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BANKRUPTCY REDISTRIBUTIVE POLICIES AND THE LIMITS OF THE JUDICIAL PROCESS

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Business failure negatively affects a broad range of interests, yet the bankruptcy process directly protects only a small segment of interest-holders: the creditors. Some commentators argue for expansion of that protection to encompass redistributive norms and provide for the interests of non-investors in the failed business. The Bankruptcy Reform Act of 1994's establishment of a national commission to study the bankruptcy process and its broader policy implications brings with it the opportunity to consider that redistributive argument and perhaps change the process to include the interests of non-investors under the reorganization umbrella. In this Article, Professor Frost responds to those who would have the bankruptcy reorganization process protect the interests of non-investors in the failed enterprise. The author outlines the arguments both for and against such protection, and concludes that the bankruptcy process is institutionally incapable of achieving redistributive goals. This process-oriented view of business reorganizations holds that protection of non-investor interests should be left to those institutions and processes capable of competently providing it.

INTRODUCTION

Business failure is an essential function of any economic system. It is necessary to what Schumpeter described as the process of "creative destruction," through which capitalist economies grow through a continual process of innovation and resulting obsolescence.[1] Schumpeter's basic insight into the dynamic evolution of the

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1. JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 81-86 (1942).

economy may have as much resonance today as when he coined the phrase. Rapid changes in information technology, increasing globalization of trade, changes in management technology, reductions in regulation, and the privatization occurring in formerly socialist states have caused a restructuring of business radical enough to lead Jensen to describe it as a "Third Industrial Revolution."[2]

The darker side of the process shows in the displacement that accompanies the death of businesses as they are creatively destroyed. Technological change has not only made possible products and manufacturing and distribution methods inconceivable 50 or 100 years ago; it has also eliminated or substantially reduced the demand for a wide range of products and services. Entire industries struggle to adapt to new products or new methods of providing services. Take the retail industry as an example. In his 1942 book, Schumpeter noted the demise of small independent retailers caused by the rise of the department store.[3] Today, retailing giants struggle to meet the challenge of competition from discount stores that utilize new technologies to increase the efficiency of their distribution networks.[4]

While a number of firms succeed in meeting the challenge of the gales of creative destruction, many others fail. The late 1980s witnessed a dramatic increase in business failures[5] and bankruptcies.[6] Accompanying this rise was an ever-increasing focus on the social problems caused by economic adjustments. Business failure affects radically diverse interests—the interests of the creditor in being paid, the interest of the shareholder in maintaining her residual claim to the earnings of the business, the interest of the employee in retaining her source of income, and the interests of the surrounding community in maintaining an institution that provides numerous indirect benefits. The toll that business failure exacts on dependent constituencies goes beyond job loss and creditor recovery statistics. The closing of a failed business may produce shock waves that reverberate throughout the local, regional or national economy.

The search for a solution to the social problems accompanying business failure has influenced debates surrounding corporate law and governmental response to the problems of failure for years. In the

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2. Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 835 (1993).
3. SCHUMPETER, *supra* note 1, at 85.
4. Carol J. Loomis, *Dinosaurs*, FORTUNE, May 3, 1993, at 36.
5. *See* 1994 ECON. REP. OF THE PRESIDENT tbl. B-95, at 378.
6. 1991 ANN. REP. OF THE DIRECTOR OF THE ADMIN. OFF. OF THE UNITED STATES CTS. tbl. 13, at 104 (bankruptcy cases 1981-1991).

late 1970s and early 1980s, the focus of the debate was on plant closings[7] and governmental bailouts.[8] More recently, the controversy surrounded the displacement accompanying the so-called "two-tiered bust-up hostile takeover."[9] Today the social palliative of choice may be shifting toward the bankruptcy reorganization process.

This Article responds to those who would ask the bankruptcy system to protect the interests of non-investors. The bankruptcy process is institutionally incapable of resolving the loss distribution issues among all who are interested in the outcome of the case. Even assuming that the social costs accompanying business failure should be spread over a broad base, the judicial system is particularly ill-equipped to make the types of judgments required to distribute losses in a way that bears any resemblance to rational policy.

The Bankruptcy Code[10] (the "Code") provides two alternatives for distressed businesses. Chapter 7 of the Code provides a judicially supervised liquidation of the business assets, with the proceeds going to its investors. Chapter 11 provides a reorganization mechanism under which the business may continue operating while restructuring the investor claims against its assets. After these claims are adjusted to reflect the value of the business as an ongoing entity, the business emerges from bankruptcy protection to begin life anew.

Over the past several years, dissatisfaction with the Chapter 11 process has grown in both the academic community and the popular press. As a result of repeated calls for bankruptcy reform, on October 22, 1994, President Clinton signed the Bankruptcy Reform Act of 1994.[11] Among its provisions is one for the creation of a commission to study bankruptcy laws.[12] The last such commission was formed in the early 1970s and led to wholesale changes in the bankruptcy process. In his statement upon signing the 1994 Act, President Clinton charged the commission with a review of the broad policy implications of the bankruptcy process—including the effect of

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7. *See, e.g.*, Richard B. McKenzie, *The Case for Plant Closings*, *in* PLANT CLOSINGS: PUBLIC OR PRIVATE CHOICES 205 (Richard B. McKenzie ed., 1984) (analyzing the National Employment Priorities Act of 1979).

8. *See, e.g.*, Robert B. Reich, *Bailout: A Comparative Study in Law and Industrial Structure*, 2 YALE J. ON REG. 163, 191-97 (1985) (tracing congressional debate over the United States' loan guarantee for the Chrysler Corporation).

9. *See* 131 CONG. REC. 8812 (1985) (statement of Martin Lipton).

10. 11 U.S.C. §§ 101-1330 (1994).

11. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994).

12. *Id.* §§ 601-10, 108 Stat. at 4147-50.

the process on individual communities.[13] In addition, the National Economic Council is conducting a study of bankruptcy laws, including an analysis of the effects of increasing the representation of the "public interest."[14] Adding to the pressure for far-reaching change of the bankruptcy laws is the fact that dissatisfaction with the process comes at a time when the country (or at least the executive branch) seems particularly reform-minded.[15]

Most bankruptcy reform proposals respond to claims that the Chapter 11 process is an inefficient means of debt collection. Commentators advocating changes in the process generally see bankruptcy as a device intended solely to maximize the economic value of the estate for the benefit of its creditors. Under this narrowly tailored economic approach, Chapter 11 is believed to fare poorly in comparison to various market-oriented solutions.

A growing number of commentators have observed that this economic approach to bankruptcy analysis fails to address the very real concerns facing those who have come to depend on the continued existence of the business. While employees, communities, and other business dependents may not have traditional claims, the failure of businesses nevertheless implicates their interests. Thus, an analysis of the reorganization process that excludes the interests of these constituencies is too narrow. On this view reorganization can only be understood as a broadly inclusive mechanism of social policy intended to distribute the social costs of business failure.

This debate is implicated in what is perhaps the most significant issue addressed by the bankruptcy process—whether the assets of the failed business should continue to be used in their pre-bankruptcy configuration or liquidated in whole or in part. Chapter 11 is premised on the notion that keeping the assets together will result in an increase in value over that obtainable in a liquidation. Rarely will this answer to the asset deployment issue be so clear cut, however. Some businesses fail simply because they are obsolete or operate in

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13. 30 WEEKLY COMP. PRES. DOC. 2129 (Oct. 22, 1994).

14. DAILY REP. FOR EXEC. (BNA) Jan. 17, 1994 (statement of Secretary of Transportation Pena).

15. In the words of one commentator:

> [T]he Clintonites are indeed focused—*on everything.* They are policy omnivores. From rural-electrification non-recourse loans to the perks of Federal Home Loan Bank Board Examiners, from the depreciated value of a privately owned photocopier to the proper cost of a hysterectomy, nothing in American life is exempt from the expert hand of Harvard technocracy.

Andrew Ferguson, *Invasion of the Policy Wonks*, WASHINGTONIAN, Aug. 1993, at 34, 37.

industries suffering from overcapacity. Others fail because of purely financial problems, such as excessive debt service or managerial failure. Those asking asset deployment questions must consider the possibility that the failure was caused by fundamental problems that cannot be remedied. Even assuming that some aspects of the business are viable, the inquiry must further consider the liquidation of parts of the business.

Such asset deployment questions involve a wide range of assumptions regarding future and counter-factual data. Decisionmakers must consider not only the causes of the financial disaster and the likelihood that remedial measures will reverse the problems, but must also consider the economic value of a range of options, including liquidation. Even in hindsight, it will often be unclear whether the option chosen was the best among the wide range available. Thus, in a world of uncertainty, particular asset deployment decisions cannot be characterized as "correct" or "maximizing." It makes sense to discuss asset deployment issues only in terms of the process through which such decisions are made.

This process-oriented view of asset deployment issues gives substance to the debate over the appropriate role of the reorganization process. To the extent the Chapter 11 process is intended to serve the interests of investors in the failed enterprise, the process through which asset deployment decisions are made should locate decision-making power in the hands of those holding incentives to maximize economic value. Investors who stand to gain or lose from a particular decision are more likely to find and pursue the asset maximizing strategy than is a decisionmaker, such as a judge, who has no assets at stake in the outcome.

If this group of investors believes that the best course of action is to attempt a reorganization, there will be little tension between the investors and the non-investor[16] constituencies. If, on the other hand, the investors choose liquidation, their desires will conflict

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16. The use of the term non-investor is a matter of convenience to denote those groups without a non-bankruptcy "right to payment." *See* 11 U.S.C. § 101(5)(A) (1994) (defining "claim" broadly as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured"). Of course, employees may be investors in the sense that they have rights to payment under employment contracts or based on other legal rights. Likewise, communities affected by the bankruptcy of a firm may have rights to payment. This Article does not question the rights of these groups as investors. Instead the question raised here is whether the bankruptcy process should grant these groups rights based on something besides their "investor" status.

directly with the non-investors who stand to lose jobs, taxes, customers and sources of supply. If the bankruptcy system is designed to serve the interests of investors, this process approach dictates that the company should be liquidated. If, however, bankruptcy is intended to serve some broader constituency, decisionmaking authority might be relocated to a decisionmaker who is more likely to delay the liquidation option.

Such delay works to the advantage of non-investors because they stand to gain from the prolonged operation of the enterprise but bear none of its costs. The delay imposes costs on the investors because they are forced to continue an investment in which they see little hope of success. In this sense, and against a backdrop of contractual rules that provide investors a right to determine the fate of the firm, bankruptcy protection for non-investors might be fairly characterized as fulfilling some redistributive policy.

Most economic theorists dismiss the desirability of a redistributive reorganization process with little more than a passing reference. For the most part, proposals for reform of the bankruptcy laws have started from the perspective that bankruptcy exists only to provide a collection mechanism for creditors. The failing of this view is not that it comes out in the wrong place, but rather that its advocates have done little to respond to those urging a broader view of bankruptcy's role.

A response is not only possible but necessary. The establishment of a review commission presents an opportunity for a wide-ranging review of the bankruptcy process that could lead to a substantial change in the way we view its goals. An approach to bankruptcy that focuses on the social problems accompanying financial failure requires that we consider the institutional capabilities of the system. For the most part, the bankruptcy debate has revolved around the issue of the trade-off between allocative efficiency and broader goals of equity and justice. What has been missing from the debate is an analysis of the system's ability to determine who ultimately bears the cost of redistributive policies.

This Article examines the problem of determining the incidence of redistributive cost in the bankruptcy system. The claim here is not that the bankruptcy process is an administratively expensive method of pursuing redistributive policies. Neither does this Article claim that such policies create intolerable social costs by introducing allocative inefficiencies into the free market economy. Instead, the focus here is on the practical problem of fitting means to ends. Concluding that non-investors should be afforded some relief from the most devastating effects of financial failure is only the beginning of the inquiry. A rational bankruptcy policy must ensure both that such relief goes to those in need and that its costs are not borne by those least able to pay. This Article demonstrates that the bankruptcy process specifically and the judicial process generally are poorly designed to render informed and rational judgments on these questions.

Section I sets the stage by examining the academic debate over the appropriate function of bankruptcy law, illustrating the inadequacy of the economic theorists' response to the concerns raised by commentators seeking an expanded role for the process. Section II analyzes the method through which Chapter 11 of the Code attempts to fulfill redistributive policies and demonstrates the ways in which the structure of the process is ill-suited to meeting those goals. Section III explores the normative goals underlying calls for a redistributive bankruptcy policy and demonstrates the importance of understanding who will bear the cost of the redistributive policies. Section IV examines the information problems that are likely to accompany bankruptcy redistributions and that bear on the question of cost spreading identified in Section III. Finally, Section V examines the structure of the bankruptcy judicial process and the difficulties its judges will encounter in attempting to redistribute the costs of business failure.

I. BANKRUPTCY THEORY AND THE INCLUSION OF NON-INVESTOR INTERESTS

Over the past several years, dissatisfaction with the Chapter 11 reorganization process has increased, resulting in a number of proposals for its reform or repeal.[17] Contemporary bankruptcy commentary, while diverse, can be divided roughly into two camps.

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17. *See, e.g.*, Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992) [hereinafter Adler, *Risk Allocation*]; Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) [hereinafter Adler, *Financial and Political Theories*]; Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J. LAW, ECON. & ORG. 523 (1992); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986) [hereinafter Baird, *Uneasy Case*]; Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992) [hereinafter Rasmussen, *Debtor's Choice*]; Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983); David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994).

One group of commentators sees bankruptcy as a device narrowly designed to maximize creditor returns[18] while another group sees the process as an opportunity to address the vast range of social problems caused by business failure.[19] This section examines the debate surrounding the role of Chapter 11 in addressing social problems.

By far the most influential approach to bankruptcy law has been the creditors' bargain model developed by Baird and Jackson.[20] In the creditors' bargain model, Baird and Jackson view bankruptcy against the backdrop of non-bankruptcy debt collection rules, justifying the process by a perceived need to overcome the collective action problems inherent in state law systems.[21] In Baird and Jackson's account, creditors of financially troubled firms, if left to their own devices, would engage in a destructive race under non-bankruptcy collection law that would result in the piecemeal liquidation of the business.[22] Bankruptcy's automatic stay stops the

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18. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 5 (1986) [hereinafter JACKSON, LOGIC AND LIMITS]; Adler, *Risk Allocation*, *supra* note 17, at 53; Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 101-03 (1984) [hereinafter Baird & Jackson, *Adequate Protection*]; Bradley & Rosenzweig, *supra* note 17, at 1045; Rasmussen, *Debtor's Choice*, *supra* note 17, at 53.

19. *See* David Gray Carlson, *Bankruptcy Theory and the Creditors' Bargain*, 61 U. CIN. L. REV. 453, 475-78 (1992) [hereinafter Carlson, *Bankruptcy Theory*]; Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994); Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541, 545-47 (1993) [hereinafter Korobkin, *Contractarianism*]; Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 766-68 (1991) [hereinafter Korobkin, *Jurisprudence*]; Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 352-60 (1993) [hereinafter Warren, *Imperfect World*]; Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 785-89 (1987) [hereinafter Warren, *Bankruptcy Policy*].

20. The creditors' bargain model has spawned a vast amount of literature. The contours of the argument can be gleaned from JACKSON, LOGIC AND LIMITS, *supra* note 18; Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987) [hereinafter Baird, *Loss Distribution*]; Baird, *Uneasy Case*, *supra* note 17; Baird and Jackson, *Adequate Protection*, *supra* note 18; Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

21. Baird, *Loss Distribution*, *supra* note 20, at 827; Baird, *Uneasy Case*, *supra* note 17, at 128-33; Baird & Jackson, *Adequate Protection*, *supra* note 18, at 100-01. Adler and Picker question whether the collective action problems that justify bankruptcy's interference with contract could not be solved through the market. Adler, *Financial and Political Theories*, *supra* note 17, at 319-23; Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 647 (1992).

22. Baird, *Uneasy Case*, *supra* note 17, at 133; Jackson, *supra* note 20, at 862, 864.

race and allows for coordinated, value-maximizing collection among the investors in the enterprise.[23]

The core of the creditors' bargain model is its reliance on the rhetoric of hypothetical contract and transaction costs to explain the need for a legal, as opposed to a market, regime to resolve the questions posed by business failure. The bankruptcy regime is written into all debt contracts as a consequence of federal bankruptcy law. Baird and Jackson justify this imposition by pointing to the impossibility of contracting among the diverse parties interested in the debtor.[24] In this manner, the creditors' bargain model attempts to vindicate bankruptcy's interference with non-bankruptcy debt collection rights.

From this theoretical starting point, the model justifies only a fairly minimalist bankruptcy regime. Under the model, bankruptcy exists solely as a collection device benefiting those holding claims legally cognizable under non-bankruptcy law.[25] Bankruptcy's encroachment on non-bankruptcy collection rights is closely circumscribed to include only those limitations necessary to avoid the collective action problems inherent in the non-bankruptcy debt collection process. Thus, relative priorities must be preserved so far as practicable, and bankruptcy should not result in redistributions of entitlements.[26]

Working from this emphasis on bankruptcy's debt collection aspects, many commentators have questioned whether the creditors' bargain model can justify the existence of the reorganization provisions of Chapter 11. The model posits market failure as a justification for bankruptcy. But while market failure may require some form of collective proceeding—such as that provided by Chapter

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23. The creditors' bargain model also provides a monitoring cost justification for bankruptcy's automatic stay and pro rata distribution scheme. Under a non-bankruptcy race collection scheme, each creditor would have an incentive to expend resources monitoring the debtor and preparing for the race. Since the race would go to the swiftest, each creditor would have an incentive to expend resources developing expertise in collection. Such expenditures are lessened in a system that assures each creditor of a pro rata distribution upon financial failure. *See, e.g.*, Jackson, *supra* note 20, at 863.

