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Bankruptcy Primitives

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On the 25th Anniversary of the Bankruptcy Code, the American Bankruptcy Institute has called an academic conference to assess where bankruptcy law has been in the last quarter century and where it is going or, perhaps more accurately, where it should go. I will leave to others the nuance of bankruptcy history. I will paint with a broad brush to give my perceptions of what the Bankruptcy Code always has been and of what it might be instead.

In Part I of these remarks, I discuss the bankruptcy fresh start for individuals and bankruptcy process as the central features of current law. In Part II I attempt to break down bankruptcy to its primitive features. In Part III I offer reform proposals based on those features.

I. Fresh Start and Process

The Bankruptcy Code provides a fresh start for individual debtors and process for all. For individuals, bankruptcy process can be exceedingly simple. Many individuals pass through with little non-exempt property to be distributed among creditors and so, for them, bankruptcy process is little more than a gateway to bankruptcy's substance: the discharge. The discharge exempts what is for many individuals their most important asset, human capital. After a bankruptcy discharge, most claims are extinguished (though

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a few—child-support obligations, e.g.—are singled out for special treatment and are not discharged).¹

For corporations, in contrast, process is (for the most part) everything. There are no exempt assets. Everything of value goes to the creditors of an insolvent firm (or should) and thus there is no discharge of obligations, at least not in any real sense. (Although reorganized companies formally receive a discharge, this is merely to implement a recapitalization, not to shield any assets from creditors in the way that discharge shields an individual debtor's human capital.) Among corporate creditors, moreover, state-law priorities rule the day (with a few limited exceptions such as a small priority for unpaid employee wages earned on the eve of bankruptcy).² Secured creditors, for example, retain a priority interest in their collateral despite a bankruptcy petition. So for a corporate debtor bankruptcy neither shields assets nor (generally) establishes entitlements among creditors. It does provide a process for recapitalization: replacing old claims and interests with new. Increasingly, as discussed below, even in bankruptcy's reorganization chapter, Chapter 11, bankruptcy process also provides a forum to sell corporate assets and to divide the proceeds of sale among the creditors. When this occurs, much of the process geared to recapitalization is essentially meaningless. Still, to say that process does not matter does not imply that anything else does.

There have been two important sorts of criticism leveled at the Bankruptcy Code. The first is a suggestion that a discharge for individual debtors is too easily obtained even by those who are not in dire straights. The second, applicable primarily to corporate

¹ See Bankruptcy Code, 11 U.S.C. §523.

² See Bankruptcy Code, 11 U.S.C. §507.

bankruptcy, is that the Chapter 11 process is cumbersome and expensive, so much so that a corporate debtor's owners and managers who are in control during Chapter 11 (and to some extent its employees generally) can exploit the process at the expense of creditors' legitimate claims. Where such exploitation occurs, those claims are only nominally honored by the Bankruptcy Code.

Each of these criticisms has been addressed, to a limited extent, by the Bankruptcy Reform Act of 2003, which is still (and seemingly endlessly) pending before Congress. Individuals with above medium income would be forced into Chapter 13, which confers a more limited discharge than Chapter 7. Corporations, for their part, if small, could not prolong a Chapter 11 reorganization more than months unless the prospect of a successful reorganization were clear.

In addition to legislative response, creditors have reacted to the perceived problem of wasteful debtor-controlled reorganization. As Douglas Baird has explained at this conference, for most corporate debtors in bankruptcy, creditors now quickly wrest from managers control of the Chapter 11 process and more quickly than in the past liquidate firms whose assets are worth more in the hands of other managers.

None of this, though, accomplishes complete reform, in my view. The Reform Act may catch some individual debtor abuse, but it is overbroad. Perhaps many of the debtors forced into Chapter 13 would have expected to benefit from a broader Chapter 7 discharge and would have been willing to pay more in interest on their debt obligations in order to achieve such a discharge. Mandatory Chapter 13 for high-income debtors is also underinclusive. Perhaps some or many debtors who would be able to choose Chapter 7 even under the Reform Act rules would have preferred to waive the right to so broad a

discharge and opt instead for cheaper loans. The Reform Act, moreover, is a similarly blunt instrument in its treatment of abuse by corporate debtors. Large firms would be unaffected by the Act, and small firms could still use Chapter 11, albeit for a shorter period of time, even if some process other than Chapter 11 would have been more suitable from the outset. Perhaps more to the point, it may be that few small firms stay in Chapter 11 longer than they would be permitted to stay under the Reform Act. As discussed briefly later in these remarks, for small firms, Chapter 11 may simply be largely irrelevant.

