks have tried to maintain their dominance by expanding their involvement in securities underwriting. *See* Jathon Sapsford, *New Rules Roil Japan Bond Underwriting*, WALL ST. J., June 11, 1997, at A18 (banks taking advantage of 1993 rule change enabling them to engage in underwriting).

ager-displacing bankruptcy powerfully reinforces the credibility of a relational monitor's threat to take action in an *ex ante* system.[66]

The costs to managers of responding to powerful bank shareholders are justified by important benefits. Although the presence of large shareholders can be intrusive, the shareholders' long-term commitment to the firm makes it nearly impossible for an outsider to acquire sufficient stock to effect a hostile takeover.[67] Moreover, the cataclysmic effect of failure enhances the attractiveness of relational monitors whose long-term stake in the firm will encourage them to stick with the firm in the event of a temporary downturn in fortunes. From a less benign perspective, managers may also be able to neutralize large shareholders to some extent through implicit side payments such as future business at supracompetitive rates.[68]

Because harsh, manager-displacing bankruptcy cements the relational governance arrangements in an *ex ante* system, a shift to manager-driven bankruptcy would have a serious destabilizing effect. If managers could file for bankruptcy without fear of immediately losing their jobs and with a real possibility of reorganizing, the relational bank's threat of displacement would lose much of its bite. An unforgiving bankruptcy regime is thus crucial—not just useful—to *ex ante* governance.

To complete the picture, one more player must be added to our account of *ex ante* governance: the state. In Japan in particular, the government plays an active role in corporate governance. In addition to an ongoing process referred to as Administrative Guidance, the state sometimes pressures relational monitors to preserve a troubled

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66. In the corporate finance field, Robert Hauswald makes a somewhat similar point, and develops a theory of the relationship between banking and bankruptcy laws that parallels my analysis in some respects. *See* Robert B.H. Hauswald, Banking Systems, Bankruptcy Arrangements and Institutional Complementarity (March 27, 1996) (unpublished manuscript, on file with author) [hereinafter Banking Systems]; Robert B.H. Hauswald, Financial Contracting, Reorganization and Mixed Finance: A Theory of Banking Systems (March 7, 1996) (unpublished manuscript, on file with author) [hereinafter Financial Contracting]. In contrast to my approach in this Article, he focuses narrowly on the role of limited and universal banking. This, together with his focus on legal rules rather than how governance functions in practice, leads to substantial differences in the analyses. Thus, Hauswald reaches the unlikely conclusion that Japanese governance parallels American rather than German governance. *See also* F.H. Buckley, *The Canadian Keiretsu*, 9 J. APPLIED CORP. FIN. 46, 52 (1997) (absence of stay of enforcement rights crucial to banks' influence in Canada).

67. *See* ROE, STRONG MANAGERS, *supra* note 2, at 171 ("managers [in Japan and Germany] prefer institutional white squires, who shield managers from outside pressures, to takeovers"); Sheard, *supra* note 43, at 319 (role of interlocking shareholdings in chilling takeovers).

68. For a similar concern about concentrated shareholding in Canadian firms, see Ronald J. Daniels & Jeffrey G. MacIntosh, *Toward a Distinctive Canadian Corporate Law Regime*, 29 OSGOODE HALL L.J. 863, 884-88 (1991).

firm that the monitor would otherwise force into liquidation.[69] In both Japan and Germany, the state is also much more likely than in the United States to rescue (either directly or indirectly) a failing firm.[70]

Although state intervention is a form of forced reorganization, managers will still behave very much as they would under an unforgiving bankruptcy regime. Managers cannot assume that the state will intervene, and they almost certainly will be removed even if it does. Moreover, the absence of a well-developed managerial labor market ensures that managers will gravitate toward the kinds of relational governance that minimize the likelihood of failure in the first instance.

One final point of clarification: while banks are the most obvious relational monitors, it is important to emphasize that other firms also may play this role in an *ex ante* system. In Japan, for instance, roughly one-third of the existing *keiretsu* are comprised of cross-holdings among firms and their suppliers and customers.[71] Non-bank financial institutions, such as insurance companies, pension funds or other large-scale shareholders, may also act as relational monitors. Relational governance should therefore be seen as comprehensive monitoring by any one or any combination of these firms.

C. Complements and Substitutes in Corporate Governance: Some Concluding Thoughts

Although this Article has argued that active markets tend to correlate with manager-driven, reorganization-based bankruptcy (an *ex post* framework) and that we can expect to see manager-displacing bankruptcy in regimes characterized by relational governance (an *ex ante* framework), this does not mean that every nation's governance regime will fit as neatly into one category or the other as the United States, Japan, and Germany do. On the contrary, my evolutionary theory predicts a dynamic relationship between the approaches to corporate governance in any given country. A shift in corporate gov-

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69. *See* Aoki, *supra* note 63, at 32; Milhaupt, *supra* note 61, at 36-39.

70. The United States government does occasionally intervene when a firm is in financial distress, as it did with Chrysler during the 1980s, and has done so more frequently with banks, such as Continental Illinois, that are similarly "too big te fail." But these examples are exceptions to the rule. For a detailed case study illustrating the often indirect nature of governmental influence in Japan, see Richard Pascale & Thomas P. Rohlen, *The Mazda Turnaround*, 9 J. JAPAN STUD. 219, 230-33 (1983).

71. *See* Gilson & Roe, *Overlaps*, *supra* note 39, at 882; *see also* Aoki, *supra* note 63, at 21 (40 percent of shares of non-financial firms held by financial firms, 30 percent held by other non-financial corporations).

ernance due to legal changes, politics, or the parties' responses to these factors will only take hold if there is an analogous shift on the bankruptcy side.

To develop these insights further, it is useful to draw on several concepts that have figured prominently in the recent corporate literature. Milgrom, Roberts, and their co-authors have characterized governance devices that seem to function in tandem as "substitutes" and "complements."[72] Complementary devices vary together, such that increases in one almost always entail increases in the others.[73]

In more technical terms, complements are subject to increasing returns to scale because adding a complementary mechanism enhances the effectiveness of those aspects of the system that are already in place.[74] As a result, complements tend to reinforce one another while alternative arrangements prove unstable.

Substitutes, by contrast, are replacements for one another. The appearance of one tends to reflect a shift away from the other. Thus, in a firm's decision whether to engage independent contractors or employees to sell a product, salaries and commissions are substitute incentive devices. If a firm shifts to salary, it also is likely to increase its use of salary complements such as job rotation and limits on outside activity.[75]

With corporate governance, then, market-driven corporate governance complements flexible, manager-driven bankruptcy in an *ex post* system, and relational governance complements manager-displacing bankruptcy in *ex ante* regimes. Similarly, each of the complements in the *ex post* system is a substitute for the corresponding device in an *ex ante* system. Thus, relational governance (with thin labor markets) is a substitute for active takeover and managerial

72. *See, e.g.*, Bengt Holmstrom & Paul Milgrom, *The Firm as an Incentive System*, 84 AM. ECON. REV. 972 (1994); Paul Milgrom & John Roberts, *The Economics of Modern Manufacturing: Technology, Strategy and Organization*, 80 AM. ECON. REV. 511 (1990). For a useful, relatively non-technical introduction te this literature, see JAMES A. BRICKLEY ET AL., MANAGERIAL ECONOMICS AND ORGANIZATIONAL ARCHITECTURE 71-74 (1997).

73. *See, e.g.*, Milgrom & Roberts, *supra* note 72, at 514. Milgrom and Roberts argue that the covariance of complementary institutions is a function of increasing returns, which they define as "supermodularity."

74. *See id.*

75. *See* Holmstrom & Milgrom, *supra* note 72, at 989.

labor markets,[76] and manager-displacing bankruptcy substitutes for a manager-driven, reorganization-based bankruptcy process.[77]

Consider in slightly more detail what would happen if one part of the governance regime were altered. As discussed earlier,[78] in a regime that mixed *ex post* governance with manager-displacing (*ex ante*) bankruptcy, managers would have an incentive to seek out relational investors both to neutralize the threat of a hostile takeover, and to reduce the likelihood of a bankruptcy filing in the event of financial distress.[79]

To complete the analysis, consider the perspective of investors. In a regime with scattered shareholdings, liquid markets, and manager-displacing bankruptcy, substantial gains are available to an investor who acquires a concentrated stake. Such an investor is particularly well positioned to monitor the firm, since managers' concerns about hostile takeovers and the threat of displacement in the event of bankruptcy will afford significant leverage over managerial decision making. Gains that stem from enhanced monitoring would often be socially beneficial, but there is a less benign side as well. A concentrated investor may also enjoy special treatment from managers who are eager to buy the investor's peace—managers may direct business to the investor, for instance, or offer other private benefits.[80] Whatever the mix of benefits, the overall effect would be to move corporate governance in an *ex ante* direction.

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76. An interesting illustration of the substitutionary relationship can he found in commentaters' characterization of relational governance—in particular, relational shareholders' ability to effect change—as "intornalizing" the takeover market. *See, e.g.*, Sheard, *supra* note 43, at 318-20.

77. Because voting authority is important to hoth *ex ante* and *ex post* governance, proxy contests play an intriguing intermediate role in the two systems. The threat of a proxy contest is an important component of *ex ante* governance, as this reinforces the relational moniters' leverage over the dehtor. But the availability of the device tends to make its use unnecessary. In an *ex post* system, by contrast, proxy contests are an important adjunct to the takeover process. In the 1950s, most American takeovers were effected through proxy contests, and proxy contests have become more prevalent in recent years due te the obstacles to direct takeovers.

78. *See supra* notes 52-54 and accompanying toxt.

79. As also discussed earlier, an alternative possibility is that the managers of distressed firms might try to retain control in bankruptcy and to effect a reorganization—that is, to shift the regime back in an *ex post* direction. If this proved successful over time, the nation's corporate law would also tond to retain an *ex post* character. For an argument that something like this occurred in American corporate law and bankruptcy in the 1950s, see *infra* Part III.E. The point, once again, is that the relationship between corporate law and bankruptcy is dynamic, and that the two will evolve in tandem.

80. Ed Rock has characterized this as a "dark side" of the recent enthusiasm for relational governance in the United States. Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987 (1994); *see also* Daniels & MacIntesh, *supra* note 68, at 896 (describing Canadian corporate governance).

The analysis thus far has shown that the combination of *ex post* corporate law and *ex ante* bankruptcy would prove unstable. The opposite combination—*ex ante* corporate law and *ex post* bankruptcy—is implausible for very similar reasons. Without manager-displacing bankruptcy, relational governance would lose much of its effectiveness. Unless creditors took control of the bankruptcy process (thus shifting it in an *ex ante*, manager-displacing direction), stock ownership would fragment; we would then expect to see market correctives such as takeovers or, in their absence, proxy contests replace relational monitoring as the principal mechanism for disciplining managers.[81]

The evolutionary theory developed in this Article does not depend on any particular claims about the direction as causality. It seems likely that changes in corporate governance will more frequently prompt changes in bankruptcy, rather than the reverse, given that the percentage of publicly held firms that fail at any particular time is relatively low. But the important point is that a shift in one attribute will inevitably lead to a shift in the other, as managers and investors adjust to the change.

The theoretical analysis raises a host of questions. First, why has the United States gravitated toward *ex post* governance, whereas Japanese and German corporate law is characterized by *ex ante* governance? Second, is one approach more efficient than the other? Third, how stable is the approach in any given country? That is, will the patterns that we see under existing law endure, or can we expect to see significant changes, such as a convergence on *ex ante* governance, *ex post* governance, or some middle ground?

The next two Parts address the first question, how it is that corporate governance evolves within a given nation, with particular emphasis on the evolution of *ex post* governance in the United States. These Parts show both the institutional nature of the evolutionary process and the extent to which changes in corporate governance have paralleled changes in corporate bankruptcy. Having considered the issue of "why" there is *ex post* governance in this country, and *ex ante*

81. American corporate governance in recent years seems at first glance to be an exception to this analysis. In the 1980s, managers successfully lobbied the legislatures of many states for anti-takeover protection, thus shifting American corporate governance in an *ex ante* direction. This does not mean that American corporate law is now *ex ante* in nature, however. Anti-takeover statutes and other developments have burdened the market for corporate control, but takeovers have not disappeared. Bidders have increased their use of other pressures, such as proxy contests, to effect change. Though not as market-driven as it might be, American corporato law, like American bankruptcy, has remained decidedly *ex post* in character.

governance in Japan and Germany, we can then compare the efficiency and stability of the two systems in Part V.

III. THE EVOLUTION OF AMERICAN CORPORATE LAW AND CORPORATE BANKRUPTCY

Part II contended that corporate bankruptcy is the crucial missing piece in understanding corporate governance. Having explored this argument in general terms, we shift now to a more nuanced, historical perspective, beginning in this Part with the emergence of *ex post* governance in the United States. The analysis will once again place particular emphasis on bankruptcy, both because of its importance to the overall story and because much of this story has not previously been told. But it is important to keep in mind that the overall focus is on both corporate governance and corporate bankruptcy. To make this explicit, I will regularly relate the analysis to historical developments on the corporate law side.

The account that follows is one of adaptive evolution.[82] Although the focus of this part is descriptive rather than normative, the analysis will be colored by my view that competitive pressures impel the evolutionary process in developed nations in a generally efficient direction.[83] Although political and historical events can influence development, sometimes in dramatic ways, the resulting system is unlikely to prove markedly inefficient over time.[84]

Periodic price shocks have served as the principal catalyst for change, prompting nearly all of the historical developments in our

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82. The most prominent exponent of this institutional approach to economic history is Douglass North. *See* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1991); *see also* Pavel Pelikan, *The Formation of Incentive Mechanisms in Different Economic Systems*, *in* INCENTIVES AND ECONOMIC SYSTEMS: PROCEEDINGS OF THE EIGHTH ARNE RYDE SYMPOSIUM, FROSTAVALLEN 26-27 (Stofan Hedlund ed., 1985) (developing theory of adaptive evolution of institutions).

83. This will be particularly apparent when the Article compares the efficiency of *ex ante* and *ex post* governance in Part V.B.

84. Because manager-driven corporate reorganization emerged in the United States in the common law, the analysis that follows has important implications for the debate as to the efficiency of the common law. *See, e.g.*, George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65 (1977); Paul H. Rubin, *Why is the Common Law Efficicnt?*, 6 J. LEGAL STUD. 51 (1977). For a discussion of the debate spawned by these articles, see Skeel, *Public Choice*, *supra* note 30, at 662-63.

Interest group distortions—especially the influence of lawyers—call into question any strong claims about the efficiency of the common law. Yet market competition acts as a powerful countoractive to any egregious inefficiencies in the bankruptcy framework. *See infra* Part V.A.1.

corporate bankruptcy framework.[85] To appreciate how the existing framework emerged and the uniquely American flavor of the process, it is useful to focus on three different factors: (1) interest group influence; (2) structural constraints; and (3) ideology. I use these factors to explain five critical phases in the development of manager-driven corporate reorganization. The story begins with the emergence of equity receiverships to reorganize railroads in the nineteenth century. It continues with the uncertainty in the 1920s as to whether the managers of non-railroad corporations could use the receivership device to reorganize. Next are the sweeping changes ushered in by the New Deal, and the decline of the role of the Securities and Exchange Commission in corporate bankruptcy beginning in the 1950s. This Part concludes with a brief discussion of the 1978 Bankruptcy Code and subsequent trends.

At each stage of the analysis, I also note the prevailing characteristics of corporate governance. The correlation between changes in corporate governance and in corporate bankruptcy is not immediate, but the historical analysis strongly confirms the link between the two.

A. The Storyline: Three Central Factors

The methodology of public choice figures permanently in the analysis. Public choice analysis assumes that legislators and other institutional players, such as judges, tend to act in their own self-interest; and that largely because of this, interest groups play a particularly influential role in legislative and judicial developments, just as they do in the marketplace.[86] Yet interest group analysis by itself can only begin to explain how the current framework arose.[87] To provide a more complete account I also consider the crucial role that structural constraints and ideology have played in directing the evolution of American corporate bankruptcy.

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85. North argues that dramatic shifts can occur in the wake of significant price changes because price changes give the relevant parties an incentive to renegotiate the rules of interaction. Yet the tenacity of existing norms may prevent change even if the formal rules change. *See* NORTH, *supra* note 82, at 86-91. In the analysis that follows in this Part and the next, we will see evidence of both elements—dramatic change and the tenacity of underlying norms.

86. For a detailed discussion of the public choice literature and its two principal strands of interest group theory and social choice, see Skeel, *Public Choice*, *supra* note 30. In the political sphere, interest group influence stems from the fact that interest groups tend te participate much more actively in the legislative process—contributing to campaigus and voting, for instance—than does the diffuse general group of voters. *See id.* at 651-52.