24. *See, e.g.*, *id.* at 866-67. Rasmussen argues that nothing about bankruptcy requires that it be conceived as a mandatory regime. Potential debt and equity holders could bargain with a corporation over the range of bankruptcy remedies the corporation could seek. The articles of incorporation provide a vehicle through which such agreements could be effected. Thus, under Rasmussen's regime, bankruptcy would operate as a default rule. Rasmussen, *Debtor's Choice*, *supra* note 17, at 55-68.

25. *See, e.g.*, Baird & Jackson, *Adequate Protection*, *supra* note 18, at 103.

26. Jackson, *supra* note 20, at 860.

7 of the Code—it is possible that markets themselves could respond to the concerns addressed by Chapter 11.

Chapter 11 provides a legal framework designed to address the asset deployment and distributional questions raised by financial failure.[27] While liquidation and distribution of the cash generated by liquidation are possible responses to the deployment and distribution questions, the general thrust of Chapter 11 is that the business may have a higher value in the hands of its pre-bankruptcy claimants.[28] Thus, Chapter 11 is premised on the desirability of keeping the assets of the business intact and distributing new debt and equity claims in the business to the pre-bankruptcy claimants. This view of the process leads many analysts to analogize Chapter 11 to a sale of the business to its pre-bankruptcy creditors.[29]

The question raised by this description of the reorganization process is whether Chapter 11's mandatory allocation of negotiating leverage and its default rules requiring judicial valuation of the business are necessitated by a market failure. Put differently, are there any real impediments to market-based solutions to the deployment and distributional aspects of financial failure? Several market-based solutions have been proposed. The simplest is to require a market auction of the assets of the bankrupt business, thus completely bypassing the negotiation structure of Chapter 11.[30] In a somewhat more complicated proposal, Bebchuk has suggested an option framework under which participants would be granted the right to purchase a package of reorganization securities for a strike price

27. *See* Christopher W. Frost, *Running the Asylum: Governance Problems in Bankruptcy Reorganizations*, 34 ARIZ. L. REV. 89, 91-94 (1992).

28. *See* H.R. REP. NO. 595, 95th Cong., 2d Sess. 220 (1977) ("The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap."), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179. This premise is also illustrated by the requirement that a Chapter 11 plan of reorganization provide creditors at least as much as they would have received in a liquidation under Chapter 7 of the Code. *See* 11 U.S.C. § 1129(a)(7) (1994).

29. *E.g.*, JACKSON, LOGIC AND LIMITS, *supra* note 18, at 210-13; Baird, *Uneasy Case*, *supra* note 17, at 127.

30. *See* Baird, *Uneasy Case*, *supra* note 17, at 136. Markell proposes that the debtor's exclusive right to file a plan be terminated upon the debtor's filing of a "new value" plan. This termination would reduce entry fees for non-owner bids and enable the parties to conduct an auction-like process. Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 117-19 (1991).

More recently, Baird has expressed some reservations about the effectiveness of auctions in all cases. Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633, 647-52 (1993).

equal to a pro rata share of the claims senior to the option holder.[31] Other commentators, such as Adler, have taken the more radical approach of advocating repeal of Chapter 11 in its entirety, arguing that capital markets can provide an *ex ante* solution to the collective action problems posited by the creditors' bargain model.[32]

What links all of these reform proposals is that they share creditor wealth maximization as a common criterion for a well-functioning bankruptcy regime.[33] To justify the existing bankruptcy regime under an economic analysis, one must show how the process leads to better and cheaper asset deployment decisions than does the market. Most commentators advocating repeal or radical change of Chapter 11 rely on a generalized belief that the process is not well-suited to maximizing the creditors' returns.[34] Still others defend the process as satisfying the creditor wealth-maximization criterion in ways that markets cannot.[35]

While the debate rages over whether the existing bankruptcy process satisfies the criterion of creditor wealth maximization, a small but growing group of commentators are questioning the criterion itself.[36] This group points to the displacement that accompanies

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31. Bebchuk, *supra* note 17, at 785-88; *see also* Aghion et al., *supra* note 17, at 532-36 (proposing a procedure similar to Bebchuk's involving solicitation of bids for the post-bankruptcy firm).

32. Adler, *Financial and Political Theories*, *supra* note 17, at 323-33 (advocating what he calls "chameleon equity"); Adler, *Risk Allocation*, *supra* note 17, at 489.

33. *See* Adler, *Risk Allocation*, *supra* note 17, at 463-79 (noting that reallocation imposes substantial efficiency costs); Aghion et al., *supra* note 17, at 525-26 (stating that the role of bankruptcy is to centralize a firm's dismantling for the collective good of its creditors); Baird, *Uneasy Case*, *supra* note 17, at 127-28 (stating that bankruptcy avoids a destructive race by individual creditors for their respective claims); Bebchuk, *supra* note 17, at 776 (noting that reorganization is desirable where going concern value is worth more than assets sold piecemeal); Markell, *supra* note 30, at 70 (noting that reorganization is premised on creditors' rights taking priority over equity interests).

34. *See* Adler, *Risk Allocation*, *supra* note 17, at 484-89; Bebchuk, *supra* note 17, at 780; Roe, *supra* note 17, at 601.

35. *See* Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 414-17 (1990); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 757-58 (1993) [hereinafter LoPucki & Whitford, *Corporate Governance*]; 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, 127-31 (1990) [hereinafter LoPucki & Whitford, *Bargaining Over Equity's Share*]; David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 503-09.

36. Warren, for example, offers a view of bankruptcy that calls attention to other distributional issues of the regime. Warren, *Bankruptcy Policy*, *supra* note 19, at 811-14; *see also* Warren, *Imperfect World*, *supra* note 19, at 356 (offering a normative justification for distributive policies). Korobkin argues that the varied dimensions of bankruptcy law

many bankruptcies and asks why a rational bankruptcy system cannot take account of these interests. Financial failure may affect the interests of employees, suppliers, communities, and others in ways that cannot be captured by the creditor wealth-maximization model. As a normative proposition, these commentators ask, why shouldn't the bankruptcy system consider all interests affected by financial failure?[37]

The attack is on two levels. First, critics of the economic approach assert that the bankruptcy system as currently constituted does not adhere to the strictures of the economic models. In support, they point to the history of bankruptcy legislation[38] and to several examples of bankruptcy's redistributive effects.[39] Second, critics attack the economic approach's lack of concern with noneconomic interests on a normative basis. Because corporate failure affects broader interests than the ownership claims given primacy in the economic models, the system that deals with this failure must take into account all of the competing interests and values affected. Otherwise, the critics assert, the model is without adequate normative underpinnings.[40]

Among all of the critics, Korobkin has best captured the essence of the debate over the appropriate role of corporate bankruptcy law. Korobkin's true problem with the economic account is that it

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show that its policies have evolved from more than just the economic account. Korobkin, *Jurisprudence*, *supra* note 19, at 732-39. Gross believes that the economic model is useful but limited as it reveals only "one important piece of data"—money. Gross, *supra* note 19, at 1039. Carlson sees the creditors' bargain model as having "pure rhetorical appeal" which "cannot coherently account for the bankruptcy gain." Carlson, *Bankruptcy Theory*, *supra* note 19, at 460, 478 (1992). Ponoroff and Knippenberg argue that creditor wealth maximization is not the sole purpose of bankruptcy, but rather that it is premised on an "ever-shifting basis upon which bankruptcy courts must act to sort out and order a broad spectrum of interests clamoring for protection in the bankruptcy proceeding." Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 966 (1991).

37. Carlson, *Bankruptcy Theory*, *supra* note 19, at 475-78; Donald R. Korobkin, *Value and Rationality in Bankruptcy Decisionmaking*, 33 WM. & MARY L. REV. 333, 341 (1992) [hereinafter Korobkin, *Bankruptcy Decisionmaking*]; Warren, *Bankruptcy Policy*, *supra* note 19, at 787-88.

38. David Gray Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341, 1389 (1987); Korobkin, *Jurisprudence*, *supra* note 19, at 746-51.

39. *See* Warren, *Bankruptcy Policy*, *supra* note 19, at 785-93; *see also* Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 178-90 (1989) (outlining possible redistributive motivations in bankruptcy).

40. Carlson, *Bankruptcy Theory*, *supra* note 19, at 477-78; Korobkin, *Bankruptcy Decisionmaking*, *supra* note 37, at 335.

"misidentifies the problem to which bankruptcy law uniquely responds."[41] In contrast to the economic theorists' focus on the debt collection aspects of the process, Korobkin sees bankruptcy as a response to myriad problems associated with financial distress—a "competition of diverse human values that are fundamentally incommensurable"[42]—providing a forum in which economic as well as non-economic aims may be pursued.[43] An important aspect of his theory is his broad conception of the corporation. He writes that a view of bankruptcy that identifies a corporation as a pool of assets "overlooks an essential aspect: a corporation is also an enterprise; it has personality."[44] He notes that a corporation, unlike property, "has potential;" he then goes on to ascribe personal attributes to the corporation—seeing it as a moral, political and social actor.[45]

From this perspective, Korobkin views the bankruptcy process as a response to the problems that financial distress poses to the corporation in all of its aspects.[46] Having liberated the corporation from characterization as a pool of assets, Korobkin is free to bring rehabilitative values into the equation. No longer is it relevant simply to examine how the pool should be used and ownership interests divided among the capital investors. Instead, a larger rehabilitative discourse emerges from the bankruptcy process.[47] Participants in this discourse include not only those economically interested in the outcome but also a broader group affected by the operations of the corporation.[48]

In what may be the strongest normative stand against the creditors' bargain model, David Gray Carlson attacks the model's lack of inclusiveness with moralistic rhetoric. He sees the model as a license for the debtor to "pillage the estate[s] of . . . non-

41. Korobkin, *Jurisprudence*, *supra* note 19, at 721.

42. *Id.* at 765.

43. *Id.* at 768-80. In a later piece, Korobkin provides some specifics regarding the ways in which such interests may be considered. Korobkin, *Contractarianism*, *supra* note 19, at 572-75.

44. Korobkin, *Jurisprudence*, *supra* note 19, at 745.

45. *Id.*

46. *Id.* at 768-72.

47. *Id.* at 772-74.

48. Korobkin's value-based account for bankruptcy includes labor and management demands for compensation, creditors' demands for payment, shareholders' demands for return on their investment, and government demands for taxes, along with other public and community interests. *Id.* at 762-63.

creditor[s],"[49] and states that the model would justify robbing a liquor store if it would maximize returns.[50] Carlson believes this vice undermines both the utilitarian and libertarian underpinnings of the model.[51]

Taking a much more limited stand against the narrow focus of the economic account of bankruptcy law, Warren has criticized the approach on both positive and normative grounds.[52] She views bankruptcy as incorporating loss distribution norms.[53] In describing the bankruptcy scheme, Warren sees a "dirty, complex, elastic, interconnected"[54] process in which losses are distributed according to criteria beyond those set out in credit contracts as they might be enforced under non-bankruptcy law.[55] From a normative perspective, Warren simply illustrates that a significant problem with the creditors' bargain model is that while attempting to eschew all discussion of distributional consequences, the model itself offers a distributional scheme—non-bankruptcy collection law—without inquiring into that scheme's appropriateness.[56]

While the recommendations of the critics of the economic approach to bankruptcy analysis are as diverse as those of the economic analysts themselves, the idea of inclusion seems to provide a unifying thread. According to the critics, by limiting the purpose of

49. Carlson, *Bankruptcy Theory*, *supra* note 19, at 476. Carlson elaborates:

> Exile from the bargain allows the bargainers to prey on the excluded outsider. In this model the exiled person is erased and dehumanized. For instance, the simple creditors' bargain is quite consistent with the premise that bankruptcy law should permit the debtor to pillage the estate of a noncreditor. Since creditors in the bargain are not altruistic and are concerned only with maximizing their collections, justifying such crimes is something the creditors' bargain could encompass.

Id. (footnote omitted).

50. *Id.*

51. *Id.* at 477-78.

52. Warren, *Bankruptcy Policy*, *supra* note 19, at 777; Warren, *Imperfect World*, *supra* note 19, at 373-77.

53. Warren, *Bankruptcy Policy*, *supra* note 19, at 777 ("I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing—and sometimes conflicting—values in this distribution." (footnote omitted)).

54. *Id.* at 811.

55. *Id.* at 790-93.

56. *See id.* at 789-90. Warren does not go so far as to approve of a bankruptcy system that results in the vindication of community interests. Warren, *Imperfect World*, *supra* note 19, at 356 n.47. In a similar vein, Carlson objects that the creditors' bargain is unable to justify accepting state collection law as the natural baseline against which creditors bargain. Carlson, *Bankruptcy Theory*, *supra* note 19, at 461.

bankruptcy to providing a collective means of collecting debt, economic theorists have excluded from the debate the possibility that bankruptcy may be an institution designed to resolve a wide range of problems. They see the economic approach as limiting the participation of communities and employees even though the process directly implicates their interests. From the descriptive perspective presented by Warren, the economic theory fails to account for those aspects of bankruptcy law that protect those interests. From the normative perspective presented most clearly by Korobkin, the approach fails to consider all of the interests worthy of protection.

Advocates of the creditor wealth-maximization criterion seek to justify their exclusion of non-investor interests by pointing to the need to avoid forum-shopping problems in the bankruptcy process.[57] In their view, displacement of employees and communities dependent on a business is an unfortunate result of business failure that occurs whether a company fails inside of bankruptcy or out.[58] Redistributive rules will simply create incentives to use, or avoid, the bankruptcy process for reasons having nothing to do with whether the company is facing a collective action problem. Since bankruptcy is a costly device designed to avoid the specific problem of the common pool, incentives that cause over- or under-utilization of the process are to be condemned.[59]

While the forum-shopping analytic is attractive, it alone is an inadequate response to the normative criticisms of the economic approach to bankruptcy. Economic theorists begin by asserting that the bankruptcy process is intended only to address collective action problems at the lowest possible cost and then proceed to condemn all incentives that stand in the way. As Korobkin has observed:

> The economic account is like the stereotypical ugly American abroad. "The Eiffel Tower," he complains, "is

57. *See* Baird, *Loss Distribution*, *supra* note 20, at 818; *id.* at 828 ("Allowing priorities outside of bankruptcy but not inside is an open invitation to forum shopping . . . .").

58. According to Rasmussen:

> It is one thing to express compassion for displaced workers, retirees who are left with real bills but worthless promises, or communities struggling with a disappearing industrial base. . . . Realizing that many companies that fail never file a bankruptcy petition, the societal effect of system-wide business failures seems not to be a *bankruptcy* concern. Put simply, all of the problems associated with corporate failure are not necessarily bankruptcy problems.

Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319, 324 (1991). In other words, it is not bankruptcy's mission to be the only regime in which a failing business can honor claims of those who have little or no claim to its assets.

59. *See* Baird, *Loss Distribution*, *supra* note 20, at 824-28.

> not tall enough to be the Empire State Building and not expensive enough to be the Trump Tower." His response to anything foreign is to understand it in his own terms and to evaluate it according to his own standards.[60]

The basic problem with the forum-shopping analytic is that it begs the question of the appropriate role of the bankruptcy process. The analytic begins from the perspective that bankruptcy exists as a device to maximize economic returns to investors; it does not justify such a view. Its reasoning is circular: Bankruptcy protection for non-economic interests is undesirable because forum-shopping problems will increase the cost of protecting economic interests; therefore, bankruptcy should focus only on the protection of economic interests.[61] Thus, the forum-shopping analytic is normatively satisfying only when one sees bankruptcy in its limited terms.[62]

In essence, participants in the bankruptcy debate are speaking past one another.[63] Advocates of the economic approach seem to be primarily concerned about preserving allocative efficiency.[64] Maximizing creditor wealth translates directly into maximizing asset values. Maximizing asset values, in turn, satisfies the general allocative efficiency mandate that assets be put to their highest and best use.

Most of the critics of the economic approach would agree that market norms and allocative efficiency are important,[65] but would

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60. Korobkin, *Jurisprudence*, *supra* note 19, at 740.

61. According to Korobkin, "[T]he creditors' bargain model suffers from the same disability as the economic model itself: its explanation is limited by the economic account's vision of bankruptcy law as a mechanism for achieving superior economic returns." *Id.* at 737.

62. One may more charitably view the argument by focusing on the fact that bankruptcy simply provides an optional avenue of enforcement. If non-bankruptcy collection law does not provide substantive protection for the interests of non-investors, crafting that protection under bankruptcy law may simply result in its non-use. *See* Baird, *Loss Distribution*, *supra* note 20, at 829-30. Thus, limiting protection of such interests to the bankruptcy arena will reduce the effectiveness of that protection. One obvious response to this argument is that it asserts that less-than-complete protection is worse than no protection. A broader objection is that the argument assumes that bankruptcy must remain optional—the true reason for bankruptcy's optional character lies principally with the cost argument taken up here.

63. One recent exception appears in Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1 (1994) [hereinafter Rasmussen, *Social Justice*], in which Rasmussen attempts to meet, head on, arguments based on redistributive norms.

64. Adler provides an expansive analysis of all of the potential costs of the reorganization process. *See* Adler, *Risk Allocation*, *supra* note 17, at 456-76.

