

2002

# Limiting Liability Through Bankruptcy

G. Marcus Cole

*Notre Dame Law School*, [gcole2@nd.edu](mailto:gcole2@nd.edu)

Follow this and additional works at: [https://scholarship.law.nd.edu/law\\_faculty\\_scholarship](https://scholarship.law.nd.edu/law_faculty_scholarship)



Part of the [Bankruptcy Law Commons](#)

---

## Recommended Citation

G. Marcus Cole, *Limiting Liability Through Bankruptcy*, 70 U. Cin. L. Rev. 1245 (2002).

Available at: [https://scholarship.law.nd.edu/law\\_faculty\\_scholarship/1402](https://scholarship.law.nd.edu/law_faculty_scholarship/1402)

This Article is brought to you for free and open access by the Publications at NDLScholarship. It has been accepted for inclusion in Journal Articles by an authorized administrator of NDLScholarship. For more information, please contact [lawdr@nd.edu](mailto:lawdr@nd.edu).

# LIMITING LIABILITY THROUGH BANKRUPTCY

*Marcus Cole\**

## INTRODUCTION

In 1819, the Supreme Court of the United States decided a dispute that would be unimaginable in today's world. The case was *Sturges v. Crowninshield*, and involved the discharge of a debt under a New York insolvency statute.<sup>1</sup> The facts of the case were not extraordinary: A merchant-shipowner by the name of Richard Crowninshield shifted his extensive foreign trade operations from Salem, Massachusetts to the port of New York, where, on March 22, 1811, he borrowed \$1,543.72 from Josiah Sturges, expecting little difficulty in repaying him.<sup>2</sup> After all, at the beginning of 1811, Crowninshield was at the height of prosperity, with net assets of nearly \$200,000, comprised of six ships, goods, and cash.<sup>3</sup> But the War of 1812 devastated American shipping, and those heavily invested in it. Just one year after borrowing the money from Sturges, Crowninshield found himself sitting in New York's debtors' prison, with debts exceeding his assets by almost \$7,000. Crowninshield was soon to be rescued, however, by a New York insolvency law passed in 1811. It granted debtors like him a release from debtors' prison, and a discharge of his remaining obligations.<sup>4</sup>

Josiah Sturges took exception to the discharge of the sums due him, and challenged the constitutionality of the New York statute. The Supreme Court sided with Sturges, holding that Crowninshield's

---

\* Associate Professor of Law, Stanford Law School, and Visiting Professor of Law, Northwestern University School of Law. The original title of this Article, "Bankruptcy as Asset Partition," has been changed to reflect the observations made by Professor David Skeel. I thank Douglas Baird, Joseph Bankman, Bernard Black, Richard Brooks, Richard Craswell, David Dana, Barbara Fried, Tracey George, Henry Hansmann, the Honorable Edith Jones, Dan Keating, Michael Klausner, Peter Letsou, Thomas Merrill, Adam Mossoff, Robert K. Rasmussen, Robert Sitkoff, David A. Skeel, Jr., Jeff Strnad, George Triantis, Frederick Tung, Michelle White, Kimberly Yuracko, and participants in the University of Cincinnati Law Review Symposium on Bankruptcy and Corporate Reorganization, and the Northwestern University School of Law Faculty Zodiac Property Law Workshop, for their thoughtful comments and suggestions in the formative stages of this project. I am particularly grateful for the support of Dean David Van Zandt of the Northwestern University School of Law. This Article is dedicated to my two sons, Claude Cole and Constantijn Cole, and the hope that these descendants of slaves cherish and protect their inheritance of freedom, and its responsibilities.

1. 17 U.S. (4 Wheat.) 122, 123 (1819).

2. MAURICE G. BAXTER, DANIEL WEBSTER AND THE SUPREME COURT, 110-12 (1966).

3. PETER J. COLEMAN, DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY, 1607-1900, at 32-33 (1974).

4. *Id.* at 33.

assertion that the discharge freed him from the obligation was unacceptable.<sup>5</sup> While the Court was in agreement that it would not permit *Crowninshield* to escape his obligation to Sturges, the justices could not agree as to how the New York statute ran afoul of the Constitution. The possibilities stemmed from two different constitutional provisions. First, the Constitution conferred upon Congress the exclusive power to enact uniform laws on the subject of bankruptcies.<sup>6</sup> Second, it also prohibited the states from impairing the obligations of contracts.<sup>7</sup> The inability of the justices to agree as to which of these two constitutional provisions prohibited the New York discharge left debtors, creditors, and state legislators with uncertainty as to whether and how state debtor-creditor laws could be constitutional. Despite this uncertainty, however, one thing was very clear from the opinion in *Sturges v. Crowninshield*: the Court, for the very first time, nearly thirty years after ratification of the Constitution, had confronted the question of whether an "insolvency" law and a "bankruptcy" law were the same thing.

What makes the case unfathomable for the modern imagination are not the facts, which are ordinary and timeless, but both the issue of law, and the fact that it had not arisen earlier. Actually, two things are evident from the circumstances surrounding this case. First, it is clear that for at least thirty years, creditors, who had the most to gain by challenging state insolvency laws, had presumed them to be constitutional. After all, hundreds, if not thousands, of debtors fell under the "protection" of state insolvency laws each and every year leading up to the Court's decision in *Crowninshield*.<sup>8</sup> Second, the *Crowninshield* case demonstrates that in a great many colonial commercial minds, including the minds of the creditors most affected, insolvency law and bankruptcy law were two different things.

To the modern bankruptcy lawyer, the idea that bankruptcy law might be something other than insolvency law is a bizarre notion. We talk of insolvent individuals and entities as having "gone bankrupt." Finance literature itself commonly refers to the accouterments of insolvency as "bankruptcy costs."<sup>9</sup> Newspaper accounts frequently

---

5. *Sturges*, 17 U.S. at 208.

6. U.S. CONST. art. I, § 8 ("the Bankruptcy Clause").

7. U.S. CONST. art. I, § 10 ("the Contracts Clause").

8. COLEMAN, *supra* note 3, at 31. Nearly a decade after its decision in *Crowninshield*, the Supreme Court ultimately decided that states had the power to discharge debts arising after the passage of the state discharge provisions, but only so long as Congress did not pre-empt the field. *Ogden v. Saunders*, 25 U.S. (12 Wheat.) 213, 269 (1827).

9. RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE*, 511-16 (6th ed. 2000).

describe companies that have become hopelessly encumbered as “bankrupt,” even before any federal court petition is filed. Today, bankruptcy and insolvency are thought to be synonymous.

If modern notions of insolvency are so inextricably intertwined with our understanding of bankruptcy, how is it possible that Colonial, and as will be demonstrated, English lawyers before them, thought of bankruptcy as something other than insolvency law? Perhaps it was because bankruptcy law performed a function wholly apart from that performed by insolvency law. If it did, has this function of bankruptcy remained a part of its operation in today’s economy? Is there some aspect of bankruptcy law that makes it essential, such that a move toward contractual or state law insolvency regimes would deprive our economy of bankruptcy’s essential role within it? In short, is there an essential function that bankruptcy has performed, and continues to perform, that makes it indispensable?

The purpose of this Article is to expose that function of bankruptcy law that distinguished it from English and Colonial insolvency law, and to determine the scope of and need for bankruptcy law to perform that function in contemporary society. I posit that the distinguishing character of bankruptcy law was, and continues to be, its ability to serve as a temporal asset partitioning device. By asset partition, I mean the ability of a structure to sequester the assets of an owner of an enterprise from the reach of the creditors of that enterprise, or the assets of the enterprise from the reach of the creditors of the firm’s owners.<sup>10</sup> In short, bankruptcy law is a limited liability device. It achieves this quality through the operation of the discharge it affords to debtors falling within its protective hedge. Bankruptcy law’s ability to act as a limited liability device is what rendered it very useful, if not indispensable, to commercial existence before the 19th century. It is also this quality that makes bankruptcy law essential in certain contemporary circumstances, but superfluous, and perhaps pernicious, in others.

There are two irrefutable truths about modern American bankruptcy. First, the overwhelming majority of firms that experience financial failure do not employ or experience the bankruptcy process.<sup>11</sup> Professors Douglas Baird and Robert Rasmussen have recently explored this first truth, and have predicted that corporate bankruptcy’s usefulness will become limited to that of an auction block where sophisticated creditors and their debtors reach contractual and

---

10. *E.g.*, Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000).

11. Douglas Baird & Robert Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 752 (2002) [hereinafter Baird & Rasmussen, *The End of Bankruptcy*].

consensual substitutes for the bankruptcy approach to the problem of the common pool.<sup>12</sup> The second truth is that the bankruptcy process can be used by firms that are not confronting financial failure. These firms, as well as many individuals, employ bankruptcy to limit liability, even when they are not in danger of suffering financial or economic distress. In short, while most firms that fail do not use bankruptcy, some firms that use bankruptcy are not in danger of failing. This Article explores the second of these two truths, examining the ways in which solvent corporations and individuals use bankruptcy as a temporal asset partition to limit liability.

This Article proceeds in four parts. In Part I, I explore the operation of bankruptcy law as a temporal limited liability device. Bankruptcy can be distinguished from insolvency in that insolvency is simply a financial condition of a debtor with liabilities exceeding its assets. With simple insolvency, an insolvent debtor's responsibility for satisfaction of its obligations persists through the period of insolvency, and is extinguished only upon the death or dissolution of the debtor. Bankruptcy, on the other hand, is a legal condition of a debtor, one that need not be insolvent. Bankruptcy acts to terminate a debtor's responsibility to satisfy its obligations. For human debtors, this discharge grants a "fresh start," permitting the individual to re-deploy her productive capacities for the benefit of society. For the corporate debtor, a reorganization is accompanied by a fictional death and rebirth, allowing the restructured firm to capture its "going concern value," free from past encumbrances. Unlike insolvency, the discharge afforded by bankruptcy law acts as a temporal asset partition that limits a debtor's liability to those claims that arose before the impenetrable veil of bankruptcy falls. Bankruptcy protects going concern value from the reach of creditors of the past, and preserves it for the benefit of the creditors of the future. Bankruptcy is, in essence, an asset partition.

Part II explains the dual nature of asset partitions. First, I adopt the nomenclature of Professors Henry Hansmann and Reinier Kraakman,<sup>13</sup> who define affirmative asset partitions as those that keep firm assets free from claims of the personal creditors of the firm's owners, and defensive asset partitions as the opposite: protecting personal assets of firm owners from claims of the firm's creditors. The concept of "limited liability," for example, is a form of defensive asset partitioning. Second, I explain the Hansmann-Kraakman thesis, which asserts that one of those two functions, affirmative asset partitioning, is the essential role of

---

12. *Id.*

13. Hansmann & Kraakman, *supra* note 10.

organizational law.<sup>14</sup> The corollary of this thesis is that defensive asset partitioning is not an essential aspect of organizational law, and is available through contractual and other means. This section concludes by characterizing bankruptcy as an extreme form of defensive asset partitioning, one that is temporal and irreversible.

In Part III, I explore the temporal asset-partitioning history and character of bankruptcy law, and how it once operated and continues to serve as a limited liability device. In the terms provided by Hansmann and Kraakman, bankruptcy can be properly understood as a drastic form of defensive asset partitioning. Its history, in fact, supports the Hansmann-Kraakman thesis, in that because it operated in a world generally without secured credit, it performed a useful but inadequate commercial function. Early English and colonial American bankruptcy law was available only to merchants and traders, who were deemed worthy of this protection because of the unpredictable fortunes of commerce and markets. Bankruptcy afforded protection of certain of a businessman's personal assets from the creditors of his business, assets necessary to pick himself up, dust himself off, and start all over again. As a limited liability device, then, it could be characterized as providing defensive asset partitioning. English and early American bankruptcy law began to die in the colonial period, just as the modern corporation began to take shape. I posit that it is bankruptcy's failure to provide affirmative asset partitioning, referred to as "essential" by Hansmann and Kraakman, that leads to its being supplanted by organizational law in the 19th century. In fact, bankruptcy law in America ceased to exist for almost the entirety of the 19th century, returning to the scene permanently but strangely disfigured in 1898.<sup>15</sup>

Part IV explores the modern use, by lawyers, of the asset partitioning ability of bankruptcy law. I examine five classes of cases where the commonly held belief that bankruptcy law is a solution to a common pool problem is demonstrably inaccurate. These cases, categorized as (1) mass tort bankruptcies, (2) ring-fencing, (3) jurisdiction-jumping by wealthy deadbeats, (4) "scotchguarding" judgment-resistance, and (5) retail real estate lease rejection bankruptcies, are all examples involving the invocation of the bankruptcy process to address concerns other than a limited, common pool of assets exceeded by the claims against it. The common thread that unites these contemporary uses of bankruptcy is instead its operation as a limited liability device, frequently a secondary

---

14. *Id.* at 394-96.

15. Congress's passage of the Bankruptcy Act of 1898 gave the United States its first permanent bankruptcy law, one that operated for eighty years. See Charles Jordan Tabb, *The History of the Bankruptcy Laws of the United States*, 3 AM. BANKR. INST. L. REV. 5, 23-26 (1995).

or duplicate one. The secondary asset partitioning effect of bankruptcy creates a clear incentive for questionable forum shopping, where debtors and affiliated third parties prefer the friendly confines, and vagaries, of a bankruptcy court in an effort to circumvent the operation of the rule of law, particularly with respect to priorities, in the non-bankruptcy world.

Part V considers the three implications that flow from the recognition of bankruptcy's ability to partition assets. First, I note that if the central purpose of bankruptcy is to reduce the cost of credit *ex ante*, and if it accomplishes this purpose through asset partitioning, then it may be superfluous, and perhaps pernicious to allow corporations to have access to it in certain circumstances. This means that corporate insolvency might better rest within the purview of state law, a position articulated by Professor David Skeel of the University of Pennsylvania.<sup>16</sup>

The second implication, and corollary of the first, is that bankruptcy continues to perform as an important asset partition for sole proprietorships and partnerships. Businesses employing these organizational forms should be entitled to invoke the limited liability afforded by bankruptcy, along with individuals engaged in commercial investment and speculation. This vision of the purpose of bankruptcy would also suggest a revisiting of the widely accepted notion of "consumer bankruptcy," although such an examination is beyond the scope of this Article.

The third implication of bankruptcy as a limited liability device involves the current debate over "the end of bankruptcy."<sup>17</sup> This debate revolves around the rise of consensual workouts and prepackaged chapter 11 plans as alternatives to traditional chapter 11 restructurings. Proponents of these developments assert that they are more efficient than traditional chapter 11 reorganizations, and a positive step toward a world where contract supplants bankruptcy.<sup>18</sup> Viewing bankruptcy as a limited liability device may add a new perspective on this debate. If the central purpose of bankruptcy is to reduce the cost of credit *ex ante*, and if it performs this function through asset partitioning, and if this asset partitioning is better performed by organizational law, and furthermore, if bankruptcy's ancillary purposes (restructuring) are better performed by contract, then who needs bankruptcy law? In short, the

---

16. See David K. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994) (urging transfer of the bankruptcy power to state control).

17. Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 11, at 751.

18. *Id.* at 752; see also Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 100-107 (1992) and Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998).

third implication is that, while it may be accurate to view the widespread use of corporate bankruptcy law as something that is dying, as Professors Baird and Rasmussen suggest, it may be more appropriate to view its widespread use as something to be killed.

## I. WHAT DOES BANKRUPTCY DO?

### A. *The Common Pool Paradigm*

When Thomas Jackson published *The Logic and Limits of Bankruptcy Law* in 1986, he framed virtually all bankruptcy scholarship that would follow for the next fifteen years.<sup>19</sup> Jackson's take on bankruptcy was that it was a non-exclusive solution to a common pool problem, and that for it to be at all effective, it must reflect what creditors might have agreed to had they been able to get together before hand.<sup>20</sup> This "creditors' bargain" approach to bankruptcy has divided the world of bankruptcy academics into two camps: the "Law and Economics" scholars who appear to adopt the creditors' bargain as the essential purpose of bankruptcy, and the "Progressives" who contend that the purpose of bankruptcy is to promote social welfare, ordering and redistribution that is not politically feasible through other means.<sup>21</sup> The common pool, according to the Progressives, should be shared by more claimants than the Law and Economics scholars are willing to acknowledge.<sup>22</sup>

Both sides of the spectrum share one thing in common: Jackson's characterization of bankruptcy as a solution to the common pool problem that arises when a debtor's liabilities exceed its assets. This understanding of bankruptcy has led Professor Robert Rasmussen to advocate contractual, or privately packaged reorganizations over judicially supervised chapter 11 reorganizations.<sup>23</sup> He argues that debtors and their creditors are more efficient at restructuring troubled firms, and that their contractual solutions are better than "creditors' bargains" in the Jacksonian sense. Professors Douglas Baird and Rasmussen have recently embarked on an extension of this argument,

---

19. THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986). Jackson's theory of the creditors' bargain was actually developed in an earlier article. See Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

20. *Id.* at 16-17 ("The single most fruitful way to think about bankruptcy is to see it as ameliorating a common pool problem created by a system of individual creditor remedies.").

21. See, for example, Karen Gross, *The Need to Take Community Interests Into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994).

22. KAREN GROSS, *FAILURE AND FORGIVENESS*, 13 (1996); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992).

23. See Rasmussen, *supra* note 18, at 100-101.



trumpeting the “End of Bankruptcy,” and pointing to the explosion of “pre-packaged” bankruptcies and private work-outs that have supplanted and circumvented the operation of chapter 11.<sup>24</sup> According to Baird and Rasmussen, the contractualization of bankruptcy has enhanced the control creditors enjoy in those cases where their debtors fall within the chapter 11 process.<sup>25</sup> These developments have alarmed the Progressives, who believe that “private” corporate bankruptcy undermines the public policy objectives and third party non-creditor stakeholder interests that are to be advanced through judicially administered bankruptcy.<sup>26</sup>

Several scholars have questioned the “common pool” paradigm that reigns over bankruptcy scholarship.<sup>27</sup> Each has identified the source of the collective action fixation within the literature as stemming largely from the widespread association of bankruptcy with insolvency.<sup>28</sup> But what if bankruptcy, in the English and American tradition, has an important or even essential role apart from its function as a solution to a collective action problem? The answer to this question lies in an examination of how bankruptcy is used. Such an examination reveals that the purpose of bankruptcy frequently is not to solve a common pool problem, but rather, to operate as a device to limit liability, one that is often necessary to facilitate commercial activity.

### B. *The Essential Character of Bankruptcy Law*

Bankruptcy limits liability. It does this by erecting a legal partition between assets against which past creditors have claims, and “going concern value” or future assets, against which only future creditors can seek satisfaction. The separation of past assets and claims from future assets and claims is the very characteristic that distinguishes bankruptcy from insolvency. It is this temporal characteristic that makes bankruptcy a drastic, irreversible legal partition.<sup>29</sup> A firm or individual may cycle in

---

24. *Id.*

25. *Id.*

26. See Warren, *The Untenable Case for Repeal of Chapter 11*, *supra* note 22, at 439.

27. See, e.g., Barry Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); Rasmussen, *supra* note 18, at 101; Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992); and Randal C. Picker, *Voluntary Petitions and the Creditors' Bargain*, 61 U. CIN. L. REV. 319 (1992).

28. Professor Adler presents a more complete attack on the common pool paradigm in his forthcoming book, *THE LAW OF LAST RESORT* (chapter on file with author).

29. The substance of the current article has been dramatically rewritten to recognize the temporal nature of the asset partitioning performed by bankruptcy, as pointed out by Professor David Skeel's symposium remarks regarding this Article.

and out of insolvency frequently, as much as several times a year, month, or even within a day.<sup>30</sup> This “solvency cycling” is ubiquitous, and uneventful, as long as the debtor in question sustains periods of solvency to offset the periods of insolvency. The important thing to remember about insolvency is that it exists all around us, and very rarely involves bankruptcy law or bankruptcy procedures. Insolvency need not be a common pool problem, so long as the common pool is a “living and breathing” one. If the assets to which creditors can look to satisfy their claims have a good possibility of expanding, then insolvency is merely a fleeting inconvenience. Insolvency becomes a common pool problem when the common pool of assets is “frozen,” in other words, not permitted to expand or contract. This happens when a person dies, a corporation is dissolved, faces imminent dissolution, or when a bankruptcy petition is filed.

But a bankruptcy petition can be filed, and frequently is filed, by persons and companies well outside the realm of insolvency.<sup>31</sup> These debtors resort to bankruptcy, not because of the existence of a common pool problem, but because of bankruptcy’s ability to partition the past from the future. Solvent debtors file bankruptcy to limit liability, not to solve a common pool problem. On the other hand, the vast majority of insolvent debtors never resort to a bankruptcy filing.<sup>32</sup> The simple truth about bankruptcy and insolvency is this: *an insolvent debtor need not be bankrupt, and a bankrupt debtor need not be insolvent.*

The distinction between the condition that we know of as “insolvency” and that we know of as “bankruptcy” helps us to understand the difference between insolvency law and bankruptcy law. We can think of insolvency law as the law of debtors and creditors that governs the satisfaction of claims, but does not discharge them in the absence of satisfaction. Insolvent debtors are still liable for claims against them, and will have to satisfy those claims from future assets if present assets are insufficient to satisfy those claims.<sup>33</sup> Bankruptcy law, on the other hand, can be thought of as law that effects a discharge of claims, whether or not they are satisfied in full, and prohibits future

---

30. The condition of “living paycheck-to-paycheck” is perhaps the most common example of solvency cycling within the period of a month. The recent phenomenon of “day traders” provides an example of solvency cycling within a day.

31. Section 301 of the Bankruptcy Code places no insolvency requirement on a debtor seeking to file a voluntary petition. 11 U.S.C. § 301 (2002). Section 303 does, however, place some showing of insolvency, albeit a crude one, upon creditors seeking to force a debtor into bankruptcy through the filing of an involuntary petition. See 11 U.S.C. § 303(h) (2002).

32. See Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 11, at 753.

33. Garnishment law is an example of insolvency law that taps future income to satisfy past obligations.

assertion of those discharged claims.<sup>34</sup> Bankruptcy limits a debtor's liability on past and present claims to an artificially fixed and static, current pool of assets. It also prevents claimants on that pool from reaching the debtor's future assets or going concern value unless they exchange their past positions for new ones. This separation of past claims and assets from future claims and assets is also irreversible.<sup>35</sup> Bankruptcy is, in effect, a limited liability device, and a drastic one at that.

That bankruptcy is a limited liability device is not a new assertion; it dates at least as far back as 1827, when the Supreme Court finally resolved the issue as to whether bankruptcy laws and insolvency laws were the same thing. In *Ogden v. Saunders*, the Court concluded that while states could enact insolvency laws that regulated affairs between debtors and creditors generally, a law that discharged a debt was a bankruptcy law.<sup>36</sup> The Bankruptcy Clause prohibits states from enacting such laws if Congress pre-empted them by passing its own discharge law.<sup>37</sup> According to the *Ogden* court, a bankruptcy law, by discharging a debt, limited the debtor's liability on the obligation in a way that insolvency law did not.<sup>38</sup> In the absence of a discharge, an insolvent debtor's liability on an obligation persisted until his ship came in.

At least one modern commentator has also characterized bankruptcy as a form of limited liability.<sup>39</sup> As a limited liability device, bankruptcy can be said to do what other limited liability devices, such as the corporate veil, accomplish: they partition assets to which certain creditors look for satisfaction from other assets which are shielded from their reach. Bankruptcy, as a limited liability device, is an asset partition.

---

34. Section 524 of the Bankruptcy Code provides for both the discharge of claims asserted in a bankruptcy proceeding, as well as a prohibition on the assertion of those claims at any point in time after the conclusion of the case. See 11 U.S.C. § 524 (2002).

35. Reaffirmation of a discharged debt may be viewed as a reversal of the effect of a bankruptcy discharge, but is perhaps more accurately viewed as a new obligation between parties to the discharged obligation. See 11 U.S.C. § 524(f) (2002).

36. *Ogden v. Saunders*, 23 U.S. (12 Wheat.) 213, 269 (1827).

37. *Id.* at 270.

38. *Id.*

39. See Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173 (1987).

## II. BANKRUPTCY AS ASSET PARTITION

*A. Asset Partitioning Defined*

Professors Henry Hansmann and Reinier Kraakman undertook the most thorough explication of asset partitioning in their recent article, *The Essential Role of Organizational Law*.<sup>40</sup> Hansmann and Kraakman define asset partitioning as the designation of a separate pool of assets that are available to satisfy claims by a firm's creditors, distinct from the personal assets of the firm's owners and managers, and the assignment of priorities in the resultant distinct pools of assets.<sup>41</sup> When a firm is owned as a freestanding legal entity, the assets owned by that entity in its own name become a separate pool of firm assets, distinct from the personal assets of any of the owners of the firm.<sup>42</sup>

The latter part of the Hansmann-Kraakman definition of asset partitioning is the assignment of priorities to creditors with respect to the segregated asset pools. This second aspect of asset partitioning takes two forms. The first assignment of priorities is to the creditors of the firm with regard to the assets associated with the firm's operations. Firm creditors, in other words, have a right to have their claims satisfied from the firm's assets before the personal creditors of the firm's owners can have resort to those assets. This priority allows potential firm creditors to make assessments about the risks associated with extension of credit to the firm.<sup>43</sup> For this reason, these firm assets can be thought of as "bonding assets."<sup>44</sup> Hansmann and Kraakman designate this function as "affirmative asset partitioning," to reflect the bonding for the firm's obligations.<sup>45</sup>

A second form of asset partitioning is the opposite of the first. It sections off the personal assets of the firm's owners, and grants priority in those personal assets to the personal creditors of the firm's owners. Personal assets perform the bonding function for the personal creditors of the firm's owners, giving them a basis upon which to make personal credit determinations. We can think of this form of asset partitioning as "limited liability," and for this reason, Hansmann and Kraakman have

---

40. Hansmann & Kraakman, *supra* note 10, at 392.

41. *Id.* at 393.

42. *Id.*

43. *Id.*

44. Hansmann & Kraakman, *supra* note 10, at 392.

45. *Id.* at 393.

labeled it "defensive asset partitioning."<sup>46</sup> The characteristics of each form of asset partitioning are addressed in turn.

## *B. The Two Forms of Asset Partitioning*

### *1. Affirmative Asset Partitioning*

Affirmative asset partitioning can be best understood in the context of the corporate form of business ownership. The formation of a corporation assigns a priority in that corporation's assets to claims of the corporation's creditors.<sup>47</sup> The principal benefits of affirmative asset partitioning lie within its ability to reduce costs. First, asset partitions reduce the costs of creditor monitoring.<sup>48</sup> A creditor to a business operated by a sole proprietor, for example, must be familiar with, and keep informed about, the economic prospects for the business and its industry. But a creditor of a sole proprietorship must also monitor the personal affairs of the proprietor, since mismanagement of those affairs will cause personal creditors to have access to the assets of the business to which our firm's creditor has extended credit. A creditor to a corporation, on the other hand, can dispense with the need for such monitoring of the personal affairs of the firm's owner or owners. Instead, the creditor can gain a more accurate assessment of the risks of credit associated with the business and its markets, since the partition afforded by the corporate veil shields the firm's assets from personal credit risks and circumstances.<sup>49</sup> These monitoring cost savings are multiplied when we factor in additional owners of the firm.

Likewise, firms engaged in disparate industries with unrelated operations and prospects impose more monitoring costs on the firm's potential creditors. In order to accurately assess the risks of credit extension, potential creditors must learn all there is to know about all of the various enterprises in which the firm is engaged. A firm can reduce this cost of monitoring to its creditors by partitioning the assets of each endeavor into subsidiary corporations, allowing each creditor to focus on one type of operation within one particular industry. Multiple owners and multiple enterprises, then, could present potentially insurmountable monitoring costs in the absence of effective affirmative asset partitioning. While affirmative asset partitioning has other benefits

---

46. *Id.* at 393-94.

47. *Id.* at 394-95.

48. *Id.* at 399-405.

49. *Id.* at 401-03.

as well, its ability to reduce monitoring costs is the one function that is difficult to duplicate through contractual means. It is for this reason that Hansmann and Kraakman identify affirmative asset partitioning as the essential role of organizational law.<sup>50</sup>

## 2. Defensive Asset Partitioning

Defensive asset partitioning, like affirmative asset partitioning, can be best understood through the lens of the corporate form. In a corporation, the creditors of the business have no claim upon the personal assets of the firm's shareholders.<sup>51</sup> These personal shareholder assets are instead pledged exclusively to the personal creditors of those shareholders in the event of personal insolvency.<sup>52</sup> This exclusive form of defensive asset partitioning has come to be referred to as "limited liability."<sup>53</sup> But limited liability is not the only form of defensive asset partitioning, which can range from that extreme of exclusivity, to intermediate and nonexistent protection of owner assets from firm creditors.<sup>54</sup> The reason for this variety is due to the relative costs and benefits of the various levels of defensive asset partitioning.

The costs associated with defensive asset partitioning derive principally from the incentives and possibilities it creates for owners of a firm to behave opportunistically with respect to the firm's creditors. First, a fundamental principle of finance is that residual claimants on a firm, because of their exclusive claim to any potential upside in the fortunes of the firm, have an incentive to undertake riskier projects than would be preferred by creditors of the firm, who receive fixed compensation and enjoy none of potential upside that exceeds their claims.<sup>55</sup> Limited liability means that if risky projects do not pan out, both creditors and residual claimants share the loss, but only to the extent of their investment in the firm.<sup>56</sup> With all of the upside, but only a share of the downside, owners of the firm can be said to enjoy an option on the value of the firm. The resultant divergence between the interests of the firm's owners and the firm's creditors that this option

---

50. *Id.*

51. *Id.* at 397.

