

# Contractual Bankruptcy Waivers: Reconciling Theory Practice and Law

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# CONTRACTUAL BANKRUPTCY WAIVERS: RECONCILING THEORY, PRACTICE, AND LAW\*

*Marshall E. Tracht†*

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## INTRODUCTION

It is commonly said that a business<sup>1</sup> may not waive its right to protection under the Bankruptcy Code and that any attempt to do so is void as against public policy. Over the past few years, however, bankruptcy scholars have argued that it would be economically efficient to allow firms to renounce their right of access to the bankruptcy courts.<sup>2</sup> At the same time, corporate and bankruptcy lawyers have become increasingly adept at designing techniques that keep firms from utilizing the bankruptcy laws without running afoul of the law's hostility to waivers. Thus, we have created a situation in which both theory and practice are increasingly at odds with the established view of the law—a conflict which has gone largely unaddressed in the legal literature. Moreover, as courts have recently begun to grapple with these new bankruptcy avoidance techniques, they have responded in an ad hoc manner that reflects the absence of a framework for analyzing waivers under the Bankruptcy Code. The purpose of this Article is to offer a reasoned approach to the analysis of bankruptcy waivers, combining the economic justifications for bankruptcy law with the legal structure of the Code.

Bankruptcy waivers raise fundamental questions about the nature and purposes of the bankruptcy system, and the confusion about waivers highlights the absence of a uniform explanation for bankruptcy law. During the past decade, bankruptcy theory has been dominated by a debate between proponents of economic models that emphasize bankruptcy as a wealth-maximizing solution to the collective action problem facing creditors of insolvent firms, and critics who see broader social goals for the bankruptcy system.<sup>3</sup> Economic analyses suggest that waivers could enhance the functioning of the bankruptcy system, benefiting both firms and their creditors.<sup>4</sup> However, critics are troubled because bankruptcy waivers, even if they are wealth-maxi-

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<sup>1</sup> This Article does not address the waivability of bankruptcy rights by natural persons, only by business debtors. See *infra* text accompanying note 24.

<sup>2</sup> See *infra* note 4.

<sup>3</sup> For an extensive bibliography on the debate over the creditors' bargain model and other attempts to provide a normative foundation for bankruptcy law, see Linda J. Rusch, *Bankruptcy Reorganization Jurisprudence: Matters of Belief, Faith and Hope—Stepping into the Fourth Dimension*, 55 MONT. L. REV. 9, 10 n.1 (1994).

<sup>4</sup> See Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); James W. Bowers, *The Fantastic Wisconsin Zero-Bureaucratic-Cost School of Bankruptcy Theory: A Comment*, 91 MICH. L. REV. 1773, 1786-88 (1993) (citing Rasmussen); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach To Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992) (advocating legislative creation of bankruptcy options to which firms could bind themselves in advance); Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. & ECON. 595 (1993) (arguing that bankruptcy waivers would permit workouts to succeed where they now fail).

mizing for firms and their creditors, may adversely affect employees, suppliers, customers, and the community at large.<sup>5</sup>

This Article challenges the accepted view that bankruptcy waivers are unenforceable under the Bankruptcy Code. Waivers have a potentially valuable role to play under the Code, and this role does not depend on the normative conclusions of wealth-maximizing economists or deny broader concerns a place in bankruptcy jurisprudence. However, waivers cannot be held enforceable *per se* under the Bankruptcy Code. Waivers should be enforced in many cases; in other cases, waivers may provide information useful in considering the proper disposition of the bankruptcy case; and some waivers should be disregarded completely. As shown below, the proper role of contractual bankruptcy waivers follows from an understanding of their evidentiary import in the context of Bankruptcy Code requirements.<sup>6</sup>

Part I begins with a discussion of the various types of commonly used bankruptcy avoidance techniques and their treatment under the case law. Part II discusses the basic economic functions of business bankruptcy and provides an initial analysis of the waiver of bankruptcy rights in light of these functions. It then examines the empirical support for this initial analysis. Part III considers the role of waivers in furthering a central task in the bankruptcy process—sorting viable businesses from lost causes—and connects the economic function of bankruptcy waivers to the provisions of the Bankruptcy Code. In particular, Part III focuses on the accuracy and appropriateness of contractual versus judicial determinations of these matters. Part IV considers some potential objections to waivers, and expands the analysis to include problems raised by asymmetric information and agency costs, concluding that economic theory supports the enforcement of informed, consensual bankruptcy waivers. It also considers the case of unsophisticated borrowers, and a special situation in which waivers often arise—as provisions in prebankruptcy restructuring attempts. Part V applies the analysis of Parts I through IV, and offers a coherent approach to the enforcement of waivers under existing law. The final section offers some conclusions and observations.

## I

### CURRENT LAW AND PRACTICE

As bankruptcy filings increased in the late 1980s and early 1990s,<sup>7</sup> commercial lawyers became more sophisticated in dealing with poten-

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<sup>5</sup> See *infra* Part III.C.

<sup>6</sup> See *infra* Parts III, V.

<sup>7</sup> Business bankruptcies increased from 47,415 in 1981, see U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 541 tbl.865 (113th ed. 1993), to a high of 88,278 in 1987, before levelling off in the 60,000 to 70,000 range.

tial bankruptcy issues both in structuring new transactions and in restructuring existing ones. This change precipitated an increased awareness of the direct and indirect costs of bankruptcy, including legal fees, delay, and the opportunity for borrowers to use bankruptcy as a strategic weapon with which an insolvent firm's equity holders could keep some of the firm's value from its creditors.<sup>8</sup> In light of this growing understanding of the costs and risks of bankruptcy, creditors often agreed to workouts in which they made concessions (for example, forbearing from enforcement or foreclosure) in order to avoid bankruptcy. Over time, however, it became clear that these concessions often accomplished little, because nothing in the workout barred the firm from subsequently filing for bankruptcy. Thus, a creditor could make concessions and still face all of the costs it had hoped to avoid.

As a result, creditors now commonly bargain for protections against a subsequent bankruptcy filing as part of a workout.<sup>9</sup> However, understanding that courts will not permit a firm to waive its eligibility for bankruptcy protection, creditors typically seek less direct ways to accomplish a similar result. These provisions can be divided into three broad categories: restraints on bankruptcy access; waivers of specific bankruptcy rights (generally, the automatic stay); and incentives to refrain from utilizing the bankruptcy laws.

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See U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 553 tbl.864 (115th ed. 1995).

<sup>8</sup> See *infra* Part II.B.

<sup>9</sup> See Jeffrey W. Warren & Wendy V.E. England, *Pre-petition Waiver Of The Automatic Stay Is Not Per Se Enforceable*, AM. BANKR. INST. J., Mar. 1994, at 22, 22 ("Practically every loan modification or business workout agreement drafted today contains a series of boilerplate 'bankruptcy waiver' provisions."). The growing use of such provisions is reflected in the recent practitioners' literature on their drafting and enforcement. See, e.g., ALVIN L. ARNOLD, REAL ESTATE INVESTOR'S DESKBOOK § 11.04[8] (3d ed. 1994); MICHAEL T. MADISON ET AL., THE LAW OF REAL ESTATE FINANCING, F12-42 (rev. ed. 1996); Craig H. Averch, *Bankruptcy Issues: Emphasizing Drafting Considerations in Protecting Against Insolvency (Including Selected Issues in Single Asset Real Estate Bankruptcies)*, in REAL ESTATE DEFAULTS, WORKOUTS, AND REORGANIZATIONS 303 (ALI-ABA Course of Study Materials Vol. 1, Phila., Pa., Sept. 22-24, 1994); Mikel R. Bistrow & James Baillie, *Waiver of Bankruptcy Protections in Pre-Bankruptcy Workout Agreements*, in BUSINESS WORKOUTS MANUAL (Supp. 1994), reprinted in NEGOTIATING "NO SECOND BITE" CLAUSES AND OTHER BANKRUPTCY WAIVERS IN DEBT RESTRUCTURING (A.B.A. Sec. of Bus. Law, New Orleans, La., Aug. 8, 1994); David L. Campbell & Julie E. Lennon, *Drafting Bankruptcy Relief Clauses in Loan Documents*, 10 PRAC. REAL EST. LAW. 27 (1984); Thomas M. Mayer, "Bankruptcy-Proof" Entities, "Bankruptcy-Resistant" Workouts, and Tolling Agreements, in REAL ESTATE WORKOUTS AND BANKRUPTCIES 37 (PLI Real Est. Law & Practice Course Handbook Series No. N-402, 1994); Scotta E. McFarland, *Waivers of Bankruptcy Rights in Workout Agreements*, PROB. & PROP., Nov./Dec. 1994, at 15; John P. McNicholas, Note, *Prepetition Agreements and the Implied Good Faith Requirement*, 1 AM. BANKR. INST. L. REV. 197 (1993).

### A. Restraints on Bankruptcy Filing or Eligibility

For a creditor that wants to avoid entanglement in a firm's bankruptcy, the most effective remedy would be a waiver of the firm's ability to be a debtor under the bankruptcy laws, relegating the firm and its creditors to state-law collection proceedings. I refer to this as a waiver of bankruptcy eligibility.<sup>10</sup> More limited waivers might bar a firm from attempting to reorganize through bankruptcy but would allow it to remain eligible for bankruptcy liquidation,<sup>11</sup> or would bar a voluntary bankruptcy filing by a firm but not purport to limit the ability of creditors to file an involuntary bankruptcy against it.<sup>12</sup>

A firm cannot waive its bankruptcy eligibility entirely, because the Code grants creditors the right to file an involuntary petition against a firm and there is no apparent way for a firm to extinguish this right. Nor can a firm waive its right to convert a liquidation case to reorganization; this is barred by the only provision in the Bankruptcy Code specifically addressing waivers.<sup>13</sup> Thus, of the possible waivers regarding access to bankruptcy, we are left only with the question of whether a firm can waive its right to file a voluntary petition.

Although there is little case law on this question, courts seem to accept, almost as a matter of faith, that commercial agreements waiving the right to file for bankruptcy are unenforceable. Several decisions suggesting a constitutional right to file for bankruptcy—an idea that is patently incorrect—indicate just how deep the roots of this conviction lie.<sup>14</sup>

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<sup>10</sup> References to bankruptcy "eligibility" include the availability of bankruptcy relief on either a voluntary or involuntary basis. Thus, a waiver of eligibility is broader than a simple waiver of a firm's right to initiate a voluntary bankruptcy case.

<sup>11</sup> Such a waiver would presumably be invalid under 11 U.S.C. § 706(a), which provides that any waiver of the right to convert a Chapter 7 case to a case under Chapter 11, 12, or 13 is unenforceable. 11 U.S.C. § 706(a) (1994).

<sup>12</sup> A bankruptcy case may be commenced by the filing of a bankruptcy petition by the debtor, pursuant to 11 U.S.C. § 301 (1994), called a voluntary petition. Alternatively, creditors may file an involuntary bankruptcy petition against a debtor pursuant to 11 U.S.C. § 303 (1994), which will result in a bankruptcy case if the creditors can show that the debtor is generally not paying its debts as they come due, or that a custodian was appointed to take possession of substantially all of the debtor's assets within 120 days before the filing of the petition.

<sup>13</sup> See 11 U.S.C. § 706(a) (1994). The legislative history of the Code indicates that the Code's silence on other waivers was not meant as an endorsement of such waivers. See 124 CONG. REC. 32,401 (1978) ("The explicit reference in title 11 forbidding the waiver of certain rights is not intended to imply that other rights, such as the right to file a voluntary bankruptcy case under section 301, may be waived."). Nonetheless, § 706(a) indicates that Congress was aware of the issue and declined to outlaw waivers of bankruptcy rights.

<sup>14</sup> See, e.g., *In re Citadel Properties, Inc.*, 86 B.R. 275, 275 (Bankr. M.D. Fla. 1988) ("The Court pauses to suggest that a total prohibition against filing for bankruptcy would be contrary to Constitutional authority as well as public policy."). The idea appears to have originated in *Merritt v. Mt. Forest Fur Farms of Am., Inc.* (*In re Mt. Forest Farms of Am., Inc.*), 103 F.2d 69, 71 (6th Cir.), cert. denied, 308 U.S. 583 (1939). *Mt. Forest Fur* referred to a "constitutional right to relief under § 77B of the Bankruptcy Act. Art. 1, § 8, clause 4,

Although numerous courts have commented in dicta on the unenforceability of a firm's waiver of the right to file bankruptcy, few cases actually raise the issue and none analyze it.<sup>15</sup> The only pre-Code case directly on point appears to be *In re Los Angeles Lumber Products Co.*,<sup>16</sup> in which the court refused to dismiss a voluntary reorganization filing on the basis of a bond indenture provision that barred the firm from invoking any law that would alter, impair, or impede the bondholders' rights and remedies. "[A]ny such attempted restriction upon the debtors' rights even in a voluntary proceeding would seem to this court to be void, as contrary to public policy."<sup>17</sup> The court made no effort, however, to identify the "public policy" at issue or to explain how the waiver violated it.

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Constitution of the United States, U.S.C.A." *Id. Mt. Forest Fur* is then cited in *In re Donaldson Ford, Inc.*, 19 B.R. 425, 430 (Bankr. N.D. Ohio 1982) and *In re Pine Tree Feed Co.*, 112 F. Supp. 124, 126 (D. Me. 1953). However, the Constitution provides that "[t]he Congress shall have Power . . . To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States. . . ." It does not require Congress to pass a bankruptcy law, much less give anyone a right to invoke it. U.S. CONST. art. I, § 8, cl. 4. *See also* *United States v. Kras*, 409 U.S. 434, 446-47 (1973) (holding that an individual has no constitutional right to a bankruptcy discharge, nor is the right to bankruptcy protection a fundamental right requiring a compelling governmental interest before it may be limited).

<sup>15</sup> Apart from the three cases discussed in the text, the law on waivers of eligibility or the right to file for bankruptcy consists of broadly-worded, dismissive dicta. *See, e.g.*, *United States v. Royal Business Funds Corp.*, 724 F.2d 12, 15 (2d Cir. 1983) (dicta regarding "the general rules that a debtor may not agree to waive the right to file a bankruptcy petition," citing cases holding that a state court injunction or a receivership will not preclude a bankruptcy filing); *In re Jenkins Court Assoc. Ltd. Partnership*, 181 B.R. 33, 35 (Bankr. E.D. Pa. 1995) (dicta that "restraints against filing for bankruptcy . . . are, of course, contrary to a long line of authority as well as public policy," citing only *In re Citadel, infra*); *In re Club Tower, L.P.*, 138 B.R. 307, 312 (Bankr. N.D. Ga. 1991) (dicta that agreements which prohibit a borrower from filing for bankruptcy violate public policy); *In re Citadel Properties, Inc.*, 86 B.R. 275 (Bankr. M.D. Fla. 1988) (dicta stating, without authority, that "[t]he Court pauses to suggest that a total prohibition against filing for bankruptcy would be contrary to Constitutional authority as well as public policy"); *In re Gulf Beach Dev. Corp.*, 48 B.R. 40 (Bankr. M.D. Fla. 1985) (dicta stating, without authority, that "the Debtor cannot be precluded from exercising its right to file Bankruptcy and any contractual provision to the contrary is unenforceable as a matter of law. . . ."). *See also* *Mayer, supra* note 9, at 53 ("That proposition is so generally assumed as common sense and horn-book law that courts no longer cite authority for it.").

<sup>16</sup> 24 F. Supp. 501 (S.D. Cal. 1938), *aff'd*, 100 F.2d 963 (9th Cir.), *rev'd on other grounds sub nom.*, *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). At least one other pre-Code case is relevant, if not directly on point. Relying largely on *Los Angeles Lumber*, the court in *In re Southern Land Title Corp.*, 301 F. Supp. 379 (E.D. La. 1968) held that a stipulation entered by the debtor in one bankruptcy case, consenting to its dismissal with prejudice, could not bar creditors from filing an involuntary petition against the debtor because "[a]greements in derogation of the right to seek reorganization are most strictly construed if, in fact, they are not void as contrary to public policy." 301 F. Supp. at 396. *Southern Land Title* cites two additional cases for this proposition, *In re Sponsor Realty Corp.*, 48 F. Supp. 735 (S.D.N.Y. 1943) and *In re Hudson Coal Co.*, 22 F. Supp. 768 (M.D. Pa. 1938), neither of which provides more than tangential support.

<sup>17</sup> *Los Angeles Lumber*, 24 F. Supp. at 515.

Since the passage of the Bankruptcy Code in 1978, there have been two additional cases on point. In *In re Tru Block Concrete Products, Inc.*,<sup>18</sup> creditors and shareholders agreed to create a liquidating trust to dispose of the assets of a failed corporation. If the liquidation was not completed in five months, the creditors would be permitted to foreclose without the firm filing for bankruptcy. When the liquidation was not timely completed, the firm filed.<sup>19</sup> The court declined to dismiss the petition, citing the "well settled principal [sic] that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy."<sup>20</sup> In *In re Adana Mortgage Bankers, Inc.*, the Government National Mortgage Association ("GNMA") argued that a debtor's bankruptcy filing was ineffective because it violated a contractual term requiring prior notice to GNMA of any bankruptcy filing.<sup>21</sup> The court rejected this argument stating, "It is clear that ' . . . an advance agreement to waive the benefits of the (Bankruptcy) Act would be void."<sup>22</sup>

Given that these two cases are separated from *Los Angeles Lumber* by fifty years and a major revision of the statutory framework, it is remarkable how similarly the three cases read. *Los Angeles Lumber*, *Tru Block Concrete*, and *Adana Mortgage* each rely, for their principal support, on cases holding that an individual may not waive the right to a bankruptcy discharge.<sup>23</sup> The error in applying this authority to the business context is emphasized by the *Adana Mortgage* court's explicit reliance on the fresh start policy, because that policy is implicated only in cases concerning human beings rather than legal entities.<sup>24</sup>

<sup>18</sup> 27 B.R. 486 (Bankr. S.D. Cal. 1983).

<sup>19</sup> *See id.* at 487.

<sup>20</sup> *Id.* at 492.

<sup>21</sup> 12 B.R. 989 (Bankr. N.D. Ga. 1980), *vacated as moot*, 687 F.2d 344 (11th Cir. 1982).

<sup>22</sup> *Id.* at 1009 (citing *Fallick v. Kehr*, 369 F.2d 899, 904 (2d Cir. 1966)).

<sup>23</sup> *Los Angeles Lumber*, 24 F. Supp. at 516, relies on *In re Weitzen*, 3 F. Supp. 698 (S.D.N.Y. 1933) (holding an individual's agreement to waive bankruptcy discharge unenforceable) and *Federal Nat'l Bank v. Koppel*, 148 N.E. 379 (Mass. 1925) (same). *Tru Block Concrete*, 27 B.R. at 492, cites four cases for the proposition that waivers are against public policy, all of which hold that an individual cannot waive rights concerning his or her bankruptcy discharge: *Fallick v. Kehr*, 369 F.2d 899 (2d Cir. 1966); *Watrous v. George* (*In re George*), 15 B.R. 247 (Bankr. N.D. Ohio 1981); *Johnson v. Kriger* (*In re Kriger*), 2 B.R. 19 (Bankr. D. Or. 1979) and *Weitzen*, 3 F. Supp. 698. *Adana Mortgage*, 12 B.R. at 1009, relies on *Fallick*, *Weitzen* and *Koppel*.

