TILBURG UNIVERSITY

TILEC

TILEC Discussion Paper

DP 2004-016

Creditor- and Debtor-Oriented Corporate Bankruptcy Regimes Revisited

By

Sefa Franken

ISSN 1572-4042

Creditor- and Debtor-Oriented Corporate Bankruptcy Regimes Revisited

Sefa Franken*

* Lecturer at the Law Faculty of the University of Tilburg, the Netherlands and research fellow at the Center for Company Law and the Tilburg Law and Economics Center (TILEC), University of Tilburg. I benefited from helpful comments and suggestions by John Armour and Joseph McCahery.

Abstract

While the corporate bankruptcy regime of the United States provides for a so-called debtor-oriented regime, many European corporate bankruptcy regimes could hitherto be labeled as creditor-oriented. Yet bankruptcy reform in Europe generally emphasizes the need for introducing schemes that facilitate business rescue, which has already led several European countries to add reorganization mechanisms to their bankruptcy laws. Surprisingly, at either side of the Atlantic, policy makers pay little attention to corporate bankruptcy as a corporate governance mechanism. This paper argues that the comparative efficiency of corporate bankruptcy regimes cannot be considered separate from the governance structures of firms that make use of the bankruptcy laws. To evidence this, the paper analyzes two types of governance structures, namely that of the small and medium-sized firm with a concentrated secured bank lender and that of the publicly-held firm with a dispersed ownership structure. This account gives rise to a reformulation of the tradeoffs made by debtor- and creditor-oriented regimes and suggests that different optimal regimes may exist for different types of firms.

1. INTRODUCTION

Within the European Union (EU), many Member States have either promulgated or are still in the process of considering the introduction of procedures designed to facilitate business reorganization. In the main, the reasons stated for adding reorganization regimes to the insolvency laws[1] are the low recoveries of unsecured creditors in bankruptcy and the barriers that secured creditors' powers in bankruptcy form to successful reorganization efforts. At the EU level, in turn, the desire to become the most competitive economy[2] has led to initial investigations into the role

---

[1] The terms 'insolvency law', 'bankruptcy law', and 'corporate bankruptcy law' will be used interchangeably throughout this paper. Consideration of issues facing the entrepreneur-individual who experiences insolvency problems is outside the scope of this paper.

[2] See European Council, 'Presidency Conclusions: Lisbon European Council 23 and 24 March 2000', para. 5, available at

bankruptcy law could play in fostering entrepreneurship and innovation. Here the emphasis is, in the first place, on offering entrepreneurs a second chance, although both the recent calls within the EU for assessing national bankruptcy laws and the reports commissioned by and submitted to the European Commission (EC) do not make a sharp divide between the role of bankruptcy law in fostering entrepreneurship and innovation, on the one hand, and promoting business rescue regimes in general, on the other hand.[3] As a consequence, the best procedure project launched by the Commission in 2002 appears targeted more generally at inspiring the Member States toward maintaining an institutional framework conducive to business rescue.

Unsurprisingly, the high level of discord in many jurisdictions, concerning the functioning of the extant corporate bankruptcy laws, has influenced and structured the direction of the debate. In the United States (US), for instance, criticism of the debtor-oriented reorganization regime has led some critics to recommend a repeal of Chapter 11. Moreover, while some commentators have advocated the introduction of an auction or contingent equity scheme, others defend a contract approach to corporate bankruptcy law. In many European countries, dissatisfaction with the creditor-oriented bankruptcy regimes has prompted both bankruptcy scholars and lawmakers to consider the inclusion of reorganization procedures in their national bankruptcy laws.

To date, policy-makers on either side of the Atlantic have paid very little attention to bankruptcy as a corporate governance mechanism. This is all the more surprising if one considers that bankruptcy essentially is about control over a corporation's assets. Consequently, the question regarding to which party control should be ceded in bad states of the world is a fundamental issue of corporate bankruptcy law. Viewing corporate bankruptcy law as a corporate governance mechanism means

---

<http://ue.eu.int/Newsroom/LoadDoc.asp?BID=76&DID=60917&from=&LANG=1> (last visited 13 August 2004).

3 Philippe & Partners, Deloitte & Touche Corporate Finance, *Bankruptcy and a Fresh Start: Stigma on Failure and Legal Consequences of Bankruptcy*, (Brussels, July 2002); European Commission, Enterprise Directorate General, *Best Project on Restructuring, Bankruptcy and a Fresh Start, Final Report of the Expert Group* (September 2003).

linking the function of bankruptcy law to the governance structures of specific firms. Within the governance structures of firms, debt structure—the very reason that firms go bankrupt—fulfils a pivotal role. Different debt structures correlate to different governance problems within firms.[4] When drafting reform proposals bankruptcy policy makers should, therefore, take into account the role that debt fulfils in the governance of firms. Disregarding the role of debt structure comes with the risk that reform proposals may be misguided. For instance, an assumption underlying many of the recent bankruptcy reforms in Europe is the view that secured debt, and in particular concentrated secured debt, is both an obstacle to business reorganization and a reason for the low recoveries of unsecured creditors in bankruptcy. However, this reform approach denies the important monitoring, screening and bonding role that concentrated secured debt may play in the governance of firms. In the United States, on the other hand, skepticism regarding the functioning of Chapter 11, with respect to large publicly-held firms, overlooks the beneficial role that Chapter 11 may play in fostering an *ex post* efficient reallocation of control where capital structures of firms do not provide for an *ex ante* mechanism to reallocate control.

This paper suggests that bankruptcy regimes function efficiently to the extent that they complement the specific governance characteristics of firms. The upshot is that neither the debtor-oriented nor creditor-oriented regime of corporate bankruptcy law, when considered separate from firm characteristics, is clearly the more efficient regime. Moreover, it follows that neither of the regimes is the more optimal one in an absolute sense. Thus, considering the governance structures of specific firms, this paper articulates the view that different optimal regimes may exist for different firms. Consequently, a bankruptcy regime may have a comparative advantage if it is more responsive than other regimes to the governance mechanisms at work in firms. Section 2 recounts several important tenets of the economic approach to corporate bankruptcy law, describes the distinction between creditor- and debtor-oriented corporate

---

[4] J. Armour et al. 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom', *55 Vanderbilt Law Review* (2002) p. 1699, at pp. 1720-2.

bankruptcy regimes, and delineates the characterization of the efficiency tradeoffs made by these regimes.

Section 3 then turns to assess the implications of viewing corporate bankruptcy as a governance mechanism. It suggests that the initial characterization, elaborated in Section 2, falls well short of explaining the respective tradeoffs of the two main corporate bankruptcy regimes. By neglecting to consider the impact of different governance structures on the functioning of corporate bankruptcy laws and by not including law-in-action in the analysis, they do not offer a sufficiently comprehensive picture required to assess the comparative advantages of these regimes. To evidence that the efficient functioning of corporate bankruptcy law cannot be considered separate from the governance structures of firms, this section discusses the small and medium-sized business with concentrated debt and equity structures, and the large, publicly-held firm with a dispersed ownership structure.

The analysis draws on the incomplete contracts and property rights approaches to the firm. Central to this analysis is the extent to which capital structures of firms provide for an *ex ante* mechanism to transfer the residual right of control in bad states of the world or, instead, are incomplete in that they do not, and cannot, provide for such a mechanism from an *ex ante* time perspective. It is suggested that the capital structure of the small and medium-sized business assigns *ex ante* a contingent residual right of control to the concentrated secured bank lender. As a consequence, the role of bankruptcy law is to confirm the residual right of control of the relational bank lender. The capital structure of the prototypical publicly-held firm, in turn, fails to make an *ex ante* assignment of the contingent right of control. The role of bankruptcy law, then, is to offer for an *ex post* mechanism that facilitates the transfer of the residual right of control.

Section 4 moves on to argue that amending creditor-oriented regimes with measures designed to enhance the reorganization possibilities for SMEs may not be warranted. It suggests, moreover, that a debtor-oriented regime does not necessarily weaken the management disciplining effects of concentrated relational lenders, provided that it is responsive to the governance structure of small and medium-sized businesses. On the other hand, with respect to publicly-held firms with dispersed ownership structures this section proposes that repealing the open-ended debtor-oriented regime and replacing it by a more rigid bankruptcy regime could potentially impede the efficient reallocation of control *ex post*. Section 5 concludes by arguing that creditor- and debtor-oriented regimes essentially offer optimal bankruptcy regimes for different types of firms, and identifies a number of research questions that arise as a consequence of the analysis presented in this paper.

2. AN ECONOMIC APPROACH TO CORPORATE BANKRUPTCY LAW

The reduction of bankruptcy costs is the main concern of the economic approach to bankruptcy law. Bankruptcy costs are divided in direct and indirect costs. Direct costs are such costs as filing and professional fees incurred by the bankrupt firm. Indirect costs come in two types. First, bankrupt firms incur costs because its business operations are hampered due to a loss of suppliers, customers and key personnel. Second, bankruptcy law imposes costs on the firm by evoking suboptimal investment incentives among the firm's managers, shareholders and creditors. This second type of indirect costs is generally perceived as the more important source of costs.

By focusing on this second type of indirect bankruptcy costs, the law-and-economics approach to corporate bankruptcy law largely builds on the major tenets of the principal-agent theory of the firm. The principal-agent theory provides for an integrated explanation of the managerial agency costs associated with, on the one hand, the separation of ownership and control and, on the other hand, the division of ownership among the firm's shareholders and creditors.[5] Bankruptcy law's provisions that affect the distribution to creditors and shareholders, as well as those that affect the control over the distressed firm's assets, evoke agency costs in the form of over-investment and under-investment incentives among the firm's shareholders, creditors and managers prior

---

[5] See M.C. Jensen and W.H. Meckling, 'The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', 3 *Journal of Financial Economics* (1976) p. 305.

to (*ex ante*) as well as after (*ex post*) the start of a bankruptcy procedure. Over-investment occurs if the company invests in projects that reduce firm value, whereas under-investment occurs if the company fails to invest in projects that would have increased firm value. From a law-and-economics perspective, the aim of bankruptcy policymaking should be to reduce the *ex ante* and *ex post* suboptimal investment incentives created by corporate bankruptcy law in order to enhance the value of the firm's assets.

