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Douglas G. Baird

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THE REORGANIZATION OF CLOSELY HELD FIRMS AND THE "OPT OUT" PROBLEM

DOUGLAS G. BAIRD*

Debates over the law governing the reorganization of closely held firms frequently rest on the premise (albeit often unstated) that choosing the ideal bankruptcy distributional rule (the rule governing the distribution of the assets of an insolvent firm among bondholders, general creditors, and shareholders) is of central importance. This premise may be unsound.

The paper begins with the observation that the costs associated with opting out of bankruptcy put a cap on the costs any unsound bankruptcy rule can impose. Black letter law provides that a corporate debtor cannot waive its right to file a bankruptcy petition. Many have therefore assumed that "opting out" of bankruptcy is not possible. In fact, however, there are many ways to structure transactions that are economically equivalent to opting out. These range from eliminating debt from the capital structure of a firm altogether, to making stock pledge agreements. None of these arrangements are uncommon. (Nearly one-third of all closely held corporations, for example, have no institutional debt.)¹ Nor does it appear that they are costly. Consequently, it may follow that the costs of existing bankruptcy law cannot be substantial.

The paper argues that the ability of parties to shape their investments in firms is responsible for the small costs of bankruptcy. The paper focuses on how investors can minimize the costs of bankruptcy even when they do not take steps to avoid it altogether. The typical closely held firm in financial distress has a simple capital structure. There is a single large institutional lender with a security interest in all of the firm's assets. There are also a group of unsecured creditors, consisting (apart from insiders) largely of trade creditors. Once the firm enters bankruptcy, it is typically not worth enough to pay the single institutional lender in full. Trade

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1. Mitchell A. Petersen & Raghuram G. Rajan, *The Benefits of Firm-Creditor Relationships: Evidence From Small Business Data*, 49 J. FIN. 3, 8 (1994).

creditors receive little, if anything, if the firm fails.

This structure, which puts much of the costs of bankruptcy on trade creditors, may in large part be a sensible response to the existing legal regime. The supplier of goods, while nominally a creditor, is in many respects like an investor who is asked to make ongoing equity investments. The supplier does not vary credit terms, but rather decides how much credit to extend and makes this decision based on its judgment about the firm's prospects.

It makes little sense to advocate a rule as sound bankruptcy policy if those adversely affected by the rule can navigate around it. Examining the ability of parties to opt out of bankruptcy rules in whole or in part is necessary before we engage in any debate about what bankruptcy law *should* do. Too often, debates about bankruptcy policy become abstract debates about the virtues of respecting contractual priorities or abstract inquiries into what these contractual priorities should be. Given the ability of investors to craft investment instruments for any given bankruptcy regime, there are limits to the extent to which bankruptcy law can impose any particular distributional scheme that departs from the one investors would reach contractually.

Once we take the ability of parties to respond to bankruptcy into account, it may be that we have a better sense of where to focus our attention when we worry about bankruptcy reform. It may not be possible to make bankruptcy law serve powerful redistributive goals, regardless of whether such redistributions would be sound policy. Debates about redistribution in bankruptcy may be less important than debates over the costs of the bankruptcy procedures. For example, the costs of preparing the disclosure statement or of noticing various hearings may matter much more than the absolute priority rule and the new value exception. A sense of the relative stakes may move us away from debates about redistribution in bankruptcy and towards debates on the costs of the bankruptcy procedures.

Part I of this paper reviews the costs of bankruptcy's procedures. Part II examines the ability of parties to reshape debt instruments in anticipation of whatever bankruptcy rules are in place. Part III explores the way in which departures from the contractual priorities skew the decision of when a bankruptcy petition is filed in the first place. I argue again that the procedural costs of bankruptcy may be smaller than they might appear.

I.

The closely held firms that form the bulk of corporate Chapter 11 filings have, with the conspicuous exception of tax claims, very little

nonconsensual debt.² Many of the complications that we see in the megacases, such as massive tort liability, environmental liability, collective bargaining agreements, and pension obligations, are not present in these cases. If workers are creditors of the firm, they are typically owed just for their last pay period and obligations to them do not loom large in the capital structure of the firm.

The typical corporate Chapter 11 debtor has a single large institutional lender, which has a fully perfected security interest in all of the debtor's assets. The debtor also has substantial tax obligations. The debtor typically owes money to its suppliers. These obligations are generally not secured. (Sellers of substantial pieces of equipment as well as motor vehicles, however, often retain purchase money security interests in them.) Finally, the debtor usually has a number of loans from shareholders and their close relatives.³

In such a case, as a matter of black letter law, the fully secured institutional lender is entitled to be paid in full before any other creditor receives anything (ignoring for the moment the possibility that there are sellers who enjoy purchase money security interests). If the firm were sold immediately for cash, the principal lender would have first claim on the proceeds of the sale up to the amount of its loan.⁴ There are many ways, however, in which a secured lender's priority will not be fully respected in Chapter 11.