52. *Id.*

53. *Id.*

54. General partnerships and sole proprietorships, for example, provide no defensive asset partitioning. See Larry E. Ribstein, *Partner Bankruptcy and the Federalization of Partnership Law*, 33 WAKE FOREST L. REV. 795, 800-01 (1998).

55. BREALEY & MYERS, *supra* note 9, at 482-484.

56. Hansmann & Kraakman, *supra* note 10, at 396.

creates, can be seen as a cost of defensive asset partitioning which is borne by all investors in the firm.

Another related cost of defensive asset partitioning resides in the direct conflict between the interests of the firm's owners and the firm's creditors. This clash can manifest itself with the owner's incentives to deplete the resources of the firm in anticipation of insolvency, or by converting those assets into a form inaccessible to the firm's creditors (*i.e.*, the leisure enjoyed through shirking). In either event, these potential distributions of the firm's assets to the owners of the firm represent a cost of defensive asset partitioning, a cost which must manifest itself in the cost of credit.<sup>57</sup>

In order for defensive asset partitioning to exist in the face of its costs, it must produce benefits that exceed them. In truth, defensive asset partitioning, in the form of limited liability, has many benefits that explain its existence. First, as is true with its affirmative mirror image, defensive asset partitioning reduces monitoring costs. Defensive asset partitioning, in the form of limited liability, allows personal creditors of firm owners to focus attention on the assets of those owners.<sup>58</sup> Limited liability also reduces monitoring costs for the firm's owners.<sup>59</sup> In the absence of limited liability, each owner of the firm would need to monitor, not only the fortunes of the firm, but the assets and liabilities of their co-owners as well.<sup>60</sup>

Second, limited liability reduces decision-making costs by homogenizing the interests of the owners of the firm. Distributions to shareholders in a corporation are treated equally, without the need for costly managerial determinations or lobbying.<sup>61</sup> Third, in firms with a separation of ownership and control, limited liability shifts some of the costs of monitoring the professional managers of a firm from the firm's owners to the firm's creditors.<sup>62</sup> If creditors of the firm know that they have recourse only to assets of the firm, then they are more likely to scrutinize the activities of the managers, both before and after the extension of credit. The firm's dispersed owners can "free ride," to some extent, on the less-dispersed creditors' monitoring efforts.<sup>63</sup> A fourth benefit of limited liability is that it avoids the costly process of prosecuting and executing judgments against the firm's owners. If the

---

57. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATION LAW*, 44 (1991).

58. *Id.*

59. EASTERBROOK & FISCHEL, *supra* note 57, at 41.

60. *Id.* at 41-42; *see also* Hansmann & Kraakman, *supra* note 10, at 396.

61. EASTERBROOK & FISCHEL, *supra* note 57, at 42.

62. Hansmann & Kraakman, *supra* note 10, at 395.

63. EASTERBROOK & FISCHEL, *supra* note 57, at 42-43.

number of owners of a firm is very large, this cost can be large relative to the amount collected.

A fifth benefit of limited liability is that it facilitates the transfer of firm ownership.<sup>64</sup> Potential claimants on the assets of a firm without defensive asset partitioning are entitled to have their claims satisfied by the personal assets of the firm's owners. Potential buyers of shares in such a firm are unable to know with any accuracy the extent to which co-owners will be able to shoulder the liability load. Some of these co-owners may be looking to free ride on the assets of the potential buyer and other co-owners. Only knowledge of the holdings of other owners can provide potential buyers with an understanding of the risk they are about to undertake, and how to price it. Defensive asset partitioning provides just such a fix on this risk, enabling markets for trading firm ownership to develop.<sup>65</sup>

A sixth and final benefit of defensive asset partitioning, in the form of limited liability, is its ability to permit a firm's owners to control the risks they are willing to bear with respect to the firm. Owners can shift more or less assets into the firm with respect to creditors or other owners, depending upon how much they wish to put at risk within that particular firm. The absence of limited liability would expose all of a particular owner's assets to the risks of the enterprise, leaving nothing for the owner to decide with respect to the amount which she would like to expose to the firm's prospects.<sup>66</sup>

### III. BANKRUPTCY AS A TEMPORAL DEFENSIVE ASSET PARTITION

The Hansmann-Kraakman thesis of the essential role of organizational law is supported by, and consistent with, the history of English and American bankruptcy law and the origins of the modern corporate form. The corporation became a formidable commercial force just as bankruptcy law was proving unwieldy as an asset partitioning device. In a very real sense, however, we can think of the corporation as the natural successor to English and early American bankruptcy law, because it was able to provide what bankruptcy law could not: affirmative asset partitioning, plus more flexible defensive partitioning.

---

64. See Susan E. Woodward, *Limited Liability in the Theory of the Firm*, 141 J. INSTIT'L & THEORETICAL ECON. 601, 601 (1985); see also EASTERBROOK & FISCHER, *supra* note 57, at 42-43.

65. EASTERBROOK & FISCHER, *supra* note 57, at 43.

66. *Id.* at 43-44.



*A. The Bankruptcy Precursor to the Corporation*

Bankruptcy's ability to operate as a limited liability device is difficult to imagine when viewed through the lens of modern corporate bankruptcy, in large part because we envision the bankruptcy of an insolvent firm as the transfer of all residual ownership in the firm's assets to the holders of claims against those assets.<sup>67</sup> But business bankruptcy law did not always entail this "lock-stock-and-barrel" transfer of ownership from shareholders to creditors, and in some cases, it does not follow this paradigm today. To understand how bankruptcy can operate as a limited liability device, a defensive asset partition if you will, it is helpful to consider a time when business and individual bankruptcy were one and the same: early English and colonial American bankruptcy.

*1. English Bankruptcy: Merchants and Traders Only*

While bankruptcy law, in one form or another, is thought to be thousands of years old, English law's adoption of it placed an indelible and lasting mark upon it. From its very beginnings, English bankruptcy law applied only to merchants and traders.<sup>68</sup> These individuals were deemed to be the only economic actors in society whose personal financial circumstances needed to be shielded from the volatilities of commerce and commercial speculation. Ordinary debtors, not engaged in trade, were not entitled to bankruptcy treatment, and the protection afforded by its discharge. According to Blackstone, the laws of England were:

cautious of encouraging prodigality and extravagance by this indulgence to debtors; and therefore they allow the benefit of the laws of bankruptcy to none but actual traders; since that set of men are, generally speaking, the only persons liable to accidental losses, and to an inability of paying their debts, without any fault of their own. If persons in other situations of life run in debt without the power of payment, they must take the consequences of their own indiscretion, even though they meet with sudden accidents that may reduce their fortunes: for the law holds it to be an unjustifiable practice, for any person but a trader to encumber himself with debts of any

---

67. Adler, *supra* note 26, at 314; see also Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, *supra* note 19, at 857.

68. W. J. JONES, *THE FOUNDATIONS OF ENGLISH BANKRUPTCY: STATUTES AND COMMISSIONS IN THE EARLY MODERN PERIOD*, 5 (1979); see also, HUGH BARTY-KING, *THE WORST POVERTY: A HISTORY OF DEBT AND DEBTORS*, 15-16 (1991).

considerable value. If a gentleman, or one in a liberal profession, at the time of contracting his debts, has a sufficient fund to pay them, the delay of payment is a species of dishonesty, and a temporary injustice to his creditor: and if, at such time, he has no sufficient fund, the dishonesty and injustice is the greater. He cannot therefore murmur, if he suffers the punishment which he has voluntarily drawn upon himself. But in mercantile transactions the case is far otherwise. Trade cannot be carried on without mutual credit on both sides: the contracting of debts is therefore here not only justifiable but necessary. And if accidental calamities, as by loss of a ship in a tempest, the failure of brother traders, or by the nonpayment of persons out of trade, a merchant or trader becomes incapable of discharging his own debts, it is his misfortune and not his fault.<sup>69</sup>

This quote from Blackstone reveals a clear understanding of bankruptcy law as an asset partition, designed to provide limited liability exclusively for merchants and traders. Since the inception of its discharge, bankruptcy has acted as a partition between the future assets of a bankrupt debtor and the past claims against that debtor. By shielding future income from past claims, bankruptcy limits liability on those claims.

Bankruptcy law provided this form of limited liability in the following way. Suppose an individual found himself hopelessly encumbered by debt. If he were unable to qualify for bankruptcy relief as a trader or merchant, he was susceptible of "having the bailiff in the house," to gather up his possessions on writ of execution on a judgment secured by one or more of his creditors, "to be sold up" for the benefit of those creditors.<sup>70</sup> If our debtor's personal belongings were insufficient to bring enough from a bailiff's sale to satisfy the claims of his creditors, he stood the risk of confinement in debtors' prison.<sup>71</sup> Our unfortunate debtor could avoid debtors' prison by fleeing the country in a form of self-imposed banishment, by seeking the increasingly limited sanctuary found behind church doors, or by "keeping house," a form of self-imposed house arrest that took advantage of the common law's prohibition on the entering of a man's house to serve civil process.<sup>72</sup> Our debtor would be plagued by these possibilities for as long as his indebtedness lasted, even if it lasted for the rest of his life.<sup>73</sup>

---

69. WILLIAM BLACKSTONE, 2 COMMENTARIES ON THE LAWS OF ENGLAND 473 (1765-1769) (1858).

70. GEORGE ELIOT, *THE MILL ON THE FLOSS*, bk. 4, ch. 3, at 332 (1992).

71. See Jay Cohen, *The History of Imprisonment for Debt and its Relation to the Development of the Discharge*, 3 J. LEGAL HIST. 153, 158-159 (1982).

72. *Id.* at 158.

73. *Id.* at 159; see also BARTY-KING, *THE WORST POVERTY*, *supra* note 68, at 14.

Things would be very different for our debtor, however, if he were a merchant or trader. The Statute of 13 Elizabeth, enacted in 1570, provided that only traders and merchants, persons who earned their living "buying and selling," were eligible for bankruptcy.<sup>74</sup> To be sure, the debtor's creditors would have resort to most of the debtor's assets, personal and business assets alike, without distinction for the most part.<sup>75</sup> The creditors could access most, but not all of the debtor's assets, because merchants and traders were deemed critical, as businessmen, to the fortunes of the whole society. In order to preserve their contributions to society, it was necessary for bankruptcy law to shield certain property from the reach of creditors.<sup>76</sup> This property, which the law deemed "exempt" from the reach of creditors, typically included the merchant's tools of trade, clothing, scriptures, and other personal property that would permit the businessman to start anew, returning to productive service to the economy.<sup>77</sup>

But what if our merchant's assets, excluding those necessary for him to continue to devote his productive capacities to the common weal, were insufficient to satisfy his creditors? Would he be relegated to working for his creditors until the end of his days? Or would he recognize the hopelessness of his circumstance, choose to give up his trade, and live off of the alms of others, or assets sequestered from creditors?

While early English bankruptcy was limited to merchants and traders, it failed to address the difficulty of hopelessly encumbered but otherwise productive men of commerce. In order to preserve these capacities for the benefit of society, Parliament enacted the Statute of Anne in 1704.<sup>78</sup> It created a right of discharge for honest but unfortunate merchants and traders, as an incentive to cooperate with their creditors.<sup>79</sup> It also gave our merchant the incentive to return his entrepreneurial shoulder to the

---

74. 13 Eliz., cap 7 (1570). Although the Statute of 13 Elizabeth is widely regarded as the first English bankruptcy statute, that distinction is more properly hung, given the definition advanced in this Article, on the bankruptcy act of 1543. The 1543 statute, passed during the "benevolent despotism" of Henry VIII, afforded a discharge to "commercial men" only, and was the first to provide for pro rata distributions to creditors. JONES, *supra* note 68, at 11-16. See also Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5 (1995).

75. BARTY-KING, *supra* note 68, at 68 ("execution could be taken out against any of his possessions except his wearing apparel, bedding for himself and family, and the tools of his trade.").

76. Cohen, *supra* note 71, at 158.

77. BARTY-KING, *supra* note 68, at 68.

78. See Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 30 (1986).

79. *Id.*

wheel of commerce, with the assurance that all new business would be conducted on a clean slate.<sup>80</sup>

Under English law, bankruptcy law was business law. As business law, bankruptcy's discharge was, and is, a form of limited liability.

## 2. Colonial Understandings

Like many things in colonial America, bankruptcy law was distinctly English, reserving its discharge, and the limited liability that it represented, for the benefit of merchants and traders. The colonists were too dependent upon the flow of capital and credit from England to make any significant changes, or waves.<sup>81</sup> When the colonies became so well established that their survival was no longer in doubt, they developed their own bankruptcy laws, which largely tracked the logic, if not the form, of their English precursor.<sup>82</sup> That logic entailed four objectives. The first was to protect society from the volatilities to which staple-oriented economies were subject when crop failures or wars disrupted normal production and trading activities.<sup>83</sup> Second, these laws sought to mitigate the severity of creditor remedies that might deprive society of the productive capacities of the merchant-debtor. Third, they sought to avoid the chain reaction that might result from the failure of a single merchant or planter by spreading the losses equitably among all creditors.<sup>84</sup> Finally, they advanced the original purpose of the discharge: to give "producers," merchants, traders, and now planters, the incentive and opportunity to produce once again, free from the misfortunes of the past.<sup>85</sup>

The American Revolution changed very little about bankruptcy law or its purposes.<sup>86</sup> There was some discrimination against Tory creditors after the war, but there were no formal repudiations of pre-war debts, and even the Treaty of Paris in 1783 provided for their payment.<sup>87</sup> The principal effect of the revolution was the fact that each state was left to its own devices when it came to crafting the bounds of the relations between its debtors and its creditors. This, in turn, meant that creditors extending credit beyond state lines faced uncertainty with regard to the

---

80. *Id.* at 31.

81. See COLEMAN, *supra* note 3, at 6 (1974).

82. *Id.* at 31.

83. *Id.* at 12.

84. *Id.* at 13.

85. *Id.*

86. Hoppit makes the opposite claim with respect to English bankruptcy law. See Hoppit, *supra* note 81, at 122-27.

87. COLEMAN, *supra* note 3, at 16.

applicable law governing collection of debts. In order to engage in interstate commerce, creditors had to keep abreast of disparities between regimes.<sup>88</sup> A national, uniform bankruptcy law could have solved this problem, but that was virtually impossible under the Articles of Confederation.<sup>89</sup> Such a question would have required unanimous approval of the states, and if anything is true about the history of American bankruptcy law, it is that it has been acrimoniously controversial since the founding of the republic.