<sup>24</sup> *See* THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 4-5, 190-92 (1986); DOUGLAS G. BAIRD & THOMAS H. JACKSON, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 110 n.45 (1984); ELIZABETH WARREN, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 341 (1993). To protect individuals' rights to a fresh start, courts have consistently held that an individual may not waive the right to a bankruptcy discharge. *See, e.g.*, *Klingman v. Levinson*, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987); *Alsan Corp. v. DiPierro* (*In re DiPierro*), 69 B.R. 279, 282 (Bankr. W.D. Pa. 1987); *Markizer v. Economopoulos* (*In re Markizer*), 66 B.R. 1014, 1018 (Bankr. S.D. Fla. 1986); *Johnson v. Kriger* (*In re Kriger*), 2 B.R. 19, 23 (Bankr. D. Or. 1979); *In re Weitzen*, 3 F.



The humanitarian concerns that compel us to offer a fresh start in life to a person in financial trouble are not implicated when the bankrupt entity is a legal fiction. Nor are the economic concerns the same. A person must be freed from debt to have an incentive to re-enter the economy in a productive capacity, but a business entity can cease to function without loss to the economy if its assets are effectively redeployed or if the very same business is continued by a new entity or purchaser. Although business and personal bankruptcy invoke similar concerns in some areas, it cannot be assumed, without analysis, that bankruptcy waivers are such an area. These cases leap, without discussion, from an almost unassailable proposition—that it violates fundamental purposes of bankruptcy law for an individual to waive the right to a fresh start—to an entirely different one that is far less clear—that business entities may not waive the right to file voluntary bankruptcy petitions.

As additional support, *Los Angeles Lumber* and *Adana Mortgage* rely on cases holding that a court, when appointing a receiver, cannot bar corporate officers from filing a bankruptcy petition.<sup>25</sup> These cases, however, involve a legal issue far removed from contractual waivers; their holdings are based on the Supremacy Clause and the federal courts' exclusive jurisdiction over matters arising under a national bankruptcy statute.<sup>26</sup> And it is a far cry from saying that a court may not bar a firm from bankruptcy to saying that the firm may not voluntarily relinquish its right to file. The fact that the federal courts have exclusive jurisdiction over bankruptcy matters does not tell us how those courts should treat contractual bankruptcy waivers.

Thus, none of the cases on which the courts relied address the enforceability of a contractual waiver of bankruptcy rights by a business entity. More telling than the absence of authority, however, is the missing analysis. Each of these cases invalidates a contractual pro-

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Supp. 698 (S.D.N.Y. 1933); *Federal Nat'l Bank v. Koppel*, 148 N.E. 379 (Mass. 1925). Waiver of the automatic stay may impose substantial hardship on an individual, but it does not deny a fresh start, and courts have treated such waivers less strictly. See, e.g., *In re Powers*, 170 B.R. 480 (Bankr. D. Mass. 1994) (waiver of the automatic stay by an individual shifts burden to opponents to show why waiver should not be given effect); *In re Cheeks*, 167 B.R. 817 (Bankr. D.S.C. 1994) (enforcing an individual's knowing and informed waiver of the stay).

<sup>25</sup> See *Los Angeles Lumber*, 24 F. Supp. at 516 (citing *Struthers Furnace Co. v. Grant*, 30 F.2d 576 (6th Cir. 1929) and *In re American & British Mfg. Corp.*, 300 F. 839 (D. Conn. 1924)); *Adana Mortgage*, 12 B.R. at 1009 (citing *Merritt v. Mt. Forest Fur Farms of Am., Inc.*, (*In re Mt. Forest Fur Farms of Am., Inc.*), 103 F.2d 69, 71 (6th Cir. 1939) and *In re Pine Tree Feed Co.*, 112 F. Supp. 124, 126 (D. Me. 1953)).

<sup>26</sup> See *Mt. Forest Farms*, 103 F.2d at 71; *Struthers Furnace*, 30 F.2d at 577 (citing *American & British Mfg.*); *Pine Tree Feed*, 112 F. Supp. at 126 (citing *Mt. Forest Fur Farms*); *American & British Mfg.*, 300 F. at 847, 849-50. See *International Shoe Co. v. Pinkus*, 278 U.S. 261 (1929) (holding that states may not implement insolvency statutes that conflict with the federal bankruptcy law).

vision on "public policy" grounds, without specifying the policies at stake or explaining how bankruptcy waivers violate those policies.<sup>27</sup>

Nonetheless, practitioners facing this judicial consensus generally forego direct waivers of the right to file bankruptcy. Instead, similar results are sought through organizational structures or contractual devices that hinder the firm should it attempt to invoke the bankruptcy laws. One method is to create an entity that is not eligible for relief under the Bankruptcy Code. Individuals, partnerships, corporations, and trusts that qualify as business trusts are all eligible debtors.<sup>28</sup> In some circumstances, a trust format may bar an entity from bankruptcy. However, trusts are not viable for most commercial enterprises, and in many cases would still be considered business trusts eligible for bankruptcy.<sup>29</sup>

A second method is to put provisions in the firm's organizational documents that render it difficult for the firm to file for bankruptcy. For example, a voluntary bankruptcy filing must be made by those with authority to act for the firm under state law.<sup>30</sup> A corporate charter or a partnership agreement could simply bar anyone from filing a petition, but many practitioners believe such a provision would be held unenforceable.<sup>31</sup> Instead, a provision that a bankruptcy filing may only be made upon a unanimous or supermajority vote of shareholders or directors may be combined with a voting proxy in favor of one or more creditors, or with creditor representation on the board of directors, in an attempt to effectively disable the firm from voluntarily filing for bankruptcy.<sup>32</sup> Similarly, a partnership cannot file a voluntary petition without the consent of all general partners.<sup>33</sup> Thus, a

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<sup>27</sup> See *supra* note 15.

<sup>28</sup> 11 U.S.C. § 109 (1994) provides that a "person" may be a bankruptcy debtor. "Person" includes "individual, partnership and corporation, but does not include governmental unit . . ." 11 U.S.C. § 101(41) (1994). 11 U.S.C. § 101(9) (1994) defines corporation to include a "business trust," but the Bankruptcy Code provides no criteria for distinguishing business trusts from other trusts.

<sup>29</sup> For cases discussing the meaning of "business trust," see *Shawmut Bank Conn. v. First Fidelity Bank (In re Secured Equip. Trust of E. Air Lines, Inc.)*, 38 F.3d 86 (2d Cir. 1994) (trust created to facilitate a secured financing arrangement held not to be a business trust) and *In re Tru Block Concrete Products, Inc.*, 27 B.R. 486 (Bankr. S.D. Cal. 1983) (liquidating trust for corporation is a business trust).

<sup>30</sup> *Price v. Gurney*, 324 U.S. 100, 106 (1945); *Keenihan v. Heritage Press, Inc.*, 19 F.3d 1255, 1258 (8th Cir. 1994); *In re Minor Emergency Ctr. of Tamarac, Inc.*, 45 B.R. 310, 311 (Bankr. S.D. Fla. 1985).

<sup>31</sup> See The Tribar Opinion Committee, *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 Bus. Law. 717, 730 n.50 (1991).

<sup>32</sup> See, e.g., *Keenihan*, 19 F.3d at 1258-59 (stock pledge agreement authorizing creditor to vote stock enabled creditor to bar debtor from filing for bankruptcy); *In re Minor Emergency Ctr.*, 45 B.R. at 311-12 (bylaws requiring both directors to vote on corporate actions rendered invalid bankruptcy filing authorized by only one director).

<sup>33</sup> An involuntary petition may be filed by less than all of the general partners. See 11 U.S.C. § 303(b)(3) (1994).

structure that provides a creditor with control over a general partnership interest will give that creditor power to block a voluntary filing.<sup>34</sup>

From the creditor's perspective, such roundabout devices are inferior in several ways to an enforceable waiver of bankruptcy eligibility. First, they provide no protection against an involuntary filing by other creditors of the firm (acting either independently or in cooperation with the firm).<sup>35</sup> Some protection against involuntary petitions may be achieved by placing strict limitations on the firm's ability to incur debt, but such restrictions are cumbersome, often unrealistic, and never fully effective.<sup>36</sup> Second, any exercise of authority by the creditor to prevent a voluntary filing could raise the specter of lender liability or equitable subordination.<sup>37</sup> Finally, none of these methods can ensure that a bankruptcy case will be dismissed without considerable litigation.

Another common method of attempting to bar a firm from bankruptcy is for the firm to stipulate in its agreement with the creditor that any voluntary bankruptcy filing would be in bad faith and that such bad faith is cause to dismiss the petition.<sup>38</sup> Similarly, the firm may stipulate to particular facts intended to increase the likelihood that the bankruptcy court would grant a motion to dismiss the case or abstain from jurisdiction.<sup>39</sup> Such provisions are less valuable than an outright waiver because they require the creditor to incur the costs and delay of challenging the filing and provide no assurance of success. Moreover, it appears courts will enforce these provisions, if at all, only in the context of a workout, not as part of the initial loan agreement.<sup>40</sup>

The most important development in limiting bankruptcy access has been the rise of structured financing transactions, or asset securi-

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<sup>34</sup> See Mayer, *supra* note 9, at 47, for an example of such a structure.

<sup>35</sup> For allegations of cooperative "involuntary" filings, see *In re Sky Group Int'l, Inc.*, 108 B.R. 86, 90 (Bankr. W.D. Pa. 1989) and *In re Southern Land Title Corp.*, 301 F. Supp. 379, 428-30 (E.D. La. 1968).

<sup>36</sup> Almost any firm will have some dealings with creditors other than the creditor seeking the waiver, and there is no way to ensure that there will not be involuntary claimants, such as tort victims, who could file a petition. See Mayer, *supra* note 9, at 44-45.

<sup>37</sup> See *id.* at 48-50.

<sup>38</sup> The court may dismiss a case for "cause," after notice and a hearing. See 11 U.S.C. §§ 707(a), 1112(b) (1994). Some courts have given effect to bad faith provisions. See, e.g., *In re Aurora Investments, Inc.*, 134 B.R. 982 (Bankr. M.D. Fla. 1991); *In re Orange Park South Partnership*, 79 B.R. 79 (Bankr. M.D. Fla. 1987). For a discussion of these agreements and a sample contractual provision, see McNicholas, *supra* note 9.

<sup>39</sup> See *In re Jenkins Court Assocs. Ltd. Partnership*, 181 B.R. 33, 36 (Bankr. E.D. Pa. 1995) (stating that facts recited in a prepetition agreement intended to show bad faith of any subsequent bankruptcy filing should be given little weight due to the passage of two years since the agreement was signed).

<sup>40</sup> See *infra* text accompanying note 54.

tizations, which total in the hundreds of billions of dollars each year.<sup>41</sup> In a structured financing, a company sells a pool of assets to an entity, often called a special purpose vehicle or SPV, which sells to the public securities backed by those assets. The proceeds of the securities offering are used to pay the company for the assets. SPVs are designed to be "bankruptcy remote"—to make a bankruptcy of the SPV, voluntary or involuntary, unlikely—and to insulate the SPV from the effects should the company itself go into bankruptcy.<sup>42</sup> A structured financing does not attempt to render the operating company itself ineligible for bankruptcy; it tries to isolate the asset pool transferred to the SPV from the risk of the company's bankruptcy.<sup>43</sup> To the extent that the structured financing allows a firm to protect investors from the costs associated with a bankruptcy filing by or against the firm, the firm can borrow from those investors at lower rates than otherwise possible.<sup>44</sup> Bankruptcy protections for SPVs have been largely but not entirely successful; several SPVs have been caught up in bankruptcy proceedings notwithstanding the attempted protections.<sup>45</sup>

## B. Waivers of the Automatic Stay

Given the uncertain efficacy of agreements intended to keep a firm out of bankruptcy, creditors often seek waivers of specific bankruptcy rights, most commonly the automatic stay.<sup>46</sup> If enforced, a waiver of the stay allows a secured creditor to foreclose on its collateral notwithstanding the pendency of the bankruptcy case, insulating that creditor from the costs of bankruptcy. Other rights are occasionally waived, such as the right to seek any extension of the debtor's exclu-

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<sup>41</sup> Structured financings totalled \$300 billion in 1991, \$425 billion in 1992, and \$480 billion in 1993. The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 540 tbl.2 (1995) [hereinafter *Structured Financing Techniques*]. On structured financings generally, see Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994).

<sup>42</sup> See Schwarcz, *supra* note 41, at 135-36.

<sup>43</sup> See *Structured Financing Techniques*, *supra* note 41, at 529 ("Structured financings are based on one central, core principal—a defined group of assets can be structurally isolated, and thus serve as the basis of a financing that is independent as a legal matter, from the bankruptcy risks of the former owner of the assets.").

<sup>44</sup> Schwarcz, *supra* note 41, at 133, 151.

<sup>45</sup> See Malcolm S. Dorris & Edward J. O'Connell, *Problem Cases in Bankruptcy*, in NEW DEVELOPMENTS IN SECURITIZATION 453, 468-90 (PLI Commercial Law & Practice Course Handbook Series No. A-704 1994).

<sup>46</sup> 11 U.S.C. § 362(a) (1994) provides that the filing of a bankruptcy petition by or against the firm automatically stays all acts against the debtor or the debtor's property, with certain limited exceptions not relevant here. Thus, the automatic stay stops all litigation against the debtor and all acts by creditors to collect their debts or foreclose on their collateral.

sivity period<sup>47</sup> or to extend the period to assume or reject a lease or contract with the creditor.<sup>48</sup>

Nearly all of the published cases on contractual waivers of specific bankruptcy rights address waivers of the automatic stay granted to a secured creditor during a prepetition workout. Several cases have enforced such agreements according to their terms.<sup>49</sup> Other courts have refused to give any effect to stay waivers, finding that they violate public policies central to the Bankruptcy Code.<sup>50</sup> Finally, some courts have taken a middle position, holding that although such waivers are not enforceable per se, they are entitled to some weight in considering a motion by the creditor to lift the stay<sup>51</sup> or to dismiss the case<sup>52</sup> for "cause."<sup>53</sup>

Courts that enforce these waivers rely heavily on the public policy of encouraging out-of-court restructurings,<sup>54</sup> reasoning that nonjudicial resolutions are less expensive for the parties and less burdensome on the courts.<sup>55</sup> Moreover, once the firm has obtained the benefits of the agreement, through an extension of additional time or money, it would be unfair for the court to deprive the creditor of the protection

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<sup>47</sup> Under 11 U.S.C. § 1121(b) (1994), the debtor has the exclusive right to file a plan of reorganization during the first 120 days of the bankruptcy proceeding. Section 1121(d) provides that this period may be increased or reduced by the court for cause. See 11 U.S.C. § 1121(d) (1994).

<sup>48</sup> Under 11 U.S.C. § 365(d), a trustee generally has 60 days to assume or reject an unexpired lease or executory contract in a liquidation case before "such contract or lease is deemed rejected"; but, in a reorganization case, a debtor may assume or reject such a contract or lease at any time up until confirmation of a plan of reorganization (except for leases of nonresidential real property, which must be assumed or rejected within 60 days in order not to be deemed rejected). The 60 day period may be extended by the court for cause.

<sup>49</sup> *In re Hudson Manor Partners, Ltd.*, 28 Collier Bankr. Cas. 2d (MB) 221 (Bankr. N.D. Ga. 1991); *In re Club Tower L.P.*, 138 B.R. 307 (Bankr. N.D. Ga. 1991); *In re Citadel Properties, Inc.*, 86 B.R. 275 (Bankr. M.D. Fla. 1988).

<sup>50</sup> *Farm Credit of Cent. Fla.*, *ACA v. Polk*, 160 B.R. 870 (M.D. Fla. 1993); *In re Sky Group Int'l, Inc.*, 108 B.R. 86 (Bankr. W.D. Pa. 1989); *cf. In re Best Finance Corp.*, 74 B.R. 243 (Bankr. D. P.R. 1987) (refusing to honor postpetition waiver). For an argument that waivers of the automatic stay should not be enforceable, see William Bassin, *Why Courts Should Refuse to Enforce Pre-Petition Agreements that Waive Bankruptcy's Automatic Stay Provision*, 28 IND. L. REV. 1 (1994).

<sup>51</sup> See *In re McBride Estates, Ltd.*, 154 B.R. 339 (Bankr. N.D. Fla. 1993) (absent showing of changed circumstances, waiver is "cause" to lift automatic stay; sanctioning debtor and its counsel for unjustifiably contesting creditor's motion to lift the stay).

<sup>52</sup> See *In re Growers Properties No. 56 Ltd.*, 117 B.R. 1015, 1020 (Bankr. M.D. Fla. 1990) (granting motion to dismiss for bad-faith filing and lifting the stay "for cause").

<sup>53</sup> 11 U.S.C. § 362(d)(1) (1994) allows the court to modify or terminate the automatic stay "for cause." Sections 707(a) and 1112(b) permit the court to dismiss a case "for cause," in Chapter 7 and Chapter 11 cases, respectively. See 11 U.S.C. § 707(a), 1112(b) (1994).

<sup>54</sup> See *In re Cheeks*, 167 B.R. 817, 819 (Bankr. D.S.C. 1994); *In re Powers*, 170 B.R. 480, 483 (Bankr. D. Mass. 1994) (citing *Cheeks*); *In re Club Tower L.P.*, 138 B.R. 307, 312 (Bankr. N.D. Ga. 1991).

<sup>55</sup> See *Club Tower*, 138 B.R. at 312.

from bankruptcy that it bargained for.<sup>56</sup> Finally, these courts note that a waiver of the stay is not equivalent to a waiver of the right to file bankruptcy because it leaves all other bankruptcy rights in place.<sup>57</sup>

Courts refusing to enforce the stay generally reason that the stay protects not just the firm but all of its creditors, and that the firm lacks the power to waive the rights of its creditors.<sup>58</sup> Moreover, waiver of the stay threatens the firm's ability to conduct an orderly liquidation or reorganization—central goals of bankruptcy law.<sup>59</sup>

### C. Bankruptcy Disincentives

Given the uncertainties inherent in more direct waivers, creditors often insist on indirect leverage that will help protect them against a bankruptcy filing. The most common forms of indirect leverage are "springing" or "exploding" guaranties<sup>60</sup> and standby letters of credit. These arrangements impose liability on the principals of a firm if it goes into bankruptcy. Thus, a lender making a nonrecourse loan to a real estate limited partnership may require a guaranty from the general partners holding them personally liable for the mortgage debt if the partnership ever files a voluntary bankruptcy proceeding or becomes the subject of an involuntary bankruptcy proceeding that is not dismissed within ninety days of its commencement.<sup>61</sup> Alternatively, the lender may require a letter of credit that can be drawn in the event of a bankruptcy filing. The firm's principals are then obligated, or their assets pledged, to reimburse the issuing bank.

Bankruptcy courts have not directly addressed the validity of springing and exploding guaranties. However, the courts sometimes temporarily enjoin actions against third parties if those actions threaten irreparable harm to the debtor.<sup>62</sup> A court concerned that a springing or exploding guaranty threatens the debtor's reorganiza-

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<sup>56</sup> Cf. *In re Colonial Ford, Inc.*, 24 B.R. 1014, 1022-23 (Bankr. D. Utah 1982) (noting benefits derived by debtor from out-of-court workout).

<sup>57</sup> *Club Tower*, 138 B.R. at 311-12. But see *In re Jenkins Court Assocs. Ltd. Partnership*, 181 B.R. 33, 36-7 (Bankr. E.D. Pa. 1995) (refusing to enforce waiver of the automatic stay in a single-asset real estate case, because in such a case waiver of stay may be equivalent to waiving the right to bankruptcy protection entirely).

<sup>58</sup> *Farm Credit of Cent. Fla., ACA v. Polk*, 160 B.R. 870, 873-74 (Bankr. M.D. Fla. 1993); *In re Sky Group Int'l, Inc.*, 108 B.R. 86, 88-89 (Bankr. W.D. Pa. 1989).

<sup>59</sup> *Jenkins Court*, 181 B.R. at 37; *Farm Credit*, 160 B.R. at 873-74; *Sky Group*, 108 B.R. at 89.