Even if a plan of reorganization is confirmed immediately, the principal lender will not receive cash, but rather a note that the bankruptcy court finds is equal to the value of the firm. Rarely, however, will interest on the note run at a rate that is high enough to enable the institutional lender to find anyone who will acquire the note at its face amount. The risk premium that the note carries—perhaps only one or two percent above the market rate—falls short of compensating the principal lender. The reorganized firm is highly leveraged. Hence, a substantial portion of the note represents an equity investment in the firm and the interest rate should reflect this. Firms that leave Chapter 11 are much more likely to fail than similar firms in the same industry, and a risk premium of only a point or two falls far short of compensating them for the risk.

2. This point must be qualified in the case of businesses that engage in manufacturing. They can face environmental cleanup obligations that alone approach and even exceed the value of the firm.

3. Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. & ECON. 223, 228 (1991).

4. 11 U.S.C. § 1129(b)(2) (1988).

In most cases, a plan of reorganization is never confirmed. The Chapter 11 case is converted to Chapter 7 and the principal lender does in fact receive all of the assets. The reorganization, however, typically takes a year and a half or more⁵ and the assets are worth substantially less following the reorganization than they were worth at the time the petition was filed. Among other reasons for this devaluation, substantial resources are lost keeping the business in operation and paying for the costs of the reorganization. If the assets at the outset are worth less than what the principal lender is owed, the principal lender bears the entire downside if the assets fall in value, but does not enjoy the entire upside if things go better than expected.

That the principal lender's claim is not paid in full does not itself impose an efficiency loss. Indeed, it is not self-evident that the principal lender would bargain before the fact for the right to be paid in full before the owner-manager receives anything. A deadweight social loss, however, does arise from existing law, regardless of what the efficient distribution of assets would look like. The tension between the law and language of corporate reorganization is itself a source of inefficiency.⁶

The problem arises because the entitlements of the different players turn on what is done with the assets of the firm. The principal lender does best (and those junior to it do worst) when there is an immediate sale for cash. The more protracted the reorganization and the less straightforward the plan of reorganization, the worse the secured lender does and the better the other creditors do. Substantial costs arise from the distribution scheme in Chapter 11, not because there is a departure from the absolute priority rule (or whatever distribution scheme would be optimal), but because those in control of the reorganization have incentives to take actions that are themselves inefficient.

The bankruptcy scholarship that asserts that even fully secured creditors should "share some of the hurt" and bear part of the costs of reorganization fails to explain why such a creditor should, as a normative matter, bear the costs of bankruptcy in the way that it does—a way that brings costs that worsen everyone's position. The most conspicuous costs of existing bankruptcy law arise not because it departs from the absolute priority rule,

5. See Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 739-45.

6. See Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565 (1950) (explaining the rationale behind three pre-Code bankruptcy concepts, reorganization value, fair and feasible plan, and the cram down power, as the result of a political struggle between junior and senior debtors, not an attempt to further efficient resolution of a firm's financial crisis).

but rather because it departs from the absolute priority rule while claiming that it is respecting absolute priority. The principal advantage of schemes that do away with Chapter 11 entirely and force an immediate sale lies not so much in such a procedure vindicating the absolute priority rule, but rather in severing the decision about the distribution of the assets from the decision about how the assets should be deployed. In the next two parts of the paper, I want to ask to what extent the distribution schemes themselves are likely to matter, once we make the assumption that the distributional scheme itself will not affect how the assets are used or affect the out-of-pocket costs of the bankruptcy proceeding.

II.

Suboptimal distribution schemes affect to some extent the ability of entrepreneurs to finance projects that have a positive net present value. In competitive capital markets, we should expect that the costs of departing from the optimal distribution scheme are most likely to be borne by the entrepreneurs, rather than by those who provide them with capital. Creditors receive a competitive risk-adjusted rate of return under any bankruptcy regime. What changes are the types of borrowers to whom they are willing to extend credit, how much credit they extend, and the rate of interest they charge. If, for example, a bankruptcy law distributes assets away from senior lenders relative to their contractual priority, these senior lenders may lend less to small businesses, insist on more collateral for each dollar lent, and charge a higher rate of interest. Indeed, instead of lending money, investors could search out different financial vehicles, either in this country or abroad.