The need for certainty in interstate credit transactions led to the adoption of the Bankruptcy Clause of the Constitution. It authorizes Congress "[t]o establish . . . uniform laws on the subject of bankruptcies throughout the United States."<sup>90</sup> The framers of the Constitution in 1787 devoted very little of their deliberations to the Bankruptcy Clause, and there is no evidence that the ratifying conventions of the states gave much thought to it either.<sup>91</sup> A conclusory remark made by James Madison in Federalist Number 42 is the only reference to the Bankruptcy Clause in the Federalist Papers. There, Madison asserts that "[t]he power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where parties or their property may lie or be removed into different States, that the expediency of it seems not likely to be drawn into question."<sup>92</sup>

What was meant by "uniform laws on the subject of bankruptcies," could, however, be drawn into question. An "originalist" interpretation of the Clause might insist that what the framers had in mind was the system of bankruptcy prevailing at the time. This presumption, however, requires us to answer yet another question: "prevailing where?" Did the framers, by reference to "bankruptcy laws," mean laws bearing that particular label, reflecting their understanding of the compulsory, involuntary form of proceeding confined to traders and merchants under English law?<sup>93</sup> Or did the framers mean to confer

---

88. *Id.* at 12.

89. *Id.* at 17. See also F. REGIS NOEL, A HISTORY OF THE BANKRUPTCY CLAUSE, OF THE CONSTITUTION OF THE UNITED STATES OF AMERICA, 74 (1918).

90. U.S. CONST. art. I, § 8, cl. 4. See CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 4-8 (1935); F. REGIS NOEL, A HISTORY OF THE BANKRUPTCY LAW 76-81 (1919); Vern Countryman, *A History of American Bankruptcy Law*, COM. L.J. 226 (June/July 1976).

91. NOEL, *supra* note 90, at 77.

92. THE FEDERALIST NO. 42 (James Madison) (1961).

93. See COLEMAN, *supra* note 3, at 18. According to Professor Charles Warren, "It is highly probable that the attention of the framers was chiefly centered on bankruptcy in relation to commerce, and that the exercise of the [bankruptcy] power was conceived as primarily for the benefit of the commercial class of creditors and debtors, as in England." WARREN, *supra* note 90, at 7.

upon Congress the power to promulgate laws concerning insolvency generally?

If the framers of the Bankruptcy Clause meant to give Congress the power to govern insolvency, then they intended to grant sweeping powers to the central government by the standard prevailing at the time. Insolvency laws governed the affairs of individuals unable to claim the special status and limited liability afforded to merchants and traders under the bankruptcy laws. Among the states, there was no prevailing practice with respect to insolvency. The colonies maintained widest variation.<sup>94</sup> Three of the thirteen colonies had laws discharging insolvents of their debts.<sup>95</sup> Six of the colonies gave full relief only for select insolvents, and then only during sporadic periods.<sup>96</sup> Four of the colonies never bothered to enact insolvency legislation.<sup>97</sup>

The distinction between bankruptcy laws and insolvency laws was quite real at the time of the framing. Pennsylvania, in fact, had two distinct regimes: a bankruptcy system and an insolvency system.<sup>98</sup> As noted earlier, the idea that the Bankruptcy Clause did not empower Congress to enact insolvency laws was tested in *Sturges v. Crowninshield*.<sup>99</sup> The very existence of dual regimes to govern insolvency and bankruptcy independently, and the litigation in the nation's highest court over whether these terms were synonymous, provide insight into the way early Americans viewed bankruptcy law and insolvency law. Bankruptcy law provided limited liability for businessmen, and their creditors, who could find it nowhere else at the time.

### 3. The Corporate Successor to Bankruptcy

The monopoly that bankruptcy held over the highly coveted supply of limited liability was soon to be broken. Corporations were quite uncommon before 1800, and the few that existed were not business corporations.<sup>100</sup> Almost all colonial corporations were either governmental subunits or eleemosynary institutions: churches and charities. In England, only the crown had the right to incorporate. After the Revolution, it was generally understood that state legislatures were the arm of government vested with the power to make

---

94. WARREN, *supra* note 90, at 6-7.

95. COLEMAN, *supra* note 3, at 14 (Rhode Island and the Carolinas).

96. *Id.* at 272.

97. *Id.*

98. WARREN, *supra* note 90, at 6-7.

99. 17 U.S. (4 Wheat.) 122 (1819).

100. LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 188 (2d ed. 1985).

corporations.<sup>101</sup> Even with this expansion of power, in all of the 18th century, only 335 businesses were issued corporate charters.<sup>102</sup>

Things changed in the 19th century. More charters were issued to businesses, primarily those engaged in banking, transportation infrastructure, or water provision.<sup>103</sup> In Pennsylvania, for example, 2,333 business corporations were chartered between 1790 and 1860.<sup>104</sup> These special acts of the legislature were supplanted by the passage of general incorporation statutes, which facilitated the incorporation of dramatically more firms. In 1811, New York passed a Manufacturing Act, which permitted the incorporation of any manufacturing business for a term of twenty years with the simple filing of a certificate.<sup>105</sup> This is considered the first general business incorporation statute, and was followed by competing statutes in other jurisdictions.<sup>106</sup>

Neither the New York act, nor any of its competitors, provided for limited liability at first.<sup>107</sup> This feature of the modern corporation would develop slowly over the course of the 19th century. The rise of the limited liability corporation brought with it affirmative asset partitioning. With these dual forms of asset partitioning available through the corporate form, bankruptcy as asset partition lost its central place in American business. The development of secured credit in the 20th century afforded affirmative asset partitioning through means other than the corporate form. Together, bankruptcy and secured credit could have offered American businesses defensive and affirmative asset partitioning, respectively. Early forms of secured credit were viewed with suspicion, however. By the time security interests came to be seen as something other than fraudulent, bankruptcy was already out of fashion as the primary limited liability device in commerce.<sup>108</sup> Unlike American partnership law, however, which lost its ability to afford defensive asset partitioning with the passage of the 1978 Bankruptcy

---

101. JOHN W. CADMAN, JR., *THE CORPORATION IN NEW JERSEY: BUSINESS AND POLITICS 1791-1875* (1949).

102. FRIEDMAN, *supra* note 100, at 189.

103. *Id.* at 188.

104. *Id.* at 189; see also HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW 1836-1937* 12 (1991).

105. *Id.* at 195.

106. Act of Mar. 22, 1811, ch. LXVII, §§ 1, 1811 N.Y. Laws 111 (authorizing corporate formation without a special charter to "manufactur[e] woolen, cotton, or linen goods"); see Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations*, 49 AM. U. L. REV. 81, 101 (1999).

107. Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593, 1653-54 (1988).

108. The United States was without a permanent bankruptcy law until passage of the Bankruptcy Act of 1898. See Tabb, *supra* note 74, at 5.

Code, American bankruptcy preserved and expanded its ability to afford limited liability. A parallel evolution took place in England. Just seventeen years after the passage of Britain's first general incorporation statute in 1844, and six years after the passage of the Limited Liability Act of 1855, Parliament officially abolished the distinction between insolvency and bankruptcy.<sup>109</sup> Bankruptcy was suddenly available to anyone, without regard to commercial activity. While Victorian bankruptcy became increasingly associated with consumers, businesses looked to the more effective means of partitioning assets available through organizational law. The corporate form had supplanted bankruptcy as the asset partition of choice on both sides of the Atlantic.

### *B. The Preservation of Asset Partitioning in Modern Bankruptcy Law*

Asset partitioning in modern bankruptcy law can be thought of as the product of the confluence of three acts of Congress: the Bankruptcy Act of 1898, the Chandler Act of 1938 and sections 301 through 303 of the Bankruptcy Code of 1978.<sup>110</sup> These three statutes expanded bankruptcy relief to corporate debtors, including those seeking restructuring, and detached bankruptcy relief, at least formally, from insolvency.<sup>111</sup> The absence of an insolvency requirement, when coupled with departures from non-bankruptcy priorities, preserves bankruptcy's role as an asset partitioning device. Solvent debtors employing bankruptcy to manipulate state law priorities can preserve a portion of future assets for the benefit of pre-bankruptcy managers and junior stakeholders. The evolution of bankruptcy legislation that dispensed with absolute priority and proof of insolvency, then, has preserved bankruptcy's early character as a temporal asset partition.

The Bankruptcy Act of 1898 was the product of a long struggle, primarily between northeastern financial interests, and southern agricultural concerns. When it was adopted, it captured the relations between small businesses and their financiers, as well as providing for the treatment of individuals. The compromise that allowed the bill to pass where others had failed was over an issue that had previously proven intractable: property exemptions. The new law provided

---

109. See Paul G. Mahoney, *Contract or Concession? An Essay on the History of Corporate Law*, 34 GA. L. REV. 873, 890 (2000).

110. The Bankruptcy Act of 1898, (act July 1, 1898, ch. 541, 30 Stat. 544) (repealed 1979); The Chandler Act of 1938 (The Bankruptcy Act of 1938), Ch. X, §§ 268, 269, 270; Ch. XI, §§ 395, 396; Ch. XII, §§ 520, 521, 522; Ch. XIII, § 679 (repealed 1979); The Bankruptcy Code of 1978, 11 U.S.C. § 101 *et seq.* (2002).

111. DAVID A. SKEEL, JR., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA*, 73-100 (2001).



federal procedures, which implemented state exemption law, a compromise that would last until the present day.<sup>112</sup>

Noticeably absent from the 1898 Act, through the lenses of 21st century glasses, was a provision for reorganization of corporations. That body of law grew up spontaneously, and contemporaneously, in the federal courts. The "equity receivership" was a process by which large, asset-laden, economically viable but financially strapped companies, typically railroads, restructured.<sup>113</sup> The process began when the management of the company and its leading creditor, often a Wall Street investment bank, agreed to a plan which would shed the debt of the company while preserving some, if not much, of the equity interests of shareholders.<sup>114</sup> The bank would approach the company's various creditors, and secure their agreement to a restructuring which would often allow them to recover, in an orderly and reliable fashion, a portion of their claims, but without hope of being made whole. The creditors might even receive ownership stakes in the reorganized entity, alongside those of the original shareholders.<sup>115</sup> The bank would then engage its Wall Street attorneys to orchestrate a foreclosure sale on its behalf, where the bank, as lead and senior creditor, or a committee of senior creditors, would bid their debt to control the restructuring of the firm.<sup>116</sup> This arrangement would result in the approval of a consensual reorganization plan, blessed with a court order.<sup>117</sup>

This state of affairs evolved until the dawn of the New Deal. Onetime Yale law professor and Chairman of the Securities and Exchange Commission, William O. Douglas made it his mission to end the "private" equity receivership, and to bring corporate reorganizations under the control of the federal government. Douglas distrusted big business, and intended to end Wall Street's influence over corporate restructurings that so deeply affected the fortunes of the economy and

---

112. See G. Marcus Cole, *The Federalist Cost of Bankruptcy Exemption Reform*, 74 AM. BANKR. L.J. 227, 246 (2000).

113. See Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 921-923 (2001) [hereinafter Baird & Rasmussen, *Control Rights*].

114. *Id.*

115. *Id.* See also *N. Pac. Ry. v. Boyd*, 228 U.S. 482 (1913) (holding that a foreclosure sale could not result in former shareholders participating in a restructured company in which a creditor senior to shareholders received no interest).

116. DOUGLAS BAIRD & THOMAS JACKSON, *CASES, PROBLEMS & MATERIALS ON BANKRUPTCY*, 961-962 (2d ed. 1990).

117. Baird & Rasmussen, *Control Rights*, *supra* note 113, at 923.

the workers within it.<sup>118</sup> The passage of the Chandler Act in 1938 accomplished Douglas's aims.<sup>119</sup>

The 1978 Bankruptcy Code has undone much of what the Chandler Act imposed on business bankruptcy. Among the most important qualities to be revived was bankruptcy's temporal asset partitioning ability. Under the Bankruptcy Code, a debtor need not prove that it is insolvent in order to seek relief voluntarily.<sup>120</sup> As a practical matter, actual insolvency was deemed unnecessary for bankruptcy. Long before the travails of Arthur Andersen, bankruptcy courts were well aware of the fact that many assets and liabilities were difficult to measure or ascertain with certainty. Valuations of "good will" and other intangible assets were as elusive and arbitrary as the extent of potential exposure, for example, to tort claimants holding unliquidated damage claims. This lack of an insolvency requirement, as will be demonstrated, permits solvent debtors to sequester assets behind the veil cast by bankruptcy's discharge.<sup>121</sup>

#### IV. THE MODERN USE OF BANKRUPTCY AS LIMITED LIABILITY DEVICE

The historical underpinnings of bankruptcy's asset partitioning character would be interesting in and of themselves. The asset partitioning function of bankruptcy law, however, continues to play an important role in its present deployments. The cases presented here are just a few illustrations of how the "common pool" paradigm distracts attention from and facilitates the central use of bankruptcy, as asset partition, in certain contexts. The following cases are examples, not of collective action problems solved through bankruptcy, but rather of assets and value sequestered by it.

---

118. See SKEEL, DEBT'S DOMINION, *supra* note 110, at 101-27.

119. *Id.* at 113-19 ("Douglas's Chandler Act strategy . . . was a smashing success in the short run.")

120. 11 U.S.C. § 301 (2002).

121. The only insolvency requirement in the Bankruptcy Code addresses the treatment of involuntary petitions. Here, Section 303 of the Code imposes an insolvency requirement, but a meager one at best. In order to sustain an involuntary petition and to avoid sanctions for a wrongful one, creditors must make a showing of the debtor's insolvency. But even this requirement is a qualified one. Section 303 merely requires a showing of insolvency "in the cash flow sense;" a demonstration that the debtor has failed to pay its debts when due. Even a solvent debtor, therefore, could theoretically be kept within the confines of an involuntary petition under this rule. This is a departure from the standard under the Act, which required a showing of insolvency "in the bankruptcy sense," that is, a demonstration that the debtor's liabilities exceeded its assets.

*A. Mass Tort Bankruptcies*

Mass tort bankruptcies form a class of cases of their own. They can be loosely defined as cases where a manufacturer or service provider has engaged in activity that has exposed it to a very large number of actual or potential tort suits, and where the manufacturer or service provider files a bankruptcy petition as a result of this exposure.<sup>122</sup> Examples of mass tort bankruptcy cases include those of asbestos manufacturers, breast implant manufacturers, the A.H. Robbins "Dalkon Shield" bankruptcy, and numerous other cases marked by environmental hazard and products liability exposure on the part of various corporate debtors.<sup>123</sup>

Across the entire spectrum of cases upon which we might attach the label "mass tort bankruptcy," there is one characteristic common to them all. It is not insolvency.<sup>124</sup> Instead, the one characteristic common to all mass tort bankruptcy cases is the failure or inability to have a mandatory (non-opt-out) class action certified, which would have forced tort plaintiffs to litigate claims in unison.<sup>125</sup> These cases can be thought of as "defensive bankruptcy filings" because they represent an attempt by mass tort defendants to reign in otherwise unmanageable litigation.<sup>126</sup> A defensive bankruptcy filing forces all of the tort litigation into one forum, where the defendant can marshal one set of lawyers, with a coordinated argument, all without the collateral estoppel risks concomitant with litigation in each and every jurisdiction on the planet.<sup>127</sup>

Defendants in the mass tort setting already have the defensive asset partitioning offered by limited liability under corporate law. Bankruptcy provides a second defensive asset partition, protecting those assets of the firm that exceed the claims asserted against the firm. The residual claimants on a firm emerging from a mass tort chapter 11 can reinvest

---

122. See G. Marcus Cole, *A Calculus Without Consent: Mass Tort Bankruptcies, Future Claimants, and the Problem of Third Party Non-Debtor "Discharge,"* 84 IOWA L. REV. 753, 755 (1999).

