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DISCUSSION OF *IMPROVING BANKRUPTCY PROCEDURE* BY PHILIPPE AGHION, OLIVER HART, AND JOHN MOORE

PHILIP H. DYBVIG*

By bringing together a wide range of bankruptcy scholars and practitioners, this Conference has made very clear the broad extent of opinions about current bankruptcy law. One extreme view suggests bankruptcy is a mysterious and wonderful process that has many benefits that are difficult or impossible to quantify or enumerate. A polar extreme view, presented in the paper I am discussing by Aghion, Hart, and Moore (AHM),¹ is that bankruptcy is a complicated and costly solution to a very simple problem.² I suspect the truth (or at least the most useful view of the world) lies between the two extremes. It certainly should be possible to quantify and enumerate the functions of the bankruptcy process, and the resulting demystification should be an input to improved policy decisions. On the other side, the existing proposed simple alternatives to bankruptcy, such as that of AHM, neglect important functions of bankruptcy. The AHM paper in particular weakens its own case by neglecting existing institutions.

Perhaps because of our shared economic training, I am predisposed to be sympathetic with the central motivation of AHM. For example, I have a casual perception that Chapter 11 works poorly for large firms. Based on what I know about large publicized bankruptcies, the bankruptcy process is unnecessarily slow, arbitrary, manipulable, and destructive of prior contracting. Unfortunately, the hard evidence I am aware of neither confirms nor refutes my perception.³ To the extent that my perception is

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1. Philippe Aghion et al., *Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849 (1994).

2. The paper I am discussing is a slightly different exposition of the plan proposed in Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORGANIZATION 523 (1992).

3. For example, the analysis of Professor Bowers, see James W. Bowers, *Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses*, 72 WASH. U. L.Q. 955 (1994), is clearly flawed because a large fall in stock price on announcement of bankruptcy would be expected due to the bad news about firm fundamentals implicit in the announcement. This price reduction would occur whether the bankruptcy process is value-neutral, value-destroying, or somewhat value-enhancing. Accordingly, the fall in stock price is no evidence at all concerning the value impact of bankruptcy. Adverse selection on later sale is conditioned on information available at

accurate, each of the shortcomings of the bankruptcy process causes avoidable economic damage, the cost of which must be borne by somebody and is a dead-weight loss to society as a whole.

If the costs of the existing process are indeed large, there should be an advantage in changing the bankruptcy system from the current process towards a more mechanical contract-based process that will avoid these costs, and AHM proposes such a contracting structure. Their contracting solution is unavailable now because it is hard or impossible for firms to agree *ex ante* not to enter bankruptcy. Furthermore, making the contract-based solution the default rule would eliminate the need for firms to expend resources writing the necessary contracts themselves. Unfortunately, as I discuss below, AHM does not contain an adequate argument in favor of the proposed scheme, and minimally, a number of details of the scheme need to be resolved.

The starting point of AHM is a list of desiderata for bankruptcy schemes. I would have much preferred an analysis from first principles, which is admittedly absent,⁴ because it would have helped to isolate the assumptions underlying these desiderata. Short of that, it is useful to remember that it is intended to be implicit in each of the desiderata that *ex ante* economic efficiency is the ultimate goal. It is not obvious that the AHM scheme satisfies the desiderata outside the simple framework in which they are implicitly applied. For example, if *ex post* efficiency (desideratum 1) takes into account externalities in the community and the welfare of current and potential tort claimants, the AHM scheme seems much less attractive than it does in the case of a simple textbook firm bankruptcy with only financial claimants.

I also have a particular quibble with desideratum 3, which says bankruptcy should preserve absolute priority.⁵ It seems useful to have bankruptcy produce a predictable outcome to facilitate contracting (although we know randomization can in principle be useful in contracting), but it is unclear that this predictable outcome must necessarily be the one from optimal liquidation choice under absolute priority. Perhaps more important-

the time of the sale (including the announcement). Thus, the stock price fall on announcement does not counter the underpricing argument. I am not, however, claiming that the conclusion reached by Bowers, *see id.*, is wrong. Instead, I am pointing out that the logic of the argument is incorrect (and not in conformance with the standards applied to such interpretation by the finance profession), and should not be taken as evidence in one direction or the other.

4. Aghion et al., *supra* note 1, at 851.

5. *Id.* at 852.

ly, absolute priority is hard to define for large public companies with large numbers of claimants, which include not only a potpourri of financial claimants, but also various tort claimants, employee, supplier, and customer contracts, pension liabilities, and environmental obligations.⁶ It indeed may be optimal to exclude nonfinancial claimants from the bankruptcy process, but that is an assumption of AHM, not a conclusion.⁷ It is doubtful that the administrative procedure for determining absolute priority will be any simpler than the current process, which actually follows a variant of desideratum 4: i.e., let the claimants decide. Another possible alternative to preservation of absolute priority is to allocate to claimants in liquidation amounts that approximate the values they would receive in continuation of the business. This would help to ensure productive efficiency by minimizing the conflict about whether to liquidate.