Under a suboptimal distribution scheme, the redistribution that takes place is not typically from the creditors to the debtor, but rather from successful entrepreneurs who never file bankruptcy petitions, but have less access to credit and must pay more for it, to unsuccessful entrepreneurs who receive more in bankruptcy than they would have received in an arm's length bargain. (If entrepreneurs who are more likely to be successful cannot distinguish themselves from those who are less likely, both will be charged the same rate of interest. It is necessarily too high for the first group, but too low for the second. The difference between the rate they are actually charged and the rate they would pay if the information were available is the amount of the wealth transfer.) We, of course, do not know the size of this wealth transfer among entrepreneurs. In any event, it is the efficiency consequences of this redistribution that are of more importance,

rather than its size. We want to know the extent to which, as a result of this change, projects with a positive net present value are not funded, are not funded as quickly, or are funded at greater cost.

We gain a sense of the kind of loss that might arise by looking at the substantial literature, beginning with a paper by Jackson and Kronman,⁷ that explores the efficiency justifications for secured credit. Projects may go forward only if the entrepreneur can borrow and give the new lender priority with respect to the proceeds of that project.⁸ Other explanations suggest that secured credit can reduce the monitoring costs that arise with every extension of credit. A creditor with a priority right to a particular asset has an incentive to invest resources in looking after that asset.⁹ If secured credit brings benefits to those who invest in a business venture, a bankruptcy rule that undercuts the priority of the secured lender diminishes the benefits that secured credit brings.

Chapter 11 undercuts the priority of a secured creditor in a number of ways. A fully secured creditor would rather be paid off the day before the filing of a bankruptcy petition than participate in the bankruptcy process, even though such a creditor is supposed to be paid in full in bankruptcy. Lenders who want to take security interests should anticipate what will happen to them in bankruptcy. They can adjust their interest rates and ensure that they will receive a competitive rate of return, but the benefits of having priority are lost.

The crucial question for us, however, is the size of such losses. There are several reasons to think that the overall loss may be modest. First, the benefits of secured credit may in fact be small, and hence the costs of failing to recognize it in full may be small as well. Secured credit probably brings benefits, given that many creditors take security interests and debtors are willing to grant them. The costs of obtaining secured credit, however, are trivial. It has to offer only small benefits in order for creditors to ask for it. Even so, secured credit is not ubiquitous. A publicly traded firm, for example, might well find that the signal it sends to shareholders by borrowing on an unsecured basis more than offsets the benefits of

7. See Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979).

8. René M. Stulz & Herb Johnson, *An Analysis of Secured Debt*, 14 J. FIN. ECON. 501, 515-17 (1985).

9. Saul X. Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 57-58 (1982).

borrowing on a secured basis.¹⁰ Even in the case of closely held firms, not all firms have secured debt. Berger and Udell, for example, suggest that only fifty-three percent of the lines of credit of closely held firms are secured.¹¹ It is likely that secured credit is efficiency-enhancing where it exists and would bring greater efficiency benefits if it were fully respected in bankruptcy. Nevertheless, these benefits are not so overwhelming that all firms take advantage of them.

The costs of failing to respect the optimal priority scheme among creditors may be small for a second reason. The benefits of secured credit may persist even if the priority of secured creditors is partially undermined. Secured credit, for example, may bring efficiency benefits because it gives the secured creditor an incentive to monitor the debtor. The kind of monitoring that the secured lender is likely to do, however, remains fixed across different kinds of firms. A lender will have an established procedure for monitoring all borrowers, such as checking to ensure that insurance premiums have been paid or that tax liens have not been filed.¹² If we justify secured credit because of such monitoring, undercutting the priority that the secured creditor enjoys in bankruptcy brings an efficiency loss only if it changes the kind of monitoring that the secured creditor does. When a secured lender's monitoring consists of taking discrete actions, it does not necessarily follow that diminishing the priority of the secured creditor brings with it an efficiency loss. The same amount of monitoring may take place.

If one takes a further step back, the losses from undercutting contractual priority seem smaller still. What matters in the end is the effect of bankruptcy rules on entrepreneurial activity. By definition, bankruptcy affects only entrepreneurial projects that have creditors. Such projects may not define a large part of the landscape. Petersen and Rajan suggest that twenty-eight percent of closely held corporations have no institutional debt at all.¹³ The only debt is short-term accounts payable and loans from

10. Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73, 74-75 (1993).

11. Allen N. Berger & Gregory F. Udell, *Lines of Credit, Collateral, and Relationship Lending in Small Firm Finance*, tbl. 2 (March 1993) (on file with the *Washington University Law Quarterly*) (reporting results of analysis of data collected in the National Survey of Small Business Finances).