Creditor response to perceived corporate abuse is more potent than the new bankruptcy legislation. In prior scholarship, I have argued that optimal insolvency rules are endogenous to a firm's capital structure and to the firm's likely economic prospects for survival despite financial setback.³ This scholarship could predict the story that Baird tells of a creditor revolt to take control of corporate bankruptcy. Indeed the original, redoubtable paper on this topic, written by Baird and Bob Rasmussen, note that the dynamic relationship I describe among capital structure and assets configuration helps explain how the recent trend they identify could have been accomplished without significant harm to a debtors' going-concern value.⁴ If creditors can now organize themselves sufficiently to take charge of Chapter 11 and sell off an insolvent debtor—in operating segments or piecemeal if necessary—then one might expect that creditors would put themselves into position to exercise such control in firms unlikely to be economically viable despite financial failure. This would be so particularly if

³ See Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. Rev. 343 (1997).

⁴ See Douglas G. Baird and Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751, 781-82 (2002).

technological changes have driven firms to organize in fungible parts and thus with fewer firm-specific assets, as Baird & Rasmussen suggest. One would expect, therefore, that many firms upon filing for bankruptcy would pass quickly into the hands of creditors, who would liquidate them quickly despite any protest from the debtor's managers or shareholders. And that's just what Baird & Rasmussen observe.

As attractive as this story is, particularly to me, it is not the entire story. The sea change that Baird describes may be somewhat incomplete in at least two ways and it may be, at least in small part, temporary. The primary Chapter 11 mechanism that puts creditors in control is DIP finance, and it may put only a subset of creditors in control. When a corporate debtor enters bankruptcy without sufficient unencumbered funds to continue, the debtor must immediately obtain debtor-in-possession finance, or it must go out of business. If a prepetition creditor, or a group of such creditors, is the sole source of DIP funds, then this creditor or creditors call the shots, even if the result ultimately is partial or complete liquidation of the debtor's business. That many firms arrive in bankruptcy without unencumbered funds, moreover, is not a coincidence, but part of an ex ante plan by creditors who are foresighted enough to demand pledges of liquid assets and thus perhaps leave the secured creditors as the sole source of needed funds.

To the extent that the old world of Chapter 11 permitted debtors inefficiently to continue their operations in reckless pursuit of a business reversal, such creditor planning and execution can be seen as a positive step. But liquidation is seldom as simple as described in a law professor's hypothetical. There may be winners and losers, and one concern about the new world of DIP finance is that the creditors who offer the new funds may win at the expense of other creditors (particularly if the debtor does not *wholly*

liquidate). The result may be inefficient decisions about whether a debtor survives as a business enterprise or to what extent. As leading bankruptcy practitioner Harvey Miller, along with coauthor Shai Waisman, puts it, examples abound where large commercial debtors could not resolve their dispute without the mechanisms of Chapter 11 that, in his view, preserved the debtors assets on a going-concern basis.⁵ Miller & Waisman cite as examples cases such as Enron, Global Crossing, WorldCom, W.R. Grace, Armstrong, Conseco, A.H. Robbins, and Johns-Manville, some of these certainly recent enough to count as part of the new world of bankruptcy reorganization. Whether Miller is right or wrong about whether negotiation among creditors within the Chapter 11 process was salutary, it is interesting if he is right merely that such process played a role, that there was not simply a quick auction of assets or some other automatic distribution of interests. Not only managers can hijack a process for their own benefit.

Further evidence that the Chapter 11 process in the new world may not provide the seamless transition of assets as might first appear is the recent controversy of so-called DIP finance “roll-ups.” In a roll up, a prepetition secured creditor receives priority not only for new funds lent to finance the debtor’s operation, at least until it is sold, but for the full amount of the creditor’s pre-petition debt regardless of whether the creditor’s claim was fully or only partially secured. This has raised cries of protest from unsecured creditors who complain about breaches in priority. It is not at all clear that the proposed disposition of assets requested by the DIP lender under a roll up would maximize the

⁵ See Harvey Miller and Shai Waisman, *The Erosion of Debtor Protections in the Face of Expanding Creditors Rights and Control* (NYU Workshop on Bankruptcy and Business Reorganizations, September 2003).

return to creditors collectively even though it might maximize the return to the highly favored DIP lender.

Not every firm in Chapter 11, moreover, comes under creditor control (or liquidates most of its assets). Some firms, albeit many fewer than in the past, continue to reorganize under the traditional Chapter 11 process under the substantial influence if not complete control of debtor managers. Although cases are hard to classify, a few recent examples of such firms in bankruptcy, even among only large, publicly traded firms, may include K-Mart, WorldCom, and United Airlines. Even as more firms reorganize in prepackaged (or prenegotiated) bankruptcy plans—where significant dissent is silenced in advance by agreement of the debtor and the largest creditors—the arrangements in these plans are negotiated in the shadow of a full Chapter 11 process that the debtor’s managers may well have controlled. The old world of Chapter 11, then, including perhaps coerced creditor concessions, may survive to a significant extent in the new world. One consequence of any lingering traditional Chapter 11 reorganization process could be that although more firms liquidate today than in the past, perhaps fewer do than should.