65. *See, e.g.*, Korobkin, *Contractarianism*, *supra* note 19, at 595.

disagree that allocative efficiency is the only goal of a bankruptcy regime.[66] These commentators speak in redistributive terms. Concern for the individual or community harmed by the strict enforcement of contract is their touchstone, yet they often fail to meet the concerns of the economic theorists by addressing the specific ways in which they believe that the bankruptcy system might be well suited to protecting the interests of those groups. Economic analysts, of course, speak in economic terms. Their primary concern lies in the preservation of market norms as a means of increasing aggregate wealth (taken by the economic theorists as the best measure of well-being). Yet, at least in the area of bankruptcy scholarship, they often fail to respond directly to the claim that bankruptcy may provide an avenue for achieving distributional goals—even at a cost of some allocative inefficiency.

A justification for limiting bankruptcy law to the enforcement of investor claims is possible. Treating bankruptcy as a broadly inclusive device intended to protect the interests of investors and non-investors alike requires close scrutiny of the capabilities of the process to achieve those goals. It is not enough simply to point to problems in need of resolution. We must further assess the fit between our normative goals and the institutions designed to achieve them. As this Article will demonstrate, bankruptcy in particular and the judicial process generally are poorly designed to achieve redistributive goals. While this institutional capability argument has been made by several economic theorists, including Baird and Jackson themselves,[67] the concern has been inadequately developed in favor of the forum-shopping argument. But there is more to the institutional capability argument than has been heretofore made. Rather than being an adjunct to the forum-shopping concerns that dominate the economic analysis, the argument deserves elevation to an independent justification for an investor-focused bankruptcy regime.

II. NON-INVESTOR PROTECTION UNDER CHAPTER 11

One of the primary grounds for criticism of the creditor wealth-maximization criterion is that it is not an accurate description of the current bankruptcy system.[68] The bankruptcy process departs from

66. *See* Warren, *Imperfect World*, *supra* note 19, at 340.

67. Baird & Jackson, *Adequate Protection*, *supra* note 18, at 101-02.

68. *See, e.g.*, Jackson & Scott, *supra* note 39, at 163 ("[T]he simple maximization perspective treats as indistinguishable—and equally undesirable—the various distributional effects that are unambiguously present in bankruptcy."); Korobkin, *Jurisprudence*, *supra*

non-bankruptcy priorities in ways that cannot be justified under the economic criterion.[69] Thus, critics argue, bankruptcy can only be explained fully in terms that include loss allocation and the protection of non-investor interests as a fundamental policy.[70]

While the jury is still out on the empirical question of whether the reorganization provisions of the Code are an efficient means of maximizing creditor wealth,[71] it is becoming increasingly difficult to understand Chapter 11 in such narrow terms. Creditor wealth maximization does not necessarily require a reorganization process that incorporates delay and thorny valuation problems. There is little reason to believe that a market-based solution to the asset deployment questions raised by failure would not serve the ends of creditor wealth maximization more effectively than does the current process.[72]

If Chapter 11 cannot be understood on the basis of creditor wealth maximization, perhaps it can be explained on the basis that it provides some protection for various non-investor interests by distributing the losses occasioned by business failure among all affected groups.[73] The bankruptcy process distributes the losses from

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note 19, at 739 ("[I]f the essence of bankruptcy is simply to maximize economic outcomes, why did bankruptcy law emerge as a system with the varied contours and dimensions that it has?").

69. *See, e.g.*, Korobkin, *Jurisprudence, supra* note 19, at 739.

70. *See id.* at 788-89; Warren, *Bankruptcy Policy, supra* note 19, at 813.

71. In their highly publicized empirical study of the effects of Chapter 11 on returns to bondholders, Bradley and Rosenzweig concluded that the process has failed to provide an efficient means of maximizing creditor returns. Bradley & Rosenzweig, *supra* note 17, at 1049. Their study has been roundly criticized, principally on methodological grounds. *See* Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669 (1993) [hereinafter Korobkin, *Unwarranted Case*]; Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992) [hereinafter Warren, *Untenable Case for Repeal*].

72. *See supra* notes 27-32 and accompanying text.

73. In addition to their substantial methodological objections to the Bradley and Rosenzweig study, both Warren and Korobkin criticize the study for failing to take into account other goals of the reorganization process. Warren notes that redistributional goals may provide a justification for slight inefficiencies in the process. Warren, *Untenable Case for Repeal, supra* note 71, at 467-77. Korobkin criticizes Bradley and Rosenzweig for failing to develop their claim that maximizing firm value is consistent with protecting the interests of non-investor constituencies. Korobkin, *Unwarranted Case, supra* note 71, at 728-34.

Gross criticizes Bradley and Rosenzweig solely on the basis of their failure to consider the goal of protecting community interests in the Chapter 11 process. Gross, *supra* note 19, at 1035-36.

failure in two ways. First, the Code includes a small number of explicit departures from the general principle of equality of distribution. As one example, section 507(a) provides a limited priority for particular claims[74] in order to protect certain classes of vulnerable claimants.[75] A second and more substantial shift in non-bankruptcy entitlements is the redistributive effect of the reorganization provisions of Chapter 11 of the Code. The delays inherent in the process may result in substantial redistributions from the creditors of the business to equity holders, managers and the employees and communities dependent on the business. One way of justifying such delays may be that by allowing delays the process will serve to protect the interests of non-investors by providing the business with every opportunity to weather the storm.[76] This policy of indirect loss allocation is well represented in the legislative history surrounding the enactment of the Bankruptcy Code.[77]

In some cases, however, reorganization policy need not raise redistributive concerns. Part of the justification for Chapter 11 is that, in a successful reorganization, everyone can win.[78] The investors in the business enjoy the going-concern value preserved by the avoidance of a piecemeal liquidation, and the non-investor constituencies benefit from the continuation of a business that provides employment, pays taxes and contributes to the general well-being of the community in many other ways.[79]

Of course, if every reorganization resulted in the realization of positive going-concern value, the justification would prove dispositive. No one could possibly object to a process that provided creditors with an enhanced recovery and saved jobs to boot. The problem with this justification is that it says nothing about the cases in which there will be winners and losers. In cases involving businesses that ultimately prove impossible to reorganize, an attempt at reorganization may

74. 11 U.S.C. § 507(a)(3) (1994) (providing wage priority to the extent of $4,000); *id.* § 507(a)(4) (providing priority for pension plan contributions); *id.* § 507(a)(5) (according grain producers and fishermen priorities); *id.* § 507(a)(6) (providing priority for consumer deposits).

75. Warren, *Imperfect World, supra* note 19, at 352-53.

76. *Id.* at 354-56.

77. For an analysis of the legislative history, see *id.* at 355 n.45.

78. The legislative history of the Bankruptcy Code states, "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." *See* H.R. REP. NO. 595, *supra* note 28, at 220, *reprinted in* 1978 U.S.C.C.A.N. at 6179.

79. Warren, *Imperfect World, supra* note 19, at 354-56.

prove costly to the creditors of the business who have watched good money chase bad. In these cases, those operating within the process must address redistributive issues.

The uncertainty surrounding the business prospects of the debtor complicates such issues. Investors of varying priorities will likely diverge in their assessment of the proper course of action. Relatively senior creditors may seek the immediate liquidation of the business, while junior claimants and equity holders are more likely to attempt to prolong the reorganization effort. Investors and managers may act strategically to influence asset deployment decisions in an effort to achieve some distributional advantage. Somewhere within the complex web of negotiations designed to resolve these conflicts lie the understated redistributive policies of Chapter 11. This section examines the redistributive function of Chapter 11 in an effort to illustrate the indirect way in which it operates and the haphazard way in which non-investor protection is provided.

A. *Chapter 11 as a Protective Device for Non-Investor Interests*

Chapter 11 provides a forum and impetus for negotiations intended to address the asset deployment and financial restructuring issues facing participants in a failed corporation.[80] First, some decision must be made regarding the appropriate deployment of the business assets. Is the business fundamentally sound or is it no longer economically viable? Put differently, can the assets best be used in their present configuration or are they best liquidated piecemeal?[81] Second, the ownership interests in the assets must be reconfigured. If the business is of insufficient value to satisfy all of the claims

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80. *See* Frost, *supra* note 27, at 91-101; LoPucki & Whitford, *Corporate Governance*, *supra* note 35, at 678-80. The negotiations center on the development of a plan of reorganization that sets forth the resolution of both the asset deployment and financial restructuring questions. *See generally* 11 U.S.C. § 1123 (1994) (setting out the required and optional contents of a plan of reorganization).

81. Chapter 11 is premised on the idea that the value of a business is maximized by keeping the assets together rather than liquidating the assets on a piecemeal basis. *See supra* note 28 and accompanying text. The process provides several opportunities to test the presumption. For example, § 1129(a)(7) requires that a plan of reorganization provide each claimant with at least as much as that claimant would receive in a Chapter 7 liquidation before the plan may be confirmed. 11 U.S.C. § 1129(a)(7) (1994). Not only does such a requirement provide a minimum level of protection for the priority of each claimant, but it also attempts to ensure that the corporation has positive going-concern value.

against it, the claims must be revised to reflect the value of the business.[82]

Maximizing the economic value of the estate for the benefit of the creditors as a group requires that each decision be viewed separately. The value-maximizing deployment of assets exists independently of the distributional question.[83] A business that makes an obsolete product will continue to do so no matter how the claims against its assets are distributed. Thus the process should limit the ability of parties to manipulate the deployment decision in an effort to obtain some distributional advantage.[84] In addition, a value-maximizing bankruptcy regime would ensure that the individual or group in control of the deployment decision hold the residual claim to the assets of the business.[85] That is, decisionmakers should stand either to gain or lose depending on the success or failure of the approach chosen. Since deployment decisions involve uncertainty, such decisions cannot be characterized as "correct" *ex ante*. Instead of a quest to find the correct decision, the best the process can hope for is to locate decisionmaking authority in the group interested in the outcome of the decision. Only this group holds the correct set of incentives to make value-maximizing decisions.

In concept, Chapter 11 fulfills these two requirements of value maximization. Through its voting structure, the process allows those economically interested in the business to make determinations

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82. Through its classification and impairment provisions, Chapter 11 allows the renegotiation of the capital structure of the business to reflect the value of the reorganized entity. *See* 11 U.S.C. § 1123(a) (1994) (requiring that the plan of reorganization specify the treatment of any class of claims or interests that is impaired under the plan). As to the general structure of the Chapter 11 reorganization process, see Kenneth Klee, *All You Ever Wanted to Know about Cram Down Under the New Bankruptcy Code,* 53 AM. BANKR. L.J. 133 (1979) [hereinafter Klee, *Cram Down I*]; Kenneth Klee, *Cram Down II,* 64 AM. BANKR. L.J. 229 (1990).

83. This assertion is a relatively straightforward application of the Modigliani-Miller theorem that a firm's capital structure does not affect overall firm value. Franco Modigliani & Merton G. Miller, *The Cost of Capital, Corporate Finance and the Theory of Investment,* 48 AM. ECON. REV. 261 (1958).

84. *See, e.g.,* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule,* 55 U. CHI. L. REV. 738, 787 (1988) ("Bankruptcy law should ensure that fights about who owns a firm's assets should not undercut efforts to use them in the most beneficial way possible.").

85. *See* Frost, *supra* note 27, at 135-38. This tenet of value maximization has long been a staple of financial economic literature. *See, e.g.,* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 68 (1991) ("As the residual claimants, shareholders have the appropriate incentives . . . to make discretionary decisions.").

regarding the appropriate deployment of assets.[86] By setting out default distributional rules, Chapter 11 also provides limits on the ability of parties to manipulate the deployment decision to their distributional advantage.[87]

In practice, however, Chapter 11 may depart substantially from the requirements of value maximization. One widely noted example is the failure of the process to compensate under-secured creditors for the delay in enforcing their non-bankruptcy right to foreclose on the property securing their claims.[88] As Baird and Jackson have illustrated, this failure provides junior claimants an opportunity to avoid the cost of delay as they attempt to prolong the inevitable death of the business.[89] In terms of the asset deployment decisionmaking process outlined above, the failure to pay interest separates those in control of the decision (managers and junior claimants) from the group bearing the cost of an incorrect decision (the under-secured creditor). The result of such a separation is likely to be a protracted reorganization.

The manipulation of asset deployment decisions not only results in a reshuffling of entitlements among investors of different classes, but it also may provide incidental protection of various non-investor constituencies. To illustrate, imagine a Chapter 11 debtor corporation that operates a manufacturing facility in a community that is completely dependent on the plant. The community's dependence is manifested in several ways. Most directly, many of its residents work at the plant. In addition, a number of businesses in the community supply the plant with raw materials and ancillary services such as office cleaning and refuse collection. Other businesses such as banks, restaurants and auto repair shops serve the employees of the plant. Finally, the community relies on the taxes paid directly by the plant and by the direct and indirect dependents of the plant.

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86. The Code allows only a claimant or equity interest holder to accept or reject a plan of reorganization. 11 U.S.C. § 1126(a) (1994).

87. In the absence of a negotiated solution to the financial restructuring question, the Code applies a rule of absolute priority to the distribution. 11 U.S.C. § 1129(b) (1994). The absolute priority rule requires each class of claimants to be paid in full in cash or in reorganization securities prior to the retention or receipt of any property by junior claimants. For a general discussion of the absolute priority rule, see Klee, *Cram Down I*, *supra* note 82, at 140-46.

88. In United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 382 (1988), the Supreme Court held that under-secured creditors (those creditors with claims in excess of the value of the property securing them) were not entitled to receive monthly payments for the use value of their collateral.

89. Baird & Jackson, *Adequate Protection*, *supra* note 18, at 129.

The manufacturing plant produces vacuum switches for the automotive industry. As automotive technology has progressed, vacuum switches have been increasingly replaced by electronic switches produced by other manufacturers. Revenues therefore have declined substantially and, immediately prior to filing the petition, the company's managers foresaw that the company soon would be out of cash. In the month preceding the bankruptcy, management wisely refused to make a quarterly interest and sinking fund payment on the company's substantial public debt. Protected by the automatic stay,[90] the business will be able to operate for at least a year, using operating revenues supplemented by this hoard of cash.

During the exclusivity period,[91] management desperately worked to develop a business plan that would allow the business to survive. Management's plan required a modest retooling of the plant that would allow it to produce vacuum testing devices that could be sold to the auto repair industry. In a motion to extend the exclusivity period,[92] management presented the outlines of the business plan to the bankruptcy court. Several large holders of public debt argued against the extension of exclusivity and sought to convert the case to Chapter 7.[93]

These creditors' argument revolved around their assertion that the market for automotive testing equipment is dominated by a few large, well-known, companies, and that entry into the market would use up the remaining cash. They further argued that even if the business could enter the market successfully, the same technological innovations that destroyed the market for switches would ultimately eliminate the need for testing equipment. While the immediate liquidation of the business would result in substantial losses to all

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90. Section 362 of the Code imposes a stay against collection activities upon commencement of the bankruptcy case. 11 U.S.C. § 362(a) (1994).

91. The debtor retains the exclusive right to propose a plan of reorganization for 180 days after the order for relief. *Id.* § 1121(b).

92. One of the most important factors regarding the length of the bankruptcy process is the debtor's ability to retain control of the plan process. The Code provides that the court may extend, or reduce, the period of exclusivity. *Id.* § 1121(e). Motions for extensions of exclusivity are common, particularly in large, complex reorganizations. *See* LoPucki & Whitford, *Corporate Governance*, *supra* note 35, at 716-19 (providing statistics on extensions of exclusivity for 43 large bankruptcy cases).

93. The Code allows parties in interest to move for the dismissal of a Chapter 11 case or its conversion to Chapter 7 for cause. 11 U.S.C. § 1112(b) (1994). Cause includes such factors as continuing losses, *id.* § 1112(b)(1), inability to effectuate a plan, *id.* § 1112(b)(2), and unreasonable delay that is prejudicial to creditors, *id.* § 1112(b)(3).

concerned, the losses resulting from such a liquidation would be less than the losses likely under management's plan.

This situation clearly presents the conflict between the desires of the community and those of the creditors of the failing business. To the extent that the judge is concerned only with maximizing the value of the estate from the perspective of the creditors, she need only determine which group of investors holds the residual claim to the assets of the business. By isolating this group, the judge can determine who will be called upon to put assets at risk in the decision to retool the plant.[94] These claimants hold the correct set of economic incentives to make the decision that will maximize the value of the estate. Assuming that under no circumstances is it likely that the business will have a value adequate to pay the public bondholders in full, the judge should consider the wishes of these creditors and liquidate the business. They among all investors stand to gain or lose from the success or failure of the retooling investment.[95]

If, on the other hand, the bankruptcy judge considers the interests of the community and other dependents on the plant, the

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94. In the words of the Seventh Circuit Court of Appeals:

> [S]elf interest concentrates the mind, and people who must back their beliefs with their purses are more likely to assess . . . value . . . accurately than are people who simply seek to make an argument. Astute investors survive in competition; those who do not understand the value of assets are pushed aside. There is no similar process of natural selection among expert witnesses and bankruptcy judges.

In re Central Ice Cream Co., 836 F.2d 1068, 1072-73 n.3 (7th Cir. 1987).

95. *See* Frost, *supra* note 27, at 135-38.

In practice, it will be difficult to isolate the group that holds the residual claim. Finding that group requires that we know the value of the business, yet finding the value of the business involves the same problems presented in determining the correct asset deployment. Value is contingent on expected return and risk—the same variables at issue in the question of asset deployment. This difficulty does not mean that the judge must abandon the use of financial economic principles in guiding her decision, however. In many cases it will be possible to determine who does not hold the residual claim, even if is not possible to determine precisely who does. In the example presented here, it may be possible to establish that, even in a best-case scenario, the company will remain insolvent. If that is the case, the court should discount any argument put forth by equity holders because they are not backing their investment with assets. *See* Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625 (1991) (proposing a procedure to exclude equity holders from participation in the case if it is clear that the debtor is insolvent and will remain so for the duration of the case); David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 500 (1992) (suggesting that, while it is difficult to determine who all of the residual owners are, it is unlikely that shareholders occupy this position). Similarly, in many cases, the court may discount the decision of senior lenders who are likely to be paid in full even in the worst case scenario. Frost, *supra* note 27, at 135-38.

outcome of the issue is far from clear. The judge may determine that the interests of the community in keeping the business operating outweigh the interests of the creditors in liquidating the business. Alternatively, the judge may believe that the business is too far gone to save and see little reason to prolong the agony.