12. See Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 653-60 (1992).

13. Petersen & Rajan, *supra* note 1, at 8 (reporting results of analysis of data collected in the National Survey of Small Business Finances). This figure does not include unused lines of credit. *Id.* at 8 n.5.

shareholders and their friends and families. Many projects in high technology industries, such as computer or bioengineering, are financed through limited partnerships with venture capitalists, and therefore have no debt. When these firms fail, there will not be bankruptcy petitions. A bankruptcy proceeding assumes the existence of debt, yet much entrepreneurial activity can take place without it. Indeed, the kinds of Chapter 11 cases that pose the most difficult problems as a matter of theory—those cases in which much of the value of the firm is in the firm-specific skills of the owner-manager—may arise infrequently in practice because such ventures are often not financed with debt.

An inefficient bankruptcy law will drive entrepreneurs to nondebt financing. This form of financing, of course, brings its own costs. We may be worse off than we would be in a world in which we had an efficient bankruptcy law, but the cost is often not the loss of the benefits of venture, but rather the added costs of pursuing the project in another form. A common method used to determine whether the actions of a firm are efficient is to ask what would happen if there were no debt and the entire firm were in the hands of a single owner. This inquiry is not a wildly counterfactual one. Many firms have no debt and are effectively in the hands of a single owner. If the costs of such a capital structure were large, we should not see it used so often. The ability to do business in this form places a floor on the efficiency losses that result from bankruptcy.

To put the problem on an entirely theoretical plane, departures from the optimal distribution scheme in bankruptcy bring no efficiency losses whatsoever in an efficient capital market. A market for derivatives can come into being in which the original securities can be recombined in the way that effectively returns investors to the optimum. An investor that wanted to be paid in full before others received anything could buy a derivative security that gives it exactly this right.

Small, closely held firms account for thirty-eight percent of the GNP of the United States.¹⁴ Those who invest in these firms face substantial information problems, and the capital markets to which they turn are imperfect. Investors face both a moral hazard and an adverse selection problem. Credit may be rationed to these firms, because if lenders raised their rates higher they would attract ever riskier debtors who, because of

14. WILLIAM J. DENNIS ET AL., N.F.I.B. FOUNDATION, *SMALL BUSINESS AND BANKS: THE UNITED STATES* (1988), cited in Petersen & Rajan, *supra* note 1, at 4.

the high rate, would be inclined to take even more risks.¹⁵ These firms have no publicly traded securities, let alone derivatives. Nevertheless, these firms can adjust to bankruptcy distributional schemes by the kinds of debt they issue. Publicly traded firms have a rigidly hierarchical debt structure. The only variable might be the term of the debt. The capital structure of closely held firms cannot be arranged in such a strictly hierarchical fashion.

Closely held firms typically have only a single institutional lender.¹⁶ When the firm is in good financial health, this loan will be for less than forty percent of the asset value of the firm.¹⁷ In about half the cases, the institutional lender provides other financial services, such as checking accounts or credit card processing.¹⁸ This lender, however, does not rely simply on the assets of the debtor for repayment. It will frequently ask for and receive a personal guarantee from the owner-manager of the firm.¹⁹ As far as this lender is concerned, the firm is not doing business in limited liability form. In the case of small firms in which the owner of the business has sufficient assets to meet the guarantee, this institutional lender has opted out of Chapter 11's distribution scheme. It will be paid in full. In the event that the owner will not have sufficient assets to meet the guarantee, the lender's ability to call on the guarantee gives the lender a way to limit the ability of the owner to use the Chapter 11 process as a way to extract money from the lender. Such control is further enhanced if the owner-manager has pledged the stock to the lender.

There are tax advantages to keeping assets in corporate solution, but these are easy to exaggerate. Many small firms take advantage of Subchapter S and face only a single layer of taxation. In recent years, there has been increased use of limited liability companies, the shareholders of which also face only a single layer of tax. For the owners of many small firms, there is insufficient reason to keep assets in corporate solution and to take advantage of the tax benefits of debt. The benefits are not

15. Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AMER. ECON. REV. 393 (1981).

16. The description of small firms is drawn from Petersen & Rajan, *supra* note 1. They rely on the National Survey of Small Business Finances collected by the Small Business Administration. The survey covered only firms with fewer than 500 employees that were not in the agriculture, forestry, fishing, finance or insurance underwriting, or real estate investment trust industries. The sample included 3404 firms; only 1875 were corporations. As noted, of the corporations, 28% have no institutional debt. *Id.* at 6-8.