I do not mean to overstate this point. Evidence shows fewer and fewer cases in which breaches in priority award assets to shareholders of an insolvent firm. And managers typically lose their jobs when a firm enters bankruptcy. But as illustrated by court-appointed Martin Shugrue’s failed attempt to resurrect Eastern Airlines, even new managers, without a tie to shareholders or former directors, sometimes attempt to continue an enterprise that would be better off sold, perhaps in a noble or misguided attempt to preserve jobs or community contacts. Whether such behavior is an aberration, or more common than that, remains to be seen.

Finally, faced with the threat of concerted creditor control through DIP finance, debtors' counsel and management financial advisors can be expected to be more creative in the acquisition of friendly DIP loans. Anecdotal evidence suggests that this process has already begun.

Once again, I want to be careful not to overstate my concerns here. There is no question that fewer large firms are reorganized in tact under a traditional Chapter 11 process. When a corporate debtor files a Chapter 11 bankruptcy petition, the firm is "in play" and where there is a market in place for a viable firms' assets one can expect bids to arrive. Moreover, bankruptcy courts today have become accustomed to such a process and a rare judge today would resist creditor demand to sell, particularly as more and more bankruptcy creditors today are distressed-debt professionals (a.k.a. "vulture capitalists") who have purchased debt precisely so that they can seek to direct the bankruptcy process toward a sale of the debtor's assets. But there may remain a problem with respect to perhaps a few firms that do not attract significant bids for assets as a going concern. For those firms, the managers or some subset of creditors may be able to persuade other creditors and the bankruptcy court that one disposition of the firm is in the best interest of all when that is not in fact the case. As compared to possible alternatives, discussed below, the traditional Chapter 11 process may exacerbate this risk. And while fewer firms may be so affected than in the past, bankruptcy law has always been directed toward a solution for a relatively few firms as at any given time most firms either succeed or fail without use of bankruptcy law. A better solution is preferable even to a good one.

II. Bankruptcy Primitives

As intimated above, and described more fully below, I want to suggest that ideal bankruptcy law would differ from current law with respect to the discharge of individuals and with respect to the process-centric rules of Chapter 11. As just noted, recent reform proposals and changes in practice do not fully address the problems with current law, so the question becomes one of: What would? In answering this question, I want first to break bankruptcy law down to its essential elements. In earlier scholarship I have noted that debt as a financial instrument is not a “primitive” in that it can be broken down into two parts: a fixed obligation and a right of the holder unilaterally to enforce that obligation.⁶ Here I similarly want to reduce bankruptcy law, which operates on debt, to its essential components, or “primitives.”

There is exactly one function that bankruptcy law *must* serve. That is, by logical necessity—whether explicitly in a code or by explicit or implicit deference to state law—bankruptcy law must establish priority among conflicting claims. Put another way, the only essential element of bankruptcy law is for it to provide or adopt a property regime. If the Bankruptcy Code is silent, then state law priorities will prevail. Otherwise priorities are established as dictated by the Code. Thus, whether by congressional action or inaction, bankruptcy law establishes priorities among conflicting claims. There is choice of *how* bankruptcy law will do this, but not of *whether*, as even derogation of power has affirmative consequences.

⁶ See Barry E. Adler, *The Law of Last Resort*, 55 Vand. L. Rev. 1661 (2002).

Another component of bankruptcy law, at least as we know it today in the United States, is not literally necessary but is central: the discharge of an individual debtor. Society could function if an individual were forced to bear the burden of debt indefinitely, regardless of the circumstances, but there are good arguments to be made that society would not be the better for such treatment of debtors. Human beings are risk averse, and it is perfectly reasonable to assume that many or most would benefit from debt relief as insurance against hard times.⁷ Thus the discharge that is at the heart of individual bankruptcy cases seems sensible, at least as a default rule.

These two features of bankruptcy law—establishment of priorities and discharge of an individual’s debt—are what I refer to here as bankruptcy primitives. Were I a lawmaker, I would focus on setting these features optimally. It is not clear that bankruptcy law should venture beyond these primitives.