123. *Menard-Sanford v. Mabeey, (In re A.H. Robins Co. Inc.)*, 880 F.2d 694 (4th Cir. 1989). The Dalkon Shield was an intrauterine contraceptive device manufactured by the debtor. *Id.*

124. Virtually no reasonable estimate of damages in the Dow-Corning breast implant cases would have resulted in a circumstance where the defendant-debtor's liabilities would have exceeded its assets, estimated to be approximately \$5 billion in 1996.

125. A non-opt-out or mandatory class action, under Rule 23 of the Federal Code of Civil Procedure, would require all claimants of a particular type to join the class litigation, or be forever barred from asserting a claim at a later date. FED. R. CIV. P. 23(b)(1). The prerequisites for establishing a non-opt-out class action are virtually insurmountable in the context of a mass tort case. For the standard, see *Ortiz v. Fibreboard Corp.*, 527 U.S. 815 (1999).

126. See Cole, *A Calculus Without Consent*, *supra* note 122, at 767.

127. *Id.*

without fear that victims of the firm's previous life might reappear to threaten their stake in the firm. Bankruptcy leaves the excess value of the firm "exempt" from these claims, in much the same way that English and colonial bankruptcy exempted a merchant's tools of trade.

An example of a defensive bankruptcy filing that illustrates the use of bankruptcy as asset partition can be found in the breast implant litigation that beleaguered manufacturers of silicone gel breast implants in the 1990s. Dow Corning, a successful manufacturer of silicone gel breast implants, was a joint venture subsidiary of the Dow Chemical Company and Corning, Incorporated.<sup>128</sup> Dow Chemical and Corning each owned fifty percent of the shares in Dow Corning, and each participated, at various levels and over the course of several decades, in the development of much of the underlying technology exploited by their subsidiary.<sup>129</sup>

Dow Corning was a cash cow, generating annual income of nearly \$1 billion by the early 1990's.<sup>130</sup> Suddenly, in 1991, a few women complained of "connective tissue diseases," ailments of the ligaments and tendons, and began to associate their illnesses with breast implants that they had opted for years earlier.<sup>131</sup> Once reports of lawsuits involving silicone gel breast implants hit the news wires, Dow Corning found itself deluged with litigation from tens of thousands of plaintiffs in all fifty states, the District of Columbia, Puerto Rico, Guam, the American Virgin Islands, and foreign jurisdictions including Canada, Australia, New Zealand, the United Kingdom, Japan, France, Germany, and Italy.<sup>132</sup>

Despite the whirlwind of products liability litigation in which it found itself, Dow Corning and its parents took solace in a few facts. First, there was no or very little credible scientific evidence that their product caused any harm to anyone.<sup>133</sup> Second, even if the tens of thousands of plaintiffs were successful in their efforts, the three companies estimated Dow Corning's overall exposure at roughly \$4 billion, a staggering sum to be sure, but shy of the subsidiary's \$5 billion book value.<sup>134</sup> With

---

128. *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002).

129. *Id.* at 651.

130. MARCIA ANGELL, M.D., SCIENCE ON TRIAL: THE CLASH OF MEDICAL EVIDENCE AND THE LAW IN THE BREAST IMPLANT CASE (1996).

131. *Id.* at 64.

132. See Kathleen Carter-Stein, Note, *In Search of Justice: Foreign Victims of Silicone Breast Implants and the Doctrine of Forum non Conveniens*, 18 SUFFOLK TRANSNAT'L L. REV. 167, 168 (1995).

133. *Id.* at 169. See also Peter J. Goss et al., *Clearing Away the Junk: Court-appointed Experts, Scientifically Marginal Evidence, and the Silicone Gel Breast Implant Litigation*, 56 FOOD & DRUG. L.J. 227 (2001).

134. ANGELL, *supra* note 130, at 65.

these considerations in hand, the parents decided to roll the dice, and trust "the system."

The three companies chose to do battle with each and every plaintiff, standing on both principle and science, employing gladiators from the nation's largest law firms.<sup>135</sup> And the first few rolls of the dice paid off. The parent companies had many of the direct claims against them dismissed.<sup>136</sup> The subsidiary won several trials that proceeded through to jury verdicts.<sup>137</sup> The three companies' confidence in both "the system" and their "stand your ground" strategy started to quaver a bit, however, when a Harris County, Texas jury returned its special verdict form. The form had asked for simple yes or no answers to each of several questions relating to the evidence of the victim's harm, and the responsibility of the product and each of the companies for that harm, if any.<sup>138</sup> The jury found that the victim did manifest disease, but that neither the product nor the companies were responsible for her injuries.<sup>139</sup> Then, in a twist of logic that only a Harris County jury can explain, they awarded the victim \$4.1 million.<sup>140</sup>

The Harris County result caused the companies to do two things. First, they immediately filed motions to set aside the jury award, with intentions to appeal if they failed to prevail on these motions.<sup>141</sup> Second, and more importantly, it caused the companies to reassess their decision to "dance with the devil." If a jury could be persuaded to award a breast implant plaintiff damages upon a determination of no fault, then it was only a matter of time before a jury would find fault in order to award damages to a sympathetic plaintiff. Such a jury determination would impose collateral estoppel on the companies' liability defenses in all subsequent cases, creating a domino effect, from battle to battle, that would eventually choke off any hopes to win the war.<sup>142</sup> Each case, involving each plaintiff, in every jurisdiction, had the power to control the outcome of all other cases. The companies considered the prospects of making their case simultaneously in several jurisdictions, and they did not like them. To have the best chance, they had to get the cases aggregated in one forum.

---

135. *Id.*

136. Jean Hellwege, *Plaintiffs Score Victories in Breast Implant Cases*, TRIAL 16 (March 1999).

137. Krista R. Stine, *Silicone, Science and Settlements: Breast Implants and a Search for Truth*, 63 DEF. COUNS. J. 491 (1996).

138. *Laas v. Dow Chem. Corp.*, No. 93-04266 (S.D. Tex. Feb. 15, 1995).

139. *Id.*

140. *Id.*

141. ANGELL, *supra* note 130, at 65.

142. *Id.*

Aggregating the claims would not be easy. Each plaintiff had the implant surgery under factual circumstances that would preclude voluntary class action, let alone a non-opt-out one.<sup>143</sup> For cases that qualified for diversity jurisdiction, the companies had a plan that proved somewhat successful. They had the cases removed from state to federal court, and then persuaded the federal courts involved to transfer venue to the multi-district litigation forum presided over by Judge Sam Pointer of the Northern District of Alabama.<sup>144</sup> This aggregation of claims in one federal forum reduced the strain of the companies' legal resources, but left other cases, which were not removed, dangling in far-flung state courts. When the negotiations presided over by Judge Pointer reached an impasse, the three companies resorted to a strategy that proved very successful: Dow Corning filed for bankruptcy.<sup>145</sup>

The bankruptcy filing in the Eastern District of Michigan solved virtually all of the problems confronted by the three co-defendant companies. First, it halted all litigation against the subsidiary, and aggregated all claims in one forum, to be addressed by one team of the finest lawyers the companies could assemble. Second, it provided an opportunity for the parent companies to seek the protection of Dow Corning's bankruptcy proceeding, through an extension of the automatic stay to their own, related litigation.<sup>146</sup> Third, and most importantly for our discussion here, Dow Corning's bankruptcy filing provided the three companies with a mechanism to fix and cut off all present and future claims in order to preserve the excess value of all three defendant corporations. In other words, Dow Corning's bankruptcy allowed the companies to partition assets.

The parent companies, with market capitalizations of \$26 billion and \$18 billion respectively, were never in danger of insolvency from the breast implant litigation.<sup>147</sup> Their share value did suffer, however, from the uncertainty of undiscovered future claims. In order to remove this uncertainty, the companies sought their own asset partitioning through a third party non-debtor "discharge."<sup>148</sup> A third party non-debtor

---

143. Rule 23 requires a commonality of claims, including factual circumstances, in order to certify a class action. FED. R. CIV. PRO. 23(b).

144. Judge Sam Pointer is the author of MULTI-DISTRICT LITIGATION (1991). See *Breast Implants: Dow Chemical Can't Certify 1995 Ruling to 6th Cir. For Appeal in re Dow Corning Corp.*, 9 ANDREWS MED. DEVICES LITIG. REP. 4 (2002).

145. Thomas M. Burton, *Dow Corning Moves to Quit Chapter 11—Plan for \$3 Billion Includes Big Trial, but Creditors May Have Other Ideas*, WALL ST. J., December 3, 1996, at A3.

146. *Judge Denies Motion To Stop Implant Suits On Dow Chemical Co.*, WALL ST. J., June 9, 1995, at B12.

147. George Gunset, *Bankruptcy Filing May Stall Implant Suits*, CHI. TRIB., May 16, 1995, at 1; see also Sandra Chereb, *Judge Rejects Dow Chemical Request on Award*, LAS VEGAS REV. J., February 10, 1996, at 1B.

148. Cole, *A Calculus Without Consent*, *supra* note 122, at 755.

discharge is a section 105(a) injunction on behalf of the third party, issued by the bankruptcy court, protecting the third party from liability arising from claims related to its association with the debtor.<sup>149</sup> Such injunctions are typically awarded in exchange for a contribution of some type to the debtor's reorganization, and as a result, are rarely objected to, since the only affected parties present are getting more out of the deal than they would realize without it.<sup>150</sup> In other words, third parties can use a related debtor's bankruptcy proceeding to "buy" protection, and asset partitioning, from future claims without being insolvent or filing for bankruptcy themselves.<sup>151</sup>

Although the parent companies were not entirely successful in obtaining their own asset partition, their subsidiary, Dow Corning, was. As noted earlier, Dow Corning was solvent when it filed its defensive, voluntary bankruptcy petition. Through bankruptcy, it arrived at a cap on its breast implant liability, and provided for a claims resolution facility to distribute damage awards from a trust to be funded by company profits for a period of ten years.<sup>152</sup> In short, residual ownership of this very profitable company was transferred to tort victims for a specified period of time, after which it will revert to the parent companies. The parent companies merely lent the goose that laid the golden eggs. Bankruptcy prevented the killing of it.

Although it may serve as an extreme example, Dow Corning's chapter 11 bankruptcy proceeding is not extraordinary. To the contrary, the capping and disposition of tort claims through chapter 11 has become de rigeur for solvent companies facing unmanageable mass tort exposure and litigation.<sup>153</sup> Bankruptcy's discharge, unhinged from any insolvency requirement, has provided many solvent companies with a way to partition assets.

### B. "Ring-Fencing"

"Ring-fencing," as an explicit bankruptcy strategy, is associated with only one, but very prominent and controversial case: the chapter 11 bankruptcy proceedings of the Pacific Gas & Electric Company of California.<sup>154</sup> Ring-fencing, according to the lawyers who asserted this strategy, is the practice of filing a bankruptcy petition on behalf of a

149. *Id.* at 759-60.

150. *Id.* at 792-95.

151. *Id.*

152. *In re Dow Corning Corp.*, 244 B.R. 721 (Bankr. E.D. Mich. 1999).

153. Cole, *A Calculus Without Consent*, *supra* note 122, at 755.

154. *In re Pac. Gas & Elec. Co.*, 271 B.R. 626 (Bankr. N.D. Cal. 2002).

subsidiary of a corporate parent company, while preserving the integrity of the parent and siblings of the debtor, as well as any distributions that may have been made to those affiliates.<sup>155</sup> Ring fencing allows for the restructuring of the subsidiary through chapter 11, even if the earnings of that subsidiary, had they been retained and not distributed to the parent-shareholder, would have been sufficient, theoretically, to satisfy the claims against the subsidiary in full.<sup>156</sup>

The etymology of the term is an odd story in itself. It appears to be derived from a requirement imposed upon large private utility companies in various markets around the world. In Australia, for example, an electric utility is forbidden from operating in two "regions."<sup>157</sup> Australian law provides for an exception to this general prohibition, however, if a parent company owns two "independent" subsidiaries that operate in different regions. The regulations specifically require the parent company to "ring-fence" the operations of one subsidiary from any other, such that each operates as though they were completely unrelated entities.<sup>158</sup> The object of the ring-fencing requirement ostensibly is to deny large companies the opportunity to engage in predatory pricing to undercut and displace smaller competitors.<sup>159</sup>

PG&E's lawyers turned this regulatory requirement into a strategy in their chapter 11 proceeding. The two principal concerns for the PG&E legal team were the large shareholder distributions made shortly before the bankruptcy petition was filed, and executive bonuses paid to parent and subsidiary managers within the same time frame.<sup>160</sup> Each of these distributions of cash were met by alarm in the press, and among the

---

155. See *California Pacific Gas & Electric's Move to Isolate Assets Raises Controversy*, SAN JOSE MERCURY NEWS, August 28, 2001 ("At its simplest, you can think of PG&E as a modern-day kingdom with two big subdivisions. One is the regulated utility, Pacific Gas & Electric, which sells electricity and natural gas to millions of Californians and owns a vast network of hydroelectric facilities and land across northern California. While traditionally very profitable, the utility lost \$3.48 billion last year. The other, a gated community, holds the non-regulated National Energy Group. National Energy Group owns most of the rest of what constitutes PG&E Corp., including 612 miles of gas pipelines, more than 30 power plants and energy trading operations. National Energy Group made \$162 million in profit last year. It's this segment that executives "ring-fenced"—the legal jargon for isolating a subsidiary from other companies in the same corporate fiefdom.").

156. *Id.*

157. See Office of the Regulator-General, State of Victoria, Australia, *Issue Paper: Ring-Fencing in the Electricity and Gas Industries*, (July 2000) (on file with author); see also [http://www.reggen.vic.gov.au/elec\\_27j.htm](http://www.reggen.vic.gov.au/elec_27j.htm) (last visited May 16, 2002).

158. Office of the Regulator-General, *supra* note 157, at 12.

159. *Id.* at 3.