87. *See* ROE, STRONG MANAGERS, *supra* note 2, at 22-32 (emphasizing role of populism and other factors in legislation affecting corporate governance).

1. Interest Groups

From an interest group perspective, players are in many respects the same as in the political account of corporate law, though with several important differences. The analysis will pay particular attention to the role of managers (both their presence and, at times, their surprising absence), Wall Street banks, and New Deal reformers. Much more than in corporate law, lawyers[88] also left their mark in important ways.

2. Structural Constraints

Most of the principal structural constraints we will see on corporate law can be traced to the federalism enshrined in the United States Constitution. In contrast to most other nations, the United States is divided into numerous individual states that traditionally have wielded substantial political power. States' influence comes both from explicit constitutional directives and the power they derive from the federalist system as a whole.[89] In addition to federalism, the respective roles of Congress and the courts figure prominently in the evolutionary story.

3. Ideology

The final factor is ideology, which the Article will construe broadly to mean any widely held view about the appropriate treatment of publicly held corporations. Perhaps the most enduring ideological commitment in this country is an aversion to the concentration of capital in large banks and corporations. In corporate law, this aversion helps to explain the fragmentation of banks and the much smaller role they play in the United States, as compared to Japan and Germany.[90] It also influences debates about bankruptcy—sometimes in counterintuitive ways. Although manager-driven reorganization seems to cater to big business and may therefore provoke a skeptical

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88. The focus throughout the early part of the story will be on the elite Wall Street reorganization bar, which developed and perfected the equity receivership procedure. Although the general bankruptcy bar—lawyers involved in the bankruptcy cases of individuals and small businesses—does not figure in the initial development of corporate reorganization, its influence does have an important—albeit partially accidental—effect on the Chandler Act of 1938 and subsequent developments. *See infra* Part III.E.

89. As noted earlier, I refer to structural constraints rather than simply federalism because other, often related factors—such as the nature and capacity of the judicial system—also come into play. *See supra* note 34.

90. *See supra* notes 28-29 and accompanying toxt.

response, for instance, it also diminishes the influence that banks and other large stakeholders might have in a harsher, manager-displacement regime.

Two other ideological themes also recur: first, the American fascination with second chances and reversals of fortune;[91] and second, the view that certain firms cannot be permitted to fail, even if Congress itself cannot realistically take action.[92]

One must, of course, be cautious about attaching causal significance to ideology, since it almost by definition reflects the nature of prevailing institutional conditions. Yet ideological currents do shift in ways that are useful to understanding the emergence of the American corporate governance and corporate bankruptcy framework.

Using these tools, let us consider the remarkable story of how *ex post* governance emerged in the United States.

B. Equity Receiverships and Railroad Reorganization

If the early history of flexible, reorganization-based corporate bankruptcy could be distilled to a single word, that word would be "railroads."[93] As difficult as it is to imagine today, the existence of manager-driven reorganization was not at all inevitable. Well into the nineteenth century, financial distress meant displacement of the firm's managers and piecemeal liquidation, much as it does in Japan and Germany today.[94]

To understand why this changed, and the peculiar institutional pressures that produced our current bankruptcy system, we must briefly consider the explosive growth and rocky history of railroads in the nineteenth century. In both the 1870s and the 1890s, the railroads were crippled by financial crises brought on by overexpansion and a shaky national economy.[95] One after another the railroads failed, raising the question: what should be done?

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91. This theme pervades much of the popular mythology about America and its history, from the Horatio Alger stories to Frederick Jackson Turner's "frontier thesis." *See, e.g.*, FREDERICK J. TURNER, THE FRONTIER IN AMERICAN HISTORY (1920).

92. Recent beneficiaries of this are Chrysler, which the government helped to keep out of bankruptcy, and in banking, Continental Illinois.

93. This in a sense is no surprise, since the railroads were the nation's first true publicly held corporations. The changes in technology that produced the railroads and later, the other great trusts, initiated the era of large-scale business in America. The classic account of the influence of technology on the emergence of publicly held corporations is ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977).

94. *See, e.g.*, Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 745-46 (1991).

95. *See* Albro Martin, *Railroads and the Equity Receivership: An Essay on Institutional Change*, 34 J. ECON. HIST. 685, 688 (1974).

The role of ideology in answering this question was simple and quite clear. Almost everyone agreed that the railroads could not be permitted to fail. Unlike most other corporations, railroads served a crucial public function that was essential to the nation's growth. Interestingly, vestiges of this sentiment can still be found in the Bankruptcy Code's special railroad provisions, which forbid liquidation and require judges to take the "public interest" into account.[96]

The governments of most other countries, Japan and Germany included, might well have responded by intervening directly or indirectly to rescue the railroads. In this country, by contrast, Congress never intervened. The parties were left to their own devices due to structural constraints that loomed particularly large in the nineteenth century.

The Constitution explicitly authorizes Congress to establish the nation's bankruptcy laws.[97] If there had been a bankruptcy law on the books at the end of the 1870s or in the early 1890s, the law itself could have provided for railroad reorganization, as the current Code does.[98] The absence of a bankruptcy law was the result of impassioned debate on both whether there was a need for federal bankruptcy and how extensive Congress's bankruptcy powers actually were.[99] Powerful advocates of states' rights, ranging from Thomas Jefferson early in the century to John Calhoun later on, argued for very limited powers. Most importantly for present purposes, the debates raised serious doubts as to whether Congress could regulate the bankruptcy of corporations, given that the states regulated all other aspects of a corporation's existence.[100]

Congress could have intervened in other ways but similar constraints rendered this unlikely. Although railroads are a classic example of interstate commerce, Congress's Commerce Clause powers were construed extremely narrowly for much of the nineteenth century. Even if it could have intervened in multi-state railroads,

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96. Bankruptcy Code § 1165; *see also* KAREN GROSS, FAILURE AND FORGIVENESS 219 (1997).

97. U.S. CONST. art. I, § 8, cl. 1 & 4 states that "Congress shall have the Power . . . [t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."

98. *See generally* Martin, *supra* note 95, at 688 (emphasizing the absence of any federal bankruptcy law between 1878 and 1896, and railroad bondholders' foreclosure rights as important facters in the emergence of equity receivership).

99. For a discussion of the nineteenth century debates as te the scope of the Bankruptcy Clause and its applicability to corporations, see Skeel, *Rethinking*, *supra* note 5, at 476-89.

100. *See id.* at 480-82. Thus, Senator Henry Clay of Kentucky argued forcefully that " 'Corporations are artificial beings, created by the States. . . . [The States] know when it is best to make or abolish them.' " *Id.* at 481 (quoting CONG. GLOBE, 26th Cong., 1st Sess., at 848 (1840)).

Congress's authority over single state railroads was questionable.[101] More importantly in practical terms, the states were sufficiently powerful—particularly in the Senate—to tie Congress's hands.[102]

Congress's inability to act did not mean that state legislatures could fill the void. Because many railroads operated in more than one state, and states had very little ability to influence out-of-state activities, state legislatures proved similarly impotent.[103]

This then was the dilemma: a deep ideological consensus suggested that railroads should not be permitted to fail, but structural constraints stymied the most obvious solution. The fact that structural constraints precluded a legislative solution is particularly noteworthy given that so many of the principal interest groups—not just the managers of railroads, but shareholders, creditors, investment bankers, and railroad lawyers—were squarely in favor of reorganizing rather than liquidating the railroads.[104]

A key factor in the parties' convergence of interests was the chaotic capital structure of the railroads. Railroads frequently financed expansion by selling secured bonds to the public (often to foreign rather than American investors).[105] Rather than granting blanket security interests, as a firm might do today, the railroads offered discrete sections of track or other assets as collateral.

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101. As late as the New Deal bankruptcy reforms of the 1930s, some lawmakers continued to raise questions as to whether Congress could invoke its commerce powers to regulate single state railroads. As a result, the railroad reorganization provision, section 77, as initially enacted was limited to railroads that engaged in interstate commerce.

102. Until 1913, senators were elected by state legislatures, which gave states enormous influence in the Senate. *See, e.g.*, Todd J. Zywicki, *Senators and Special Interests: A Public Choice Analysis of the Seventeenth Amendment*, 73 OR. L. REV. 1007 (1994).

103. Statos' inability to affect out-of-state interests was one of the arguments for federalizing corporate bankruptcy in the nineteenth century. *See* Skeel, *Rethinking*, *supra* note 5, at 547 & n.327; *see also* Ogden v. Saunders, 25 U.S. (12 Wheat.) 212, 368 (1827) ("discharge under a state law [is] incompetent to discharge a debt due a citizen of another state").

104. Some interest groups might prefer that a particular railroad be allowed to fail—healthy, competing railroads, for instance, or firms engaged in competing modes of transportation such as shipping (and in this century, trucking). It is possible that these interests lobbied against legislative intervention, though I have seen no evidence of this in my research.

The possibility that such groups might have reinforced the resistance to federal legislation points to an important advantage of a judicial solution such as the one that emerged—only the parties directly interested in the fate of a particular railroad would have standing to support or oppose the receivership process. Receivership is therefore an example of a context where the choice of institutions (in this case, the courts rather than Congress) significantly affects the interest group dynamic. For a discussion of institutional choice, see generally NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY (1994).

105. By the early part of this century, European investors held roughly one-third of the bonded debt of American railroads. *See* F.H. Buckley, *The American Stay*, 3 S. CAL. INTERDISC. L.J. 733, 743 (1994) (citing WILLIAM Z. RIPLEY, RAILROADS: FINANCE AND ORGANIZATION 8 (1927)).

Consequently, one issuance might be secured by a segment of track in one part of the state, another by track in a different part. What resulted was a crazy quilt of security interests, made even more Byzantine by waves of mergers among the railroads.[106]

The problems from the bondholders' perspective were that it would be nearly impossible to unravel the respective priorities of the bond issues, and that the value of their collateral—say, one hundred miles of track in the middle of nowhere—was essentially worthless unless the railroad remained intact. As a result, bondholders who under other circumstances might have fiercely resisted managers' efforts to reorganize[107] had every bit as much to gain from keeping the railroad intact as its managers and shareholders did.

With strong ideological and interest group support for preserving railroads and with legislative or executive solutions largely foreclosed, railroad managers, through their lawyers and investment bankers, turned to the only obvious alternative: the judicial system.[108] In effect, managers and their advisers took creditors' state law debt collection remedies and turned them inside out to fit the needs of troubled railroads. In a pattern that reorganization lawyers perfected through time, the railroad would arrange for a friendly creditor (generally an out-of-state creditor, to create federal diversity jurisdiction) to file a creditor's bill asking for the appointment of a receiver.[109] Rather than preparing to liquidate assets, as a creditor's

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106. *See, e.g.*, Martin, *supra* note 95, at 699 (the "fact is that only a financial wizard . . . could have sorted out the property represented by the mortgages of the numerous railroads which comprised the Wabash").

107. Secured creditors and mortgage holders generally are viewed as having little to gain through a manager-driven bankruptcy reorganization process. At best, they are made no worse off than in liquidation, and in reality their interests are impaired in a variety of ways. For a discussion, see 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, 187-89 (1989).

108. Perhaps more accurately, the railroads' lawyers and bankers used the judicial system te effectuate what in many respects was a negotiated workout—i.e., private ordering. For an argument that the early railroad receivership practice reflectod a gradual shift from paternalistic efforts by bankers te act as trustees for scattered bondholders te private ordering through contract, see Rohert W. Gordon, *Legal Thought and Legal Practice in the Age of American Enterprise, 1870-1920*, *in* PROFESSIONS AND PROFESSIONAL IDEOLOGIES IN AMERICA 70, 101-08 (Gerald L. Geison ed., 1983).

109. Paul D. Cravath, one of the leading lights in the reorganization bar, described the standard procedure in detail in a much-cited article. Paul D. Cravath, *Reorganization of Corporations: Certain Developments of the Last Decade*, *in* 1 SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 153 (1917) [hereinafter 1 SOME LEGAL PHASES]. The Cravath firm played a central role in the railroad receiverships from the beginning, and was one of several Wall Street firms whose elite status was closely tied te their reorganization practice. The firm's history, written by Cravath's successor as the firm's (and arguably the nation's) most prominent reorganization lawyer, gives much of the flavor of the

bill contemplated, the receivers, who generally included members of the railroad's management, worked out the terms of a reorganization.[110] At the same time, the railroad's investment bankers formed bondholder "protective committees" and attempted to persuade the bondholders to deposit their securities with the committee, which would commit the bondholders to the terms of the eventual reorganization. Once everything was in place, the bonds and other security interests were foreclosed and the railroad's assets were "sold" in a foreclosure sale. In reality, the "sale" simply effected a reorganization of the railroad's capital structure.[111] The judges who oversaw this manipulation of liquidation procedures knew exactly what was going on[112] but the pressure to reorganize the railroads was so strong that they routinely approved the reorganizations.[113]

This is not to say that railroad receiverships proved to be one big happy party for everyone. The parties negotiated aggressively

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early successes. ROBERT T. SWAINE, 2 THE CRAVATH FIRM AND ITS PREDECESSORS: 1819-1948, at 167-75 (1948) (describing "Frisco" reorganization).

110. Because even federal courts did not have jurisdiction over out-of-state property, it was necessary to set up ancillary receiverships in each of the districts where the railroad had property. *See, e.g.*, James Byrne, *The Foreclosure of Railroad Mortgages in the United States Court*, *in* 1 SOME LEGAL PHASES, *supra* note 109, at 77, 78-79.

111. For another recent article describing the equity receivership process in the context of a defense of current Chapter 11, see Douglas G. Baird, The Hidden Virtues of Chapter 11: An Overview of the Law and Economics of Financially Distressed Firms (1997) (unpublished manuscript, on file with author). One commentator has argued that, if existing creditors had been precluded from bidding at the foreclosure sale, third-party bidders might have made bids, and a liquidation-based regime might have emerged. *See* Jeffrey Stern, Note, *Failed Markets and Failed Solutions: The Unwitting Formulation of the Corporate Reorganization Technique*, 90 COLUM. L. REV. 783, 800-01 (1990).

It is important to keep in mind that the equity receivership process took place entirely outside of the federal bankruptcy laws. It was not until the 1930s that Congress added an effective manager-driven reorganization provision to the Bankruptcy Act.

112. Commentators roundly criticized the collusive nature of jurisdiction and the artificiality of the ostensible foreclosure "sale" early on. *See, e.g.*, D.H. Chamberlain, *New Fashioned Receiverships*, 10 HARV. L. REV. 139, 141 (1896). For a later, rather colorful critique of the practice, see Jerome Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganizations*, 19 VA. L. REV. 541 (1933); William H. Taft, *Recent Criticism of the Federal Judiciary*, 18 A.B.A. REP. 237, 260-64 (1895).

113. In the most notorious of all the railroad receiverships, the Wabash—notorious because the railroad's managers dispensed with the pretense of creditor action and simply requested the receivership themselves—Judge Treat alluded to this pressure in justifying his decision to honor the railroad's request:

> [Unless a crediter acts] the court must either stop running the road, or an expenditure be made for the benefit of all parties in interest . . . in order that it shall be made a going concern. Otherwise, in the expressive language of a distinguished friend, you have nothing but a streak of iron-rust on the prairie.

Central Trust Co. v. Wabash, 29 Fed. 618, 626 (E.D. Mo. 1886). For a vigorous criticism of the *Wabash* case, see Chamberlain, *supra* note 112, at 143-46. For an argument that the judges in the equity receivership cases had an ideological interest in promoting the development of railroads, see GERALD BERK, ALTERNATIVE TRACKS: THE CONSTITUTION OF AMERICAN INDUSTRIAL ORDER, 1865-1917, at 55-60 (1994).

over their respective stakes in the reorganization. General creditors increasingly complained that the railroad's managers, shareholders, and bondholders were colluding to squeeze them out. The Supreme Court agreed in several cases that eventually produced bankruptcy's absolute priority rule.[114] At the same time, however, the Court consistently upheld the equity receivership device for reorganizing railroads.[115]

The late nineteenth century also was a time of great transition in corporate law generally. After carefully doling out charters in the early nineteenth century, states began to grant them much more liberally by the middle decades.[116] The late nineteenth century saw the emergence of the great trusts and a much more market-based (and quite controversial) corporate law as technology supported large-scale enterprise.[117] It was the rapid expansion of railroads and other business ventures, and managers' efforts to address the financial distress that sometimes ensued, which continued to create pressure for manager-driven corporate reorganization.

C. The 1920s: Cracks in the Reorganization Wall

The same Wall Street bankers and lawyers who perfected the railroad receivership form in the 1870s continued to dominate the receivership practice in the early twentieth century as advisors to debtors and the bondholder protective committees set up to effect a reorganization. The reorganizers also continued to wrestle with many of the issues that had arisen earlier—most prominently, how dissenting creditors were to be treated and how strictly priorities were to be construed—but by 1908, the validity of the process as a whole was clear.[118]

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114. *See* Northern Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913) (holding that unsecured creditor cannot he squeezed out); Louisville Trust Co. v. Louisville, New Albany, & Chicago Ry. Co., 174 U.S. 674 (1899) (same). The absolute priority rule prohibits lower priority creditors and shareholders from retaining any interest unless higher priority creditors are paid in full.

