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Theodore Eisenberg*

BASELINE PROBLEMS IN ASSESSING CHAPTER 11†

Dealing with failing businesses is like dealing with failing marriages. It is messy. The bigger the business the messier the process is likely to be. Many big business failures in the United States go through their death throes or cure their ills in reorganizations under Chapter 11 of the Bankruptcy Act.[1] As the vehicle in which big business messes travel, Chapter 11 is viewed as unnecessarily complex, time-consuming, and costly. The justification for Chapter 11's very existence has been challenged.[2]

This article suggests that we are blaming the vehicle for the mess that it carries. Much of what is problematic with divorce law is that divorce must deal with personal misery. Divorces produce unhappy results, we can't do much about the underlying problem, so we reform divorce law. Business failure is also an unfortunate, sometimes tragic, event. Much of what is problematic with Chapter 11 is that it must deal with commercial misery. There are limits on how content we are likely to be with even the most perfect reorganization law.

Distinguishing the misery and cost *inherent* in dealing with failing businesses from the misery and cost *added* by the way Chapter 11 deals with such businesses is an important but often ignored issue.[3] Calls for abolition of Chapter 11 start with the truism that it is costly. But if dealing with a failing business is inherently costly, the important question is how much cost Chapter 11 adds, not the raw cost of the Chapter 11 proceeding. We have some information about the latter cost but none about the former. As explored below, much of the cost attributed to Chapter 11 is the inherent cost of addressing business failure. Reorganizing was costly before Chapter 11, it was costly before bankruptcy law even dealt with

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† I would like to thank Lynn M. LoPucki, Lemma Senbet, Bruce Simon, and participants at the Corporate Stakeholder Conference for their comments.

1 11 USC §§ 1101 et seq.

2 Barry E. Adler 'Bankruptcy and Risk Allocation' (1992) 77 *Cornell LR* 439; Michael Bradley and Michael Rosenzweig 'The Untenable Case for Chapter 11' (1992) 101 *Yale LJ* 1043 (hereinafter 'Untenable'); Michael Bradley and Michael Rosenzweig 'Time to Scuttle Chapter 11' *NY Times* 8 March 1992 (hereinafter 'Scuttle'); Douglas G. Baird 'The Uneasy Case for Corporate Reorganization' (1986) 15 *J. Legal Studies* 127

3 It is noted in Adler, supra note 2, 467–8, and in Lynn M. LoPucki and William C. Whitford 'Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1990) 139 *U. Pa. LR* 125, 147 n43.

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reorganizations, and it will remain costly if we modify bankruptcy law or remove the reorganization process from bankruptcy.

We may use an erroneous yardstick not only to measure Chapter 11's efficiency. A related problem vexes analysis of Chapter 11's distributional results. Critics usually judge Chapter 11 against a classical state law liquidation model. In this model a failing firm's assets are distributed according to time-honoured priorities. It is common, for example, to recommend that non-bankruptcy entitlements, usually state law rights, be preserved in bankruptcy except to the extent necessary to administer the bankruptcy proceeding.[4] If they cannot be preserved, state law rights should at least provide the measuring stick for rights in bankruptcy. The relevant state law rights are rights on liquidation.

Using liquidation priorities has substantial implications for Chapter 11. For example, if, under state law, a secured creditor has the right to repossess collateral, bankruptcy law should honour that right or disrupt it to the minimum extent necessary. Delaying foreclosure should lead to compensation.[5] The classical liquidation model also is the source of the controversial absolute priority rule.

State law rights must influence bankruptcy distributions.[6] But a little-noted fact about America's corporate history limits state law entitlements' role in reorganization. There has been no substantial period when many large corporations coexisted with a classical state law liquidation regime. The classical regime ceased to exist almost as soon as corporations became large enough to be worth saving. As the modern corporation emerged, the receivership – the traditional method for handling businesses that could not be immediately liquidated – was transformed to preserve large enterprises. The transformation of receiverships eroded the classical liquidation model well before Chapter 11 or its statutory predecessors were enacted. More importantly, classical liquidation doctrine developed when corporations either did not exist or were not large enough to be worth saving.

Thus, we erroneously measure Chapter 11's efficiency by focusing on its absolute costs. We also misjudge its distributional results by comparing

4 E.g., *Butner* v. *United States*, 440 US 48 (1979); Thomas H. Jackson *The Logic and Limits of Bankruptcy Law* (1986) 20–4; Theodore Eisenberg 'Bankruptcy Law in Perspective' (1981) 28 *UCLA LR* 953, 958; Theodore Eisenberg 'A Bankruptcy Machine That Would Go of Itself' (1987) 39 *Stan. LR* 1519, 1520 (book review)

5 Jackson, supra note 4, 183–90; Adler, supra note 2, 454; Baird, supra note 2, 147. But see *United Savings Ass'n of Texas* v. *Timbers of Inwood Forest Associates, Ltd.* 484 US 365 (1988).

6 Tort and contract claims against the debtor generally arise under state law. Indeed, without some claim under state law, it is often difficult to justify an entity's participation in a bankruptcy proceeding.

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them with a classical liquidation regime that predates large corporations. To develop these points, section I narrows the focus to large reorganizations. Section II provides historical background that is central to both of my claims. Section III builds on the historical discussion to suggest that much of the cost and delay in Chapter 11 are unavoidable. After analysing a recent empirical attack on Chapter 11, Section IV considers the history's implications for modern reform proposals.

I *Limiting the focus to large cases*

At the outset it is helpful to narrow the inquiry from study of all possible bankruptcies or even all possible reorganizations. One ought to distinguish large Chapter 11 cases from the mass of consumer and small-business bankruptcies in which unsecured creditors receive very little.[7] Large Chapter 11 cases often result in substantial payments to unsecured creditors. LoPucki and Whitford studied all Chapter 11 cases filed on or after 1 October 1979, which resulted in confirmation of a plan on or before 31 March 1988, in which the debtor had assets of at least $100 million and at least one class of publicly held securities.[8] In the 30 of these cases with insolvent debtors, the percentage paid on unsecured claims ranged from 0.5 per cent to 81.6 per cent. More than half the unsecured creditors received at least 25 per cent of their claims and, in seven cases, unsecured creditors received more than 50 per cent of their claims.[9] In 13 additional cases, the total value distributed to unsecured creditors and shareholders equaled at least the amount of unsecured claims.[10] The notion that all of bankruptcy is a disaster because unsecured creditors receive nothing is not true for large corporate reorganizations.

Second, unlike most Chapter 11 debtors, the big debtors, loosely defined, do emerge as reorganized entities,[11] though often much smaller

7 James W. Bowers 'Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure' (1990) 88 *Mich. LR* 2097, 2098–9 and n2 (general creditors don't get paid by bankrupts; collecting studies)

8 Lynn M. LoPucki and William C. Whitford 'Preemptive Cram Down' (1991) 65 *Am. Bankr. LJ* 625, 625 n2

9 Ibid. 626 (table 1)

10 Ibid. 626 (table 1 note a)

11 Lawrence A. Weiss 'Bankruptcy Resolution: Direct Costs and Violation of Priority Claims' (1990) 27 *J. Fin. Econ.* 285, 291 (30 of 35 Chapter 11 filings led to reorganizations); Lynn M. LoPucki and William C. Whitford 'Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1991) *Wis. LR* 11, 41 n105. On the failure rate of small Chapter 11 cases, see, e.g., Tom Furlong 'Many Firms Don't Survive Filings for Bankruptcy' *L.A. Times* 13 January 1992; Mary Graham *The Atlantic* March 1992, 28; 'After the Recession: Bankruptcy Practice Boon Escalates Through 1990s' *Ill. Leg. Times* March 1991, 1.

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in size than before entering Chapter 11.[12] They do not liquidate. Chapter 11 works to preserve something in big cases and is not always simply a stalling tactic used to ensure management's salaries while the firm drifts to inevitable liquidation. There likely are economies of scale at work.[13] Certain threshold costs of Chapter 11 are unavoidable and for many firms they are too high. Ease of entry into Chapter 11 may be too easy, thereby attracting businesses with no real prospect of reorganization.[14] This may suggest skewing Chapter 11's availability towards large firms. But for big firms the costs are manageable.

Limiting our focus to large Chapter 11 cases, it is tempting to believe that recent growth in bankruptcies has led to greater than usual urgency to refine bankruptcy law. But reorganization of a non-trivial fraction of major American businesses dates back almost a century. Around the turn of the century 'railroad corporations owning about one-half of the total mileage of the United States have been subjected to the process of reorganization or readjustment.'[15] One federal judge 'estimated that fifty per cent of the corporations of to-day [1916] have gone through some form of reorganization in the last twenty years.'[16]

Thus, recent alarm at the growing number of Chapter 11 cases, while understandable, may lack historical perspective. Periods of recession always trigger increased bankruptcy filings and generate scrutiny of the bankruptcy system. This pattern suggests beginning with a look at reorganization efforts preceding Chapter 11.

II *The rise of corporations and the partial fall of the classical liquidation model*

Reorganizations before Chapter 11 and its predecessors supply background information for analysing both Chapter 11's costs and delay and

12 Stratford P. Sherman 'Bankruptcy's Spreading Blight' *Time* 3 June 1991, 123

13 James S. Ang, Jess H. Chua, and John J. McConnell 'The Administrative Costs of Corporate Bankruptcy: A Note' (1982) 37 *J. Fin.* 219; Jerold B. Warner 'Bankruptcy Cost: Some Evidence' (1977) 32 *J. Fin.* 337, 343. Weiss reports no scaling effect (Weiss, supra note 11, 289), but his sample consists exclusively of large firms. See Alan C. Shapiro *Modern Corporate Finance* (1990) 1006.

14 For data on debtors' assets in Chapter 11 cases see Gordon Bermant, Patricia A. Lombard, and Elizabeth C. Wiggins 'A Day in the Life: The Federal Judicial Center's 1988–1989 Bankruptcy Court Time Study' (1991) 65 *Am. Bankr. LJ* 491, 497 (table 1). About 80 per cent of Chapter 11 debtors for which information was available had assets of less than $1 million. Ibid.

15 Paul D. Cravath 'Reorganization of Corporations' in 1 *Some Legal Phases of Corporate Financing, Reorganization and Regulation* (1917) 153, 154

16 Ibid.

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the use of classical liquidation rights to shape Chapter 11's distributional rules. The cost and delay of the largely private reorganizations before the 1930s provide a basis for comparing today's fees and delays. The receiverships of that time also show the erosion of the classical liquidation model just when corporations began to substantially influence commercial life.

A. THE RISE OF CORPORATIONS

The modern corporate era emerged in the mid- to late-nineteenth century. Berle and Means report that in 1800 there were only 335 profit-seeking corporations in the United States, and most of these were turnpike, bridge, and canal companies.[17] The first important manufacturing corporation dates from 1813. By 1830 it had all of 76 stockholders, a number that rose to 123 by 1850.[18] After the Civil War, large publicly held companies dominated the railroad industry.[19] The phenomenon quickly spread. 'Following the lead of the railroads, in the last part of the Nineteenth Century and the early years of the Twentieth, one aspect of economic life after another [came] under corporate sway.'[20] The 1899 census reported that corporations produced two-thirds of all manufactured products; by 1919, the figure was 87 per cent.

While growing corporations transformed business as usual, financially troubled railroads transformed business in hard times. The stress of failing railroads demanded a new legal vehicle because the railroads simply could not be allowed to fail. After a look inside equity receivership practice, I describe its problems and its effect on classical priorities.

B. PRE-BANKRUPTCY RECEIVERSHIPS

In 1916, Paul Cravath, a prominent reorganization lawyer, delivered lectures on corporate reorganization to the Association of the Bar of the City of New York. His lectures were recognized as leading discussions of equity receiverships.[21] For purposes of presentation, Cravath hypothesized an insolvent railroad corporation with several mortgage bond issues,

17 Adolf A. Berle and Gardiner C. Means *The Modern Corporation and Private Property* rev. ed. (1967) 11
18 Ibid. 12-3
19 Ibid. 13
20 Ibid. 14
21 John Gerdes, 1 *Corporate Reorganizations under Section 77B of the Bankruptcy Act* (1936) iii (1936) (preface). Cravath's lecture is also referred to in Charles Thomas Payne 'The General Administration of Equity Receiverships of Corporations' (1922) 31 *Yale LJ* 685, 699, and was later described as presenting the point of view of reorganizers in Jerome Frank 'Some Realistic Reflections on Some Aspects of Corporate Reorganization' (1933) 19 *Va. LR* 541, 543.

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preferred and common stock, substantial unsecured debt, and current operating debt for wages, supplies, and the like.[22] The company was about to default in interest payments on one of its mortgages and a banker representing the bondholders sought legal advice. Chapter 11 was not available.

The first step, Cravath reported, was to secure the appointment of a receiver with sufficient power to protect and operate the property pending foreclosure on the bonds and reorganization.[23] Appointing a friendly receiver avoided having another creditor obtain a receiver friendly to it. 'The experienced reorganizer stands in special dread of an unfriendly receivership proceeding which may force the property into the hands of a receiver who is incompetent or who is under the direction of a court lacking the necessary powers effectively to administer a property running through several states.'[24] Also important was the need to protect the debtor's property from creditors. Receivers could delay foreclosure of liens and execution of judgments in pursuing their traditional task of liquidating a firm's assets.[25]

A friendly receiver had to be appointed quickly, lest another party get one appointed first. The court receiving the first receivership bill made the appointment. Receivers had to be appointed in all jurisdictions in which the corporation had property.[26] The creditor initiating the receivership would then file ancillary proceedings in other jurisdictions, seeking the appointment of receivers in each of them.