160. Jennifer Bjorhus, *PG&E Corp. Gave Top Executives \$18 Million in Bonuses in 2001*, SAN JOSE MERCURY NEWS, (March 14, 2002) ("PG&E handed out \$18 million in bonuses to its top executives last year—the year its electric utility filed for bankruptcy protection.").



various groups representing California consumers concerned about electricity supply and the prices they were to going to have to pay for it.<sup>161</sup> PG&E's management and lawyers anticipated, no doubt, the uproar these distributions might cause. They made them nevertheless, confident that in the end, they would rest safely behind the protection afforded by bankruptcy's asset partition.

PG&E's road to the shelter of chapter 11 bankruptcy began innocently enough. In 1995, California enacted sweeping legislative reforms that purported to "deregulate" electricity markets across the state.<sup>162</sup> In truth, what the legislature accomplished, with the assistance and approval of short-sighted electric utility providers, was to create what hindsight has proven to be an unstable regulatory regime. First, the legislation required conglomerates like PG&E to divest their energy production capacity. This requirement grew out of the belief that deregulation would permit retailers with production capacity to manipulate supply, thereby creating shortages that would cause prices to spike.<sup>163</sup> They could retain any assets required to transmit electricity from suppliers to consumers, but little else.<sup>164</sup> Second, retailers, newly stripped of their production capabilities, were permitted to sell to consumers and businesses, at retail prices that were capped by the statute, electricity they purchased at spot prices on the wholesale production grid.<sup>165</sup> These price caps were set to expire after sunk costs were recovered.<sup>166</sup> Third, and importantly, retailers like PG&E were forbidden from purchasing their electricity through long-term contracts, which would have allowed them to hedge against price fluctuations.<sup>167</sup> This third requirement was designed to prevent retailers from capturing a windfall that they need not pass along to consumers. Instead, retailers

---

161. *California Officials Sue PG&E—Claim Utility Funded Affiliates*, NAT. GAS WK., January 14, 2002, at P5 ("The lawsuit also claims that PG&E created new entities to 'ring-fence' its unregulated assets in order to protect them during the utility's bankruptcy. Allegedly, the parent company also collected \$278 million in income taxes from the utility that wasn't paid to the state.")

162. Cal. Pub. Util. Code §§ 367-376 (2002).

163. Peter Fox-Penner & Greg Basheda, *A Short Honeymoon for Utility Deregulation*, ISSUES SCI. & TECH. 5156 (2001).

164. *Id.* See also Charles F. Bostwick, *Utilities Nixed '95 Bid to Add New Plants: Purchasing Power Elsewhere Cheaper*, SAN DIEGO UNION & TRIB., January 21, 2001, at A3.

165. Editorial, *No Better Option: Davis' Plan to Ease the Power Crisis Won't Really Please Anyone, but It's the Fairest One Now on the Table*, L.A. TIMES, February 19, 2001, at B6 ("The freeze on rates—designed to make deregulation politically palatable—is a major reason that the utilities have gone as much as \$12 billion in debt.")

166. Michael McGrath, *Another Perspective: California's Shadow*, 26 ELEC. PERSP. 64 (2001).

167. Cal. Pub. Util. Code §§ 367-376 (2002). See also Peter List, *California Power Contagion*, 15 GLOBAL FIN. 6568, (2001).

were required to source their wholesale electricity supply from spot markets.<sup>168</sup>

Retailers, including PG&E, helped craft the legislation, and applauded its passage.<sup>169</sup> While they were not enamored of the retail price caps, they saw these as set high enough to allow profitability. They had greater uneasiness about the divestiture of productive capacity, but were able to reconcile this defeat as a cost of progress on other fronts. With these two arms, production and hedging, tied behind its back, PG&E skipped down the road to what it thought was a freer and more rational future.

Rationality gave way to rationing, however, when the natural gas supply in the northwest shrank below critical levels in late 1999. Over two thirds of California's electricity was supplied by "clean burning" natural gas generating stations, and the drop in gas supply brought with it spikes in natural gas prices, and of course, in wholesale electricity prices.<sup>170</sup> As these wholesale prices skyrocketed during the autumn of 2000 and the winter of 2001, PG&E, like other retailers, found itself often purchasing electricity at prices approaching \$0.30 per kilowatt/hour, ten times the three cent price cap imposed upon the prices at which it could sell to end users of electricity.<sup>171</sup>

By March of 2000, two things were clear: PG&E could not continue to purchase energy for far more than it could sell it, and the State of California could not force out-of-state electricity producers to supply energy with no prospect of being paid. The State of California did, however, agree to guarantee payment on behalf of PG&E, whose credit rating had fallen to junk bond status and below, and had no prospect of borrowing funds needed to purchase electricity wholesale.<sup>172</sup> When PG&E finally succumbed to the market realities, it filed a chapter 11 petition in the Northern District of California on April 5, 2001, making

---

168. Cal. Pub. Util. Code §§ 367-376 (2002). See also Robin Fields, *The California Energy Crisis Trading Floor Breathing Last Gasps in Failure of Deregulation*, L.A. TIMES, January 29, 2001, at A1.

169. Nancy Vogel, *Enron Vision Proved Costly to Firm, State Energy: Wild Promises of the Savings From Deregulation Helped Bring it About. In the End the State Paid Heavily For New System, and Enron Was Left a Small Player*, L.A. TIMES, January 28, 2002, at B1.

170. Stephanie Anderson Forest, with Christopher Palmeri, *Thriving Under Suspicion*, BUS. WEEK, August 6, 2001, at 72; John Elvin, *There's No Need to Freeze in the Dark*, 17 INSIGHT MAG. 22 (March 12, 2001).

171. TESTIMONY OF THE HONORABLE JUDY MARTZ GOVERNOR OF MONTANA BEFORE THE COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE, Wednesday, June 20, 2001, 2001 WL 21756253 ("State rules barred California utilities from recovering wholesale power costs from retail rates, forcing utilities to buy power at 30 cents per kilowatt-hour and resell it for 3 cents. It was those rules—imposed by the State of California—that destroyed the financial health of the utilities and drove Pacific Gas & Electric (PG&E) into bankruptcy.")

172. Tim Reiterman & Jerry Hirsch, *The State Rate Hike Will Cover Power Costs, State Says*, L.A. TIMES, July 23, 2001, at A1.

it only the third utility to resort to bankruptcy since the Great Depression.<sup>173</sup>

If PG&E's bankruptcy filing was alarming, the news of its pre-bankruptcy maneuvers created an uproar. Soon after the bankruptcy filing, business reporters discovered that PG&E had paid close to \$13 billion in dividends to its sole shareholder and parent company, the Pacific Gas & Electric Holdings Company, Inc., over the course of the several months leading up to the filing; but while the subsidiary was still solvent. What made the revelation all the more disturbing was the fact that the debtor-subsidiary had outstanding obligations to the State of California and electricity wholesalers estimated at approximately \$12 billion.<sup>174</sup> PG&E added insult to injury, in the eyes of consumer groups, when it submitted a request to the bankruptcy court for the payment of retention bonuses for corporate officers, duplicating payments that had already been made to the officers of the parent company.<sup>175</sup>

Consumer groups and State officials, outraged by the revelations of bankruptcy eve distributions, clamored for equitable action by Judge Dennis Montali to right these apparent wrongs. PG&E's counsel calmly asserted their arguments, and prevailed upon Judge Montali to ignore the politics and follow the law. First, PG&E demonstrated that while the shareholder distributions were large, they did not leave the company unreasonably undercapitalized at the time, and were therefore beyond the reach of fraudulent conveyance actions.<sup>176</sup> Second, it argued that the bonuses, both pre-petition to parent company managers, and post-petition to the debtor-utility's senior executives, were a necessary and commonplace method for retaining management expertise in a period of uncertainty.<sup>177</sup>

The biggest concern for PG&E's lawyers was whether the "ring-fence" would hold. A substantive consolidation motion, in search of the

---

173. Howard Mintz, *San Francisco Judge to Make Big Decisions in PG&E's Bankruptcy Case*, SAN JOSE MERCURY NEWS, Saturday, April 7, 2001. Prior to the PG&E filing, only El Paso Electric Co. in Texas and the Public Service Co. of New Hampshire have chosen to go the same route as PG&E, filing bankruptcy to cope with insolvency and an inability to reach deals with state regulators and politicians. Both of those utilities turned to bankruptcy court because they built nuclear power plants that were too costly, and emerged from chapter 11 after years of litigation and tens of millions of dollars in bankruptcy-related costs. *Id.*

174. *State Sues PG&E / Parent Firm Shifted Billions of Dollars Illegally, Attorney General Charge*, S.F. CHRON., January 10, 2002, at A1 ("PG&E Corp. created new holding companies in 'a ring-fencing move to prevent assets from being diverted for possible creditor claims if the utility filed for bankruptcy,' the attorney general said. The complaint also said the holding company funneled cash from PG&E through tax payments that exceeded the utility's actual share of liabilities.").

175. Jennifer Bjorhus, *PG&E Corp. Gave Top Executives \$18 Million in Bonuses in 2001*, SAN JOSE MERCURY NEWS, (March 14, 2002).

176. *Id.*

177. *Id.*

assets of the parent-shareholder, as well as sister company holdings and production capacity, was held in abeyance by thin corporate veils.<sup>178</sup> But the veils have held, and the distributions of assets will be forever free from the claims arising out of the electricity crisis of 2001, thanks to a chapter 11 discharge, acting as temporal asset partition.

### C. "Jurisdiction-Jumping Deadbeats"

Corporate debtors are not alone in their enjoyment of bankruptcy law's asset partitioning. The phrase "jurisdiction-jumping deadbeats"<sup>179</sup> refers to a phenomenon at the heart of bankruptcy exemption reform. It is a controversial, but straightforward phenomenon. A debtor with extensive assets and comparably extensive debts, changes her state of residence on the eve of bankruptcy. She converts her assets into property that the new state exempts from creditor levy, and then files a petition for bankruptcy under chapter 7 of the Bankruptcy Code.<sup>180</sup> The bankruptcy filing will stay any collection activities on the part of her creditors<sup>181</sup> It will also result in the division of any remaining, nonexempt assets among her creditors on a pro rata basis, and the discharge of any further obligation on her pre-petition debts.

What makes jurisdiction jumping both possible and attractive is the conjunction of two facts: states vary dramatically as to the types and extent of the property they deem exempt from creditor levy, and federal bankruptcy law incorporates those disparate state exemption schemes. Anecdotes of jurisdiction-jumping deadbeats abound. Familiar stories and names include actor Burt Reynolds, and former Commissioner of Major League Baseball, Bowie Kuhn.<sup>182</sup> These anecdotes have overshadowed all debate over property exemptions in bankruptcy, and have driven recent reform efforts. Both the House of Representatives, as well as the Senate have passed bills circumscribing the operation of state homestead and property exemption laws, capping them, effectively for the first time, for debtors in the five states where they had been unlimited for as long as two hundred years.<sup>183</sup> President Clinton vetoed

---

178. Scott Herhold, *Stocks Comment Column: Bottoms up to Pg&E, the Parent and Utility*, SAN JOSE MERCURY NEWS, April 16, 2001.

179. See Cole, *The Federalist Cost of Bankruptcy Exemption Reform*, *supra* note 112, at 229.

180. Although this discussion focuses on chapter 7, a consumer debtor might employ jurisdiction jumping in chapter 13, and if the deadbeat debtor is a professional with business debts, the process explained here can be accomplished, in a much more complicated fashion, through chapter 11.

181. See 11 U.S.C. § 362 (2002).

182. SKEEL, *supra* note 111, at 41.

183. Greg Hitt, *Bankruptcy-Overhaul Bill Nears Passage: Stringency, Not Forgiveness, Distinguishes Measure Backed by Financial-Services Industry*, WALL ST. J., May 8, 2002, at A4.

reform measures presented late in his administration, and President Bush is being lobbied by many within his home state of Texas to do the same with the current efforts. Until reform actually takes hold, jurisdiction-jumping by well-heeled deadbeats will continue as a classic case of bankruptcy as asset partition.

The asset partitioning that occurs in the case of jurisdiction-jumping is very akin to the original role played by bankruptcy in its early English and colonial American manifestations. Well-heeled citizens often become well-heeled through extraordinary productivity and human capital. They are often professionals: lawyers, doctors, dentists, and engineers. They typically continue to engage in productive work after reaching the sanctuary of the target exemption regime.<sup>184</sup> They are, in a very real sense, like the sole proprietors that early bankruptcy law identified as "merchants or traders." When they flee to a new jurisdiction in search of more generous property exemptions, they are employing the limited liability function of bankruptcy to sequester more assets from their creditors than might otherwise be possible. In other words, they are partitioning-off more assets.

States afford "more" limited liability through their exemption regimes for a multitude of reasons. One study has demonstrated that states with unlimited homestead exemptions have lower mortgage interest rates, and a concomitant higher rate of home ownership.<sup>185</sup> This result stands to reason, because debtors confronted with a choice of creditors to pay with nonexempt assets, like cash, are likely to pay creditors holding security (a mortgage) in exempt assets first.<sup>186</sup> This preference makes mortgage lending in states like Florida and Texas safer than in other states, and this reduction in risk is reflected in interest rates.<sup>187</sup> The fiscal and social policy reflected in a state's choice of exemption levels takes effect when combined with bankruptcy's defensive asset partition.

#### D. "Scotchgarding": Not "Judgment Proof," Just "Judgment Resistant"

The use of bankruptcy as an asset partition is not limited to circumstances involving many claims on a debtors assets. Sometimes, just one claim can give rise to the employment of bankruptcy's limited liability qualities, and the nuisance involved in its invocation. Such a use of bankruptcy can be thought of as "Scotchgarding," to coin a

---

184. See Margaret F. Brinig & F. H. Buckley, *The Market for Deadbeats*, 25 J. LEGAL STUD. 201 (1996).

185. Jeremy Berkowitz & Richard Hynes, *Bankruptcy Exemptions and the Market for Mortgage Loans*, 42 J. LAW & ECON. 809, 826 (1999).

186. *Id.*

187. Cole, *The Federalist Cost of Bankruptcy Exemption Reform*, *supra* note 112, at 254.

phrase, because it does not render a debtor or its assets "judgment proof," merely "judgment resistant." Bankruptcy, in such instances, becomes a bargaining device, meant to deprive claimants of the full value of their claims, precisely because of the time and expense required to see the bankruptcy process through to its threatened discharge.

The most colorful example of Scotchguarding can be found in the 1987 bankruptcy filing of Texaco, Inc. At the time of its bankruptcy petition, Texaco was nowhere in the vicinity of insolvency, having a net worth of approximately \$25 billion.<sup>188</sup> The filing was merely one move in a series of strategic plays in a multibillion dollar legal battle. Texaco's bankruptcy was a move to thwart Pennzoil. The facts are worth revisiting.