A bankruptcy regime is *ex post* efficient if it reduces over-investment and under-investment during a bankruptcy procedure. In general, a bankruptcy regime is *ex post* efficient if it timely closes economically distressed firms, whereas it leads to the continuance of firms that are economically efficient but financially distressed. However, information asymmetry between managers and investors and uncertainty on the firm's value may lead to suboptimal asset deployment decisions. A fundamental aim of corporate bankruptcy law, therefore, is to provide for mechanisms that reduce information asymmetry and uncertainty on the firm's value in order to ascertain that the assets are put to their highest-valued use.

A bankruptcy regime is *ex ante* efficient if it fosters desirable risk taking by managers and shareholders in general, while at the same time it reduces the chance of over-investment and under-investment by all firms within an economy. This first measure of *ex ante* efficiency considers the impact of bankruptcy regimes on the efforts of entrepreneurs and managers as well as on the costs of capital for firms. Furthermore, in order to be *ex ante* efficient a bankruptcy regime should induce financially distressed firms to timely turn around their economic and/or financial distress by divesting their assets or restructuring their debts either inside or outside of bankruptcy. This second measure of *ex ante* efficiency considers the impact of bankruptcy regimes on over-investment and under-investment once a firm is in financial distress.

2.1 Creditor- and Debtor-Oriented Bankruptcy Regimes

Corporate bankruptcy regimes are generally divided into 'creditor-oriented' or 'hard' and 'debtor-oriented' or 'soft' regimes on the basis of a few main legal characteristics. On the one hand, a corporate bankruptcy regime is characterized as creditor-oriented if it replaces management for a court-appointed trustee ('hard' on management) and it does not provide for a complete stay of the creditors' enforcement rights, but permits senior secured creditors to enforce their claims against the debtor's assets. As a consequence, business continuation during bankruptcy is an unlikely event. The applicable distributive rule is the absolute priority rule, meaning that the distribution to creditors and shareholders should follow the priority ranking outside of bankruptcy. The limited automatic stay and the application of the absolute priority rule make that the bankruptcy regime emphasizes the protection of creditors' *ex ante* bargained for rights. On the other hand, a corporate bankruptcy regime is characterized as debtor-oriented if it provides for a reorganization procedure that leaves management in place as the debtor-in-possession ('soft' on managers), and it offers a complete stay of the creditors' enforcement rights. Even though liquidation is an option under a debtor-oriented regime, the manager-friendly character and the complete stay make firm continuation in bankruptcy an attractive option to the managers. The applicable distributive rule in reorganization is loss-sharing, meaning that creditors and shareholders are allowed to agree on a distribution that deviates from the priority ranking outside of bankruptcy. A debtor-oriented regime is thus said to place less emphasis on the protection of the creditors' *ex ante* bargained for rights.

The description of the debtor-oriented regime is clearly based on the main characteristics of Chapter 11 of the US Bankruptcy Code. Upon filing for Chapter 11 virtually all creditors' enforcement rights, including the rights of the secured creditors, are stayed.[6] During the procedure the debtor's management stays in place as the debtor-in-possession and continues to run the debtor's business operations[7] subject to the oversight of the bankruptcy judge and an unsecured creditors' committee.[8] During the first 120 days of the procedure the debtor-in-possession has the

---

[6] 11 USC s. 362.

[7] In order to do so the debtor-in-possession has the power to use, sell and lease property of the estate (11 USC s. 363), to incur new loans (11 USC s. 364), and to unilaterally assume or reject executory contracts (11 USC s. 365).

[8] Appointment of an unsecured creditors' committee is mandatory, see 11 USC s. 1103(c)(1), (2).

exclusive right to propose a reorganization plan to the firm's shareholders and creditors.[9] Chapter 11 aims at the formulation of a reorganization plan that distributes the firm's value among its shareholders and creditors. The bankruptcy judge has to confirm the reorganization plan if all the classes that are entitled to vote have accepted the plan.[10] This implies that shareholders and creditors can consensually deviate from the absolute priority rule. If not all classes entitled to vote have accepted the plan, the bankruptcy court can 'cram-down' the plan against a dissenting class if it is fair and equitable toward such a class, that is, if such class is paid in full or the classes ranking below the dissenting class do not receive any payment.[11] Thus, the cram-down provisions reinstate the absolute priority rule with respect to dissenting classes. Stated differently, it prescribes 'relative' priority.

Even though many European lawmakers have moved to include reorganization procedures in their insolvency laws, none of the laws can be classified as being debtor-oriented. None have a debtor-in-possession system similar to that of Chapter 11. For instance, they generally do not embrace a loss-sharing rule, or the stay of creditors' enforcement rights is often more restricted either in time or in scope.

Until recently, the insolvency laws of England were generally considered to be the most creditor-oriented insolvency laws of the European countries. This was mainly due to the important role that administrative receiverships fulfilled in the English insolvency system. Even though the Insolvency Act 1986 provided for a reorganization regime in the form of the administration procedure, this procedure was not often used for such purpose as floating charge holders could veto the appointment of an administrator by appointing an administrative receiver. As a consequence, the English insolvency laws were highly creditor-driven in character, as receiverships were 'private', i.e. not collective, procedures effectively realizing the company's assets to the benefit of the floating charge holders. Administrative receiverships were

---

9 11 USC s. 1121(d). After 120 days the exclusivity period is often routinely extended.

10 11 USC s. 1128(a).

11 11 USC s. 1129(b)(1).

criticized for failing to maximize value to the benefit of unsecured creditors and for their lack of transparency and accountability to a range of groups who were affected by the receiver's decision-making.[12] Therefore, the Enterprise Act 2002 amended the 1986 Insolvency Act[13] by considerably curtailing the possibility to appoint administrative receivers.[14]

A bankruptcy regime that still lacks a proper reorganization procedure is that of the Netherlands. Under the Dutch Bankruptcy Act, firms can choose between a liquidation procedure and a suspension of payments procedure. The liquidation procedure stays the enforcement rights of the unsecured creditors and privileged creditors, whereas the suspension op payments procedure only stays the enforcement rights of the unsecured creditors. In both procedures, secured creditors can still enforce their claims against the debtor's assets except for the possibility to request the court to order a stay for a maximum period of two months. The distribution in bankruptcy adheres to the absolute priority rule. In both procedures the debtor can offer a composition to its unsecured creditors. In practice, the suspension of payments procedure mainly functions as a doorstep to the liquidation procedure. In order to preserve businesses, mostly going-concern asset sales out of liquidation bankruptcy are used.[15]

---

12 See Department of Trade and Industry, *The White Paper, Productivity and Enterprise: Insolvency—A Second Chance*, Cm 5234, (July 2001) at p. 9.

13 For a comprehensive overview of the procedures of the 1986 Insolvency Act and the amendments made to such Act by the Insolvency Act 2000 (implemented 1 January 2003) and Part 10 of the Enterprise Act 2002 (implemented 15 September 2003), see I.F. Fletcher, 'UK Corporate Rescue: Recent Developments', 5 *European Business Organization Law Review (*2004) p. 119; also D Prentice, 'Bargaining in the Shadow of the Enterprise Act 2002', 5 *European Business Organization Law Review* (2004), p. 153.

14 See *infra* nn. 41 and 42 and accompanying text.

15 For a more extensive description of the Dutch bankruptcy regime, see S. Franken, 'Bankruptcy Law and Business Reorganization in the United States and the Netherlands', in: R. Vriesendorp, J.A. McCahery and F. Verstijlen (eds), *Comparative and International Perspectives on Bankruptcy Law Reform in the Netherlands*, (Boom Juridische Uitgevers, Den Haag, 2001) pp. 53-97. Another example of a creditor-oriented regime is the Swedish auction-based insolvency regime, see B.E. Eckbo and K.S. Thorburn, 'Control Benefits and CEO Discipline in Automatic Bankruptcy Auctions', 69

Prior to 1999, the German bankruptcy laws were very similar to those of the Netherlands. In 1999, however, the new Insolvency Act introduced a single gateway to both liquidation and reorganization. The reasons for amending the existing laws were the lack of assets available for distribution to the (unsecured) creditors and the desire to introduce a business reorganization procedure.[16] Under the new Act the enforcement rights of all creditors, including those of the secured creditors, are stayed. As a rule management is replaced by a court-appointed trustee. Yet the court can leave the debtor's management in control of the company, albeit under the supervision of an administrator, provided that the debtor has requested so and the continued control by management does not harm the creditors' interests.[17] Creditors rights include a right to commission the administrator to make a reorganization plan, and a right to approve several important decisions such as the liquidation of all assets, the sale of the debtor's business as a going-concern, and the incurring of sizeable loans.

Another important difference between Chapter 11 and many of its European counterparts is that the plan procedures of the latter are less sophisticated, so that they are less apt for the restructuring of more complex capital structures. Although the German plan provisions are relatively more sophisticated, they still suffer from important omissions. In principle, all unsecured and secured creditors, if affected by the plan,

---

Journal of Financial Economics (2003) p. 227. In Finland a reorganization provision has been added to the bankruptcy laws in 1993. Yet, this procedure cannot be classified as debtor-oriented: an administrator has to supervise the operations of the debtor, the administrator is closely involved in drafting the reorganization plan, and the stay is not automatic, see S.A. Ravid and S. Sundgren, 'The Comparative Efficiency of Small-Firm Bankruptcies: A Study of the US and Finnish Bankruptcy Codes', 27 *Financial Management* (Winter 1998) p. 28; S. Sundgren, 'Does A Reorganization Law Improve the Efficiency of the Insolvency Law? The Finnish Experience', 6 *European Journal of Law and Economics* (1998) p. 177.