A particular weakness of AHM is in the examples that are intended to illustrate the deficiencies of existing law. These examples do not seem to be consistent with actual law, and at a minimum, they are incompletely specified. Example A is supposed to be a situation in which current institutions will perform an economically unjustified liquidation of the firm.⁸ Senior creditors are owed \$100, and in six months the firm will be worth either \$40 or \$180. The current liquidation value is \$110, which is less than the firm value on continuation of \$120. The example is not very explicit (about why the firm is in bankruptcy or about the claim of junior debt, which I take for convenience to be zero⁹), but there does not seem to be a real problem. If the senior debtors are owed their \$100 payable six months from now (or later), then management can propose a plan that maintains this promise. Under the definition of bankruptcy law, they have an unimpaired claim, and are presumed to vote for the plan, which is approved since equity (the other class) votes for it. (Any junior debtors

6. I have tried to limit the list in the text to formal legal commitments, but we also could add other externalities such as the "effect on the community." Arguments about whether such concerns should be included in the bankruptcy process seem to be based more on political beliefs than on hard analysis or evidence. For people who believe that government can and should help alleviate the problems of its disadvantaged citizenry, it is obvious that community concerns should be included in the analysis. The opposite is equally obvious for people who tend to think that government involvement generally does more harm than good and, therefore, that government should limit itself to minimal functions of enforcing contracts and defense.

7. There is actually a bit of ambiguity in the AHM paper on this point. We could alternatively interpret the paper as saying that it is easy to adapt the AHM process for other types of claims not explicitly included in the model. It does not sound easy to me.

8. Aghion et al., *supra* note 1, at 859.

9. If there is a junior debt claim, the analysis is slightly messier but the conclusion is unchanged.

could be induced to vote for the plan, too.) Interestingly, the presumption of an affirmative vote by the unimpaired claimants is a feature of extant law that already addresses some of the concerns of AHM.¹⁰

Alternatively, if the \$100 is due now, management can use the period of exclusivity to stall a decision on a plan until after the debt is due. Or, management could use debtor-in-possession financing to raise \$100 (through the issuance of junk bonds) to pay off the senior creditors' claim. There are many ways in which the current institution can be used to avoid the inefficiency. Although I have not shown that this outcome will occur (because that depends on details not included in the example and a specific model of decisionmaking), it is clear that the description by AHM is inconsistent with current institutions.

Example B¹¹ is also problematic. I agree that the outcome would probably not be liquidation with payment according to strict priority, but it is not obvious that the likely outcome (liquidation with payment on a different schedule) is any worse, a priori. To be more specific, we require a fundamental analysis with an explicit model respecting the institutions. By the way, I assume the reference to the "Coase Theorem" was in response to someone's criticism, since I am sure the authors know that the Coase Theorem is not valid when there is asymmetric information (which exists in most real situations, and especially in bankruptcy).

Is the procedure in the paper really consistent with bankruptcies of individuals and small firms? One attractive strand of the paper is the distinction between ownership and control, and the idea that a firm can survive even if management and the current ownership are left out. However, these notions clearly do not make sense for individuals or small companies. Rehabilitation is also a motive special to individuals (or perhaps small firms). Presumably, like restrictions on indentured servitude, rehabilitation helps to keep individuals from inflicting too much damage on themselves by entering bad contracts.¹² This is not strictly speaking an economic argument, since economic agents never make mistakes! Nonetheless, it might be one reason why individuals should be treated differently from large companies. It also seems that a typical individual bankruptcy would involve only a handful of claimants and that bankruptcy court would serve primarily as a threat point in negotiations among the

10. 11 U.S.C. § 1126(f) (1983).

11. Aghion et al., *supra* note 1, at 859.

12. Obviously, this scheme raises a political question: should individuals be free to make their own mistakes? Protection after the fact destroys some freedom to make a commitment before the fact.

individual and the claimants. These characteristics are not found in a big corporate bankruptcy.

There are some practical questions regarding the conversion of debt claims to equity. Many bondholders hold bonds because they do not want equities, perhaps because they are not legally allowed to hold them.¹³ The time of bankruptcy is perhaps the time when both information asymmetries and risk are greatest. For somebody who wanted to hold bonds in a safer firm before bankruptcy, this is a very bad time to either sell or hold the new equity. Because of the information asymmetry, selling will be at a large discount, and because of the high risk, holding will be very unattractive. Also, debtholders often do not want to be in control of the firm.

Some aspects of the scheme do not seem plausible at all. For example, comparison of various bids, and especially combination of partial bids, does not seem like an easy matter. When noncash or partial-cash bids are allowed, their assigned valuation will affect the number of shares that each existing claimant will get, so assigning shares consistent with absolute priority is problematic. And, tacking on the scheme of Professor Bebchuk,¹⁴ which allows some claimants to buy out shares of more senior claimants, is inconsistent with the large set of claimants and complicated priority structure characteristic of large bankruptcies.

To summarize, bankruptcy may serve purposes outside the short list in the paper. However, I do not think that there is a mysterious large set of functions of bankruptcy that cannot be classified and studied. The AHM paper is one attempt to move towards a more efficient procedure, and it is a start at moving the debate forward. A better understanding of the functions of bankruptcy and the underlying economics can only help to guide us towards better policy.

13. This inability to hold equities may be true of banks or other institutions or investment funds that must comply with regulations mandating maximum or minimum levels of investment in various asset classes.

14. See Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988).