115. *See, e.g., Northern Pac. Ry. Co.*, 228 U.S. at 509-10; *In re* Metropolitan Ry. Receivership, 208 U.S. 90, 112 (1908); *Louisville Trust Co.*, 174 U.S. at 689.

116. *See* Skeel, *Rethinking*, *supra* note 5, at 483; *see also* Henry N. Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129 (1985).

117. For an argument that the Supreme Court's rejection of Sherman Act challenges to the sugar trust reflected a belief that states should regulate merger activity, and that the statos' failure to do this facilitated the trusts' expansion, see Charles W. McCurdy, *The Knight Sugar Decision of 1895 and the Modernization of American Corporate Law, 1869-1903*, 53 BUS. HIST. REV. 304 (1979).

118. In 1908, the Supreme Court explicitly endorsed the jurisdictional basis for railroad receivership. *See In re Metropolitan Ry. Receivership*, 208 U.S. at 112.

At first glance the routinization of receiverships might suggest that manager-driven bankruptcy, and perhaps even an overall system of *ex post* corporate governance, was in place in the United States as of the early 1900s. This would be getting ahead of the story, however, in several respects. First, even with railroads, governance patterns deviated from the *ex post* paradigm of active markets and manager-driven bankruptcy. A true *ex post* system requires not just a reorganization option in bankruptcy, but also that managers have some control over the process.[119] Although managers had initially called the shots in important respects, at least in the days of larger-than-life owners like Jay Gould, creditors often controlled the receivership process in the early 1900s.[120] From managers' perspective, the conditions were closer to a manager-displacement regime than might initially seem the case.

Just as railroad receivership contained hints of an *ex ante* regime, so too did railroad governance. Although railroad securities were often widely held, the same creditors that controlled the bankruptcy process—including J.P. Morgan and Company and other banks—also figured prominently outside of receivership. In addition te their role as bankers, they often held substantial amounts of securities and served on the board, much as Japanese and German banks do today.[121]

Why did managers relinquish so much control to creditors during this time? The most obvious explanation is that a small group of investment banking firms controlled large scale financing.[122] One

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119. *See supra* Part II.B.

120. Investment bankers exerted particular influence in the receivership process—often displacing existing management—from the late nineteenth century on. *See* Buckley, *supra* note 105, at 743; *see also* E.G. CAMPBELL, THE REORGANIZATION OF THE AMERICAN RAILROAD SYSTEM, 1893-1900, at 145-82 (1938). J.P. Morgan and Company played an important role in several of the reorganizations. *See* CHERNOW, *supra* note 22, at 67-69.

Receivership practice in this era paralleled in many respects the current landscape of Canadian corporate law. Canadian law, like American practice in the 1920s, includes a reorganization option, but creditors exert much more influence over the process than in the current, manager-driven American regime. For an extensive comparison, see Lynn M. LoPucki & George G. Triantis, *A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies*, 35 HARV. INT'L L.J. 267 (1994).

121. Early efforts to neutralize the role of large financial intermediaries in corporate governance had already begun to take effect. In addition to New York's legislation prohibiting insurers from holding stock in the wake of the 1905 Armstrong investigation, the 1911-1912 Pujo hearings (together with a desire to curry favor with President Wilson) prompted J.P. Morgan's partners to unilaterally resign from all of the corporate boards on which they had previously sat. *See* CHERNOW, *supra* note 22, at 180. Yet Morgan and other banks continued to retain enormous influence until the sweeping reforms of the New Deal.

122. For a good summary of the debate as to whether the bankers' influence was benign or malignant, see DeLong, *supra* noto 22, at 205.

possibility, then, is that managers had little choice but to cede control to J.P. Morgan or one of its counterparts if they wished to issue securities publicly. It is also quite possible that managers could diminish the risk of displacement through implicit side payments to the investment bank, as they do in Japan and Germany today.

The second reason the *ex post* system was not fully in place in the early 1900s, at least on the bankruptcy side, is that the developments we have considered all involved railroads. Equity receiverships could easily be adapted to non-railroad corporations, and they made sense as a response to these firms' financial distress. Yet the impulse toward manager-driven reorganization was weaker in several respects. Most importantly, the perception that railroads were public in nature and could not be allowed to fail simply did not apply to many non-railroad corporations. As with ideological concerns, the interest group dynamic also played out somewhat differently. Whereas railroads were vastly more valuable as going concerns than in liquidation, this was not so self-evidently true with other corporations. Thus, there was much less of an obvious consensus in favor of manager-driven reorganization.

Starting in the 1920s, the Supreme Court began hinting that railroads *were* a special case, and that the Court had serious doubts about other firms' use of the receivership process. In *Harkin v. Brundage*, the Court suggested that it would not simply rubberstamp, in non-railroad cases, the collusive techniques that managers and their professionals used in railroad receiverships to establish jurisdiction.[123] The Court was still more explicit in *Shapiro v. Wilgus*, where it indicated that these techniques passed muster in railroad cases only because railroads were "public service corporation[s]" whose "service[s were] in furtherance of the public good."[124] The Court went on to say that "[w]e have given warning more than once . . . that the remedy [when only private interests are at stake] is not to be granted loosely, but is to be watched with jealous eyes."[125]

123. 276 U.S. 36, 52 (1928).

124. 287 U.S. 348, 356 (1932).

125. *Id.* The Court returned to this theme yet again in *First Nat'l Bank v. Flershem*, 290 U.S. 504 (1934), where Justice Brandeis noted that "[a]ll of the cases in which this Court appears to have [upheld the use of an equity receivership] in aid of reorganization upon the ground of insolvency dealt with railroads or other public utilities where continued operation of the property . . . seemed to be required in the public interest." *Id.* at 515 n.7.

As of the late 1920s, then, the status of manager-driven receivership for non-railroad corporations was uncertain.[126] Far from embodying a clear *ex post* character, American corporate governance, with the continuing influence of the much criticized "Money Trust" banks, had in many respects shifted in an *ex ante* direction.

D. Remaking American Bankruptcy Law in a New Deal Image

In the standard account of American bankruptcy law, *ex post* bankruptcy began with the bankruptcy reforms of the New Deal. As bankruptcy scholars are quick to note, these reforms eliminated the problems that had bedeviled the jerry-rigged receivership process and established a reorganization-based bankruptcy system once and for all. As we have seen, in the political account of American corporate governance, the New Deal financial reforms played a central role in fragmenting financial intermediaries and reifying the patterns we see in publicly held corporations.[127] To the extent that flexible, reorganization-based bankruptcy took permanent form in the 1930s, these developments strongly confirm the complementary relationship between market-driven corporate governance and manager-driven bankruptcy, exemplifying one part of the system developing in tandem with the other.

As convenient as this account is, it is nevertheless misleading in important respects. Rather than a single set of reforms, for instance, the New Deal bankruptcy reforms proceeded in two distinct steps, the first culminating in 1933 and 1934 and the second in 1938. Moreover, while these reforms did eliminate some of the obstacles to reorganization under the equity receiverships, the 1938 reforms added manager-*displacing* provisions that largely reversed the effect of codifying manager-driven reorganization.

The analysis that follows views the New Deal bankruptcy reforms through the lens of the three factors we have been considering. On the legislative side, bankruptcy lawyers and New Deal reformers are the principal interest groups. The most significant surprise is the relative silence of corporate managers. Although managers actively responded to shifts in the background regime, they added their voices to the legislative debates much less than one might have predicted.

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126. *See, e.g.*, Henry Friendly, *Some Comments on the Corporate Reorganizations Act*, 48 HARV. L. REV. 39, 42-45 (1934) (discussing the "waxing doubt [due to the Supreme Court pronouncements] as to the validity of the procedural device").

127. *See supra* notes 23-29 and accompanying text.

1. Codifying Corporate Reorganization: Sections 77 and 77B

All of the New Deal bankruptcy reforms can be traced to the *Thacher Report*, which, together with the earlier *Donovan Report*, presented the findings of a widespread investigation commenced in 1929.[128] The investigation found evidence of substantial administrative corruption. To remedy this, the *Thacher Report* recommended sweeping changes to the powers and compensation of bankruptcy referees and trustees, and the creation of a bankruptcy administrator.[129] The *Thacher Report* also proposed that a new, manager-driven, corporate reorganization provision be added to the Bankruptcy Act.[130]

Lawmakers immediately converted the *Thacher Report* recommendations into proposed legislation, and the House and Senate judiciary committees held extensive joint hearings on the legislation in early 1932.[131] In contrast to subsequent congressional activity, the joint hearings focused almost exclusively on personal bankruptcy and administrative structure.[132] Although it was clear that the proposals were too controversial for serious consideration in 1932, an election year, a more limited bill covering personal bankruptcy, corporate reorganization, and railroad reorganization was quickly introduced in the House in January 1933.

128. STRENGTHENING OF PROCEDURE IN THE JUDICIAL SYSTEM: THE REPORT OF THE ATTORNEY GENERAL ON BANKRUPTCY LAW AND PRACTICE, S. DOC. NO. 72-65 (1932) [hereinafter THACHER REPORT]. The *Donovan Report*, 71ST CONG., REPORT ON THE ADMINISTRATION OF BANKRUPTCY ESTATES (Comm. Print 1931) [hereinafter DONOVAN REPORT], focused on administrative abuses in the bankruptcy system. The investigation continued when Judge Thacher, a principal contributor to the *Donovan Report*, became Solicitor General under President Hoover. Using the *Donovan Report* findings as a backdrop, the *Thacher Report* proposed wide-ranging changes to the Bankruptcy Act.

129. *See* THACHER REPORT, *supra* noto 128, at 104-07 (administrators), 110-23 (trustees), 123-25 (referees).

130. *See id.* at 90. Interestingly, the *Thacher Report* was commissioned during the Hoover administration while many of the reforms it proposed were adopted under Roosevelt. William Douglas' involvement spanned both eras, first through his work investigating personal bankruptcy and later on the protective committee project he spearheaded with the SEC.

131. *See Joint Hearings on S. 3866 Before the Subcomms. on the Judiciary*, 72d Cong., 1st Sess. (1932) [hereinafter *1932 Hearings*].

132. The principal interest groups who testified in the hearings were: the Attorney General's office, represented by Lloyd Garrison, who proposed and defended the bill; general bankruptcy lawyers (individually and through organizations such as the American Bar Association), who vehemently opposed the bill as making unnecessary changes to a generally effective system; organizations of various trade creditors, who enthusiastically supported the bill—particularly its provision to appoint an executive branch administrator to moniter cases; and bankruptcy referees, whose views were somewhat mixed on issues other than strengthening their authority. It appears to have been the lawyers' unified opposition that doomed the bill.

By this time pressure to take action had mounted. With no further hearings and relatively little debate, the House approved the entire bill and passed it on to the Senate.[133] After initially dropping the corporate and railroad reorganization sections from the bill,[134] Senator Daniel Hastings reintroduced Section 77, the railroad reorganization section. In February 1933, the Senate passed the proposed bill, including the railroad section, despite concerns that it was acting too quickly and that it should go further and give the Interstate Commerce Commission ("ICC") complete control over distressed railroads.[135] With the President's signature in March, the legislation became law.[136]

In addition to bringing railroads within the Bankruptcy Act for the first time, Section 77 made several other important changes. It provided that dissenters would be bound by a two-thirds vote of their class;[137] it also gave the ICC authority to propose trustees, to set limits on compensation, and most significantly, to pass judgment on any proposed reorganization plan.[138]

With railroad reorganization taken care of, Congress turned its attention to corporate reorganization. After cursory hearings before the House Judiciary Committee,[139] Congress debated the proposed corporate reorganization section in early 1934.[140] Like Section 77,

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133. *See* 76 CONG. REC. H2931-32 (1933).

134. *See* 76 CONG. REC. S4876 (1933). In addition to Section 77, the railroad reorganization provision, the bill also included new sections governing compositions—i.e., negotiated compromises of debt terms with creditors—for individuals (Section 74) and farmers (Section 75).

135. The railroad amendment passed by a vote of 42-15 (excluding paired votes), *see* 76 CONG. REC. S5134 (1933), and the bill as a whole then passed by a vote of 44-8 (excluding pairs), *see* 76 CONG. REC. S5136 (1933). Thereafter, the House agreed to the bill, as amended in several respects by the Senato, by a vote of 207-26. *See* 76 CONG. REC. H5360 (1933).

Several senators complained that the railroad provision had not been given sufficient study, and that only Senator Hastings understeod its torms. *See, e.g.*, 76 CONG. REC. S4884 (Feb. 24, 1933) (Senator Bratton, another member of the three senator subcommittee considering the railroad provision, noting that only Hastings focused on the provision); *see also* Max Lowenthal, *The Railroad Reorganization Act*, 47 HARV. L. REV. 18, 22 (1933) (complaining that the provision was passed too quickly and included insufficient safeguards).

136. *See* Act of March 3, 1933, ch. 204 § 77, 47 Stat. 1474 (1933) (codified prior to repeal at 11 U.S.C. § 204 (1934)).

137. The most important effect of the voting requirement was to eliminate the obligation to pay dissenting creditors in cash.

138. Section 77(e) (binding effect of two-thirds vote); 77(c) (appointment of trustees); 77(f) (expenses).

139. The House Judiciary Committee considered the corporate reorganization provision briefly at the end of lengthy hearings on municipal bankruptcy. *See Hearing on H.R. 1670, etc, 5009, Before the House Comm. on the Jadiciary*, 73d Cong., 1st Sess. (1933) [hereinafter *Section 77B Hearing*].

140. Much of the Senate debate was unrelated to the corporate reorganization provision itself, focusing on farm relief proposed by Senator Frazier and including a lengthy filibuster by Senator Huey Long when it was clear the farm amendment would fail. *See* 77 CONG. REC.

Section 77B provided for the binding of dissenters through a classwide vote. The new section differed, however, in one dramatic respect: it did not provide for governmental oversight parallel to the role of the ICC in railroad reorganization.[141]

This was how manager-driven corporate and railroad reorganization became part of the Bankruptcy Act and equity receiverships came to an end. Notice that these reforms occurred at precisely the same time as Congress passed the Securities Act of 1933, the Securities Exchange Act of 1934, and the Glass-Steagall Act of 1933.

As is often the case, the backdrop of each of these changes was a dramatic price shock—here, the onset of the Depression and the wave of failures it produced.[142] The Depression had an obvious effect on the structural constraints that had forced the managers of troubled railroads in a judicial direction in the nineteenth century. Whatever the constitutional limitations, there was a widespread view that Congress must take action.[143] Thus, structural constraints and ideological considerations both strongly influenced the legislative turn that bankruptcy reform took in the early 1930s.

While this much is old hat, the plot thickens when we consider the role of interest groups in the enactment of Sections 77 and 77B. The single most active interest group was the reorganization bar, which vigorously supported codification of corporate reorganization.[144] In at least one respect the bar's support is puzzling. Wall Street lawyers had an enormous interest in the existing equity receivership practice. This interest would seem to give them ample reason to resist codification, since legislative action might undermine the value of their expertise with existing procedures or diminish the flexibility of the procedures. Why then were Wall Street lawyers so enthusiastic about codifying corporate reorganization?

S8082 (1934) (farm amendment rejected); *id.* (bill passes Senate). The House, which had passed the provision the previous year, once again passed the bill with very little debate. *See* 77 CONG. REC. H5015 (1934).

141. The most obvious reason for the difference between the railroad and corporate sections is that the ICC already had oversight authority over railroads, whereas no existing agency had previously (i.e., prior to the creation of the SEC in 1933) exercised authority over corporations.

142. *See* NORTH, *supra* note 82, at 83-92 (noting the importance of price changes).

143. *See, e.g.*, ARTHUR SCHLESINGER, THE CRISIS OF THE OLD ORDER 166-76 (1955) (describing desperate conditions of 1932 and pressure for federal action).

144. Most prominently, Robert Swaine urged federal legislation in several speeches and articles. *See, e.g.*, Robert T. Swaine, *Corporate Reorganization—An Amendment to the Bankruptcy Act—A Symposium*, 19 VA. L. REV. 317 (1933) [hereinafter Swaine, *Corporate Reorganization*]; Robert T. Swaine, *Federal Legislation for Corporate Reorganization: An Affirmative View*, 19 A.B.A. J. 698 (1933) (reprinting speech) [hereinafter Swaine, *Federal Legislation*].