To those familiar with the intellectual discussion of bankruptcy law, the striking omission from my short list of bankruptcy’s essential functions is the omission of bankruptcy as a *process*, one that solves the collective-action problem among creditors who might, if left to their own devices, destroy a valuable going concern in a grab race for assets. (Harvey Miller’s observation noted earlier was in this vein.) Baird and Tom Jackson have in the past stressed process as the sole legitimate role of bankruptcy law (perhaps other than discharge for an individual).⁸ As I have argued elsewhere, however, the threat of a grab race—even for those firms who are viable and should continue—exists only if one accepts as given the status quo of corporate finance, where creditors

⁷ See, e.g., Barry Adler, Ben Polak & Alan Schwartz, *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. Legal Stud. 585 (2000).

⁸ See, e.g., Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (1986).

hold conflicting debt obligations unconstrained by any *prior* agreement to settle up among themselves in the event that the debtor cannot pay them all in full. As I (and others) have argued in the past, the corporate charter serves as a common node of contact among all creditors, whenever claims arise in the life of a corporation,⁹ and thus in a world free of regulatory constraint such as (but not limited to) the Bankruptcy Code, one might expect debtors and creditors to solve their collective action problem *ex ante* by providing in a charter for the provision of a customized process in the event of default. Bankruptcy law as process would be unnecessary.

One might see little harm in the Chapter 11 process if that process is the one that firms would adopt on their own. But there are at least two reasons to doubt that all firms, or even most, would favor the Chapter 11 process, which is not a primitive, but is instead made up of numerous components each laden with substantive consequences for a corporate debtor's constituents.

First, for firms in which creditors lack the leverage or foresight to gain control of the reorganization process, the debtor's managers, as debtor-in-possession, dictate the course of the Chapter 11 case and will have an opportunity to propose a reorganization plan. Although the debtor cannot unilaterally impose a plan on all of its creditors, control over the proposal combined with the prospect of judicial cramdown against creditor dissent gives the managers significant influence over creditors who might concede to a less than optimal plan in order to have *some* resolution that will salvage their claims. The results may include continuation of a business that should liquidate, at least in substantial

⁹ See Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 *Stan. L. Rev.* 311 (1993).

part, and a distribution among creditors and equity that violates contractual priority among creditors (as where secured creditors make concessions that leave them with perhaps less than liquidation of their collateral would have provided). For example, in the Chapter 11 case of *In re Traffic Stream*,¹⁰ filed in May 2003, the DIP and the indenture trustee for \$119 million of secured notes are in a pitched battle for control over the debtor's operating subsidiaries, the shares of which served as collateral for the notes. If the DIP wins, one might expect concessions from the noteholders. Where contractual priority is violated, there is not only (or even) a sense of unfairness, but rather such violation disturbs the arrangement between the debtor and its investors and can thus raise the debtor's ex ante cost of capital. Moreover, with the exception of prepackaged reorganizations, the process of achieving such concessions can be costly in fees from professional services and distraction from business operation.

Second, the entitlements that serve as a backdrop for negotiations in Chapter 11 are determined by the value of the debtor's assets ex post, at the time of bankruptcy. So, for example, if a debtor owes senior creditors \$100 and junior creditors \$100 when it files for bankruptcy the junior creditors are entitled to a stake in the reorganized debtor if and only if the firm is then worth more than \$100. (Similarly, the debtor's shareholders are entitled to a stake if and only if the firm is then worth more than \$200.) If the junior and senior creditors disagree as to the firm's value, a court can settle the dispute in a cramdown hearing. Much uncertainty may plague such a hearing or, thus, any negotiations that take place in the shadow of such hearing. Consequently, because uncertainty interferes with dispute resolution, the costs of ex post valuation can be a

¹⁰ Case No. 03-13292-SMB, United States Bankruptcy Court Southern District of New York.

significant source of unjustified concessions and a substantial component of the process expense noted above.

As I have argued in past work, parties might wish to avoid ex post valuation altogether by agreeing in advance how a firm's assets will be allocated in the event of an uncured payment default, saving them the time and trouble of ex post valuation.¹¹ In this illustration, the parties might agree, for example, that if the debtor defaults on its obligations and cannot cure such default in a reasonable time the firm will be *automatically* reorganized with the senior claims left outstanding, the junior claims canceled and converted into new equity claims, and the old equity claims simply canceled. Or, if the investors were sufficiently confident that an uncured default would imply the firm's lack of continued economic viability—as Baird & Rasmussen contend is more and more the case—the preordained plan might be simply to permit individual creditor action and piecemeal liquidation without even the threat of interference from a management-lead reorganization process.