While the Code does not explicitly grant the judge the authority to consider the interests of the community in making her decision,[96] there may be an implicit presumption operating in favor of giving the company a chance to reorganize. The Code places few limits on the judge's discretion to extend exclusivity.[97] Providing the corporation a chance to reorganize against the wishes of the residual claimants is perhaps the only method through which the bankruptcy process can effect a sharing of losses between those residual claimants and others.[98]

It is no answer to say that the retooling stands a chance of succeeding and that in such a case the creditors will benefit from a higher recovery than an immediate liquidation would provide. From the perspective of the creditors, while it is true that the project does have some chance of succeeding, it also has a chance of failure—that is, it has risk. Presumably, the creditors have made an evaluation of the project's risk and return and have determined that the net present value of the project is negative. Unless creditors systematically undervalue investments, forcing such investments will result in an increase in creditor losses from financial failure.

B. Non-Investor Protection and the Bankruptcy Governance Structure

The decisions that most concern everyone in a Chapter 11 case usually revolve around a single conflict: the interests of relatively senior claimants on the estate versus the interests of those junior to

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96. In contrast, § 1165 requires that the court consider the public interest in applying particular sections of Chapter 11 that relate solely to railroad reorganizations. *See* 11 U.S.C. § 1165 (1994).

97. For example, the Code places no outside restriction on the length of time a debtor may remain in Chapter 11. Also, until recently, decisions to extend exclusivity were considered interlocutory and, therefore, nonappealable. *See, e.g.,* First Am. Bank of N.Y. v. Century Glove, Inc., 64 B.R. 958, 961-62 (Bankr. D. Del. 1986). The Bankruptcy Reform Act of 1994 amended 28 U.S.C. § 158(a) to make orders extending or shortening the exclusivity period immediately appealable. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 102, 108 Stat. 4106, 4108 (1994).

98. The point here is not that bankruptcy judges routinely make such implicit loss allocations. Instead, the foregoing analysis supports only the observation that the bankruptcy process is capable of performing its loss allocation function only indirectly—through asset deployment decisions.

them. In most Chapter 11 cases, creditor and equity interests are likely to diverge significantly.[99] Equity owners, understanding that the liquidation of an insolvent firm will reveal their lack of economic interest in the business, are likely to opt for reorganization at all costs.[100] On the other hand, creditors who will likely be paid in full—even on the liquidation of the business—have little incentive to continue their relationship with the firm in bankruptcy.[101] These creditors likely would opt for liquidation regardless of the soundness of the business. Not only will senior and junior claimants clash regarding such fundamental issues as the contents of the plan of reorganization, but they may also find that many subsidiary issues implicate the broader reorganization/liquidation conflict.[102] The Code places the management of the business at the center of this conflict through the concept of the debtor in possession[103] and through its provisions granting the debtor the exclusive right to propose a plan of reorganization.[104]

Chapter 11 provides a structure for negotiation of the issues raised by the liquidation/reorganization conflict. The negotiations take place against a backdrop of three different types of rules. The first type includes rules that provide a representational structure.[105]

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99. *See* LoPucki & Whitford, *Corporate Governance*, *supra* note 35, at 683-87.

100. *See id.* at 685 ("The holders of underwater claims and interests often have reason to oppose liquidation until the distributions to them under a reorganization plan have been fixed."); *see also* Baird & Jackson, *Adequate Protection*, *supra* note 18, at 107 ("Members of any group of investors that would be eliminated by a present liquidation or sale of assets have nothing to lose by seeking a solution that avoids a final distribution today."); Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1496 (1993) ("Shareholders [of an insolvent firm] are highly motivated to overinvest in risky propositions and to underinvest in stable ones. Shareholders also are likely to delay liquidation, even if this strategy causes further loss to the firm.").

101. Because such claimants have fixed claims, they will not benefit from any potential increase in value resulting from the reorganization. In the event of catastrophe, however, such creditors may bear some of the losses. *See* Frost, *supra* note 27, at 130; *see also* Lin, *supra* note 100, at 1491 ("Unlike shareholders, creditors prefer management to risk as little as possible because they have little to gain if the risky ventures succeed and will suffer further loss if these projects fail.").

102. Frost, *supra* note 27, at 97-101.

103. Formally, the debtor in possession is the pre-bankruptcy entity. 11 U.S.C. §§ 101(13), 1101(1) (1994). Of course, in the case of a corporation, a grant of power to the debtor in possession is effectively a grant of power to the management of the bankrupt corporation. *See* LoPucki & Whitford, *Corporate Governance*, *supra* note 35, at 679-80.

104. *See supra* notes 91-92.

105. Section 1102 requires the appointment of a creditors' committee representing the interests of general unsecured creditors. 11 U.S.C. § 1102(a) (1994). Such a committee is necessary to overcome the collective action problems that would otherwise be faced by a

Another type provides standards for operating the business.[106] Finally, the Code provides default rules for the distribution of assets or claims against assets.[107] This backdrop of rules operates to provide each group of pre-bankruptcy investors negotiating leverage that roughly corresponds with its non-bankruptcy entitlements.[108]

Conventional bankruptcy analysis focuses on the clash of priorities of those holding debt and equity claims against the corporation to resolve the reorganization/liquidation dilemma. Where do non-investor interests fit within this carefully crafted negotiation structure? One answer is, everywhere generally but nowhere specifically. The Code provides a right to "part[ies] in interest" to raise and be heard on any issue in Chapter 11.[109] While "parties in interest" may be read broadly enough to include the interests of labor unions, the city in which the business is located and even individual

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large number of claimants, each holding a small claim. Without some representational structure, many individual creditors would lack the incentive to monitor managers or even engage in the negotiations over the plan. The size of their claims simply would not justify the time and expense involved.

106. The requirement of judicial approval of such transactions as debtor-in-possession financing and asset sales can be seen as an attempt to replace market and contractual controls on managerial behavior that exist outside of bankruptcy. *See* Frost, *supra* note 27, at 125-29.

107. The absolute priority rule and the best interest of the creditors test seek to ensure that managers and equity holders are unable to combine with senior creditors in an attempt to freeze out the interests of unsecured creditors. *See generally* Markell, *supra* note 30, at 74-90 (outlining the origins and status of the absolute priority rule).

108. Many of these Code provisions may be appropriately characterized as attempts to resolve the agency problems created by a separation of ownership from control in a situation in which ownership is uncertain. The multiple contractual defaults that characterize and provide impetus for the bankruptcy process create the uncertainty in ownership. Ownership is contingent on the value of the assets. If the corporation is solvent, shareholders may be characterized as owners. In the more likely event that the corporation has an insufficient value to pay its debts in full, some class of creditors should be the owners. The question of firm value, and therefore ownership, is the essence of the negotiations over the question of how interests in the corporation should be divided. While those negotiations proceed, the managers of the business may be called upon to serve multiple masters. *See, e.g.*, Edward S. Adams, *Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results*, 73 B.U. L. REV. 581, 603-05 (1993); Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1488 (1993); Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1, 36 (1989).

109. 11 U.S.C § 1109(b) (1994); *see also* FED. R. BANKR. PROC. 2018(a) (allowing the court to "permit any interested entity to intervene generally or with respect to any specified matter").

employees,[110] the Code nowhere grants these parties any substantive rights. Instead, the most important rights in a Chapter 11 proceeding—the right to vote on a plan of reorganization[111] and rights under the absolute priority rule[112]—are the exclusive province of debt and equity investors.

This is not to say that non-investor constituencies are without champions in the bankruptcy arena. But the representation of the community and the employees in the process turns on whether some group with substantive entitlements share their goals. Non-investor groups are likely to hold incentives that correspond with those of the investors who are unlikely to receive any distribution from the reorganization or liquidation of the business.[113] For both groups the liquidation of the business is the worst possible outcome.[114] This harsh reality, coupled with the fact that these groups do not put any capital at risk in the continuation of the business, creates an incentive to extend the reorganization in the hope that the business's prospects will improve dramatically.[115]

This method of indirect protection is incoherent at best. While non-investor interests may be represented by equity holders or managers, nothing requires such representation. Nearly two-thirds of the businesses filing a bankruptcy petition over the past three years have chosen to liquidate under Chapter 7.[116] Even in Chapter 11 nothing protects the interests of communities and employees once the managers and junior interests have abandoned the effort.

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110. *See In re* Public Serv. Co., 88 B.R. 546 (Bankr. D.N.H. 1988) (refusing to limit intervention under Rule 2018(a) and party in interest status under § 1109(b) to creditors or interest holders); *see also In re* Johns-Manville Corp., 36 B.R. 743, 754 (Bankr. S.D.N.Y. 1984) ("[T]he concept of 'party in interest' is an elastic and broad one designed to give a Court great latitude to insure fair representation of all constituencies impacted in any significant way by a Chapter 11 case.").

111. 11 U.S.C. § 1126 (1994).

112. *See supra* note 87.

113. In most bankruptcy cases, shareholders of the business will occupy this position. Assuming that the business is hopelessly insolvent, shareholders have little to lose in extending the reorganization as long as possible. *See* Frost, *supra* note 27, at 130.

114. *See supra* notes 83-95 and accompanying text.

115. Several commentators have also demonstrated that insolvency also creates an incentive to pursue high risk projects because those in control of the decisionmaking apparatus reap substantial gains from high risk projects but do not bear any significant risk of loss. *See* Baird, *Uneasy Case*, *supra* note 17, at 131-32; Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 732-39 (1993). Prolonging the reorganization process can be viewed as a high risk strategy when there is little likelihood of a successful reorganization.

116. *United States Bankruptcy Court Data*, THE BANKRUPTCY YEARBOOK AND ALMANAC (1992, 1993).

In addition, protection for non-investor interests is nonexistent in corporations that do not have significant credit capital. As Baird has illustrated, one possible means of opting out of the current bankruptcy regime is to eliminate significant debt from the capital structure of the business.[117] Placing all of the capital providers in the firm on the same priority level eliminates their ability to achieve gains through strategic behavior. Investors in a corporation funded purely through equity capital have the same incentives and, therefore, can be expected to choose the value-maximizing decision without regard for the interests of non-investor constituencies.

The fact that the bankruptcy system provides only incomplete protection to non-investor interests does not, standing alone, warrant an elimination of the protection that does exist. A little protection may be better than none at all. The problem instead lies in balancing the limited benefits of this method of protection against the cost of its benefits. Under the current regime, non-investors gain or lose protection without regard to the worth of their claims. Thus, the process is not designed to ensure that its benefits flow to those in need.

The bankruptcy system also fails to consider explicitly the cost of the indirect protection, not only on the creditors of the business, but also on constituencies far removed from a particular case. As will be illustrated in the remainder of this paper, non-investor protection in the bankruptcy process may have economy-wide effects that are poorly considered due to the indirect nature of the protection. Bankruptcy judges and lawyers speak in economic and legal terms rather than social terms. Under its current design, the reorganization process pushes social policy concerns into the background where they lurk unspoken. Facts essential to determining the social costs of failure find no means of expression. As a consequence, while it is possible that the process serves some broad social function, we cannot be sure of the level of such concern, its cost, or who bears that cost. As a matter of institutional design, the current bankruptcy regime seems ill-suited to undertake an analysis of the difficult policy choices implicated by distributive goals.

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117. Douglas G. Baird, *The Reorganization of Closely Held Firms and the "Opt Out" Problem*, 72 WASH. U. L.Q. 913, 913-14 (1994).

III. DISTRIBUTIVE JUSTIFICATIONS FOR A PROTECTIVE BANKRUPTCY REGIME

Of course, the fact that the existing bankruptcy process does not provide a coherent means of distributing the social costs of business failure does not provide a normative justification for excluding non-investor interests from its reach. It may simply point out the need for reform. It might be possible to craft a bankruptcy scheme that explicitly considers the costs and benefits of non-investor protection in particular cases. The railroad reorganization provisions of the Code[118] might provide some guidance. Section 1165 provides the statutory authorization lacking in non-rail cases by requiring the court to consider the interests of the public in applying several substantive provisions of the railroad reorganization sections.[119] The representational concerns discussed above are also alleviated in a rail case. Section 1164 provides regulatory authorities the right to appear and be heard in cases involving railroads.[120] Finally, section 1163 reduces the governance problems that might be encountered in a protective bankruptcy regime by requiring the appointment of a trustee in every railroad reorganization case.[121]

The observation that the specific managerial and representational difficulties involved in the protection of non-investor interests might be resolved places us at a crossroads. Should corporate bankruptcy reform take us in the direction of creating a broad, inclusive regime designed to balance all of the competing interests affected by business failure? Or should we instead limit the reorganization process so that it focuses solely on investor claims, and leave the alleviation of the hardship associated with business failure to other institutions?

The practical and normative dimensions of such questions are interwoven. What we should be looking for in choosing a direction is the fit between the practical capabilities of the process and the normative policies chosen. This section begins that exploration by analyzing the justifications underlying protective bankruptcy policies

118. 11 U.S.C. §§ 1161-74 (1994).

119. *Id.* § 1165. The judge must consider the public interest in applying sections relating to collective bargaining agreements, rejection of a lease of a rail line, abandonment of a line, determination of administrative expense priority, the contents and confirmation of a plan of reorganization, and the liquidation of the rail debtor.

120. 11 U.S.C. § 1164 (1994).

121. *Id.* § 1163. The appointment of a trustee at least provides a check against managers who might raise tenuous public interest concerns in order to perpetuate themselves in office.

in an attempt to distill the practical questions raised by those justifications.

A. *The Normative Dimension: Departures from Explicit Contracting Based on Distributive Aims*

The way in which we view Chapter 11's function depends in large part on our view of the baseline allocation of rights in the corporate enterprise. Discussions centering on such notions as wealth transfers or externalities are particularly unhelpful unless we have developed a firm sense of entitlements. If one starts from the perspective that contractual default gives creditors at least a contingent claim to the assets of the business, prolonging the reorganization in order to protect the interests of non-investors can be viewed as causing a wealth transfer from the creditors to the non-investors.[122] But if we view employees, communities, suppliers and other non-investors as having interests entitled to protection, the lack of such protection in bankruptcy could be characterized as creating a wealth transfer from these stakeholders to the creditors.

One method of addressing the problem of determining a baseline is by resort to the notions of efficiency that characterize market and contractual analysis. Standard economic analysis suggests that the baseline itself becomes less important when express contract is available to allocate gains and losses *ex ante*.[123] On one hand, if the bankruptcy process were designed to focus solely on investor interests, non-investor constituencies could bargain for protection against the losses caused by firm failure. Employees could bargain for severance pay devices. Communities could bargain for protection by conditioning tax abatements or the provision of services on the continued operation of the plant for a period of time sufficient to allow the community to recoup its investment.[124] The breach of such contrac-

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122. The creditors of the business are delayed in the enforcement of their rights, and the capital they would have realized from the exercise of those rights is placed at risk in a venture in which they would not otherwise be interested in investing.

123. The Coase Theorem suggests that in the absence of transaction costs parties will bargain to the most efficient allocation of rights regardless of the baseline rule. Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). According to this view, the desirability of a particular baseline turns on whether it minimizes transaction costs. *See infra* notes 127-32 and accompanying text.

124. States are beginning to require that companies agree to repay tax abatements and other economic incentives in the event of plant closure or other failure of the project to provide anticipated benefits. Susan Headden, *Dealing with Corporate Flight*, U.S. NEWS & WORLD REP., June 13, 1994, at 62; James B. Treece et al., *States Now Want a Money-Back Guarantee*, BUS. WK., Sept. 21, 1992, at 35-36.

tual protections would give rise to claims, in turn providing these stakeholders a direct voice in the bankruptcy process.

On the other hand, to the extent that the bankruptcy regime protects non-investors, providers of capital might have an incentive to counteract such protections through contractual devices. In theory at least, a broad, inclusive bankruptcy process could incorporate procedures through which non-investors might agree to forego the protections the process provides. Creditors could insist upon receiving waivers of protection as a condition of lending.[125] In a world without transaction costs, investors and non-investors alike would be indifferent to the baseline allocation of rights in the bankruptcy process.[126]

On this view, the choice of policy direction becomes a matter of determining which baseline minimizes transaction costs. Since bargaining to change baseline entitlements is costly, minimizing transaction costs generally requires that the baseline chosen comport with parties' *ex ante* desires in as many cases as possible.[127] This criterion seems to support an investor-focused bankruptcy regime. Employees and communities rarely bargain for a voice in the bankruptcy process even though the current regime protects their interests imperfectly, if at all. Therefore, if we assume that these constituencies' relationships with corporations are the product of freely exercised and informed choice,[128] we would likely conclude that an investor-focused view of bankruptcy most closely conforms to the desired risk allocation of all the parties.[129] The relative cost of

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125. *See* Rasmussen, *Debtor's Choice*, *supra* note 17, at 66-67 (advocating the use of a corporation's articles of incorporation as a contractual device through which a waiver of bankruptcy protections might be effected).

126. Of course, in a world truly without transaction costs, bankruptcy itself would not be necessary. Parties would negotiate complete contingent contracts providing for outcomes for each possible state of the world.