<sup>60</sup> A springing guaranty is one that "springs" into existence upon the happening of a specified event—an express condition precedent. An "exploding" guaranty is one that terminates upon the happening of a specified event.

<sup>61</sup> For a sample exploding guaranty agreement, see MADISON ET AL., *supra* note 9, at F12-41.

<sup>62</sup> See, e.g., *Wysko Inv. Co. v. Great Am. Bank*, 131 B.R. 146 (D. Ariz. 1991) (enjoining creditor from drawing on a letter of credit on which a debtor's principal was the account party); *Lahman Mfg. Co. v. First Nat'l Bank (In re Lahman Mfg. Co.)*, 33 B.R. 681 (Bankr. D.S.D. 1983); *First Fed. Sav. & Loan v. Pettit*, 12 B.R. 147 (E.D. Ark. 1981).

tion might enjoin enforcement of the guaranty while the bankruptcy is pending.<sup>63</sup> And although a bankruptcy court may not permanently relieve a nondebtor of its liabilities absent extraordinary circumstances,<sup>64</sup> it is interesting to ponder whether some bankruptcy judges might view a bankruptcy-triggered guaranty as just such an extraordinary circumstance. Standby letters of credit have been tested, and although the law has sometimes wavered,<sup>65</sup> they are generally effective despite a bankruptcy filing.<sup>66</sup>

If disincentives succeed in their objective, they leave little or no trace in the law records. Debtors who "go gentle into that good night"<sup>67</sup> rather than file for bankruptcy do not show up in the case books or bankruptcy statistics. Thus, it is impossible to say to what extent such disincentives are currently keeping firms from bankruptcy.

#### D. Conclusion

Courts have been ambivalent in their response to bankruptcy waivers. There is a general agreement that neither bankruptcy eligibility nor the right to file for bankruptcy may be waived. However, partial restraints, such as restrictions in a firm's charter, may be used to create hurdles on the road to bankruptcy. Less sweeping waivers, such as waivers of the automatic stay or admissions that any filing

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<sup>63</sup> See *First Fed. Sav. & Loan*, 12 B.R. 147 (enjoining mortgagee's action against debtor's parents because it might place undue pressure on the debtor and thus affect reorganization).

<sup>64</sup> 11 U.S.C. § 524(e) (1994) provides that a bankruptcy discharge does not discharge the obligation of any nondebtor. Numerous courts have construed this as barring bankruptcy plans from modifying the obligations of guarantors or other third parties. See *Underhill v. Royal*, 769 F.2d 1426 (9th Cir. 1985); *Union Carbide Corp. v. Newboles*, 686 F.2d 593 (7th Cir. 1982); *R.I.D.C. Indus. Devel. Fund v. Snyder*, 539 F.2d 487 (5th Cir. 1976), *cert. denied*, 429 U.S. 1095 (1977). Other courts have upheld permanent injunctions protecting third parties from liability, given extraordinary circumstances—generally mass-tort bankruptcies. See *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694 (4th Cir.), *cert. denied*, 493 U.S. 959 (1989); *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988). For a discussion of the issues raised by bankruptcy court involvement in a dispute between two nondebtors, such as a creditor and a guarantor of the debtor's obligations, see Howard C. Buschman III & Sean P. Madden, *The Power and Propriety of Bankruptcy Court Intervention in Actions Between Nondebtors*, 47 *Bus. Law.* 913 (1992).

<sup>65</sup> *In re Delaware River Stevedores, Inc.*, 129 B.R. 38 (Bankr. E.D. Pa. 1991) (invoking conditional stay on letter of credit); *Wysko Inv. Co.*, 31 B.R. 146 (same); *Twist Cap Inc. v. Southeast Bank (In re Twist Cap, Inc.)*, 1 B.R. 284 (Bankr. D. Fla. 1979) (same).

<sup>66</sup> See, e.g., *First Fidelity Bank v. Prime Motor Inns, Inc. (In re Prime Motor Inns, Inc.)*, 130 B.R. 610 (S.D. Fla. 1991) (reversing bankruptcy court order that indenture trustee return proceeds of a letter of credit); *Zenith Labs., Inc. v. Security Pac. Nat'l Trust Co. (In re Zenith Labs., Inc.)*, 104 B.R. 667 (Bankr. D.N.J. 1989) (collecting on letter of credit permissible and not in bad faith); *Page v. First Nat'l Bank (In re Page)*, 18 B.R. 713 (D.D.C. 1982) (no showing that an injunction prohibiting cashing of letter of credit would aid tax preparation of a successful plan).

<sup>67</sup> DYLAN THOMAS, *COLLECTED POEMS* 128 (1957).

should be deemed to be in bad faith, have engendered a mixed response. And indirect restrictions on the use of bankruptcy through leverage on principals, if properly structured, are generally effective but not beyond challenge. The existence of so many partially effective "half-way" measures raises the question of whether more consistent and appropriate results would be obtained by eliminating the general prohibition on bankruptcy waivers.<sup>68</sup> The answer to this question requires an examination of the purposes of bankruptcy and the provisions of the Bankruptcy Code.

## II

### ECONOMIC EFFICIENCY AND BANKRUPTCY WAIVERS

#### A. Waivers and the Economic Theory of Bankruptcy

It has become common in the bankruptcy literature for proponents of a law and economics approach to suggest that firms should be permitted to waive their bankruptcy rights. The most thorough suggestion along these lines was made by Robert Rasmussen, who proposes that bankruptcy law be amended to permit firms to specify in their organizational documents which of a "menu" of choices will be used to resolve the failure of the firm. This "menu" includes bankruptcy reorganization, bankruptcy liquidation, a "contingent equity" option, or state law processes.<sup>69</sup> According to Rasmussen, this regime would permit firms and their creditors to select the most effective mix of creditor rights and remedies given the particulars of the firm.<sup>70</sup> Although Rasmussen has perhaps fleshed out this idea most thoroughly, other prominent bankruptcy scholars, including Douglas Baird, James Bowers, and Alan Schwartz, have also addressed it.<sup>71</sup>

The economic models focus on the role of bankruptcy law in establishing efficient contracts among firms and their creditors, and they often begin with the observation that bankruptcy solves a collective action problem for the firm's creditors. Outside of bankruptcy, creditors have rights against the firm and its assets to collect their debts. Under this nonbankruptcy "grab law," the first creditor to stake a claim to an asset belonging to the firm is entitled to be paid out of

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<sup>68</sup> The alternative, rendering all of these methods entirely ineffective, is probably impossible because the lines between bankruptcy avoidance techniques and the ordinary and necessary tools of commerce are too fine. For example, to eliminate springing guaranties, would all guaranties be barred? If not, would a guaranty become unenforceable if the creditor offered to waive it in exchange for a deed in lieu of foreclosure that is not challenged by a bankruptcy case? As to charter provisions restricting the ability to file bankruptcy, would creditor representation on the board be barred? Or would filing be permitted even without authorization under state law, thus opening the possibility of a filing by one officer against the directions of the board?

<sup>69</sup> See Rasmussen, *supra* note 4, at 100-07.

<sup>70</sup> See *id.*

<sup>71</sup> See articles cited *supra* note 4.



that asset. Upon default, secured creditors foreclose on their collateral, applying the proceeds to their debts. Unsecured creditors bring suit, secure judgment liens and levy on assets, subject only to prior liens on those assets. One result of this "grab law" is a "race to the courthouse": creditors may expend time, money, and effort to be the first to secure a claim to a particular asset, resulting in overinvestment in monitoring the firm's financial condition, wasteful litigation, and high collection costs.<sup>72</sup> Moreover, selling assets in this piecemeal fashion sacrifices any value that the firm may have as a going concern in excess of the value of its assets sold individually.<sup>73</sup>

The result is that by attempting to maximize their individual recoveries, creditors as a group recover less than if they could coordinate their efforts and hold a single, collective proceeding in which the firm's assets are sold in a manner that maximizes proceeds and minimizes costs. However, there is no way for a diverse and constantly changing body of creditors to negotiate such an agreement.<sup>74</sup> To resolve this common-pool problem, bankruptcy law attempts to bind each individual creditor with restrictions that maximize the recovery of the creditors as a group and impose an agreement (the hypothetical "creditors' bargain") which would be negotiated ex ante by profit maximizing creditors aware of the costs and benefits of bankruptcy and state law rights.<sup>75</sup> The firm benefits from this agreement, because if collectivization enhances creditors' recoveries upon the firm's insol-

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<sup>72</sup> See Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 866 (1982).

<sup>73</sup> See Jackson, *supra* note 72, at 864-65. "Going concern value" refers to the excess of the value of the assets in reorganization over their value in liquidation. Where appropriate, distinction must be made between value that can be realized upon piecemeal liquidation through state court proceedings and the value that can be realized through a bankruptcy liquidation, which might include sale of the assets to a third party as a going concern. See JACKSON, *supra* note 24, at 14-15.

<sup>74</sup> See Jackson, *supra* note 72, at 866-67.

<sup>75</sup> The creditors' bargain model attempts to provide a normative basis for bankruptcy law by viewing it as a hypothetical consensual agreement among creditors. The model was originally proposed by Thomas H. Jackson. See Jackson, *supra* note 72. The model was substantially revised by Jackson and Robert E. Scott. 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 (1989).

veny or otherwise reduces credit costs,<sup>76</sup> the firm will be able to borrow at lower rates.<sup>77</sup>

If bankruptcy is the solution to a collective action problem, it is often assumed that the bankruptcy system must be mandatory and unwaivable for all parties.<sup>78</sup> However, a full formulation of the creditors' bargain in a world where bankruptcy is costly but available would specify that the use and provisions of bankruptcy law be waivable.

Consider the result if bankruptcy rights may be waived by the firm, but not by any creditor without the consent of the firm. If the economic explanation of bankruptcy is correct, rational, profit maximizing firms generally would not waive these rights because waivers would increase their overall cost of capital. Creditors,<sup>79</sup> aware that they have lost the benefits of an efficient collection mechanism in the event of insolvency, would increase the aggregate interest rate they charge or reduce their lending.

However, bankruptcy may be a losing proposition for some firms—meaning that it would result in administrative, managerial, and monitoring costs greater than the combination of going concern value that would be preserved, enforcement and monitoring costs that would be avoided, and other gains creditors obtain from bank-

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<sup>76</sup> Collectivizing the debt collection process may benefit creditors in three basic ways: it may reduce the total cost of debt collection from insolvent firms by allowing one collective proceeding rather than many individual ones; it may provide mechanisms (such as preference and fraudulent conveyance law) that reduce "eve-of-bankruptcy" strategic behavior, by the firm or creditors, which prejudices the interests of the creditors as a whole; and it may preserve the going concern value of the firm, if any. See Warren, *supra* note 24, at 346-52. Jackson and Scott suggest another possible benefit—a modification of the creditors' bargain that attempts to explain why creditors might agree to reallocate value in bankruptcy relative to nonbankruptcy entitlements. Jackson & Scott, *supra* note 75. They propose that risk averse creditors who are unable to fully diversify their investments may find it efficient to share certain risks that are outside the control of the parties. This modification of the creditors' bargain has been criticized. See, e.g., Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 484-87 (1992) (arguing that risk sharing can be achieved more effectively through contract negotiations outside of bankruptcy).

<sup>77</sup> See Rasmussen, *supra* note 4, at 55-68; Jackson, *supra* note 72, at 861 n.21 (noting that the allocation of savings between the firm and its creditors will depend on the "elasticities of the supply of and demand for credit").

<sup>78</sup> See Bassin, *supra* note 50, at 10-11 ("Permitting parties to contract for relief from stay prior to bankruptcy, without court approval, would allow creditors to circumvent the bankruptcy judge's role of protecting creditors as a whole from consuming the debtor's assets to their own detriment."); see also Mayer, *supra* note 9, at n.87.

<sup>79</sup> If bankruptcy actually provides net benefits to shareholders (through the impairment of creditors' rights and the violation of absolute priority) rather than creditors, then shareholders rather than creditors will adjust their required yield. That is, a waiver will reduce the price of the firm's stock. Thus, the costs of the waiver will be directly factored into the calculations of managers that seek to maximize shareholder value. The end result is the same.

ruptcy.<sup>80</sup> In these cases, creditors would expect to fare better if bankruptcy rights were waived, and would lend to a firm on better aggregate terms if the firm could assure them that they would be spared the costs of bankruptcy. Firms would waive their bankruptcy rights only if the costs imposed by exercise of those rights are expected to exceed the benefits generated by them.<sup>81</sup> Thus, waivers may be a means of sorting, in advance, whether a firm's creditors are likely to benefit from the mechanisms offered by bankruptcy law.<sup>82</sup> Of course, this depends on firms and creditors being able to predict whether bankruptcy is likely to be beneficial or detrimental, but there is reason to believe this is possible.<sup>83</sup>

Moreover, as the variety of devices used in current practice demonstrates, waiver is not an all or nothing proposition. A firm may agree to waive specific bankruptcy rights that are expected to impose costs greater than the benefits they offer.<sup>84</sup> A firm and its creditors could determine whether various components of the bankruptcy system are efficient, given the nature of the firm's assets, business, and management.<sup>85</sup> Thus, a firm might choose to waive its right to reorganize while maintaining its right to use bankruptcy law to effect a

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<sup>80</sup> See James W. Bowers, *Rehabilitation, Redistribution or Dissipation: The Evidence For Choosing Among Bankruptcy Hypotheses*, 72 WASH. U. L.Q. 955, 967 n.55 (1994) (noting the possibility that the bankruptcy system has reduced the amount of available secured credit).

<sup>81</sup> In fact, there is reason to believe that some firms would even eschew efficient bankruptcy waivers. See *infra* Part IV.B.

<sup>82</sup> Jackson and Scott suggest that one reason for bankruptcy reorganization is to preserve the idiosyncratic value that some owners attach to a firm, in excess of its market value. In exchange for the right to preserve an interest in the firm in the event of insolvency, such owners will pay a premium to creditors. In suggesting that bankruptcy serves as such mandatory insurance, they note that it is impossible for bankruptcy to distinguish between equity holders with such idiosyncratic preferences, and equity holders who merely claim such preferences for strategic reasons. Jackson & Scott, *supra* note 75, at 175. Enforceable bankruptcy waivers would provide a solution to this sorting problem by allowing equity holders without such preferences to waive their right to reorganization. Something approximating this type of waiver may be accomplished by partnerships and closely held firms, indirectly, by pledging the ownership interests to a creditor. However, this does not eliminate the costs of the bankruptcy case; it just transfers the role of equity to one creditor out of many.

<sup>83</sup> See *infra* Part III.B.

<sup>84</sup> Cf. Baird, *supra* note 4, at 144:

If they could have bargained together before investing in the firm, each investor would have been willing to pay for additional procedures to protect its interests only until the cost of the uncertainty eliminated by additional procedure was less than the cost of the procedures designed to eliminate it. Procedures can be too extensive or too limited.

<sup>85</sup> For example, Mark Roe suggests that bankruptcy sharing may be undesirable if one purpose of secured financing is to provide a signal of confidence in the venture to the secured creditor. Mark J. Roe, *Commentary on "On The Nature Of Bankruptcy": Bankruptcy, Priority, and Economics*, 75 VA. L. REV. 219, 222 (1989). For an interesting view on why the bankruptcy laws might incorporate inefficient provisions, see F. H. Buckley, *The American Stay*, 3 S. CAL. INTERDISCIPLINARY L. J. 733, 761-778 (1994) (evaluating interest-group and sociological theories for why the United States adopted the automatic stay, concluding that

liquidation more efficiently than under state law.<sup>86</sup> Or, if it is efficient to insulate a particular secured creditor from the costs of bankruptcy,<sup>87</sup> the firm might waive the automatic stay as to that secured creditor and its collateral.<sup>88</sup> Waiver of the automatic stay may have advantages for the creditors as a whole, compared with a waiver of bankruptcy eligibility. Such a waiver does not negate the preference or fraudulent conveyance provisions of the Bankruptcy Code, which protect creditors from strategic behavior by firms on the verge of bankruptcy.<sup>89</sup> It does not prohibit reorganization if reorganization is feasible without the secured creditor's collateral.<sup>90</sup> Even if the collateral is necessary for a reorganization, waiver does not preclude reorganization because the creditor may agree not to foreclose in exchange for a share of the excess value created by reorganization.<sup>91</sup>

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the most plausible explanation was the desire of the federal judiciary to enhance its prestige by luring railroad receivership cases from state to federal court).

<sup>86</sup> 11 U.S.C. § 706(a) (1994) specifically states that a waiver of the right to convert a liquidation case to a reorganization case is unenforceable. See *supra* notes 11, 13.

<sup>87</sup> George Triantis has suggested that purchase-money security interests might, in some cases, be explained by the presumption that the goods are worth more to the purchaser than to the seller at the time of sale, but upon default may be worth more to the seller because the seller's specialized knowledge of resale markets allows the seller to redeploy the assets to their best use. See George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992); see also James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097, 2140-41 (1990) (security interest may be given to creditor where creditor is most efficient liquidator of the asset, and asset may be left unencumbered where firm is better liquidator). Combined with the costs experienced by sellers forced to participate in bankruptcy in order to repossess, this explains why some firms and creditors would negotiate stay waivers.

<sup>88</sup> The argument that automatic stay waivers are unenforceable "ipso facto" clauses was properly rejected in *In re Powers*, 170 B.R. 480, 482-83 (Bankr. D. Mass. 1994). Under 11 U.S.C. § 365(e) (1994), a "right or obligation under [an executory contract] or [unexpired lease] may not be terminated or modified . . . solely because of a provision" regarding insolvency or bankruptcy. However, this does not cover a waiver, which provides that the contract's ordinary terms be enforced despite bankruptcy.

<sup>89</sup> See *In re Club Tower L.P.*, 138 B.R. 307, 311-312 (Bankr. N.D. Ga. 1991).

<sup>90</sup> Liquidation and reorganization are points on a spectrum, rather than absolutes, because even reorganizing corporations typically sell off some assets. See Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 604-606 (1993). If certain assets could be identified in advance as candidates for sale upon insolvency, stay waivers might be justified for such assets.

<sup>91</sup> See *infra* text accompanying notes 149-50. Such transactions within bankruptcy may correct inaccurate ex ante estimates of the costs and benefits of bankruptcy, although bilateral monopoly problems might also prevent some efficient postpetition negotiations from succeeding. Douglas Baird and Randal Picker used game theory to model negotiations between management of a closely-held firm and a secured creditor with a lien on all of the firm's assets, suggesting that exempting this primary creditor from the automatic stay (while continuing to stay actions by other creditors) might enhance bargaining between the parties. See Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311 (1991).

In essence, waivable bankruptcy rights would give firms a choice of insolvency regimes.<sup>92</sup> Firms could determine whether their costs of capital would be lower if their creditors have access to collective reorganization proceedings, collective liquidation proceedings, or are relegated to their individual state-law entitlements.<sup>93</sup> This waiver scenario is distinct from the situation posed in the original creditors' bargain hypothetical, where creditors find themselves unable to negotiate to a bankruptcy system in a world without one. The bankruptcy system exists and is readily available.<sup>94</sup> Once such a system exists, the firm can act as a broker which, to lower its own costs, will consider whether or not the creditors' collective interests are served by such a system.<sup>95</sup> If bankruptcy rights cannot be waived, then we have replaced one hold-out problem—collective proceedings in a world without bankruptcy law depend on unanimous consent—with another: even if bankruptcy imposes greater costs than benefits, it cannot be waived without the unanimous consent of creditors and the firm. A single creditor<sup>96</sup> that sees an advantage for itself in invoking bankruptcy can take the rest along for the ride.<sup>97</sup>

This economic analysis indicates that waivers may be beneficial if the primary purpose of bankruptcy law is to maximize the recovery of creditors when a firm becomes insolvent, thereby minimizing the firm's cost of capital.<sup>98</sup> Critics generally do not dispute that enhancing creditor recoveries is a primary purpose of many provisions of the bankruptcy law.<sup>99</sup> However, they take exception to enthroning credi-

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<sup>92</sup> Of course, the choice need not be infinite. Transaction costs may argue for allowing only a restricted number of types of waivers. See Jackson & Scott, *supra* note 75, at 202-03; Rasmussen, *supra* note 4, at 100 n.210. It seems likely that only a limited number of standard waivers would be used widely, including waivers of bankruptcy eligibility, waivers of reorganization rights, and waivers of the automatic stay.