17. *Id.* at 10 n.8.

18. *Id.* at 8.

19. Berger & Udell, *supra* note 11, at tbl. 2.

worth the extra layer of taxation.

Even though the bank loan may be the only debt that appears on the balance sheet, there are other investors in these firms. When a firm is not in distress, the amount owed suppliers is typically quite small. About one-third of these suppliers offer a discount if payment is made early—typically, a discount of two percent if payment is made within ten days. Interest begins to run if payment is not made within a certain period, typically within thirty days. Firms that are offered discounts for early payments typically take them, and over seventy-five percent of payments to suppliers are paid before interest starts to run. For small firms, their own suppliers are a potential source of credit, even though it is not ordinarily used.²⁰

Suppliers often have a stake in the survival of the firm as a going concern. A supplier may have a firm-specific investment in the debtor. For example, it may manufacture a custom component for a product that the debtor sells. Alternatively, the debtor may have committed resources to selling the particular brand of merchandise that the supplier sells. The supplier can look forward to profits from future sales. It may be willing to forgo profits in the short term in order to capture benefits at a later time.

By contrast, a financial institution may not have the ability to incur costs over the short term based on the prospect of future business. When a bank must compete with other financial institutions in extending credit and when it holds no special informational advantages over other lenders, it enjoys a competitive rate of return at all relevant times. It has no anticipated future rents that justify making any sacrifice in the short term.²¹

The nature of the relationship between the firm and the supplier is hard to categorize. As a legal matter, of course, once the supplier ships goods, it becomes a garden-variety general creditor. As such, it is entitled to share pro rata in the firm's unencumbered assets in the event that the firm files a bankruptcy petition and liquidates. This description, however, does not capture the nature of the relationship under existing law. First, the firm enjoys a discretionary line of credit. Even when there is nothing on the balance sheet indicating that the debtor has a source of credit other than the bank, the suppliers may provide a substantial source of credit that can be drawn on automatically and can serve as a cushion for the debtor during occasional downturns in business. Second, the credit is available only to

20. These data are drawn from Petersen & Rajan, *supra* note 1, at 24 tbl. VII.

21. Mitchell A. Petersen & Raghuram G. Rajan, *The Effect of Credit Market Competition on Firm-Creditor Relationships 1-2* (Feb. 1993) (on file with the *Washington University Law Quarterly*).

the extent that the debtor buys goods or services from the supplier. The debtor has nothing to gain by acquiring supplies unless it has some prospect of selling them.²² Hence, this line of credit is quite different from an ordinary one that a debtor in distress can use, for example, to pay off recalcitrant creditors.

Although the legal form of the relationship between the supplier and the firm is one of creditor-debtor, the supplier is in many respects like an equity investor. When a small firm liquidates, there is typically nothing left for the general creditors. Even if the firm has hard assets (and many service firms do not), the principal lender will have priority. If anything is left, the tax collector will take priority. Moreover, the amount owed any one supplier is too small for the supplier to be actively involved in the bankruptcy proceeding. For all practical purposes, suppliers receive nothing in the event of a liquidation.

Suppliers of services or nonfungible goods understand that, under existing law, they are gambling on the survival of the firm when they extend trade credit. They are looking entirely to revenues that the firm generates as a going concern. On the other hand, the supplier that issues trade credit may well be paid before a secured bank lender that would take priority over it in a liquidation. A firm that remains in operation has the ability to pick and choose the debts that are paid. Because the rate charged for trade credit is so high, and because the supplier can induce payment by threatening to refuse future extensions of credit or withholding future deliveries altogether, the supplier is in a position to ensure that it is paid before the bank as long as the firm does in fact continue as a going concern.

Current bankruptcy law may make conventional extensions of general credit unattractive to investors, but trade credit, which has the characteristics of both equity and priority loans, may become relatively more attractive. Suppliers are sources of credit under existing law because they have a stake in the firm's success as a going concern. They receive priority if the firm survives, not because of their legal entitlement, but

22. When the supplies are fungible commodities such as steel or wheat, the principal lender benefits when the debtor acquires inventory if the lender holds a security interest in inventory. Increases in the amount of inventory just before bankruptcy, however, may give rise to a voidable preference attack. 11 U.S.C. § 547(b) (1988). Trade creditors could protect themselves from the priority claims of secured creditors by taking a purchase money security interest, 11 U.S.C. § 547(c)(3) (1988), but they typically do not do so. Baird, *supra* note 3. Why they do not when the goods are fungible remains a mystery.

because the credit they extend is short-term. Moreover, they have the ability to monitor the debtor and they can refuse to do further business or require cash on delivery before shipping additional goods. Due to the equity-like features of supplier credit and the suppliers' ability to monitor additional extensions of credit as the firm is close to failure, this credit is a more likely source of capital in regimes in which the distribution scheme is biased away from creditors in a way that is inefficient.