127. *See* EASTERBROOK & FISCHEL, *supra* note 85, at 15 ("[C]orporate law should contain the terms people would have negotiated, were the costs of negotiating at arm's length . . . sufficiently low.").

128. This assumption, of course, cannot hold. *See infra* notes 134-41 and accompanying text.

129. In analyzing corporate constituency statutes that provide protection to non-shareholder constituencies, Macey noted:

> Merely because non-shareholder constituencies decline to contract for the right to veto certain transactions does not mean that they are unable to do so. Rather, the absence of contractual protection for such non-shareholder constituencies may simply reflect the fact that such constituencies are unwilling to pay for such protection in the form of lower wages or lower interest rates on debt.

Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L.

bargaining around the alternative baselines also supports an investor-focused bankruptcy process. Under such a regime, communities and employees can negotiate for protection individually or collectively if they are willing to forego wages or other contractual provisions as a quid pro quo for such protection.

Under a bankruptcy regime that includes significant protection for non-investor interests, however, bargaining for an alternative baseline would be much more difficult. Free rider problems would infect the process of contracting around a stakeholder protective bankruptcy regime. Because the bankruptcy process provides protection only indirectly, through manipulation of the asset deployment decision,[130] opting out of the regime would require the acquiescence of all affected parties. Protection through this means is not particularized.[131] The retention of bankruptcy protection by one group of stakeholders would inure to the benefit of all such groups, even those who have waived the protection.

Consider the perspective of a lender under such a regime. Obtaining a waiver of bankruptcy protection from the borrower's labor union only ensures that the union will not assert its claim to protection. If non-unionized employees, the local community, consumer groups, suppliers or others affected by the potential closure of the business can press a claim for its continued operation, the lender will find that its treatment in bankruptcy remains unaffected by the labor union's waiver. Of course, since an incomplete waiver amounts to no waiver, the incomplete waiver will never occur. From the lender's perspective it would matter little whether most of the stakeholders had waived their right to protection in bankruptcy. Lenders would face losses of the same magnitude whether the liquidation was delayed for the benefit of a few non-investors or many. Therefore, any waiver would have to be unanimous.

The breadth of parties interested in the failure of a business would render such a unanimous waiver costly, if not impossible. Many of such claims for protection arise from reliance on the

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REV. 23, 36 (1991).

130. *See supra* notes 79-98 and accompanying text.

131. Protection through other means, such as the special priorities referred to *supra* note 74, is particularized. Individual beneficiaries of such protective rules could theoretically waive the protections individually. As such, a transaction cost analysis of such rules might augur in favor of their inclusion in the process, assuming that the protective priorities were cast as non-mandatory, off-the-rack rules. Currently, there is no method through which the beneficiaries of such protections can waive the benefit of the priorities *ex ante*.

continued existence of the business operation rather than through a formalized contractual relationship. Even assuming that the process would recognize a waiver of a claim to protection, problems would arise with respect to representation and compensation for such a waiver. These contracting difficulties would, to a large extent, render a regime that protects non-investor interests in the business mandatory rather than bargained.[132]

Free-rider problems might also affect the cost of bargaining around a creditor-focused bankruptcy regime, but the problem is likely to be less severe. To the extent that communities, employees and other non-investor constituencies bargain for a voice in the bankruptcy process, their exercise of that right might benefit nonparties to the bargain. For example, a small group of non-unionized employees might bargain for severance pay rights that would give that group a claim in the bankruptcy of the company. In return, the company would likely demand wage concessions or other favorable terms. The employees' exercise of their right to influence the asset deployment decision would provide benefits to other employees who also seek to avoid the closure of the business. These positive externalities would provide some limit on the willingness of all non-investors to bargain for such rights.

Notwithstanding such a free-rider problem, transaction costs should remain lower under an investor-focused bankruptcy regime for two reasons. First, the positive externalities only exist when the employees with the bargained-for claim choose to use that claim to advocate an investment decision that benefits them in their capacity as employees—that is, a decision to continue the operation of the plant. The employees may eliminate the free-rider problem by exercising their rights as creditors to participate in the bankruptcy distribution. In other words, by bargaining for severance pay, the employees buy two types of protection: the right to influence the asset deployment decision and the right to participate in bankruptcy distributions. Only the former carries free-rider problems.

Second, and perhaps more significantly, the free-rider problems associated with this type of bargaining may be reduced by the formation of bargaining coalitions. In many situations, small groups

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132. Rasmussen's intriguing proposal to allow corporations, in their articles of incorporation, to choose the type of bankruptcy regime that will govern their demise does not suffer from this defect. Under his model, the articles provide a contractual mechanism through which all of the parties can opt in or out of such a regime. Rasmussen, *Debtor's Choice*, *supra* note 17, at 66.

of employees would not find it in their interests to bargain for a substantial voice in the bankruptcy process. The cost of such a voice would be too high given the inability to particularize the protection. But all of the company's employees might find that their share of the cost is worth it to them, even considering that their assertion of the right may create some positive externalities. Thus the free-rider problem in this context can be expected to vary with the size of the bargaining group. In contrast, under the non-investor protective regime, any substantial reduction in free-rider problems will occur only when the bargaining coalition approaches unanimity.

Thus, efficiency concerns point in the direction of a bankruptcy regime that focuses solely on creditor wealth maximization. This baseline leaves non-investors the ability to bargain for protection individually or in groups, ensuring maximum flexibility in the structure of default risk relationships. The alternative would likely result in mandated protection of non-investor interests because contracting for a complete waiver of such protections would be prohibitively expensive.

Of course, this efficiency-oriented analysis implicates some fairly strong moral arguments. In the view of the strong defender of the market, the results of the efficiency inquiry might be taken as conclusive from a moral basis as well. Non-investors would have no cause to complain that the bankruptcy regime excludes their interests. Stakeholders have a choice whether to rely on the benefits the business brings them. Thus, their decision to rely (without the protection of express contract) brought benefits that compensated them for the displacement associated with the failure of the business. By the same token, creditors would have no morally based complaint that an inclusive bankruptcy policy works a wealth transfer from them to non-investors. Creditors lending in a legal environment that protects these interests will adjust their interest rate to compensate for the additional risk the system imposes upon them.[133]

One way of expressing this notion is through the rhetoric of choice. Goods are distributed throughout society on the basis of consumers' willingness to commit part of their wealth—including

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133. As one commentator has noted:

> [T]he anticipated frustration of contractual priority makes such priority less attractive to investors and deprives them of the full advantage of priority contracts. For example if a high priority creditor anticipated the possibility of making concessions in bankruptcy reorganization, it might expend resources to monitor a firm and protect its interest in anticipation of bankruptcy.

Adler, *Financial and Political Theories*, *supra* note 17, at 317.

individual endowments of skills—to the purchase of those goods. Insurance against financial catastrophe in the form of claims against the failed firm can be profitably analyzed as a type of good that employees and communities could buy.

That this approach is controversial is an understatement. Critics of the market system would note that markets can achieve distributive justice only if the initial allocation of goods and abilities that the market values is just.[134] The market vindicates only preferences backed by wealth. What counts as wealth is, in turn, determined by the market. Wealth in the view of the economists includes not only material wealth but also endowments of skill recognized to be of worth to others.[135] Therefore, if the initial distribution of wealth, including skills valued in the market, cannot be justified on moral grounds, allowing free transfer of wealth through the market might not result in a just outcome.[136]

Injustice in the initial distribution of wealth can be viewed as a direct answer to the rhetoric of choice. The poor in society do not possess the necessary wealth to make effective choices. This lack of "choice" undermines the legitimacy of the *ex ante* bargain by making us less sure that the non-investors have been adequately compensated for the risk of loss. Markets cannot work to distribute risk unless all of the participants are free to bargain. Freedom to bargain necessarily implies that each party can make credible threats, including a threat to leave the bargaining table. The community and employee may not have the wealth necessary to make their voices heard in the bargaining process. On this view, bankruptcy may be seen as an appropriate means of correcting this imbalance in bargaining power.[137]

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134. *See* JOHN RAWLS, A THEORY OF JUSTICE 310-15 (1971); *see also* ALLEN BUCHANAN, ETHICS, EFFICIENCY, AND THE MARKET 64-78 (1985) (criticizing on distributive grounds Nosick's moral case for the market); ARTHUR M. OKUN, EQUALITY AND EFFICIENCY: THE BIG TRADEOFF 65-87 (1975) (noting the disparities in wealth and income that remain unaddressed by the market); Anthony T. Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472, 475-97 (1980) (arguing that contract law must be used to achieve distributional goals if it is to be morally acceptable).

135. According to Rawls, "No one supposes that when someone's abilities are less in demand or have deteriorated ... his moral deservingness undergoes a similar shift." RAWLS, *supra* note 134, at 311.

136. Rawls further states, "The distributive shares that result [from a system that awards premiums based upon scarce natural talent] do not correlate with moral worth, since the initial endowment of natural assets and the contingencies of their growth and nurture in early life are arbitrary from a moral point of view." *Id.* at 311-12.

137. Korobkin, *Contractarianism, supra* note 19, at 558.

A related criticism of the market view is that individuals may not understand that their best interests require some protection against financial failure. Heuristic biases may

In the related context of plant closing decisions and corporate takeovers, distributive motives have led some commentators to advocate the imposition of a mandatory rule protecting the interests of non-investors. For example, Duncan Kennedy has advocated the imposition of a mandatory term in employment contracts that would require companies to convey idle assets to the union in trust for the workers.[138] Similarly, Joseph Singer has argued that legal protection of the reliance interest should be extended to the employee/employer relationship in the context of plant closings.[139] In the corporate takeover arena, several commentators have recommended expanding directors' duties to include a duty to consider the effect of substantial corporate changes on a variety of non-investor constituencies.[140]

A bankruptcy regime protective of the interests of non-investor constituencies would impose a redistributive device similar to that proposed by these commentators. Under such a regime, credit contracts would include a mandatory term alleviating the harshness of strict enforcement in the event of general financial failure. Such a term would create rights benefitting non-investors beyond those created by their contractual or tort-based relationship with the firm. Against an existing social and legal regime that grants primacy to the

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result in their systematic underestimation of risk, resulting in a failure to bargain for protection. Thus, paternalistic motivations may weigh in favor of protecting non-investors in the event of failure. Such protection would be justified even though the rule may result in the lowering of wages or the reduction of employment levels. *See* Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 624-31 (1982).

138. Kennedy, *supra* note 137, at 629-31.

139. Joseph Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611, 724-32 (1988). Both Kennedy and Singer were writing in response to the situation presented by United Steel Workers of Am. Local 1330 v. United States Steel Corp., 492 F. Supp. 1 (N.D. Ohio 1980), *aff'd*, 631 F.2d 1264 (6th Cir. 1980). In *United Steel Workers*, the steel workers union claimed an easement in the obsolete and unprofitable millworks at Youngstown and Mahoning Valley, Ohio. The basis for the claim was the local community's historical dependence on steel manufacturing and representations that, if the employees made the plants profitable, they would not close. The union sought an injunction against the closure of the plants or, in the alternative, an injunction requiring U.S. Steel to sell the plants to the plaintiffs. The court held that the union had no contract or property right to such relief. *Id.* at 11.

140. *See, e.g.*, John C. Coffee, Jr. *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 10-12 (1986); David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 265-67 (1991); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 584 (1992); Marleen A. O'Conner, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1194 (1991); Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 48-49 (1991).

notion of freedom of contract, such a mandatory term finds its justification in the desire to call off freedom of contract to serve distributional aims.[141]

B. *The Practical Dimension: Achieving Distributional Ends Through Bankruptcy Policy*

It is pointless to debate the desired ends of a legal institution without developing a sense of whether the institution under study is capable of achieving those ends. It is not my aim to make the definitive case for or against redistributive urgings. For purposes of this Article, we may assume that these goals are desirable. The importance of understanding the moral justifications for a redistributive bankruptcy policy lies principally in the practical questions such justifications generate.

A decision to redistribute entitlements through the bankruptcy process raises two principal concerns. Initially, because the redistributive policy is likely to result in allocational inefficiencies, the process must enable the decisionmaker to understand and control the level of redistribution.[142] Some businesses encounter financial difficulty simply because their products can no longer compete with alternative products. Keeping those businesses alive through a redistributive bankruptcy policy represents a social cost for the period of time during which the resources are kept from their most highly valued uses. Given imperfect information, any reorganization process will preserve corporations beyond their economic lifespan and will let die corporations that could be saved if only their financial troubles could be resolved. While both types of errors are undesirable, an

141. While most critics of the economic approach to bankruptcy policy espouse concerns grounded in distributive justice, *see supra* notes 36-56 and accompanying text, some of Carlson's rhetoric seems to speak the language of corrective justice, *see supra* notes 49-50 and accompanying text. Although this Article is not directly responsive to those who view corporate law as creating a license in the capitalist to exploit workers and communities, the institutional competence arguments presented *infra* notes 144-221 and accompanying text, apply with equal force. Asserting that the structure of bankruptcy law enables capital contributors to steal away the labors of loyal workers in a way that cries out for a rectification of the resulting moral imbalance says little about the institution's capability to accomplish such a correction. The fluidity of capital markets renders it unlikely that bankruptcy courts can achieve corrective justice by placing more of the costs on the capitalists. As demonstrated *infra* notes 144-72 and accompanying text, capital markets will simply pass much of the costs of the correction on to others.

142. Much of the economic scholarship seems to be principally concerned with this problem. *See* Adler, *Risk Allocation*, *supra* note 17, at 464-79 (providing an expansive analysis of the potential costs of a redistributive regime).

incorporation of redistributive goals in the bankruptcy system makes it more likely that the process will shore dying businesses beyond their efficient lives.[143] How much of this type of error we should tolerate depends on how strongly we embrace redistributive goals.

An equally serious problem raised by redistributive policies is defining the group that will ultimately bear the cost of the redistributions. Even if one concludes that some allocative efficiency can be sacrificed in the interest of a more just distribution of the costs of failure, a decision to depart from market-based risk allocations requires consideration of the incidence of redistributive cost. It is this problem that most clearly illustrates the inadequacies of the bankruptcy process.

How broadly or narrowly to spread the cost of an inclusive bankruptcy regime must, in the first instance, depend on the goals underlying its departure from contractual solutions. Without some means of determining who bears the cost of the protective provisions, satisfying the goals underlying the policy is a matter of happenstance. A bankruptcy policy intended to soak the wealthy capitalists in favor of the worker could have the disastrous effect of causing business closings (and their attendant dislocation) in wholly unrelated areas. We might, therefore, discover that the policy effects a transfer from worker to worker rather than from capitalist to worker.[144]

An analysis of distributional goals cannot end with moral arguments regarding the desirability of wealth redistributions. Once the desirability of such transfers is established, the analysis must consider whether the institution under study is capable of realizing such goals. As illustrated earlier, our current bankruptcy process is ill-suited to the task. The remainder of the Article demonstrates the inability of any judicial process to come to grips with the questions raised by bankruptcy redistributional policies.

IV. PROBLEMS IN DETERMINING THE INCIDENCE OF REDISTRIBUTIVE COST

Determining who would bear the cost of protecting non-investor interests in the bankruptcy process is likely to be an extremely complex, if not impossible, task. The cost of allocative inefficiency

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143. *See supra* notes 90-98 and accompanying text; *see also* Michelle J. White, *Does Chapter 11 Save Economically Inefficient Firms?*, 72 WASH. U. L.Q. 1319, 1339 (1994) (providing a game theoretic model that shows that the current design of the bankruptcy process is likely to result in the reorganization of economically inefficient firms).

144. *See* Rasmussen, *Social Justice*, *supra* note 63, at 39.

created by a redistributive bankruptcy system will be spread in at least two ways. First, the cost will be spread through increases in the cost of capital as investors adjust their required returns in response to the possible redistributions.[145] Second, some of the cost may be borne by industry competitors as the bankruptcy process maintains businesses in industries suffering from overcapacity.[146] The results of both types of loss spreading are difficult to predict.

Determining the incidence of redistributive cost raises complex theoretical and empirical problems that push and pull toward differing conclusions. We cannot pretend to have the necessary data even to begin the process of determining the economy-wide effects of the existing regime, much less to predict the ultimate consequences of a regime that more explicitly incorporates the interests of non-investor constituencies. It may be true that the allocational efficiency losses created by the protection of non-investor interests are spread across a broad base (and justified as a form of social insurance) or borne by the wealthiest members of society (and justified as a method of wealth redistribution). It may also be true that the cost of bankruptcy redistributive policies falls principally on those least able to bear the burden.

Of course, it is more likely that the answer lies somewhere in between, but without substantially more data, it is difficult to make strong claims regarding the incidence of redistributive cost. It is not, however, necessary to an institutional analysis that such strong claims be made. It is enough to illustrate the types of information problems the institution is likely to encounter in accomplishing redistributive goals. Accordingly, the following discussion is intended to illustrate some of the competing considerations involved in determining the incidence of redistributive cost.

A. *Redistributive Policies and the Cost of Capital*

If employees and communities have a recognizable interest in keeping the business operating, the cost of protecting that interest will be borne, in the first instance, by the capital providers of the business.[147] But we cannot simply assume that the cost of such a

145. *See infra* notes 147-64 and accompanying text (discussing this phenomenon).

146. *See infra* notes 165-71 and accompanying text.