[16] See A. Flessner, 'National Report for Germany', in W. W. McBryde, et al. (eds.), *Principles of European Insolvency Law* (Amsterdam: Kluwer Legal Publishers, 2003), n. 100 (noting that the most hotly debated issue during the reforms was the extent to which security interests had to be curbed in order to facilitate more effective insolvency proceedings).

[17] ss. 270-85 Insolvenzordnung (InsO).

vote on the plan, and creditors can be divided in classes if their economic interests would require so.[18] However, shareholders do not vote on the plan, but are also not wiped out under the plan. As a consequence, shareholders can still keep some value after plan acceptance even if their interests are clearly under water.[19] A similar problem exists in the Netherlands, where only unsecured creditors can vote as one class on a composition.[20] In addition, both in Germany and the Netherlands separate approval of the shareholders is required if a plan restructures the company's share capital. Moreover, the German plan provisions make a debt-for-equity swap even more complicated by requiring each individual creditor's consent to a plan that converts his claims to shares.[21]

2.2 *Ex Ante* and *Ex Post* Efficiencies of Creditor- and Debtor-Oriented Regimes

In principle, creditor- and debtor-oriented regimes can be characterized by their own tradeoffs of efficiencies and inefficiencies. Under a creditor-oriented regime, both shareholders and managers have a tendency to delay bankruptcy filings as shareholders are likely not to receive any distribution in bankruptcy and managers inevitably lose their jobs. Such delays result in over-investment if a redeployment of the firm's assets would have yielded a higher value for the assets.[22] If the

---

18 ss. 222 par 1 and 2, 237, 238 InsO.

19 See Flessner, loc. cit. n. 16, at p. 187.

20 For this effect under Dutch law, see Franken, loc. cit. n. 15, at pp. 81-2.

21 s. 230 par 2 InsO.

22 See, e.g., J.E. Stiglitz, 'Some Aspects of the Pure Theory of Corporate Finance: Bankruptcies and Takeovers', 3 *Bell Journal of Economics & Management Science* (1972) p. 458 at p. 462; M.H. Miller, 'The Wealth Transfers of Bankruptcy: Some Illustrative Examples', 41 *Law and Contemporary Problems* (1977) p. 39 at pp. 41-2; S. Titman, 'The Effect of Capital Structure on a Firm's Liquidation Decision', 13 *Journal of Financial Economics* (1984) p. 137 at p. 145; D.E. Ingbermann, 'Triggers and Priority: An Integrated Model of the Effects of Bankruptcy Law on Overinvestment and Underinvestment', 72 *Washington University Law Quarterly* (1994) p. 1341 at p. 1351; A. Schwartz, 'The Absolute Priority Rule and the Firm's Investment Policy', 72 *Washington University Law Quarterly* (1994) p. 1213 at p. 1216; R.K. Rasmussen, 'The *Ex Ante* Effects of Bankruptcy Reform on Investment Incentives', 72 *Washington University Law Quarterly* (1994) p. 1159 at p. 1172; M.J. White, 'The Corporate

degree of insolvency is very high shareholders may also have a tendency to under-invest as the chance that the firm will be restored to solvency is very small.[23] Because of shareholders' limited liability, the downside risks of their suboptimal investment behavior are shifted to the higher-ranking creditors in the form of lower distributions in bankruptcy. This *ex ante* inefficient investment behavior is, however, traded off against an *ex post* efficiency. Because a creditor-oriented regime does not allow for renegotiation during bankruptcy, the probability of *ex post* over-investment as a result of delay tactics by shareholders *ex post* is relatively low. Secured creditors, in turn, have a tendency to push for quick liquidations because delays in the filing for bankruptcy negatively affect the value of their collateral. This leads to *ex post* under-investment if economically viable firms are liquidated instead of being preserved as going-concerns. Moreover, quick liquidations may lower the proceeds realized on the assets. However, this inefficiency is traded off against an *ex ante* efficiency. The strict application of the absolute priority rule and the possibility secured creditors have to enforce their rights protects creditors' *ex ante* bargained for rights. This lowers the costs of debt capital for firms in general, which increases the access of firms to debt funding and thus may lead to less under-investment by firms outside of bankruptcy. Finally, the investment preferences of lower ranking creditors are diffuse. In the main, subordinated creditors' and trade creditors' interests may be aligned with the interest of business continuation and, therefore, their investment incentives are similar to those of the shareholders.

Under a debtor-oriented regime the loss-sharing rule opens the possibility for the shareholders to receive a distribution in bankruptcy even if the firm does not return to a solvent state. A loss-sharing rule, therefore, increases *ex ante* efficiency by reducing the shareholders' incentive to delay bankruptcy filings. Similarly, not ousting management in bankruptcy may entice managers to file for bankruptcy at an earlier

---

Bankruptcy Decision', in J.S. Bhandari and L.A. Weiss (eds.), *Corporate Bankruptcy: Economic and Legal Perspectives*, (Cambridge University Press, 1996) at pp. 211-15.

[23] See, e.g., G. Triantis, 'A Theory of Regulation of Debtor-in-Possession Financing', 46 *Vanderbilt Law Review* (1994) p. 901 at p. 920.

moment in time. However, this *ex ante* efficiency is traded off against an *ex post* inefficiency. In order to capture some distribution the shareholders and junior creditor classes will have a tendency to protract the renegotiation process during bankruptcy by coming up with optimistic projections of the firm's going-concern value.[24] Such delays may lead to the inefficient continuation of firms in bankruptcy. The downside risks of such over-investment are borne by the higher-ranking creditors.[25] Management, in turn, can pursue its own wealth maximization by aligning with those shareholders' and creditors' interests that favor business continuation over liquidation. Specifically, trade creditors may favor continuation during bankruptcy provided that they can continue deliveries to the firm against full payment of their post-petition claims. By lowering the expected return of senior creditors in bankruptcy, the complete stay and a loss-sharing rule may affect the willingness of senior creditors to extend debt funding to financially distressed firms. As a consequence, a loss-sharing rule creates *ex ante* inefficiencies in the form of under-investment if it reduces the access of economically viable firms to debt financing.

In sum, a creditor-oriented regime may be strong in mitigating both *ex ante* under-investment by protecting the creditors' *ex ante* bargained for rights and *ex post* over-investment by not allowing for renegotiation during the bankruptcy procedure, whereas it may be weak in curtailing both *ex ante* over-investment by enticing firms to delay their bankruptcy filings and *ex post* under-investment by liquidating too many economically viable firms. In contrast, a debtor-oriented regime may be strong in mitigating both *ex ante* over-investment by inducing earlier bankruptcy filings and *ex post* under-investment by keeping more healthy firms intact, whereas it may be weak in curtailing both *ex ante* under-investment *ex post* over-investment by offering a lower degree of protection to the creditors' *ex ante* bargained for rights and by allowing too many economically distressed firms to reorganize respectively.

---

[24] See, e.g., W.H. Meckling, 'Financial Markets, Default, and Bankruptcy: The Role of the State', 41 *Law and Contemporary Problems* (1977) p. 13 at p. 33-5.

[25] See, e.g., B.E. Adler, 'Bankruptcy and Risk Allocation', 77 *Cornell Law Review* (1992) p. 439, at pp. 448-9.

3. CORPORATE BANKRUPTCY AS A GOVERNANCE MECHANISM

The initial characterization of creditor- and debtor-oriented regimes provided above suggests that neither regime is clearly more efficient as both come with their own tradeoffs of efficiencies and inefficiencies. However, there are two important reasons why this characterization falls short of explaining the tradeoffs made by these regimes. First, based on the main tenets of the principal-agent theory the characterization essentially only deals with fully dispersed ownership structures, while ignoring other ownership structures. Second, by using law-in-the-books templates it does not consider other factors that may affect the comparative efficiency of bankruptcy regimes. Thus, these arguments cause us to reconsider the value of the insights of the initial characterization on the decision to reallocate control in bad states of the world and on the role of corporate bankruptcy law with respect to such decision.

The manner in which bankruptcy law should deal with the issue of control cannot be considered separate from the governance structure of firms outside of bankruptcy. In general, the existence of many different types of firms, with many different characteristics, causes difficulties when attempting to classify them. Not only do firms differ at the level of concentration of their equity ownership, but also their debt structures vary from concentrated structures--that rely heavily on relational bank financing involving the granting of security interests in a large part of the debtor's assets--to more dispersed debt structures that rely much less, or not at all, on relational bank lending and secured debt. As is well-known, equity and debt fulfill different roles in the governance of the firm.[26] Common shareholders invest in the most specialized use of the firm's assets, being their current use. Shareholders together with the manager's control the assets in that the shareholders monitor the management and have the residual rights of control that are not allocated to the managers on the basis of the corporate contract. Debtholders, on the other hand, monitor the alternative uses of the firm's assets and accordingly hold the

[26] See O.E. Williamson, 'Corporate Finance and Corporate Governance', 43 *Journal of Finance* (1988) p. 567 at p. 568 (viewing equity and debt as alternative governance structures whose use depends on the degree of asset specificity).

residual right of control with respect to these alternative uses. The less firm specific the assets are, the higher their redeployment value and the more likely the use of concentrated and senior debt. Likewise, the more alternative specialized uses there are, the more likely the use of dispersed debt structures and junior debt would be.[27] A function of debt, therefore, is to reveal important information on the prospects of the firm in different states of the world by tracking the redeployment value of the assets. Moreover, assigning specialized monitoring functions to different claimholders saves on monitoring costs and reduces information asymmetry between the different residual claimholders and management. In addition to the monitoring function, debt also fulfils a management disciplining function as the risk of loosing control to the debtholders upon default bonds managers to the interests of debtholders by reducing their incentives to engage in risky behavior.[28]

Similarly, the reason for using secured debt can be found in the monitoring, screening, and bonding functions it fulfills. For one thing, secured debt prevents a duplication of monitoring costs by and overcomes a free-rider problem among debtholders by assigning the monitoring function to a single lender.[29] Moreover, by granting security interests to creditors specializing in monitoring the redeployment value of specific assets, secured debt comes with screening efficiencies.[30] In general, specialization among lenders leads to a great variety of security arrangements, which aim at monitoring different types of assets or

---

[27] See, e.g., D.B. Johnsen, 'The Quasi-Rent Structure of Corporate Enterprise: A Transaction Cost Theory', 44 *Emory Law Journal* (1995) p. 1277 at pp. 1341-2.