After the initial receivers were appointed, a foreclosure receiver was appointed under a creditor's bill to foreclose any mortgage on the debtor's property.[27] After foreclosing the mortgage in the court of the primary receivership, ancillary foreclosure bills would be filed in each court in which there was mortgaged property. Cravath recommended that the mortgage be foreclosed before adoption of a reorganization plan. The reorganization plan was unlikely to please everyone and was apt 'to

22 Cravath, supra note 15, 154
23 Ibid. 157
24 Ibid.
25 Thomas K. Finletter *The Law of Bankruptcy Reorganization* (1939) 4, 12; James F. Gluck and August Becker *The Law of Receivers of Corporations Including National Banks* 2d ed. (1896) § 84 at 441–2; Shirley T. High *A Treatise on the Law of Receivers by James L. High* 4th ed. (1910) §§ 140a, 141; John W. Smith *The Law of Receiverships* 2d ed. (1900) § 7 at 25 (right to enforce liens suspended during receivership)
26 Cravath, supra note 15, 158
27 James Byrne 'The Foreclosure of Railroad Mortgages in the United States Courts' in 1 *Some Legal Phases of Corporate Financing, Reorganization and Regulation* (1917) 77, 79

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result in the formation of opposition groups disposed to adopt obstructive tactics for the purpose of securing modifications.'[28] Procedural challenges in the foreclosure proceedings offered the best opportunity for obstruction.[29]

Following foreclosure, securities in a newly incorporated firm would be issued in exchange for interests in the old firm. The old firm's assets would be transferred to the new firm. Without engaging in a legal battle, the disgruntled creditors could only pursue the shell of a firm left behind.

Notwithstanding speed and proper jurisdictional gamesmanship in the general and foreclosure receiverships,[30] all may not go smoothly. Receiverships raised questions of who may be a receiver,[31] the receiver's powers, the court's power to supervise the receiver, authority to enter into or reject contracts, priorities among creditors, the status of tort claims, the status of secured claims, the power to borrow funds on a secured or unsecured basis,[32] and much more. Creditors' bills and foreclosure proceedings, commenced by friendly creditors at the request of the debtor, may be met by motions to intervene by less friendly creditors. Counsel for the debtor may then have to litigate the question of whom may intervene in creditors' bill proceedings and in foreclosure suits.[33] Stockholders may seek to intervene, sometimes successfully. Even bondholders represented by the trustee in the foreclosure suit could intervene if their position contradicted that of the majority of bondholders.

The receiver's routine business was extensive. A prudent receiver would seek an order requiring the prompt filing of creditors' claims, and barring those claims not promptly filed.[34] Adjudication of all claims would not be possible so the receiver needed the power to settle claims.[35] It was necessary to use representative claims to avoid negotiation or adjudica-

28 Cravath, supra note 15, 175
29 Ibid. 175
30 See Byrne, supra note 27.
31 Gluck and Becker, supra note 25, § 23 at 84
32 Gluck and Becker, supra note 25, § 96 at 520. But limitations on the power to borrow in equity receiverships were said to be one of their flaws. Gerdes, supra note 21, § 15
33 *Pennsylvania Steel Co.* v. *New York City Ry. Co.* 160 F. 222 (CCSDNY 1908); *Metropolitan Street Railways Case* 181 F. 285 (CCSDNY 1910); *Central Trust Co.* v. *Chicago R.I. & P.R. Co.* 218 F. 336 (2d Cir. 1914)
34 Payne, supra note 21, 688; *Decker* v. *Gardner* 124 NY 334, 26 NE 814 (1891)
35 Payne, supra note 21, 689; *Pennsylvania Steel Co.* v. *New York City Ry.* 180 F. 514 (CCSDNY 1910)

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tion of each claim.[36] It was sometimes necessary to raise funds through issuance of receiver's certificates,[37] with doubt about their ability to prime existing liens.[38]

While or before the formal litigation securing appointment of receivers was proceeding, and the receiver processed the mass of claims, the interested parties organized. A bondholder's protective committee would be formed.[39] The reorganization committee, which could draw its members from other committees, was given broad power. Counsel was told to include among the committee's powers those of employing accountants, engineers, counsel or other experts.[40] Recognizing possible problems, Cravath nevertheless noted that a bondholder's protective agreement 'usually provides that the Committee's decision as to its own compensation, as well as its expenses, shall be binding on' the bondholders.[41] Meanwhile committees protecting other bonds, if any, stockholders, and unsecured debt could be expected to form, all undoubtedly with their reimbursement agreements.[42] There may even be two or more committees representing the same class of securities.[43]

Complexities would arise and Cravath noted 'the infinite variety' of questions facing counsel to the bondholder's committee. A single example could not address all the issues in a complex reorganization and, for now, this summary of his description will suffice. But we should note that Cravath described a simple situation in which, as in many railroad reorganizations, the bondholders held a security interest in all of the firm's assets. The bondholders were clearly in charge. Firms with less of their property subject to mortgages may have had less certainty about their reorganization.

In summary, the traditional receivership's principal benefit was its ability to maintain the status quo; it could be used to hold secured

36 Payne, supra note 21, 691; *Pennsylvania Steel Co.* v. *New York City Ry.* 208 F. 168 (SDNY 1913)

37 Payne, supra note 21, 696–7

38 Ibid.

39 Cravath, supra note 15, 162. The drafting of the agreement conferring powers on the protective committee required great care. Even carefully drafted agreements may not avoid litigation when new variations on reorganization practice occur. One case litigated the issue of whether a committee's reorganization plan could be proposed after, as well as before, a foreclosure sale of the bonded property. *Colonial Trust Co.* v. *Wallace* 183 F. 897 (CCSDNY 1910); Cravath, supra, 169

40 Cravath, supra note 15, 167

41 Ibid.

42 Ibid. 172

43 Ibid. 175

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creditors and judgment creditors at bay. The new receiverships relied on this effective stay, but added a new goal – the reorganization sale, not the liquidating sale, of the debtor. Thus, as corporations became large enough to render their dismemberment or forced sale wasteful, a new legal institution developed to prevent the waste. The assumed clear non-bankruptcy arrangement of creditors' rights has not existed in the modern corporate era.

C. PROBLEMS WITH RECEIVERSHIPS

Problems afflicted the equity receiverships. Cravath was hostile to any group that would oppose or delay reorganization. Minorities and dissenters were nuisances and obstructionists who were to be given representation primarily to avoid successful procedural attacks on the reorganization plan. The reorganization process was tailored to minimize the chance for successful dissent, not necessarily through striking a fair deal, but through seizing every procedural and litigative advantage.

The reorganization sketched by Cravath was a matter of contract among stockholders, creditors, and their committees. It was largely beyond court supervision 'and the court accordingly had no control over the charges which the committees might make for the services of their committee members, counsel and agents.'[44] In later years, court supervision grew.[45]

The receiverships could not bind dissenting minorities.[46] Cash had to be raised to satisfy them or they would delay the reorganization or try to pursue the debtor's successor corporation after reorganization. While small minorities of interests could pose undue obstacles, junior interests often were viewed as treated unfairly.[47] Companies with mortgages on all of their assets rarely would be sold without using the outstanding mortgages as part of the purchase price.[48] Junior interests unwilling to buy out secured creditor interests often could not participate in the

44 Finletter, supra note 25, 17; Gerdes, supra note 21, § 18. Cf. *United States* v. *Chicago, M., St. P. & Pac. R.R. Co.* 282 US 311 (1931).

45 Payne, supra note 21, 699

46 Finletter, supra note 25, 17; Gerdes, supra note 21, § 17. But see *Phipps* v. *Chicago, R.I. & P. Ry. Co.* 284 F. 945 (8th Cir. 1922), cert. dism., 262 US 762 (1923) (unusual effort to bind dissenting minority creditors in federal equity receivership), commented on in Finletter, supra, 27; Gerdes, supra, § 17; James W. Moore and Edward H. Levi *Gilbert's Collier on Bankruptcy* 4th ed. (1937) para. 1673 at 1498

47 E.g., Wilber G. Katz 'The Protection of Minority Bondholders in Foreclosures and Receiverships' (1936) 3 *U. Chi. LR* 517; Jospeh L. Weiner 'Conflicting Functions of the Upset Price in Corporate Reorganizations' (1927) 27 *Col. LR* 132

48 Gerdes, supra note 21, § 16

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reorganization.[49] In times of depression, with prices viewed as artificially depressed, this was regarded as unjust.[50]

These objections combined with doctrinal difficulties that lent an unseemly air to equity receiverships. 'The theory of the [traditional] receivership was that it was incidental to the enforcement of the creditors' claims which were to be enforced through a sale of the property.'[51] Traditional receiverships thus contemplated that the creditor initiating the receivership and the debtor were true adversaries. The traditional sale would be an arm's length transaction and proceeds would quickly be distributed according to liquidation priorities.

Federal equity receiverships abandoned the doctrinal underpinnings of traditional receiverships. Friendly creditors commenced equity receiverships at the debtor's request.[52] Their goal, as suggested by Cravath, was to keep less friendly creditors at bay during the reorganization. Members of the bar less upstanding than Cravath pushed too hard. 'At times the receivership was an instrument of fraud or covin,' leaving management too much control.[53] The foreclosure sale, far from being at arms-length to outsiders, was friendly to at least one group of creditors.[54] Indeed, the entire receivership procedure often was structured to assure that one and only one purchaser – the reorganization committee – could purchase the assets.[55]

Time and money. The complex, procedurally novel, receiverships raised special concerns about two familiar issues: time and money. A depression in the 1870s helped prompt the first wave of railroad equity receiverships.[56] Of these, eight large, medium-sized, and small railroads in receivership in the 1870s had an average receivership length of over

49 Finletter, supra note 25, 18; Moore and Levi, supra note 46, para. 1673 at 1498

50 Moore and Levi, supra note 46, para. 1673. A brief statement of the need for bankruptcy reorganizations echoed the themes noted in the text: 'It is generally conceded that the bankruptcy statute is the only effective vehicle for corporate reorganizations. It permits control of recalcitrant minorities, eliminates obstructive and wasteful ancillary receiverships, avoids circuitous foreclosure sales and, generally, affords a procedure which is speedier, less expensive and simpler than that available in an equity receivership proceeding looking towards a reorganization.' Jacob I. Weinstein *The Bankruptcy Law of 1938: Chandler Act* (1938) 192

51 Moore and Levi, supra note 46, para. 1673 at 1497–8. See Gerdes, supra note 21, § 14 at 42–3.

52 *Duparquet Huot & Moneuse Co.* v. *Evans* 297 US 216, 219 (1936) (Cardozo J)

53 Ibid. 219

54 Moore and Levi, supra note 46, para. 1673 at 1498

55 Finletter, supra note 25, 13

56 Albro Martin 'Railroads and the Equity Receivership: An Essay on Institutional Change' (1974) 34 *J. Econ. Hist.* 685, 689

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four years, with only one lasting less than two years.[57] Prosperity returned in the late 1870s, but a financial panic in the 1880s triggered another wave of railroad receiverships.[58] Seven large, medium, and small railroad receiverships in the 1880s lasted for an average of a little under four years, with as many as three lasting less than two years.[59] In addition, Dagget reports the following reorganization times for various railroads: Baltimore & Ohio, more than three years;[60] Erie, more than two years;[61] Philadelphia & Reading, more than three years;[62] East Tennessee, Virginia & Georgia, 17 months;[63] Richmond & Danville, over two years;[64] Atchison, Topeka & Santa Fe, about two years;[65] Union Pacific, more than four years;[66] Northern Pacific, three years.[67]

Substantial time also was required to reorganize or liquidate non-railroad corporations. National Salt Company was in receivership, starting in 1902, for more than two years before being finally liquidated.[68] The United States Leather Company took many years to reorganize its capital structure without use of receivership or bankruptcy proceedings.[69] The American Bicycle Company failed to reorganize successfully despite more than a decade of effort.[70] Even Westinghouse's simple, successful receivership reorganization took more than a year.[71]

57 Ibid. 691 (table 1)
58 Ibid. 696–7
59 Ibid. 702 (table 2)
60 Stuart Daggett *Railroad Reorganization* (1908) 21, 29
61 Ibid. 61, 73
62 Ibid. 125, 141
63 Ibid. 154, 157–8
64 Ibid. 176, 187
65 Ibid. 205, 216
66 Ibid. 240, 256
67 Ibid. 289, 308
68 Arthur S. Dewing *Corporate Promotions and Reorganizations* (1914) 223–5
69 Ibid. 16–48
70 Ibid. 249–68
71 Ibid. 182. Dewing observes: 'The reorganization which followed this technical insolvency was of the simplest kind. It involved no sale of assets, no new company, not even any new form of security; no stock assessment was required, nor was a mortgage placed on the Company's property. The creditors merely funded their obligations, and the stockholders contributed additional money.' Ibid. 197. And sometimes, as today, non-court reorganizations were completed quickly. Ibid. 227–48 (The United States Realty and Construction Company). Gilson et al. report a mean time of 15.4 months for 80 successful out-of-court restructurings. Stuart C. Gilson, Kose John, and Larry H.P. King 'Troubled Debt Restructurings: An Empirical Study of Private Reorganization Firms in Default' (1990) 27 *J. Fin. Econ.* 315, 335 (table 5)