Along these lines or by their own design firms of any size could fashion their own insolvency process.¹² Any firm that hoped to preserve the possibility of going-concern value might include a feature analogous to the automatic stay of current law, so the disposition of a debtor's assets could take place at once in a single forum. But perhaps little else of Chapter 11 process would survive customization. Small firms might find any such design prohibitively expensive, but these firms, typically dominated by an

¹¹ See Adler, *supra* note 3; Adler, *supra* note 9.

¹² For a different approach to bankruptcy contracting, one that focuses on an attempt to extract information from managers of a financially distressed firm, see, e.g., Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 Yale L.J. 1807 (1998).

entrepreneur and a single creditor, get little out of the current Chapter 11 bankruptcy process anyway, an observation that prompted the small-firm provisions of the Bankruptcy Reform Act of 2003, discussed above. Thus, process, central to the original Baird & Jackson bankruptcy paradigm, may serve little useful purpose even for those firms that currently escape quick liquidation at the hands of DIP lenders within Chapter 11.

III. Reform Proposals

With the foregoing as background, I would recommend to Congress that it consider different and greater changes to bankruptcy law than proposed in the pending legislation. These recommendations have two themes: greater freedom to contract where relationships are consensual and higher priority for holders of nonconsensual claims.

A. Freedom of Contract

Bankruptcy law could better serve its basic functions with greater freedom of contract both for individual and corporate debtors. Individuals are discussed first, then corporations.

(i) Individual Debtors

As noted above, the Bankruptcy Reform Act of 2003 would limit the discharge of high-income individual debtors by eliminating their Chapter 7 option. If these debtors sought bankruptcy relief, they would have to file for Chapter 13 and upon the demand of a general creditor contribute future disposable income to repay prebankruptcy obligations. As a mandatory rule, this provision seems needlessly harsh.

Imagine, for example, that a restaurant manager quits her job with a fast-food chain and opens a diner financed primarily by bank debt that the manager guarantees.

The diner struggles from the beginning and the manager finds that she cannot both pay the diner's debts and support her family. Initially, however, she is not ready to give up. She gets her job back with the fast-food chain and she moonlights at the diner. Her husband, who was formerly a caretaker for the couple's children but did not work outside the home, now also pitches in at the diner. Still the debts pile up and revenues do not increase. The debtor is finally ready to quit and closes the restaurant. To repay her debts she sells the assets she has of value (her home is fully mortgaged) but cannot fully satisfy her obligations. She contemplates bankruptcy.

This scenario is fictional but not fanciful. It reflects the plight of many moderate-income debtors who seek bankruptcy protection. Under the proposed Bankruptcy Reform Act, this debtor might be forced to repay the debts of her failed business even while her family gets by on bare essentials. Under Chapter 7, she could have a truly fresh start and her family could enjoy the entire benefit of her managers' salary.

In this illustration, moreover, the results of the Reform Act proposal might not be merely a poor outcome *ex post*. In anticipation of failure the debtor, if risk averse, might never attempt to open the diner even if the gamble were a good one *ex ante*. In this case, the Reform Act would here discourage efficient investment.

To be sure, the debtor might have opened the diner in corporate form and *not* personally guaranteed the business debts. But without some personal responsibility, the debtor might well have found that no lender would finance so risky a business. Perhaps the ideal balance, at least for this debtor, would be for her to guaranty the diner's loans but retain the option to receive a full discharge of her obligations. Creditors presumably would charge the debtor more for fully dischargeable loans than for loans that could be

discharged only in part, but the debtor's guaranty would not be entirely meaningless. To discharge her obligations the debtor would have to sell all her nonexempt assets and would suffer a reputational hit (at least in credit market) of having filed a Chapter 7 bankruptcy petition. Where Chapter 7 is an option, therefore, a lender would be expected to charge a higher interest rate than if a debtor could seek relief only under Chapter 13, but that interest rate might not be prohibitive and a deal could perhaps be struck.

This illustration, and countless similar circumstances, support the view that the Reform Act's discharge limitation should not be mandatory. A debtor should be able to opt out of the Reform Act's treatment of high-income debtors. Perhaps a public registry could be established where debtors could declare such intention to opt out. A debtor on that registry, whatever her income, could then file under Chapter 7 so long as she had no debts still outstanding from a time prior to entry on the registry. She could take her name off at any time and would then lose the Chapter 7 option while any debts were outstanding from a time that her name was not on the registry. This process, while perhaps unfamiliar, would not be complex, less so than the process of filing and maintaining financing statements now routine under Article 9 of the Uniform Commercial Code.

More complicated systems are also possible, as where a debtor would subject some but not all of her obligations to Chapter 7 discharge thus heavily favoring those exempt from discharge. If such a mixed system of opt-out were adopted, a public registry would be unnecessary as a debtor could always file for Chapter 7 but in that proceeding would be able to discharge only those debts designated as fully dischargeable in the relevant loan agreement.