[28] On the monitoring, informational and management disciplining role of debt see, e.g., M. Harris and A. Raviv, 'Capital Structure and the Informational Role of Debt', 54 *Journal of Finance* (1990) p. 321, at pp. 322-3; F.H. Easterbrook, 'High-Yield Debt as an Incentive Device', 11 *International Review of Law & Economics* (1991) p. 183, at pp. 190-1.

[29] See T.H. Jackson and A.T. Kronman, 'Secured Financing and Priorities Among Creditors', 88 *Yale Law Journal* (1979) p. 1143, at pp. 1153-4.

[30] See, e.g., F.H. Buckley, 'The Bankruptcy Priority Puzzle', 72 *Virginia Law Review* (1986) p. 1393, at pp. 1425-6; P. Shupack, 'Solving the Puzzle of Secured Transactions', 41 *Rutgers Law Review* (1989) p. 1067, at p. 1091; Johnsen, loc. cit. n. 27, at pp. 1340-1.

businesses.[31] For instance, lenders who finance the acquisition of specific types of assets will generally hold property interests in these assets by making use of lease constructions, securitization transactions, factoring arrangements, or pledges in the assets financed. As the redeployment value of these assets is typically high, the focus of these lenders will mainly be on monitoring collateral value. In contrast to the security interests in specific assets, blanket security agreements force lenders to focus on monitoring the cash flows generated by the business as a whole as the value of the assets covered by blanket liens fluctuates and may be relatively low. In addition, secured debt in the form of blanket security arrangements offers lenders leverage over the debtor's business decisions. As the security arrangement allows the lender to withdraw vital assets from the business, blanket liens force the debtor to cooperate with the lender and thus bond the debtor's interests to that of the lender. This so-called hostage effect empowers the lender to influence the debtor's investment decisions.[32] Moreover, by offering the lender a contingent right of control blanket liens entice the lender to make firm-specific investments by providing valuable financial coordination and sharing expertise with the debtor in managing the business. The benefits of such firm-specific investments likely accrue to all the debtor's creditors as they limit risky investment behavior by the debtor.[33]

Returning to the relationship between governance structures and corporate bankruptcy law, the central problem that a firm faces under conditions of financial or economic distress is the decision on the reallocation of the residual right of control. In this regard, it is worth noting that the residual right of control refers to the possibility to exert power over the management of the debtor's assets with the aim of wealth maximization. In general, the reallocation of the residual right of control

---

[31] For an overview of different types of secured lending and the monitoring specializations of different lenders see C.A. Hill, 'Is Secured Debt Efficient?' 80 *Texas Law Review* (2002) p. 1117 at pp. 1124-33.

[32] See R.E. Scott, 'A Relational Theory op Secured Financing', 86 *Columbia Law Review* (1986) p. 901 at p. 904.

[33] B.E. Adler, 'An Equity-Agency Solution to the Bankruptcy Priority Puzzle', 22 *Journal of Legal Studies* (1993) p. 73 at p. 77.

should be such that it fosters *ex ante* incentives to make firm-specific investments of human and financial capital. The role now of corporate bankruptcy law with respect to the reallocation of the residual right of control derives from the efficiency with which a firm's capital structure deals with such reallocation decision. This would suggest that corporate bankruptcy law only would have to intervene in the governance of the firm's assets if the firm's governance conditions are suboptimal. Typically the more complicated capital structures are, the less likely they are to provide clear-cut guidance *ex ante* on the reallocation of the residual right of control. Likewise, the more specialized alternative uses of the assets exist, the less likely it will be that there are specific directives *ex ante* for reallocating residual control. Under these conditions, renegotiation *ex post* or the interference of a third party decision maker may be required in order to reallocate the residual right of control. Hence, as the 'completeness' of capital structures varies, the role that corporate bankruptcy has to fulfill in the governance of financial or economic distress varies accordingly.

In order to show the relationship between corporate governance and corporate bankruptcy law, the next two sections will consider two prototypical firms representing opposite extremes: 1) the small and medium-sized business with a relational secured bank lender, and 2) the large publicly-held firm with a dispersed equity and debt structure. With respect to the first firm, the contract with the relational bank lender provides for a mechanism of renegotiation outside of bankruptcy that is mutually beneficial to the debtor and the creditors. There is initial evidence on the comparative efficiency of assigning the residual right of control under conditions of insolvency to the relational bank lender, which evidence suggests that the role of corporate bankruptcy law with respect to these firms is not much more than reinforcing the power exercised by the concentrated secured debtholders. With regard to the large publicly-held firm, managers are disciplined by *ex post* market correctives. The reallocation of the residual right of control is thus left over to open-ended *ex post* mechanisms. This requires a bankruptcy regime that facilitates efficient renegotiation *ex post*. Moreover, the process of resolving financial distress is much more open-ended as it is more difficult to design an optimal bankruptcy response *ex ante*.

3.1 Small and medium-sized businesses with a concentrated debt structure

The typical small and medium-sized enterprise (SME) is characterized by concentrated equity ownership with a shareholder-manager or a small group of shareholders owning a substantial part of the shares. Also, it may have a long-term lending relationship with one main bank lender. Despite the fact that the main bank lender only provides around forty per cent of the firm's debt financing, it nevertheless holds floating and fixed security interests in a substantial part of the debtor's assets. Its trade creditors are generally dispersed. Because the interests of the shareholders coincide with that of the manager-owner, the lender-manager conflict likely dominates in SMEs.[34]

This type of SME may benefit from the leverage of a concentrated secured bank lender. The advantage of the concentrated bank lender's role as monitor of the firm's economic and financial condition is that once the firm is confronted with a downturn of its fortune the bank lender may require the firm to take adequate restructuring measures. Concentrating the liquidation rights with the relational bank lender by granting it security interests in a considerable part of the firm's assets bonds the manager's interests to that of the relational bank lender by effectively placing the power to take the shut-down decision in the hands of the bank lender. A hard bankruptcy regime reinforces the monitoring and bonding functions of relational bank debt, by making the bank lender's threat power outside of bankruptcy a credible one. As a consequence, managers are enticed to follow more conservative investment policies that reduce the chance of bankruptcy. Moreover, it induces financially and economically distressed debtors to renegotiate their loans and restructure their operations outside of bankruptcy. This is efficient as the costs of these out-of-court restructurings are relatively low as negotiation only takes place between the debtor and the relational bank lender. Furthermore, considering that relational bank lending is an

---

[34] See Hill, loc. cit. n. 31, at pp 1139-40; A.N. Berger and G.F. Udell, 'The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle', 22 *Journal of Banking & Finance* (1998) p. 613 at pp. 634-51.

important source of funding for SMEs, reinforcing the relational bank lender's contingent rights of control in bankruptcy induces such lenders to make firm-specific investments outside of bankruptcy. To be sure, the downside of a hard bankruptcy regime remains that the liquidation sales or auctions of the assets in bankruptcy generally depress the prices made for the assets and result in low recovery rates for the unsecured creditors.[35] Yet, these *ex post* costs--in the form of lower proceeds--need to be balanced against the possible higher *ex ante* benefits resulting from the combination of concentrated private bank debt and hard bankruptcy regimes.

That the *ex ante* benefits of a bankruptcy regime that enforces the leverage of the concentrated secured bank lender may be considerable, is evidenced by recent research of Franks and Sussman into the files of 542 financially distressed SMEs in the UK that were placed in the hands of the rescue units of their main bank lenders. Even though in most cases the bank provided only 40% of the loans, it nevertheless invariably held floating and fixed charges on nearly all the firm's assets. Consequently, it had the right to appoint an administrative receiver.[36] The Frank and Sussman study shows that banks make very limited concessions, are slow to exercise liquidation rights and rarely increase interest-rate margins to compensate for increased default risk.[37] Furthermore, they

---

[35] Cf. R.G. Hansen and R.S. Thomas, 'Auctions in Bankruptcy: Theoretical Analysis and Practical Guidance', 18 *International Review of Law and Economics* (1998) p. 159, at pp. 168-172; B.E. Eckbo and K.S. Thorburn, *Overbidding vs. Fire-Sales in Automatic Bankruptcy Auctions*, Working Paper, Dartmouth College (2001) (providing research into bankruptcy auctions in Sweden showing that the greater the proportion of secured debt the higher the probability of piecemeal liquidation is, and showing that auction premiums in excess of the piecemeal liquidation value of the assets tend to be significantly lower the greater the fraction of secured debt).

[36] J.R. Franks and O. Sussman, *Financial Distress and Bank Restructuring of Small-To-Medium Size UK Companies*, CEPR, Discussion Paper Series, no. 3915 (May 2003) at pp. 3, 15-7.