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Receiverships of substantial businesses were regarded as excessively costly. Cravath, defensively, alludes to the going rate in 1916. 'A fee of $100,000 to counsel upon the consummation of a successful reorganization may seem high to one who does not realize that it is compensation for two or even three or four years of perhaps the hardest work and the gravest responsibility which fall to a lawyer's lot ...'[72] Inflation alone would bring this fee to well over $1 million in current dollars.[73] And practice today is much more complex. Cravath's reorganization work occurred before ERISA, before environmental laws, before the need to consider federal income tax implications, before federal regulation of securities, and before the massive growth of federal and state agencies. The $100,000 refers only to his firm's counsel fees. The reorganization committee also had to pay its own compensation and that of the other agents employed in the course of the reorganization.[74] Foreclosure of the mortgage, in the near-fictitious sale to secured creditors was not by the bondholder's committee or its counsel but by counsel for the financial institution representing the bondholders.[75] A glimpse at other fees comes from the efficient, swift 1891 Westinghouse reorganization. Dewing reports: 'In consideration of their services as a Reorganization Committee, and for the underwriting of the $3,000,000 of preferred stock, the bankers received a commission of $125,000 in preferred stock and $125,000 in cash' – more than 8 per cent of the issue.[76]

By the time the first federal statutory reorganization provision was enacted in 1934, costs were a widely recognized problem with equity receiverships.[77] One important defect was the complexity and expense of multiple administration brought on by the requirement that receivers be appointed in every state in which the debtor did business.[78] Even without multiple receiverships, the high fees of individual receiverships and

72 Cravath, supra note 15, 208–9

73 E.g., US Department of Labor *Handbook of Labor Statistics* (1989) 475 (table 113)

74 Cravath, supra note 15, 209

75 Ibid. 175

76 Dewing, supra note 68, 171

77 There were, however, substantial defenders of the status quo. Robert T. Swaine '"Democratization" of Corporate Reorganizations' (1938) 38 *Colum. LR* 257; Joseph L. Weiner 'The Securities and Exhange Commission and Corporate Reorganization' (1938) 38 *Colum. LR* 280

78 Finletter, supra note 25, 12–3; Gerdes, supra note 21, § 14; Moore and Levi, supra note 46, para. 1673 at 1497

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foreclosures had attracted attention.[79] Much litigation concerned the proper level of compensation for receivers.[80]

D. PRIORITIES

On priority matters, classical liquidation rules were quickly found wanting. The new receiverships, in a few decades, ran roughshod over classical liquidation principles. Unsecured creditors not only were paid without mortgagees being paid in full, they often were given priority over mortgagees. In moving from traditional receiverships to modern reorganizations, not everything changed. Some practices evolved and some remained locked in pre-nineteenth-century molds. Treatment of unsecured creditor claims showed the most activity while the absolute priority rule, developed before corporate reorganizations, remained intact.

New treatment of unsecured creditors. New rules dealing with unsecured creditors can be traced through editions of James High's *Treatise on the Law of Receivers.* In his first edition in 1876, High moved smoothly from section 394 to section 395.[81] In the 1886 second edition, High found it necessary to interrupt the flow by adding a new subdivision between these sections.[82] The new subdivision, 'Preferred Debts,' occupied 14 pages and began with a rant against the improving treatment of unsecured creditors in equity receiverships.

> That mere contract debts of the railway company, as for labor, materials and supplies, incurred prior to the appointment of a receiver, and unsecured by any lien upon the property, can, through the aid of a court of equity, be given priority over antecedent mortgages, would seem a proposition wholly indefensible upon sound legal reasoning.[83]

79 E.g., *United States* v. *Chicago, M., St. P. & P. R.R. Co.* 282 US 311, 337 (1931) (Stone J dissenting); *Bailie* v. *Rossell* 60 F.2d 806 (3rd Cir. 1932); *Trustees Corp.* v. *Kansas City, M. & O. Ry. Co.* 26 F.2d 876, 882 (8th Cir. 1928); *Seaboard National Bank* v. *Rogers Milk Products Co.* 21 F.2d 414, 416 (2d Cir. 1927) ($37,000 realized from sale of mortgaged premises; less than $10,000 to be paid to mortgage bondholders after expenses of administration); *Penner* v. *Drilling Develop. Co.* 293 F. 766, 767 (D. Mont. 1923); Gerdes, supra note 21, § 14; Jacob Treiber 'The Abuses of Receivership' (1910) 19 *Yale LJ* 275, 278–9

80 Gluck and Becker, supra note 25, §§ 98, 103 (cases cited in footnotes) (passim)

81 Section 394 was called 'Rights of action vested in receiver.' Section 395 was called 'Receivers answerable in official capacity for injuries sustained.' James L. High 'A Treatise on the Law of Receivers 254' (1876) 257–8

82 James L. High *A Treatise on the Law of Receivers* 2d ed. (1886) §§ 394a–4i

83 Ibid. § 394a at 330

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But, High conceded, the indefensible was already so deeply entrenched that it could no longer be questioned.[84] The unsecured claims that had grown to take priority, even over a mortgage, included pre-receivership debts for labour, materials, equipment, supplies, and rent due for rolling stock.[85]

By High's fourth edition in 1910 the subdivision on preferred unsecured debts had grown to 33 pages.[86] High still began, word for word, with the second edition's rant,[87] but at least a quarter-century of practice was now against him. The fourth edition cited more than a dozen pre-receivership items that could take priority over a mortgage. They ranged from the debtor's attorney's salary to claims for damages from abutting property owners.[88] High also added an entire section devoted to establishing that pre-receivership claims for personal injuries did not take priority over mortgages, citing 11 cases in support.[89] He failed to cite the cases allowing the opposite result.[90] The unsecured and tort creditor priorities that High bemoaned are today the law in railroad reorganizations.[91] The improving treatment of some unsecured creditors was not limited to railroads, with their quasi-public interest. Receiverships of more private corporations also began to develop similar rules.[92]

84 Ibid. § 394a at 330–1

85 Ibid. §§ 394b–4g at 331–42. During the time of High's first and second editions, nearly all states enacted laws giving liens for labour and materials furnished to railroads. Smith, supra note 25, § 276 at 479–80 n1

86 High, supra note 25, §§ 394a–4n at 503–35. By the fourth edition, a new High had replaced the original as author of the treatise. See note 25, supra.

87 Ibid. § 394a at 503

88 Ibid. § 394d at 516–7. These claims were not all limited to a fixed amount of time before the receivership.

89 Ibid. § 394i at 528–9 and n94. Accord, Smith, supra note 25, § 279 at 490

90 A few courts, *Farmers' Loan & Trust Co.* v. *Northern Pac. Ry. Co.* 71 F. 245 (CCD Wash. 1895); *Farmers' Loan & Trust Co.* v. *Kansas City, W. & N.W. Ry. Co.* 53 F. 182, 184 (CCD Kan. 1892); *Green* v. *Coast Line Ry.* 97 Ga. 15, 24 SE 814 (1895), and at least one unreported reorganization, Payne, supra note 21, 690 (in 1911 tort creditors of the Metropolitan Railway system were accorded bondholder rights), afforded pre-bankruptcy tort creditors priority in receivership proceedings.

91 11 USC § 1171

92 *Drennen* v. *Mercantile Trust & Deposit Co.* 115 Ala. 592, 23 So. 163 (1897); *Jones* v. *Arena Publishing Co.* 171 Mass. 22, 50 NE 15 (1898); *L'Hote* v. *Boyet* 85 Miss. 636, 38 So. 1 (1905); *Dickinson* v. *Saunders* 129 F. 16 (1st Cir. 1904). See Mass. Rev. Laws of 1902, ch. 150, § 29; High, supra note 25, § 312c at 380. But see *Merriam* v. *Victory Placer Min. Co.* 37 Ore. 321, 56 P. 75 (1899); *Security Savings & Trust Co.* v. *Goble, N. & P. R. Co.* 44 Ore. 370, 74 P. 919 (1904); High, supra, § 312d at 381. High noted this troublesome development, which he hoped would be arrested, in the preface to the fourth edition. High, supra, vii–viii

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The theories under which even tort creditors could trump a mortgage were not startling. There was much discussion of the theory of mortgages and whether routine earnings could be 'diverted' for the benefit of mortgagees when routine operations had not been paid for.[93] But the underlying principle had fairness overtones. Those who allowed the enterprise to keep operating – suppliers, workers, and others – should not be subordinate to the mortgagee because their effort may have created or preserved the collateral's value.

Absolute priority survived. On another basic issue the new receivership jurisprudence remained wedded to a classical model. For while it became more generous to unsecured creditors it remained faithful to the absolute priority rule. The absolute priority rule mandates that senior interests be paid in full before junior interests can receive anything of value. For example, creditors must be paid in full before shareholders may retain any interest in a reorganized firm.

Railroad Company v. *Howard*,[94] an 1868 Supreme Court case, is an early major foundation of the modern absolute priority rule.[95] In *Howard*, a secured creditor foreclosed on the assets of an insolvent railroad. The foreclosure sale yielded too little to pay off the mortgage but the mortgagee nevertheless agreed to share the proceeds of the sale with the railroad's stockholders. The railroad's unsecured creditors, who received nothing, attacked the transaction as a fraudulent conveyance.

In finding for the unsecured creditors, the Court relied on a liquidation model. A failing corporation holds it assets in trust for its creditors. On termination of the corporation, the creditors must be paid in full before stockholders enjoy any residual.[96] *Howard* measured the distribution against state law governing liquidating corporations. This approach continued to *Northern Pacific Railway Company* v. *Boyd*,[97] the fountainhead of the modern absolute priority rule. As stated in *Boyd*:

> [Stockholders] were in the position of insolvent debtors who could not reserve an interest as against creditors. Their original contribution to the capital stock was subject to the payment of debts. The property was a trust fund charged primarily with the payment of corporate liabilities.[98]

93 High, supra note 25, § 394c; Smith, supra note 25, § 275 at 473–4
94 74 US 392 (1868)
95 See Frank, supra note 21, 543
96 74 US 409–10
97 228 US 482 (1913)
98 Ibid. 504

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In *Boyd*, while describing a reorganization, the Court relied on a liquidation model to mandate priorities. As Blum later noted, creditors could not enjoy their rights upon liquidation, but reorganization is merely a 'substitute for enforcement of rights through liquidation.'[99]

III *Time and money in Chapter 11*

Concerns about modern Chapter 11 echo concerns about equity receiverships and pre–Chapter 11 bankruptcy law. Much criticism of Chapter 11 raises concerns about time and money.[100] And High's concern about failure to honour contractual priorities is akin to modern apprehension about violations of absolute priority and other distributional issues. This section considers time and money issues. Section IV addresses modern reform proposals designed to save time and money and to reshape distributional results.

A. TIME AND COST DATA

Pre-1930s reorganizations for which information is readily available consumed more than two years on average.[101] While the available data are not a systematic sample, they probably present a reasonable picture of big-case practice. These were the cases worth writing about. And, for present purposes, a precise estimate is unnecessary; ballpark figures will do.

Data about modern big cases have been more systematically gathered. LoPucki and Whitford present data on the elapsed time of modern large Chapter 11 reorganizations. They find, with some regional variation, an average time of less than 2.5 years from filing to plan confirmation.[102] Gilson and others, studying 89 large Chapter 11 proceedings between

99 Walter J. Blum 'The Law and Language of Corporate Reorganization' (1950) 17 *U. Chi. LR* 565, 581 n22. See Note 'Dissolution Preferences and Public Utility Holding Company Act Simplifications – The Otis Case' (1945) 58 *Harv. LR* 604, 608.

100 Baird, supra note 2, 138; Bradley and Rosenzweig, Scuttle, supra note 2; Karen Donovan 'As Macy's Fees Mount, Judge Issues a Warning' *Nat'l LJ* 3 August 1992; Phyllis Furman and Judy Temes 'Tough Talks, Soaring Fees Loom for Macy, Crain's' *New York Bus.* 3 February 1992; Claudia MacLachlan 'Anger Rises Over Bankruptcy Fees' *Nat'l LJ* 9 March 1992; Allan Sloan 'Valentine's Day Massacre at LTV; Reorganization Will Wipe Out Debt Holders Not Already Dead' *Newsday* 16 February 1992

101 See above.

102 LoPucki and Whitford, supra note 11, 31–2 n68. This is for relatively complex companies with at least $100 million in publicly held securities. These companies had, on average, more than 6,000 employees, sales of over $700 million, and assets of more than $600 million.

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1978 and 1987, report a mean bankruptcy-proceedings length of 20.4 months.[103]

Data about modern, successful, non-bankruptcy work-outs also are helpful in evaluating Chapter 11. Gilson and others supply data on 80 large firms (median assets of $101 million) that successfully restructured their debt out of court.[104] The mean length of the restructuring effort was 15.4 months. For 89 unsuccessful restructurings that ended in Chapter 11 filings, the mean time for the pre–Chapter 11 debt restructuring effort was 8.1 months. As noted above, Chapter 11 proceedings consumed a mean time of 20.4 months.

Two conclusions emerge from these data. First, modern reorganization proceedings under Chapter 11 probably take no longer than the receivership reorganizations predating federal statutory reorganizations. If one excludes the largest firms, modern proceedings may even be faster.[105] Second, firms that can restructure their debt outside Chapter 11 do so more quickly than firms that require resort to Chapter 11.

Pre–Chapter 11 equity receivership costs were substantial, but precise data about those costs are not available. Chapter 11 costs are also substantial but, viewed as percentages of assets, they are not shocking. Early studies of modern bankruptcies showed direct costs in large bankruptcies to be about 1 per cent to 3 per cent of assets.[106] More recent and comprehensive work by Weiss finds costs of large bankruptcies to be about 3 per cent of assets.[107] They are unlikely to be an order of magnitude higher than the old receiverships' costs.