<sup>93</sup> See Bowers, *supra* note 80.

<sup>94</sup> It might seem that the firm, as the hub of contractual relationships with its creditors, could as easily create bankruptcy law as opt out, thus invalidating a basic premise of the creditors' bargain model—the need for a noncontractual bankruptcy system to overcome transaction costs that prevent its contractual establishment. However, in addition to the holdout problem, the complexity of the bankruptcy law probably renders it impossible of creation through direct negotiation, and bankruptcy relies on the existence of a public infrastructure (bankruptcy courts, the United States Trustees, and so forth) that would likely bar the private creation of bankruptcy law.

<sup>95</sup> Bowers, *supra* note 80, at 2140-42.

<sup>96</sup> This may be a slight overstatement, because it takes three creditors with unsecured claims totalling \$5,000 to file an involuntary petition against a firm with more than 12 creditors. See 11 U.S.C. § 303(b) (1994). The basic point stands, however.

<sup>97</sup> Professor Warren suggests that one of the advantages of our bankruptcy system is that by relying on private parties to institute the proceedings, we avoid imposing bankruptcy costs on those who see no benefit in its use. Warren, *supra* note 24, at 369. This overlooks the holdout problem.

<sup>98</sup> See Jackson, *supra* note 72, at 861, 869-70; Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 18-19.

<sup>99</sup> See, e.g., Warren, *supra* note 24, at 344.

tor wealth-maximization as the sole goal, arguing that other policies should, and do, play a legitimate role in bankruptcy law, and that an agreement among creditors that ignores the interests of employees, customers, and the community at large cannot provide an adequate normative basis for bankruptcy.<sup>100</sup> For reasons addressed below,<sup>101</sup> I do not believe that this dispute must be resolved to establish overall standards for the treatment of waivers under the current law. Thus, I will continue to examine the implications of waivers in the context of maximizing value for the firm and its creditors. Part III.C will examine the extent to which other policies embodied in the Bankruptcy Code modify these implications.

### B. Administrative Costs and the Efficiency of Bankruptcy

The simple model presented in the preceding section suggests that waivers may be a rational and beneficial response to a bankruptcy system whose costs sometimes outweigh its benefits. As a first check of this idea, it is worth asking whether the costs imposed by bankruptcy are large enough to provoke such a response. This is an empirical question for which final answers are not available, but the existing data offer some guidance.<sup>102</sup>

Bankruptcy reorganization costs may indeed be high enough to render it inefficient to reorganize many firms with going concern value, particularly smaller firms.<sup>103</sup> Estimates of the direct (legal and administrative) costs of reorganization for large firms are comparatively modest, although not insignificant.<sup>104</sup> In smaller cases, however,

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<sup>100</sup> See *id.* at 352-60.

<sup>101</sup> See *infra* Part III.C.

<sup>102</sup> The empirical data discussed in the text cannot prove, with certainty, whether or when bankruptcy is efficient, either for the parties to the case or for the public interest. Nor is the economic reasoning presented here free from challenge. However, courts are currently faced with the dilemma of enforcing or declining to enforce waivers; they cannot wait for final proof but must act daily on the basis of the best available information. This Article suggests that, on the basis of the available evidence, there are strong reasons to suppose that many waivers should be enforced in order to better carry out the purposes of bankruptcy. At the very least, those who support the status quo should be compelled to present affirmative arguments for the existing hostility to waivers, rather than rely on unreasoned and generally inapposite precedent.

<sup>103</sup> See JACKSON, *supra* note 24, at 215-24; Baird, *supra* note 4 (suggesting that the costs of corporate reorganization may outweigh its benefits).

<sup>104</sup> See Adler, *supra* note 76, at 465 n.107 (citing estimates of the direct costs of reorganization that range from 3% to 25% of the firm's value); Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1078 (1984) (finding direct costs of 6.2% of asset value); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 289 (1990) (study of public companies reporting that the "direct costs of bankruptcy are 20.6% of the market value of equity, . . . 3.1% of book value of debt plus the market value of equity, . . . and 2.8% of the book value of total assets. . .").

costs may be quite substantial.<sup>105</sup> A recent, albeit limited, study of small business bankruptcies found that over twenty percent of the distributions in Chapter 11 cases were paid to professionals, and that other direct costs amounted to almost six percent of distributions.<sup>106</sup>

Although empirical data is indispensable, it runs the risk of discounting what cannot be measured. Estimates generally ignore the indirect costs of bankruptcy reorganization even though they may often exceed the direct costs.<sup>107</sup> A primary indirect cost is the loss of value caused by management distraction during the bankruptcy case.<sup>108</sup> Further losses may be caused by employees and suppliers who react to the bankruptcy proceeding by reducing their investment in activities that will have value only if the firm continues to exist.<sup>109</sup> Customers may turn from the firm out of warranty concerns or to develop more reliable suppliers in case the firm fails.<sup>110</sup> These indirect costs of bankruptcy are extremely difficult to measure but are likely significant. For example, one of the few studies to attempt to quantify indirect costs estimated them at 10.5% or more of the firms' prebankruptcy value, compared with direct costs of 6.2%.<sup>111</sup>

Another cost that is generally absent from the quantitative studies is the time value of money. If it takes two years of bankruptcy to realize a gain for creditors, then the value of the bankruptcy distributions must be discounted for the delay.<sup>112</sup> Under the Bankruptcy Code,

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<sup>105</sup> See Robert M. Lawless et al., *A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies*, 1994 U. ILL. L. REV. 847, 870.

<sup>106</sup> See *id.* at 851. This study excluded, for both theoretical and practical reasons, distributions to secured creditors. Thus, bankruptcy costs are measured against distributions to unsecured creditors, for whose benefit bankruptcy supposedly is designed. See *id.* at 860-62. The study used data on 30 Chapter 7 cases and 27 Chapter 11 cases, eliminating from the original universe of 75 cases 18 no-asset Chapter 7 cases. From the remaining 57 cases, the authors eliminated nine Chapter 7 cases and five Chapter 11 cases in which total secured debt exceeded total assets. These are the cases that probably have the least justification for being in bankruptcy, and if these cases had been included in the database (as they must be in firms' and creditors' expectations about bankruptcy), they presumably would have increased the estimates of bankruptcy cost relative to its benefits.

<sup>107</sup> See, e.g., Michelle J. White, *Bankruptcy Costs and the New Bankruptcy Code*, 38 J. FIN. 477, 486 (1983) ("[I]t is impossible to infer from data on bankruptcy transactions costs [direct costs] alone whether total bankruptcy costs are high or low, since the former are only a very small part of the latter.")

<sup>108</sup> See Adler, *supra* note 76, at 465; Weiss, *supra* note 104, at 289.

<sup>109</sup> See Adler, *supra* note 76, at 465-67; Weiss, *supra* note 104, at 289.

<sup>110</sup> See Weiss, *supra* note 104, at 288.

<sup>111</sup> See Altman, *supra* note 104, at 1078.

<sup>112</sup> See Lynn M. LoPucki, *The Trouble With Chapter 11*, 1993 WIS. L. REV. 729, 740-44 (LoPucki cites several studies on the duration of bankruptcy cases and concludes that the duration of bankruptcy cases has significantly increased under the 1978 Code. The median time for confirmation of a Chapter 11 plan was found by one recent study to be 17.5 months, and by another to be 21.6 months. Earlier studies had shown times ranging from 9.5 months and 12 months. For large public companies, figures ranged from 16 months to 32 months.)

however, unsecured and undersecured creditors are denied interest on their claims, thus formalizing a substantial distortion in measuring bankruptcy costs.

Bankruptcy reorganization also imposes direct costs on creditors which are not included in these estimates. For example, a secured creditor may incur substantial expenses in managerial attention and legal fees, protecting its lien rights, securing "adequate protection," monitoring the debtor, contesting the valuation of collateral and the appropriate interest rate in any proposed "cramdown" plan, participating in plan negotiations, and even proposing its own plan. Even an unsecured creditor that chooses to remain relatively inactive in the bankruptcy case may incur costs in filing a proof of claim, seeking legal advice on the effects of bankruptcy, and attempting to evaluate a plan and disclosure statement.

As has often been noted, these costs may induce inefficient rent-seeking behavior because they are not borne equally by all involved in the bankruptcy process.<sup>113</sup> Assuming that the firm is insolvent, equity holders lose nothing when the firm incurs these costs by filing for bankruptcy.<sup>114</sup> The costs of the bankruptcy process are borne by creditors either directly or through reduced recoveries from the bankruptcy estate. Many of these costs are at least partly within the control of the firm's management, which may expedite or delay the case, giving management bargaining leverage with which to extract value for equity holders from creditors.<sup>115</sup> Other provisions of bankruptcy law

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<sup>113</sup> See *infra* notes 115-17.

<sup>114</sup> This does not mean that the costs are not borne by equity holders overall. These indirect costs will result in higher interest rates demanded by creditors in anticipation of losses imposed by bankruptcy rules. However, equity holders do not bear the marginal cost of deciding to file a case, and thus they do not weigh those costs against their potential gains from filing.

<sup>115</sup> Indirect evidence of this is provided by Allan C. Eberhart et al., *Security Pricing And Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457 (1990), which found that the bankruptcy proceedings are shorter where shareholders receive greater deviations from their absolute priority entitlements—in other words, creditors apparently can shorten the stay in bankruptcy by purchasing peace with equity holders. Studies of Chapter 11 reorganizations consistently show meaningful deviations from absolute priority. See, e.g., Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms In Reorganization*, 44 J. FIN. 747 (1989) (finding that 21 of 27 firms showed deviations from absolute priority, averaging 7.6% of firm assets, and noting that payments to shareholders can be viewed as the purchase by creditors of the shareholders' option to delay reorganization); Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 176 (1990); Weiss, *supra* note 104 (indicating that 29 of 37 firms showed deviations from absolute priority). Where principals are obligated for firm debt, reallocation may also occur outside of the bankruptcy case, through a release by the creditor of a guaranty or other liability owed by a principal of the debtor. Thus, estimates of the reallocation based solely on assets within the bankruptcy case may miss part of the benefit realized by equity holders.



may also redistribute value away from creditors to equity holders, even when creditors are not paid in full.<sup>116</sup>

To the extent that equity holders, through management, can affect the costs of the proceeding or otherwise reallocate value away from senior claimants relative to their nonbankruptcy rights, they have a reason to file for reorganization however unlikely reorganization may be.<sup>117</sup> An examination of the results of Chapter 11 filings lends credence to the suggestion that unwarranted reorganization cases are often filed. Only about seventeen percent of filed Chapter 11 cases result in confirmed plans, and many of these confirmed plans are not successfully consummated.<sup>118</sup> While not conclusive proof, these numbers suggest that many reorganization efforts are not justified and would be better handled under Chapter 7 liquidation or state law.<sup>119</sup>

Not only is there reason to question the value of many bankruptcy reorganization cases, but there is reason to question the efficiency of bankruptcy liquidation relative to winding-up insolvent firms under state law.<sup>120</sup> Studies indicate that unsecured creditors receive

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<sup>116</sup> For a discussion of the numerous methods by which bankruptcy debtors may coerce a redistribution from creditors to equity holders, see Adler, *supra* note 76, at 447-55; Baird & Picker, *supra* note 91, *passim*; Lucian A. Bebchuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J. L. ECON. & ORG. 253 (1992).

<sup>117</sup> The possibility of reallocation is an incentive to file for bankruptcy in both efficient and inefficient circumstances. See Randal C. Picker, *Voluntary Petitions and the Creditors' Bargain*, 61 U. CIN. L. REV. 519, 536 (1992) (finding that violation of absolute priority is an inducement for debtor to file bankruptcy where bankruptcy is efficient, and it thus mitigates the agency problem caused by the divergence of shareholder and creditor interests).

<sup>118</sup> For example, one of the few studies compiling data on plan confirmation reported that of 260 Chapter 11 cases filed in Poughkeepsie, N.Y. from 1980 to 1989, 45 resulted in confirmed plans. Nine of these plans provided for liquidation of the debtor. Of the remaining 36 plans calling for continuation of the debtor as an operating company, only 17 are believed to have been consummated. Thus, only 6.5% of Chapter 11 cases resulted in an ongoing reorganized firm, and only 38% of the cases in which plans were actually confirmed did so. See Susan Jensen-Conklin, *Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law*, 97 COM. L.J. 297, 316-30 (1992). Jensen-Conklin indicates that these results are in line with those of a larger national study. See *id.* at 317. It should be noted that larger firms are much more likely to confirm reorganization plans. Thus, LoPucki and Whitford show that for the 43 largest cases filed between 1979 and 1988, roughly 90% confirmed plans. See LoPucki & Whitford, *supra* note 115, at 137-41.

<sup>119</sup> Warren properly cautions against drawing too strong an inference from these numbers which necessarily do not capture many of the potential benefits of "failed" Chapter 11 proceedings, such as the possibility that the bankruptcy allowed preferences or fraudulent conveyances to be avoided or resulted in an efficient Chapter 7 liquidation rather than an inefficient state-law liquidation. See Warren, *supra* note 24, at 373-77. It should also be noted that these numbers miss many of the costs of bankruptcy. The point here is not that the bankruptcy system as a whole is inefficient, but rather that the system would likely benefit if poorer bankruptcy prospects were screened out.

<sup>120</sup> Of course, bankruptcy and state-law piecemeal dismemberment are not the only two alternatives. Private contractual arrangements can also be used to deal with insolvency. Until 1992, Canada permitted secured creditors to enforce contractual provisions permit-

payments in less than three percent of Chapter 7 cases (including both individual and business cases).<sup>121</sup> One study found that more than sixty percent of the unmortgaged assets in business Chapter 7 cases went to bankruptcy professionals, and another ten percent to the direct costs of the bankruptcy proceeding, leaving only thirty percent for unsecured creditors.<sup>122</sup> Not surprisingly, it has been suggested that failing firms may dispose of their own assets more effectively than bankruptcy law.<sup>123</sup>

That bankruptcy is of little value to unsecured creditors has gained additional support from a different sort of data. A recent study of stock market data found that when a firm files for bankruptcy, there is a statistically significant negative effect on the value of the stock of its unsecured creditors (but not its secured creditors), supporting the hypothesis that bankruptcy dissipates value otherwise available for unsecured creditors.<sup>124</sup> Moreover, the data show that bankruptcy imposes a net loss on the shareholders of public corporations despite the regular violation of absolute priority, providing another indication that bankruptcy's costs may indeed exceed its benefits in many cases.<sup>125</sup>

That the costs exceed the benefits in many or even most bankruptcy cases does not necessarily mean that bankruptcy is inefficient or should be abolished.<sup>126</sup> For example, the availability of bankruptcy

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ting them to appoint a receiver to take control of a firm's assets upon default, thus eliminating the concern that management will undertake risky, suboptimal strategies after default in an attempt to restore solvency and preserve their jobs. Moreover, this remedy was quick, eliminating many of the direct costs of a bankruptcy proceeding. See Buckley, *supra* note 85, at 738-40, 750-52.

<sup>121</sup> See Lynn LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1932 n.172 (1994).

<sup>122</sup> See Lawless et al., *supra* note 105. James Ang examined a cross-section of business liquidation cases under the pre-1978 Bankruptcy Act, finding that administrative expenses averaged 7.5% of liquidation value of the assets. See James S. Ang et al., *The Administrative Costs of Corporate Bankruptcy: A Note*, 37 J. FIN. 219, 223-24 (1982). The discrepancy between these studies may be due to the fact that Lawless counted only distributions to unsecured creditors, ignoring mortgaged assets, while Ang counted all of the debtors' assets.

<sup>123</sup> See James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27, 51-57 (1991).

<sup>124</sup> See Bowers, *supra* note 80, at 967-68.

<sup>125</sup> See *id.* at 957 n.11. Deviations from absolute priority are larger for small, private companies than for public companies. See LoPucki & Whitford, *supra* note 115, at 149. However, the costs of bankruptcy may also be larger as a share of the firm's assets. See text accompanying notes 103-06. On balance, it is difficult to know whether shareholders benefit from bankruptcy in smaller cases.

<sup>126</sup> For a heated debate on the efficiency of the bankruptcy system and the conclusions that can, or cannot, be drawn from the empirical data, see Bowers, *supra* note 80 (citing empirical evidence that bankruptcy results in a net dissipation of the debtor's value); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992) (an empirical study concluding that shareholders fare worse under the Bankruptcy Code than under prior law); Jagdeep S. Bhandari & Lawrence A. Weiss, *The Untenable Case For Chapter 11: A Review of the Evidence*, 67 AM. BANKR. L.J. 131 (1993) (criticizing the

may lead to efficient restructurings in many cases that do not get to court and so do not appear in the data.<sup>127</sup> However, this observation does not negate the value of a mechanism that would permit poor candidates for reorganization to avoid the costs of a failed reorganization, or allow the liquidation of firms under state law where Chapter 7 provides no net advantage. If, as the prior section suggests, bankruptcy waivers can serve as this mechanism, then they may fulfill an important function in rendering the bankruptcy system more efficient.

### III

#### WAIVERS AND BANKRUPTCY SORTING

##### A. The Bankruptcy Sorting Process

Although bankruptcy waivers provide a mechanism by which creditors and firms may attempt to sort, in advance, promising bankruptcy candidates from less promising ones,<sup>128</sup> or valuable bankruptcy rights from costly ones,<sup>129</sup> the Bankruptcy Code itself provides mechanisms for accomplishing this.<sup>130</sup> For example, when a creditor moves to dismiss a Chapter 11 case or to convert it to liquidation under Chapter 7, the court is directed to convert or dismiss the case, "whichever is in the best interest of the creditors and the estate, for cause, including" various factors.<sup>131</sup> These factors primarily address the risk that no plan will be confirmed and consummated, or that creditors will suffer unduly from the delay, expense, or business losses caused by the reorganization effort.<sup>132</sup> Thus, the court is asked to determine

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Bradley and Rosenzweig study); Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganizations: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669 (1993) (same); Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992) (same); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992) (same); Bowers, *supra* note 4 (replying to Warren and LoPucki).

<sup>127</sup> See Warren, *supra* note 24, at 373-77.

<sup>128</sup> See *supra* text accompanying notes 79-83.

<sup>129</sup> See *supra* text accompanying notes 84-91.

<sup>130</sup> See Michelle J. White, *Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganizations and Out-Of-Court Debt Restructurings*, 10 J.L. ECON. & ORG. 268 (1994) (suggesting that asymmetric information may result in errors in separating efficient bankruptcy candidates from inefficient ones). White notes the possibility that out-of-court restructurings may in fact cause effective filtering techniques in bankruptcy (if such things exist) to become ineffective. However, White's model assumes that the goal of the firm's managers is to avoid liquidation regardless of the interests of its creditors. Under this premise, a firm would not agree to a bankruptcy waiver unless that waiver either (1) sufficiently delayed the time until liquidation for the managers to make up the loss they suffer from the greater likelihood of liquidation, or (2) decreased the likelihood of insolvency through lower capital costs. Thus, inefficient waivers would be rare under the premises of White's model.

<sup>131</sup> 11 U.S.C. § 1112(b) (1994).

<sup>132</sup> See *id.* The listed factors are:

the likelihood that the parties are truly benefitting from the bankruptcy process.