One reason was that however lucrative ancillary receiverships were for professionals in the states where satellite receivers were needed, the Wall Street lawyers who quarterbacked the process saw them as a costly nuisance.[145] Second, the existing receivership strategy required the managers of troubled firms and their lawyers to pay dissenting creditors in cash, which became increasingly difficult as the Depression dried up sources of capital.[146] The reorganization bar saw federal legislation as a way to eliminate both of these practical problems and at the same time remove the cloud of legal uncertainty hanging over the use of receiverships to reorganize non-railroad firms.[147]

Closely allied with the reorganization bar—although less visible—were the Wall Street underwriters who played a central role in organizing protective committees, serving as receivers, and acting as underwriters for any securities issuance required for the reorganization.[148]

The biggest surprise, given their prominent place in equity receivership history, is that managers stayed well in the background in the legislative debates that produced Sections 77 and 77B. Debtors and potential debtors had an obvious interest in supporting legislation that made reorganization easier, and they lobbied directly from time to time.[149] But these appearances were much more the exception than the rule.[150]

One possible explanation for managers' silence is that they could protect themselves more effectively in other ways, and thus had little need to promote manager-driven reorganization. If managers

145. *See, e.g.*, Swaine, *Corporate Reorganization, supra* note 144, at 320-21 (noting inconvenience of ancillary receiverships and courts' use of process to dispense patronage); Friendly, *supra* note 126, at 46.

146. *See* Swaine, *Corporate Reorganization, supra* note 144, at 326 (noting burden of paying cash to dissentors); Friendly, *supra* note 126, at 48 (same).

147. *See supra* notes 123-26 and accompanying text.

148. Investment bankers did not testify in the hearings that produced Sections 77 and 77B. It was only in the subsequent reforms, particularly the abortive Lea Bill, that investment bankers played an active and visible role. An obvious explanation for this is that, unlike Sections 77 and 77B, the subsequent reforms directly attacked investment bankers' roles in corporate reorganizations.

149. *See Section 77B Hearing, supra* note 139, at 207 (Representative Shannon of Missouri reads telegram urging reform as beneficial to the reorganization of Long Bell Lumber Co.). More often, the influence of managers can be seen indirectly. Senator Hastings, for instance, noted on several occasions that railroad executives supported the passage of Section 77. *See, e.g.*, 76 CONG. REC. S5107 (1933) (emphasizing that the ICC and railroad executives approve of the reforms).

150. Eric Posner found a similar dearth of lobbying by debtors and their managers in his extensive analysis of the political economy of the 1978 Bankruptcy Code. Eric Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 54-55 (1997).

included generous severance provisions in their compensation, for instance, their employment contracts might counteract any concerns about bankruptcy, much as golden parachutes reduce target directors' aversion to takeovers. Yet severance rights have a crucial limitation. Severance payments would simply be treated as an unsecured claim in bankruptcy and thus would offer only limited protection.[151]

The more likely explanation stems from managers' bounded foresight. Most managers do not anticipate that their firm will fail, so they see little reason to lobby prior to failure. Further, although the managers of current debtors care deeply about the parameters of bankruptcy law, they generally will not benefit from subsequent reform.[152] From this perspective, the fact that potential debtors played at least a background role can be seen as a tribute to the depth and severity of the Great Depression.

Another surprise in the legislative history of Sections 77 and 77B is that the New Deal reformers offered precious little resistance to these reforms, despite the fact that the most obvious beneficiaries were managers and Wall Street professionals.[153] Although they were enacted at precisely the same time as Glass-Steagall and the Securities Acts, the reorganization provisions protected most aspects

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151. Managers could ensure a much greater recovery by taking a security interest to collateralize the severance payments, but I have not seen evidence that managers have ever done this. Bankruptcy attorneys sometimes insist on security to assure priority in bankruptcy. *See, e.g., In re* Martin, 817 F.2d 175, 176 (1st Cir. 1987) (law firm with mortgage on debtor property).

152. In view of this, it is not surprising that the debtors who did lobby were principally concerned about transition effects. Thus, some debtors hoped legislation would affect their existing reorganization effort, *see, e.g., Section 77B Hearing, supra* noto 139, at 207 (telegram supporting reform as beneficial to the reorganization of Long Bell Lumber Co.); others hoped to avoid coming changes, *see, e.g.,* 77 CONG. REC. S13,769 (1935) (Senator Barkley successfully introducing amendment during 1935 debates making clear that new mandatory trustee requirement included in the 1935 revisions to Section 77 would not apply to existing reorganizations).

The concern with transition effects was equally pronounced in the later hearings that led to the Chandler Act in 1938. *See, e.g., Hearing Before the Comm. on the Judiciary, House of Representatives, on H.R. 6439*, 75th Cong. 164 (1937) (statement of William O. Douglas, SEC Chairman) (arguing that the reforms should be applied to pending cases) [hereinafter *1937 House Hearings*]; *id.* at 290 (statoment of Alfred N. Heuston, Bar Association of New York City) (arguing against application to current cases).

153. This would change dramatically later in the 1930s, but at this point there were only a few lone voices excoriating corporate managers, Wall Street underwriters and the reorganization bar. One reformer who was quite vocal, even early on, was Max Lowenthal. Lowenthal's hook, *The Investor Pays*, which focused on the St. Paul railroad receivership, sharply criticized underwritors and the reorganization bar. MAX LOWENTHAL, THE INVESTOR PAYS (1933). He was similarly critical in several law review articles. *See, e.g.,* Lowenthal, *supra* note 135, at 22 (criticizing the railroad reorganization provision).

For an explanation of one prominent reformer's silence, see Lotter from William O. Douglas to E. Merrick Dodd, William Douglas Papers, Container No. 5, Library of Congress (Jan. 29, 1934) (commenting on Dodd's concerns about Section 77B and suggesting that "any opposition would be more effective if it envisaged a rather definite alternative").

of existing practice. Principally due to efforts of the ICC, Section 77 did attempt to curb bankers' fees by subjecting them to ICC oversight,[154] and it gave the ICC a central role in the proceedings. But Section 77B, the general corporate reorganization provision, did not provide for any additional governmental oversight.[155] Moreover, both sections gave the reorganization bar and their clients, debtors' managers, much of what they wanted: reorganization would bind dissenters, and existing management would often remain in control.

The stunning success of the reorganization bar can be attributed to several important distinctions between corporate bankruptcy and the other governance reforms taking place at the same time. Probably the most important distinction was ideological. Whereas ideology sounded a consistent theme in the latter context—that it was time to rein in the Wall Street bankers—its influence on bankruptcy reform was somewhat more nuanced. Concerns about big business and the excessive control of bankers abounded, but they competed with a widespread perception that something must be done quickly to rescue large numbers of railroads and other corporations that were on the verge of collapse.[156]

A second distinguishing factor was the very different interest group dynamic. In the banking and securities reforms, Wall Street banks were aligned against both the reformers and a powerful interest group—small town banks—that would benefit enormously if the Wall Street banks were crippled. Because no similarly powerful

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154. Section 77 gave the ICC authority to set maximum amounts for fees, but both reformers and the reorganization bar suspected that the parties could circumvent the strictures through contractual provisions that provided for fees explicitly. *See* Lowenthal, *supra* note 135, at 52-56 (reformer concerned that the oversight would prove ineffective); Churchill Rodgers & Littleton Groom, *Reorganization of Railroad Corporations Under Section 77 of the Bankruptcy Act*, 33 COLUM. L. REV. 571, 587 (1933) (attorneys confident the strictures could be avoided).

155. For a note of alarm on this score, see Joseph L. Weiner, *Corporate Reorganization: Section 77B of the Bankruptcy Act*, 34 COLUM. L. REV. 1173, 1195 (1934) ("[L]ooking at Section 77B as New Deal legislation, it leaves much to be desired. . . . [I]t may fairly be said that the operation of equity receiverships . . . was not made the subject of any extensive inquiry."). *See also* E. Merrick Dodd, Jr., *Reorganization Through Bankruptcy: A Remedy for What?*, 35 HARV. L. REV. 1100, 1135 (1935) (Section 77B, "taken as a whole, seems more nearly to embody the views of reorganizers than any other group").

156. Thus, one or two legislators complained that Section 77 would simply help out corporate debtors, rather than helping small investers, *see, e.g.*, 76 CONG. REC. H2918 (Jan. 23, 1933) (remarks of Rep. Dies); yet both legislators and commentators voiced the view that bankruptcy relief for corporations was one of only two ways of dealing with the Depression (inflating the currency being the other), *see* 77 CONG. REC. S7902 (1934) (remarks of Sen. Shipstead); George G. Battle, *The Enactment of the New Bankruptcy Law Will Check the Tendency Toward Currency Inflation*, 19 VA. L. REV. 340, 340-42 (1933).

interest group played an analogous role in bankruptcy reform, the reformers did not have an obvious ally in their efforts.[157]

If the new railroad and corporate reorganization sections marked the end of New Deal reform, we would have a particularly tidy account of how Congress locked in *ex post* governance by fragmenting banks and codifying manager-driven corporate reorganization at the same time. Rather than stopping with Sections 77 and 77B, however, Congress adopted far more sweeping reforms in the years that followed.

2. New Deal Reform in Full Bloom: The Chandler Act of 1938

It was perhaps inevitable that Congress would soon overhaul its work from the 1930s. The new manager-driven reorganization framework had been adopted in great haste and many members of Congress viewed it from the beginning as a stop-gap measure.[158]

Congress first revisited the regulation of railroad reorganization in Section 77. After relatively extensive hearings in early 1935,[159] Congress quickly passed amendatory legislation.[160] The most important amendments, all of which had been urged by the ICC, made the appointment of trustees mandatory; provided a cramdown procedure to facilitate reorganizations favored by the ICC even if one or more classes voted the plan down; and reinforced the ICC's control over the payment of expenses.[161]

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157. The effect of these differences is particularly striking if we consider that Section 77, with its overlay of ICC oversight, was enacted at the end of President Hoover's term, whereas Section 77B, which gave the reorganizers even more of what they wanted, bore President Roosevelt's signature.

158. Thus, by the time the SEC neared completion of the protective committee study Congress had commissioned in 1934, much more dramatic changes were in stere.

159. *See Hearing Before the Comm. on the Judiciary, House of Representatives, on H.R. 6249*, 74th Cong. (1935) [hereinafter *1935 Railroad Hearings*].

160. *See* Bankruptcy Act of 1898 Amendments, Pub. L. No. 74-381, 49 Stat. 911 (1935) (amending 11 U.S.C. § 205 (1935)).

161. The initial impetus for revisiting Section 77 was the ICC's concern that railroads were simply languishing in bankruptcy. *See* REPORT OF THE FEDERAL COORDINATOR OF TRANSPORTATION, H.R. DOC. NO. 74-89 (1935) (recommending changes). Few corporations reorganized, due apparently to shareholders' belief they would fare better if they waited out the Depression. The principal controversy in the hearings concerned the ICC's proposal that valuation be based on present and projected future earnings only—replacement values were explicitly excluded. Railroad shareholders (including controlling interests such as the Van Sweringens, who became notorious for the extensive railroad empire they built in the 1930s) feared that their interests would be wiped out under this standard. The bill as passed adopted a modified and slightly compromised version of the ICC provision.

Though dramatic in some respects, the amendments to Section 77 could fairly be described as tinkering.[162] Section 77 continued to assume that managers would remain in place (together with a noumanagement trustee), and thus remained largely manager-driven. Congress's amendments to Section 77B would go much further, and with the Chandler Act of 1938, would wrench the corporate reorganization provisions in a manager-displacing, *ex ante* direction.

The deliberations that eventually led to the Chandler Act began when a group of academics and practitioners formed the National Bankruptcy Conference in order to address the many issues they believed were neglected by the 1933 and 1934 reforms.[163] Until the late 1930s, when the SEC entered the picture, the National Bankruptcy Conference's relatively technical proposals were the principal basis for discussion about additional amendments to the Bankruptcy Act.[164]

What spurred the SEC into action was a report Congress had commissioned from the SEC when it enacted the Securities Exchange Act of 1934.[165] As William Douglas, who was given control of the report, investigated corporate reorganization prior to and under Section 77B, he became increasingly convinced that the practice was shot through with abuse. The report's most frequent targets were underwriters and the reorganization bar, who were depicted as more concerned with fees and keeping managers happy than with the investors they ostensibly represented.[166]

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162. For a useful overview generally praising the changes though questioning the constitutionality of the cramdown provision, see Henry J. Friendly, *Amendment of the Railroad Reorganization Act*, 36 COLUM. L. REV. 27 (1935).

163. Among the organizations that spearheaded the National Bankruptcy Conference were the American Bar Association, the Commercial Law League, the National Credit Men's Association, and the National Association of Referees in Bankruptcy. *See* Reuben G. Hunt, *The Progress of the Chandler Bankruptcy Bill*, 42 COMM. L.J. 195, 195 (1937).

164. *See, e.g., 1937 House Hearings, supra* note 152 (statement of Rep. Chandler) (describing National Bankruptcy Conference efforts and subsequent proposal by SEC to completely overhaul Section 77B).

165. *See* Securities Exchange Act of 1934, Pub. L. No. 73-291, §§ 4, 211, 48 Stat. 881, 885, 909 (1934).

166. The report eventually filled eight volumes, 1-8 SECURITIES AND EXCHANGE COMMISSION REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937-40) [hereinafter SEC REPORT]. Critics challenged its breathless, "dime novel" tone, Robert T. Swaine, *"Democratization" of Corporate Reorganizations*, 38 COLUM. L. REV. 256, 259 (1938), and even Douglas himself noted that the report was as much a brief supporting the SEC proposals as an objective report, *see 1937 House Hearings, supra* note 152, at 199 (statement of William O. Douglas, SEC Chairman) (describing the reports as "in the nature of briefs in favor of the Chandler Bill"); *see also* E. Merrick Dodd, Jr., *The SEC's Reform Program for Bankruptcy Reorganization*, 38 COLUM. L. REV. 223, 225 (1938) (advocate of the reforms noting that the

Drawing almost verbatim from the proposals of the SEC report, with at most the grudging acquiescence of the National Bankruptcy Conference,[167] the Chandler Act adopted two kinds of curatives in Chapter X, the chapter designed to address the reorganization of publicly held firms. The first curative was to end the perceived hegemony of a debtor's managers and underwriters over corporate reorganization. Chapter X achieved this by essentially removing these insiders from the process altogether. Thus in every sizable case, Chapter X required that the debtor's current managers be replaced by a trustee.[168] Not only were underwriters and the firm's lawyers prohibited from becoming the trustee, but their ability to manage the reorganization process and to shape its outcome was also eliminated. Chapter X permitted only the disinterested trustee, not the underwriters or any other party, to propose a reorganization plan,[169] and it gutted the old protective committee process by prohibiting anyone from soliciting acceptances of a reorganization plan until the plan had been proposed by the trustee and approved by the court.[170]

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reports are "essentially briefs" and "we should he on our guard against the easy assumption that the picture [the reports provide] . . . is one which is in no need of retouching").

167. The National Bankruptcy Conference voted at a meeting in March 1937 to approve the SEC's corporate reorganization proposals, but as recounted by John Gerdes, the vote was extremely close and few National Bankruptcy Conference members were present at the time. *See 1937 House Hearings, supra* note 152, at 363-65 (remarks of John Gerdes). Several members of the conference actively criticized the reforms in the hearings, particularly the mandatory appointment of a trustee. *See, e.g., id.* at 284 (statement of Alfred N. Heuston) (criticizing trustee provision and likelihood that SEC involvement would slow cases down).

For its part, the SEC also compromised on several issues with the National Bankruptcy Conference in order to assure passage. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 196 (1982) (SEC accepted provision that would allow relatively small creditors to initiate a bankruptcy case).

168. *See* Chandler Act, Pub. L. No. 75-696, § 156, 52 Stat. 840, 888 (1938) (codified prior to repeal at 11 U.S.C. § 156 (1938)). The Chandler Act permitted a court to appoint an existing manager as trustee, but required in such circumstances that a second, non-insider also be appointed.

The mandatory trustee requirement was by far the most hotly contested provision in the Chandler Act. It drew vigorous criticism both in the hearings and in the dissenting report of a minority of the Senate Judiciary Committee. *See, e.g.,* SENATE COMM. ON THE JUDICIARY, REPORT ON H.R. 8046, S. REP. NO. 75-1916 (1938).

169. *See* Chandler Act § 169, 52 Stat. at 890 (codified prior to repeal at 11 U.S.C. § 569 (1938)). For a discussion criticizing (delicately) the diminished role for private parties in negotiating a plan, see James N. Rosenberg, *Reorganization: Yesterday, Today, and Tomorrow,* 25 VA. L. REV. 129, 144, 146 (1938).

170. *See* Chandler Act § 169, 52 Stat. at 890 (codified prior to repeal at 11 U.S.C. § 569 (1938)).