103 Gilson et al., supra note 71, 335 (1990) (table 5). Other studies find similar mean times from filing to reorganziation. Allan C. Eberhart, William T. Moore, and Rodney L. Roenfeldt 'Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings' (1990) 45 *J. Fin.* 1457, 1460 (2.1 years); Julian R. Franks and Walter N. Torous 'An Empirical Investigation of U.S. Firms in Reorganization' (1989) 44 *J. Fin.* 747, 753 (higher mean, but due to inclusion of some lengthy railroad reorganizations)

104 Gilson et al., supra note 71, 335 (table 5)

105 A comparison to the time consumed in modern liquidations may also be relevant. I am unaware of available US data on this subject, but Japanese data are intriguing. For example, in liquidating bankruptcies from 1981 to 1985, the time period from bankruptcy adjudication to conclusion of the case by distribution to creditors was under one year in less than 16 per cent of the cases. Only slightly more than half the cases concluded distributions within two years. Theodore Eisenberg and Shoichi Tagashira 'Should We Abolish Chapter 11? The Evidence from Japan' *J. Legal Studies* (forthcoming). These data do not include no-asset cases.

106 Theodore Eisenberg 'Bankruptcy in the Administrative State' 50 *Law & Contemp. Prob.* (Spring 1987) 3, 42 n177

107 Weiss, supra note 11, 289

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B. THE TIME AND COST INHERENT IN DEALING WITH LARGE-BUSINESS FAILURES

The staying power of the time and cost objections suggests a possibility often ignored by Chapter 11's critics: reorganizing failing businesses in which all interested parties cannot reach agreement is difficult. Neither private contractual arrangements, which dominated equity receiverships, nor legislation, which has been tried for the last 60 years, eliminated the difficulty. The common concerns raise other possibilities as well. Perhaps near-magical solutions that will eliminate the problems have been overlooked. Or, perhaps marginal progress can be made in reducing costs and time, but it is unlikely to be substantial enough to satisfy critics. Without dismissing the other two possibilities, this section develops the first.

Three factors suggest the difficulty of major reorganizations. First, the tasks that must be performed are inherently complex. They include multiparty bargaining in a tense, negative atmosphere filled with uncertainty and blame. Reorganizing a large firm can require agreement among thousands of parties with interests in a corporation. The impossibility of face-to-face multiparty bargaining yields to representation through committees, whether in or out of Chapter 11. But committees take time to be appointed, organize, retain professionals, arrive at positions, construct proposals, negotiate those proposals, and obtain approval of them. If the initial proposal fails to gain acceptance, or if there are competing proposals, the process of arriving at positions and constructing and negotiating proposals is renewed. Professionals conducting these activities have workloads that include other matters.

Much of the legal work involved in large bankruptcies is not routine. It is far more complex than drafting a will or serving as counsel in a sale of real estate. It is probably more complex and intense than most sophisticated contract negotiations or private financings. In reorganization, unlike in many transactions served by big-firm lawyers, the economic deal among the parties cannot be known before the attorneys work. There are likely to be rounds of negotiations in a multiparty negotiating context, all conducted while trying to keep a troubled business afloat. Because of the complex and uncertain nature of the work, attorneys working on reorganizations may deliver more valuable legal work to firms than do attorneys in more routine transactions. Nor can much of the legal work be avoided.

I am not sure what other human endeavors provide useful comparisons for the time consumed in reorganizing a business. Transitions, ranging from changing jobs to buying homes, are expensive. Affairs must be wound up and a new accounting begun. Transitions of size and com-

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plexity comparable to those of large reorganizations may not proceed much more quickly than many reorganizations presently do.

Second, if Chapter 11 is more costly than private work-outs, all parties have an incentive to negotiate to avoid Chapter 11. Those with a financial interest in the firm have an incentive to bargain to an economically efficient solution.[108] If non-bankruptcy work-outs generate savings over Chapter 11, creditors could negotiate a settlement and split the savings among themselves or with stockholders.[109] When these savings cannot be achieved, there may be a reason for the bargaining failure.[110]

It is tempting to posit that transaction costs and other bargaining obstacles render simple Coasean analysis unrealistic for complex business reorganizations. But many firms do successfully negotiate reorganizations outside bankruptcy. And other firms compress the bankruptcy process, thereby saving costs, by using prepackaged bankruptcies.[111] Work-outs that avoid lengthy Chapter 11 proceedings, one suspects, involve less complex bargaining, fewer parties, and more room for successful negotiation, than reorganizations that reach Chapter 11. Private reorganizations take, on average, about a year less to complete than Chapter 11 reorganizations.[112] Chapter 11 cases may take longer not largely because Chapter 11 is a more formal and slower process than private negotiation, but because a substantial selection effect is at work. Chapter 11 only operates in cases that are likely to take longer. Cases that can be quickly and efficiently resolved by negotiation never reach Chapter 11.

Gilson and others' data suggest that Chapter 11 receives an especially difficult set of corporations in comparison with those that reorganize outside Chapter 11. Firms that privately restructure their debt have more bank debt than firms in Chapter 11.[113] Bank debt, in contrast to trade

108 Ronald Coase 'The Problem of Social Cost' (1960) 3 *J. of Law & Econ.* 1; Gilson et al., supra note 71, 318; Mark J. Roe 'The Voting Prohibition in Bond Workouts' (1987) 97 *Yale LJ* 232, 236. Cf. Elizabeth Hoffman and Matthew L. Spitzer 'Experimental Tests of the Coase Theorem with Large Bargaining Groups' (1986) 15 *J. Legal Studies* 149, 167 (other parties should pay secured creditor to avoid loss of asset on foreclosure).

109 Roe, supra note 108, 236

110 Frank H. Easterbrook 'Is Corporate Bankruptcy Efficient?' (1990) 27 *J. Fin. Econ.* 411

111 Larry Light 'Quickie Bankruptcies: Speed Isn't Everything' *Bus. Week* 29 April 1991, 72; Pat Widder 'Bankruptcy Increasingly a Done Deal' *Chi. Trib.* 2 September 1991; 'Restructurings & Bankruptcies' *Corp. Fin. Week* 23 December 1991 (special supplement). See also Dwight Cass 'Street Weighs New Bankruptcy Technique' *Corp. Fin. Week* 9 September 1991, 1 (possible use of declaratory judgments).

112 Gilson et al., supra note 71, 336

113 Ibid. 334

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debt, offers both more sophisticated and fewer parties with whom to negotiate. The likelihood of reaching agreement may be higher. In addition, the number of creditors per dollar of debt is higher for Chapter 11 debtors than for privately reorganized debtors.[114] The greater number of creditors should make bargaining more difficult.[115] I thus suspect that businesses that cannot reorganize privately have characteristics that differ from those that can. Those different characteristics, not Chapter 11, may explain most of the added cost in Chapter 11.

Private reorganizations differ from Chapter 11 in another way. They not only work on a cleaner set of cases; they do so more privately. The fees paid in non-bankruptcy work-outs are not routinely revealed. In bankruptcy, attorney and other fees are subject to court approval and therefore are publicly known. Indeed, approval of fees was a chief reform of 1930s bankruptcy legislation.[116] But approval requires publication. A public that reads of the cost of Chapter 11 cases, and not of the cost of private work-outs, understandably gets the impression that Chapter 11 is unduly expensive.

Third, the commonality of the objections to both equity receiverships and Chapter 11 suggests that they address situations of uncommon difficulty. The equity receivership reorganizations sketched above suggest the substantial time and costs inherent in reorganizing major businesses. Cravath's description is not of a simple process. Both pre–Chapter 11 receiverships and large Chapter 11 proceedings consume substantial time – often more than two years. Either both forms of proceeding are unnecessarily slow or the reorganization of a large failing firm unavoidably takes substantial amounts of time.

Some of the costs associated with pre-statutory reorganizations could be reduced. The appointment of multiple receivers was wasteful. The all-but-fictitious foreclosure sale, followed by transfer of assets to a newly formed corporation, involved mostly paper shuffling. One could just pronounce the old assets free of prior claims and allow the corporation to retain its identity. But the equity receivership reorganizations, like modern Chapter 11 cases, raised a core set of unavoidable issues. That

114 Ibid. For evidence that debt structure affects the outcome of Japanese composition cases, see Eisenberg and Tagashira, supra note 105.

115 See *Ill. Leg. Times*, supra note 11.

116 Senate Rep. No. 482 'To Amend the Bankruptcy Act – Corporate Reorganization' 73d Cong., 2d Sess. 3 (1934), reprinted in *Hearings on H.R. 31 and H.R. 32, Bankruptcy Act Revision, Before the House Subcommittee on Civil and Constitutional Rights, Committee on the Judiciary* 94th Cong., 1st & 2d Sess. 365, 367 (1976) (Supp. App. pt. 1)

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both vehicles used to reorganize businesses have been regarded as expensive ought to make one wary of quick fixes that promise to eliminate most of the costs.

C. WHAT DOES CHAPTER 11'S ADDED COST PURCHASE?

Even allowing for the inherent time and cost of fixing a failing business, Chapter 11 adds some time and cost to the reorganization process. The added formality of in-court filings and proceedings may generate delays and costs in Chapter 11 that are not inherent costs of mending a troubled business. And the existence of a substantial bankruptcy court system imposes social costs less visible but no less real than the costs of individual cases. But, as in the case of any legal or arbitral proceeding, we ought to ask whether what is being purchased is worth its cost. The bankruptcy system and Chapter 11 do deliver some things of value. Although the 1930s reorganization laws did not solve all the problems of reorganizing a businesses, they did ameliorate some problems by shifting major reorganizations into the public domain.

1. Fairness and routine in procedure, and certainty

One problem with equity receiverships was their vulnerability to attack by disgruntled parties. And some disgruntlement was warranted.

> In practice it has been the function of groups of powerful creditors and stockholders to plan and carry through such reorganizations as those powerful groups thought wise, without regard in many cases to the equities of minor groups and in most cases without regard to the wishes of many interested parties who were without the necessary funds or ability to combat the plans of the majority.[117]

The receiverships were conducted in a manner designed to reduce the opportunity for dissent. Cravath recommended only the process minimally necessary. His race to appoint a receiver was not just an act of lawyerly competitiveness. He sought and believed he obtained procedural advantages for his client that a neutral third party might not agree should belong to his client. The procedure employed was calculated to raise the costs of dissent, even legitimate dissent. Dissenters would have to formally contest foreclosure proceedings or chase successor corporations. Each of these forms of participation constituted lawsuits with subsidiary questions and substantial costs. Minority participation in Chapter 11 is probably less expensive and less disruptive than it would be absent Chapter 11.

117 Payne, supra note 21, 699

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The costs of defending 'guerilla' attacks on procedurally questionable receiverships can be reduced or avoided when a more formal procedure, run fairly, effectively cuts off collateral attack on a confirmed reorganization plan. One of the most famous collateral attacks on a receivership reorganization – and one that troubled Cravath the most – came years after its implementation.[118]

2. *An adjudicator*

In addition to procedural regularity, Chapter 11's added cost purchases what most judicial proceedings supply, a neutral adjudicator. Given perceptions about Chapter 11's high costs, we often can treat the act of Chapter 11 filing as evidence of bargaining failure. Many troubled businesses avoid Chapter 11. The greater Chapter 11's direct added costs, the greater the chance that the filing results from bargaining failure.

When Chapter 11 operates in cases of bargaining failure, its costs purchase an important benefit – resolution of a bargaining impasse. Parties regularly recognize the benefit of going to court or seeking arbitration to resolve impasses rather than resorting to more destructive mechanisms. In Chapter 11, bargaining failure's centrality may be obscured by the many participants and the focus on the company's financial difficulties.

In important respects, resort to Chapter 11 is a drastic example of bargaining failure. There are many parties, multiplying the uncertainty, and all have been disappointed by the business's failure. They do not come to the bargaining table happy. The costs of buying out of the impasse are higher than the costs of routine two-party conflicts. A neutral, binding adjudicator may be a sound investment.

Holding all else constant, Chapter 11 may be more costly than a private reorganization. But all else rarely is constant. When large companies invoke Chapter 11 after sophisticated creditors have failed to reach a private agreement, there is a good chance that its costs purchase something of value. Whether those costs can be substantially reduced is considered in section IV.

IV *The modern reform movement*

There is another view of what the historical picture supports. The common problems of equity receiverships and modern Chapter 11 reorganizations may suggest not that the problems are unavoidable, but

118 Cravath was upset about *Northern Pac. R.R. Co.* v. *Boyd* 228 US 482 (1913) (5–4 decision). Cravath, supra note 15, 193

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that both mechanisms are flawed. Several critics read the Chapter 11 experience as unsatisfactory and propose abolishing or reforming it. It has become commonplace to view Chapter 11 as beyond repair. A thoughtful New York Times economics columnist suggests that anything would be better than Chapter 11 as it now works.[119]

After reviewing a recent empirical critique of Chapter 11, this part considers whether the historical perspective may shed light on modern reform proposals. At the mechanical level, history suggests that simple abolition of Chapter 11 will not achieve reformers' desired results. More positive legislation will be needed and managment responses to a curtailed or repealed Chapter 11 must be considered. More substantively, I explore the historical contingency of the absolute priority rule, the limits on what can be achieved by strictly adhering to it, and the fragility of assumptions underlying some unsecured creditors' subordinate status.