In late 1983, Pennzoil had followed, with great interest, the dissension within the board of Getty Oil, a reserve-rich producer and retailer.<sup>189</sup> Gordon Getty, a director and owner, as trustee of the Sarah C. Getty Trust, owned approximately forty percent of the company, and was dissatisfied with the company's performance and direction.<sup>190</sup> Pennzoil saw Getty's troubles as an opportunity. In late December, 1983, Pennzoil's board and management announced an unsolicited tender offer for 16 million shares of Getty Oil at \$100 each.<sup>191</sup>

Shortly after this announcement, Pennzoil contacted both Gordon Getty, and the Getty Museum in Los Angeles, which held another twelve percent of the company.<sup>192</sup> After a few days of negotiating, the parties drafted a "Memorandum Agreement" under which Pennzoil would obtain three-sevenths of Getty Oil, and the Trust would own four-sevenths of the company.<sup>193</sup> Under this agreement, Gordon Getty would become chairman of the new company, and J. Hugh Liedtke, Pennzoil's chief executive officer, would become chief executive officer of the new company.<sup>194</sup>

The Memorandum Agreement further provided that Pennzoil would pay \$110 per share for the 12% held by the museum, and all other outstanding public shares.<sup>195</sup> Pennzoil would then have the option to purchase 8 million more shares to achieve its desired percentage of the company. The agreement also provided that Pennzoil and the Trust would try, in good faith, to restructure Getty Oil within a year, but

---

188. SKEEL, *supra* note 111, at 1.

189. THOMAS PETZINGER, JR., OIL AND HONOR: THE TEXACO-PENNZOIL WARS, 251-262 (1987).

190. *Texaco, Inc. v. Pennzoil*, 729 S.W.2d 768, 770 (Tx. Ct. App. 1987).

191. *Id.* at 785.

192. *Id.*

193. *Id.*

194. *Id.*

195. *Id.*

failing that, the assets of Getty were to be divided between them, with three-sevenths going to Pennzoil, and four-sevenths going to the Trust. The agreement stipulated that it would expire if not ratified by the Getty board at its meeting on January 2, 1984.<sup>196</sup>

Although Getty's board was resistant at first, it agreed to Pennzoil's overture, but only on the condition that the \$110 price be sweetened with a five dollar "stub," a distribution resulting from the sale of a subsidiary, and payable over five years. Pennzoil agreed to this modification of their deal over the telephone, and announced the merger to the world the next morning.<sup>197</sup>

Despite the pending and eventual agreement with Pennzoil, Getty managers were busy soliciting competing bids during its board deliberations. When Texaco learned of Pennzoil's interest in Getty, it quickly assembled an in house financial team to evaluate the target company. Within one day, Texaco had determined that it would make a play for Getty. On January 5, 1984, when Getty lawyers were supposed to be in a meeting drafting the final documents of the contract with Pennzoil, they met instead with Texaco representatives, who offered \$125 per share.<sup>198</sup> When the Getty board learned of the Texaco offer, it immediately and unanimously voted to withdraw its acceptance of the Pennzoil bid, and to accept the Texaco proposal.<sup>199</sup>

Texaco's strategy was implemented flawlessly. First, it contacted the lawyer for the museum, and secured an agreement to purchase its shares at the higher price. Then it took evidence of the purchase to Gordon Getty, who Texaco knew was frightened of being left holding a minority interest in the company, worthless "paper."<sup>200</sup> Texaco's chairman, Howard McKinley, then secured Gordon Getty's agreement, and presented it to the board along with its intent to own 100% of Getty.<sup>201</sup>

Pennzoil management was angry at what it saw as a much larger company using its considerable resources to scuttle its contract. Pennzoil tried to stop the Texaco-Getty merger by seeking a temporary injunction against those two companies in the Delaware Chancery Court. In rejecting Pennzoil's request, Vice Chancellor Brown suggested that he thought the facts demonstrated that Pennzoil had a

---

196. *Id.*

197. PETZINGER, *supra* note 189, at 272.

198. *Id.* at 251.

199. *Texaco v. Pennzoil*, 729 S.W.2d at 774.

200. PETZINGER, *supra* note 189, at 257-58.

201. *Id.* at 259.

contract with Getty, but that its remedy at law, money damages, was adequate.<sup>202</sup>

Pennzoil managers were deeply disappointed by the ruling, but heartened by the opinion. Their principal concern was that litigation in Delaware would advantage Texaco, a New York corporation with considerably greater resources than Texas-based Pennzoil. Pennzoil remedied this disadvantage, however, by taking advantage of a little-known rule of Delaware procedure. A plaintiff, it seems, could non-suit a defendant, without leave from the court, at any time up until the defendant files an answer.<sup>203</sup> All of the defendants, including Getty Oil, the museum, and the lawyer-defendants had filed answers. All of the defendants, that is, except for Texaco. Pennzoil used this fact to non-suit Texaco, and file a new lawsuit, fifteen minutes later, in the Harris County Courthouse in its hometown of Houston.<sup>204</sup>

Texaco paid dearly for its procedural oversight. The Harris County jury returned a verdict of \$7.53 billion against it in damages for tortious interference with a contract.<sup>205</sup> The jury also slapped Texaco with a \$3 billion punitive damage award, finding Texaco's actions to be malicious.<sup>206</sup> An appeals court ordered remittance of \$2 billion, leaving Texaco saddled with a judgment against it for \$8.53 billion, the largest damage award in the history of the world at the time.<sup>207</sup>

Although an \$8 billion award would gut most companies, Texaco was never in danger of insolvency. Its \$25 billion net worth would suffer a serious dent, but the company could survive the hit. Texaco was not about to let Pennzoil have the last laugh, however. Texaco would do anything it could in order to undermine Pennzoil's victory, and the one thing it could do, as a solvent company, was file for bankruptcy. In the end, Pennzoil's collection efforts were frustrated, not by insolvency, but by bankruptcy and the long, expensive road to its asset partitioning discharge. Pennzoil was forced to negotiate, settling for a more modest payout of \$4.3 billion.<sup>208</sup> Bankruptcy did not make Texaco judgment-proof, as might be accomplished, theoretically, through organizational law. Instead, bankruptcy made a solvent Texaco judgment-resistant.

---

202. *Id.*

203. *Id.* at 260.

204. *Id.* at 261.

205. *Id.*

206. *Id.*

207. *Id.* at 256.

208. *Id.* at 262.



*E. Retail Real Estate Lease Rejection*

The fifth, and by far the most frequent, example of bankruptcy's use as a limited liability device can be found in cases involving the chapter 11 reorganizations of retailers. Retailers file bankruptcy petitions like no other category of business.<sup>209</sup> In fact, retailer bankruptcies are so common that it is quite appropriate to assert that bankruptcy is part of the retail business. It is perhaps from the frequency with which retailers file bankruptcy petitions that we stand to learn the most about bankruptcy as a limited liability device.

The reasons for the frequency of retailer bankruptcy are obvious to those familiar with either bankruptcy law or the retail industry. A retailer's business is, for the most part, its location. Sure, it matters what the retailer is selling, but what the retailer is selling depends, in the end, on whether someone nearby is selling the same thing. Even Starbuck's Coffee has a limit to its proliferation: we are unlikely to see Starbuck's outlets next door to each other. Location, location, location is the fundamental principal of retailing, and all of those locations are, for the most part, leased.

Leasing locations rather than owning them allows a retailer the ability to gauge the cost of goods sold as a function of the cost of putting those goods on display. Margins on certain types of goods, say coffee, may be large enough justify a lease on the ground floor of a downtown office tower, while margins on another good, say produce, may not be so large. Leases also grant retailers the flexibility to cease offering their wares for sale when real estate becomes too pricey. Even the fact that a real estate lease is a fee for a term of years does not deprive retailers of this flexibility, because the source of the flexibility is the Bankruptcy Code itself.

Under section 365 of the Bankruptcy Code, a debtor-in-possession in a chapter 11 case, exercising the powers of the trustee, can assume, assign, or reject executory contracts to which the debtor is a party, including unexpired leases where the debtor is the lessee.<sup>210</sup> Rejection of a contract or lease is treated, for the most part, as a pre-petition breach of contract, resulting in a pre-petition, unsecured bankruptcy claim for the victim of the breach.<sup>211</sup> Where a debtor is insolvent, damages for breach of contract are reduced to the victim's pro rata

---

209. Dean Starkman, *Repo Men of Retailing—'Space Liquidators' Unload Real Estate Left Behind When Big Chains Go Bust*, WALL ST. J., Nov. 28, 2001, at B1.

210. See 11 U.S.C. § 365 (2002).

211. *Id.*

share of its bankruptcy claim.<sup>212</sup> Since breach of contract in bankruptcy generally bears only a fraction of the costs of breach outside of bankruptcy, breach of contract becomes a more attractive alternative in bankruptcy. But note that this result is true only for the insolvent debtor; a solvent debtor in bankruptcy will have to pay full damages for breach of contract. This is true unless the victim of the breach is a landlord and the contract to be breached is a commercial real estate lease.

For landlords, the Bankruptcy Code has its own special form of torture, namely, section 502(b)(6).<sup>213</sup> This provision disallows any claims asserted by a landlord from the breach of a lease to the extent that the claim exceeds "the rent reserved by such lease, without acceleration, for the greater of one year, or fifteen percent, not to exceed three years, of the remaining term of such lease . . . ."<sup>214</sup> Section 502(b)(6), in other words, places a cap on a landlord's claim. That cap may be calculated, according to section 502(b)(6), as follows: A landlord can get a claim equivalent to up to one year's rent if the lease has less than 6.7 years remaining; fifteen percent of all remaining rent payments if the lease term has between 6.7 and 20 years remaining; and a total of three years' rent if the lease term has more than 20 years left on it. A long term lease under the Bankruptcy Code, then, is merely a free option on the value of the underlying real estate for the benefit of the tenant. If the value increases, the tenant keeps the lease; if the value decreases, the tenant files for bankruptcy and rejects the lease, paying reduced damages under the section 502(b)(6) formula.

Retailers know and use section 502(b)(6). They also know that they need not be insolvent to take advantage of the reduced damages for

212. *Id.*

213. Section 502 provides, in relevant part, that:

(b) [T]he court . . . shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—

\*\*\*

(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—

(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—

(i) the date of the filing of the petition; and

(ii) the date on which the lessor repossessed, or the lessee surrendered, the leased

property; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates . . . .

11 U.S.C. § 502(b)(6) (2002).

214. *Id.*

breach provided under it. As a result, retailers frequently visit the question as to which of their locations are unprofitable, and nearly as frequently resort to chapter 11 of the bankruptcy code to shed the leases to those unprofitable sites. Many do so without regard to the solvency of the firm overall.

As you might suspect, long term commercial real estate leases, by and large, do not exist. They do not exist, by and large, because both landlords and their potential tenants know the treatment they receive under the bankruptcy code.<sup>215</sup> Instead, most commercial real estate leases, in tight real estate markets, tend to be drawn for five year terms or less. A five year term permits a commercial landlord the ability to target a one year damages claim in the event of a tenant bankruptcy filing. It also affords the landlord nearly all the downside market protection it can get in the shadow of section 502(b)(6). As one might also suspect, security deposits on commercial real estate closely tracks the one year damage expectation.<sup>216</sup>

The market adjustments made by retailers and their landlords to the damages cap afforded by the bankruptcy code reveals a great deal about the use of bankruptcy as a limited liability device. In the case of commercial real estate lease rejection, solvent debtors can visit bankruptcy frequently to limit liability to their largest creditors, and knowing this, these creditors can price commercial space accordingly. In short, the use of bankruptcy as a limited liability device can function as a normal and expected backdrop against which debtors and creditors bargain.

## V. IMPLICATIONS OF LIMITING LIABILITY THROUGH BANKRUPTCY

Bankruptcy's use as a limited liability device is interesting in and of itself. The controversial cases enabled by this device might be remedied, theoretically, by either requiring insolvency for the invocation of bankruptcy's procedures or the elimination or discretionary application of the discharge in cases later determined to be those involving solvent debtors. While such a fix might eliminate the troublesome cases, such a proposal is not the object of this Article. Instead, the interesting thing about bankruptcy's use as an asset partition is not the controversial cases that it produces, but rather, the things it tells us about the nature of bankruptcy itself. These implications of bankruptcy as temporal asset

---

215. Marcus Cole, *Informal Guarantees in Venture Capital Finance: The Case of Silicon Valley Commercial Real Estate* [forthcoming, draft on file with author].

216. *Id.* at 11.

partition are, principally, three. First, it suggests that perhaps corporate reorganization is not, in the purest sense, bankruptcy law, and should instead be considered a matter of state insolvency law, contract law, and equity. Second, it suggests that while corporate debtors are not necessarily in need of the additional defensive asset partitioning provided by bankruptcy, partnerships and sole proprietorships always have such a need. These forms of business organization also share a special need for the affirmative asset partitioning provided by secured credit. Third and finally, bankruptcy's function as an asset partition suggests that it is often superfluous, performing functions, particularly in the commercial context, that can be better served by organizational and contract law, as well as the principles of equity. Each of these three implications is explored in turn.

*A. Federal Bankruptcy Law Versus State Insolvency and Contract Law*

In their recent article, *The End of Bankruptcy*, Professors Douglas Baird and Robert Rasmussen assert that corporate debtors and their creditors have developed sophisticated private contractual solutions to issues of reorganization that have caused them to have a decreasing reliance on the federal bankruptcy mechanism.<sup>217</sup> Baird and Rasmussen point to the growth of non-bankruptcy workouts and prepackaged bankruptcy reorganization plans, as evidence of this sophistication.<sup>218</sup> They also suggest that when creditors acquiesce to the bankruptcy process, they do so to consolidate and exercise their control rights.<sup>219</sup> Part of the reason for the flight from the bankruptcy system is the discovery of alternative means by which bankruptcy's principle function, the reduction of the cost of credit, might be accomplished. Corporate debtors and their creditors achieve this overarching purpose through consensual, contractual mechanisms, operating under state law, which need not pay obeisance to artificial mechanical standards like the "absolute priority rule."<sup>220</sup> Baird and Rasmussen view these developments as signaling the end of corporate bankruptcy.<sup>221</sup>

A vision of bankruptcy as asset partition is consistent with, and supports the Baird-Rasmussen thesis. But it goes further. Corporate debtors and their creditors can often anticipate and negotiate workouts

---

217. Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 11, at 12. See also Baird & Rasmussen, *Control Rights*, *supra* note 113, at 923.

218. Baird & Rasmussen, *Control Rights*, *supra* note 113, at 923.

219. *Id.*

220. Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 11, at 13.

221. *Id.*

that can meet their particular needs far better than a one-size-fits-all bankruptcy system. They can also employ organizational law to their greatest advantage, achieving as many effective asset partitions as they desire. In fact, according to one leading critic of consensual corporate manipulations of organizational law and consensual contractual bankruptcy, corporate and bankruptcy law have given corporate debtors the ability to acquire "judgment proofing."<sup>222</sup>

If both corporate law and bankruptcy law provide asset partitioning, are they redundant? Could corporate debtors and their creditors achieve the results they desire in the absence of bankruptcy? Or does bankruptcy offer something more that is unavailable under state corporation and contract law?