There is, of course, a flip side to a choice-of-discharge regime. The question arises whether a debtor should be permitted to opt not for greater discharge rights but for *less* protection. Ostensibly this question is easily answered by one who generally believes in freedom of contract. The answer is simply “yes.” Although some debtors might want much insurance against hard times and may be willing to pay a price in higher interest rates for such insurance, as in the above illustration, it is also the case that some debtors might not want so much insurance and would be unwilling to pay the price if given the choice. Generally, society does not require individuals to purchase insurance against risk of loss that the individual herself would bear. It is not immediately clear why insurance against financial distress is different.

Take the debtor from the prior example, but now assume that she has no family to support. She believes that the restaurant she hopes to open could not possibly survive long term unless it were able to sustain losses for a period of years longer than her bank as primary lender is willing to endure unless she can pledge her future income as a restaurant manager (or even a job with relatively low income) should the business fail. Chapter 13 would permit the bank to demand disposable income for 3 years, but that’s not enough for the bank, which cannot be sure that the debtor would qualify for Chapter 13 at the time she filed for bankruptcy (even if she were compelled to file were she eligible) and, in any case, the bank would like a pledge of disposal income for 6 years. Also, the bank would like to supply its own definition of disposable income rather than leave that definition to a bankruptcy court. The debtor, who is young and ambitious, might wish to accept these terms as she is confident that she will eventually make a great success, earning her wealth and self-fulfillment. The American Dream.

This latest version of the restaurateur illustration suggests that a debtor should be able to waive the right to discharge at least to the extent that the debtor would not become a burden to society while repaying her obligations. A registry such as the one suggested above could list debtors as either eligible or ineligible for either Chapter 7 or Chapter 13. Or, as noted above, debts could be handled on an individual basis, by reference to the loan agreement.

On reflection, however, matters are not quite this simple. As a policy consideration, an individual debtor's option *out* of a full discharge right is not symmetrical to an option *in*. Even if one puts aside risks of externalities—such as the risk that a debtor would become a burden to society or would not support her family—a debtor's renunciation of a discharge option is problematic. Well rehearsed in the psychology literature is the fact that individuals frequently make important life decisions that they later regret. Hyperbolic discounting of future burdens as well as lack of self control and forgetfulness have all been identified as sources of excessive consumer borrowing and spending. Moreover, even lenders in a competitive market may be able to take advantage of these biases (as individuals who miscalculate the true cost of credit may not react rationally to what they fail to perceive as lower-cost offers). Allowing an individual to opt-out of discharge, therefore, might well exacerbate these problems.

Although the problems of psychological bias are real, and important, they do not necessarily justify a mandatory rule on discharge but rather may inform the appropriate default rule and the manner in which one must opt out of that default rule. Perhaps the default rule should permit full Chapter 7 discharge that could not be waived absent a debtor's signature on a written, fully informative disclosure document. This document

could be worded in plain language—to account for the possibility that the debtor is not sophisticated about legal matters—with appropriate spaces for initials (or sentences handwritten by the debtor) on key provisions of the waiver. Significantly, these key provisions could include a summary of the psychological biases individuals are known to suffer and an explanation of the consequences the debtor might encounter as a result of such biases.

One could, of course, object to a waiver of discharge even if the waiver is explicit, written, and based on full disclosure. The psychological biases that plague an individual's borrowing decisions may also affect her ability to assess her susceptibility to the biases themselves. One might worry, moreover, that unsophisticated debtors might be persuaded to sign or write out a document that they don't understand even if the writing itself recites that they do understand. But these arguments are, at base, parentalistic. They rest on a belief that a lawmaker knows more than an individual what's best for that individual. Such an argument is not necessarily mistaken, but it is harder to defend than an appeal to avoid psychological bias alone.

This said, whatever one's view on whether the bankruptcy law should permit an opt out of a full-discharge regime, it seems (at least to me) relatively uncontroversial that debtors should be permitted to opt into such a regime. Thus, as discussed above, if Congress is to restrict the use of Chapter 7 it should do so only as a default rule.

(ii) Corporate Debtors

The case for freedom of contract is more straightforward for corporate debtors. As discussed above, the process of Chapter 11, while perhaps less relevant than in the past, may not be ideal where it does matter. Given the option, investors might choose to

customize the process that will follow an uncured default. That process may include an automatic allocation of interests among the creditors or may specify that no special process would apply, leaving resolution to state-law collection remedies. Chapter 11 is not for every firm, and the Bankruptcy Code should not permit it to be an option for every firm where the debtor's corporate charter indicates that an alternative process would obtain in the event of default. As of now, it seems likely that at least some courts would treat a waiver of bankruptcy as illegitimate even for a corporate debtor. This should change.