A. THE FLAWED EMPIRICAL CASE AGAINST CHAPTER 11

Bradley and Rosenzweig's recent abolition proposal differs from others' in that they make an admirable effort to demonstrate empirically the adverse effects of Chapter 11.[120] Two central claims are worth separating. First, they claim to establish that Chapter 11 leads to a net social loss.[121] Second, they claim that, since the 1978 enactment of modern Chapter 11, a group of financially healthier firms has resorted to bankruptcy but their losses have been greater. The picture of healthier firms faring worse under the new act suggests a serious problem with the Act. The system operates to transfer wealth from creditors and shareholders to managers.[122] But neither of Bradley and Rosenzweig's major assertions survive scrutiny.

1. Net effect on social welfare

Their most important claim may be that Chapter 11 reduces social welfare. Their evidence consists of greater losses to creditors and shareholders in the period since Chapter 11 was amended in 1978 (the post-Act period) than in the period before (the pre-Act period).[123] One can accept all of Bradley and Rosenzweig's empirical findings and still reject this conclusion. They have not measured the net social welfare effect of post-Act Chapter 11.

119 Peter Passell 'Fun, Games, Bankruptcy' *N.Y. Times* 29 April 1992
120 Bradley and Rosenzweig 'Untenable' supra note 2
121 Ibid. 1088
122 Ibid. 1076
123 Ibid. 1067–72, 1088

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Let us accept, in addition to Bradley and Rosenzeig's empirical findings of greater post-Act losses, their assertion that Chapter 11 encouraged the incurrence of more debt. The benefits of a legal regime that encourages more debt cannot be measured solely by studying business failures. If greater risks were taken through the incurrence of more debt, there should be more and bigger failures. Bradley and Rosenzweig detect such effects but they do not account for the benefits of taking greater risks. The benefits of greater risks show up in the set of firms that never reach bankruptcy and were not part of their study. In fact, their market-based measure of firm health shows firms doing better post-Act than pre-Act.[124] Perhaps the Act increased risk-taking, thereby giving both bigger pay-offs for successful firms and bigger losses for unsuccessful firms. The net result is what matters from a simple social welfare point of view. Bradley and Rosenzweig have not addressed that question.

Consider an analogy to gambling. Suppose a gambler decides to increase her bets and wants to know if the increased betting strategy is beneficial. One would ascertain that by measuring the amount of losses and subtracting them from the amount of winnings. If one compared the amounts of losing bets in the low-bet era with the amounts of losing bets in the high-bet era one would find, not surprisingly, that bigger losses were incurred in the high-bet era. But it would be equally unsurprising to find that, when bets succeeded, the winnings were also higher in the high-bet era. To determine whether the increased-bet strategy was successful, one cannot focus solely on the losing bets. Yet that is what Bradley and Rosenzweig seem to do in limiting their consideration of welfare effects to bankrupt firms.

It may be that, within the category of failed firms, one can reduce costs without losing the bigger pay-offs for firms that successfully incur more debt. But that is a different claim than that Chapter 11's asserted generation of debt has resulted in a net social loss. The former claim may be addressed by tinkering with costs, adjusting valuation mechanisms, and the like. The latter claim is a case for outright repeal of Chapter 11. Although we should remain open to evidence that Chapter 11 reduces social welfare, Bradley and Rosenzweig have not established that claim.

2. Alternative or more complete explanations

Putting aside net welfare claims, Bradley and Rosenzweig's explanation of their findings of greater post-Act losses – that Chapter 11 encouraged

124 Ibid. 1061

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firms to take on more debt[125] – is of independent interest. At the margin this claim seems plausible. All other factors being equal, one might expect a set of Chapter 11 rules more favourable to a debtor to encourage that debtor to incur more debt. The more favourable set of rules reduces *some* of the risk of the greater debt.

I emphasize 'some' because the challenge for Bradley and Rosenzweig is to identify how much of the increased debt is caused by factors other than the more favourable set of Chapter 11 rules and how much is caused by Chapter 11's changed rules. None of their evidence firmly establishes Chapter 11 as a major cause of increased debt or even as a cause of increased filings. To isolate Chapter 11 as a cause one must at least identify and account for other plausible possible causes. They consider one such cause, the relative health of bankrupt firms before and after revision of Chapter 11.[126] But their evidence on this point is inconclusive.[127]

A more complete analysis would consider other causes of increased corporate debt, losses, and bankruptcy filings that are independent of changes in Chapter 11. For example, if corporations were tending to use

125 Ibid. 1047

126 Ibid. 1063–7

127 To show that healthier firms were filing for bankruptcy in the post-Act period than in the pre-Act period, Bradley and Rosenzweig rely on an analysis of return on assets (the ROA). The biggest difference is in year 0 (the year of bankruptcy). In that year, filing firms show an ROA pre-Act of -19.50 and post-Act of –27.47. Bradley and Rosenzweig 'Untenable' supra note 2, 1064 (table 4). The greater post-Act negative return is in a direction opposite to their thesis of healthier firms filing post-Act. They explain this away in a footnote as evidence of management's mismanagement during bankruptcy rather than as evidence of firms in deeper trouble before bankruptcy. Ibid. n60. This is not obvious and seems to assume their thesis. An equally plausible explanation is that more highly leveraged firms crashed faster and farther in the post-Act period. It is also worth noting the pre-and post-Act differences are trivial and inconclusively small in bankruptcy year –1 and bankruptcy year –2. Ibid. (table 4). This suggests that their entire case for greater health in post-Act firms rests on data from three to five years prior to bankruptcy. A significant difference in three- to five-year lags of ROA does not provide persuasive evidence when, in the year of bankruptcy, the significant effect is in the opposite direction and there is no noticeable effect in the two years prior to bankruptcy. Bradley and Rosenzweig's own debt evidence is that Chapter 11 post-Act firms had higher debt-to-asset ratios that pre-Act firms. Ibid. 1094–5. They interpret this to mean that the Act caused management to be increasingly willing to risk financial distress by incurring high levels of debt. But the source of that increased willingness is unlikely to have been only the Act. They do not consider alternate sources of increased indebtedness, such as the pre-Act trends identified below. If riskier firms were failing, the loss to stockholders and debtholders should be greater. But it may be because their investments were riskier, not because bankruptcy cost more. A relevant question might be: What was their return on a portfolio of similarly risky investments, some of which failed and some of which did not?

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more debt or riskier debt in the pre-Act period and that trend continued in the post-Act period, then increased post-Act indebtedness and bankruptcy losses cannot easily be attributed to changes in Chapter 11. Similarly, if a pre-Act trend towards greater use of Chapter 11 by failing firms continued in the post-Act period, increased bankruptcy filings cannot easily be attributed to changes in Chapter 11. Evidence exists that each of these causes contributed to growing losses and filings in the post-Act period.

Increased use of debt. There is evidence that corporate debt in the 1970s and 1980s was higher than in the 1950s and 1960s.[128] By several measures of debt-asset ratios there was more debt growth in the early to mid-1970s than in the period around 1978, but not all the evidence supports such a view.[129] Thus, increased debt in the 1980s may simply be part of a long-term trend predating the amendments to Chapter 11.

Figure 1 presents the time trend in what one might call the current ratio: the ratio of a firm's current assets to its current liabilities. This ratio might have a special significance for bankruptcy filings and losses in bankruptcy because it provides a measure (admittedly imperfect) of what firms must currently pay and their liquid assets available to make those payments. The data in Figure 1[130] suggest that the current ratio was in decline before Chapter 11 was amended[131] and that the decline was not exacerbated by the 1978 changes to Chapter 11. The current ratio declined from 1.9 in 1965 to less than 1.5 in 1979. Even the decline from a peak around 1976 occurred before Chapter 11 took effect. Perhaps some of that decline can be attributed to anticipation of new Chapter 11's becoming effective in 1979, but the longer-term trend from 1965 to 1973, together with decline from 1976 to 1979, better supports the hypothesis that corporate America's trend towards a lower current ratio had little to do with enactment of Chapter 11. Well before new Chapter 11, firms were maintaining fewer current assets in relation to current debts.[132]

128 Ben S. Bernanke and John Y. Campbell 'Is There a Corporate Debt Crisis?' Brookings Papers on Economic Activity, 1:1988, 83–4 n2 citing Robert A. Taggert Jr 'Secular Patterns in the Financing of U.S. Corporations' in Benjamin M. Friedman (ed.) *Corporate Capital Structures in the United States* (1985) 13; Alfred E. Kahn 'Bad Hangover from the Credit Binge' *N.Y. Times* 4 November 1992 (letter to editor).

129 Bernanke and Campbell, supra note 128, 98 (table 3)

130 These data are from *Statistical Abstracts of the United States*.

131 See James Grant *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken* (1992).

132 One study shows a substantial jump in interest expense to cash flow ratios from 1979 to 1980 and in real interest expense to cash flow ratios from 1979 to 1982. Bernanke and Campbell, supra note 128, 106–7 (tables 6 and 7). Some of the

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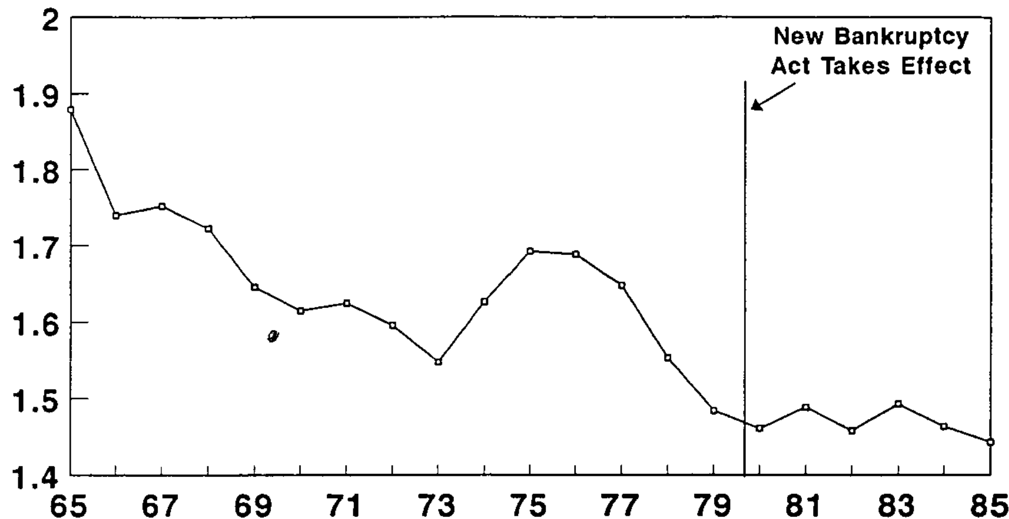
FIGURE 1
Indebtedness trend in non-financial corporations

Current ratio
(Current assets/current liabilities)



Source: *Statistical Abstracts of the United States*

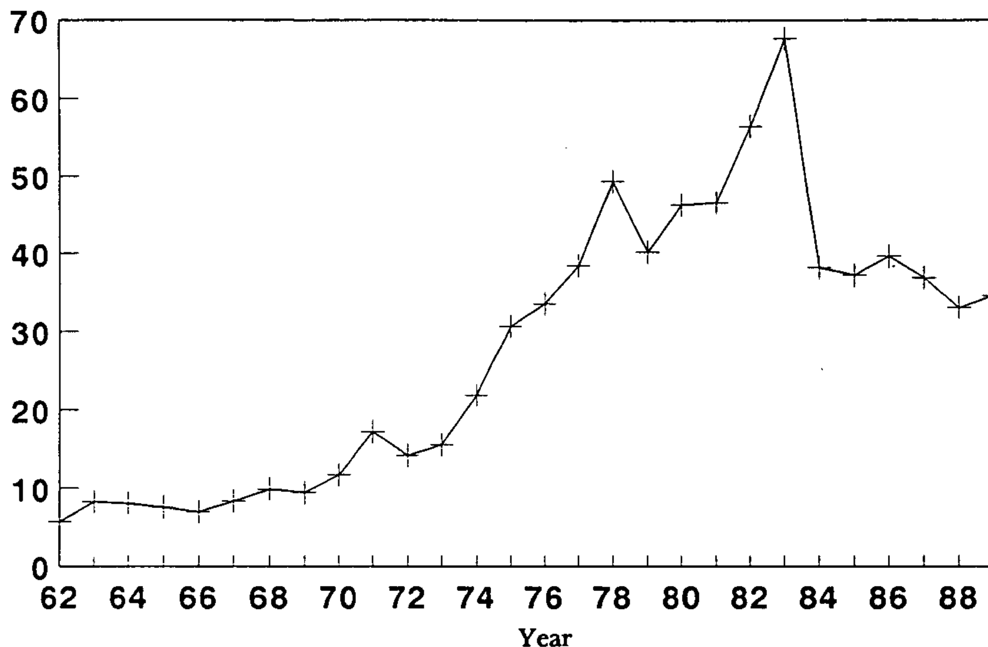
The riskiness of debt as well as its level is relevant. Not long after Chapter 11 changed, corporate America increasingly resorted to leveraged buy-outs (LBOs). LBOs have generated much discussion about their causes and effects; but no substantial portion of that discussion suggests their emergence stems from reform of Chapter 11. Explanations range from greed on the part of investors and managers, to efforts to make corporations more efficient, to a herd mentality. If the movement towards LBOs was independent of changes in Chapter 11, the number of LBOs might supply an index of corporations' general inclination to take on risky debt, thereby generating greater losses in Chapter 11.[133]

Increased resort to Chapter 11 by failing firms. Many failing firms do not file for bankruptcy. Suppose that Chapter 11, for whatever reason, becomes more attractive to failing firms. We might observe an increase in Chapter 11 filings even if Chapter 11, or amendments to it, had no causal effect on the increase in failing firms. If, for a constant number of failures, the trend to use of Chapter 11 increased, we would see more Chapter 11 cases without an increase in the number of business failures.

differences between their results and the results in the text may be due to differences in the firms comprising the samples used to compute the ratios.