The sorting process is also inherent in secured creditors' motions for relief from the automatic stay. The Bankruptcy Code provides for relief from stay either "for cause,"<sup>133</sup> or based on a specific finding that the firm has no equity in the collateral and the collateral is not necessary for an effective reorganization.<sup>134</sup> The first standard clearly encompasses the potential costs and benefits of the proceeding. The second standard requires the court to determine whether reorganization is a reasonable prospect and, because administrative expenses must be paid as part of any confirmed plan, it presumably requires the court to consider whether reorganization is feasible given the likely direct costs of the bankruptcy proceeding.<sup>135</sup> Thus, a lift stay hearing can be an early opportunity to argue that there is no prospect of reorganization.<sup>136</sup>

The plan confirmation process is also designed to sort firms according to whether or not the bankruptcy proceeding will enhance creditor recoveries. A reorganization plan cannot be confirmed if any objecting creditor does not receive at least as much as it would under

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(1) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation; (2) inability to effectuate a plan; (3) unreasonable delay by the debtor that is prejudicial to creditors; (4) failure to propose a plan under section 1121 of this title within any time fixed by the court; (5) denial of confirmation of every proposed plan and denial of a request made for additional time for filing another plan or a modification of a plan; (6) revocation of an order of confirmation under section 1144 of this title, and denial of confirmation of another plan or a modified plan under section 1129 of this title; (7) inability to effectuate substantial consummation of a confirmed plan; (8) material default by the debtor with respect to a confirmed plan; (9) termination of a plan by reason of the occurrence of a condition specified in the plan; or (10) nonpayment of any fees or charges required under chapter 123 of title 28.

These factors are examples, not an exclusive list. See 11 U.S.C. § 102(3) (1994) (the words "includes" and "including" are not limiting").

<sup>133</sup> 11 U.S.C. § 362(d) (1994).

<sup>134</sup> See 11 U.S.C. § 362(d) (2) (1994).

<sup>135</sup> Administrative expenses, which include the costs of bankruptcy professionals and the costs of operating the business during the bankruptcy case, are given priority over unsecured claims. Thus, where administrative expenses are too great to be paid as part of a successful reorganization, the costs are incurred and yet the firm is still not reorganized. Moreover, many bankruptcy costs are not considered "administrative expenses" and thus never show up within the reorganization proceeding at all. These include the cost of managerial time expended by creditors, the fees of bankruptcy professionals employed by creditors (only oversecured creditors may collect such fees as part of their claims), and the foregone interest on creditors' claims. These costs are typically not considered in bankruptcy court adjudications.

<sup>136</sup> This is a deliberately biased hearing, however, because bankruptcy courts grant a substantial benefit of the doubt to the debtor in any lift stay motion brought early in the case. See *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 376, (1988) (noting that "bankruptcy courts demand less detailed showings during the four months in which the debtor is given the exclusive right to put together a plan").

Chapter 7, which in essence requires that a plan not be confirmed unless it generates more value than liquidation.<sup>137</sup> The requirement that the plan yield more than liquidation is further supported by a requirement that the judge determine whether or not the plan is "likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor."<sup>138</sup>

The general refusal to enforce bankruptcy waivers thus presumably reflects a determination either (1) that the bankruptcy process is better than *ex ante* negotiations at distinguishing good bankruptcy candidates from poor ones (i.e., the earlier assessments of private parties are not as accurate as the later assessments of bankruptcy judges), or (2) that firms and their creditors will not make appropriate judgments of the social costs and benefits associated with a waiver (private assessments will not incorporate the full range of legitimate bankruptcy concerns). Both of these concerns must be addressed in considering the role of contractual waivers in the bankruptcy process.

#### B. Accuracy of Contractual v. Judicial Assessments

The refusal to enforce bankruptcy waivers may reflect a belief that private parties lack the information or ability to determine, at the time of the waiver, whether a subsequent bankruptcy proceeding would be worth the cost.<sup>139</sup> However, it seems likely that at least some firms and their creditors can determine with reasonable accuracy whether reorganization or liquidation is likely to be preferable should the firm become insolvent.<sup>140</sup> For many types of firms, the probable

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<sup>137</sup> See 11 U.S.C. § 1129(a)(7) (1994) (providing that any dissenting impaired creditor must receive at least as much as it would in a Chapter 7 liquidation proceeding).

<sup>138</sup> 11 U.S.C. § 1129(a)(11) (1994).

<sup>139</sup> Whether or not waivers would sort firms might depend on whether permitting waivers would result in a pooling or separating equilibrium. If neither borrowers nor lenders can determine in advance whether a firm is likely to be a good or bad bankruptcy candidate, then the result may be a pooling equilibrium in which either all firms or none would waive their bankruptcy rights. It could be expected that all firms would waive their bankruptcy rights if (1) a waiver is on average the profit maximizing choice for borrowers and lenders, and lenders cannot determine which, if any, firms can profitably retain bankruptcy rights, or (2) waivers are profit maximizing for lenders but not for borrowers, and lenders can compel borrowers to accede to waivers due to a lack of borrower understanding or bargaining leverage. See *infra* Part IV.C. The evidence from Canada, where until 1992 firms could contract to permit their creditors to appoint a receiver upon default, is that the result might be a pooling equilibrium in which most or all firms waive their bankruptcy rights. See Buckley, *supra* note 85, at 754. Given that even major corporations agreed to receivership provisions, it is difficult to construe this as evidence that lenders were taking advantage of unsophisticated borrowers. Hence, it appears likely that waivers represent an efficient choice for many firms.

<sup>140</sup> Very little has been written on the attributes of firms that reorganize successfully as opposed to those whose reorganization efforts fail—a remarkable gap in the literature. Professor LoPucki offered some preliminary information in 1983, Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKER L.J. 99 (1983), and additional indications are provided in White, *supra* note 107, at 483. At

differential between these scenarios may be predictable. For example, single-asset real estate enterprises<sup>141</sup> typically are worth almost as much in liquidation as in reorganization.<sup>142</sup> Firms that depend on the unique knowledge or talents of owner/managers, customer goodwill, or other intangibles that are not readily transferable, are likely to have greater differentials.<sup>143</sup> Thus, it is not surprising that a study would find that manufacturing firms have a fifty-seven percent success rate in Chapter 11 (eighty-six percent for large manufacturers), compared with twelve percent for other types of debtors.<sup>144</sup> And as experience under the Bankruptcy Code (adopted in 1978) accumulates, firms and their creditors should become better at gauging its costs and benefits.<sup>145</sup>

Further, firms and their creditors may be better than bankruptcy judges at predicting the likely costs and benefits of bankruptcy.<sup>146</sup> A

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least one empirical study has examined the attributes of public firms that are able to successfully reorganize without resort to bankruptcy. The study concluded that various identifiable features (fewer creditors and less complex financial structures, more debt to banks, and more intangible assets) were statistically significant indicators of the ability to restructure successfully without a bankruptcy filing. See Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315 (1990). Moreover, the Gilson study indicates that stock market participants are able to anticipate which firms will and will not be able to restructure privately. See *id.* at 342-45. However, the model had quite limited explanatory power. Other studies confirm that the market is able to make meaningful predictions about the likely outcomes of bankruptcy filings. See Bowers, *supra* note 80. On the cost side, Altman, *supra* note 104, at 1077, reports that total direct and indirect costs of bankruptcy were 12.2% of firm value for a sample of large retailers, but 23.7% for large industrial companies, indicating parties might anticipate significant differences based on observable firm characteristics.

<sup>141</sup> "Single asset real estate" is not intended to have the limited meaning provided in section 101(51B) of the Bankruptcy Code which, among other things, limits the definition to entities with noncontingent, liquidated secured debt of \$4 million or less. As a conceptual matter, larger entities are equally within the category.

<sup>142</sup> See Brian S. Katz, *Single-Asset Real Estate Cases and the Good Faith Requirement: Why Reluctance To Ask Whether A Case Belongs In Bankruptcy May Lead To The Incorrect Result*, 9 BANKR. DEV. J. 77, 85 (1992).

<sup>143</sup> Gilson et al. theorize that Chapter 11 will be more expensive, relative to private restructurings, for firms whose assets are intangible or firm-specific, because this type of value is more likely to be lost in Chapter 11. This variable was statistically significant as an indicator of the likelihood of restructuring outside of bankruptcy, adding credence to hypothesis. See Gilson et al., *supra* note 140, at 334-36.

<sup>144</sup> LoPucki, *supra* note 140, at 100, 108-14. Given the sample studied (48 cases filed in one district in one year), these results are not necessarily representative of all Chapter 11 filings.

<sup>145</sup> Indeed, as discussed in Part I, *supra*, it appears that this increased understanding of the costs and benefits of the Bankruptcy Code has spawned the current interest in bankruptcy waivers. Further, if waivers were routinely enforced, the ability to determine when a waiver is or is not efficient would become a source of competitive advantage for lenders, leading them to hone their abilities to determine optimal remedies for different types of firms.

<sup>146</sup> For a contrary view, arguing against the enforcement of waivers of the automatic stay because of the value of having an "unbiased and unprejudiced overseer of the debtor's creditors and assets" (the bankruptcy judge), see Bassin, *supra* note 50, at 10.

decision on expected costs and benefits made by market participants would reflect all readily available information.<sup>147</sup> In contrast, there are various inherent limitations in deciding a motion to lift stay, dismissing the proceeding, or confirming a plan. First, the bankruptcy judge must reach a decision by sorting between competing biased projections by the parties' respective witnesses. Second, the judge is likely to discount many indirect costs of bankruptcy. Some, such as lost market opportunities caused by bankruptcy delay, inefficiencies caused by the rent-seeking behavior of bankruptcy participants, or perceptions about the future direction of relevant markets, are difficult or impossible to show through admissible evidence. These factors may involve problems of hearsay or speculation and may be inadmissible under the rules of evidence. Other significant factors are deemed legally irrelevant even though they are economically significant, such as the costs incurred by creditors in dealing with the bankruptcy case.<sup>148</sup> Finally, the market permits people trained and experienced in business matters, rather than law, to make these judgments, and permits a borrower to seek another decisionmaker (that is, apply to other lenders) if it believes a particular lender is unreasonable or uses poor judgment.

Moreover, errors in anticipating the prospective value of a future bankruptcy case may be corrected through postdefault negotiations. In *Los Angeles Lumber*, for example, the waiver was contained in a bond indenture which provided for amendment with the consent of holders of seventy-five percent of face value of the debtor's outstanding bonds.<sup>149</sup> Believing that the bankruptcy would preserve significant going concern value, holders of over ninety-two percent of the outstanding bonds consented to the reorganization.<sup>150</sup> Thus, the court could have held the waiver enforceable, or abstained on that question, and still held the bankruptcy petition effective on the grounds that the waiver had been terminated by the consent of the bondholders. *Los Angeles Lumber* provides a perfect example of how voluntary adjustments can correct an inefficient waiver of bankruptcy rights.

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<sup>147</sup> See Baird, *supra* note 4, at 136-37.

<sup>148</sup> The confirmation process does not even ask the correct question. In evaluating, at the time of confirmation, whether reorganization or liquidation will yield more for creditors, the costs of the proceeding itself are sunk costs that must be paid under either alternative. Instead of asking, "Are the benefits of reorganization greater than the costs," the court asks, "Having already borne the costs of reorganization, is reorganization better than liquidation?" And, the costs borne by creditors are ignored altogether (with the possible exception of reasonable costs incurred by oversecured creditors. See 11 U.S.C. § 506(b) (1994)). Thus, the confirmation process cannot address whether the case should have been handled as a reorganization in the first place.

<sup>149</sup> 24 F. Supp. 501, 504 (S.D. Cal. 1938), *aff'd*, 100 F.2d 963 (9th Cir. 1939), *rev'd on other grounds*, 308 U.S. 106 (1939).

<sup>150</sup> See *id.* at 514.

Commentators and evidence suggest that bankruptcy judges have limited ability to forecast accurately the merits of a bankruptcy case, and that their judgment may be skewed in favor of debtors—that is, reorganization.<sup>151</sup> For example, the Bankruptcy Code provides that a plan may not be confirmed unless the judge determines that “confirmation of the plan is not likely to be followed by the . . . need for further financial reorganization.”<sup>152</sup> Nonetheless, LoPucki and Whitford report that in thirty-two percent of the Chapter 11 cases involving large public corporations where the corporation remained intact after confirmation of a plan, the corporation was forced to file for bankruptcy again.<sup>153</sup> In a study of Chapter 11 cases confirmed in one district in New York, only fifty-eight percent of debtors performed in accordance with their reorganization plans.<sup>154</sup>

Bankruptcy Court determinations have at least one important advantage over waivers, however. A waiver represents a judgment made in advance about the likely costs and benefits of a future situation. It may turn out that the firm enters bankruptcy under surprising conditions and that the original expectations do not reflect the situation at the time of the case.<sup>155</sup> As just noted, this problem is mitigated by the possibility that the creditor can be induced to relinquish the waiver in exchange for a share of the value generated by the reorganization. However, it is also possible that bilateral monopoly problems will prevent such an agreement.<sup>156</sup> For this reason, it is not enough to say

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<sup>151</sup> See JACKSON, *supra* note 24, at 220-21 n.38 (noting the comparative efficiency of markets versus judges in valuing enterprises); Mark J. Roe, *Bankruptcy and Debt: A New Model For Corporate Reorganization*, 83 COLUM. L. REV. 527, 547-48 (1983). This is not to deride either the ability or motivation of judges. However, there is some doubt whether contested judicial proceedings are a successful means of conducting financial evaluations. This is one reason corporate law relies on the business judgment rule. See, e.g., *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) (“This deference—the business judgment rule—is, of course, simply a recognition . . . of the limited institutional competence of courts to assess business decisions.”); *Auerbach v. Bennett*, 393 N.E.2d 994, 1000 (N.Y. 1979) (stating that “the business judgment doctrine, at least in part, is grounded in the prudent recognition that courts are ill equipped” to make business judgments).

<sup>152</sup> 11 U.S.C. § 1129(a)(11) (1994).

<sup>153</sup> See LoPucki & Whitford, *supra* note 90, at 608-09.

<sup>154</sup> See Jensen-Conklin, *supra* note 118, at 324.

<sup>155</sup> See Karen Gross, *Taking Community Interests Into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031, 1043-45 (1994) (arguing that use of flexible procedures such as bankruptcy, rather than strict enforcement of ex ante contractual agreements, is justified because ex ante bargains may fail to properly anticipate developments).

<sup>156</sup> A bilateral monopoly arises when parties have no choice but to negotiate with each other, and so neither party faces the constraint of competition in conducting its negotiation. Transaction costs may be high in bilateral monopoly situations, because each party will expend efforts at garnering a larger share of the potential profits from the transaction. Where these types of strategic bargaining efforts become excessive, they may keep the parties from coming to terms, even though a negotiated resolution would be profitable for both. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 61, 62 (4th ed. 1992).



that a bankruptcy waiver is automatically enforceable, regardless of the facts that develop thereafter. There should be some opportunity to address the possibility that the agreement no longer represents an accurate balancing of interests, but that strategic bargaining has prevented a contractual readjustment.<sup>157</sup>

### C. Appropriateness of Contractual Assessments

Courts have often stated that bankruptcy waivers violate public policy and are therefore not enforceable.<sup>158</sup> This argument is difficult to evaluate given the consistent failure to identify the policy at issue, but the concern presumably lies with the public's interest in the bankruptcy process.

If the goal of bankruptcy is to maximize value for creditors, the analysis in Parts II and III indicates, with certain caveats, that waivers should be given substantial weight by the courts. However, the purposes of bankruptcy may be broader than creditor concerns, embodying the interests of the wider community.<sup>159</sup> A bankruptcy waiver could reduce the opportunity to preserve various positive externalities, imposing losses that go beyond the financial stake of creditors and shareholders to include the welfare of employees, communities, and customers. When a firm minimizes its capital costs by opting out of bankruptcy protections, it may do so not because this decision is societally optimal when these noncreditor interests are counted, but because the internalized benefits of bankruptcy are less than the inter-

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<sup>157</sup> Although this concern appears to justify judicial review, the conclusion is not beyond challenge. Courts will sometimes err in their decisions regarding the enforcement of particular waivers, and there is no logical reason why the benefits of correcting inefficient waivers must exceed the direct costs of judicial review plus the costs of erroneous determinations. Nonetheless, courts do have the benefit of information not available to the parties at the time of the contract, a factor which will loom large in a presumably small number of cases presenting extraordinary and unanticipated developments.

<sup>158</sup> See *supra* notes 14-22 and accompanying text.

<sup>159</sup> See generally Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75 (1995) (discussing wealth redistribution); Gross, *supra* note 155 (addressing the importance of community interests); Hon. Barry S. Schermer, *Response to Professor Gross: Taking The Interests Of The Community Into Account in Bankruptcy—A Modern-Day Tale of Belling the Cat*, 72 WASH. U. L.Q. 1049 (1994) (asserting that the community interest argument errs in three respects: definition, application, and the role of the decisionmaker); Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541, 552-58 (1993) (arguing that the first principles of bankruptcy law are inclusion of all affected by financial distress and rationally determining how they fare); Warren, *supra* note 24 (noting that the bankruptcy system preserves value, distributes value, and allocates costs of failing businesses). Accommodating interests beyond those of the firm and its creditors does not inherently invalidate an economic, wealth-maximizing approach to bankruptcy law. See Frost, *supra* (arguing that bankruptcy courts are ill-suited to pursue redistributive goals); Rasmussen, *supra* note 98 (arguing that a Rawlsian objective of social justice leads to wealth maximization as the proper goal for bankruptcy policy).

nalized costs.<sup>160</sup> If bankruptcy encompasses interests beyond those of the creditors and the firm, a contractual waiver cannot be presumed to reflect the proper judgment of its total costs and benefits.

The debate over the proper goals of an ideal bankruptcy law need not be settled in considering the treatment of waivers under the Bankruptcy Code, which pays considerable attention to maximizing creditor recoveries without adopting the single-minded pursuit of that goal. The Code permits the bankruptcy judge to convert or dismiss the case, or lift the stay, "for cause." As noted above, the standards specified in the Code go primarily to the ability to confirm and implement a plan of reorganization and the risk of undue prejudice to creditors.<sup>161</sup> Thus, the court must focus on the likelihood and potential cost of reorganization in determining whether "cause" exists to convert, dismiss, or lift the stay.

However, the creditors' bargain has not been enacted into law. The "cause" standard is deliberately vague, permitting the court to consider whatever factors it deems appropriate within a broad range of discretion.<sup>162</sup> Although far from clear, the legislative history indicates that members of Congress were concerned with the fate of employees and communities as well as the preservation of economic value for creditors and investors.<sup>163</sup> Thus, the Code arguably permits consideration of broad social concerns in ruling on the enforceability of particular waivers.<sup>164</sup> However, these concerns do not mandate that waivers be rejected out of hand nor even that they be presumed invalid. Rather, these concerns may be considered alongside the goal of wealth maximization. Different judges will perceive the balance dif-

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<sup>160</sup> Korobkin, *supra* note 159, at 552-58; LoPucki & Whitford, *supra* note 90, at 603; Warren, *supra* note 24, at 356; Warren, *supra* note 126. Moreover, to the extent that bankruptcy has as a deliberate policy the internalization of costs of business failure that would otherwise be externalized, the blanket enforcement of waivers would frustrate this policy. See Warren, *supra* note 24, at 361-68.

<sup>161</sup> See *supra* text accompanying note 132.

<sup>162</sup> See H.R. REP. No. 595, 95th Cong., 2d Sess. 405-06 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6361-62:

Subsection (b) gives wide discretion to the court to make an appropriate disposition of the case when a party in interest requests. The court is permitted to convert a reorganization case to a liquidation case or to dismiss the case, whichever is in the best interest of creditors and the estate, only for cause. . . . The list is not exhaustive. The court will be able to consider other factors as they arise, and to use its equitable powers to reach an appropriate result in individual cases.