[37] Ibid., at pp. 3, 17 (Franks and Sussman observed that banks generally delayed their decision to put the firm in liquidation with 5.2 months); Cf. Eckbo & Thorburn, loc. cit. n. 15, at pp. 230, 236-8 (researching a sample of SMEs that went through the Swedish automatic auction regime and finding no empirical support for the contention that a hard regime would induce CEO's to enter into over-investment in order to delay or avoid bankruptcy).

found that banks usually made the decision to put the firm in bankruptcy, while they found little to no evidence that trade creditors entered into asset grabbing, creditor runs, litigation or threatening with liquidation to enforce repayment of their debts. Instead, trade creditors tended to maintain or even expand lending during distress.[38] Even though they found that banks generally realize high recovery rates on their claims while other creditors realize low recoveries suggesting that banks time liquidations when the value of the firm equals the value of the bank's collateral, their evidence also suggests that a bank's decision to liquidate a firm is sensitive to a firm's own restructuring efforts.[39] Their results show that the concentrated bank lenders' involvement in the management of SMEs mainly serves the preservation of going-concern value by facilitating restructuring outside of bankruptcy.

This empirical work gives credence to the theory that the concentrated secured bank lender fulfils an important monitoring role in the governance of SMEs and that concentrating liquidation rights with the main bank lender mainly serves as a bonding device.[40] These benefits also accrue to the unsecured trade creditors, not in the form of recoveries in bankruptcy, but in the form of continued trading relationships with the businesses that are kept afloat outside of bankruptcy. Franks and Sussman's results challenge the strength of the criticism on the role of secured bank lenders in the turn-around of financially distressed SMEs. It also casts doubts on the recent abolition of administrative receiverships in the UK insofar as it regards their use with respect to SMEs. Under the new UK Insolvency Act qualifying floating charge holders are precluded from appointing an administrative receiver.[41] In

---

[38] See Franks and Sussman, loc. cit. n. 36, at pp. 3-4.

[39] Ibid., at pp. 4, 18 (finding that main banks recover between 74% and 77% of their loans).

[40] See also J. Armour and S. Frisby, 'Rethinking Receivership', 21 *Oxford Journal of Legal Studies* (2001) p. 73, at pp. 81-2. For a previous empirical research concluding that the potential for rehabilitation of companies going into administrative receivership seemed to have improved as a result of the efforts and actions taken by the bank holding a floating charge, see K. Pond, *Rescuing Insolvent Companies via Administrative Receivership—Analysis of Qualitative Survey Data*, available at Social Science Research Network, abstract=43880 (October 1997).

[41] Enterprise Act 2002, Pt. 10, s. 72A.

addition, in order to prevent that the proceeds freed up as a result of the abolition of the Crown preference would be distributed to the floating charge holder, a new distributive rule provides that a part of the company's net property has to be made available for the satisfaction of the company's unsecured creditors.[42] The tendency to blame the secured creditor for the low recoveries of unsecured creditors in bankruptcy—which tendency is certainly not unique to the UK[43]—overlooks the *ex ante* efficiency benefits that secured bank lending brings to the governance of SMEs by reducing information asymmetry and constraining risky investment behavior of debtors. Moreover, pointing to the low recoveries of unsecured creditors in bankruptcy selectively focuses on that part of the SMEs that finally ends up in bankruptcy, while negating the positive externalities that secured bank debt brings to unsecured creditors by timely instigating the restructuring of financially distressed and badly managed firms.

However, without administrative receiverships for floating charge holders banks can continue to fulfill their role in the governance of SMEs by bargaining for floating charges and fixed charges that together cover significant parts of the debtor's assets. For instance, although the Netherlands does not have a floating charge similar to the pre-Enterprise Act 2002 floating charge, the pattern of bank financing to SMEs is very similar in that SMEs pledge large parts of their assets to their 'house' bank and, once firms start to experience financial difficulties, the house bank generally intensifies its leverage by placing firms under the control of special rescue departments. An important characteristic of the Dutch

---

42 Ibid., s. 176A.

43 For instance, Swedish insolvency legislation has recently been amended by limiting the rights of a floating charge holder in bankruptcy, see G. Lofalk, 'The Far-reaching Reforms of Swedish Insolvency Legislation', *Eurofenix* (Autumn 2003) pp. 8-11; cf. C. Bergström, et al., 'Secured Debt and the Likelihood of Reorganization', 21 *International Review of Law and Economics* (2002) p. 359 (studying Finnish reorganization cases finding that well-secured creditors are more likely to oppose reorganization, and finding a negative correlation between how well-secured banks are and the likelihood of confirmed reorganization plans. On the basis of their research they suggest that limiting the priority of secured debt might stimulate reorganizations. Their study, however, does not consider the role that large secured bank creditors may have played in the reorganization efforts of the firms studied).

collective bankruptcy procedure, though, is that the powers of the secured creditors to enforce their claims in bankruptcy essentially remain in tact.[44] Dutch banks contend that bank-led informal restructurings lead to the preservation of the business of 75% to 80% of the firms placed under the control of their rescue units. In a study of a selection of files dealt with by the rescue units of two Dutch banks, Van Amsterdam found that the success rate of the bank-led out-of-court restructurings were lower than banks generally contend, but were nevertheless still high enough to suggest that banks play an important role in preserving going-concern value of SMEs.[45] He distinguished between a 'bank success rate', meaning that the bank receives full payment of its loans, and a 'societal success rate', meaning that either (a part of) the business is preserved or, although the business is terminated outside of bankruptcy, all its debts are paid in full.[46] Van Amsterdam found that of the 235 files of bank one the 'bank success rate' was 71%, while the 'societal success rate' ranged from 55% to 61%. Of the 267 files of bank two the 'bank success rate' ranged from 72% to 80%, while the 'societal success rate' ranged from 48% to 57%.[47]

Together the results of Franks and Sussman and van Amsterdam suggest that not only the formal characteristics of a bankruptcy regime matter, but also the extent to which the insolvency proceedings reinstate the contingent right of control of the relational bank lender. Again if we return to the UK, one observes that, despite the abolition of administrative receiverships, qualifying charge holders are still afforded the right to directly appoint an administrator or to intervene by appointing an administrator upon the receipt of a notice of an administration order.[48] These rights, which offer secured lenders the possibility to seize control of the administration procedure, may offset the possible negative effects that the abolition of administrative

44 See *supra* n. 15 and accompanying text.

45 A.M. van Amsterdam, *Insolventie in economisch perspectief* [Insolvency in Economic Perspective] (Amsterdam: Boom Juridische Uitgevers, 2004).

46 Ibid., at pp. 229-31.

47 Ibid., at pp. 233-7.

48 Enterprise Act 2002, Pt. 10, Sch. B 1 to Insolvency Act 1986, s. 248, paras. 14-21.

receiverships might otherwise have on the role of bank control in reducing agency costs.[49]

Apart from the low recovery rates of unsecured creditors, bank-led informal restructurings are criticized for their lack of transparency and accountability to the creditors and other interested parties that are affected by the bank lenders' decision making.[50] Given the perceived benefits that bank control may have for SMEs, the case for more transparency of the informal renegotiations between firm and bank lender seems not a very strong one. For one thing, the informal character and the secrecy of the renegotiation process between bank and firm provides for a low cost restructuring process and prevents indirect costs in the form of the termination of trade credit and loss of trade. In addition, unsecured creditors benefit from the reduction of suboptimal investment decisions resulting from *ex ante* supervision by the bank. Moreover, to the extent that trade creditors have accounted for the possibility of zero recovery in bankruptcy they may as well be indifferent on the issue of transparency. Increasing transparency outside of bankruptcy, therefore, is more likely to impose additional costs on the firm than add value. To be sure, the conflict between bank lender and unsecured trade creditors likely boils down to the issue of the bank lender's 'private benefits of control'. In this, an analogy could be made to the conflict between a blockholder and minority shareholders of a

---

[49] See I.F. Fletcher, loc. cit. n. 13, at p. 151; J. Armour and R.J. Mokal, *Reforming the Governance of Corporate Rescue: The Enterprise Act 2002*, at p. 7-9 (unpublished paper draft 6 May 2004).

[50] See, e.g., Department of Trade and Industry, *supra* n. 12. In a similar vein, criticism on the dominant secured bank lender often focuses on its partiality, by pointing to the fact that the secured bank lender will in the first place serve its own interests. Therefore, the involvement of a 'disinterested' trustee in bankruptcy is defended as a 'neutralizing' factor, in order to balance the different interests involved. See recently J.L. Westbrook, 'The Control of Wealth in Bankruptcy', 82 *Texas Law Review* (2004) p. 795 at pp. 825-7 (2004); D. Hahn, *Concentrated Ownership and Control of Corporate Reorganizations*, Bar-Ilan University, Faculty of Law, Working Paper no. 6-03 (October 2003). Not only does this kind of criticism often negate the benefits of secured lender control with respect to SMEs, it also tends to overlook that secured lenders, although not formally in control during bankruptcy, can still exert power over decision-making processes in bankruptcy.

corporation, where the benefits of having a blockholder lie in the reduction of managerial agency costs and the disadvantages in the quasi-rents that the blockholder may extract from the corporation. Similarly, the conflict of interest between bank lender and unsecured creditors likely focuses on the question of whether the bank lender has defrauded the other creditors through fraudulent transfers of the debtor's assets or preferential payments by the debtor to the bank. To address this issue, however, bankruptcy law provides for its own 'self-dealing provisions' in the form of the avoiding powers.

An SME relying heavily on concentrated relational bank lending may benefit most from a creditor-oriented regime. With respect to this type of firm, a creditor-oriented regime fosters *ex ante* out-of-court restructuring, and tends to rescue a considerable part of the financially distressed firms outside of bankruptcy. The downside of this regime may be the undue liquidation of a part of the firms that file for bankruptcy and the generally low recoveries of unsecured creditors in bankruptcy. Yet, by keeping firms afloat outside of bankruptcy *ex ante* bank supervision creates positive externalities for trade creditors in the form of continued trading opportunities, which may offset the low chance of a distribution in bankruptcy. Finally, the risk of *ex ante* over-investment seems to be attenuated as relational bank lenders force distressed firms to timely take appropriate restructuring measures. Thus, with respect to SMEs the *ex ante* benefits of a creditor-oriented regime may outweigh its *ex post* costs.