133 Even at their peak, LBOs were not numerous enough to generate massive increases in bankruptcy filings. I rely on the number of LBOs reported in *Statistical Abstracts of the United States*.

FIGURE 2
Chapter 11 business filings as a percentage of business failures



If one can rely on the available data, there has been a striking increase in the percentage of failing business firms that resort to Chapter 11. Figure 2 plots, for each year since 1962, Chapter 11 filings as a percentage of business failures.[134] In the 1960s, Chapter 11 filings comprised less than 10 per cent of Dun & Bradstreet's reported business failures. By the early 1980s, they comprised more than 40 per cent of such failures. As of 1984, due to methodological changes, Dun & Bradstreet's business failure reports were not directly comparable with their earlier reports.[135] But for almost the entire period for which Dun & Bradstreet claims internal consistency in its data, there was a trend towards increased reliance on Chapter 11, in contrast to other failure mechanisms. Thus, even if business failures had remained constant we might have seen increased Chapter 11 filings due to changes in business preference for its

134 The number of Chapter 11 filings comes from the Administrative Office of the United States Courts and are reported by Bradley and Rosenzweig 'Untenable' supra note 2, 1090. The number of business failures comes from Dun & Bradstreet. The Dun & Bradstreet Corporation *Business Failure Record* (annual publication)

135 The Dun & Bradstreet Corporation *Business Failure Record* (annual publication)

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procedures. This growing preference predates the 1978 amendments to Chapter 11.[136]

I do not claim to have firmly established that pre-Act debt trends explain the increased number of bankruptcies. But analysis of the sources of increased bankruptcy filings must at least grapple with this issue. Since Bradley and Rosenzweig have neither measured Chapter 11's net social cost nor provided persuasive evidence that Chapter 11's promotion of debt use in the post-Act period is a cause of greater losses, I conclude that they have not established an empirical case for Chapter 11's repeal.

B. THE LIMITS OF MERELY REPEALING CHAPTER 11

Putting aside empirical questions, calls for repeal of Chapter 11 need to account for the origins of Chapter 11. The early equity reorganizations that led to Chapter 11 were largely matters of private contract. Cravath

136 Bradley and Rosenzweig also portray amended Chapter 11 as less responsive to market forces than pre-1980 Chapter 11: 'First, we look to the relation between the frequency of filing and the return to the market and find that there is no relation between the two after the Act, whereas before the Act there was a negative correlation between filings and return to the market.' Bradely and Rosenzweig 'Untenable' supra note 2, 1057. But for the sample that includes unlisted firms, the inverse relationship between market return and filings is 'stronger' after than before, in the sense that the market return regression coefficient is a bigger negative than before the new Act: regression coefficient before new Act = –12.80 (highly significant)' and 'regression coefficient after new Act = –22.14 (insignificant).' Ibid. 1062 (table 3A). The higher post-Act coefficient suggests that the inverse relationship was stronger, not weaker, post-Act than pre-Act. It is true that the post-Act coefficient is less statistically significant than the pre-Act coefficient. But lack of statistical significance does not establish the absence of the inverse relationship. Inability to reject the null hypothesis is not the same as establishing it. Indeed, since they had fewer data points (10) in the post-Act period than in the pre-Act period (16), even precisely the same effect would show up as less significant. For small samples, overemphasis on significance levels is a common, but not necessarily correct, feature of data interpretation. Rupert G. Miller Jr *Beyond ANOVA; Basics of Applied Statistics* (1986) 3. For listed firms, reported in their table 3B, the entire effect they detect in the pre-Act period is a function of pre-1970 years. If one limits the regression to two 10-year periods, one before and one after the act, there is no significant relationship between filings and market return in *either* period. Indeed, the coefficient on the pre-Act Market Return variable is the same (–.001) as the coefficient on the post-Act variable in their published regression. The following table presents the results of the regression for listed firms using the years 1970–79, not the longer pre-Act period used by Bradley and Rosenzweig. The dependent variable is the percentage of listed firms filing (adjusted R Square = –.097):

Variable	*B*	*SE B*	*Beta*	*T*	*Sig. T*
Previous year's % of listed firms	.341	.312	.464	1.10	.310
Previous year's market return	–.001	.002	–.237	–.560	.593
(Constant)	.427	.160		2.66	.032

I conclude that Bradley and Rosenzweig have not established that the relationship between market return and bankruptcy filings changed in the post-Act decade from the pre-Act decade.

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stated as fact that courts had no role to play in these matters, apparently other than serving as a forum to trigger receiverships and foreclosure sales. There was no relevant statutory guidance. Despite private domination and lack of statutory control, reorganizations were regarded as procedurally unfair, sometimes fraudulent, costly, and time-consuming.

1. The possible re-emergence of receiverships

If, as some propose, we repeal Chapter 11,[137] what is to stop the return of the reorganizing receivership? The Federal Rules of Civil Procedure expressly contemplate federal receiverships with practice 'in accordance with the practice heretofore followed in courts of the United States ...'[138] This seems broad enough to authorize the return of the equity receiverships displaced by Chapter 11 and its statutory predecessors.[139] At a minimum one would need both to repeal Chapter 11 and to consider the likely reemergence of the reorganizing receivership.

This possible re-emergence cannot be analysed in isolation of other provisions. Creditors today rarely seek to trigger involuntary bankruptcy.[140] Since appointing a receiver is a ground for involuntary bankruptcy,[141] however, the practices and norms of creditors considering involuntary bankruptcy will become much more important in a world without Chapter 11 than they are today. If creditors continue their current infrequent use of involuntary proceedings, repeal of Chapter 11, and the predictable rise of receiverships, will return reorganization practice to the receivership format.

One response might be to pre-empt state and federal receivership law as well as repeal Chapter 11. Yet some favouring Chapter 11's repeal probably would not go so far. Orderly liquidations are preferable to disorderly ones. If Chapter 11 were repealed, we might leave federal and state law receivership practice in place for true liquidations while precluding its use for disguised reorganizations.

But then who is to decide whether a particular firm is abusing the re-

137 Adler, supra note 2, 443–4 (abolish bankruptcy reorganization and kindred provisions); Bradley and Rosenzweig 'Untenable' supra note 2 (give corporations no protection)

138 Fed. R. Civ. Proc. 66

139 Priorities determined almost a century ago in equity receiverships continue to govern railroad reorganizations. 11 USC § 1171. On similar priorities in maritime law, strange to the general commercial world, see George A. Rutherglen 'Admiralty and Bankruptcy Revisited: Effects of the Bankruptcy Reform Act of 1978' (1991) 65 *Tulane LR* 503.

140 E.g., Theodore Eisenberg *Bankruptcy and Debtor-Creditor Law* 2d ed. (1988) 456 (showing data from the Administrative Office of the US courts)

141 11 USC § 303(h)

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ceivership form by masking a reorganization as a liquidation? Presumably, some court must resolve this matter. Who is to be heard on this matter? Presumably, in this era of fair procedure, all interested parties. By what standards will courts assess whether we have a true liquidation or a reorganization? By the value of assets to be sold? By the identity of the parties receiving the assets? While deciding these questions, shall we stay creditors' collection efforts and prevent secured creditors from foreclosing? If creditors are stayed, shall we compensate them for the delay? The questions that arise might require development of something that looks similar to what we now call Chapter 11. Nor can these questions be avoided by giving each creditor the power to push the debtor into a federal bankruptcy system that, after reform, had no Chapter 11. Most of the same questions will arise, regardless of forum. Even allowing parties to contract out of bankruptcy will require addressing the question of receiverships.

2. Managerial reaction to a reformed or repealed Chapter 11

It is also possible that creditors will respond to increased use of receiverships by increasing their willingness to trigger involuntary bankruptcies. If that happens, one expects managers to be reluctant to seek receiverships. With Chapter 11 repealed, securing appointment of a receiver in effect gives aggressive creditors the option to accept the receivership or to push the firm into a liquidating Chapter 7 proceeding. A likely management response is to not resort to either Chapter 7 or receivership.

Failure to account for likely management responses is a more general problem with repeal or reform proposals. However unattractive Chapter 11 should be to managers,[142] most reformers hope to make it distinctly less so. Perhaps the most important consequence of reforms – abolishing Chapter 11, reducing the exclusive period for proposing a reorganization plan, or forcing auctions – would be on firms' inclination to seek it. Managers who know their firms will be auctioned are unlikely to resort

142 The universally hypothesized managerial fondness for Chapter 11 is puzzling, at least for managers who value their jobs. Gilson finds that significant changes take place in the board of directors and the CEO. 'On average, only 46% of directors who sit on the board before financial distress, and 43% of the CEOs, are still present when their firms emerge from bankruptcy or settle privately with creditors less than two years later.' Stuart C. Gilson 'Bankruptcy, Boards, Banks, and Blockholders' (1990) 27 *J. Fin.* 355, 356. See also Stuart C. Gilson 'Management Turnover and Financial Stress' 25 *J. Fin. Econ.* (1989) 241, 248 (table 3). These turnover rates seem well above normal. Ibid. 371. LoPucki and Whitford find even more striking turnover rates for management. Lynn M. LoPucki and William C. Whitford *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies* (1992) 74. Perhaps these studies' results are only beginning to be widely known in the management community.

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to Chapter 11. This was the lesson from Chapter X of the old bankruptcy act. When trustees had to be appointed managers showed a predictable distate for using Chapter X.[143]

If managers are reluctant to invoke Chapter 11, the effect will be similar to having repealed Chapter 11. Gaining the full benefits of Chapter 11 reform requires both reform and resort to Chapter 11. Unless provisions forcing the use of Chapter 11 or vitiating the effect of receivership practice accompany Chapter 11 reform, we may have a perfect but largely unused provision. Firms may struggle, without protection, beyond the point at which they can most efficiently be saved.[144]

C. THE LIMITS OF IMPROVED VALUATION MECHANISMS

Another group of reform proposals would not abolish Chapter 11 but would modify the method for valuing a firm.[145] Their proponents share a belief that more market-oriented valuation methods should replace the judicial valuations Chapter 11 now employs when bargaining fails. Market-based valuation may be a promising path for reform. But two factors limit the cost and time savings they are likely to yield. First, available data suggest that the valuation problem is less cumbersome in large Chapter 11 proceedings than is widely believed. Second, reforming the valuation process will leave Chapter 11 with substantial problems or create some new ones.

1. The valuation problem

Critiques of Chapter 11 view firm valuation as its central problem and the absolute priority rule as the central feature of valuation.[146] Sharehold-

143 A similar pattern exists in Japan where statutory composition proceedings are favoured over corporate reorganization proceedings in part because management retains greater control in composition proceedings.

144 See generally Michelle J. White 'Corporate Bankruptcy as a Filtering Device (presented at American Law and Economics Association meeting 1992).

145 Philippe Aghion, Oliver Hart, and John Moore 'The Economics of Bankruptcy Reform' (NBER paper, February 1992); Lucian A. Bebchuk 'A New Approach to Corporate Reorganization' (1988) 101 *Harv. LR* 775; Mark J. Roe 'Bankruptcy and Debt: A New Model for Corporate Reorganization' (1983) 83 *Col. LR* 527. I suspect that proposals that go further and recommend abolishing Chapter 11 would in fact retain some of its features. Their primary concern seems to be with the valuation mechanism, delay opportunities it creates, and violations of absolute priority. See Adler, supra note 2.

146 The absolute priority rule dominates discussion of Chapter 11 in two conflicting ways. On the one hand the rule has been criticized from its earliest manifestations in Supreme Court cases (Cravath, supra note 15, 191, 195), to its modern implementation in the Bankruptcy Act. 11 USC § 1129(b). See Douglas G. Baird and Thomas H. Jackson 'Bargaining After the Fall and the Contours of the Absolute Priority Rule' (1988) 55 *U. Chi. LR* 738. It is said to be both inflexible and not worth its costs. Ibid.

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ers hoping to retain an interest in the reorganized firm have an incentive to assert going-concern values in excess of creditor claims and to delay reorganization. Otherwise, they take nothing in the reorganized firm. Senior creditors who wish to own the entire reorganized firm have an incentive to assert going-concern values less than or equal to their claims. This freezes out junior creditor and shareholder interests.

The incentives to inflate or deflate value generate awkward negotiations. Shareholders, for example, may threaten to force a valuation of the firm. Senior interests often are believed to give shareholders more than their due to avoid the costly valuation process.[147] Nearly all Chapter 11 reform proposals emphasize the costliness and distortion of this valuation threat.

To explore the historical contingency of the absolute priority rule, assume that the law at the time of *Howard*, prior to the rise of big corporations, was somewhat different from the creditors-must-be-paid-in-full-first rule. Suppose the historical liquidation rule were more attuned to uncertainty and could be summarized as follows: Senior interests must be paid in full before junior interests, with an allowable margin of error of 10 per cent. That is, if senior interests were not paid in full, junior interests could receive no more than 10 per cent of the value distributed on liquidation.

This would be a strange rule to adopt in a pure liquidating context. One knows with certainty whether senior interests are paid in full. There is no need, in the name of uncertainty, to allow junior interests anything. But assume further that big corporations existed and that the 10 per cent rule was used in the case of their reorganization only to reflect the uncertainty of valuation. In short, state debtor-creditor law would have essentially maintained liquidation priorities but, as a concession to uncertainty, allowed for non-trivial but minor departures upon reorganization.