In my earlier work on this topic, I observed that not only the Bankruptcy Code but other laws posed impediments to free corporate contracting about insolvency. Among these are tax law, corporate law, and commercial law.¹³ A detailed explanation is beyond the scope of these remarks. Suffice it to say here that although reform of the Bankruptcy Code to permit contracting around Chapter 11 would not solve every legal problem a financially distressed corporate debtor confronts, removal of one obstacle would be a start. If contract were the source of process, corporate bankruptcy law could usefully be reduced to its fundamental element, establishment of priority among conflicting claims.

B. Bankruptcy Priority

At this point of the analysis, an oddity and an objection come to mind. The oddity is that one would treat the establishment of priority as a role for bankruptcy *law* yet consider process a matter of contract. The objection is that it is a mistake to assume investors should dictate the resolution of financial distress, in a corporate charter or

¹³ See Adler, *supra* note 9.

otherwise, as in some bankruptcy cases claims are held not only by investors but by *nonconsensual* creditors. I deal with each of these observations in turn.

Priority among claims can be established by contract but only if the contract is among creditors. If a debtor corporation issues senior and junior debentures, for example, purchasers of the junior interest explicitly agree to their subordination and there is no conflict between the obligations. The Bankruptcy Code honors this contractual arrangement if state law would. Bankruptcy law must do more, however. It also must address a situation in which a debtor issues obligations that do not include subordination provisions. So, for example, a debtor might pledge the same collateral to two different creditors on account of different loans. If the debtor cannot fully repay both loans state real estate mortgage law or Article 9 of the UCC will establish priority between the claims. The Bankruptcy Code generally honors the state law entitlement. In this way, bankruptcy law—here by reference to state law—fulfills a fundamental purpose, the essential primitive of priority as I describe it above.

That bankruptcy law generally follows state-law entitlements is unobjectionable in these examples. States may differ somewhat in how they establish priority, in real estate mortgages, under their own versions of Article 9, or (in the absence of contrary agreement among investors) by reference to a race for a judgment lien on unencumbered assets. But the differences among jurisdictions are small and the applicable rules almost always sensible. A perfected interest in a debtor's assets requires some form of public notice, usefully warning competitors, whether that notice is provided by filing in an appropriate records office or by having a sheriff seize the property on behalf of a lender who seeks to become a lien creditor. It is not clear that a uniform rule in bankruptcy

would serve any additional purpose, though it would offend notions of federalism and could inhibit experimentation among jurisdictions. (Similarly, the Bankruptcy Code's deference to state law exempt-property rules for individual debtors is largely unobjectionable at least so long as a debtor does not change the rules on his creditors by moving to a new state before filing a bankruptcy petition.).¹⁴

These priority rules are property rules as they establish entitlements when claims conflict. But at least to the extent that lenders understand these rules before they extend credit, the rules *can* be characterized as contractual as no investor holds a subordinated claim without knowledge that a senior claim exists, or may later come into existence, with priority established through notice of the senior interest. One who lends under these rules and does not establish priority herself implicitly consents to actual or potential subordination. So even if one thinks of priority as naturally contract-based, bankruptcy law's deference to state-law entitlement does establish priority consistent with a contract regime.

One might note that I have not here invoked the now standard proceduralist response to any suggestion that bankruptcy law alter state-law entitlement. That response, crafted primarily by Douglas Baird and Thomas Jackson, is that bankruptcy law is about process—a solution to the collective-action problem—and not about priority or entitlements.¹⁵ In the Baird & Jackson paradigm, any appeal to the idea that a particular bankruptcy entitlement is good or bad is met with a claim that good or bad it may be, but a bankruptcy issue it is not. In the bankruptcy-primitives paradigm I have sought to

¹⁴ On exempt property and jurisdiction jumping, see Marcus Cole, *The Federalist Cost of Bankruptcy Exemption Reforms*, 74 Am. Bankr. L.J. 227 (2000).

¹⁵ See Jackson, *supra* note 8.

establish here, however, the standard approach is turned upside down. Process is not a bankruptcy issue, entitlement is.

My disagreement with my colleagues (and casebook coauthors) Baird and Jackson, with whom I seldom find issue, stems from an analysis of the primary reason they give to oppose special bankruptcy law entitlement: the cost of forum shopping. Their concern is, or has been, that if different substantive rights existed inside bankruptcy, as compared to out, parties who would benefit from the substantive bankruptcy result would have a perverse incentive to invoke the potentially cumbersome and costly bankruptcy process for a debtor not otherwise a good candidate for the process. The forum shopping concern, however, has always been easy to overstate and, in any case, has to some extent withered on the vine.