147. In analyzing the protection afforded retirees by § 1114 of the Bankruptcy Code, Keating observed, "The fundamental flaw with § 1114 is that it attempts to create new wealth where none exists. Since bankruptcy is by nature a zero-sum game, the granting of new priorities to one class will necessarily reduce the return to other classes." Daniel

regime will stop there. Capital markets specialize in understanding and controlling risk. While the interjection of the community or public interest provides a new challenge to the capital providers by placing another risk into the equation, there is little reason to believe that the market could not price this risk.[148]

Capital markets' ability to price risk dramatically affects the analysis, however. Through pricing, the markets may distribute further the costs of non-investor protection. The introduction of the community and employee interests into the bankruptcy system will create a non-controllable risk in every investment contract: the risk that the investor will be forced to invest in negative net present value projects.[149] The introduction of this risk can be expected to increase the cost of capital as firms are unable to make credible commitments that capital may be withdrawn from the project.[150]

An increase in the cost of capital in turn will have an effect on firm decisions regarding either the price and output of its product or its demand and the price paid for its inputs. If firms face a demand curve for their products and a supply curve for all other factors of production that are not significantly altered by the protective term, the increase in cost can only result in some restriction in output coupled with a reduction in payments to other inputs. The firm faces a zero sum game with respect to its operations, and we cannot expect to eliminate the costs of producing goods and services by redistributing the risks of failure.[151]

Keating, *Bankruptcy Code § 1114: Congress' Empty Response to the Retiree Plight*, 67 AM. BANKR. L.J. 17, 47 (1993).

148. According to Warren, "Bankruptcy involves risk distribution among private parties. But the risk that a debtor will fail, and that loan collection will be accomplished through bankruptcy, is something that private parties can certainly price." Elizabeth Warren, *Why Have a Federal Bankruptcy System?*, 77 CORNELL L. REV. 1093, 1096 (1992).

149. As illustrated *supra* notes 79-98 and accompanying text, a bankruptcy regime that allows the judge to extend the reorganization for the benefit of non-investor constituencies effectively forces objecting creditors to invest in a project that they have determined to have a negative net present value. While it is an empirical question, no reason exists to believe that creditors systematically undervalue such investments. As Judge Easterbrook has explained, investors are subject to competition. Those who misvalue assets will not survive. *See In re* Central Ice Cream Co., 836 F.2d 1068, 1072 n.3 (7th Cir. 1987). Thus, the net effect of this forced investment therefore can be expected to increase the losses lenders will experience in bankruptcy cases.

150. *See* Daniel A. Farber and John H. Matheson, *Beyond Promissory Estoppel: The "Invisible Handshake,"* 52 U. CHI. L. REV. 903, 944 (1985) (criticizing Kennedy's analysis for ignoring this economic reality).

151. *See* Keating, *supra* note 147, at 47.

To those who are willing to tolerate some allocative inefficiency in furtherance of distributional goals, an increase in the cost of capital may not seem particularly troublesome.[152] Ideally a redistributive bankruptcy policy would result in the production of fewer (perhaps slightly fewer) toasters and televisions together with a slight increase in the price of such items. The economy may contract slightly, but if the cost of contraction would be borne across a wide sector of society, it might be a small price to pay for the benefit of more employee and community security.

The difficulty with this argument is that it assumes that the cost of employee and community protection will be spread across the broadest possible base. Broad redistribution of the cost of redistribution incorporates requirements that are unlikely to exist in practice. First, broad redistribution requires that capital providers remain ignorant of varying levels of risk across industry and geographic sectors. Second, the approach explicitly assumes that non-investor protection will have no significant impact on the supply and demand relationships governing factors of production other than capital. Finally, broad redistribution requires that none of the costs of *ex post* redistributions will be shifted to industry competitors. In practice none of these requirements are likely to be achieved.

B. Targeted Increases in Capital Costs

Assuming that the cost of bankruptcy redistributions will be spread across a broad base requires that one further assume that lenders will increase the cost of credit uniformly over all loans. Such an overall increase would increase the cost of producing goods and services somewhat uniformly and no one industry or geographic area would bear a disproportionate share of the burden. Of course, the credit market cannot be expected to remain blind to differing levels of risk among companies, industries and geographic areas. Lenders specialize in discerning differences in the relative risk of enterprises. Their ability to adjust the cost of credit to reflect the increased cost of failure may result in those companies located within industries that are in the worst financial situation bearing most of the cost of the redistributive policy.[153] Inasmuch as employees and communities

152. *See* Warren, *Imperfect World*, *supra* note 19, at 338 ("If the inquiry over bankruptcy policy becomes nothing more than a debate over allocative efficiency, it will pass over crucial elements of the policy scheme that cannot be so neatly tied up in economic models.").

153. *See* Rasmussen, *Social Justice*, *supra* note 63, at 20.

dependent on these industries are the intended beneficiaries of the policy, redistributive goals may not be achieved.

Consider such beleaguered industries as the steel or oil industries during the 1980s or the airline industry today. Redistributive bankruptcy policies would raise the risk of lending to companies in such industries and limit their ability to secure capital on a cost-effective basis. Because the long-range survival of these businesses may depend on the availability of capital for modernization and adaptation to changing preferences, the net effect of a redistributive term may be harmful to precisely those groups it is intended to benefit.

The reaction of lenders to an increase in the losses created by a redistributive bankruptcy policy might also affect a wide variety of risky enterprises. Start-up and high-tech businesses might find necessary funding unavailable or excessively costly. In short, a policy designed to protect workers and communities in one sector of the economy may simply redistribute wealth to those groups from the workers and communities who would have benefitted from a new business that failed from want of capital.[154]

Section 1110 of the Code[155] and the legislative history surrounding that section provide a case in point. Section 1110 requires that the trustee of an airline debtor cure defaults and agree to perform the obligations under certain leases of, or purchase money obligations for, aircraft and spare parts within sixty days of the initiation of a bankruptcy case. If the trustee fails to cure the defaults and make the required agreement within this time, the automatic stay is no longer applicable to the lender who is then free to foreclose on the equipment.[156] In this way, the provision relieves the aircraft lender from the burden of delay inherent in Chapter 11 by limiting the ability of others to keep those assets invested in what the lender believes to be an investment with negative net present value.

In the legislative history to the predecessor to section 1110,[157]

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154. *See* Baird & Jackson, *Adequate Protection*, *supra* note 18, at 102 ("Keeping a firm in one town from closing may have the indirect effect of keeping a new one in a different town from opening.").

155. 11 U.S.C. § 1110 (1994).

156. For a more detailed analysis of the operation of § 1110, see James W. Giddens & Sandor E. Schick, *Section 1110 of the Bankruptcy Code: Time for Refueling?*, 64 AM. BANKR. L. REV. 109 (1990); Sandor E. Schick, *When Airlines Crash: Section 1110 Revisited*, 48 BUS. LAW. 277 (1992).

157. Section 116(5) of the Bankruptcy Act provided that the right of lessors and conditional sellers of aircraft, engines, propellers, appliances, and spare parts to take

Congress made clear that the motivation for the provision was to ensure that airlines would have access to the capital needed to purchase new equipment.[158] Congress was concerned principally that small airlines were having difficulty attracting capital to expand and renovate their fleets and that such a provision benefitting equipment lenders would allow increased access to capital at a lower cost.[159] The airline industry supported the inclusion of section 1110 in the Bankruptcy Code,[160] and several airlines have appeared as amici curiae supporting a broad interpretation of the statute in litigation regarding the provision's reach.[161]

The positive reaction of the airline industry to provisions benefiting its lenders should give pause to advocates of a protective bankruptcy policy. Companies outside of bankruptcy may be harmed by a bankruptcy regime that enables managers of companies in bankruptcy to delay the process. Provisions limiting the ability of managers to use delay as a method of redistributing the losses resulting from financial failure may be necessary to reduce the cost of credit capital to a level that will ensure continued expansion and renovation.

C. Changes in Firm Demand for Non-Capital Inputs

A second factor affecting the breadth of redistribution is the effect redistributive bankruptcy policies may have on a firm's decisions regarding the mix of capital and labor. A redistributive approach to bankruptcy may reduce the firm's demand for inputs (such as labor) that carry the highest redistributive cost.[162] If the

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possession of the property would not be affected by the provisions of Chapter X of the Act. Pub. L. No. 85-295, 71 Stat. 617 (1957) (current version at 11 U.S.C. § 1110), *reprinted in* 1957 U.S.C.C.A.N. 681.

158. H.R. REP. NO. 944, 85th Cong., 1st Sess., pt. 1, at 2 (1957), *reprinted in* 1957 U.S.C.C.A.N. 1926-27.

159. *See id.*

160. *See* Letter from Leo Seybold, Vice President, Federal Affairs, Air Transport Association of America, to Honorable Dennis DeConcini (Nov. 29, 1977), *reprinted in Bankruptcy Reform Act of 1978: Hearings before the Subcommittee on Improvements in the Judicial Machinery of the Senate Committee on the Judiciary*, 95th Cong., 1st Sess. 933 (1978).

161. *See In re* Continental Airlines, Inc., 932 F.2d 282, 285 (3d Cir. 1991); *In re* Pan Am Corp., 125 B.R. 372 (Bankr. S.D.N.Y. 1991). Both the *Continental* and *Pan Am* litigation concerned the question of whether the protections afforded lenders under § 1110 extended to lenders involved in sale-leaseback transactions of aircraft. The airline amici took the position that such lenders should be protected by § 1110. *See Continental*, 932 F.2d at 285.

162. *See* McKenzie, *supra* note 7, at 217 ("[W]hen firms do invest in this country, they will, because of severance pay requirements, be inclined to substitute capital for labor.

interests of employees are to be valued in the bankruptcy process, it stands to reason that there would be some direct relationship between the number of employees and the amount of redistribution the process entails. To the extent that this relationship holds, firms with higher levels of employment may find their cost of capital increased disproportionately. This increase may create an incentive to substitute capital for labor in an effort to reduce the potential cost of failure to their lenders.[163]

Communities may face similar problems. To the extent that bankruptcy policy protects communities' interests in the continued operation of a plant, corporations may avoid close relationships with communities likely to develop a dependency on the business. Indeed firms may find that the increased cost of capital associated with community dependency is enough to tip the scale in favor of locating operations away from poorer areas.[164] Location in poor communities may increase the chance that a bankruptcy judge may limit the ability to close the plant. Like the situation facing the employees, the greater the dependency, the higher the value likely to be placed on community interest. Lenders perceiving this threat may choose to increase the cost of loans to businesses in such areas.

Thus, with respect to both employees and communities, the breadth of redistribution may be affected significantly by substitution of inputs that are less likely to tug at the heartstrings of the decision-maker. Surely an automated plant with 100 employees that is located in a wealthy suburb of New York presents a much less compelling case for loss redistribution than does a labor-intensive plant located in a poor community in the Rust Belt. Understanding this, bankers may adjust the cost of credit accordingly. Firms, in turn, may adjust

. . ."); Rasmussen, *Social Justice*, *supra* note 63, at 20 ("A bankruptcy redistribution to the least advantaged results in nothing more than a tax on those individuals who choose to deal with persons worse off than themselves.").

163. Because capital and labor are substitute inputs to production, one might argue that an increase in the cost of capital would result in an increased demand for labor. *See* RONALD G. EHRENBERG & ROBERT S. SMITH, MODERN LABOR ECONOMICS: THEORY AND PUBLIC POLICY 66-69 (2d ed. 1985). But to the extent that firms are better able to assure lenders that the redistributive effect of a bankruptcy is reduced in firms that are capital intensive, the effect may be an increase in capital. Thus the cost of redistributive bankruptcy policies may be more appropriately thought of as a cost of labor rather than a cost of capital.

164. *See* Jonathan R. Macey, *Externalities, Firm Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 198-99; Rasmussen, *Social Justice*, *supra* note 63, at 20, 27-31.

their location and mix of capital and labor in an effort to reduce their capital costs.

D. *Industry-Wide Effects of Redistributive Policies*

The effect of bankruptcy redistributive policies on the competitors of the business undergoing a reorganization may dramatically affect the breadth of redistribution. Forcing lenders to subsidize continued operations of businesses that, but for the subsidy, would cease operations artificially maintains the supply of the goods or services produced. Such allocative inefficiency not only will result in an increase in the cost of capital as lenders respond to the subsidy but, in individual cases, may result in damage to other corporations in the industry.

Again, the airline industry provides a useful example of how inclusive bankruptcy policies may result in redistributions that place the cost of non-investor protection onto other firms in the same industry. During the first three years of the 1990s the industry lost over $10 billion.[165] These losses occurred during a time when a number of large carriers (including Pan Am, TWA, and Eastern) were operating under Chapter 11. Several industry representatives have laid a portion of the blame for the industry's losses on the bankruptcy process.[166] Reports of one study state that $3 billion of the total industry losses can be linked to competition from Chapter 11 carriers.[167]

Claims of industry executives that the industry's woes are solely the result of the Chapter 11 process should, of course, be treated with some suspicion. After all, prompt liquidation of bankrupt carriers works to the advantage of carriers who manage to avoid bankruptcy. But even if it is difficult to make the case that Chapter 11 is entirely

165. Kenneth Labich, *What Will Save the U.S. Airlines*, FORTUNE, June 14, 1993, at 98.

166. " 'The industry's constant price wars have deprived it of the ability to balance costs and revenues . . . and it is the bankrupt and overleveraged airlines that are leading prices downward.' " *Airline Executives Wrangle Over Need to Overhaul Bankruptcy Rules*, 64 Antitrust & Trade Reg. Rep. (BNA) No. 1619, at 741-42 (June 17, 1993) (statement of Robert Crandall, Chairman of American Airlines). Crandall also alleged that "[t]he Chapter 11 carriers have initiated 55% of all fare reductions during the past 12 months." *Id.* at 742.

167. *See Viewpoint: 'Airline Bankruptcy Virus Must Be Stopped,'* AVIATION WK. & SPACE TECH., May 3, 1993, at 66 (quoting study by Aviation Forecasting & Economics); Stephen Solomon, *The Bully of the Skies Cries Uncle*, N.Y. TIMES, Sept. 5, 1993, § 6 (Magazine), at 13.

to blame for the airline industry's decline,[168] it is possible that the extension of time spent in Chapter 11 by bankrupt carriers artificially maintained capacity in an industry already plagued by excess seats.

More importantly, management of bankrupt businesses may have an incentive to engage in pricing strategies that would not be pursued by companies outside of bankruptcy. Once a company becomes insolvent, it is in the interest of its shareholders to undertake investments that have a remote likelihood of success but a high payoff.[169] Low pricing may be viewed as such an investment. Desperate to prolong the life of a dying company, shareholders might urge management to price the company's goods and services low enough to maintain the business in the short term—even if the cost is longer term operating losses. After all, since the alternative to operation is a liquidation in which the creditors will not be paid in full, the funding for such losses would come from the creditors.

This incentive raises a familiar problem in a new light. A redistributive bankruptcy provision causes asset deployment decisions such as pricing to be disconnected from the creditors whose capital is at risk in the decision.[170] If the bankruptcy process is made to protect a wide range of interests, creditors may find their voice to be less than effective. At least in the short term, industry competitors and their dependents may bear some of the cost of such protection as they are forced to match the pricing of the bankrupt business or lose customers.[171]

Targeted increases in the cost of credit capital, the substitution of inputs to the production process and the industry-wide effects of maintaining failing companies all render any broad distribution of the costs of non-investor protection unlikely. Further, these reactions to

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168. Several airline industry executives point to more general economic problems, such as the effect of the Gulf War and a failure to enforce the antitrust laws, as being the primary cause for the losses experienced by the industry. Labich, *supra* note 165, at 99. The Clinton Administration seems to have struck something of a middle ground. The administration has commissioned the National Economic Council to study the effects of limiting the exclusivity period for Chapter 11 companies while endorsing the provisions of Senate Bill 540 (the Senate version of what has now been enacted as the Bankruptcy Reform Act of 1994) that would limit the time that airlines have to decide whether to assume or reject terminals, gates, and related facility leases. DAILY REP. FOR EXECS. (BNA), at 1-2 (Jan. 7, 1994) (statement of Transportation Secretary Pena).

169. *See supra* notes 99-100, 114 and accompanying text.

170. *See supra* notes 88-89 and accompanying text.

171. Delta airlines estimated that it lost $700 million from 1988 through 1991 trying to match Eastern's low fares during Eastern's final years of operation. *See* Edward H. Phillips, *Congress Backs Reform of Airline Bankruptcy Law*, AVIATION WK. & SPACE TECH., May 30, 1994, at 58.

the protection of employee and community interests in the bankruptcy process may make it impossible to determine who bears the cost of the redistributive policy. The cost may be borne by the individuals and communities that the policy is intended to protect. Alternatively, the cost may fall disproportionately on employees and communities dependent on competitors or on the dependents of other risky businesses.

It is not nearly enough to say that the interests of employees and communities are deserving of protection—they may be. But moving from abstraction to practice requires much more than wishful thinking. It requires an understanding of the possible effects of the decision. This Article suggests only a few possible directions in which a bankruptcy regime designed to protect community and employee interests may take the rest of the economy. Doubtless there are many more factors that will influence the cost of capital in a world in which such non-investor interests are recognized.[172] One thing can be said with a high level of certainty, however. Predicting the effects of redistributive policies will be an extraordinarily inexact undertaking.

V. BANKRUPTCY REDISTRIBUTIONS AND THE LIMITS OF THE JUDICIAL PROCESS

Regardless of the strength of our commitment to achieving a just distribution of wealth in society, we must pay close attention to the abilities and limitations of the institutions chosen to reach such goals. The information problems accompanying bankruptcy redistributions present a practical obstacle to the realization of redistributive goals in the process. This section examines the institutional features of the bankruptcy judicial process that limit its ability to accomplish such redistributions in a rational way.