If there had been corporations worth reorganizing earlier in the nineteenth century, I doubt that the 10 per cent rule would have developed under state law. Social scientists had not yet fully come to

Even exceptions to the rule are controversial. E.g., Bruce A. Markell 'Owners, Auctions, and Absolute Priority in Bankruptcy Reorganization' (1991) 44 *Stan. LR* 69. On the other hand, much concern about the functioning of Chapter 11 is about failures to honour this suspect rule. E.g., Adler, supra note 2, 440. Collectively, critics both hate the rule and yet are troubled by failures to honour it. Much recent writing is about how best to honour it.

147 E.g., Jackson, supra note 4, 216; Bebchuk, supra note 145, 779–80; Roe, supra note 145, 543

grips with the concept of uncertainty,[148] and the legal system remains uncomfortable with it.[149] But had there been corporate candidates for reorganization and had something like the 10 per cent rule developed, we might not have thought it bizarre. We might even have admired our forefathers' flexibility. Embodying the uncertainty of the process may be preferable to the relentless search for the perfect, or even marginally best, valuation mechanism. If this were the status of state debtor-creditor law at the time of *Howard*, it would not have been strange for the Supreme Court, or for later equity receiverships, to have adopted it.

Adopting this modest change in the absolute priority rule could reduce modern concern about absolute priority.[150] For large firms the vast majority of departures from absolute priority fit well within the 10 per cent margin for error. LoPucki and Whitford found that only two of 30 insolvent firms distributed more than 8 per cent of the combined unsecured/equity distribution to equity.[151] In one of those firms, management controlled 75 per cent of the stock. The managers 'were able to secure a very favorable distribution to equity in part because their continued participation in the company was critical to its future success.'[152] It seems misleading to attribute this departure from absolute priority to legal rules. Of $3.04 billion distributed to equity and unsecured creditors in the 29 big insolvent Chapter 11 cases in which data were available for both equity and unsecured creditors, $154 million, or 5.1 per cent, went to equity security holders.[153] Including data about value distributed to secured debt would probably reduce equity's share of the pay-out to well under 4 per cent.

When firms are solvent, equity has a legitimate claim to some distribution. Given the doubt attending any valuation, it is not troubling if equity receives value in cases in which there is genuine doubt about whether the equity is worthless. For what LoPucki and Whitford viewed as solvent firms in Chapter 11, six of eleven cases led to some shortfall in the distribution to unsecured creditors, but unsecured creditors all

148 See Theodore M. Porter *The Rise of Statistical Thinking 1820–1900* (1986); Stephen M. Stigler *The History of Statistics: The Measurement of Uncertainty Before 1900* (1986).
149 See *McCleskey* v. *Kemp*, 481 US 279 (1987).
150 I am not suggesting formalizing the 10 per cent rule. The extent of distribution violations may then change to reflect the new formal rule. I am simply suggesting a more relaxed attitude about the size of the violation.
151 LoPucki and Whitford, supra note 3, 142
152 Ibid. 143 (note f)
153 These calculations are based on LoPucki and Whitford, supra note 3, 142 (table III).

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received at least 85.6 per cent of their claims.[154] For two of the three firms that LoPucki and Whitford report as receiving less than 90 per cent Weiss reports unsecured creditors received more than 90 per cent of their claims.[155]

Every firm that Weiss reports as violating absolute priority for unsecured creditors either had 8 per cent or less of the unsecured/equity distribution go to equity,[156] was solvent,[157] was reported by LoPucki and Whitford as having a trivial distribution to equity,[158] had a position too ambiguous to evaluate,[159] or was not large enough to make it into the LoPucki-Whitford sample. Of the seven firms not in the LoPucki-Whitford sample, the distributions to equity in four cases appear to be small, and the degree of absolute priority violation in the other three cases cannot be determined for lack of data about the value distributed to equity.[160]

Eberhart and others report an average deviation of 7.6 per cent from absolute priority.[161] Every firm in Eberhart's sample that deviated from absolute priority by more than 8 per cent was either solvent (according to LoPucki and Whitford) or too small to make it into the LoPucki-Whitford sample.[162] For firms not in the LoPucki-Whitford sample that

154 Ibid. 166 (table IV(A))

155 These firms are AMI International and Lionel Corp. Compare LoPucki and Whitford, supra note 3, 166 (table IV(A)) with Weiss, supra note 11, 295 (table 3).

156 These firms are Anglo Energy, Combustion, Cook United, HRT Inds., KDT Inds., McLouth Steel, Saxon Inds., Towle Mfg., White Motor, and Wickes. Compare Weiss, supra note 11, 295 (table 3) with LoPucki and Whitford, supra note 3, 142 (table III).

157 These firms are AMI International, Lionel Corp., Penn-Dixie, Revere Copper & Brass, and Salant Corp. Compare Weiss, supra note 11, 295 (table 3) with LoPucki and Whitford, supra note 3, 166 (table IV(A)).

158 For Seatrain Lines, LoPucki and Whitford state that the property distributed to equity was of inconsequential value. LoPucki and Whitford, supra note 3, 142 (table III note c). Weiss reports it as violating absolute priority. Weiss, supra note 11, 295 (table 3)

159 For Manville, LoPucki and Whitford only deal with commercial and trade creditors and, understandably, did not try to deal with asbestos health and property claims. The creditors they did deal with had no shortfall. LoPucki and Whitford, supra note 3, 166–7 (table IV(A) and note c). Weiss simply lists it as violating absolute priority. Weiss, supra note 11, 295 (table 3)

160 The firms with small distributions to equity are Goldblatt Bros., Weiss, supra note 11, 305; Morton Shoe, ibid. 307; Shelter Resources, ibid. 310; and Spencer Companies, ibid. Lack of information about the value distributed to equity prevents assessing the size of the absolute priority violation in Beker Inds., ibid. 301; Imperial Inds., ibid. 305; and Richton International. Ibid. 308.

161 Eberhart et al., supra note 103, 1458

162 Ibid. 1463 (table II). The solvent firms on the Eberhart list are AMI International, Charter Company, and Revere Copper & Brass. The other firms showing more

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substantially violate absolute priority we cannot tell whether some special expertise of a management-shareholder group enabled then to obtain a sizeable distribution.

In the three cases in which Weiss reports a violation of secured creditor priority, one resulted from a creditor-proposed plan that they later regarded as too generous, one resulted from a seemingly genuine dispute about what the secured creditors were entitled to, and one, not really a violation, resulted from the fact that the creditor's secured claim was smaller than the face amount of its debt.[163]

In short, violations of absolute priority are frequent but, as a percentage of distributions, small. If one allows for the inherent uncertainty in valuation, the deviations seem within reason. Acknowledging the uncertainty in the process could accommodate almost all existing major reorganization results. Failure to fully honour absolute priority seems only mildly troublesome. It may be historical accident – due to the relatively recent development of corporations – that we even have the rule in its stark form.[164]

LoPucki and Whitford read their data as pointing towards a modest reform, a pre-emptive cram down of equity.[165] Furthermore, they find the reason for departures from absolute priority usually do not stem from fear of equity's power to force a valuation. Departures stem from assorted reasons tangentially related to fear of valuation. 'In nearly every [insolvent] case, the negotiators knew the company was insolvent and that equity would be entitled to nothing in an adjudication.'[166] Could something so clear to the parties be lost on the judge?

One explanation for equity's modest undue receipts points to an agency problem. Among a relatively small group of high-level bankruptcy

than 10 per cent deviation from absolute priority are not in the LoPucki-Whitford sample.

163 Weiss, supra note 11, 295–6. The difference between the face amount of the debt and the value of the collateral was due to a decline in the value of the collateral.

164 There also is an asymmetry in accounting for violations of absolute priority. When insolvent firms distribute value to equity, it is easy to detect a violation of absolute priority. When firms are undervalued and shareholders receive too little, there is no obvious way to establish the undervaluation.

165 LoPucki and Whitford, supra note 8

166 LoPucki and Whitford, supra note 3, 195. 'The attorneys for most of the equity committees acknowledged that they could not have presented even a plausible case for solvency. Others thought they could have presented evidence of solvency but that evidence was not strong enough to persuade even themselves. With only a single exception, the lawyers who negotiated equity's share believed that, in their particular case, equity could have been zeroed out through cram down.' LoPucki and Whitford, supra note 8, 629

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lawyers,[167] there is a feeling that everyone at the bargaining table usually should get something.[168] All lawyers could then describe their negotiations as successful. They avoided some litigation and brought their clients some value. Lawyers in other contexts are believed to behave this way.

Another explanation may be that, despite formal legal rules, parties often behave in accordance with shared norms. These norms, while influenced by formal entitlement, provide much of the basis for resolving disputes.[169] In sophisticated negotiations among lawyers in an adjudicatory setting, a non-legal explanation pushes the belief in subordination of legal entitlements to the limit. If, however, LoPucki and Whitford's surmises are correct, this may be a fruitful path for exploration. Perhaps all that is needed is for a few more creditor committees to take a firm stand and force a cram down over shareholder objections. If the behavioural norm shifts to enforcing obvious rights rather than bargaining them away, junior interests may be less inclined to spend the time and energy needed to delay reorganizations.[170]

2. *Limits of valuation reform*

The surprisingly modest scope of the absolute priority problem suggests that new valuation mechanisms can supply only modest distributional shifts. And most proponents of market-based valuation mechanisms are admirably candid about the problems that would remain even if their proposals were adopted.

The modern efficient market in securities, which forms the foundation for many valuation reform proposals, is not the same as the market for the companies who issue those securities. There is a difference between markets for shares in companies and markets for companies.

167 LoPucki and Whitford, supra note 3, 156 n65 (15 law firms accounted for nearly half of the major appointments)

168 Ibid.

169 E.g., Robert C. Ellickson *Order Without Law: How Neighbors Settle Disputes* (1991) 141–7

170 A related explanation may be that lawyers misperceive the actual functioning of the legal system. Assume that cram down of a reorganization plan over equity's objections likely will be successful. If both parties do not perceive this, their settlement behaviour will give more to equity than legal entitlements require. For some surprising misperceptions about the legal system, see Kevin M. Clermont and Theodore Eisenberg 'Trial by Jury or Judge: Transcending Empiricism' (1992) 77 *Cornell LR* 1124; Theodore Eisenberg and James A. Henderson Jr 'Inside the Quiet Revolution in Products Liability' (1992) 39 *UCLA LR* 731; James A. Henderson Jr and Theodore Eisenberg 'The Quiet Revolution in Products Liability: An Empirical Study of Legal Change' (1990) 37 *UCLA LR* 479. For sources of differing perceptions, see Theodore Eisenberg and Stewart J. Schwab 'What Shapes Perceptions of the Federal Court System?' (1989) 56 *U. Chi. LR* 509.

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> It is one thing to say that the market effectively values the opportunities of Chrysler Corporation and International Harvester via the several thousand shares traded daily; it is quite another to say that there is a liquid market, with many potential purchasers, for entire automobile and farm machinery companies.[171]

Even limiting the focus to securities, the market in risky debt securities is not viewed as nearly as efficient as the basic equities securities market.[172]

Some market-based proposals call for abandonment of Chapter 11 and sale or auction of the firm. One such proposal reflects implicit concern about the market for firms by carefully considering who would conduct the sale.[173] Professor Baird plausibly argues that the residual claimants should conduct the sale because they have the incentive to sell at the highest price.[174] But determining the residual claimants can regenerate the delay and uncertainty in the current bankruptcy valuation process.[175] Another proposal seems to call for the forced sale at auction by investment bankers.[176] It is ironic that, in an area where perceptions about fees are a major concern, one would turn even more of the process over to investment bankers. They are perceived as having more outrageous fees

171 Roe, supra note 145, 573

172 John C. Coffee and William A. Klein 'Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations' (1991) 58 *U. Chi. LR* 1207, 1217–20. These troublesome differences led Roe to propose an intermediate solution, in which only 10 per cent of a reorganizing firm's securities would be issued to establish the firm's value. But if the offer of shares is to be a traditional underwriting at a set price, 'problems arise when determining the size of the valuation offering and its price.' Roe, supra note 145, 578. Before fixing the price one would need an estimate of value. The whole process might require judicial intervention in the underwriting bargain, which would reintroduce the problem sought to be avoided. Another critical feature of Roe's plan requires the reorganized firm to have an all common stock capital structure. Ibid. 530. This avoids the delay and bargaining that might accompany a negotiated or court-mandated capital structure. There is a price for this simplicity. It would be remarkable if every reorganized firm is best served by such a structure. Also, lenders to all firms would know that traditional secured credit had ceased to exist. Cf. ibid. 596. If Chapter 11 mandated that secured debt be converted to equity upon reorganization, one of the hallmarks of secured debt would vanish. One of its major benefits is to lend against a sufficient cushion to insure that debt status survives even in times of financial difficulty. And allowing an exception for secured debt (ibid. 593–5) would trigger some of the valuation problems sought to be avoided.

173 Baird, supra note 2, 137

174 Ibid. Baird also recognizes the probablility that an auction will not be best for all firms and carefully considers the potential costs and benefits of mandatory auctions. Douglas G. Baird 'Revisiting Auctions in Chapter 11' *J. of Law & Econ.* (forthcoming).

175 Ibid.

176 Adler, supra note 2, 468

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than lawyers. One description of their fees suggests that their auction fee alone would be comparable to all current combined fees in large Chapter 11 cases.[177] Other descriptions of investment banker fees in initial public offerings are frighteningly high.[178] And some may be reluctant to resort to an auction unless there is an upset price. But an upset price requires valuation, and we are back to the problem of parties proposing competing values, the core problem perceived with existing Chapter 11.