A firm has other sources of equity-like credit to which it can turn. Small firms often lease the real property on which they operate. In the case of a retail store, the lessor may be explicitly a co-venturer. Rent is often tied to gross sales. As the firm hits a downturn and revenues go down, obligations to the lessor go down as well. Even when the rent is not geared to sales, lessors may have made firm-specific investments in the premises that could not be recovered if the firm ceased as a going concern. Lessors are often willing to forgive rent in the short term in return for the prospect of enjoying future rent payments if the firm survives as a going concern. The lessor has the same characteristic as a supplier. It has nothing if the firm liquidates, but enjoys profits from its relationship with the firm to the extent that the firm survives as a going concern.

Employees or management may also provide an additional source of credit. Many workers in these small firms are paid only a market wage (or perhaps only the minimum wage) and have no firm-specific skills. Hence, they cannot make wage concessions in return for the prospect of the firm continuing as a going concern. Those who are equityholders in the firm or who otherwise have firm-specific skills, however, can make additional investments in the firm by cutting, or forgoing entirely, their own salaries. Similarly, these individuals can turn to their immediate families for additional infusions of cash. Even if the firm is insolvent, people may rationally make such loans if they help ensure that the firm survives as a going concern and the owner-managers derive more utility from running the firm than they would in any other job.

The pattern that emerges under existing bankruptcy law runs contrary to the traditional image of a debtor surrounded by many diverse creditors who, because of a collective action problem, threaten to dismember the firm piecemeal. The creditors are typically divided into two groups. There is the large institutional lender on the one hand, who has no particular stake in the firm as a going concern, and, on the other, a variety of suppliers, workers, insiders, and others who will gain nothing from a liquidation. This second group extends credit based entirely on a balancing of the costs of such credit against the potential losses they will suffer if the firm does

not continue as a going concern.

Distortions in contractual priority are minimized with such a nonhierarchical capital structure. Most of the creditors expect nothing out of the bankruptcy proceeding, do not participate in it, and hence are indifferent to its distortions. The one lender that cares about what happens has a great deal of control over the process, control that is frequently enhanced by a personal guarantee of all the debts of the firm that the owner-manager executed at the time of the original loan.

The effect of existing bankruptcy law and its departures from an optimal distribution scheme are hard to assess. Existing law may bias distribution away from those that would have priority under nonbankruptcy law relative to what is optimal. If it did this, however, it might not dramatically change the number of net present value projects that go forward. Instead, existing law may change only the way in which they are financed. Suboptimal distortions in favor of junior investors may create a bias towards all equity firms and away from institutional lenders. They may also reduce the number of institutional lenders and change the kind of monitoring conducted by each lender. Finally, they seem to enhance the role that those with stakes in the continued existence of the firm play in extending it credit as the firm encounters financial distress.

In assessing the costs of departing from existing contractual priorities, one must take into account the ability of different parties to invest in the first instance and, because of firm-specific relationships, the potential for investment instruments to come into being that respond to the distortions in the rules. The residual efficiency loss is hard to measure, but the importance of this effect should be something that could be observed by looking at how small businesses are financed in jurisdictions that do not have a law of corporate reorganization like Chapter 11.

III.

In this part of the paper, I want to look at how the distribution of assets in bankruptcy affects the time at which the petition is filed. This point can come too late or too soon. Chapter 11 offers relatively little hope to the debtor-manager, given the time at which the petition is typically filed. For closely held firms, it is a good first approximation to say that a Chapter 11 bankruptcy is a procedure in which assets are sold off and the firm ceases as a going concern. Under existing law, the only person that receives anything at the end of the day is the institutional lender, and the amount that this institutional lender receives is less than what the lender would

have received if there had been an immediate liquidation. The question I want to ask in this part of the paper is whether providing the institutional lender with less than the liquidation value of the assets in bankruptcy is likely to affect the time at which the firm enters bankruptcy, and whether this, in turn, is likely to lead to efficiency losses.