Note that virtually any bankruptcy entitlement at issue—such as whether a security interest should fully be honored—would establish priority among creditors, not between creditors and their debtor. This is significant, as creditors cannot force a debtor into bankruptcy against her or its will unless the debtor has failed to pay debts as they came due.¹⁶ If one might imagine that almost every such debtor *would* be a good candidate for bankruptcy—at least as opposed to some state law legal process—regardless of how assets would be distributed to creditors within bankruptcy, then forum shopping is not an important concern and any costs of forum shopping could easily be outweighed by a competing interest in favor of special bankruptcy entitlement. Moreover, as Baird points out at this conference, and in his article with Rasmussen, the most potentially costly form of bankruptcy process, Chapter 11, has declined in significance as in many Chapter 11

¹⁶ See Bankruptcy Code, 11 U.S.C. §303.

cases a subset of a debtor's creditors take control despite (or within) the formal rules of Chapter 11 and quickly dispose of the debtor's assets as they would like. If the process is thus not generally costly, forum shopping for that process is not as great a concern and, again, might be easily outweighed by competing considerations.

Earlier in these remarks I emphasized that the Chapter 11 process may still be costly for some firms. In these cases, one might be more concerned about forum shopping. But in a world in which bankruptcy served only its most basic functions, process would be determined by contract, as I have proposed here and elsewhere. In such a legal environment, bankruptcy law would establish *only* entitlements (assuming that the debtor is a corporation) leaving all of process to contract in light of such priority. So long as the Bankruptcy Code made clear that contractual process would override any attempt by state law to impose its own legal process—as the Bankruptcy Code should—forum shopping would not even be an issue.

This said, so far, the approach I recommend here does not conflict with the proceduralist paradigm. As noted, I see no reason to change current bankruptcy law's deference to state law for priority among lenders. But not all creditors are lenders. In a small number of bankruptcy cases, tort creditors or other nonconsensual claimants (such as children owed support from a parent) are owed significant sums. State law generally treats such claims as general obligations that, outside of bankruptcy, are subject to a creditors' race. The first to establish a judgment lien on any of a debtor's unencumbered assets has priority. And if there are no or few unencumbered assets from which a nonconsensual creditor can collect, the result is that the nonconsensual creditor simply loses. Perfected security interests come first. In bankruptcy, this system of state law

priority translates into a ratable return for nonconsensual creditors who share priority with other general creditors. Priority for the perfected security interest survives a bankruptcy petition.

There is little to support so low priority for nonconsensual claims. Standard economic analysis suggests that nonconsensual claims should have the *highest* priority, even above secured creditors. Otherwise investors—shareholders and lenders together—can externalize the risk of a debtor’s operation and internalize the benefits. A classic example would be where a cab company pledged all of its cars to secured creditors (or, the economic equivalent, leased them) then simply folded if a negligently driven taxi ran down a pedestrian who successfully sued the company.

This result not only strikes most as unfair based on any theory of justice, but induces excessive activity by the cab company and insufficient precaution. Every consideration, therefore, seems to favor tort-victim priority, which would cause a company’s investors to internalize both the cost and the benefit of corporate activity (at least to the full extent of corporate assets).¹⁷ Were I asked to suggest a reform to the Bankruptcy Code, I would recommend highest priority for nonconsensual creditors, which would include accident victims such as the pedestrian, sufferers of environmental contamination, and others with no relationship with the debtor, or an insufficient opportunity to bargain with the debtor, prior to the injury that gave rise to the claim. Where a firm devised its own process for resolution of financial distress, as I propose a

¹⁷ Compare Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale L.J. 1879 (1991). (arguing against even limited liability where a plaintiff is a tort victim).

firm should be permitted to do, one limitation on that process would be that nonconsensual creditors are awarded a return ahead of all investors.

A response that one might anticipate to this proposal, at least from some corners, is that the tort system is out of control, imposing liability on actors that have not behaved negligently or otherwise in a way that society should wish to discourage. In the extreme version of this claim, it is said that many injuries are fabricated or vastly overcompensated in damages awards. The lack of affordable medical care is frequently blamed on soaring malpractice premiums. The newspapers are full of such allegations. True or not, however, one can at least hope that rather than two malfunctioning legal systems—tort and bankruptcy—lawmakers might repair each. I at least so hope this might be the case.

Conclusion

Bankruptcy law as we know it serves many functions, perhaps too many. These remarks constitute a thought experiment, where contract handles most of what bankruptcy law now regulates, and where bankruptcy serves simply to reach where contract cannot.