<sup>163</sup> "The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders." H.R. REP. No. 595, 95th Cong., 2d Sess. 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179.

<sup>164</sup> A contrary intention could be found by emphasizing the legislative and statutory emphasis on "the best interest of the creditors and the estate," noting that the language does not refer to the best interests of the community at large. See *supra* note 162; text accompanying note 131.

ferently, but the Code has neither adopted a model of pure creditor interests nor given judges a charter to make open-ended decisions to benefit the broader community regardless of the creditors.<sup>165</sup>

When the "for cause" standard is applied, then, the court must accord significant but not always determinative weight to creditor recoveries. Considering the economic analysis of waivers in light of this standard, the relevance of a waiver of bankruptcy rights becomes apparent. A knowingly contracted waiver is evidence that the firm and its creditor(s) believed the cost of the waived right would exceed its benefit. A waiver of reorganization rights, for example, indicates that the firm and its creditor(s) believed that an effective reorganization was unlikely, or at least unlikely to be worth the expense. As it evidences the belief of some of the parties in the best position to evaluate the issue, the waiver provides an indication that "cause" does exist to convert or dismiss the case.

Similarly, a waiver of the automatic stay granted to a secured creditor is an indication that the parties expected the costs of involving the secured party in a bankruptcy proceeding would outweigh the value that the collateral would contribute to the reorganization process. If the court determined the stay was causing greater harm to the creditor than benefit to the estate, that would be a factor in favor of lifting the stay. The parties' agreed prediction of this relative balance should be considered evidence that this is, in fact, the case and should be weighed by the court in addressing a lift stay motion. Moreover, these advance waivers should be accorded greater weight than mere testimony, because the parties' negotiated agreement to include the waiver provides credibility that cannot be matched by self-interested testimony at the time of the bankruptcy case.

In short, wealth maximization is one important goal in bankruptcy. If it is considered the overriding goal, the argument for enforcing bankruptcy waivers is quite strong. However, acknowledging that other goals may play a role in bankruptcy does not lead to the conclusion that waivers are per se invalid. Rather, enforcement is appropriate absent a showing that other concerns trump efficiency in the immediate case.

#### IV

#### REFINING THE MODEL

Although the economic model outlined in Part II.A provides a framework for thinking about bankruptcy waivers, it also simplifies the

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<sup>165</sup> Under the former Bankruptcy Act of 1898, the court had authority in some bankruptcy cases to confirm or reject a plan of reorganization based on a determination that it was or was not "consistent with public policy." Warren, *supra* note 24, at 356 n.47. The current Bankruptcy Code has no such provision.

world to such an extent that its usefulness for prescribing policy is minimal. Problems related to the availability of information, the ability to process that information, and other externalities cannot fairly be assumed away, and it is these problems which define the appropriate rules regarding the enforcement of bankruptcy waivers. Part IV.A asks whether bankruptcy waivers will prejudice unsophisticated unsecured creditors or tort creditors, concluding that the risk to these parties is minimal. Parts IV.B and IV.C consider whether the economic model must be modified in light of asymmetric information between debtors and creditors and agency problems inherent in management decisionmaking, concluding that these concerns do not warrant the rejection of contractual waivers. Part IV.D considers the role of waivers in one particularly important setting—prebankruptcy workout negotiations—and finds that waivers may play an important role in encouraging consensual resolutions that would otherwise fail due to information asymmetries.

#### A. Prejudice To Unsecured Creditors

Courts that refuse to enforce waivers of bankruptcy rights often reason that those rights protect not only the firm but the firm's creditors as a group.<sup>166</sup> If bankruptcy rights protect the firm's creditors, the reasoning goes, then the firm cannot waive them because it would be waiving the rights of others.

In a world with perfect information, waivers would not harm most unsecured creditors, because they could modify their contracts with the firm in light of a waiver. In the real world, however, bankruptcy may protect unsophisticated unsecured creditors who do not know enough to modify their contracts and involuntary creditors who are unable to modify their "arrangements" with the firm to compensate for any increased risk. If this is so, then a waiver could prejudice the interests of these parties.<sup>167</sup>

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<sup>166</sup> See, e.g., *Commerzanstalt v. Telewide Systems, Inc.*, 790 F.2d 206, 207 (2d Cir.), *aff'd in part, rev'd in part*, 794 F.2d 763 (2d Cir. 1986), *modified on remand*, 684 F. Supp. 1172 (S.D.N.Y. 1988), *aff'd as modified*, 880 F.2d 642 (2d Cir. 1989) ("Since the purpose of the stay is to protect creditors as well as the debtor, the debtor may not waive the automatic stay."); *In re Sky Group Int'l, Inc.*, 108 B.R. 86, 88 (Bankr. W.D. Pa. 1989) ("The legislative history makes it clear that the automatic stay has a dual purpose of protecting the debtor and all creditors alike.").

<sup>167</sup> Professor LoPucki suggests that a principal explanation for secured credit is the ability of the firm and its secured creditors to advantage themselves at the expense of involuntary creditors and unsophisticated unsecured creditors. See LoPucki, *supra* note 121. For replies to this thesis, see Susan Block-Lieb, *The Unsecured Creditor's Bargain: A Reply*, 80 VA. L. REV. 1989 (1994); Steven L. Harris & Charles W. Mooney Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021 (1994); Steve Knippenberg, *The Unsecured Creditor's Bargain: An Essay in Reply, Reprisal, or Support?*, 80 VA. L. REV. 1967 (1994).

Moreover, there is a risk that waivers will be used to reallocate, rather than create value, which may suggest that such waivers are unfair even to sophisticated contractual unsecured creditors. Unsecured creditors who price their debt on the expectation that insolvency will result in a given distribution from the bankruptcy case may lose that expected bankruptcy distribution if the firm subsequently waives its bankruptcy rights. This would transfer value to the secured creditor<sup>168</sup> from the unsecured creditors existing at the time of the waiver. In exchange, the firm might obtain credit from the secured creditor on more favorable terms, the benefit of which inures in part to unsecured creditors (through a reduced risk of insolvency), but primarily to equity holders.<sup>169</sup>

Having acknowledged these theoretical possibilities of prejudice to unsecured creditors, the importance of these concerns in the real world is limited for at least two reasons. First, bankruptcy appears to offer little value to unsecured creditors. In fact, the evidence indicates that bankruptcy harms unsecured creditors in most cases, and thus waiving bankruptcy often will benefit unsecured creditors.<sup>170</sup> This should come as no surprise in light of the evidence on the costs of bankruptcy presented in Part II.B. Second, and a related point, unsecured creditors are subject to numerous risks to their ability to collect on their claims, and bankruptcy waivers probably add little to the total risk.

Consider the precarious position of the unsecured creditor apart from the risk of a bankruptcy waiver. Many firms do the bulk of their borrowing through secured debt, and modern secured financing techniques allow a lender to perfect a security interest in essentially all of a firm's assets.<sup>171</sup> Even if the firm has substantial unpledged assets at the time it contracts with a particular unsecured creditor, the firm could give a blanket lien to a new secured creditor or to an old creditor in exchange for an extension of time or additional credit.<sup>172</sup> And

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<sup>168</sup> Obviously, waivers could be obtained by parties other than secured creditors, but it seems most likely that waivers would be sought by secured creditors hoping to avoid the delay caused by the automatic stay. For this reason, I will generally assume that a primary secured creditor seeks the waiver.

<sup>169</sup> The reduction in interest charges by the secured creditor will benefit future unsecured creditors, whether knowledgeable commercial parties, unsophisticated trade creditors, or tort victims, by reducing the risk of insolvency. *Cf. Harris & Mooney, supra* note 167, at 2028-37 (arguing that secured credit may benefit rather than harm unsecured creditors by improving the firm's business opportunities).

<sup>170</sup> See *supra* text accompanying note 124.

<sup>171</sup> Harris & Mooney, *supra* note 167, at 2070.

<sup>172</sup> For example, in the W.T. Grant bankruptcy, the firm owed approximately \$500 million to its major creditors. See *In re W.T. Grant Co.*, 699 F.2d 599 (2d Cir.), *cert. denied*, 464 U.S. 822 (1983). Once in financial distress, the firm arranged to borrow an additional \$100 million from these creditors, granting security interests in previously unencumbered assets to secure all \$600 million. The funds permitted W.T. Grant to avoid bankruptcy for

there are numerous other ways in which unsecured creditors' claims against the firm's assets may be supplanted. Decisions regarding additional unsecured debt or the use or sale of assets may prejudice unsecured creditors.<sup>173</sup> Or the firm could pay dividends to its shareholders. As long as the transaction is not a fraudulent conveyance and falls outside the preference period, unsecured creditors have no remedy for the increased risks imposed by these types of transactions.

Thus, it is not surprising that "[t]he large bulk of unsecured credit is not extended on the basis of priority in liquidation values of assets."<sup>174</sup> Rather, unsecured creditors depend on the income stream generated by the firm and the availability of extra-legal remedies, such as the ability to mar the firm's reputation and thus impair its ability to deal with others, that may pressure the firm to pay its unsecured debt.<sup>175</sup> Unsecured creditors generally know that if the firm goes into bankruptcy, they are likely to recover little or nothing.<sup>176</sup> In fact, given the cost of bankruptcy, it is quite conceivable that such creditors, on average, would receive more outside of bankruptcy, albeit on a first-in-time basis.

This does not mean that unsecured creditors are never paid in bankruptcy. Some firms borrow substantial amounts on an unsecured

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more than a year, and thus the granting of security for the entire debt, including the pre-existing \$500 million, could not be set aside as a preference. *See id.* *See also* Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 Wis. L. Rev. 311, 337-338 (1982). Such a transaction is also subject to challenge as a fraudulent transfer, but it may be difficult or impossible to show that the transaction was made with the actual intent to hinder, delay, or defraud creditors, as required under 11 U.S.C. § 548(a)(1) (1994), or that it was not for reasonably equivalent value, as required under 11 U.S.C. § 548(a)(2) (1994).

<sup>173</sup> *See* Harris & Mooney, *supra* note 167, at 2037-41.

<sup>174</sup> LoPucki, *supra* note 121, at 1936.

<sup>175</sup> *See id.* at 1941.

<sup>176</sup> *See* Bowers, *supra* note 87, at 2098 (supporting the proposition that "[g]eneral creditors don't get paid by bankrupts"); LoPucki, *supra* note 121, at 1932 n.172 (citing study finding that general unsecured creditors received payments in only 2.8% of Chapter 7 cases); White, *supra* note 107, at 483 (noting that unsecured creditors received 3% of their claims in liquidation cases, and less than 32% of their claims in reorganization cases). LoPucki notes that payments to unsecured creditors are commonly promised in confirmed Chapter 11 plans. *See* LoPucki, *supra* note 167, at 1932 n.172. However, relatively few Chapter 11 filings result in confirmed plans and, even in those that do, the prospects of unsecured creditors appear fairly bleak. *See id.* Susan Jensen-Conklin reports that in a study of 260 Chapter 11 filings, 45 resulted in confirmed plans. *See* Jensen-Conklin, *supra* note 118, at 318. Of the 42 confirmed plans for which information could be determined, seven proposed paying unsecured creditors less than 10%; 15 plans proposed payments of 10% to 15%; 11 plans proposed payments between 16 and 30%; one plan proposed 53%; one plan proposed 75%; and the remaining seven plans promised full payment. *See id.* at 322-23. These figures suggest an average promised payment of roughly 31% of the unsecured debt, and even this apparently overstates creditor recoveries because, while many of these plans failed to consummate, the plans offering the lowest payments were the most likely to be "successful." *See id.* at 326.

basis while maintaining unpledged assets. This is particularly common among large public firms, whose lenders insist on covenants that the firm will leave substantial assets unencumbered.<sup>177</sup> Such firms are probably least likely to waive their bankruptcy rights,<sup>178</sup> but if such a firm were to waive its bankruptcy rights to advantage a particularly aggressive unsecured lender, its other unsecured creditors could be disadvantaged. However, contractual unsecured creditors routinely obtain protections against various risks, and these protections are equally applicable to waivers. Just as unsecured lenders often require negative pledge clauses,<sup>179</sup> they can require disclosures about any existing waivers<sup>180</sup> and agreements not to waive bankruptcy rights.<sup>181</sup> If they do not seek contractual protections, then they are far more at risk from the mortgaging of the firm's assets than from a bankruptcy waiver.<sup>182</sup>

Ultimately, the risks posed by a bankruptcy waiver could be further mitigated by requiring their recordation.<sup>183</sup> It would be relatively easy to provide for any waiver of bankruptcy rights to be recorded in the Uniform Commercial Code records or in an equivalent filing system, thus informing subsequent creditors who are concerned enough to verify the firm's financial condition through a search.

Tort creditors could in some cases be prejudiced by a bankruptcy waiver and, as nonconsensual creditors, they cannot obtain contractual protections against this risk. Likewise, a filing system would not improve their situation. However, the real problem facing tort creditors lies not in the risk of losing bankruptcy protection, because bankruptcy gives tort creditors little if anything more than their state law entitlements.<sup>184</sup> The real problem faced by tort creditors is the prior-

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<sup>177</sup> See LoPucki, *supra* note 121, at 1924-31; Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 216-18 (1989).

<sup>178</sup> See *infra* Part IV.B.

<sup>179</sup> See Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 922 (1986).

<sup>180</sup> Creditors routinely ask about the existence of substantial debt obligations before extending credit. See Schwartz, *supra* note 177, at 218-21. It would impose only a minimal additional burden to inquire whether prior creditors required bankruptcy waivers.

<sup>181</sup> If a creditor knowingly violates such a contract, the creditor could be equitably subordinated or face liability for tortious interference with contract rights.

<sup>182</sup> Mortgaging the assets would move the secured creditor ahead of these unsecured creditors. A bankruptcy waiver would leave these unsecured creditors with equal access to the firm's assets through state-court enforcement proceedings.

<sup>183</sup> Many bankruptcy waivers are recorded as part of a mortgage or mortgage-modification agreement. Others are contained in documents related to a filed UCC financing statement. Thus, in many cases, there is limited public notice of the waiver. However, there is no system established specifically to provide notice of bankruptcy waivers.

<sup>184</sup> Probably the major advantage that bankruptcy provides to tort creditors is the ability to solve the temporal problem in mass tort situations. Tort victims are protected by bankruptcy filing from the risk that other tort victims will complete their lawsuits and collect their claims, leaving the firm without assets to pay later claimants. A mass tort situation

ity accorded to secured claims, which may leave tort claimants without recourse to most or all of a firm's assets.<sup>185</sup> Bankruptcy does not change this basic fact of state law priority, and bankruptcy waivers are therefore unlikely to prejudice tort creditors in many cases. In fact, if waivers are efficient, they may benefit tort creditors rather than prejudice them.

The flip side of the fact that bankruptcy appears to provide little value to unsecured creditors is that the most likely beneficiaries of bankruptcy, if anyone does in fact benefit, are equity holders, given their ability to use bankruptcy to extract value from creditors despite the firm's insolvency.<sup>186</sup> If bankruptcy rights inure primarily to the benefit of shareholders, and if shareholders are adequately represented by management in the negotiations over the bankruptcy waiver, then the costs of the waiver will be accounted for by the firm and weighed against the benefits being offered by the creditor seeking the waiver.

In sum, unsecured creditors face substantial risks, and consensual unsecured creditors may take those risks into account in their transactions with the firm. But, while it is often said that bankruptcy reorganization is designed to benefit unsecured creditors, it appears to do them little good.<sup>187</sup> In light of the relative inefficacy of bankruptcy in obtaining distributions for unsecured creditors—caused largely by the availability of secured credit—the additional risks imposed by bankruptcy waivers are likely to be modest. Moreover, these risks will be offset by efficiency gains where bankruptcy would have resulted in a net dissipation of the firm's value. In light of the potential benefits of waivers, these limited increases in the risks to unsecured creditors present less than convincing support for the law's hostility to waivers.

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would generally be grounds to disregard a bankruptcy waiver under the test proposed in this Article. If the waiver is given in deliberate anticipation of a mass tort scenario, then it represents an attempt to reallocate rather than create value. If the mass tort situation was unexpected, it may represent a change of circumstances sufficiently drastic to disregard the waiver. However, even in the mass tort scenario, waivers may deserve enforcement if the firm has sufficient insurance to cover its liabilities.

<sup>185</sup> See, e.g., Michael P. Coffey, *In Defense of Limited Liability—A Reply to Hansmann and Kraakman*, 1 GEO. MASON L. REV. 59 (1994); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1646-50 (1991).

<sup>186</sup> See *supra* text accompanying notes 114, 117-19.

<sup>187</sup> See LoPucki, *supra* note 121, at 1946-47 (arguing that bankruptcy serves the interest of secured creditors by failing to recognize the extra-legal mechanisms relied upon by unsecured creditors to obtain payment of their claims).



## B. Asymmetric Information and Management Incentives

The analysis presented above assumes that both firms and their creditors have accurate information regarding the expected costs and benefits of bankruptcy. However, management may have better information than creditors regarding firm prospects.<sup>188</sup> Moreover, management's incentives are not precisely aligned either with creditors' or shareholders' interests. In the usual case, managers are relatively undiversified, having invested in the firm much of their human capital and often a large proportion of their financial portfolio.<sup>189</sup> Managers are thus concerned with increasing share value, but they are also more sensitive than other shareholders to the risk of insolvency, which could cost management their jobs.<sup>190</sup>

How does the combination of asymmetric information and management interests affect the analysis of waivers? Assume managers know whether a firm is a good bankruptcy prospect or a poor one, but creditors do not. Additionally, assume managers seek job security and increased share value. The result will be that poor bankruptcy candidates will sometimes waive their bankruptcy rights and good bankruptcy candidates will never do so.

If managers know that a firm is a poor bankruptcy candidate, then wealth maximization, for the firm and its creditors, would require that the firm waive its bankruptcy rights in exchange for advantageous credit terms. However, because creditors cannot tell whether the firm is a good bankruptcy candidate, management will be able to choose whether to disclose this fact. Management will admit that the firm is a poor bankruptcy candidate, and so waive bankruptcy rights, only if that disclosure advances their interests.

The reduced credit costs gained by a waiver will benefit managers through a lower likelihood of insolvency, longer time until insolvency, and greater job security and compensation due to improved profits. Managers will also consider the improved share value that they realize on their portfolio of company stock and options. Against these gains, managers will balance the reduced opportunity to retain their positions in case of insolvency. Chapter 11 may permit managers to retain their positions during a bankruptcy case, and offers the possibility of a

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<sup>188</sup> At least one study has presented evidence that distressed firms use their superior information and control over accounting conventions to influence the perceptions of creditors, thus improving their terms in debt renegotiations. See Harry DeAngelo et al., *An Empirical Investigation of The Relation Between Accounting Choice and Dividend Policy in Troubled Companies* (1990) (unpublished paper, University of Michigan), cited in Gilson et al., *supra* note 140, at 323-24.

<sup>189</sup> See, e.g., John C. Coffee, Jr., *Shareholder versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 18-20 (1986); Frank M. Easterbrook & David R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 107-08 (1985).

<sup>190</sup> Easterbrook & Fischel, *supra* note 189, at 108.

miraculous recovery by the firm during the bankruptcy, whether through management efforts or serendipitous market changes. Moreover, even if managers often lose their positions as a result of bankruptcy, the threat of bankruptcy might permit managers to negotiate workouts with creditors that would not otherwise be possible,<sup>191</sup> and thus enhance their job security. Thus, managers are likely to resist waivers even where they provide a net benefit to the firm as a whole.<sup>192</sup> As a result, some poor candidates will (efficiently) waive their bankruptcy rights, and others will (inefficiently) choose not to do so.