Turning to the debtor-oriented regime of Chapter 11, theory would predict that the availability of such a procedure would be too costly for bank controlled SMEs.[51] A soft regime allows managers to opt out of the contract with the bank lender by filing for bankruptcy, while enabling

---

[51] Research suggests that a considerable part of the Chapter 11 cases concern small businesses. See L.H. Fenning and C.A. Hart, 'Measuring Chapter 11: the Real World of 500 Cases', 4 *ABI Law Review* (1996) p. 119 at pp. 120-2 (finding that the typical Chapter 11 case emerging from this study was that of a medium-sized enterprise run by an individual or a small group); also E. Warren and J.L. Westbrook, 'Financial Characteristics of Businesses in Bankruptcy', 73 *American Bankruptcy Law Journal* (1999) p. 499 at p. 500 (finding that 99% of the Chapter 11 cases could be classified as small business cases).

them to continue inefficient business operations in bankruptcy. Soft regimes would thus weaken the role of the bank as an effective *ex ante* monitor of the debtor's investment decisions. Thus, providing the option of a Chapter 11-like procedure would destabilize the balance struck by a hard bankruptcy regime.

This theoretical prediction is, however, not supported by a recent study of Morrison into the decision making process of bankruptcy judges in Chapter 11, at least insofar as the *ex post* efficiency of Chapter 11 involving SMEs is concerned.[52] One of the main outcomes of his research is that the contention that Chapter 11, and more in particular bankruptcy judges, would allow SMEs to avoid liquidation and continue inefficient business operations does not appear to hold, as in most of the cases reviewed the bankruptcy judge rendered a shut-down decision during the first five months of the case.[53] Morrison found that the decision-making process of bankruptcy judges generally only allowed firms to exit Chapter 11 if there were indications of significant going-concern value. Important in the decision-making of the bankruptcy judges in the district under study was the swift motion practice. Morrison found a relationship between slower shut-down decisions and motions of debtors for cash-collateral and adequate protection orders. He argues that because the secured creditor usually supports these motions they serve as an indication to the bankruptcy judge that both the debtor and the creditor believe that the firm is a viable enterprise.[54] In contrast, motions to lift the automatic stay would serve as indications that the business is not viable.[55] A limitation, however, of Morrison's study is that it does

---

52 E.R. Morrison, *Bankruptcy Decision-Making: An Empirical Study of Small-Business Bankruptcies*, Columbia Law School, The Center of Law and Economic Studies, Working Paper no. 239, available at Social Science Research Network abstract=461031 (analyzing the decision-making in all corporate Chapter 11 filings during 1998 in the Northern District of Illinois, which covers Chicago and outlying areas; finding that the vast majority of the filings involve small firms with fewer than twenty employees and less than one million dollars in assets, and that a majority of these firms were owned and managed by a family or small group of investors).

53 Ibid., at pp. 8, 29 (approximately 50% of all shut-down decisions occurred within the first three months of the case, and 70% occurred within the first five months).

54 Ibid., at pp. 30-1.

55 Ibid., at p. 30.

not analyze the impact of capital structure on the decision-making by the bankruptcy judges. However, considering the fact that motions are opportunities for a judge to obtain information on the viability of the firm, the advantages of a speedy motion practice lie in the prevention of undue delays of the Chapter 11 procedure.[56] By hypothesis, then, the extent to which a debtor-oriented regime is able to reinstate the monitoring and informational function of the concentrated secured bank lender may depend on the efficiency of the procedure and the possibility for secured lenders to intervene at an early stage of the procedure.

3.2 The large publicly-held firm with a dispersed ownership structure

At the other end of the continuum, we find the large publicly-held firm with a pattern of dispersed share and debt ownership. Information asymmetry exists between both managers and shareholders and managers and creditors. This firm uses a variety of lending transactions. Typically, a publicly-held firm does not use blanket liens and the use of secured debt is restricted to specific assets. Unlike in the case of SMEs, secured debt does not work as a mechanism to bond the managers' interest to that of the creditors, but mainly functions as a monitor of the value of specific assets. Due to the large information asymmetry between management and claimholders, information, and specifically 'bad' information, tends to be relinquished to the market with delay. Consequently, reactions to unwanted managerial investment decisions have an after-the-fact nature in the form of replacement of under-performing managers and hostile takeovers. Thus, in a dispersed ownership structure shareholders, bondholders, and other creditors are weak *ex ante* monitors of the managers' investment decisions.

Theory now suggests that a soft bankruptcy regime would complement the governance structure of firms with dispersed ownership structures. Because market reactions are typically hard on management, the risk exists that managers do not timely signal financial or economic problems to the market and thereby postpone restructuring efforts. If the bankruptcy regime is hard on management as well, it does not pay off to

---

[56] Ibid., at pp. 9, 41-2.

managers to signal financial distress by filing for bankruptcy. However, leaving management in place in bankruptcy as the debtor-in-possession would provide managers an indirect reward for timely signaling a financial or economic downturn in the firm's fortunes.[57] A debtor-in-possession system is, therefore, said to have information forcing qualities, which benefit dispersed ownership structures by reducing information asymmetry and limiting *ex ante* over-investment.

Another explanation for having soft bankruptcy procedures is fostering efficient renegotiation *ex post* by reducing transaction costs. Firms that attract much publicly traded debt are more likely to face financial problems in the form of debt overload. Because publicly traded bonds are typically unsecured, and the enforcement of their covenants is difficult, lenders cannot easily constrain future borrowing. Consequently, renegotiation *ex post* is required to bring the level of debt back to manageable proportions. Renegotiation of complex capital structures consisting of different layers of publicly traded equity and debt is, however, inherently difficult and produces considerable transaction costs that may lead to the break-down of the renegotiation process.[58] First, due to free-riding problems among public debtholders renegotiation comes with hold-out problems. As a result, out-of-court restructurings of public debt are costly and more likely to fail than the restructuring of private concentrated debt. A debtor-oriented bankruptcy regime lowers transaction costs by providing for majority voting procedures and cram-

---

[57] See D.A. Skeel Jr., 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy', 51 *Vanderbilt Law Review* (1998) p. 1325 at p. 1341; see also P. Povel, 'Optimal "Soft" or "Tough" Bankruptcy Procedures', 15 *Journal of Law, Economics & Organization* (1999) p. 659 at pp. 676-7.

[58] S.C. Gilson, 'Bankruptcy, Boards, Banks and Blockholders: Evidence on Changes in Corporate Ownership When Firms Default', 17 *Journal of Financial Economics* (1990) p. 355 at pp. 322-23; S. C. Gilson, et al., 'Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default', 27 *Journal of Financial Economics* (1990) p. 315 at p. 345; P. Asquith et al., 'Anatomy of Financial Distress: An Examination of Junk-Bond Issuers', 109 *Quarterley Journal of Economics* (1994) 625 at p. 655; S.C. Gilson, 'Managing Default: Some Evidence on How Firms Choose between Workouts and Chapter 11', in J.S. Bhandari and L.A. Weiss (eds.), *Corporate Bankruptcy: Economic and Legal Perspectives*, (Cambridge University Press, 1996) at pp. 316-17.

down mechanisms. Second, in order to extract quasi-rents equityholders and junior debtholders can use their hold-up power by haggling over the value of the firm. Loosening the strict application of the absolute priority rule--by providing for a loss-sharing rule--can therefore be viewed as a way to lower transaction costs by preventing valuation disputes.

A third, less explored explanation of the relationship between dispersed ownership structures and debtor-oriented regimes, is the incompleteness of capital structures characterized by dispersed share and debt ownership and the concomitant need for a mechanism that assigns the residual right of control *ex post*. Essentially, the different layers of rights against the firm's differentiated income streams constitute residual rights of control in different states of the world. The senior claimholders likely only monitor the value of distinct assets, and not the cash flows of the business as a whole. As a consequence, they are ill equipped to take the shut-down decision. Even if a few of the senior claimholders would be able to take such decision, they do not have the powers to claim their residual right of control of the firm's investment decisions. In other words, the interests of management are not bonded to the interests of a single senior creditor. As a consequence, the conflict of interests between junior claimholders and senior claimholders dominates in dispersed ownership structures. Under these conditions it becomes very difficult, if not impossible, to design a capital structure that provides for a mechanism that assigns the residual right of control in bad states of the world. In other words, the dispersed ownership structure of the prototypical publicly-held firm leaves open to whom the residual right of control will be ceded in different states of the world, and mainly leaves such decision to open-ended *ex post* market processes. Firms with dispersed ownership structures would, therefore, benefit from a bankruptcy regime that not only facilitates renegotiation *ex post*, but also leaves open the entrance of third party decision makers, who can take up the role of exercising, or can facilitate the exercise of, the residual right of control.

Empirical research on the functioning of Chapter 11 in the cases of large publicly-held firms evidences the role that market mechanisms fulfill *ex post* in order to facilitate a transfer of control. First, the CEO turnover rate of financially distressed firms inside as well as outside of

Chapter 11 is remarkably high.[59] Changes of control occur as a result of claims buying by investors with a view on gaining control of the reorganized firms[60], the outright sale of companies during Chapter 11, and the sale of securities received by creditors under reorganization plans to new investors shortly after plan confirmation.[61] Second, research on Chapter 11 cases in the 80s and the early 90s revealed that Chapter 11 plans often distributed some value to shareholders and subordinated creditors even though higher ranking creditor classes were not paid in full, although on average these distributions were not very high.[62] This evidence not only indicates that Chapter 11 is not exactly soft on management and shareholders[63], but also that market mechanisms continue to fulfill an important role in the transfer of control.