The Lea Bill, which would have amended the Securities Act of 1933 to give the SEC wide ranging powers to regulate protective committee activity in bankruptcy, would have imposed even more draconian restrictions. For a description of the Lea Bill Proposals, see John Gerdes, *Section 77B, The Chandler Bill and other Proposed Revisions,* 35 MICH. L. REV. 361, 368-73 (1937). *See* Cloyd LaPorte, Note, *Changes in Corporate Reorganization Procedure Proposed by*

In addition to shutting insiders out of the process, the Chandler Act also gave broad-ranging authority to the SEC to ensure that investors' interests were adequately represented. To facilitate SEC advocacy, Chapter X gave the Commission standing to act as a party in interest at any point. Chapter X also required that any reorganization plan in a case over $3 million be submitted to the SEC for comments prior to confirmation.[171]

The effect of the reforms was to completely transform Section 77B and the equity receivership process that had inspired it. In place of manager-driven bankruptcy, the reformers interposed a harsher, manager-displacement regime. The reformers' vision did not entirely replace other perspectives. The Chandler Act preserved the reorganizers' original goal of providing a mechanism for binding dissenters. Furthermore, in what may have been in part a concession to the National Bankruptcy Conference, it limited the SEC to an advisory role,[172] rather than giving it the kind of regulatory oversight the ICC had wielded in railroad reorganizations.[173] But there was little question as to whose vision Chapter X of the Chandler Act reflected.[174]

In form, the Chandler Act preserved the *ex post* negotiation process that had developed in the equity receivership era and had been codified in Section 77B. But the Chandler Act dramatically changed the tenor of the process from manager-driven bankruptcy to a manager-displacement approach. Stated differently, the Chandler Act superficially resembled a flexible bankruptcy regime, since it contemplated reorganization of troubled firms. However, its manager-displacement presumptions gave managers an enormous

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the Chandler and Lea Bills, 51 HARV. L. REV. 672 (1938). After extensive hearings in June and July, 1937, the bill died, leaving the Chandler Act as the single source of regulation.

171. *See* Chandler Act § 172, 52 Stat. at 890 (codified prior to repeal at 11 U.S.C. § 582 (1938)).

172. *See 1937 House Hearings*, *supra* note 152, at 146 (statement of Jacob Weinstein) (suggesting the SEC agreed to be limited to an advisory role).

173. Of particular importance for subsequent developments, the SEC largely limited its focus to Chapter X's provisions for large corporations. In consequence, the National Bankruptcy Conference and the bankruptcy attorneys it represented got nearly everything they wanted in the other provisions of the Chandler Act, including those dealing with smaller corporations. This fact will figure prominently in the discussion of the developments of the 1950s. *See infra* Part III.E.

174. One of the most far reaching implications of the Chandler Act is that it altered the interest group dynamic in American corporate bankruptcy in ways that have apparently never been fully recognized. By effectively cutting Wall Street bankers out of corporate reorganization, the Chandler Act not only eliminated one previously important interest group, the bankers themselves, but it also ended the Wall Street reorganization bar's influence over corporate reorganization. Because the Wall Street firms' status was closely linked to that of their clients, the Wall Street banks, removing the banks opened up and eventually transformed bankruptcy practice.

incentive to avoid bankruptcy at all costs—precisely the incentive they have in an *ex ante* regime.[175]

E. Reinforcing Ex Post Governance in the 1950s

Rather than a single, coherent governance framework, the New Deal left a striking tension in American corporate law. On the corporate governance side, New Deal financial reform laid the groundwork for *ex post* governance by limiting institutional investors' ability to hold and exercise large equity stakes in industrial corporations. By contrast, the Chandler Act introduced a harsh, manager-displacing regime to bankruptcy.

The evolutionary theory of this Article suggests that such a regime—mixing *ex post* corporate governance with *ex ante* bankruptcy—is unstable. The theory predicts that subsequent developments would either push corporate governance in an *ex ante* direction, or managers would somehow reestablish a manager-driven bankruptcy process. This is just what happened, as the second of these possibilities gradually won out.

Although the economy emerged from the Depression in the 1940s, it was the expanding peacetime economy of the 1950s that once again turned attention to the corporate governance issues Congress had legislated on during the 1930s. Stock market trading increased to levels that had not been seen since the 1920s, and buyers suddenly began to use the voting power their shares gave them to wage contests for corporate control—a trend traced by some to Robert Young's stunning victory in the battle for control of the New York Central Railroad in 1954.[176] While the emergence of an active market for control is classic evidence of *ex post* governance, there was widespread resistance to the increase in hostile takeovers.[177] There also

175. In fact, it appears that the Chandler Act chilled filings and frequently caused liquidation, particularly as compared to the current reorganization framework. This seems likely to be at least part of the explanation for Bradley and Rosenzweig's data suggesting that shareholder value declines more significantly under current law than under the Chandler Act regime. *See* Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992) [hereinafter Bradley & Rosenzweig, *Untenable Case*]; Michael Bradley & Michael Rosenzweig, In Defense of Abolishing Chapter 11 (1995) (unpublished manuscript, on file with author).

176. *See* CHERNOW, *supra* note 22, at 508-11 (describing the proxy contost and characterizing it as an assault on previous norms of Wall Street behavior). Proxy contests were the hostile takeover device of choice in the 1950s. It was not until the 1960's that raiders began using tender offers, which proved more effective in practice.

177. *See* Eugene V. Rostow, *To Whom and for What Ends is Corporate Management Responsible*, *in* THE CORPORATION IN MODERN SOCIETY 46, 46-48 (Edward S. Mason ed., 1960) (noting and criticizing fact that "[r]aiding is regarded as something more than uncouth . . . it is

remained the possibility that banks or other intermediaries might evade the restrictions on their involvement in corporate governance[178] and that managers might welcome large, stable shareholders as an antidote to takeovers, as they have in Japan and Germany.

By the end of the 1950s and early 1960s, these issues were resolved in favor of market-driven governance rather than concentrated shareholding. Legislatively, Congress preempted banks' use of holding companies to circumvent the New Deal reforms by enacting the Holding Company Act of 1956.[179] Ideological factors such as the strong disfavor that would have met increasing involvement by banks and insurance companies in corporate affairs may also have discouraged these institutions from getting more involved.[180] Further, market trading remained strong, control contests continued, and firms increasingly used performance-based compensation to sharpen managers' focus on the performance of the firm's stock.[181]

Given the redoubled emphasis on an *ex post* approach to corporate governance in the 1950s, one might predict that managers would have found ways to evade the more draconian provisions of the Chandler Act—that is, that the upsurge in market-driven corporate governance would be accompanied by a shift in its bankruptcy law complement toward a more flexible, manager-driven regime.[182] This in fact is precisely what took place, through a remarkable sequence of events that ended the SEC's role as a major player in corporate reorganization.[183]

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treated as almost illegal"); *see also* Bayless Manning, Jr., *The American Stockholder*, 67 YALE L.J. 1477, 1494 n.32 (1958) (bemoaning increase of takeovers).

178. The chief threat came from the bank holding company structure, which banks had begun using as a means of circumventing branching restrictions.

179. Roe discusses the Holding Company Act and its significance in freezing banks out of American corporate governance in ROE, STRONG MANAGERS, *supra* note 2, at 98-100.

180. *See, e.g.*, *id.* at 87 (noting insurance company fear of additional regulation).

181. Randy Krozner has tracked the striking increase in corporations' use of stock and stock options, in the 1950s and thereafter, to align managers' interests with that of shareholders. *See* Randall Krozner, Were the Good Old Days that Good? (1997) (unpublished draft, on file with author). One reason for this may have been accounting changes in the 1950s that made it cheaper for firms to give their executives stock options. But the evolutionary theory of this Article suggests another reason: as the New Deal reforms eliminated banks' ability to serve as relational monitors, incentive compensation may have emerged, along with more active markets, as an altornative mechanism for reducing managerial agency costs.

182. Another possibility is that managers would seek legislative protection from takeovers. This in fact is exactly what they did with the 1968 Williams Act and subsequent state antitakeover statutes. But these dampened rather than eliminated the takeover market.

183. For further discussion of the events that follow and a public choice-based theory as to why the SEC disappeared, see David A. Skeel, Jr., The Rise and Fall of the SEC in Bankruptcy (1998) (unpublished draft, on file with author).

To appreciate how the SEC was outmaneuvered, one must first return to the structure of the Chandler Act itself. In addition to Chapter X, which was the focus of the SEC's attention, the Chandler Act also included a second reorganization chapter, Chapter XI.[184] In contrast to Chapter X's trustee requirement and pervasive government oversight, Chapter XI left a firm's managers in control and did not provide for SEC intervention.[185] It was clear to everyone that Chapter X was designed for publicly held corporations and that Chapter XI was designed for small firms. Yet nothing in the Chandler Act precluded the managers of a large corporation from steering the firm toward the more hospitable waters of Chapter XI rather than filing under Chapter X,[186] a defect that the SEC and commentators noticed and decried almost immediately.[187]

In the early years of the Chandler Act, the SEC appeared to have headed off managers' efforts to exploit this quirk in the legislation's draftsmanship. In *SEC v. United States Realty & Improvement Co.*, the Supreme Court agreed with the SEC that the debtor in question could not use Chapter XI, and seemed to foreclose publicly held firms from that chapter.[188] Managers continued to push the boundaries of Chapter XI, however, and in *General Stores Corp. v. Shlensky*, Justice Douglas stunned the SEC by ruling that the choice of chapter depended on the "needs to be served."[189] He made clear that even a publicly held corporation could invoke Chapter XI in an appropriate case.[190] Although the SEC won on the facts of *Shlensky*, the decision helped to ensure it would lose the war. By the 1960s and

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184. *See* Chandler Act ch. 11, 52 Stat. 840, 905-16 (1938) (codified prior to repeal at 11 U.S.C. §§ 702-99 (1938)).

185. Chapter XI was largely the work of the National Bankruptcy Conference, and was an outgrowth of the composition procedure that had long been part of the Bankruptcy Act. Chapter XI contemplatod a scale-down of unsecured debt, and consequently did not permit either secured debt or equity interests to be altered. Congress amended the chapter in 1952 to make clear that Chapter XI, unlike Chapter X, did not require adherence to the absolute priority rule. The distinctions between the chapters are described in each of the Supreme Court decisions discused below, and in a third decision, *SEC v. America Trailer Rentals Co.*, 379 U.S. 594, 603-07 (1965).

186. Ironically, firms could be kept out of Chaptor X because Section 130(7) required a showing that the firm could not obtain adequate relief under Chapter XI. For an excellent discussion, see Eugene V. Rostow & Lloyd N. Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334, 1362 (1949).

187. *See id.* at 1335 n.3.

188. 310 U.S. 434, 457-58 (1940).

189. 350 U.S. 462, 466 (1956).

190. *See id.* One of many intriguing questions raised by the case is why Douglas, the former SEC chairman and architect of Chapter X, rejected the SEC's pleas that all publicly held debtors be steered into Chapter X. The most likely explanation is that the holding reflected Douglas' continued commitment to a flexible, "functionalist" approach to bankruptcy, and that Douglas never anticipated the SEC's ultimate demise. *See* Skeel, *supra* note 183.

early 1970s, the use of Chapter XI to reorganize publicly held firms had become increasingly routine.[191]

Why, in the two decades after the Chandler Act, did the SEC begin to lose its grip over the reorganization of publicly held corporations? To a certain extent the developments just described can be attributed to historical accident. Not only did the drafters neglect to explicitly steer public firms into Chapter X, but the *United States Realty & Improvement Co.* decision may actually have thwarted the SEC from closing the loophole. Prior to this case the SEC had proposed corrective legislation, but Congress refrained from acting based, apparently, on the view that legislative action was no longer necessary.[192]

In addition to—and probably more crucial than—these events were several important institutional factors. The current managers of a troubled firm and their lawyers had strong incentives to try for Chapter XI, since this chapter would enable both to retain their positions.[193] Given the obvious intent that public firms use Chapter X instead, one might not expect their prospects for success to be good. Yet the managers and lawyers had a significant advantage over the SEC in these jurisdictional disputes: the lower court judges who decided these cases may themselves have preferred Chapter XI, since Chapter X required the lower court to share authority with the SEC, and also introduced significant delay into the process.[194] Moreover, in the absence of a complicated capital structure or credible evidence of managerial misbehavior, the ideological case for insisting on the elaborate apparatus of Chapter X was weak.[195]

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191. *See, e.g.*, REPORT OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137 (1973) [hereinafter 1973 COMMISSION REPORT] ("it is readily apparent that Chapter XI has evolved into the dominant reorganization vehicle and very suhstantial dehters are able to reorganize in Chapter XI"). This does not mean that the SEC had no role when firms reorganized in Chapter XI. The SEC still could negotiato benefits for public investors in return for its agreement not to challenge the firm's use of Chapter XI.

192. *See* H.R. REP. NO. 76-2372, AT 2 (1940).

193. An even better solution given the uncertainty of the gambit might be to do everything possible to avoid bankruptcy altogether. This suggests that the public firm managers who pushed for Chapter XI were likely to be those who simply could not avoid bankruptcy.

194. *See generally* Allen F. Corotte & Irving H. Picard, *Business Reorganizantions Under the Bankruptcy Reform Act of 1978—A New Approach to Investor Protections and the Role of the SEC*, 28 DEPAUL L. REV. 961, n.19 (1979) (noting that many of the appellate cases on the Chapter X-XI choice followed lower court denials of SEC motions to transfer to Chapter X).

195. *See, e.g.*, Melvin Robert Katskee, *The Calculus of Corporate Reorganization: Chapter X v. XI and the Role of the SEC Assessed*, 45 AM. BANKR. L.J. 171, 176-80 (1971) (arguing that Chapter X should be used in the event of serious allegations of managerial incompetence or fraud, but not as a matter of course).

It is important to emphasize that, even after *Shlensky* opened the doors to Chapter XI, the Bankruptcy Act fell well short of a pure *ex post* bankruptcy regime. Because the SEC continued to resist public firms' use of Chapter XI, and frequently succeeded, managers faced significant uncertainty if the firm filed for bankruptcy.[196]

One could characterize American corporate governance during this time in similar terms. Corporate control contests had become far more frequent, but the market for control was still very much developing and faced a variety of impediments.[197] With these caveats in place, however, we can say with some confidence that the events of this era removed any serious doubts as to whether American corporate governance would develop in an *ex ante* or an *ex post* direction. By the end of this period, it became clear that market forces rather than large shareholders would predominate in corporate governance, and bankruptcy increasingly included a meaningful reorganization option.

To underscore the significance of these developments for this Article's evolutionary story, consider a counterfactual example. Suppose managers and their lawyers had failed to circumvent the Chandler Act's manager-displacement provisions. How might firms' approach to corporate governance have developed differently? The analysis of this Article suggests that, in time, managers would have kept the debt in their firms' capital structures low to minimize the likelihood of bankruptcy, and turned increasingly to large shareholders to diminish the risk of takeovers. Similarly, the credible threat of manager-displacing bankruptcy would have reinforced investors' incentive to acquire large stakes in publicly held firms. On this reasoning, what might have emerged was, at least in theory, an *ex ante* approach to corporate governance.

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196. Mid-sized firms with publicly held securities, rather than large firms, first opened the doors to Chapter XI. *See* Benjamin Weintraub & Harris Levin, *A Sequel to Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation*, 26 FORDHAM L. REV. 292 (1957) (developing this theory); Benjamin Weintrauh et al., *Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation*, 24 FORDHAM L. REV. 616 (1956) (same); Benjamin Weintraub & Harris Levin, *Reorganization or Arrangement: An Analysis of Contemporary Trends in Recent Cases*, 37 REF. J. 103 (1963) (same).

197. In addition to a general corporate culture that still frowned on hostile raids in many respects, courts toyed with doctrinal devices that would have had a chilling effect on changes of control. *See, e.g.*, Perlman v. Feldmann, 219 F.2d 173, 178 (2d Cir. 1955) (suggesting buyers of controlling stock interests might be required to make same offer to minority shareholders); *see also* Rostow, *supra* note 177, at 46-48.

F. The View from the End of the Twentieth Century

Subsequent developments have strongly reinforced the *ex post* orientation of American corporate law. In bankruptcy the pivotal event came in 1978, when Congress completely overhauled the bankruptcy laws by enacting the current Bankruptcy Code to replace the former Bankruptcy Act.[198]

The Code's most important effect was to dramatically streamline bankruptcy's reorganization option—in ways that make it far more palatable to the managers of a troubled firm. Rather than two reorganization chapters, the Code includes only one—Chapter 11.[199] Not only does Chapter 11 all but eliminate the role of the SEC,[200] but it also adopts a strong presumption that a firm's current managers, rather than a trustee, will be the ones to run the firm in bankruptcy.[201] To smooth the road to reorganization, Chapter 11 also relaxes the requirements of the absolute priority rule.[202]

To appreciate Chapter 11's dramatic shift from the Chandler Act vision of corporate bankruptcy, the best place to start is with the single most influential interest group—bankruptcy lawyers. Because bankruptcy lawyers represent different kinds of clients—usually either creditors or debtors—they bring a variety of perspectives to bear. Yet, whatever their other differences, lawyers for both creditors and debtors are likely to favor a meaningful reorganization option, since their practice depends on it.[203]

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198. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101-1330 (1994)).