We can begin by exploring the question of who makes the decision to file a bankruptcy petition under current law. The overwhelming majority of bankruptcy petitions are filed by the owner-manager. The presence of tax claims in many of the Chapter 11 cases of small firms, however, powerfully suggests that it would be a mistake to see the petitions as being initiated by the owner-managers. Firms are required to collect income and social security taxes from their employees for the federal government. Firms in distress often use the money that should be put aside for the government to keep the firm in operation. The existence of a largely invisible source of credit that has priority over the claims of the trade creditors is itself a source of inefficiency. Trade credit works effectively because suppliers can infer the firm's financial health from its ability to make payments. An invisible source of credit hinders their ability to draw such inferences.²³ For present purposes, however, we are concerned only with the inference we can draw from the existence of these tax claims in small business bankruptcies.

The owner-managers who use these tax funds to keep their businesses afloat become personally liable for the taxes and expose themselves to criminal sanctions. Even if the likelihood of criminal prosecution is low, the probability that the IRS will ultimately hold them personally liable is high. These owner-managers are typically willing to invest all the assets they can reach and to incur these tax liabilities before they file a Chapter 11 petition.²⁴ This behavior is not one we should expect if they found the protection that Chapter 11 offers attractive. Owner-managers file bankruptcy petitions only when they are forced to do so.

Bankruptcy petitions are rarely "voluntary." Debtors do not view bankruptcy as an easy and attractive refuge over other potential alternatives for saving the business. Bankruptcy petitions are typically filed when the only alternative is immediate liquidation, usually by the institutional lender

23. The effect would be mitigated if trade creditors took purchase money security interests in the inventory that they sold, but it might not help trade creditors much if the inventory itself has little value in liquidation. Institutional lenders may, in any event, write loan covenants that prohibit the debtor from granting such interests. *See Baird, supra* note 3.

24. *Id.*

who holds a security interest in all of the debtor's assets and has the right under nonbankruptcy law to seize them. In the view of the owner-managers, Chapter 11 is better than immediate liquidation, but not much better.

Allowing the owner-manager to receive some share of the firm's assets diminishes the debtor's incentive to engage in risky activities when the firm becomes insolvent.²⁵ We might in the first instance doubt whether the problem is itself a large one. Owner-managers may have relatively little opportunity to enhance the riskiness of the firm. There are few chances equivalent to going to Las Vegas and betting everything on red.

Firms are in financial distress because no one is buying the product or service that the debtor is selling. Losses arise because the debtor continues to stay in business, not because of changes that the debtor makes in the business. Moreover, the effect of giving the managers a larger share of the firm in the event of a successful reorganization and allowing them to stay in control in bankruptcy is not likely to have a dramatic effect on their willingness to file, given that even with this benefit, many of these managers are willing to risk substantial tax obligations to avoid Chapter 11.

The decision to file a Chapter 11 petition is largely in the hands of the institutional lender. The lender does not actually file the petition, but it takes an action (such as threatening to seize the debtor's assets) that it knows will lead to the filing of the petition. Seen from this perspective, the institutional lender takes the decisive action at the moment when it stands to gain more from the debtor entering Chapter 11 than if the debtor stayed out of Chapter 11.

The debtor, knowing this, has the incentive to ensure that the nonbankruptcy option remains more attractive to the institutional lender for as long as possible. (More precisely, the owner-manager keeps the nonbankruptcy option more attractive to the institutional lender until the owner-manager either finds Chapter 11 more attractive or ceases to have the ability to make the nonbankruptcy option more attractive.) As noted, Chapter 11 is rarely more attractive to the owner-manager. Hence, the constraint that binds is the debtor's ability to make the nonbankruptcy path more attractive to the institutional lender.

25. See Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991); Michelle J. White, *The Corporate Bankruptcy Decision*, J. ECON. PERSP., Spring 1989, at 129; LUCIAN A. BEBCHUK & RANDAL C. PICKER, BANKRUPTCY RULES, ENTRENCHMENT, AND HUMAN CAPITAL (University of Chicago Working Paper in Law and Economics No. 16, 2d Series 1993).

As long as the firm can continue as a going concern and earn enough revenue to pay off the institutional lender, the institutional lender has no incentive to force a bankruptcy proceeding on the owner-manager. Even if the firm will never have sufficient assets to pay the lender in full, the owner-manager can take a number of steps to persuade the lender that it is going to be better off keeping the firm in business. If the lender does not already have a security interest in all of the firm's assets, it can be given one.²⁶ The owner-managers can give up their own salary. One or more of the managers may step down. They can agree to bring in a new manager to run the firm with them. The firm can extract concessions from suppliers and sometimes from workers. The owner-managers can borrow from relatives and pay down part of the debt. If the owner-managers have not already done so, they can execute a personal guarantee.