Recently, several scholars have emphasized that over the last few years Chapter 11 would have become a speedier procedure relying more

---

[59] L. LoPucki and W.C. Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies', 141 *University of Pennsylvania Law Review* (1993) p. 669 at pp. 723-37; S.C. Gilson, 'Management Turnover and Financial Distress', 25 *Journal of Financial Economics* (1989), p. 241 at pp. 246-8.

[60] See on claims trading C.J. Fortgang and T.M. Mayer, 'Trading Claims and Taking Control of Corporations in Chapter 11', 12 *Cardozo Law Review* (1990) p. 1; *idem.*, Developments in Trading Claims and Taking Control of Corporations in Chapter 11', 13 *Cardozo Law Review* (1991) p. 1; *idem.*, 'Developments in Trading Claims and Taking Control of Corporations in Chapter 11', 15 *Cardozo Law Review* (1993) p. 733.

[61] LoPucki and Whitford, loc. cit. n. 59, at p. 736.

[62] They rarely exceed ten per cent and often are in the range of three to four per cent of asset value. See, e.g., L. LoPucki and W.C. Whitford, 'Bargaining over Equity's Share in the Bankruptcy Reorganization of Large Publicly Held Companies', 139 *University of Pennsylvania Law Review* (1990) p. 125 at pp. 141-3; L.A. Weiss, 'Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims', 27 *Journal of Financial Economics* (1990) p. 285, at pp. 294-6; A.C. Eberhart et al., 'Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings', 45 *Journal of Finance* (1990) p. 1457, at p. 1463; J.R. Franks and W.N. Torous, 'An Empirical Investigation of US Firms in Reorganization', 44 *Journal of Finance* (1989) p. 747, at p. 761.

[63] Which takes the edge of the argument that Chapter 11 would impose high indirect costs on distressed firms by favoring business continuation to the benefit of managers and shareholders regardless of the economic viability of the firms. For this line of reasoning see, e.g., M. Bradley and M. Rosenzweig, 'The Untenable Case for Chapter 11', 101 *Yale Law Journal* (1992) p. 1043, at pp. 1049-50.

heavily on asset sales and plans negotiated prior to bankruptcy.[64] Analyzing the cases of publicly traded firms that exited Chapter 11 in 2002, Baird and Rasmussen found that the majority of the cases involved asset sales and plans negotiated prior to bankruptcy. Equity holders were often wiped out while new investors took control, removed old boards of directors and closed plants.[65] Market mechanisms appear to dominate this 'new' Chapter 11. Investment bankers facilitate asset sales while special Chapter 11 and eve-of-bankruptcy 'pay-for-performance' packages link managers' compensation to the speed of reorganization cases and prices obtained in asset sales.[66] Moreover, recent empirical research has found that debtor-in-possession lenders (dip-lenders) play an important role in screening viable firms, and in monitoring and generating information on the prospects of firms in Chapter 11.[67]

The observation that Chapter 11 has recently been used for going-concern asset sales and the execution of pre-negotiated plans orchestrated by major creditors may point much less to a new trend in

---

[64] See D.G. Baird and R.K. Rasmussen, 'The End of Bankruptcy', 55 *Stanford Law Review* (2002) 751, at pp. 786-8; *idem.*, 'Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations', 87 *Virginia Law Review* (2001) p. 921, at p. 941; *idem.*, 'Four (or Five) Easy Lessons From Enron', 55 *Vanderbilt Law Review* (2002) p. 1787, at pp. 1806-9; but see L.M. LoPucki, 'The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's The End of Bankruptcy', 56 *Stanford Law Review* (2003) p. 645 at pp. 670-1 (stating that empirical data shows that reorganization is still an important reason for large publicly held companies to file for bankruptcy).

[65] See D.G. Baird and R.K. Rasmussen, 'Chapter 11 at Twilight', 56 *Stanford Law Review* (2003) 673 at pp. 675-85 (Baird & Rasmussen have used the database of LoPucki to test their contentions made in their article 'The End of Bankruptcy', by analyzing 96 publicly traded firms that exited Chapter 11 in 2002).

[66] See D.A. Skeel, Jr., 'Creditors' Ball: The "New" New Corporate Governance in Chapter 11', 152 *University of Pennsylvania Law Review* (2003) p. 917, at p. 934.

[67] F.A. Elayan and T.O. Meyer, 'The Impact of Receiving Debtor-in-Possession Financing on the Probability of Successful Emergence and Time Spent Under Chapter 11 Bankruptcy', 28 *Journal of Business, Finance & Accounting* (2001) pp. 905-942; S. Dahiya, et al., 'Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence', 69 *Journal of Financial Economics* (2003) pp. 259-297; S. Chatterjee, et al., 'Debtor-in-Possession Financing', Working Paper (31 May 2001), pp. 1-26; M. Carapeto, 'Does Debtor-in-Possession Financing Add Value?', Working Paper, Cass Business School (6 October 2003), pp. 1-47.

Chapter 11 than to the fact that market mechanisms have an important impact on the process of taking control of distressed firms in Chapter 11. This observation thus appears to be in line with the theory that in bad states of the world the reallocation of the residual right of control takes place *ex post* through open-ended market mechanisms. Moreover, because of the severe asymmetric information problem, there is a need for intermediaries that fill the monitoring gap. The role that dip-lenders and investment bankers seem to play in the turn-around of large publicly-held firms may evidence the existence of intermediaries that have stepped into the monitoring gap. In sum, Chapter 11 did not become a more creditor-driven procedure, but is, and might always have been, a market-driven process.

However, the process of restructuring large publicly-held firms through Chapter 11 has downside considerations. Even though the chance that reorganization plans are confirmed in large cases may be relatively high and the percentage offered to unsecured creditors in reorganization plans is generally higher than in creditor-oriented regimes, the final outcome of Chapter 11 cases still depends on the extent to which Chapter 11 plans consummate. There is empirical evidence that a part of the corporations emerged from Chapter 11 with too much debt in their capital structures, which leads some of them to refile for Chapter 11 or liquidate in Chapter 7.[68] Needless to say, in a part of the Chapter 11 cases the recovery rates of unsecured creditors will thus be lower than projected under the initial reorganization plans. Moreover, there is evidence that a considerable part of the firms that emerged from Chapter 11 underperformed their industry rivals.[69] As such, the broad automatic stay keeping the pre-petition creditors at bay

---

[68] See L. LoPucki and W.C. Whitford, 'Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies', 78 *Cornell Law Review* (1993) p. 597, at p. 607; S. Jensen-Conklin, 'Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law', 97 *Commercial Lending Review* (1992) p. 297, at pp. 323-4.

[69] See E. Hotchkiss, 'Post-Bankruptcy Performance and Management Turn-Over', 50 *Journal of Finance* (1995) p. 3, at pp. 18-20; but see M.J. Alderson and B.L. Betker, 'Assessing Post-Bankruptcy Performance: An Analysis of Reorganized Firms Cash Flows', 28 *Financial Management* (Summer 1999) p. 68, at pp. 79-81.

as well as the possibility to incur debtor-in-possession loans may enable economically distressed firms to prolong their business operations for some time. As long as a debtor generates enough cash flow during Chapter 11 to pay off post-petition trade creditors and lenders it may continue its operations regardless of the economic viability of its business. Chapter 11 may then be suboptimal in that it postpones the shut-down of firms too long.

With respect to large publicly-held firms, the tradeoffs made by the debtor-oriented Chapter 11 appear to be closely related to the tradeoffs made in a market-based corporate governance system. A market-based corporate governance system is characterized by dispersed ownership structures, liquid trading markets, and the reliance on *ex post* market correctives to discipline managers' investment behavior. Market-based systems tradeoff enhanced liquidity against less *ex ante* supervision of management and more debt overhang.[70] The same tradeoff is made by a debtor-oriented regime that is used by publicly-held firms with dispersed ownership structures. Under these conditions, a debtor-oriented regime is strong in curtailing *ex ante* and *ex post* under-investment as both outside of bankruptcy and inside of bankruptcy firms have enhanced possibilities to attract additional funding. However, it is weak in mitigating managerial agency costs in the form of *ex ante* and *ex post* over-investment due to its reliance on *ex post* market correctives both outside of and inside of bankruptcy. This trade-off is also reflected in the recovery of unsecured creditors. On the one hand, unsecured creditors benefit from enhanced liquidity, which offers trade creditors increased trading possibilities both outside of and inside of bankruptcy and allows lenders, particularly bondholders, to cash out on their claims during bankruptcy by selling their claims. On the other hand, recovery rates of unsecured creditors may on average be lower than initially projected in reorganization plans as a part of the firms has to restructure again within a few years after they left Chapter 11 for the first time.

---

70 W.W. Bratton and J.A. McCahery, 'Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference', 38 *Columbia Journal of International Law* (1999) p. 213 at p. 276.