199. For a discussion in public choice terms of the debate whether to retain two corporate reorganization chapters or to enact only one, see Posner, *supra* note 150 at 108-118.

200. The SEC retains the right to be heard in Chapter 11 cases, *see* Bankruptcy Code § 1109, but it has no special authority to review plans or to exercise oversight in other ways. For a scathing criticism in the popular media of the Bankruptcy Code and its removal of SEC oversight, see Anne Colamosca, *The Bankruptcy Hustle*, NEW REPUBLIC, Feb. 17, 1979, at 15.

201. Bankruptcy Code § 1101 treats the debtor as a "debtor-in-possession" when it files for Chaptor 11 relief, and Bankruptcy Code § 1107 gives the debtor-in-possession all of the powers of a trustee. Trustees can only be appointed for cause, *see* Bankruptcy Code § 1104(a)(1), and their appointment in Chapter 11 is very much the exception, *see* Skeel, *Nature*, *supra* note 5, at 512 n.199.

202. Whereas Chapter X required that the absolute priority rule be satisfied in every case, the rule comes into play in Chaptor 11 only with respect to a class of creditors or shareholders that votos against the reorganization plan. *See* Bankruptcy Code § 1129(b).

203. In effect, bankruptcy lawyers serve as agents for their potential clients, creditors and debtors, in the lobbying process. But their agency is quite imperfect. Not only do attorneys reflect the views of actual debtors rather than healthy firms, but they also benefit from a costly bankruptcy process even if their clients do not. *See* Michelle J. White, *Legal Complexity and Lawyers' Benefit from Litigation*, 12 INT'L REV. L. ECON. 381 (1992) (considering level of legal complexity that maximizes lawyers' income).

It is important to keep in mind that the bankruptcy bar that lobbied for the current Bankruptcy Code was quite different from the corporate reorganization bar of the 1930s. Ironically, by transforming the bankruptcy bar from a domain of elite Wall Street lawyers to a less prestigious but broader-based practice, the New Deal reformers may have enhanced the bar's influence. By the 1970s, the corporate reorganization bar was much larger and more difficult to attack as an insular elite.

The managers of potential debtors were, even more than in the 1930s, conspicuously absent from the legislative process. As discussed earlier, the most obvious explanation for their otherwise puzzling silence is that the representatives of potentially troubled debtors are unlikely to both recognize their status in advance and identify themselves.[204]

The only important interest group that sought to retain the more elaborate administrative apparatus of Chapter X was the SEC. But the SEC's influence was greatly diminished by this time and its cries for regulatory supervision of large corporation bankruptcies went unheeded.[205]

Ideology may also have played an indirect role in the 1978 Code. Recall that two sometimes clashing ideological threads tend to come together in bankruptcy—a general antipathy toward large businesses and the desire to give failed businesses a second chance.[206] By the 1970s, the former concern played little role (in part because banks and Wall Street law firms were a distant memory in bankruptcy). Congress was thus less troubled by the elimination of SEC oversight than it might otherwise have been, and the general background sentiment favoring reorganization of troubled businesses counseled for the more flexible reorganization provisions that eventually passed.

The recent history of American corporate governance has tended in a very similar direction. The proxy contests of the 1950s gave way to takeovers in the 1960s and 1970s. In the 1980s, takeovers mushroomed due, among other reasons, to the advent of

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204. The contrast between bankruptcy and a hostile takeover is instructive in this regard. During the 1980s, the managers of many, and perhaps most, publicly held corporations saw their firms as potential takeover targets. Managers therefore lobbied vigorously in support of, and in fact generally initiated, the anti-takeover statutes that many states enacted. *See* Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 136-38 (1987).

Creditors generally supported the efforts to streamline reorganization, which they saw as a way to reduce the costs of the bankruptcy process. *See* Posner, *supra* note 150, at 117-18; *see also* Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411 (1990) (arguing that creditors got what they wanted in chapter 11).

205. *See* Posner, *supra* note 150, at 117-18.

206. *See supra* notes 90-92 and accompanying text.

high-yield debt and the Justice Department's diminished use of the antitrust laws to challenge horizontal mergers during the Reagan presidency.[207] At the same time, incentive-based compensation has become even more widespread, managers have increased the debt in firms' capital structures, and managerial and labor markets have become increasingly fluid.[208] There have been important countertrends as well—the most prominent being states' enactment of antitakeover statutes that significantly impede hostile takeovers.[209] But American corporate governance as a whole has all the indicia of a classic *ex post* system.

This description of the evolution of *ex post* governance in America is not intended to suggest that a nation's corporate governance system will evolve relentlessly in an *ex post* or *ex ante* direction. Even in this condensed history of the American system, there are shifts in direction—as in the Chandler Act's reversal of the much broader reorganization option that had been provided under the short-lived Section 77B. In a more exhaustive history, one could explore many more examples of partial shifts.

This Article intends, instead, to show how and why the *ex post* system now in place has developed as it has, and to support the claim that changes in the nature of corporate bankruptcy are likely to accompany corporate governance changes, and vice versa, due to the complementary relationship between them. As the analysis has suggested, *ex post* corporate governance and bankruptcy have evolved together. While the correspondence is not perfect, developments in one have paralleled changes in the other at each stage.

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207. *See* Edward B. Rock, *America's Shifting Fascination with Corporate Governance*, 74 WASH. U. L.Q. 367, 374 (1996).

208. *See, e.g.*, ROBERT C. CLARK, CORPORATE LAW § 6.2, at 200-06 (1986) (describing increased use of incentive compensation and tax changes influencing use of stock options); Raghuram G. Rajan & Luigi Zingales, *What Do We Know About Capital Structure? Some Evidence from the International Data*, 50 J. FIN. 1421, 1449-50 (1995) (describing increase in leverage between 1984 and 1991).

209. The shifting stance of the Delaware courts toward hostile takeovers has been a similarly important factor. After imposing relatively stringent obligations on the directors of a target firm to consider unwanted takeover bids in the mid 1980s, the Delaware Supreme Court gave directors more leeway at the end of the decade. For a discussion of Delaware decision making in corporate law with a particular emphasis on the court's takeover cases, see David A. Skeel, Jr., *A Unanimity Norm in Delaware Corporation Law*, 83 VA. L. REV. 127 (1997).

IV. THE EVOLUTION OF EX ANTE GOVERNANCE IN JAPAN AND GERMANY

Having considered at some length the historical developments that have produced America's *ex post* corporate law framework, our focus will now shift to Japan and Germany. As with American corporate law, the secondary literature on the history of Japanese and German corporate law is still relatively undeveloped. Even with this constraint, the overview is quite suggestive.

For both Japan and Germany, World War II was the pivotal event defining the current landscape of corporate law and corporate bankruptcy. In the wake of the war and the economic devastation it left, corporate governance patterns changed in important respects in both countries. This is not to say that the post-war period was a complete break from the two countries' previous approaches to corporate law. To the contrary, the general trend in each nation prior to the war was in an *ex ante* direction. The post-war changes led in the same direction, though with striking adjustments in each country.

A. Japan: Ex Ante Governance with a New Face

Prior to World War II, the most striking feature of Japanese corporate governance was the prominence of a handful of *zaibatsu*—family dominated corporate groups that generally spanned several industries. Interestingly, recent research suggests that the *zaibatsu* controlled less of Japan's industry than is commonly believed, and that the securities markets served as a relatively important source of financing.[210] Nevertheless, corporate governance had strong *ex ante* characteristics, as the *zaibatsu* were family controlled and large shareholders took an active interest in managing most non-*zaibatsu* firms.[211]

The first major changes in the structure of the Japanese securities markets came in connection with the wartime planning of the 1930s. Government initiatives designed to increase saving squeezed small shareholders out of the market, and the Japanese government actively intervened in corporate governance.[212] The government or-

210. *See* Okazaki, *supra* note 39, at 351-52 (only 10 of 60 of the largest mining and manufacturing firms were *zaibatsu*-related; 30-40 percent of the funds for all firms came from the capital markets).

211. *See id.* at 352-54.

212. *See id.* at 362-75.

ganized loan syndicates headed by the Bank of Japan[213] and designated which financial institutions would finance each munitions corporation.[214] The overall effect was to greatly diminish market liquidity and to reinforce the *ex ante* nature of Japanese corporate governance.

Japanese bankruptcy followed a similar pattern. In the decades prior to World War II, Japanese lawmakers enacted two different composition provisions. The first was enacted in 1899,[215] and the second dates to 1922.[216] Both are simplified procedures designed only for small businesses. In striking contrast to the United States, there is little evidence of a movement to expand the bankruptcy process to facilitate the reorganization of large, troubled firms. Firms either resolved their financial distress privately or they were liquidated.

By the time of the Allied Occupation, Japanese corporate governance and corporate bankruptcy had developed in a decisively *ex ante* direction. With the Allied Occupation came a dramatically different impulse. During the occupation, the United States required Japan to enact many of our financial reforms. The Japanese version of Glass-Steagall drove a wedge between commercial and investment banking and imposed the same limits on stock ownership by banks—no more than five percent of any corporation—that American banks face.[217] On the bankruptcy side, Japan enacted Chapter X of the Chandler Act.[218] In short, the occupation imposed on Japan nearly all of the reforms from which America's *ex post* system subsequently emerged.

Unlike the United States, however, Japanese corporate governance never developed in an *ex post* direction. Although banks could hold only limited amounts of a corporation's stock, they evaded these limitations by participating in *keiretsu*—the extensive crossholdings that characterize many of Japan's most prominent businesses.[219] Rather than discouraging this development, the

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213. *See id.* at 369. As Okazaki notes, there are obvious parallels between this practice and the main bank system that emerged after World War II.

214. *See id.* at 371.

215. *See* Shoho (Commercial Code), Law No. 48 of 1899, §§ 381 et seq.

216. *See* Wagiho [Composition act], Law No. 72 of 1922. Whereas the 1899 composition provisions were limited to corporations, the 1922 procedure is general in scope. For a brief but useful description of each, see Theodore Eisenberg & Shoichi Tagashira, *Should We Abolish Chapter 11? The Evidence From Japan*, 23 J. LEGAL STUD. 111, 115-16 (1994).

217. *See,* Roe, *Some Differences, supra* note 36, at 1951-52.

218. *See* Kaisha Koseiho [Corporate reorganization act], Law No. 172 of 1952.

219. *See* Gilson & Roe, *Overlaps, supra* note 39.

government has been an active participant. The government participates in the relational governance process through ongoing, informal contacts with the main banks and the firms they monitor.[220] Thus, though the face of Japanese corporate governance looks much different than it did before World War II, its *ex ante* characteristics have remained in full force.

The path of Japan's corporate reorganization provisions has been entirely consistent with its *ex ante* corporate governance. Whereas American firms began to evade Chapter X in the 1950s, Japan has retained the full force of the provisions as originally enacted.[221] The managers of a firm that invokes the provisions are invariably replaced by a trustee and the few troubled, publicly held firms that wind up in bankruptcy are nearly always liquidated.[222]

The story thus far suggests that banks and the managers of large firms have consistently had their way in Japanese corporate governance, subject to ongoing government intervention. Yet this is not entirely the case. As in the United States, populist sympathies have periodically left their mark on corporate governance. Yet in striking contrast, the effect of populism has been to enhance the status of labor, without attacking either the influence of banks or the concentrated ownership of prominent firms. Thus, labor has long enjoyed a much greater voice in corporate governance in Japan than in the United States.[223] Ronald Gilson and Mark Roe have recently speculated that lifetime employment may have emerged in the 1950s as an initiative by conservative businessmen designed to quell labor unrest that threatened to turn in a radical direction.[224]

Translating the developments just described into the institutional terms used in Part III provides further insight into Japanese corporate governance and the way it has developed. First, consider the relevant interest groups. Banks and the managers of firms have been consistently influential, due both to the economic power they wield and to the close, symbiotic relationship between business and government—evidenced most vividly by the practice in smaller firms

220. Milhaupt, *supra* note 61, at 28.

221. *See* Eisenberg & Tagashira, *supra* note 216, at 116 (corporate reorganization is based on former Chapter X and "is a rigid proceeding . . . [that] almost always entails a change of management).

222. *See id.*

223. *See* Okazaki, *supra* note 39, at 363.

224. *See* Ronald J. Gilson & Mark J. Roe, Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance, at 30-31 (1996) (unpublished manuscript, on file with author) (lifetime employment possibly used to "crack[ ] labor solidarity").

of appointing retiring bureaucrats to their boards.[225] The most visible competing interest group is labor. The *ex ante* system that has emerged can be seen as a compromise among the parties' interests. In return for protection against external threats such as takeovers, managers tolerate bank oversight and liquidation-based bankruptcy,[226] and labor tolerates financial concentration in return for benefits such as lifetime employment.

Second, structural constraints reinforce the *ex ante* arrangement. Japan's geography, particularly its small size and its political tradition of centralized power, have precluded the formation of influential local interest groups comparable to the local banks that have figured so prominently in American corporate law history. With the potential exception of labor,[227] there is no obvious, powerful constituency for fragmentation. Liquidation-based bankruptcy is a natural adjunct to this, since it cements the relationship between banks and the firms they monitor.[228]

Finally, and perhaps tautologically, *ex ante* governance can be seen as a reflection of the toleration of economic concentration and stigmatization of failure that form the ideological underpinnings of these historical developments.

B. Germany: The Marriage of Banks and Business

To understand the emergence of Germany's *ex ante* corporate governance framework, we must begin with that nation's longstanding pattern of powerful financial institutions. Dating back to the nineteenth century, German banks have wielded enormous power as financers and shareholders of German corporations.[229]

Prior to World War II, the attributes of *ex ante* governance were largely in place. On the corporate law side, banks and other large shareholders figured prominently in corporate governance,[230]

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225. *See* Milhaupt, *supra* note 61, at 29.

226. *See* Sheard, *supra* note 43, at 318-20 (describing protection from takeovers as an important characteristic of Japanese cross-shareholdings).

227. Recall that in one account of Japanese labor history, labor was bought off, in effect, by business leaders' decision to implement lifetime employment. *See* Gilson & Roe, *supra* note 224, at 27-35. If lifetime employment were te disappear, as some predict, labor might more aggressively challenge the current framework.

228. *See supra* note 66 and accompanying text.

229. *See* DeLong, *supra* note 22, at 228 ("the role played hy the great banks in monitoring and supervising corporate managements was an accepted part of German financial theory in the years before World War I"); *see generally* Richard Tilly, *Banking Institutions in Historical and Comparative Perspective: Germany, Great Britain, and the United States in the Nineteenth and Early Twentieth Centuries*, 145 J. INST. & THEORETICAL ECON. 189 (1989).

230. *See* DeLong, *supra* note 22, at 228.

while capital markets were insufficiently liquid to allow for *ex post* governance mechanisms such as takeovers. The German bankruptcy system was fully consistent with this. The principal bankruptcy statute, which dated to 1879, provided solely for piecemeal liquidation.[231]

Like the rest of Germany's economy, the corporate governance framework was roiled by the years around World War II, which included both hyperinflation and the economic devastation left by the war. At the end of the war, the capital markets were all but nonexistent and most of Germany's business was in shambles.[232] It was in the rebuilding of the German economy that German corporate governance might plausibly have developed in a different direction, perhaps with active markets and a diminished bank role. But as in Japan, Germany retained its *ex ante* framework, and did so at least in part through a rapprochement between business leaders and labor.

In Germany, rather than socializing or fragmenting industry, the government implemented co-determination on a national basis in 1951.[233] In addition to the "works councils" that already assured workers an audience with a corporation's management board, co-determination provided direct representation for labor on the supervisory boards of substantial German corporations.[234] With co-determination, workers expanded their voice in corporate governance, and any populist sentiment for fragmenting the nation's financial institutions was diffused.

Developments in German bankruptcy law complicate the analysis slightly, but prove fully consistent with the version of *ex ante*

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231. The statute, the Konkursordnung (KO) was promulgated in 1877 and became effective on October 1, 1879. *See* Maximilian Schiessl, *On the Road to a New German Reorganization Law—A Comparative Analysis of the Draft Proposed by the Insolvenzrechts Kommission and Chapter 11 of the Bankruptcy Code*, 62 AM. BANKR. L.J. 233, 235 (1988).

232. *See* Jurgen G. Backhaus, Co-Determination in Germany: 1949-1979 and There Beyond: Bonding or Compulsion, at 2 (1996) (unpublished manuscript, on file with author).