172. The increase in the cost of capital may be offset by other beneficial effects of the bankruptcy system. Gertner and Scharfstein have argued that Chapter 11's effect on efficiency is ambiguous. Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1209-15 (1991). In support of this proposition, they offer a theoretical model of bankruptcy that takes account of bankruptcy's effects on the problem of under-investment as well as over-investment. *Id.* at 1192-99.

The possibility of efficiency gains of the type posited by Gertner and Scharfstein does not, however, undermine the analysis here. Efficiency gains in particular cases turn on whether the firm in question would have inefficiently under- or over-invested outside of bankruptcy. *Id.* at 1192. In Gertner and Scharfstein's view, this question depends on the financial structure of the firm. It does not turn on the amount of redistribution to non-investors the system causes. Thus a redistributive bankruptcy scheme would likely ask the wrong questions to take advantage fully of potential efficiency gains.

Legal process theorists have long warned of the dangers inherent in the use of adjudication to achieve social policies.[173] Focusing on the nature of the judicial process and its limitations, these theorists attempt to articulate some division of power, principally between the courts and the legislature. Arguments for limitations on the use of judicial power to effect social change often focus on questions of legitimacy.[174] Federal judges do not answer to the will of the governed. Insulation from the prevailing political winds is a desirable attribute of the judicial process in fulfilling its traditional functions of adjudication of disputes and protection of the minority against the tyranny of the majority.[175] But once judges move across some (usually ill-defined) boundary into the realm of promoting social policy, their independence robs them of legitimacy.[176]

Questions of legitimacy do not loom large in the bankruptcy debate, however. As illustrated above, bankruptcy decisions are not expressly redistributive.[177] The fact-driven nature of the process is such that most of its redistributive character derives from the judges' attitudes in making close factual calls regarding asset deployment decisions.[178] Thus we cannot say with any certainty whether judges are going beyond the dictates of the Code to embrace broader social policies in ways that implicate legitimacy concerns. Of course, any lingering concerns over legitimacy could be directly addressed by legislative authorization to consider the interests of non-investors in making these close calls.

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173. *See, e.g.*, DONALD L. HOROWITZ, THE COURTS AND SOCIAL POLICY 298 (1977); GERALD N. ROSENBERG, THE HOLLOW HOPE: CAN COURTS BRING ABOUT SOCIAL CHANGE? 343 (1991); Lillian R. BeVier, *Judicial Restraint: An Argument from Institutional Design*, 17 HARV. J.L. & PUB. POL'Y 7, 10-12 (1994); Lino A. Graglia, *Do Judges Have a Policy-Making Role in the American System of Government?*, 17 HARV. J.L. & PUB. POL'Y 119, 124-27 (1994).

174. *See* BeVier, *supra* note 173, at 10; Graglia, *supra* note 173, at 124-30; David L. Shapiro, *Courts, Legislatures, and Paternalism*, 74 VA. L. REV. 519, 555-58 (1988).

175. Shapiro, *supra* note 174, at 555-56.

176. As one commentator opined:

> A problem with governmental power to enact "good" social policies without popular consent is that it necessarily includes the power to enact "bad" social policies without popular consent. Even more fundamentally, the essence of a system of government based on the consent of the governed is that the question of whether a social policy is "good" gets answered by the governed.

Graglia, *supra* note 173, at 124.

177. *See supra* notes 68-98 and accompanying text.

178. *See supra* notes 89-98 and accompanying text.

A. *Polycentric Problems and the Practical Limits of the Judicial Process*

Of more interest here are the insights of the legal process theorists who focus on the pragmatic capabilities of the process to effect social change. Fuller described problems such as those involved in spreading the social costs of financial failure as polycentric, involving many possible outcomes, each affecting different actors.[179] Like a spider's web, decisions regarding economic allocations involve many centers for distributing the tension caused by a single tug.[180] The web analogy is particularly apt in the corporate context. Modern financial theory describes the firm as the nexus for a complex web of contracts under which factors of production are amassed and risks and rewards are distributed.[181] A change in one of the contracts will have unpredictable effects in the way risks and returns are distributed throughout the enterprise. Complicating the problem further is the fact that the centers include risk/return relationships wholly unrelated to those in the failed enterprise. Bankruptcy decisions intended to protect the interests of a broad range of constituencies entail economy-wide effects that go beyond those concerning the participants in the particular enterprise.[182]

A number of limitations on the judicial process render it less capable than other institutions of responding to highly polycentric problems.[183] The judicial process is designed to elicit information regarding past acts or relationships.[184] It focuses on what has occurred between the parties before it rather than on what might occur in the future. This limitation is captured in the oft-noted distinction between legislative and adjudicative facts. Adjudicative facts are those that concern the immediate parties to the dispute,

179. Lon L. Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353, 394-404 (1978).

180. *Id.* at 395.

181. The seminal paper is Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

182. *See supra* notes 145-68 and accompanying text.

183. To be precise, Fuller's point was that "adjudication" (rather than the judicial process) is ill-suited to the resolution of polycentric problems. Fuller, *supra* note 179, at 393-405. The distinction is no cause for concern, however. Fuller defined "adjudication" as a process that allows affected parties to participate through presentation of proofs and reasoned argument. *Id.* at 363-65. Thus defined, the judicial process is a subset of Fuller's broader category of adjudication.

184. BeVier, *supra* note 173, at 11.

while legislative facts are those that form the basis for the creation of social policy.[185] Unlike adjudicative facts, legislative facts often turn on assumptions regarding future behavior that are difficult to ascertain—particularly given restrictive rules of evidence and procedure thought necessary for more traditional types of judicial functions.[186]

In addition to the problem of limited fact gathering capabilities, the judicial process suffers from other procedural and remedial limitations. Judicial decisionmaking focuses on resolving disputes regarding rights of parties before the court. One implication of this seemingly benign statement is the limit that such focus places on remedial possibilities. Framing issues as involving rights seems naturally to lead to outcomes that Shapiro has described as having an "on/off" quality.[187] Polycentric problems, on the other hand, typically have a wide range of possible solutions, each involving tradeoffs between competing values.[188] Another implication of the focus on "rights" is that it provides conceptual barriers to experimentation and monitoring of result by the judiciary. Having declared a right, courts are likely loath to institute oversight to determine whether granting the right was a good idea from a broad social perspective.[189]

The polycentric nature of social problems such as school funding,[190] police behavior,[191] prison reform,[192] juvenile

185. *See* Kenneth C. Davis, *An Approach to Problems of Evidence in the Administrative Process*, 55 HARV. L. REV. 364, 402 (1942). Horowitz captures the same dichotomy through the terms "social" and "historical" facts. HOROWITZ, *supra* note 173, at 45.

186. HOROWITZ, *supra* note 173, at 47-51. Horowitz notes the difficulties likely to be encountered in operating a dual system of evidence: one set of rules for historical facts and another for social facts. *Id.* at 49.

187. Shapiro, *supra* note 174, at 553.

188. Fuller, *supra* note 179, at 393-95. Fuller uses the analogy of the problem of assigning players to positions on a football team. There are a large number of possible outcomes, and the position of any one player has carryover effects on the optimal position for all of the other players. *Id.* at 395. The judicial process is likely to disregard many of these effects if the question is cast as whether a particular player has a "right" to a particular position.

189. *See* Shapiro, *supra* note 174, at 555.

190. HOROWITZ, *supra* note 173, at 106-70 (analyzing Hobson v. Hansen, 269 F. Supp. 401 (D.D.C. 1967), *aff'd sub nom.* Smuck v. Hobson, 408 F.2d 175 (D.C. Cir. 1969), *further relief ordered*, Hobson v. Hansen, 327 F. Supp. 844 (D.D.C. 1971), a school desegregation case from the Washington, D.C. school district that "recognized the right to equal distribution of school resources within a single school district").

191. HOROWITZ, *supra* note 173, at 220-54 (analyzing Mapp v. Ohio, 367 U.S. 643, 655 (1961) (extending the exclusionary rule for unconstitutional searches and seizures to state proceedings)); ROSENBERG, *supra* note 173, at 316-24 (same).

192. ROSENBERG, *supra* note 173, at 305-14.

justice[193] and problems involving the political process[194] combines with the practical limitations on the judicial process to produce skepticism regarding the judiciary's capacity to effect change in these areas. Economic questions, such as those presented in bankruptcy and other corporate law cases, also present substantially polycentric problems due to the fluidity of capital markets and their ability to adjust to changes in legal regimes.[195]

B. Redistributive Policies and the Limits of the Bankruptcy Process.

Bankruptcy is, in the main, a judicial process much like any other. Many of the problems bankruptcy judges must resolve present relatively straightforward factual, legal, and interpretative issues. Bankruptcy judges decide substantive issues of contract, tort, and property in the course of any business bankruptcy. The presence of Chapter 11 adds another dimension to the judges' task, however. The continued operation of the business during a Chapter 11 coupled with the need to provide some control over the negotiation process[196] implicate numerous administrative issues that, in turn, lead to fact-soaked inquiries involving data that are subject to a wide range of interpretations.[197]

1. The Judicial Character of Bankruptcy Redistributive Policies

These two dimensions to the bankruptcy judicial process again illustrate the two possible methods through which redistributive goals might be pursued.[198] First, Congress could legislate direct changes in entitlements. The priorities granted to particular classes of creditors provide a contemporary example of such redistributive legislation.[199] Where legislation or judicial decision directly changes the property rights of various parties, it may effect a redistribution without burdening the judiciary with the need to make such

193. *See* HOROWITZ, *supra* note 173, at 171-219 (analyzing *In re* Gault, 387 U.S. 1, 41 (1967) (affording juveniles the right to counsel in delinquency hearings)); ROSENBERG, *supra* note 173, at 314-16 (same).

194. *See* HOROWITZ, *supra* note 173, at 68-105.

195. *See id.* at 46 ("If a court refuses to enforce against a bankrupt corporation an 'unconscionable contract' for the repayment of borrowed money, will that make it more difficult for firms needing credit to obtain it and perhaps precipitate more such bankruptcies?").

196. *See supra* notes 99-108 and accompanying text.

197. See *supra* notes 90-98 and accompanying text for an example.

198. *See supra* notes 74-77 and accompanying text.

199. *See supra* note 74.

judgments. For example, a legislative enactment that merely shifted the priority of various types of claims would cause a redistribution without implicating the judicial process concerns expressed here. Enactments of this type would not require the judge to balance competing equities but instead would simply provide rules for dividing up the assets of the estate and, as such, are not objectionable on the bases set forth in this Article.

What is lost in this approach to redistribution, however, is an ability to individually tailor redistributive decisions to the needs of the parties involved in the actual cases.[200] An alternative method of accomplishing redistributive goals is to change the process in ways that have the effect of skewing asset deployment decisions toward reorganization in marginal cases. While this method avoids the tailoring problems inherent in more direct redistributive enactments, it directly implicates the judicial process concerns that follow.

It is often difficult to distinguish legal rules that directly change substantive rights from those that attempt to effect redistributions through changes in the process. Standing alone, even the legislative denial of interest to undersecured claimants[201] does not clearly provide any redistribution of the risk of financial failure. The decision that under-secured creditors are not entitled to compensation for the time value of their right to foreclose does not, by itself, carry any distributional consequences. It is only when the rule is coupled with the delay inherent in the reorganization process that the redistributive effect arises.[202] This redistributive effect lies principally in the rule's influence on asset deployment decisions.

The indirect nature of such redistributive policies requires us to consider the bankruptcy process on the level of the individual bankruptcy court and bankruptcy case. Because redistributions occur in the context of administering an individual case, decisions that arise are likely to have little precedential effect. A bankruptcy judge making a decision to extend the exclusivity period can derive little guidance from other cases. The need to tailor outcomes to specific cases is also likely to reduce redistribution-oriented legislative changes to the bankruptcy process to a fairly vague authorization for the

200. This problem is not, however, a complete basis for objection to such bankruptcy related priorities. A small degree of poorly tailored protection may be better than none at all.

201. *See* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 382 (1988), discussed *supra* notes 88-89 and accompanying text.

202. *See supra* notes 88-89 and accompanying text.

judiciary to consider the interests of the non-investor constituencies.[203] Statutes intended to alter the balance of power between competing constituencies in the process are unlikely to be self-executing. They will continue to leave vast discretion in the bankruptcy judge because of the fact-specific nature of bankruptcy cases.[204] Thus, in large part the burden of determining the amount of redistribution and who will bear the cost of non-investor protection will fall on bankruptcy judges.[205]

In some ways the bankruptcy judicial process might appear to be a uniquely qualified institution to pursue such policies. The bankruptcy process differs from other judicial proceedings in that it is intended to effect a global settlement of all of the controversies surrounding a failed business. The process provides voice to a wide range of affected persons, allowing them to pursue their interests in a single forum and allowing the decisionmaker to consider a wide range of possible solutions. Bankruptcy judges are specialists not only in bankruptcy law but also, at least in the large cases, in the specific cases before them. They come to understand the nature of the business and the far-reaching effects of their decisions much more clearly than the generalist judge who is forced to focus on a wide range of disputes.

These attributes of the bankruptcy process might appear to alleviate some of the concerns regarding institutional competence. After all, bankruptcy is already an extremely complex, far-reaching process. Bankruptcy lawyers and judges are expert in multilateral negotiation and compromise. They are accustomed to dealing with

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203. As discussed *supra* notes 118-21 and accompanying text, this has been the approach taken in the railroad reorganization setting. *See* 11 U.S.C. § 1165 (1994) (requiring the bankruptcy court to consider the interests of the public). This approach has also been used by various state legislatures in enacting corporate constituency statutes that authorize directors, and the courts reviewing their conduct, to consider the interests of various non-shareholder constituencies in evaluating takeover attempts. Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 23 (1991).

204. *See* William C. Whitford, *What's Right About Chapter 11*, 72 WASH. U. L.Q. 1379, 1402 (1994) (discussing public choice problems in bankruptcy legislation).

205. Korobkin attempts to place the burden of determining an optimal bankruptcy redistributive scheme on the legislature. *See* Korobkin, *Contractarianism, supra* note 19, at 627-31. This approach is necessary to avoid the intractable problems of indeterminacy that his redistributive scheme might otherwise entail. But Korobkin fails to provide any practical means of accomplishing a redistributional scheme that avoids the need for continued judicial involvement. Elsewhere, Korobkin has analyzed the reconciliation of conflicting "values" underlying his philosophy as a judicial problem. Korobkin, *Bankruptcy Decisionmaking, supra* note 37, at 342-44.

polycentric problems, and the nature of the process lends itself to flexible solutions to such problems.

It is natural to believe that an institution capable of resolving such difficult issues as those presented by the Johns-Manville and A.H. Robbins[206] Chapter 11 cases is capable of carrying out redistributive policies. The flaw in such an optimistic view of the capabilities of the bankruptcy process lies in its assumption that because judges in the process are capable of resolving the complex issues raised by the parties to the case, they can also account for the secondary effects of their decisions. A close examination of the decisionmaking structure of the process renders that assumption unwarranted.[207]

2. The Intractable Problem of Representation

An obvious requirement for any redistributive process is that it provides a voice to those who stand to lose. Not only is representation of such interests required to ensure due process and fundamental fairness, it is also necessary to the formation of rational policy. Policymakers are not omniscient. They can only respond to the interests of those asserting injury in the policy-making process. Only by ensuring adequate representation can the process reach sensible redistributive outcomes.

Naturally, this observation cuts both ways. Advocates of a redistributive bankruptcy regime can be taken as pressing this very point. A creditor-focused view of bankruptcy law excludes interests of non-investors and prevents the realization of their aims through the judicial process. Korobkin in particular seems to be making this argument. Korobkin advocates a theory of bankruptcy that seeks to ensure that "each person affected by financial distress have threshold eligibility to press his or her demands in that context."[208] In so doing, he seeks to avoid what he sees as a flaw in the creditors'

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206. The Johns-Manville and A.H. Robbins bankruptcies each involved massive tort liability of the debtors based on their pre-petition production of asbestos (in the case of Johns-Manville) and the Dalkon Shield (in the case of A.H. Robbins). The enormously complex issues encountered in such cases are well analyzed by Mark J. Roe, *Bankruptcy and Mass Tort*, 84 COLUM. L. REV. 846 (1984).

207. *See* Robert D. Cooter, *The Best Right Laws: Value Foundations of the Economic Analysis of Law*, 64 NOTRE DAME L. REV. 817, 833-35 (1989) (noting that the courts cannot make a sophisticated use of incidence theory).

208. Korobkin, *Contractarianism*, *supra* note 19, at 575.

bargain model's brand of contractarianism—its exclusion of categories of affected persons from the bargain.[209]

The problem with Korobkin's approach lies in identifying who is affected by business failure.[210] At one level, the affected individuals are easy to identify. Creditors, employees, managers and members of the community are obviously affected by the failure.[211] But considering only the interests of these constituencies fails to recognize the broader impact of bankruptcy decisions on economic decisions made by individuals unconnected with the firm. Bankruptcy does not operate in an economic vacuum. The decision to liquidate or to reorganize the operations of a failed firm implicates allocative concerns on an economy-wide basis. While liquidation may harm the community served by the closed enterprise, it may benefit a distant community served by a competing enterprise.[212]

While it may be theoretically possible to consider the interests of such communities, practical difficulties would abound. Assuming that such communities could be identified, their inclusion in the bankruptcy process would increase administrative cost. More importantly, however, such communities would be impossible to identify fully. In some cases we might find obvious links between the asset deployment decisions made in a bankruptcy case and the well-

209. *Id.* at 553-58. Following Rawls, Korobkin places these persons behind a veil of ignorance as to the actual positions they will occupy vis-a-vis the business enterprise and each other. *Id.* at 558-65. Korobkin argues that, bargaining from this equalized position, these persons would adopt a principal of "rational planning" under which the parties would resolve conflicting aims by protecting those who are the most vulnerable. *Id.* at 584. Korobkin defines "most vulnerable" as those parties occupying the position that provides the worst prospects for avoiding harm. *Id.* He carefully limits the effect of his argument by excluding an automatic right to participate in the process, however, suggesting that standing decisions should be left to the legislature. *Id.* at 575 n.162.