Now consider the scenario where managers know that the firm is a good bankruptcy candidate. A bankruptcy waiver would be inefficient and would lower stock value. It would also reduce job security by costing management their jobs upon insolvency, rather than permitting them to retain their jobs during, and perhaps after, reorganization. Thus, asymmetric information and management incentives should not lead to good bankruptcy candidates waiving their rights.

According to this analysis, waivers should be expected from some, but not all, firms for which the expected costs of bankruptcy exceed the benefits. Firms for which bankruptcy represents a probable net gain are expected not to waive their rights. Thus, enforcing waivers will seldom result in foreclosing bankruptcy as an option for good bankruptcy candidates.<sup>193</sup>

### C. The Problem of Unsophisticated Borrowers

If there is a significant objection to the enforcement of bankruptcy waivers, it is probably that unsophisticated borrowers may not understand the import of a waiver and so may not extract value for the waiver from the creditor obtaining the waiver. If this is so, then the presumption that a waiver represents a value-maximizing decision is not warranted.

Although borrowers have a natural advantage in understanding the specifics of their businesses, lenders may have a more relevant informational advantage in negotiating bankruptcy provisions. Lenders are present in the credit markets on a daily basis and specialize in understanding credit arrangements, security devices, and protections. Borrowers may have their primary expertise in other areas, and small

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<sup>191</sup> See *infra* Part IV.D.

<sup>192</sup> LoPucki suggests that this same reasoning may lead firms to borrow at higher cost on an unsecured basis even though less expensive secured financing is available. See LoPucki, *supra* note 121, at 1930-31.

<sup>193</sup> If a good bankruptcy candidate does enter into a waiver, there is still the possibility of correcting this fact through a renegotiation in which some of the net benefits of bankruptcy are shared with the creditor holding the waiver. See *supra* text accompanying notes 149-50.

borrowers in particular may be relatively unsophisticated regarding the legal issues and rights included in a loan agreement. Thus, lenders might succeed in obtaining waivers as "boilerplate" provisions even if those waivers are inefficient (that is, the loss they impose on the firm and its other creditors exceeds the benefits to this lender), because borrowers do not understand their significance.<sup>194</sup>

These concerns may be mitigated by the fact that borrowers hire lawyers and accountants when negotiating their financing, and thus they may purchase some of this missing knowledge. If such professionals are used or if a waiver is knowingly and specifically negotiated between the parties, it makes sense to presume that the borrower made a deliberate and informed judgment which should be enforced. However, if waivers become "boilerplate" terms in small business loans, there may be merit to the concern that borrowers are agreeing to inefficient terms that they do not understand.<sup>195</sup>

Waivers could become boilerplate for either of two reasons. First, it might be that waivers are generally an efficient loan term (that is, on average, the costs of bankruptcy exceed the benefits), and parties therefore agree to include a waiver in the absence of evidence that the specific borrower is a good bankruptcy candidate. In this case, boiler-

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<sup>194</sup> The assumption of rational, profit-maximizing behavior is of limited accuracy in any context, given the cognitive limitations of human beings, agency problems, and other market imperfections. However, the assumption will approximate reality far more closely in some circumstances than in others.

The behavioral assumptions that economists use do not imply that everybody's behavior is consistent with rational choice. But they do rest fundamentally on the assumption that competitive forces will see that those who behave in a rational manner . . . will survive, and those who do not will fail; and that therefore in an evolutionary, competitive situation . . . the behavior that will be continuously observed will be that of people who have acted according to such standards. . . . In those instances where something approximating the conditions described above exist, the neoclassical model has been a very effective model for analyzing economic phenomena. For example, in the study of finance, where financial markets tend to have many of the characteristics described above, substantial successes have been made using the straightforward assumptions just described.

DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 19-20 (1990). It is sensible to suppose that large, repeat players in the financial markets, whether lenders or borrowers, who employ individuals with experience and training in law and finance, will conform fairly closely to these assumptions. However, firms that are infrequent and inexperienced borrowers may be less likely to do so. More important in the present context, firms that go bankrupt may reflect a lower level of rational decisionmaking than firms that succeed. It appears likely, then, that many small firms that fail will have made their financing decisions on less than objectively optimal grounds.

<sup>195</sup> Moreover, waivers should be discounted unless they are part of a significant business or financing arrangement of the firm—a boilerplate waiver included on the back of an invoice from one of General Motor's stationery suppliers should not render GM ineligible for bankruptcy reorganization. These types of arrangements are the sort about which subsequent creditors may inquire, thus mitigating the information problems discussed *supra* Part IV.B.

plate waivers serve a valuable function, causing parties to select the most efficient rule most of the time.

However, there is a second possibility. Even if waivers represent a net loss, lenders might determine that they can use their informational advantage to obtain waivers at the expense of unsophisticated borrowers, resulting in inefficient loan terms. This concern is not unique to bankruptcy waivers and has resulted in laws in various other commercial lending contexts intended to establish certain minimum rights for borrowers. Perhaps the most salient examples are rules governing the foreclosure of liens. A foundational tenet of mortgage law is that a borrower may not waive the equity of redemption.<sup>196</sup> This rule is intended to protect borrowers from overreaching lenders, and it applies both to personal and commercial transactions.<sup>197</sup> Similarly, Article 9 of the UCC permits a lender and borrower to determine most of their respective rights by contract, but does not allow the borrower to waive various postdefault remedies in the initial loan documents.<sup>198</sup>

These prohibitions protect borrowers from irrational decisions, whether based on ignorance, undue optimism, or bad counsel.<sup>199</sup> They bar the waiver of certain rights that provide protection to the borrower at little or no cost to the lender because a rational borrower would almost certainly not agree to waive those rights. In short, they replace the assumption that borrowers can and will engage in rational profit maximizing behavior with certain minimal protections that recognize the irrationality that sometimes prevails. These provisions can be thought of as *per se* rules of unconscionability, premised on a belief that no informed and rational borrower would agree to waive these rights.

However, these rules are very limited in their scope and run against a powerful presumption that the enforcement of knowing and informed contracts is in the interest of the parties and society.<sup>200</sup> If

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<sup>196</sup> GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE FINANCE LAW* § 3.1 (3d ed. 1994).

<sup>197</sup> See Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 533-34 (1991) (suggesting that mortgagor protection laws serve as compulsory insurance and may correct for cognitive limitations and risk aversion of consumers, justifications less applicable to large businesses and suggesting that "these laws ought to be amended to cover only those who need the protections—homebuyers and, perhaps, small businesses").

<sup>198</sup> See U.C.C. § 9-501(3) (1994).

<sup>199</sup> See Schill, *supra* note 197, at 524-30 (cataloging reasons individuals are likely to underestimate the risk of default).

<sup>200</sup> The presumption that business entities are best protected through flexible contractual arrangements rather than mandatory provisions underlies the move in the most recent drafts of Article 9 to limit certain mandatory protections to "consumer" obligors, rather than imposing these provisions in business transactions. See U.C.C. Revised Art. 9 (Discussion Draft prepared for the meeting of the National Conference of Commissioners on

these protections are premised on the belief that no informed and rational borrower would waive them, then commercial bankruptcy waivers appear to fall outside the rationale. Given the costs of bankruptcy, it appears likely that waivers in many cases are rational, and given evidence that the parties have weighed the options, such waivers should not be voided on grounds of presumed irrationality. The concern that lenders will take advantage of borrowers' ignorance, undue optimism, or desperation may warrant the rejection of boilerplate bankruptcy waivers. Thus, it is fitting for a court to examine a bankruptcy waiver given by a small business in its initial loan documents for indications that there was, in fact, a quid pro quo. But where a waiver has been specifically negotiated by the parties with the advice of counsel, there is no reason to reject the basic presumption that contractual arrangements should be enforceable.<sup>201</sup>

#### D. Waivers and Workouts

Many mandatory borrower protections may be waived by the borrower subsequent to the initial transaction or after default. For example, under UCC sections 9-504 to 9-506, a debtor may not waive rights of notice, sale of the collateral, and redemption as part of the initial credit transaction but may waive them after default.<sup>202</sup> Similarly, the prohibition against waiving the equity of redemption does not apply to transfers occurring after the initial mortgage transaction, although such transfers will be scrutinized by the courts.<sup>203</sup> Thus, a lender may purchase the equity of redemption from the borrower after the initial transaction, provided that the purchase is fair, honest, and for adequate consideration.<sup>204</sup>

By permitting postdefault waivers, the law facilitates out-of-court accommodations by borrowers and lenders.<sup>205</sup> In so doing, it bal-

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Uniform State Laws, July 28 - August 4, 1995); Explanatory Note 7 to Section 9-105 (discussing consumer-related definitions); Introductory Notes to Part 5 (discussing the new consumer protection provisions). This presumption is also reflected in the common practice of excepting corporate borrowers from usury protections.

<sup>201</sup> As noted in detail in the following section, these concerns change in the workout context, and a bankruptcy waiver given by a small business as part of a workout agreement ought to be accorded equal weight as one given by a major corporation. In a workout context, a small business is likely to have focused on the relative costs and benefits of the bankruptcy waiver, and "protecting" small businesses by scrutinizing such waivers would inhibit workouts. See *infra* Part IV.D.

<sup>202</sup> See U.C.C. §§ 9-504 to -506 (1994).

<sup>203</sup> See NELSON & WHITMAN, *supra* note 196, § 3.3.

<sup>204</sup> See *id.*

<sup>205</sup> See *Guam Hakubotan, Inc. v. Furusawa Inv. Corp.*, 947 F.2d 398, 404 (9th Cir. 1991), *cert. denied*, 504 U.S. 930 (1992); *Ringling Joint Venture II v. Huntington Nat'l Bank*, 595 So.2d 180, 182-83 (Fla. Dist. Ct. App. 1992); *Wright v. First Nat'l Bank of Monroe*, 297 N.W. 505, 510-11 (Mich. 1941). But see *Russo v. Wolbers*, 323 N.W.2d 385, 390-91 (Mich. Ct. App. 1982); NELSON & WHITMAN, *supra* note 196, § 3.3 (arguing that, although a "close

ances the expectation that the borrower has learned to value its default rights against the concern that desperate parties will agree to unreasonable terms. While a borrower's optimism may prevent it from fully valuing its default protections at the time of the initial loan, after default the borrower is far more likely to understand the value of those protections. Thus, postdefault negotiations are, again, entitled to some presumption of rational maximizing.

Bankruptcy waivers are most often negotiated as part of a workout or restructuring rather than as part of an initial loan agreement. This appears to be based in part on practitioners' belief that initial waivers are not enforceable, but that waivers may be enforceable as part of an out-of-court workout.<sup>206</sup> But there is also an important economic explanation for the use of waivers in workouts. Waivers serve a signalling function that may allow parties to overcome transaction costs caused by asymmetric information.<sup>207</sup> Thus, a bankruptcy waiver may be efficient as part of a workout even though it would not have been an efficient part of the initial lending transaction.<sup>208</sup>

Assume managers know whether the firm's workout plans are realistic but creditors do not. Managers may claim to have a viable workout plan because they preserve their jobs during the workout attempt and the subsequent bankruptcy proceeding, and because the workout lengthens the time during which managers and equity holders can hope for an extraordinary improvement in the firm's fortunes. Thus, creditors cannot believe management's assertions that a workout is cost-effective. As a result, creditors may reject effective workout proposals because they cannot be distinguished from ineffective ones.

Management needs a signal that will assure creditors that management really believes in its workout scenario. A bankruptcy waiver provides such a signal. By sacrificing the ability, should the workout fail, to use bankruptcy to retain their positions and preserve equity's position, management and equity holders accept a significant cost if the workout fails. By agreeing to accept this cost, management demonstrates its belief that the workout is feasible. Thus, waivers provide

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call," postdefault executory waivers of the equity of redemption upon any future default should not be enforced because of the need to protect borrowers from acting on the "mirage of hope").

<sup>206</sup> See Mayer, *supra* note 9, at 53-56.

<sup>207</sup> See Stephen A. Ross, *The Determination of Financial Structure: The Incentive-Signalling Approach*, 8 BELL J. OF ECON. 23 (1977) (demonstrating that an incentive structure that will penalize managers upon filing of bankruptcy can communicate nonobservable information to investors). For a discussion of secured debt as a signalling device, see Roe, *supra* note 85, at 221-22; Scott, *supra* note 179, at 928-29.

<sup>208</sup> For an argument that including a bankruptcy waiver in the initial loan documentation will increase the likelihood of achieving consensual workouts after default, see Schwartz, *supra* note 4, at 613-20.

creditors with important information that would not otherwise be easily available regarding the sincerity of management's belief. This may enable parties to agree to workouts that would otherwise be barred by asymmetric information. This reasoning is consistent with judicial decisions holding that the public policy favoring the consensual settlements supports the enforcement of waivers given during prepetition workouts.<sup>209</sup>

There is a countervailing concern, however, arising from the increasing divergence between the interests of equity holders and creditors as the firm approaches insolvency.<sup>210</sup> Equity holders know that they need a substantial increase in firm value to recover anything, but they also know that any additional losses will be borne by the creditors. So, when failure looms, the firm's managers and equity holders may be willing to trade the value available to creditors through a prompt liquidation for additional time in which to hope for a recovery. To accomplish this, the firm might agree to a workout with its primary secured lender in which the firm obtains additional credit or an extension of time to repay existing debt and, in exchange, waives its bankruptcy rights (in whole or in part), allowing the lender to save bankruptcy costs if the firm later fails.<sup>211</sup> The firm can then engage in a high-risk strategy for recovery, and the lender will not object because it knows that its interests are protected by its collateral and the waiver. Thus, by waiving its bankruptcy rights, the firm may be sacrificing the interests of unsecured creditors with a transaction that reduces the overall value of the firm but increases the expected value of the interests of the secured creditor and the shareholders.

The Bankruptcy Code offers a mechanism to deal with the risk of this type of opportunistic workout—the parties may bind all creditors to a restructuring through a prepackaged bankruptcy plan. In a prepackaged plan, the firm solicits votes on a proposed reorganization from its creditors prior to filing the bankruptcy petition.<sup>212</sup> This plan is then filed along with the petition, and is quickly confirmed if it

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<sup>209</sup> See *In re Cheeks*, 167 B.R. 817, 819 (Bankr. D. S.C. 1994); *In re Club Tower L.P.*, 138 B.R. 307, 312 (Bankr. N.D. Ga. 1991). See also *United States v. Royal Business Funds Corp.*, 724 F.2d 12, 15-16 (2d Cir. 1983) (dismissing bankruptcy where Small Business Administration had been appointed as receiver for corporation and had provided \$3.5 million of additional financing in reliance on receivership); *In re Colonial Ford, Inc.*, 24 B.R. 1014, 1023 (Bankr. D. Utah 1982) (dismissing case because of prepetition workout).

<sup>210</sup> See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 339-43 (1976).

<sup>211</sup> Eve-of-bankruptcy conflicts are present in numerous forms other than bankruptcy waivers and are generally dealt with through preference law. See Jackson & Scott, *supra* note 75, at 169-71.

<sup>212</sup> 11 U.S.C. § 1126(b) (1994) permits votes solicited prepetition to be counted in the confirmation of a proposed plan if the solicitation was accompanied by adequate disclosure.

satisfies the Bankruptcy Code's requirements. The prepackaged bankruptcy is intended to minimize the duration—and therefore the cost—of the bankruptcy proceeding.<sup>213</sup> Thus, the Bankruptcy Code attempts to offer a relatively low-cost option in which the parties use the confirmation process to establish conclusively that a workout is an attempt to maximize value, rather than take advantage of more vulnerable creditors.<sup>214</sup> An eve-of-bankruptcy workout containing a waiver is, however, essentially a prepackaged plan that has never been submitted to the creditors as a group, or to the court, for approval. Because an eve-of-bankruptcy workout may be motivated by redistributive rather than efficiency goals, courts should be leery of routinely permitting parties to bypass the confirmation process through workouts containing bankruptcy waivers.<sup>215</sup>

Given the availability of the prepackaged plan alternative, should parties ever be allowed to bypass this process and bind others to the effects of a waiver? Although a successful prepackage lowers the costs of bankruptcy substantially, a prepackaged plan is still very expensive compared with a contractual resolution. More importantly, firms are often reluctant to file for bankruptcy with a prepackaged plan because of the concern that unexpected objections or complications could result in a fully contested bankruptcy case. Counting on a quick and inexpensive bankruptcy is a risky proposition.<sup>216</sup> Also, filing for bank-

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<sup>213</sup> See Steven R. Gross & George E.B. Maguire, *Prepackaged Chapter 11 Plans*, in CHAPTER 11 BUSINESS REORGANIZATIONS 1994, at 433, 435-36 (PLI Com. Law & Practice Course Handbook Series No. A-682, 1994) (citing four cases in which plans were confirmed within three months of filing).

<sup>214</sup> This is done by requiring that claims be grouped into similar classes, and that the plan not be confirmed without the consent of at least one-half of the creditors, holding at least two-thirds of the value of the claims, in each class that is not left "unimpaired". See 11 U.S.C. § 1124 (1994) (defining impairment); 11 U.S.C. § 1126(c) (1994) (defining acceptance by a class); 11 U.S.C. § 1129(a)(8) (1994) (each class must either accept the plan or be unimpaired). The requirement that each impaired class accept the plan may be dispensed with if at least one impaired class accepts the plan, see 11 U.S.C. § 1129(a)(10) (1994), and the absolute priority rule is complied with, see 11 U.S.C. § 1129(b) (1994).

<sup>215</sup> Cases that have honored waivers negotiated in workouts generally consider settlements that include the vast majority of the firm's creditors. Thus, the concern that the waiver might be a means of transferring value from nonconsenting creditors is mitigated. See, e.g., *In re Club Tower*, 138 B.R. 307, 309 (Bankr. N.D. Ga. 1991) (debtor had "only a few unsecured creditors whose claims are de minimis"); *In re Orange Park South Partnership*, 79 B.R. 79, 81 (Bankr. M.D. Fla. 1987) (debtor had only one legitimate unsecured creditor, with claim of \$1,100); *In re Colonial Ford, Inc.*, 24 B.R. 1014, 1015 n.2 (Bankr. D. Utah 1982) (all but three creditors, who were insiders, were included in the settlement agreement).

<sup>216</sup> It is impossible to know in advance that a prepackaged plan and solicitation of vote will be held to meet the requirements of the Bankruptcy Code. Thus, firms and creditors may be reluctant to rely on the prepack provisions of the Code. See Lillian E. Kraemer & Richard B. Paige, *Consensual Workouts—Bankruptcy Alternative for the 1990s?*, in 15 BANKING AND COM. LENDING L. 419, 449-51 (ALL-ABA Course of Study, Banking & Com. Lending Law Vol. XV, Richard T. Nassberg ed., San Francisco, Cal., Mar. 10-12, 1994).



ruptcy may result in negative publicity which many firms would prefer to avoid. Recognizing the advantages of private workouts, Congress provided that the bankruptcy courts could abstain from a case initiated by a creditor holding out from a consensual resolution.<sup>217</sup> Clearly, a waiver included in a prepackaged plan should be accorded greater deference than one contained in a contractual workout, but that does not mean that waivers incorporated in nonjudicial workouts should be void.

### E. Conclusion

If bankruptcy involves costs which in certain cases can be predicted to exceed its benefits, firms and their creditors will sometimes find it efficient to contract out of the bankruptcy system. And the costs of that system make it reasonable to believe that many waivers are rational attempts to avoid a process whose expenses exceed its value. Moreover, bankruptcy waivers may serve as a valuable tool in overcoming barriers in workout negotiations. For these reasons, waivers could enhance the efficiency of the bankruptcy system.