233. "Co-determination" refers to mandatory representation of employees in corporate governance, usually on a corporation's board of directors. Co-determination did not emerge in Germany in 1951 for the first time. Board representation for employees had been implemented in 1922, and several German states had enacted co-determination provisions in the period prior to 1951. *See id.* at 2.

234. Large German corporations generally have two boards, a management board (the "Vorstand") that makes most corporate decisions, and a supervisory board (the "Aufsichtsrat") that makes appointments to the management board and approves the annual dividend. For a useful description, see JONATHAN P. CLARKHAM, KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES 17-25 (1994).

Some commentators have argued that co-determination would not prove effective in the absence of a two-tier board, since the worker representatives on a single-tier board would be on both sides of labor negotiations. On a two-tier board, by contrast, the labor representatives serve on the supervisory board, whereas labor negotiates with the management board. *See* Backhaus, *supra* note 232, at 16.

governance that emerged on the corporate side. In 1935, Germany added a composition provision to its bankruptcy laws in response to repeated calls for a statutory mechanism for reorganizing troubled businesses.[235] Although the composition statute is, in form, a simplified reorganization provision,[236] in practice it immediately displaces managers and invariably leads to liquidation of large corporations that file for bankruptcy.[237]

German bankruptcy law will include a much more extensive reorganization procedure as of 1999, when the Insolvenzordung enacted in 1994[238] takes effect, and subsumes the two existing bankruptcy statutes.[239] Although the statute was explicitly derived from the American Chapter 11, it differs in striking and revealing respects. For instance, the German provision provides for a firm's managers to be replaced by an administrator,[240] and every case must begin as a liquidation.[241] Moreover, a request by creditors to liquidate the firm explicitly trumps any reorganization plan.[242] Despite the fanfare attending the new statute,[243] German bankruptcy law clearly will retain its harsh, manager-displacing character even after the reforms take effect, and the general pattern of *ex ante* governance will remain fully in place.

From the perspectives of our three institutional factors, the evolution of German corporate governance looks broadly similar to the evolution of Japanese corporate governance. Banks and corporate managers have had particular influence and the interests of labor have been addressed in a way that preserves the influence of concentrated banks. The ideological backdrop—a general tolerance of concentration, aversion to failure, and concern for the status of employees—can also be seen as broadly similar.

But there are some intriguing differences as well. First, the government has somewhat less of an ongoing role in Germany than in

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235. *See* The Vergleichsordnung of 1935, v. 2.26.1935 (RGB1. I S.321); Schiessl, *supra* note 231, at 238.

236. It applies only if a company can pay a substantial percentage of its unsecured obligations and must be invoked within three weeks of the time when a firm's managers become aware of its insolvency. *See* Schiessl, *supra* note 231, at 238-39.

237. *See id.* at 239.

238. *See* Bundesgesetzblatt, v. 1994 (BGB1. I S.2866).

239. For a good description, see Klaus Kamlah, *The New German Insolvency Act: Insolvenzordnang*, 70 AM. BANKR. L.J. 417 (1996).

240. *See id.* at 426.

241. *See id.* at 424.

242. *See id.* at 430.

243. Interestingly, insolvency practitioners vigorously opposed the changes, apparently because the new statute will shift power from an administrator te a firm's creditors. *See id.* at 435.

Japan,[244] which suggests that German firms may have somewhat more freedom from governmental policy concerns. Second, while Germany, like Japan, has a tradition of centralized rule, its politics now are more federalized—localities have significant influence. In view of this, one could imagine local interests taking aim at banks and large business, as in the United States. For the most part, however, they have not. This may be because large firms are a source of tax revenues and of stable employment for the communities in which they are located.[245]

Further, the historical conditions from which the existing German framework emerged may reinforce the disinclination to attack bank concentration. In addition to the manager-displacing orientation of German bankruptcy law, another impediment to enacting a more flexible regime is the rigid adherence to the absolute priority rule, which makes it difficult to preserve a stake for shareholders. The commitment to absolute priority reflects a view that banks and other creditors, rather than shareholders, financed German corporations after World War II, and thus that shareholders have no moral right to share in any bankruptcy recovery.[246]

As these differences suggest, the *ex ante* systems in Japan and Germany are a reflection of the distinct histories of the two countries. The histories underscore that neither *ex ante* nor *ex post* governance is economically inevitable.

V. SOME IMPLICATIONS OF THE DIFFERENT GOVERNANCE SYSTEMS

The preceding Parts have explored the distinct approaches to corporate governance and corporate bankruptcy in *ex ante* and *ex post* regimes, first in the abstract and then in historical terms. The rapid growth of international markets in recent years raises the obvious question of whether the current striking distinctions will endure. Are the different governance systems stable, or will each evolve in an *ex post* or *ex ante* direction, or toward some intermediate framework?

Somewhat surprisingly perhaps, the analysis that follows suggests that the current patterns will prove remarkably stable.

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244. Germany lacks the tradition of Administrative Guidance and Japanese firms' pattern of appointing ex-bureaucrats to their boards of directors. *See supra* note 69 and accompanying text (describing Administrative Guidance).

245. *See* Backhaus, *supra* note 232, at 16 (describing the symbiotic relationship between corporations and local communities).

246. Conversation with Professor Fritz Kubler (Dec. 1997).

Particularly in the nations we have considered, the prospects for significant change from the status quo seem quite limited absent a transformation of existing institutional constraints. My prediction that American corporate governance will retain its *ex post* character, and that Japan and Germany will remain *ex ante* systems, leads us back to the crncial question of whether one of the approaches is likely to be more efficient.

A. How Stable are the Ex Ante and Ex Post Systems?

The question of whether existing governance systems are stable raises two closely related issues. The first is whether the legal and political constraints that helped to produce the existing framework will eventually disappear. Will the New Deal restrictions on financial intermediaries erode in the United States, for instance, and how would their removal affect American corporate governance? Second, even apart from systemic change, can or will firms themselves contract around the existing framework or evade it in other ways? The analysis that follows will consider each of these questions, starting once again with the United States.

1. Institutional Stability Against the Odds

Enormous pressure has mounted in recent years to roll back many of the New Deal financial reforms, in large part because they increasingly hamper the competitiveness of banks against alternative forms of financing, such as issuing commercial paper.[247] Banks now have broad flexibility to branch across state lines,[248] and the Glass-Steagall barriers separating commercial and investment banking have eroded in significant respects.[249] At the same time, other institutional investors such as insurance companies, mutual funds, and pen-

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247. The irony of commercial banks' predicament is that the New Deal reforms initially assured banks almost continuous profits, since they gave commercial banks a virtual monopoly over traditional banking activities such as making loans. But as alternative forms of financing proliferated, commercial banks' inability to engage in activities such as underwriting diminished their ahility to compete. *See* Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1169-71 (1988).

248. The Riegle-Neal Act, Pub. L. No. 103-328, 108 Stat. 2338 (1994) (codified in scattered sections of 12 U.S.C.) will allow unlimited branching except in states that opt out of its provisions. For a good description of the Act and its effect, see Mark D. Rollinger, *Interstate Banking and Branching under the Riegle-Neal Act of 1994*, 33 HARV. J. ON LEGIS. 183 (1996).

249. Most prominently, the Federal Reserve has adopted a series of regulations easing the restrictions on commercial banks' ability to acquire investment-banking subsidiaries (referred to as "Section 20 subsidiaries"). The trend has triggered a flurry of acquisition activity.

sion funds have accumulated increasingly large equity stakes in many U.S. corporations.[250]

While these developments have already had significant effects, it would be a mistake to conclude they will lead in easy steps to Japanese or German-style corporate governance. In banking, for instance, interest groups such as local bankers that supported efforts to fragment large banks would continue to oppose bank concentration. The New Deal reforms also gave other interest groups—investment banks and insurance companies, for instance—a strong interest in the status quo.[251] The influence of these groups, together with the continued antipathy toward concentrated banks, makes it unlikely that United States banks will achieve anything like the influence their counterparts wield in Japan and Germany.[252]

In contrast to banks, other institutional investors have taken a more active role in corporate governance. Public pensions such as CALPers, for instance, helped to remove the chief executives of several prominent corporations. Yet institutional investors as a whole have strong disincentives to engage in active relational governance.[253]

The picture in bankruptcy is similar in many respects, but far more strongly aligned in favor of the status quo. In recent years, an increasing number of commentators have excoriated the perceived inefficiency of Chapter 11-style reorganization.[254] Based on recent insights in corporate finance, most have proposed some form of liquidation-based bankruptcy framework that would displace managers (or

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250. A 1991 study found that institutional investors hold 53 percent of all the publicly traded stock in U.S. corporations. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 827 n.27 (1992); C. BRANCATO & P. GAUGHAN, INSTITUTIONAL INVESTORS AND CAPITAL MARKETS: 1991 UPDATE, tbl.10 (Columbia Law School Institutional Investor Project, Center for Law and Economic Studies, Sept. 1991).

251. In recent years, lobbying by insurance companies has been the single most visible impediment to the elimination of Glass-Steagall Act barriers on the products banks can offer. *See, e.g.*, Keith Bradsher, *House G.O.P. Narrowing Bill on Deregulation*, N.Y. TIMES, June 9, 1995, at D1 (insurance companies successfully resist broad bill that would have reversed Glass-Steagall).

252. *See* Roe, *A Political Theory*, *supra* note 21, at 65 (expressing a similar view).

253. An enormous amount of literature has developed around the question of whether institutional investors should or will play an active role in American corporato governance in coming years. The first to note the disincentives faced by institutions other than public pension funds was Ed Rock. *See* Rock, *supra* note 54. Bernie Black developed his more optimistic view in a series of articles that began appearing at the same time. *See* Black, *supra* note 21; Black, *supra* note 250. The most recent contribution is Thomas Smith's argument that institutional investors' passivity stems less from political and legislative obstacles than from their customers' desire that the institutions eschew risk. *See* Smith, *supra* note 27.

254. *See supra* note 50 and accompanying text for references to some of this literature.

at the least, seriously destabilize their authority) as an alternative to the current regime.[255]

The existing institutional dynamic is so heavily biased in favor of an *ex post* approach to corporate bankruptcy, however, that it is difficult to imagine significant legislative change. The most prominent interest group, bankruptcy lawyers, has strong professional incentives to preserve Chapter 11 in its current form, as do bankruptcy judges.[256] If Chapter 11 is as inefficient as many commentators believe, one might expect creditors to lobby for reform. Yet, because creditors pass on the effects of inefficiency or increased efficiency to their borrowers, the principal interest of the creditors is in the transition costs of reform.[257] As a result, unless their sunk costs are unusually high, creditors have often been more interested in streamlining the existing system than with seeking significant reform.[258]

Ideological factors strongly reinforce the American tendency toward manager-driven, reorganization-based bankruptcy. At least since the nineteenth century railroad receiverships, the background ideology has favored a reorganization option rather than simply liquidating distressed firms.[259]

Notice that the stability of *ex post* bankruptcy also has a stabilizing effect on the market-driven nature of American corporate law. In addition to the other reasons to doubt any imminent shift toward Japanese or German-style governance, the existence of a manager-driven reorganization option undermines the effectiveness of the large stake-holdings that characterize an *ex ante* regime, and diminishes managers' need to invite the intrusion of large, active shareholders.[260]

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255. *See* sources cited *supra* note 50; *see also* Bradley & Rosenzweig, *Untenable Case*, *supra* note 175.

256. This is not to suggest that bankruptcy attorneys' or judges' motives are in any way malignant. Most believe strongly in the virtues of the existing framework, but this belief inevitably is conditioned by their own practice. *See* KOMESAR, *supra* note 104, at 58-65 (discussing the relationship between institutional constraints and motive).

257. For a more detailed discussion, see David A. Skeel, Jr., *Bankruptcy Lawyers and the Shape of American Bankruptcy*, 67 FORDHAM L. REV. (forthcoming, 1998).

258. Another context where creditors may take an active interest is where a proposed change may affect their market share vis-à-vis a competing form of credit. For evidence of this in connection with the 1978 Code, see Posner, *supra* note 150, at 76 (banks supported limited right of redemption, which could undermine interests of commercial finance companies); *see also* Petor V. Letsou, *The Political Economy of Consumer Credit Regulation*, 44 EMORY L.J. 587, 631-36 (1995) (describing competing lobbying interests of banks and finance companies).

259. Structural factors similarly favor the existing *ex post* framework. Not only have the original constitutional obstacles to reorganization disappeared, but the current framework also gives bankruptcy judges and the bankruptcy bar an enormous stake in its survival.

260. *See supra* Part II.B (discussing importance of manager-displacing bankruptcy to *ex ante* governance, due to the leverage it gives relational investors).

In sum, while American corporate governance, like that of other nations, is subject to continual, limited variation through time, its general *ex post* character appears to be remarkably stable.

2. Evading the Framework Through Private Ordering

Even if dramatic change in U.S. corporate governance is unlikely, individual firms may nevertheless devise alternative structures through private ordering. It is therefore important to consider how easily firms can or do opt out of the relevant system. There are significant limitations on the ease and the benefits of opting out.

In a much discussed article written at the end of the 1980s takeover boom, Michael Jensen argued that in maturing industries, American firms increasingly would opt out of traditional governance patterns by eschewing the Berle-Means corporation in favor of concentrated shareholding by entrepreneurial managers.[261] The rise of Leveraged Buyout ("LBO") firms provided his principal illustration. LBO partnerships, such as Kohlberg Kravis & Roberts, acquire firms through takeovers and then install their own managers or give the existing managers compensation packages that are closely tied to performance. By reducing the separation between ownership and control, LBO firms diminish managerial agency costs and seem to offer a dramatically more efficient alternative to the traditional publicly held firm.[262]

While LBO firms have figured prominently in American corporate law, they have had little of the transformative effect Jensen envisioned. This is due in part to difficulties in finding suitable takeover targets.[263] Moreover, because the partners of an LBO firm cannot themselves manage all of the companies, the firm must delegate managerial responsibility, which at least partially reintroduces managerial agency cost problems.[264] Finally, the heavy concentration

261. *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61.

262. *See id.* at 68-70; *see also* Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in Corporate Governance Debate*, 45 STAN. L. REV. 985 (1993) (discussing Swedish analogue to LBO associations and the obstacles to such a strategy in the United States).

263. This difficulty is magnified by state anti-takeover statutes, and to a somewhat lesser extent by Delaware's takeover jurisprudence, each of which make it more costly to pursue a hostile bid. Roberta Romano's extensive review of existing studies found that bidders make relatively low profits on average from takeovers. *See* Romano, *supra* noto 204.

264. The performance-based incentives LBO firms give to managers significantly enhance their accountability, as Jensen notes, *see* Jensen, *supra* note 261, at 68-69; but the managers still are managers rather than full owners of the firm.

of debt required to finance the initial acquisition significantly constrains managerial flexibility. In practice, LBO firms have often taken their companies public after restructuring them, serving as a transition vehicle rather than an alternative to the Berle-Means corporation.[265]

The LBO firms illustrate some of the practical obstacles to concentrated shareholding in a regulatory regime that thwarts the most likely candidate, financial intermediaries, from playing this role. Moreover, successfully opting out of *ex post* governance would require not just concentrated shareholding, but also that the firm commit itself to not invoke the Bankruptcy Code's reorganization option.[266] Yet, much as with concentrated shareholding, there are major practical and legal obstacles to foregoing the reorganization-based bankruptcy regime.

The chief obstacle to opting out of Chapter 11 is the longstanding rule that debtors cannot waive their right to file a bankruptcy petition.[267] Courts have sometimes enforced efforts to opt out of the Code, but the exceptions have been limited to contexts far afield of publicly held firms.[268] For a publicly held firm, opting out would at a

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265. For a suggestion that Money Trust banks such as J.P. Morgan and Company played an intriguingly similar role (though without taking as large an equity stake) early in the century, see Charles F. Sabel, *Comment*, *in* INSIDE THE BUSINESS ENTERPRISE, *supra* note 22, at 243-46 (commenting on DeLong, *supra* note 22).

266. Jensen has suggested that LBO firms would structure the firms they acquire in such a way as te "privatize" bankruptcy. *See, e.g.*, Michael C. Jensen, *Active Investors, LBO's, and the Privatization of Bankruptcy*, J. APPLIED CORP. FIN., Spring 1989, at 34, 41-44. But, as tbe discussion below suggests, it is all but impossible to insulate a firm from Chapter 11 if it has any outside shareholders. Even if this were not the case, devising a firm's capital structure principally to avoid the need for Chapter 11 is an odd stratogy for an operating firm.

Interestingly, Morgan appears to have been fully aware of the destabilizing effect corporato reorganization has on *ex ante* governance. The Morgan partners took extraordinary stops to keep the firms they monitored from defaulting. *See* Sabel, *supra* note 265, at 246.