The answer to these questions depends upon the content of bankruptcy law. The devil is in the details. As noted earlier, the temporal asset partitioning effect of bankruptcy requires two conditions. First, an asset partitioning bankruptcy regime requires an absence of an insolvency requirement. To sequester surplus value, there must be surplus value. Second, and equally important, an asset-partitioning bankruptcy regime must offer priorities that deviate from those found under state law. If we had a law of corporate reorganization that religiously and faithfully adhered to the absolute priority rule, there would be no asset partitioning at all. In essence, the absolute priority rule requires that the nonbankruptcy priority of claims be preserved within bankruptcy.<sup>223</sup> This rule insists that each claim be satisfied in full before any claim junior to it receives any share of the debtor's assets.<sup>224</sup>

In order for asset partitioning to occur under a bankruptcy regime, some past creditor must receive less than all to which it is entitled from an ultimately solvent debtor, one whose pre-bankruptcy owners retain an interest in the firm. Bankruptcy's discharge ensures that a past creditor so treated will never return for full satisfaction. Future claimants of a mass tortfeasor, for example, must resort to the designated claims resolution trust, even if the restructured tortfeasor proves wildly successful upon its emergence from chapter 11. Similarly, an electric utility with an understanding of simple arithmetic that enables it to foresee a future of insolvency made imminent by its regulatory environment need have no fear that disappointed creditors

---

222. See Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom"*, 54 VAND. L. REV. 231, 233 (2001); see also Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147, 148 (1998); and Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1 (1996).

223. CHARLES TABB, *THE LAW OF BANKRUPTCY*; see also 11 U.S.C. §1129(b)(2)(A) (2002).

224. *Id.*

might reemerge to lay claim to future profits made possible by reinvested dividend distributions.

Without departures from non-bankruptcy priorities, bankruptcy loses its ability to partition assets. The filing of a bankruptcy petition under such circumstances would simply be a recognition event, replicating state law and its priority scheme. Bankruptcy is reduced to a day of reckoning in which the creditors of the firm get the assets, including the going concern value of the firm. Indeed the five exceptional cases described earlier depart from the larger class of cases involving an insolvent debtor whose claimants are generally satisfied according to non-bankruptcy priorities.

The distinctive character of bankruptcy is that it offers debtors an opportunity to partition assets along a different dimension—a temporal dimension—unavailable under state corporate, contract, or insolvency law. The frequency with which this opportunity is seized upon dictates the accuracy with which creditors can price the associated risk. Commercial landlords have become so familiar with the risk that it shapes the terms of their leases. Judgment creditors lacking the opportunity to assess and price the risk of asset partitioning through bankruptcy are at the mercy of their debtor's ingenuity.

### *B. Federal Bankruptcy versus State Corporation and Consumer Law*

A corollary of the observation that corporations may not need bankruptcy and its asset partitioning abilities, is that entities without resort to the array of alternatives available to the modern corporation ought to be able to consider bankruptcy as asset partition. These include entities using the general partnership or sole proprietorship forms of commercial organization. But because bankruptcy is, by itself, just a form of limited liability, these entities need more. In addition to the defensive asset partitioning afforded by bankruptcy, sole proprietorships and general partnerships are in need of affirmative asset partitioning. This affirmative asset partitioning is, for the most part, only available to these entities through the institution of secured credit.

#### 1. Secured Credit as Affirmative Asset Partition

Alone, bankruptcy would be ineffective as an asset partition. However, while bankruptcy provides limited liability, secured credit can provide the other half of the Hansmann-Kraakman equation: "affirmative asset partitioning," by protecting the assets of the enterprise

from the personal creditors of the merchant.<sup>225</sup> Hansmann and Kraakman acknowledge the ability of secured credit to perform the task that they deem "the essential role of organizational law."<sup>226</sup> They question its effectiveness, however, because of its inability to provide liquidation protection: assurance that personal creditors of the firm's owners will not liquidate the business.<sup>227</sup>

But so what? Is liquidation protection an essential element of effective affirmative asset partitioning? The only way that Hansmann and Kraakman can claim that affirmative asset partitioning is the essential role of organizational law is to also make the claim that liquidation protection is also essential. If not, then organizational law becomes merely one of two effective means of affirmative asset partitioning, standing side by side with secured credit. And on this point Hansmann and Kraakman are not very persuasive.

Secured credit can effectively sequester assets for the purpose of bonding, providing assurance to the creditors of the firm that the personal creditors of the firm's owner will not access the bonding assets. This is the definition of affirmative asset partitioning.<sup>228</sup> The only difference between that afforded by the corporate form and that afforded by secured credit is that, although creditors can be assured that they will have resort to a particular pool of assets to protect their investment, secured credit cannot assure them, or the firm's owners, that the personal creditors of the firm will not cause the firm to be liquidated. If creditors merely require a sufficient asset base to extend credit, then the absence of liquidation protection should not deter them. The owners of the firm, through liquidation protection, preserves their control rights, vesting them with the exclusive power to liquidate the firm. Liquidation protection then, provides value to the owners of the firm *personally*, and not to the firm itself. The absence of liquidation protection does not deprive secured credit of its affirmative asset partitioning ability.

The Hansmann-Kraakman demonstration of the need for effective asset partitioning provides another, more powerful, yet previously unconsidered, justification for the existence of secured credit: a need for effective affirmative asset partitioning. Since secured lending segregates collateral from the reach of the personal creditors of a firm's owner, it is a quintessential affirmative asset partitioning device. Hansmann and Kraakman dismiss its effectiveness as such, since it does not afford the

---

225. Hansmann & Kraakman, *supra* note 10, at 395.

226. *Id.* at 396.

227. *Id.*

228. *Id.* at 397.

liquidation protection that the corporate form provides.<sup>229</sup> Nevertheless, liquidation protection is not the characteristic that defines an affirmative asset partition, nor is it the quality that makes it “essential.”<sup>230</sup> Instead, the segregation of a pool (or item) of bonding assets (or asset) is what makes the extension of credit worthwhile in many instances, and that is effectively what secured credit accomplishes. In fact, it is quite possible that had secured credit existed in a widespread and trustworthy form in the early 19th century, the corporation, as we know it, may have never become the ubiquitous institution we know today.

But corporations have developed and do exist. Given this truth about the world, then why do we need secured credit in a world where affirmative asset partitioning is ubiquitous? Because the corporate form is not for everyone. Many businesses today operate as sole proprietorships and simple partnerships. As has long been the case for these types of businesses, they do not enjoy limited liability, other than that afforded by bankruptcy’s discharge. They do, however, have a need for credit from time to time, which might be made considerably cheaper and abundant with the presence of an affirmative asset partition to set aside bonding assets for the benefit of potential creditors. Secured credit is effectively the only way that businesses operating as sole proprietorships or simple partnerships can achieve effective affirmative asset partitioning. Together, bankruptcy and secured credit provide for sole proprietorships and partnerships some of the defensive and affirmative asset partitioning that makes business life affordable and profitable.

## 2. Consumer Bankruptcy

The discussion of why bankruptcy and secured credit are necessary for sole proprietorships and partnerships also suggests yet another corollary: that individual consumers may not be ideal candidates for the asset partitioning afforded by bankruptcy. Early English and colonial American bankruptcy law was, at its very core, business law. When the Bankruptcy Clause was ratified as part of the Constitution, it was ratified against a widespread background understanding of bankruptcy as a law of business: bankruptcy as asset partition.<sup>231</sup> That asset partition was necessary and proper, in the minds of the Framers, in large part because

---

229. *Id.* at 401.

230. While Hansmann and Kraakman stress that liquidation protection is important, and very difficult to acquire without organizational law, at no point do they equate liquidation protection with affirmative asset partitioning. *Id.*

231. WARREN, *supra* note 90, at 6.



the corporate form was, at the time, beyond the imagination of the Framers.<sup>232</sup> With the advent and refinement of the corporation, however, two questions arise. First, does bankruptcy law continue to perform a necessary function as part of the larger body of business law? The answer to this question, presented in the preceding section, is “perhaps.” It is certainly necessary if partnership and sole proprietorship continue to play roles in commerce. It may also be necessary to supplement the asset partitioning enjoyed by corporations and their creditors. The second question, one that is much more difficult to answer, is whether bankruptcy law is now or ever has been appropriate for individual debtors. In other words, is “consumer bankruptcy” an oxymoron?

The modern conception of “consumer bankruptcy” appears to originate, of all places, in the Victorian imagination, and its manifestation through the Bankruptcy Act of 1898. Victorian art and literature made financial misfortune its central preoccupation. The *Mill on the Floss*, *Little Dorritt*, *Great Expectations*, *Bleak House*, and other classics emphasized the fragility of the human condition in a world without safe harbors.<sup>233</sup> The bankruptcy act of 1898 provided such a safe harbor to non-trading individuals for the first time in Anglo-American history, blurring forever our understanding of the distinction between bankruptcy and insolvency law.<sup>234</sup>

Whether the distinction ought to be blurred today is a vexing question. Recent studies have shown that, with the increasing diffusion of stock ownership and investment, individuals today have grown increasingly “mercantile” from a colonial perspective.<sup>235</sup> Consumer bankruptcy also acts as social insurance, particularly in the context of “catastrophic illness.”<sup>236</sup> Bankruptcy and its discharge permit society to shift the cost of such illnesses from the unfortunate victims of the condition to healthcare providers and their “paying” patients.<sup>237</sup> Rather than run the gauntlet of passing national health insurance legislation,

---

232. The first general incorporation statute was enacted by the State of New York in 1811, decades after the framing of the Bankruptcy Clause of Article I of the Constitution. See note 106, *supra*, and accompanying text.

233. See BARBARA WEISS, *THE HELL OF THE ENGLISH* (1986) (providing a full exploration of the theme of financial ruin that permeates Victorian art and literature).

234. SKEEL, *supra* note 111, at 24-46.

235. See Greg Ip, *Bear Ravaging Portfolios Unlikely to Maul Economy, Even Though Stock Ownership Has Spread, Most Consumers Don't Feel Affected by it*, *TORONTO GLOBE & MAIL*, March 23, 2001, at B10; see also Susan Tompor, *Taking Stock in Retirement Plans: More People Own Shares than Ever, But That May Not Be Enough to Retire on*, *ORANGE COUNTY REG.*, March 26, 2000, at K13.

236. Todd J. Zywicki, *Bankruptcy Law as Social Legislation*, 5 *TEX. REV. L. & POLITICS* 393, 400 (2001); ELIZABETH WARREN ET AL., *AS WE FORGIVE OUR DEBTORS* (1989).

237. Zywicki, *Bankruptcy Law as Social Legislation*, *supra* note 236, at 401.

defenders of the current consumer bankruptcy regime applaud its ability to substitute for such an initiative.<sup>238</sup>

A recognition of the asset partitioning function of bankruptcy suggests that the public policy debate over the functions of consumer bankruptcy ought to be confronted directly, and democratically. Such a confrontation may result in a system that provides direct, and more efficient subsidies to victims of catastrophic illnesses or investors burned in catastrophic market developments. Investors, in fact, may be able to preserve resort to bankruptcy, as "sole proprietors" of a sort. Nevertheless, a vision of bankruptcy as asset partition helps to remove these public policy questions from behind the veil of obfuscation.

### C. *The Death of Bankruptcy?*

If the central purpose of bankruptcy is to reduce the cost of credit *ex ante*, to enable economic activity and to expand social welfare, then one question remains. What form should bankruptcy law take? The analysis above suggests that a bankruptcy law that tracked the operation of state corporate dissolution law, with religious adherence to its priority scheme, would deprive bankruptcy of its effectiveness as a temporal asset partition. Elimination of the potential for debtors to sequester assets temporally would also bring elimination of the risk premium associated with bankruptcy's asset partition. A bankruptcy law deprived of its asset partitioning potential is relegated to the things that bankruptcy does well, namely, reducing transactions costs, and providing a platform for the sale of assets. Federal bankruptcy also neatly resolves the sticky jurisdictional concerns that led to the origin of the equity receivership in the federal courts.

Current bankruptcy reform legislation appears to be a move to expand, rather than eliminate, the asset partitioning character of bankruptcy. Additional special priorities, for automobile lenders, for example, increase the likelihood of bankruptcy's use as a temporal asset partitioning device.<sup>239</sup> To the extent that these departures from state liquidation and priority schemes can be limited or eliminated, the risk premium associated with bankruptcy as asset partition can be reduced.

---

238. GROSS, *supra* note 22, at 16; WARREN ET AL., *supra* note 236, at 18.

239. See S. 220, 107th Cong. (2001).

## CONCLUSION

Bankruptcy is, at its essence, a limited liability device. It differs from simple insolvency law in that it affords a discharge that lowers an impenetrable veil between past creditors and future possibilities. It does this without imposing an insolvency requirement. Insolvency law, on the other hand, resolves claims between debtors and creditors without the imposition of the temporal shield of a discharge. Accordingly, most insolvents never enter the realm of bankruptcy, or enjoy the protection of its discharge. The absence of an insolvency requirement in American bankruptcy law also means that some debtors who make use of the bankruptcy system do so without genuine concern for impending insolvency, or the common pool problem that such an insolvency might entail. In short, most insolvent debtors never go bankrupt, and some bankrupt debtors are not insolvent.

This Article shows that the use of bankruptcy by solvent debtors reveals the true nature of bankruptcy law as business law. Bankruptcy, through its discharge, is a limited liability device. Solvent debtors use bankruptcy as a drastic limited liability measure, to protect going concern value and its future income stream from past creditors. The five examples explored in this Article are not intended to comprise an exhaustive list of categories. Instead, they are offered as evidence of the prevailing understanding of the function of bankruptcy, and the diversity of circumstances under which its limited liability power is invoked.

The use of bankruptcy as a limited liability device is not necessarily problematic. The frequency with which solvent debtors invoke the limited liability afforded by bankruptcy may allow creditors to price the risk of this use of bankruptcy. Retail real estate lease rejection provides an example of such a market adjustment. Other limitations on liability exist in nature, and, as has been shown through the history of English and early American bankruptcy law, limited liability is very important for the development of commerce. In fact, bankruptcy may be the only limitation on liability afforded unincorporated businesses, such as partnerships and sole proprietorships. The effective, albeit drastic, asset partition afforded by bankruptcy, when coupled with the institution of secured credit, may be necessary to make the conduct of business as a partnership or sole proprietorship feasible. Corporations, on the other hand, already enjoy effective asset partitioning through organizational law. Bankruptcy adds a more dramatic layer of asset partitioning, with a temporal dimension. Where bankruptcy law departs from the priority scheme dictated by state law, and imposes no insolvency requirement, bankruptcy permits debtors the opportunity to sequester assets along a temporal plane. If the central purpose of bankruptcy is to lower the cost

of credit ex ante, then this purpose is undermined by the temporal asset partitioning character of bankruptcy law, which imposes an additional risk premium upon the cost of credit.