However, there are reasons to doubt whether all waivers are efficient. Some may reflect efforts to reallocate value from one group of creditors to other creditors and equity holders. Courts must also consider the likelihood that unsophisticated borrowers may agree to waivers without adequately evaluating their merits. Moreover, even the most informed lenders and borrowers may not have sufficient information and foresight to assess accurately whether a bankruptcy, occurring under uncertain conditions some years down the road, will be worth the cost to pursue. With these points in mind, the following sections attempt to specify with greater clarity the role that waivers should play under the current provisions of the Bankruptcy Code.

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<sup>217</sup> The court may abstain from, suspend, or dismiss a case if "the interests of creditors and the debtor would be better served by such dismissal or suspension. . . ." 11 U.S.C. § 305(a)(1) (1994). Out-of-court workouts might present one circumstance justifying abstention under this provision.

The court may dismiss or suspend under [section 305(a)(1)], for example, if an arrangement is being worked out by creditors and the debtor out of court, there is no prejudice to the rights of creditors in that arrangement, and an involuntary case has been commenced by a few recalcitrant creditors to provide a basis for future threats to extract full payment.

H.R. REP. NO. 95-595, at 325 (1977), S. REP. NO. 95-989, at 35 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6281. For an opinion dismissing a bankruptcy filing on essentially this ground, see *In re Colonial Ford, Inc.*, 24 B.R. 1014, 1021-23 (Bankr. D. Utah 1982). However, the requirement that the interests of the debtor be better served by dismissal makes it difficult to argue that a voluntary filing can be dismissed under this provision. See *Hartigan v. Pine Lake Village Apartment Co. (In re Pine Lake Village Apartment Co.)*, 16 B.R. 750, 753 (Bankr. S.D.N.Y. 1982).

## V

## PROPOSED STANDARDS FOR THE ENFORCEMENT OF WAIVERS

Waivers could best be implemented by explicitly amending the Bankruptcy Code to permit business entities to waive their rights, subject to limited judicial review.<sup>218</sup> Such legislation could clearly define permissible waivers and the proper grounds for challenging their enforcement. It would also provide an opportunity to re-evaluate the restriction in section 706(a) against waiving reorganization rights while retaining liquidation rights. Moreover, to the extent that public notice is deemed necessary or helpful to provide a fair opportunity for unsecured creditors to adjust their relationship with the firm, the public recordation of waivers could be established.<sup>219</sup>

However, even without legislative reform, bankruptcy courts have the authority to consider waivers in determining the proper resolution of a bankruptcy case. The Code does not prohibit a firm from waiving its right or restricting its ability to file a voluntary petition, or from waiving the automatic stay. In each of these cases, the effect of the waiver will be raised by motion, and the court will have to determine whether there is "cause" to enforce the waiver.<sup>220</sup>

In addressing this question, the court must begin with the fact that the firm agreed to relinquish its rights, thus presenting a prima facie case that, at the time, the firm believed that those rights carried costs in excess of their benefits. By giving a presumption of enforceability to waivers, courts would permit firms and their creditors to act on their beliefs and structure their relationships in the most cost-effective manner.

However, opposing parties<sup>221</sup> should be given an opportunity to rebut this presumption. Such challenges should be limited to a few narrow grounds: First, that the secured creditor and equity holders negotiated the waiver in order to reallocate value away from un-

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<sup>218</sup> For a detailed proposal implementing this idea, see Rasmussen, *supra* note 4, at 100-07.

<sup>219</sup> See *supra* text accompanying note 183.

<sup>220</sup> See *supra* Part III.A.

<sup>221</sup> Several recent cases have held that a waiver of the automatic stay bars the debtor from contesting the creditor's motion for relief from the stay, but that other creditors (who were not parties to the agreement) may still contest the motion. See *In re Powers*, 170 B.R. 480, 483-84 (Bankr. D. Mass. 1994); *In re Cheeks*, 167 B.R. 817, 819-20 (Bankr. D.S.C. 1994); cf. *B.O.S.S. Partners I v. Tucker (In re B.O.S.S. Partners I)*, 37 B.R. 348, 351 (Bankr. M.D. Fla. 1984) (holding that postpetition stipulation waiving the automatic stay bars debtor from contesting the motion for relief from stay absent extraordinary circumstances). This approach ignores a collective action problem: even if the waiver should not be enforced, no individual creditor may have a large enough stake to incur the legal costs of bringing a challenge. Thus, if challenges are to be permitted, the debtor must be allowed to bring them. What is needed is not a rule of standing that prevents waivers from being challenged, but a modification of the standard under which the validity of the waiver is tested.

secured creditors.<sup>222</sup> Second, that the waiver represents overreaching by the lender at the expense of an unsophisticated borrower.<sup>223</sup> Third, that a substantial and unpredictable change in circumstances warrants the conclusion that the *ex ante* judgment of the firm and its creditor has been superseded by events.<sup>224</sup> And fourth, that extraordinary public interests override the contractual waiver.<sup>225</sup>

If the presumption of validity is to have meaning, opponents should bear a heavy burden in seeking to overturn a waiver. First, the party opposing the waiver might show that the waiver was intended to advantage the secured creditor and equity holders at the direct expense of unsecured creditors. In this case, the waiver does not represent a good faith judgment about the total costs and benefits of the rights waived and so loses its justification for enforcement. Direct evidence of the intention of the parties will be rare, and the showing will have to be made from evidence of the debtor's business circumstances at the time of the waiver. However, one seeking to invalidate a waiver on this ground should bear an extremely heavy burden. Given that bankruptcy generally inures to the benefit of equity holders (if anyone) rather than unsecured creditors,<sup>226</sup> courts should be highly skeptical of claims that a waiver was intended to transfer bankruptcy value away from unsecured creditors.<sup>227</sup> More specifically, if the agreement was executed well in advance of bankruptcy,<sup>228</sup> or if unsecured creditors provide only a minor share of the firm's debt,<sup>229</sup> such arguments can be given short shrift.

Conversely, an objection would gain credence if the waiver was negotiated when the firm was approaching bankruptcy, or if the creditor seeking to enforce the waiver is substantially oversecured.<sup>230</sup> In particular, where a waiver is negotiated shortly before bankruptcy in a workout that fails, the court should be somewhat more willing to con-

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<sup>222</sup> See *supra* Parts IV.A, IV.D.

<sup>223</sup> See *supra* Part IV.C.

<sup>224</sup> See *supra* Part III.B.

<sup>225</sup> See *supra* Part III.C.

<sup>226</sup> See *supra* Part II.B.

<sup>227</sup> That is, if bankruptcy generally does not aid unsecured creditors, then waivers seldom harm them. Rather, if bankruptcy aids equity holders, then a waiver represents a decision by equity holders (or by management on their behalf) to waive their own rights in exchange for improved credit terms.

<sup>228</sup> If the firm is solvent when the waiver is given, any reduction in firm value through the surrender of bankruptcy rights would be borne by equity holders. Thus, waivers well in advance of bankruptcy presumably reflect a fair balancing of the costs and benefits. Moreover, if the waiver is well in advance of filing, then many contractual unsecured creditors will have time to readjust their relationship with the firm in light of the waiver.

<sup>229</sup> Reallocating a small amount of value from minor creditors is not a credible explanation for a firm waiving its bankruptcy rights.

<sup>230</sup> See *In re Sky Group Int'l, Inc.*, 108 B.R. 86, 89-90 (Bankr. W.D. Pa. 1989) (refusing to enforce prepetition waiver of the automatic stay where debtor had equity in the collateral).

sider whether there is merit to this objection. Courts have noted the importance of enforcing waivers to facilitate the negotiation of out-of-court restructurings.<sup>231</sup> But while focusing on this vital concern, the cases fail to recognize the risks of eve-of-bankruptcy strategic behavior: waivers negotiated in anticipation of bankruptcy present an enhanced risk that the firm is benefiting a preferred creditor (and equity holders) at the expense of other creditors.<sup>232</sup> Thus, for waivers negotiated within a year of the bankruptcy petition, the court should consider whether the waiver was part of a zero-sum, or negative-sum, attempt to reallocate value.<sup>233</sup> A firm and creditor can avoid this scrutiny and preempt the challenge by putting the waiver in a prepackaged plan instead of a contract.<sup>234</sup> Even after acknowledging these concerns, however, there are good reasons to favor out-of-court workouts over bankruptcy proceedings, and waivers may play a crucial role in negotiating successful workouts.<sup>235</sup> Accordingly, the validity of a waiver in a workout agreement should be presumed, absent a clear and convincing showing of improper purpose.

The court should also examine the procedural fairness of the negotiations surrounding the waiver if the borrower is relatively unsophisticated.<sup>236</sup> However, if the borrower was represented by counsel, or if the waiver was specifically negotiated rather than incorporated as "boilerplate," courts should decline to second-guess the fairness of the parties' bargain.

If circumstances have changed in an unforeseeable and dramatic fashion, thus superseding the parties' prior evaluation of the costs and benefits of bankruptcy, the waiver should be discounted because it is no longer indicative of the value of a bankruptcy case. Ordinary business reversals, mismanagement, economic recessions, and changes in the marketplace, however severe, should be viewed as within the contemplation of the parties, and not as grounds to set aside the waiver. Rather, the waiver should be unenforceable only where a business suffers a loss from a patently unexpected cause, such as a fluke natural disaster, war, or other "act of God."

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<sup>231</sup> See *supra* text accompanying notes 54-57.

<sup>232</sup> See *supra* text accompanying notes 210-11.

<sup>233</sup> A one-year period is suggested by way of analogy to the insider preference period provided in Section 547(b) of the Bankruptcy Code. The concern here is essentially the same as in preference law: that, anticipating bankruptcy, the firm's insiders are disadvantaging some creditors relative to others, in order to benefit the insiders. See JACKSON, *supra* note 24, at 125-26. For the same reason, Rasmussen suggests a one-year period before a change in a firm's choice of bankruptcy regime could take effect. Rasmussen, *supra* note 4, at 118-20.

<sup>234</sup> See *supra* text accompanying notes 212-17.

<sup>235</sup> See *supra* Part IV.D.

<sup>236</sup> See *supra* Part IV.C.

A court may also decline to enforce a waiver where extraordinary public interests warrant overriding the private benefit of the parties. Precisely when such a determination is appropriate is a matter of great dispute. Individual judges will differ as to when public concerns outweigh the financial interests of the parties under the "for cause" standard set forth in the Code.

Any of these objections will eviscerate waivers if not closely circumscribed. The *ex post* nature of court evaluation may result in the regular disallowance of valid waivers because bankruptcy courts only see cases in which, despite the workout or credit agreement containing the waiver, the firm fails. It would be natural for the courts to conclude that many waivers are unenforceable, based on an *ex post* determination that the firm gained little from the waiver. As one researcher explains,

[P]eople (judges) who have the set of information that existed prior to an event (pre-outcome information) and have knowledge of the outcome of the event are more likely to say that they *would have* expected the particular outcome that occurred than if they actually had been given only the pre-outcome information.<sup>237</sup>

In other words, knowing that the firm did end up in bankruptcy, judges are likely to overestimate the likelihood, at the time the waiver was entered into, that the firm would end up in bankruptcy, and so are likely to believe that the creditor was taking advantage of the borrower.

If waivers are commonly voided, creditors will refuse to give substantial value in exchange for them. Thus, factual inquiries into the validity of each waiver, if carried out without recognition of the systemic advantage of their availability, would eliminate their use in efficient situations.

Given the potential value of waivers and the likelihood that courts will continue to invalidate waivers that should be enforced, thus diminishing their *ex ante* value and usefulness, it can be argued that waivers should be enforced without judicial second-guessing. It may well be that the costs of litigating the enforceability of waivers and the

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<sup>237</sup> Thomas A. Buchman, *An Effect of Hindsight on Predicting Bankruptcy With Accounting Information*, 10 *ACCT. ORGANIZATIONS & SOC'Y* 267, 267 (1985). Hindsight bias has been well documented in the psychological literature, although it seems to be underappreciated in the legal literature. Among the seminal works are Baruch Fischhoff, *Hindsight ≠ Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 *J. EXPERIMENTAL PSYCHOL.* 288 (1975); Baruch Fischhoff & Ruth Beyth, "I Knew It Would Happen": *Remembered Probabilities of Once-Future Things*, 13 *ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE* 1 (1974). For significant recent works in the legal context, see Kim A. Kamin & Jeffrey J. Rachlinski, *Ex Post ≠ Ex Ante: Determining Liability in Hindsight*, 19 *L. & HUM. BEHAV.* 89 (1995); D. Jordan Lowe & Philip M.J. Reckers, *The Effects of Hindsight Bias on Jurors' Evaluations of Auditor Decisions*, 25 *DECISION SCI.* 401 (1994).

risk of judicial error in determining which waivers are efficient outweigh the value of invalidating inefficient waivers. This possibility is enhanced when we recognize that inefficient waivers may be modified by the parties consensually.<sup>238</sup> Nonetheless, under the present Code, it appears that bankruptcy courts must make an independent determination of "cause" to dismiss a case or lift the stay. Moreover, there are good reasons to permit some challenges to waivers. The problem is to constrain the judicial reluctance to enforce efficient waivers. A strong presumption of enforceability appears to be the best means of accomplishing this.

Although many decisions overlook the systemic benefits of allowing informed firms and creditors to tailor their credit terms and remedies through the use of waivers, a few courts have recognized these benefits and accordingly granted a presumption of enforceability. For example, in *In re Powers* the court wrote:

Once the pre-petition waiver [of the automatic stay] has been established, the burden is upon the opposing parties to demonstrate that it should not be enforced. In addition to . . . [any drastic economic changes since the waiver was granted] . . . the Court will consider other factors, such as the benefit which the debtor received from the workout agreement as a whole; the extent to which the creditor waived rights or would be otherwise prejudiced if the waiver is not enforced; the effect of enforcement on other creditors; and, of course, whether there appears to be a likelihood of a successful reorganization.<sup>239</sup>

Significantly, the court appears to have weighed the prebankruptcy benefits obtained by the debtor from the workout, recognizing that creditors benefitted from a greater possibility of repayment even if that possibility did not come to fruition.<sup>240</sup> Such an analysis properly defers to the parties' judgment without relinquishing the court's obligation under the Code to determine whether there is cause to dismiss the case or lift the stay.

Two particular situations, single-asset real estate cases and securitized financing vehicles, deserve specific mention because they are recurring situations that present the strongest cases for the enforcement of waivers. The majority of cases in which waivers have been considered by the courts have been single-asset real estate cases in which the

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<sup>238</sup> See *supra* text accompanying notes 84-88.

<sup>239</sup> *In re Powers*, 170 B.R. 480, 484 (Bankr. D. Mass. 1994); see also *Abdul-Hasan v. Firemen's Fund Mortgage, Inc.* (*In re Abdul-Hasan*), 104 B.R. 263, 266-68 (Bankr. C.D. Cal. 1989) (holding that the order entered in bankruptcy case prospectively lifting the automatic stay in any subsequent case is effective, and creditor need not seek relief from stay in subsequent case; if circumstances have changed, debtor should seek temporary restraining order and injunction to prevent creditor from foreclosing).

<sup>240</sup> *In re Powers*, 170 B.R. at 484.

waivers were negotiated shortly before the bankruptcy filing.<sup>241</sup> Waivers in such cases should be routinely enforced. These cases typically involve few or no unsecured creditors or unencumbered assets. Moreover, they involve little or no going concern value because a building is worth approximately as much in the secured lender's hands after foreclosure as in the borrower's hands before foreclosure. No assets are sold off separately and no economic value is squandered in such a "liquidation." In these cases, a negotiated bankruptcy waiver represents a decision by the secured creditor and the firm that the expected costs of a bankruptcy proceeding (which would be borne by the secured creditor and are largely of the type underemphasized in bankruptcy court determinations) exceed its expected benefits. With so little unsecured debt involved, the firm and secured creditor could not have been motivated by the desire to profit from an inefficient waiver that reallocates value from unsecured creditors. Thus, the waiver should be enforced.

Structured financings present an even stronger case for enforcement of bankruptcy waivers. Generally, a structured financing provides for an operating company to sell assets to a special purpose vehicle (SPV) which issues securities collateralized by those assets. The SPV is structured to be as protected as possible from the risk of bankruptcy, and the purchasers of the securities pay a premium for these protections. That higher purchase price is passed through to the operating company by the price paid by the SPV when it purchases the assets from the company. Thus, in the typical structured financing, the company receives advantageous financing terms. There is no concern that the creditor securing the waiver has overreached, since the firm defined the terms of the relationship itself. Nor is there a reason to fear prejudice to third party creditors, because securitized financings are normally a part of a firm's ongoing financial strategy and their use to disadvantage unsecured creditors

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<sup>241</sup> See *In re McBride Estates, Ltd.*, 154 B.R. 339, 342-43 (Bankr. N.D. Fla. 1993); *In re Hudson Manor Partners, Ltd.*, 28 Collier Bankr. Cas. 2d 221, 221 (Bankr. N.D. Ga. 1991); *In re Club Tower L.P.*, 138 B.R. 307, 308-09 (Bankr. N.D. Ga. 1991); *In re Growers Properties No. 56 Ltd.*, 117 B.R. 1015, 1020 (Bankr. M.D. Fla. 1990); *In re Citadel Properties, Inc.*, 86 B.R. 275, 275 (Bankr. M.D. Fla. 1988). *In re Jenkins Court Assocs. Ltd. Partnership*, 181 B.R. 33, 36-37 (Bankr. E.D. Pa. 1995), presents curious reasoning in this regard. The court refused to enforce the waiver specifically because it was dealing with a single-asset real estate partnership. The court reasoned that the policy of encouraging out-of-court restructurings was trumped by the long line of authority (citing only *In re Citadel*) and the public policy barring consensual restraints on bankruptcy rights. The *Jenkins* court noted that a waiver of the stay could technically be distinguished from a prohibition on bankruptcy filing but, in the single-asset context, waiver of the stay essentially would negate the bankruptcy. Following this reasoning, waivers by debtors that are not single-asset entities would be more likely to be enforced, an odd result given the questionable value of single-asset cases.

would be quickly reflected in changed contractual terms.<sup>242</sup> Accordingly, there is no reason to hobble structured financings with complex devices to avoid bankruptcy. It would be clearer, less expensive, and more efficient if complex structures designed to render SPVs “bankruptcy remote” could be replaced with enforceable waivers. At the very least, courts should refrain from using vague “public policy” concerns as a ground for invalidating bankruptcy protections included in structured financings.

#### CONCLUSION

The analysis presented in this Article is necessarily controversial, relying on data and assumptions that are subject to both dispute and revision. But parties will not wait until the final data is in (if in fact it ever will be) before contracting for waivers, nor can courts wait for a definitive theory before deciding the motions brought before them. This Article therefore attempts to build a reasoned approach to bankruptcy waivers, given the existing empirical, theoretical, judicial, and statutory materials. These materials call into question the prevailing rules that invalidate waivers of the right to file a voluntary petition, and suggest a framework for analyzing the enforceability of these waivers and waivers of the automatic stay.

The suggestion that we reconsider the role of bankruptcy waivers should not be surprising. The bankruptcy system has been subject, in recent years, to substantial criticism (and congressional lobbying) for being slow and expensive. These perceptions gain some support from academic studies of the cost of bankruptcy, and they gain further support from the growing use of waivers. If bankruptcy is intended to assist firms and their creditors, eyebrows should rise when those firms and creditors regularly attempt to opt out of that “assistance.” If, as argued above, waivers reflect a rational response to a system that often fails in its objectives, then they deserve greater respect than they have traditionally been afforded. If the judicial resistance to waivers does not change, firms and creditors will only continue their existing struggle to accomplish the same goal with more cumbersome and less efficient mechanisms.

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<sup>242</sup> Schwarcz, *supra* note 41, at 146-51.