We can understand that, under current law, liquidation takes place when the amount that the institutional lender receives outside of bankruptcy is exactly equal to the amount that it receives inside. Increasing the amount that the institutional lender receives in bankruptcy tends to force the firm to shut down at an earlier time. Whether making the bankruptcy petition come at an earlier time is a good thing turns on the size of the revenue stream that the owner-managers can promise the institutional lender.

Let us assume, counterfactually, that in bankruptcy the institutional lender could always receive the liquidation value of the assets. Under such a regime, whether a bankruptcy petition begins at the optimal time would turn on whether the owner-managers could credibly commit future earnings of the firm to the institutional lender that were worth more than the liquidation value of the assets.

If there were no limit on the ability of the owner-managers to convey the revenue streams of the firm to the institutional lender other than the value of the firm as a going concern, the bankruptcy filing would take place at the optimal time. The owner-managers would be able to give the institutional lender enough to keep it at bay if, but only if, the firm were worth keeping intact as a going concern. If the owner-managers had this ability to commit the entire future revenue stream to the institutional lender, a bankruptcy regime that gave the institutional lender less than the liquidation value of the assets would seem to be inefficient.

Consider the extreme legal regime in which the institutional lender

26. Of course, if the firm does not continue for at least 90 days after the grant of the security interest, the grant will likely be a voidable preference under § 547 of the Bankruptcy Code. 11 U.S.C. § 547 (1988).

receives almost nothing in a bankruptcy distribution. In such a regime, the owner-manager needs to give the lender almost nothing to keep it at bay. We can ensure that the bankruptcy starts at the right time by requiring the owner-manager to promise the undersecured creditor a bundle of rights with a value equal to the liquidation value of the firm. Allowing the owner-manager to buy peace from the lender for a lesser amount gives the owner-manager the ability to put off the bankruptcy, even when the going-concern value is less than the liquidation value. Indeed, as long as the amount that the owner-manager has to pay is less than the going-concern value of the business, the owner-manager will postpone the bankruptcy. It will not matter that the liquidation value of the business is much higher than the going-concern value.

When we keep a firm intact that should be liquidated, the delay in filing does postpone the time that the assets of the firm are put to their best use. These costs, however, may not be the largest costs that arise if a bankruptcy petition comes later than is optimal. The largest cost of postponing the liquidation of a firm that is not worth keeping intact as a going concern are the resources that are expended by the trade creditors in shipping goods that will never be sold and the time spent unproductively by the owner-managers running the enterprise. It is exactly these people, however, who stand to gain from a successful reorganization. Here again the capital structure is arranged so that, to the extent possible, those enjoying the benefits incur the costs.

The result is not perfect. The last dollars that the trade creditors and the managers put in the firm have a quasi-priority because the firm can pay trade creditors before the institutional lender. In addition, the trade creditors can profit by selling additional goods and the managers can profit from continued employment. Hence, they may be willing to invest even when the firm is not worth continuing as a going concern. Nevertheless, the concern that bankruptcy petitions come too late may not in fact be a large one, given the capital structure that firms adopt—a capital structure that puts the brunt of the cost of delaying a liquidation on those who benefit from the delay.

IV.

The equity receivership, the ancestor to modern Chapter 11, emerged, largely consensually, at the end of the nineteenth century.²⁷ The equity

27. DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 64-72 (rev. ed. 1993).

receivership was designed to handle the restructuring problems faced by large railroads. The value of these enterprises as going concerns was manifest in a way that the value of many closely held firms now in Chapter 11 is not. But, more importantly, these enterprises had dramatically different capital structures.

The railroads in Chapter 11 came into being when the large, limited liability corporation was in its infancy and the mechanics of running a railroad were largely unknown. Moreover, the railroads that needed to be reorganized were themselves typically the products of many mergers and consolidations. The capital structure of the firm often had not adjusted to the merger. A different creditor held a security interest in each branch line, each terminal, and each main line. Very little debt was unsecured. The committee structure and the bargaining that typified the old equity receivership (and that continues in modern Chapter 11) responded to these capital structures in which there were multiple secured creditors, each of whom had rights to different assets.

These primordial capital structures with diverse secured creditors have long since been abandoned. They were in all likelihood inefficient. The legal structure designed to deal with them, however, has remained in place. The persistence of such an outdated legal structure seems to be a source of substantial costs. Nevertheless, one kind of cost that existing Chapter 11 might seem to bring—forcing investors to accept a distribution of assets that is itself suboptimal—may not loom large. Even though legal institutions may not adapt well to changing economic conditions, this cost is one that investors themselves can take into account in forming the capital structure of the firm. In all likelihood, the largest efficiency losses from Chapter 11 as it currently exists do not come from the way in which bankruptcy distributes assets among investors in the firm.