267. *See, e.g.*, Fallick v. Kehr, 369 F.2d 899, 904 (2d Cir. 1966) (no waiver); *In re* Peli, 31 Bankr. 952, 956 (Bankr. E.D.N.Y. 1983) (no waiver).

268. A growing number of cases have addressed the question of whether to enforce a pre-bankruptcy waiver of the Bankruptcy Code's automatic stay. Enforcing such a provision enables a creditor to foreclose immediatoly, despite the bankruptcy filing. The cases thus far have nearly all involved individuals or very small firms who agreed to the provision in connection with a pre-bankruptcy workout. For an argument that stay waivers should be enforceable if adequate notice is provided to other creditors, see Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 97-101 (1995), and Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 335-39 (1997).

In addition to stay waivers, there is also growing interest in the issue of whether structured finance transactions can be insulated from bankruptcy. But these transactions generally involve only a subset of a firm's assets (usually receivables), and do not directly affect the ability of the firm itself to file for bankruptcy. For a discussion of tbese issues, and proposed standards for determining whether firms can opt out of bankruptcy, see Steven L. Schwarcz, Freedom to Contract About Bankruptcy (1997) (unpublished manuscript, on file with author).

minimum require that a firm secure the direct or indirect consent of each of its creditors. This is a particularly difficult obstacle for large firms.[269]

One can imagine clever ways to attempt to evade the non-waivability of bankruptcy. For example, prior to going public, a firm might adopt a provision requiring unanimous consent of its directors as a prerequisite to filing for bankruptcy.[270] Yet such a provision could not prevent an involuntary filing, and a shareholder could argue that the directors' fiduciary duties compelled them to file for bankruptcy.[271] It is not without reason that bankruptcy practitioners believe they can navigate any substantial firm into Chapter 11.

In short, American firms that attempt to opt out of the *ex post* governance system face enormous practical and legal obstacles. The obstacles are not absolute; some publicly held firms do deviate from the Berle-Means model, and some can at least partially limit the availability of Chapter 11. But the vast majority of large firms remain fully within the *ex post* framework of generally passive shareholders and retain a reorganization option in the event of financial distress.

3. Reform or Opting Out in Japan and Germany

In both Japan and Germany, there are similarly powerful constraints on opting out. On the corporate governance side, perhaps the largest obstacle to opting out is financing. The same banks that hold large stakes in industrial corporations are also the primary source of financing.[272] In consequence, a firm that seeks to keep its bank at arms-length would seriously limit its access to capital. To be sure, the

269. It is especially difficult when involuntary creditors are taken into account, given that they by definition do not have an opportunity to consent.

270. This is one of the strategies used in structured finance. For a discussion, see STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 16-24 (1990).

271. Even if most or all of the directors represent a constituency committed to avoiding Chapter 11, their duties as directors require them to act in the best interests of the firm. This may therefore obligate them to file for bankruptcy.

The ongoing Marvel bankruptcy illustrates yet another strategy. In Marvel, the bankruptcy court permitted the firm's bondholders (led by Carl Icahn) to foreclose on the stock pledged to secure their bonds. The effect of this has been to give the bondholders control of the case, much as creditors controlled many equity receiverships earlier in this century. This does not mean that creditors can routinely use stock pledges to foreclose a debtor's Chapter 11 option. The foreclosure in Marvel required court approval, which in many cases would not be given, and the bondholders still must use the Chapter 11 process in their own effort to reorganize. For a discussion of Marvel and its complexities, see David A. Skeel, Jr., *Bankruptcy Courts and Bankruptcy Venue: Some Thoughts on Delaware*, 1 DEL. L. REV. 1, 30-31 (1998).

272. *See supra* note 65 and accompanying text.

securities markets in both Japan and Germany have expanded significantly in recent years, so that banks no longer have quite the stranglehold on finance that they enjoyed in the past. In Japan, moreover, many and perhaps most of the principal banks have been in deep financial trouble themselves in recent years. Even so, banks are still sufficiently dominant that firms which resist bank oversight would put themselves at a competitive disadvantage.[273]

On the bankruptcy side, there is no existing interest group in either Japan or Germany that seems likely to mirror the role that the bankruptcy bar and bankruptcy judges play in promoting manager-driven, reorganization-based bankruptcy in the United States.[274] Moreover, banks are a powerful interest group in both countries, and they have a vested interest in manager-displacing bankruptcy as a means of solidifying their influence in corporate governance.[275] In an *ex ante* framework, there is no obvious need for a well-developed bankruptcy regime, manager-driven or otherwise. Because a few large creditors often hold most of a firm's debt, the kinds of collective action problems that serve as the principal justification for American bankruptcy law[276] arguably do not exist.

As with American firms, the path of least resistance is to accede to the existing framework, and the vast majority of large Japanese and German firms do just that.

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273. A similar analysis would apply for non-bank *keiretsu* in Japan. A firm tbat resisted the influence of a main bank, and also avoided the extensive cross-holdings—and cross-control—of a non-bank *keiretsu*, would face a major competitive disadvantage.

An interesting question is whether Japanese and German corporations will begin to look less to local securities markets and more to international ones as an alternative to relational monitoring. For instance, Japanese and German firms could quite plausibly issue stock in the United States. Thus far, relatively few firms have taken this step. One possible explanation is that managers are comfortable with the existing approach, perhaps in part because they can minimize intervention by keeping the relational moniters happy. Cultural factors may also play a role.

274. More precisely, neither country has nearly so substantial and powerful a bankruptcy bar as does the United States. In both countries, the bankruptcy process is far more administrative, and lawyers do not play a substantial role.

275. As discussed earlier, *see supra* Part IV.B, Germany has recently added a chapter 11-like reorganization provision. Like Japan's reorganization chapter, it assumes the removal of existing managers and thus will function as a manager-displacing bankruptcy regime.

276. In contemporary American bankruptcy scholarship, Thomas Jackson (and his frequent co-autbor Douglas Baird) has argued most forcefully that bankruptcy is best justified as a response to the collective action problems faced by a firm's widely-scattered creditors. *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986).

B. Which System is Better? Comparing Ex Ante and Ex Post

The likely stability of the American, Japanese, and German corporate governance frameworks brings us to a question that has lurked beneath the analysis almost from the beginning. Which of the two frameworks is superior—or would some intermediate approach prove more efficient than either *ex ante* or *ex post* governance?

While carefully hedging the comparisons, several of the initial efforts to compare Japanese and German relational governance to the Berle-Means corporation in the United States seemed particularly enamored of the Japanese and German approach.[277] An important attraction of large stakeholders is that they have a greater incentive to engage in ongoing monitoring of managers than do American shareholders.[278] In addition, these stakeholders' ongoing relationships with the firms may facilitate more extensive exchange of information between the firms and the shareholders, and promote a long-term focus not possible for market-driven American firms. In addition to these advantages there is the attraction of manager-displacing bankruptcy. Creditor control and the absence of a manager-oriented reorganization option avoid the inefficiencies of the *ex post* American reorganization process.

Given the influence wielded by relational creditors, the *ex ante* system depends heavily on the effectiveness of banks and other large stakeholders as monitors. Because banks are firms themselves, they face their own agency costs. Even taking these factors into account, however, banks may still play an important and valuable monitoring role.[279]

Ex ante governance thus offers significant attractions as compared to the American system. Yet the Japanese and German approaches also have an important downside: both create powerful incentives to avoid even beneficial risk-taking.[280] A firm's relational

277. For a similar reading of this work, see Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 74 (1995) ("[d]espite some protestations of agnosticism, [the tene of advocates of the political account of corporate governance] makes it clear that they regard the American system . . . as inferior") (citing, among others: Roe, *Some Differences*, *supra* note 36, at 1997; Black, *supra* note 250, at 813-14; Jeffrey N. Gerdon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 127 (1994)).

278. *See supra* notes 43-44 and accompanying text.

279. *See, e.g.*, ROE, STRONG MANAGERS, *supra* note 2, at 11 ("[a]s long as the intermediaries' debilities are not the same debilities afflicting the industrial firms in which they own stock . . . then there might be improvements").

280. Macey and Miller reach a similar conclusion. *See* Macey & Miller, *supra* note 277.

bank is the first and most obvious source of this risk aversion. Because Japanese and German banks, unlike their American counterparts, hold stock as well as debt, they theoretically could encourage better decision making than a holder of stock or debt alone.[281] In practice, however, banks tend to hold a much higher percentage of a firm's debt than its stock, which gives them an incentive to eschew risk.[282] The fact that the banks themselves are thinly capitalized reinforces their aversion to risk.[283]

The other principal source of risk aversion is the firm's managers. Due to the substantial human capital stake they have in their firms, managers have a natural tendency to avoid risk even apart from the particular dynamics of *ex ante* governance.[284] The draconian consequences of failure in the *ex ante* framework magnify this inclination. A manager who will immediately lose her job if the firm files for bankruptcy, and who faces a notably thin managerial labor market, is likely to view risk quite differently than one who operates in a more forgiving system.

In contrast to *ex ante* governance, the *ex post* framework encourages a more sanguine approach to risk-taking. Because the shareholders of U.S. firms tend to be diversified, they benefit if the firm takes appropriate risks.[285] While managers may be less anxious to take risks, the active managerial markets and manager-driven

281. Interestingly, requiring managers to hold both stock and debt was the stratogy Jensen and Meckling suggested more than two decades ago as a way to address managerial agency costs. *See* Jensen & Meckling, *supra* note 16, at 352-54.

Based on a similar intuition, Hauswald argues that the German system, with mixed banking and a liquidation-based bankruptcy regime that makes loan agreements effectively renegotiation-proof, is superior to the American approach of limitiug hanks' ability to hold stock. *See* Financial Contracting, *supra* note 66; Banking Systems, *supra* noto 66. As the analysis below suggests, however, this assumes that banks' stock and debt holdings are proportionate and ignores the effect of agency costs on the bank itself.

282. *See* Macey & Miller, *supra* note 277, at 84-86 (Japan), 88-89 (Germany). One factor Macey and Miller do not take into account is the fact that a bank's ongoing interest in its borrower's success gives it an equity-like stake in the borrower's future. This is true even if the bank holds only or predominantly a debt interest, since the firm's future success means future loans for the bank. *See* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 948-52 (1986) (characterizing relational bank's role as similar to a joint venturer).

283. An important feedback effect of *ex ante* governance is that it may also undermine entrepreneurial activity. For evidence that venture capital providers in Japan are often affiliated with banks and securities firms, and tend te finance retail and real estate firms rather than new technology, see Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 874-80 (1997).

284. *See* Jensen & Meckling, *supra* note 16, at 354.

285. Shareholders' willinguess to permit risk is a function of their diversification, together with the effect limited liability has in controlling their downside risk. *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985).

bankruptcy process—together with firms' increased use of stock-based compensation—all work to align their perspectives with that of their shareholders.

This is not to say that *ex post* is necessarily superior to *ex ante* governance. Just as *ex ante* governance tends toward risk aversion, *ex post* governance can encourage too much risk. Debtholders—the initial losers if a firm's risk-taking turns out badly—constrain firms through covenants.[286] But the covenants cannot be enforced if the firm files for bankruptcy. This, coupled with the fact that shareholders often retain some of their interest in a reorganization, can induce excessive risk, particularly as a firm nears insolvency.[287]

Neither the *ex ante* nor the *ex post* approach is inherently superior. Rather than anointing one or the other as preferable, it is more useful to view them as alternative mechanisms for enhancing going-concern value. From this perspective, the Japanese and German approach tends to retain going-concern value within an existing firm. Once a firm is established, *ex ante* governance, with its long-term shareholders and comparatively cautious managers, stabilizes the existing firm and strongly deters failure. *Ex post* governance, by contrast, places far less emphasis on the existing firm. The market-driven governance and amenability to failure of the *ex post* approach facilitate the redeployment of existing assets. If stability is the watchword of an *ex ante* system, *ex post* governance assumes a certain amount of creative destruction.[288]

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286. The classic account of this is Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

287. *See* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 441 (1992).

Recent empirical work on capital structure provides strong support for this view as to the differential effects of *ex ante* and *ex post* goveruance. Thus firms generally held much more debt in the United States, which offers managers the possibility of *ex post* reorganization, than in countries such as Germany that do not. *See* Rajan & Zingales, *supra* note 208, at 1445.

288. Ron Gilson has recently distinguished American and Japanese governance in somewhat similar terms. Gilson characterizes corporate governance as a trade-off between "stability," which tends to support firm-specific investment, and "mutability," which enables firms to respond quickly to changes in technology. Gilson, *supra* note 10, at 336. Gilson describes Japanese governance as biased toward stability and as a result best at adapting to niche markets, whereas American governance emphasizes mutability and adapts better to change. *See id.* at 340-42.

The same distinction can be made by analogy to evolutionary theory in biology. Evolutionary biologists initially assumed that evolutionary success meant the survival of individual organisms. In more recent years, this view has given way to the "selfish gene" approach, which posits that evolutionary success consists of the successful transmission of particular genes into subsequent generations, even if this entails high mortality for individual organisms. *See generally* RICHARD DAWKINS, THE SELFISH GENE (1989). From this perspective, *ex ante* governance parallels an organism-based approach, and *ex post* governance a selfish gene approach.

The effectiveness of each approach depends on the parties' success in counteracting its potential inefficiencies. In the United States, contractual provisions such as bond covenants help limit shareholder risk-taking.[289] Important dangers with *ex ante* governance include excessive risk aversion, and diversion by concentrated shareholders of private benefits to themselves. Bank shareholders' shareholdings and their stake in the ongoing success of the firm may partially counteract their risk aversion.[290] In Japan and Germany, these factors, together with the threat of government intervention, appear to be the principal check on the downsides of *ex ante* governance.

VI. CONCLUSION

An evolutionary theory of corporate governance and corporate bankruptcy provides a more complete account of corporate law than even the most sophisticated existing theories. Focusing on the United States, Japan, and Germany, this Article has proposed that, at least in countries with relatively stable property rights, a nation's corporate governance and corporate bankruptcy approaches will invariably prove complementary. By considering the evolutionary history of each of the systems, particularly the *ex post* system in place in the United States, we were able to see how different nations' corporate law frameworks could diverge so dramatically, and to make predictions about future developments.

Although the analysis focused on the polar cases of *ex ante* (Japan, Germany) and *ex post* governance (United States), the theory is fully applicable to other nations as well. Thus, in nations such as Canada and Great Britain, where corporate governance is more relational than the United States but more market-driven than Japan

289. Notice that shareholders as well as bondholders benefit from provisions that limit the agency costs of equity, since bondholders would otherwise demand higher interest rates to offset the risk of *ex post* risk-taking by shareholders.

290. In contoxts where the same institution does not serve both as the principal shareholder and the principal debtholder, one might expect an increased concentration of shareholding to provoke an analogous concentration in debtholding, since large creditors can more effectively monitor a concentrated shareholder than scattered crediters. Stated differently, large creditors have both a sufficient stake and sufficient access to information to counterbalance large shareholders. These factors help to explain both the tondency of closely held American firms to have a single dominant creditor and the concentration of debt (which parallels the newly concentrated equity) in most leveraged buyout transactions.

and Germany,[291] there are also intermediate approaches to corporate bankruptcy.[292]

It is important not to overstate the importance of corporate law in a nation's economic development. Technology and external price shocks may prove far more important than corporate law in determining the success of a corporate enterprise. But at least on the margin, the corporate law framework does make a difference—in the effect it has on entrepreneurial activity and on the preservation of going-concern values, for instance. So long as it does, it is important to continue to refine our understanding of the corporate governance patterns that have emerged in any given country.[293]

291. *See, e.g.*, Bernard S. Black & John C. Coffee, Jr., *Hail Brittania?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994) (noting shareholdings more concentrated in Britain than United States, but institutional shareholders do not routinely moniter); Daniels & MacIntosh, *supra* note 68, at 884-88 (describing concentrated shareholdings in Canadian firms).

292. Thus, George Triantis' valuahle work comparing bankruptcy in Canada and the United States suggests the Canadian framework includes a genuine reorganization option but is far more stringent about applying it. *See* Triantis, *supra* note 59; *see also* LoPucki & Triantis, *supra* note 120. Consistent with this, one would expect to find that Canadian managers are less highly paid than their American counterparts, that their pay is less likely to include a substantial performance-based component, and that Canadian firms include less deht in their capital structures.

293. One important area for future refinement is to map more precisely the relationship between private actors and representatives of governmental agencies. The theory could be extended to governance systems where the government not only influences corporate governance, as in Japan and Germany, but exercises a direct ownership interest, as has been true in France. *See, e.g.*, James A. Fanto, The Role of Corporate Law in the Adaptation of French Enterprises (1997) (unpublished manuscript, on file with author) (describing changes in French governance). In such a governance system, corporate managers are likely to take on some of the characteristics of agency bureaucrats.