210. *See* Rasmussen, *Social Justice*, *supra* note 63, at 12 n.42.

211. Korobkin, *Contractarianism*, *supra* note 19, at 574.

212. The communitarian approach to bankruptcy law advocated by Gross is subject to this difficulty. *See* Gross, *supra* note 19. It is not enough to advocate a bankruptcy process that considers the effect of failure on communities without some basis for defining the community. The community could be limited to that immediately affected by a planned closure of the business, but such a limitation would necessarily be artificial. "[C]ommunitarian values must operate within a community, and the solutions to social problems are deceptively simple if the affected community is defined too narrowly." Farber & Matheson, *supra* note, 150, at 944. But defining a community by reference to all of the interests affected may well be impossible or is not feasible "because there are an infinite number of community interests at stake in each bankruptcy and their boundaries are limitless." 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, 1051 (1994).

being of other communities. But, in most cases, important links between the decisions made in the bankruptcy process and the wealth of other communities may be too subtle to discern.[213]

To illustrate and sum up the points made thus far, consider the vacuum switch manufacturer example from Section III.[214] The question presented by that example is whether the court should allow the business to invest assets that would otherwise go to creditors to retool the plant to produce testing devices. Making the investment over the objections of the creditors can be justified only if: (1) the creditors are not true residual claimants and therefore put no assets at risk in the decision; (2) creditors systematically underestimate the value of such projects; or (3) the court wishes to redistribute wealth by placing inadequately compensated risk on the creditors for the benefit of the dependent community. Assuming that the bankruptcy process allows or requires the court to consider the redistributive justification, the process should also require the court to consider the incidence of the redistributive cost. This consideration in turn requires some means to ensure the representation of parties who stand to lose from the decision.

Who should have standing to press their claims in such a process? Obviously the court will hear from the creditors, management, equity holders and the local community. Should the court also consider the interests of the current manufacturers of testing equipment? What of their employees and dependents?

Standing is only one part of the problem. An equally important question is how the court should balance the interests of the potential claimants. Perhaps the court could examine other companies in the testing device industry to determine whether they are making abnormally high profits. The conclusion to this inquiry might tell the court something about how the entry of the debtor into this field will affect the dependents of other firms in the industry.

The inquiry cannot logically stop even here, however. Even if the court finds abnormally high profits in the vacuum testing industry, can it then conclude that the community in which the debtor is

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213. This problem is not unique to the judicial process. Legislative attempts to devise standing rules for the bankruptcy process would be subject to the same practical concerns. Further, the effect of bankruptcy on these far-flung communities is a fact-specific question. All a legislative body could do would be to provide very generalized standing rules, effectively leaving most of the decisionmaking power to the courts. Therefore, there is likely to be no practical way to define and grant standing to all of the persons truly interested in the failure of the business.

214. *See supra* notes 90-98 and accompanying text.

operating is the most deserving? The investment in retooling could preclude a similar investment in a more needy community. Can those communities be defined and heard in the inquiry? In fact, nothing about the moral arguments underlying bankruptcy redistributive goals requires that we stop at national borders in analyzing this question. Should we consider the possibility that some developing country might find the vacuum testing industry an attractive investment?[215] Finally, what should be the standard for appellate review for this inquiry?[216]

This analysis of the problem might strike some as a little bit extreme. Perhaps the causal links described here are somewhat tenuous to draw firm conclusions with respect to standing. Nevertheless, in a given case at least some of the links may exist. While it might be possible to articulate some means of bracketing the more tenuous redistributive effects, the bankruptcy process is ill-equipped even to begin to sort through cases to determine whether the effect of the process on the well-being of some far-flung community is deserving of consideration. Furthermore, any limit on the potential range of the interests presented will be as artificial as the limits imposed by the creditor wealth-maximization criterion.

3. The Uncoordinated Nature of Bankruptcy Decisionmaking

The tenuous nature of the causal links between a given bankruptcy decision and the well-being of distant communities provides further support for an investor-focused bankruptcy regime. A second institutional feature of the bankruptcy process that limits its competence to resolve distributional questions is that bankruptcy courts act on an uncoordinated basis. The economic effect of redistributive decisions made by any one bankruptcy judge may be small in comparison to the aggregate, economy-wide effect of decisions made by all judges. As illustrated above,[217] the way redistributions occur in bankruptcy is indirect. They occur in large part through the manipulation of asset deployment decisions and are carried through to the economy through increases in the cost of capital.[218] This mechanism renders tenuous the causal link between any one decision and economy-wide effects. The aggregate effect of all of the redistributive decisions may be significant, however. In this

215. I thank Barry Cushman for this point.
216. *See* Schermer, *supra* note 212, at 1052.
217. *See supra* notes 80-117 and accompanying text.
218. *See supra* notes 144-68 and accompanying text.

environment, the uncoordinated decision-making structure of the bankruptcy process renders it unlikely to yield informed, rational answers to redistributive issues.

Judges lack any direct means of obtaining information regarding the aggregate effect of their individual decisions. Judicial fact-finding by nature is backward looking and decision specific.[219] Judges do not look broadly at the direction they and their fellow judges are taking the economy. Even if judges attempted to develop a sense of the economy-wide effect of their collective views on bankruptcy redistributions, it is unlikely that they would have any reliable means of determining the causal relationship between their individual redistributive policies and particular economic phenomena. Judges and the lawyers practicing before them are not necessarily economists and statisticians. They often lack both the training and the resources to conduct the analyses required to determine the economic effects of such decisions.

Even assuming that we could devise some method through which such information might be disseminated, the uncoordinated decision-making approach of the bankruptcy process would remain an impediment to a rational redistributive policy. If judicial decisions entail aggregate redistributive effects, it follows that the rationality of a result in a particular case is necessarily tied to the results of other cases. Individual judges often lack any means of determining the views of their colleagues regarding present and future cases, however.

The net effect of judges' uncoordinated decisions may be redistributions that none of them desired. Consider the plight of a bankruptcy judge with a vision of the world that incorporates a balance of wealth and power that favors non-investor interests more than does the current state of affairs. If authorized to consider the interests of the community, such a judge might be inclined to skew his decisionmaking, at least in close cases, toward the continuation of the business enterprise. But our judge understands that his decisions entail at least some economy-wide effects and wishes to avoid dramatic shifts in contractual entitlements that make everyone worse off. How should such a judge approach cases he believes implicate redistributive goals?

The judge could simply ignore the economy-wide effects of his decision and take care of the people and organizations that appear before him. In limiting his focus, our judge must simply hope that his

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219. *See supra* notes 173-94 and accompanying text.

colleagues share his vision. If other judges do share his vision, he can take comfort in the fact that, overall, the correct amount of redistribution is occurring.

Because of the number and diversity of bankruptcy judges, however, it is likely that his colleagues do not share his exact vision. Perhaps some are more investor-focused. Should our judge, together with others of like mind, stick to his guns in an attempt to convince the others of the error of their ways? Should our judge, together with others of like mind, increase the amount of redistribution to counteract the effects of the investor-oriented judges' decisions? Should our judge, together with others of like mind, capitulate?

The answer depends not only on the judge's commitment to a particular vision. The answer also depends importantly on the judge's view of what all of the others will do. Perhaps the investor-focused judges will capitulate. Perhaps they will redouble their efforts to ensure that no redistributions will occur. Perhaps those judges who share the vision of our judge will capitulate. Perhaps they will overreact and permit redistributions in excess of what our judge would desire. The complexity of the problem is further compounded when one realizes that when our judge assesses the views of his colleagues he must understand that each is also assessing the views of all of the others.

While judges do have both formal and informal means of communicating their views, the nature of the problem limits their ability to express those views clearly.[220] When a bankruptcy judge decides to extend exclusivity to protect the community interest, we know only that the judge believes that the community has some interest worth protecting. We do not know how the judge views the redistribution that is occurring. There is no universally understood language to fully express the judge's view of the odds that the enterprise will succeed. But understanding this factor is vital to understanding the judge's own belief as to the level of redistribution her decisions entail. If the judge views the chances of success as slim, we might conclude that the judge places a high value on the community's need for protection. If the judge views the chances of success as good, we can draw no conclusion because we cannot tell

220. Judge Schermer has pointed out that a significant problem with the protection of the public interest in the bankruptcy process is the lack of an adequate medium to consider the value of community interests. *See* Schermer, *supra* note 212, at 1051-52. This problem not only affects the decisions of individual judges but also creates difficulties in coordination between judges.

what the judge would do with a case in which the chances were not as good. Even if the judge tells us how she views the chances, we have a further communication problem—a statement regarding the chances for success necessarily involves judgments, the bases for which are largely inarticulable.

Developing a redistributive bankruptcy system thus requires that we bracket the broad redistributive effects of the regime. The ideal of representation of all affected persons requires somewhat artificial limitations based upon our ability to discern the groups affected by the redistribution. The notion of redistribution must exclude the aggregate economic effects of the system's outcomes. But the very justification for such a regime requires that the system account for these redistributive effects. As stated earlier, support for an inclusive bankruptcy regime can be found principally in arguments grounded in distributive justice rather than efficiency. Having determined that some sacrifice of allocative efficiency is tolerable in the quest to achieve distributive justice, however, the theorist as well as the practitioner must confront the question of who will bear the costs.

This point should not be taken too broadly. The attack here is on the use of the bankruptcy system to achieve redistributive ends—not on the ends themselves.[221] Not all institutions are capable of accomplishing distributional equity. Some touch too many people in radically unpredictable ways. Bankruptcy is an example. Its intimate connection with capital markets creates serious information problems that are unlikely to be addressed by its localized and uncoordinated decisionmaking structure. As a result, the process cannot hope to satisfy the redistributive goals underlying it.

C. *Taxation as an Alternative Method of Achieving Redistributive Goals*

To say that the bankruptcy process is ill-suited to deal with the practical difficulties raised by redistributive goals is not to say that we must abandon all hope of achieving such goals. Two broad avenues exist through which government can attempt to achieve redistributional goals.[222] Government can attempt to regulate economic activity through the prohibition of contractual terms, the imposition of mandatory terms, or the creation of legal duties.[223] A

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221. I assume for this purpose the general desirability of the ends. *See supra* notes 134-37 and accompanying text.

222. Kronman, *supra* note 134, at 498-99.

223. *Id.* at 499.

bankruptcy structure that incorporates substantial protection for non-investors could be seen as a species of such a regulatory approach. An alternative method of redistribution is through the taxation and social welfare systems.[224] Government could address the problems of business failure through progressive taxation and direct spending intended to benefit the constituencies affected.

There are several reasons to believe that progressive taxation and direct governmental assistance, though not without problems, would provide a more attractive means of redistributing wealth than the bankruptcy process. Accomplishing redistributions through taxation and spending has intuitive appeal. The progressive taxation approach more clearly identifies the group that bears the cost of the redistributions. Further, spending may be targeted at groups most in need. Most of the displacement associated with financial distress presents relatively straightforward problems for those displaced. For the employee, the first concerns are how to replace the lost wages and how to pay the bills in the interim. Likewise, communities may be principally concerned with attracting replacement businesses while maintaining governmental services during this process. These parochial concerns present the simple problem of funding. Radical change of the bankruptcy process is hardly necessary to respond to the immediate concerns of those affected.

Beyond the intuitive, the use of progressive taxation and spending to accomplish redistributions avoids the decisionmaking problems that would plague efforts to use the bankruptcy system to accomplish such goals. Taxation decisions, at least on the federal level, can be conducted with an eye toward aggregate economic effects. Congress, unlike the judiciary, may consider forward-looking information regarding the broad range of economic effects taxation and transfer payments may entail.[225] This approach also avoids the problems of uncoordinated decisionmaking that would doom efforts to achieve rational redistributions through the bankruptcy process.[226] Congress and executive agencies are more likely to have the data and

224. *Id.*

225. *See* Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987) (suggesting models that tie the rate of progressivity of the tax structure to various theories of distributive justice).

226. *See* Jean Braucher, *Defining Unfairness: Empathy and Economic Analysis at the Federal Trade Commission*, 68 B.U. L. REV. 349, 384 (1988). Braucher also believes that taxes and transfer payments provide more sustained and significant methods of redistribution. *Id.* at 383-84.

the institutional competence to consider the difficult questions of the incidence of redistributive cost than are the courts.[227]

In addition to questions of the incidence of redistributive cost we must also concern ourselves with the absolute level of inefficiency created by various means of accomplishing redistributions. Of course, redistributions accomplished through progressive taxation also entail allocative efficiency losses.[228] Taxation creates an incentive for individuals to substitute leisure for work because they are unable to reap the full benefits of their earnings. As Kaplow and Shavell have recently illustrated, however, this substitution effect is present regardless of whether the redistribution is accomplished through taxation or through legal rules.[229] A bankruptcy redistributive scheme would therefore entail allocative efficiency losses both through the substitution effect and through the inefficiency of the rules themselves.

This call for limiting redistribution to taxation and transfer payments is not without difficulties. Legislative failures to consider adequately the need for redistributive policies and the incidence of their costs are commonplace.[230] Public choice problems permeate taxation legislation and may significantly affect programs designed to alleviate the displacement accompanying financial failure. The answer to such problems is not, however, to push the question into another institution, the structure of which cannot accommodate the policy-making process. While there will be inevitable problems with legislative solutions to these problems, the approach is less likely to be doomed to failure from the start.

A final objection to the suggestion that taxation be used in place of a broad redistributive bankruptcy process is that it attempts to reduce a complex social and psychological problem to mere dollars. Taxation does little to alleviate the sense of outrage that may be experienced by a community that has for years relied on the existence of a manufacturing concern.[231] It does little to alleviate the sense of loss experienced by the worker who has for years devoted heart

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227. Cooter, *supra* note 207, at 834.

228. Bankman & Griffith, *supra* note 225, at 1919 ("[P]rogressivity entails a 'trade-off' between equity and efficiency.").

229. Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD., 667, 667-68 (1994).

230. BeVier cites as an example the effect the 1991 "luxury tax" on yachts had on jobs in the shipbuilding industry. BeVier, *supra* note 173, at 11-12.

231. Carlson, *Bankruptcy Theory*, *supra* note 19, at 475 (noting that the creditors' bargain model denies the worth of "public outrage").

and soul to the enterprise that has suddenly closed due to the "greed" of the lender.[232] Such problems cannot be addressed adequately by a simple transfer payment from the federal government.

To such a charge I must plead guilty, but without apology. Governmental transfer payments do not fully compensate for the loss experienced by non-investors. But whether we like it or not, protecting non-investor interests upon business failure comes only at a cost measured in dollars and paid by someone. In our zeal to protect the people hurt by business failure we must remember to take care not to harm another equally vulnerable group.

CONCLUSION

As Warren has so aptly noted, "Bankruptcy policy debates suffer enough from communication problems."[233] Academic debate over the appropriate limits of the bankruptcy process seems to occur in two worlds that collide only rarely. Economic theorists' preoccupation with allocational efficiency and critics' obsession with theories of justice and community, while valuable additions to the debate, have obscured a fundamental point—bankruptcy is but a small part of a vast economic system.

It is not my intention to denigrate the importance of bankruptcy law, however. Bankruptcy outcomes are critical in defining the risks involved in capital formation. But the power of the process is also the source of its limitations. The bankruptcy system has an enormous potential to affect the risk relationships that define business enterprises. The question is whether that power can be controlled.[234]

This Article contends that the bankruptcy judiciary does not and cannot control that power. Control requires understanding. It also requires institutions that can assimilate information in a way that allows rational action based on that information. The institutional structure of the bankruptcy process renders it unable to develop the kind of detailed understanding necessary to formulate a rational

232. Korobkin, *Jurisprudence*, *supra* note 19, at 763 (pointing out that "[m]anagement, employees, and shareholders may view the corporation, in various contexts, as an extension of their own natures").

233. Warren, *Imperfect World*, *supra* note 19, at 338.

234. As one commentator noted, "[C]onsequences which are intended or which seem to follow from some provision in the law are often revealed to be frustrated when we look at bankruptcy not in isolation but as part of a larger system." William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS. 13, 17 (1977).

redistributive policy or to act on that information in a uniform manner.

Admittedly, the arguments presented here raise empirical questions regarding the effect of bankruptcy decisions on an economy-wide basis. It is possible that the effects of a redistributive bankruptcy policy may be susceptible to falsification by empirical data. But it is also possible that many of the redistributions occurring under such a regime may be too subtle to admit of rigorous scientific analysis.[235] At the very least, we must view with skepticism conclusions drawn from empirical studies that ignore the effect of the regime on constituencies beyond those connected with the firms under study. While they may tell of the beneficial or detrimental effects of the process on those immediately affected, they can say little regarding the overall distributional effect of the regime.

Normative analysis, of course, occupies a critical place in policy debates. Economic theory alone cannot provide a complete answer to those who question its normative underpinnings. As the development of the bankruptcy debate illustrates, we will continue to debate the normative trade-off between equality and efficiency. Policymakers must deal with the art of the possible, however. Given the practical limitations of the bankruptcy process, we should engage the normative debate in the context of other institutions.

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235. *See* Elizabeth Warren & Jay Lawrence Westbrook, *Searching for Reorganization Realities*, 72 WASH. U. L.Q. 1257, 1281-82 (1994) (identifying some of the difficulties with conducting empirical research into these types of problems).