Professor Bebchuk and others would initially distribute all of the interests in the reorganized firm to the senior creditors.[179] Junior interests wishing to maintain an interest in the firm would have to buy out the senior interests claims. In theory, if they value the firm highly enough, they should have no objection to the requirement that they buy out the seniour interests.

In many situations, parties dissatisfied with the valuation implicit in Bebchuk's method will be forced to raise cash to retain their interest in the reorganizing firm.[180] Experience with foreclosure sales should make one cautious about the ability of junior interests to raise cash to buy into troubled firms. The equity receiverships depended on foreclosure sales to clear out old interests in a troubled firm. These foreclosure sales routinely had only one bidder, the reorganization committee, which usually bid in the old debt interests in the firm.[181] Cash from bargain-hunting third parties did not appear at reorganization sales. Experience with home foreclosures raises similar concerns. Studies suggest that the vast majority of home foreclosures do not generate third-party bids.[182]

177 Adler suggests an average fee of 4 per cent on a $100 million dollar offering. Ibid. 468 n128. Since the direct costs of large Chapter 11 cases seem to be about about 3 per cent (see supra), the auction proposals may start off with higher direct costs. Adler, however, believes other savings would result.

178 Christopher B. Barry, Chris J. Muscarella, and Michael R. Vetsuypens 'Underwriter Warrants, Underwriter Compensation, and the Costs of Going Public' (1991) 29 *J. Fin. Econ.* 113, 128 (average underwriter discount of 7.17 per cent and 8.73 per cent, depending on whether underwriter warrants were used).

179 Bebchuk, supra note 145

180 Ibid. 796. Others dissatisfied would have to rely on the seemingly inefficient market in risky debt securities.

181 Ibid. 17; Moore and Levi, supra note 46, para. 1673 at 1498. Perhaps procedural improvements over the old equity receiverships would help open this process to third-party bidders.

182 Robert J. Alberts and Douglas S. Bible 'Mortgage Default in Louisiana: An Empirical Study of Recent Foreclosures on Residential Property in Caddo Parish' (1988) 15 *So. ULR* 215, 220 (1988) (lenders may choose to reduce foreclosure costs by not requesting an appraisal since they are usually the only party who bids on the property anyway); Patrick A. Bauer 'Statutory Redemption Reconsidered: The Operation of Iowa's Redemption Statute in Two Counties Between 1881 and 1980' (1985) 70 *Iowa LR* 343,

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The mortgage lender usually is the only bidder and does not make cash bids.

Nevertheless, there is some non-trivial hope that junior interests could, in appropriate cases, raise cash to maintain their interests in a firm. Wechsler's study of mortgage foreclosures in a New York county found third-party bidders in 25 per cent of foreclosure sales.[183] Bauer's study of two Iowa counties found such bidders in about 9 per cent of sales.[184] Since, in many cases, there may be no equity in the property, the low percentage of third-party bids is not per se troublesome. In no-equity cases, there should be no third-party bids. The market for troubled interests may not be uniform or deep but it will exist. The question is whether the bias of such a market towards creditor interests is more distorting than the perceived bias of the existing system towards equity interests. If, as proponents hope, market-based valuation proposals would substantially speed reorganizations, there may be a savings to distribute to both groups.

The size of that savings is as debatable as its existence. Improvements achievable through market-based valuation reform would do little to reduce the cost and delay that attend other issues arising in Chapter 11 cases. These include determining the size and rank of all claims, dealing with contingent claims, gathering assets that may have wrongfully been transferred, and dealing with workers. Despite excellent recent empirical studies we know less about the extent to which delay is a function of these factors than it is a function of the bargaining over the valuation issue.

This brief review of valuation reform proposals is not meant to suggest they lack promise for some time and cost savings. But realistic assessment of both the scope of the valuation problem and the issues that survive valuation reform requires some scepticism about whether massive savings can be attained.

D. DISTRIBUTIONAL THEMES OF VALUATION REFORM

Saving time and money through repeal or modification of Chapter 11 is one main theme of the modern reform movement. Reshaping

361 n75 (91.3 per cent of mortgage foreclosure sales were to creditors); Philip Shuchman 'Data on the Durrett Controversy' (1987) 9 *Cardozo LR* 605, 616–17 (noting studies with very high percentage of mortgagee buyers at foreclosure sales); Steven Wechsler 'Through the Looking Glass: Foreclosure by Sale as De Facto Strict Foreclosure – An Empirical Study of Mortgage Foreclosure and Subsequent Resale' (1985) 70 *Cornell LR* 850, 870 (mortgagee bought at 75 per cent of the sales)

183 Wechsler, supra note 182, 870

184 Bauer, supra note 182, 361 n75

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distributional results is the other. The history of reorganizations has implications for distributional as well as for efficiency issues.

As corporations grew, the classical liquidation model's treatment of priorities began to fade. It clung to life in the form of the rigid absolute priority rule and has been resurrected today as almost the sole measure of Chapter 11 distributions.[185] The starting premise for some market-based proposals – firmly entrenched historical priorities – turns out to be more questionable than proponents allow. Secured claimants' right to act was not honoured by traditional or reorganizing receiverships and reorganizing receiverships compromised their priority a century ago.[186] Priorities changed as corporations developed.[187] There is more room for better treatment of tort victims and other unsecured creditors in bankruptcy, while remaining faithful to history, than invocation of classical liquidation law supports.

First, preventing secured creditors from seizing assets of troubled firms is not a clear departure from state law. Even traditional receivers could prevent property subject to security interests, tax liens, and execution liens from being sold to satisfy judgments.[188] Traditional state law thus was willing to compromise traditional rights in the interest of an orderly liquidation. The automatic stay of bankruptcy law[189] thus not only does not violate traditional state law rights but may even be viewed as having strong state law roots.

Second, the question whether interest must be paid to secured creditors during reorganization is a leading example of the application of liquidation rights in bankruptcy. Law and economics experts argued that secured creditors' state law right to foreclose would allow them to earn current market interest on their collateral.[190] This right should be respected in bankruptcy. The issue reached the Supreme Court, which found no interim interest requirement in the statute.[191] If, as I suggest, receivership law was undeveloped on the treatment afforded secured

185 Adler, supra note 2, 440

186 But some market-based reformers would not rest their case solely on history. They believe their proposals are normatively superior to current Chapter 11 and would recommend them regardless of history. If, for example, history has not fully honoured secured claims in bankruptcy, we should start doing so now.

187 Indeed, the bankruptcy priority system, without generating much comment, supplies modest priority to workers' wages and pensions. 11 USC § 507

188 Note 25, supra

189 11 USC § 362

190 See note 5, supra; Adler, supra note 2, 454

191 *United Savings Ass'n of Texas* v. *Timbers of Inwood Forest Associates, Ltd.* (1988) 484 US 365

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interests in times of corporate financial distress, failure to compensate secured creditors for delay is less of a departure from classical entitlements.

Third, for employees, reliance on classical liquidation law has had another consequence. Pension rights need not be assessed against an artificially stable background of state debtor-creditor law. Widespread employee pensions, like failing giant corporations, are a modern development. The accepted social desirability of protecting pension rights through ERISA and state exemption laws[192] is also a recent development. Neither classical liquidation law nor receivership law ever faced on a large scale the question of choosing between pension rights and other corporate stakeholders. Section 1114,[193] providing limited protection to retiree benefits in Chapter 11, embodies a flexibility not available under the classical liquidation model.[194]

Some calls for distributional reform in Chapter 11 transcend history. They are based on a contractual model of the firm in which contractual rights firmly dictate priority. To evaluate this line of argument, it is helpful to divide the claims against a firm into two groups – self-conscious investors and others. Reform arguments are at their strongest when decrying Chapter 11's violation of explicit contractual agreements between well-informed investors. Within the limits of uncertainty, sophisticated shareholders, who would themselves acknowledge their subordination to creditors, should not take anything before creditors are repaid.

In evaluating many unsecured creditor claims, however, this pure contractual model breaks down. Market-based proposals often treat all unsecured creditors the same. People dealing with the debtor either are creditors or shareholders. In more refined models, preferred shareholders and junior creditors exist. In discussions of absolute priority, there often are no suppliers, workers, customers, tort victims, or abutting landowners whose property has been ruined or polluted. They are all

192 NY Civ. Prac. Law & Rules § 5205

193 11 USC § 1114

194 The measure of a right to participate in a classical liquidation, possession of a debt or equity interest, has other ramifications. In liquidation, only those who had formal interests in the firm represented by traditional debt or equity interests can participate. Less tangible interests are not recognized. Employees unaware of the need for such formal rights may give away what could be valuable assets. For example, consider employees who make wage concessions to a troubled debtor. Unless the employees obtain a formal entitlement for those concessions, the concessions will not entitle them to any part of the bankruptcy distribution. Suppose instead that the employees 'lend' the debtor their forgone wages and receive a promissory note, even on terms quite favourable to the debtor, in return. In bankruptcy, they would then be substantial creditors and not merely workers.

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'creditors' who, through some mythic bargain, have agreed to subordinate themselves to secured creditors.

I doubt that the secured creditor's bargain, real or hypothetical, is as simple as some of Chapter 11's critics allow. While a business continues to operate, secured parties expect routine business expenses, including wages and supply costs, to be paid. This both reflects business practice – daily wages are paid despite the existence of security – and probably would be part of the bargain if its terms were spelled out.[195] Suppose, due to financial difficulty, the debtor neglects to pay routine expenses but continues to pay secured parties. Do we want to require workers and suppliers to have to negotiate out of this position? All of them, regardless of sophistication? The possibility does not even exist for tort victims. If negotiation is not to be required, there is a respectable view under which amounts owed to workers and suppliers should be prior to amounts owed to secured creditors. Despite High's complaints, the equity receiverships developed something like this view. When the business must reorganize and all old debts cannot be repaid, funds 'diverted' to secured parties might reasonably be reallocated to the unpaid expenses of prior daily operation.

Whether receiverships' understandable concern for many unsecured creditors is a serious question today depends on the debt structure of reorganizing firms. I don't mean debt structure in the sense of capital structure. I mean debts owed to claimants who would not consider their interests part of the capital structure – workers, suppliers, tort victims, perhaps even attorneys' salaries. If the debt structure includes many claims connected to routine or operating expenses, the simple distributional ranking demanded by some reformers is not especially appealing.[196] When Bonbright and Bergerman coined the phrase 'absolute priority'[197] their title suggested that their discussion was limited to the claims of *security* holders. The Supreme Court's notable absolute priority cases have involved security holders.[198] Although it introduces complexity, we should keep in mind that not all unsecured claims are the same.

Preferences for pre-bankruptcy unsecured claims and departure from the absolute priority rule would have effects. Given the reallocation of

195 Smith, supra note 25, §§ 275, 276, at 473–82

196 For sizeable debts to suppliers in the Macy's reorganization, see Furman and Temes, supra note 100.

197 James C. Bonbright and Milton M. Bergerman 'Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization' (1928) 28 *Colum. LR* 127, 130

198 *Case* v. *Los Angeles Lumber Products Co., Ltd.* 308 US 106 (1939); *Northern Pac. R.R. Co.* v. *Boyd* 228 US 482 (1913)

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risks, one expects that the cost of secured credit would increase and the cost of some unsecured credit would decline.[199] In addition, parties dealing with troubled debtors would be more inclined to continue dealing with them. If routine claims for, say, one year prior to bankruptcy are honoured in bankruptcy, there is less risk in dealing with troubled debtors. Today, suppliers may prefer an early Chapter 11 filing to convert their routine claims into administrative priorities.[200]

I do not know if, on balance, the system would be better off adopting the equity receivership model. But the history of debtor-creditor law offers more flexibility than the classical liquidation model allows. That model never had to face the uncertain measurement of values generated by reallocating interests without liquidating. It never had to deal with the hoped-for continuing relationship with suppliers and workers. When the economic development of corporations generated these issues, the subordinate treatment of unsecured creditors and workers was quickly questioned and partially discarded. The absolute priority rule never took account of the uncertainty inherent in a reorganizing context. These developments make many features of Chapter 11 look less anomalous than some criticisms allow.

Ironically, the institutions that developed in response to failing modern corporations assured that we never would have a set of state law rights that contemplated reorganization. The rise of the federal equity receivership truncated development of state debtor-creditor law in the modern era. States need not refine their receivership or other laws to contemplate reorganization of the modern corporation because a largely satisfactory vehicle had already evolved. Subsequent enactment of federal bankruptcy reorganization laws, based on the equity receivership practice, assured that state debtor-creditor law never would develop in the era of the modern corporation. To this day it has not. Receivership law in the United States, unlike practice in some other countries, has become an arcane corner of debtor-creditor law, rarely taught. Treatises on the subject are dated. In general, reorganizations occur either through contract or in federal bankruptcy court.

V *Conclusion*

Understandable concern exists about the number and cost of Chapter 11 cases. Reforms premised on a faulty historical view of debtor-creditor

199 The market might quickly reflect any shifts in the absolute priority rule. It already seems to anticipate deviations from it. Eberhart et al., supra note 103

200 11 USC §§ 503, 507

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law lose some of their foundation. Normatively based proposals do not depend on a specific historical view. But reforms that propose to sweep away Chapter 11 have not been sufficiently thought through. Reforms addressing the valuation problem hold the most promise, but both the scope of the problem and the savings from reform may be exaggerated.

In the end, the goal of reform must be to exclude from Chapter 11 firms that cannot benefit from it while including firms that could benefit in a way that maximizes that benefit. Firms that can benefit must be reorganized at costs below the costs, presumably loss of going-concern value, of exclusion. The costs of reorganizing or erroneous inclusion are visible in large fees and liquidated firms. The costs of exclusion are difficult to detect but should not be ignored.

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