The foregoing analysis raises the question of whether a debtor-oriented bankruptcy regime would also be a logical complement to a blockholder-based system of corporate governance.[71] As such, concentrated share ownership structures come with the risk that the blockholder's and managers' interests coalesce. Again, the answer to this question may hinge on the level of concentration of debt ownership. Publicly-held firms of which the capital structure is characterized by the existence of a dominant blockholder and concentrated relational lenders, as well as firms with dispersed equityholders and concentrated relational bank lenders, may have greater affinity with creditor-oriented bankruptcy regimes. In the event these firms experience financial or economic distress bank lenders start to play a pivotal role in the *ex ante* supervision of management. A manager-displacing bankruptcy regime reinforces the leverage of the concentrated bank lenders by forcing managers to co-operate with the bank lender. This, in turn, fosters bank-led out-of-court restructurings. In line with this theory, Armour, et al. found that the existence of a creditor-oriented regime in England, where share ownership in publicly-held firms could be characterized as dispersed, could be explained on the basis of the prevalence of concentrated debt structures in the form of a few relational bank lenders acting together in a syndicate.[72] By means of the so-called 'London Approach', developed by the Bank of England, these bank lenders use their own 'privatized' process of restructuring the debt overload of large U.K. companies.[73] In firms with dispersed share ownership and concentrated relational bank lenders, shareholders may benefit from the leverage of the bank lenders, as they fill the monitoring gap between dispersed shareholders and management. Creditor-oriented regimes, therefore, better complement concentrated debt structures, mainly

---

[71] A blockholder-based corporate governance system corresponds with an insider/control-oriented governance system, characterized by the existence of holders of large blocks of shares, thin trading markets and the reliance on *ex ante* supervision by the blockholders to discipline management's investment behavior. Bratton and McCahery, loc cit. n. 70 at p. 227.

[72] J. Armour, et al., loc cit. n. 4 at pp. 1756-62.

[73] See J. Armour and S. Deakin, 'Norms in Private Insolvency: The "London Approach" to the Resolution of Financial Distress', 1 *Journal of Corporate Law Studies* (2001) p. 21, at pp. 31-7.

because hard regimes reinforce the role of concentrated relational lenders. This is in line with the idea that in capital structures with a dominant relational lender the process of assigning the residual right of control in conditions of financial and economic distress may already be embedded in the firm's capital structure. These capital structures may, therefore, tradeoff enhanced *ex ante* supervision of management and less debt overhang against less liquidity.

4. IMPLICATIONS FOR BANKRUPTCY POLICY

The foregoing analysis holds out a number of implications for bankruptcy policy. The relationship between corporate governance structures and bankruptcy regimes implies that neither in the United States nor in Europe a one-size-fits-all bankruptcy regime exists. Before proposing reforms to the bankruptcy laws that could potentially interfere with the governance structures of firms, lawmakers should recognize that private parties or the market are sometimes better decision makers than courts or 'disinterested' third parties. More specifically, with respect to the type of SMEs considered in this paper the concentrated secured lender is not the problem, but is part of the corporate bankruptcy regime-corporate governance equation.[74] Constraining the secured lender's rights to enforce its security in bankruptcy without offering an escape route, which allows relational lenders to take control over the bankruptcy process, may counteract the benefits that a relational lender as *ex ante* monitor of distressed firms could bring to both debtors and the other creditors. Thus, with respect to these firms there may be no need to change to a debtor-oriented regime.

As such, having a debtor-oriented regime seems no necessity if firms with concentrated debt structures dominate a country's firm population. Yet, whether or not the introduction of a debtor-oriented regime would be counterproductive in countries in which concentrated debt structures dominate may depend on the efficiency of the judicial process and on the level of protection of the rights of secured creditors. Just labeling a bankruptcy procedure as debtor-oriented on the basis of a law-in-the-books template is not sufficient to determine whether it will only have

---

[74] See Baird and Rasmussen, 'Control Rights', loc. cit. n. 64, at p. 957.

the effects of a debtor-oriented regime, or whether it could also supplement the governance structures of firms with concentrated ownership structures, more particularly with concentrated debt structures. A debtor-oriented regime is too often depicted as a regime that would indiscriminately compromise creditors' rights to the benefit of debtors and shareholders, while barring the possibility for creditors to intervene in the bankruptcy process. Yet the functioning of a debtor-oriented regime may also depend on other characteristics, such as the level of protection of (secured) creditors' rights, the swiftness and efficiency of the bankruptcy procedure, and the possibility for concentrated relational lenders to continue to influence decision-making in bankruptcy. By hypothesis, then, debtor-oriented bankruptcy regimes can function as creditor-oriented regimes with respect to firms with concentrated debt structures if they adequately protect secured creditors' rights and the bankruptcy procedure is responsive to the informational and monitoring role of concentrated relational lenders.

It may need to be emphasized that the position of senior secured creditors is generally well protected in Chapter 11. Reorganization plans must either offer secured creditors full payment or reinstate their claims, including their security interests. Moreover, the debtor-in-possession needs to offer secured creditors adequate protection of their security interests. Not providing for such protection gives a secured creditor the right to request a lift of the automatic stay. In addition, much may depend on the possibility that creditors have in an early stage of a bankruptcy procedure to move to and be quickly heard by the bankruptcy judge. In this way, creditors can form an important source of information for the bankruptcy judge. As a result, the efficiency of the judicial process in combination with the design of the bankruptcy laws may be sufficient to reinstate the role of the concentrated bank lender in the governance of SMEs or other firms with concentrated debt structures. However, the efficiency of the judicial system differs among jurisdictions. In the main, the level of enforcement of creditors' rights may be less uniform in Europe than in the US. In weaker judicial systems that offer a lower degree of protection of creditors' rights in general, the introduction of a debtor-oriented bankruptcy regime may, therefore, come with a higher risk of unwanted effects, as it weakens the rights of creditors vis-à-vis their debtors even more.[75]

With respect to Chapter 11 of the United States Bankruptcy Code, the relationship between corporate bankruptcy and corporate governance teaches that the failure of fully dispersed ownership structures to effectively assign the residual right of control in different states of the world means that the optimal bankruptcy reaction cannot be cast from an *ex ante* time perspective. As a consequence, Chapter 11 offers a rather open-ended bankruptcy procedure that facilitates the continued functioning of market processes to reallocate control over the firm's assets. Nonetheless, auction regimes, contingent equity regimes and a contract approach to corporate bankruptcy have been proposed as alternatives to Chapter 11. Mandatory auctions have been presented as outright repeals of Chapter 11.[76] Contingent equity schemes propose to design capital structures in such a way that lower ranking classes can obtain a stake in the reorganized firm by buying out their proportionate share in the higher ranking classes.[77] The contract approach to corporate

---

[75] See S. Claessens and L.F. Klapper, *Bankruptcy Around the World: Explanations of its Relative Use* (July 2003), at pp. 8-10, available at the Social Science Research Network abstract=405240 (emphasizing the importance of adequate legal rights, efficient judicial system to enforce rights or to serve as a credible threat and speedy liquidation and restructuring processes and noting that countries with comparatively weak judicial systems should not consider the implementation of a debtor-oriented regime, but should in the first place aim at strengthening creditors' rights); R. Brogi and P. Santella, *Two New Measures of Bankruptcy Efficiency*, Working Paper (May 2003) pp. 28-31 (presentation at the yearly conference of the European Association of Law & Economics held 19-20 September 2003 at Nancy, France, finding that the recovery rate and recovery time of bank credit in Italy is significantly lower respectively longer than the average European recovery rates and recovery time. Also, the average procedure of bankruptcy proceedings in Italy is seven years. This likely has adverse effects on the costs of capital for borrowers in Italy).

[76] See W.H. Meckling, 'Financial Markets, Default and Bankruptcy: The Role of the State', 41 *Law and Contemporary Problems* (1977) p. 13; M.J. Roe, 'Bankruptcy and Debt: A New Model for Corporate Reorganizations', 83 *Columbia Law Review* (1983) p. 527; D.G. Baird, 'The Uneasy Case for Corporate Reorganizations', 15 *Journal of Legal Studies* (1986) p. 127; T.H. Jackson, *The Logic and Limits of Bankruptcy Law*, (Harvard University Press, Cambridge, 1986) p. 218.

[77] See J.F. Weston, 'Some Economic Fundamentals for an Analysis of Bankruptcy', 41 *Law and Contemporary Problems* (1977) p. 47 at p. 65; L.A. Bebchuk,

bankruptcy law suggests that debtors and lenders should be allowed to contract *ex ante* on the applicable bankruptcy regime.[78] In essence, under all three approaches firms would choose *ex ante* for one particular bankruptcy regime, while leaving out the applicability of other options. Even though due to the continued market activity in and around large Chapter 11 cases auctions may turn out to be relatively successful in these cases, and in some cases the buy-out process suggested by contingent equity schemes could be applied in the framework of a reorganization plan, it does not follow that the propriety of these bankruptcy regimes can be predicted from an *ex ante* time perspective. The incompleteness of dispersed ownership structures suggests that the choice for the more optimal bankruptcy reaction cannot be made *ex ante*, but instead requires mechanisms that foster efficient reallocations of control *ex post*. It follows that repealing the open-ended debtor-oriented regime in relation to firms with dispersed ownership structures by a more rigid bankruptcy regime could potentially impede the efficient reallocation of control *ex post*.

The foregoing suggests that 'privatized' bankruptcy, in the sense that a firm's capital structure implicitly includes an *ex ante* choice for a bankruptcy regime, more likely relates to firms with concentrated debt structures, whereas such *ex ante* choice seems not to be embedded in capital structures of firms with dispersed ownership structures. This implies that the possibility for firms to make an *ex ante* efficient choice

---

'A New Approach to Corporate Reorganizations', 101 *Harvard Law Review* (1988) p. 775; M. Bradley and M. Rosenzweig, 'The Untenable Case for Chapter 11', 101 *Yale Law Journal* (1992) p. 1043; P. Aghion, et al., 'The Economics of Bankruptcy Reform', 8 *Journal of Law, Economics & Organization* (1992) p. 523; B.E. Adler, 'Financial and Political Theories of American Corporate Bankruptcy', 54 *Stanford Law Review* (1993) p. 311; L.A. Bebchuk, *Using Options to Divide Value in Corporate Bankruptcy*, NBER Working Paper Series, no. 7614 (2001).

[78] See R.K. Rasmussen, 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy', 71 *Texas Law Review* (1992) p. 51 (proposing that firms make an *ex ante* bankruptcy choice from a menu of options and include such choice in their articles of incorporation); A. Schwartz, 'A Contract Theory Approach to Business Bankruptcy', 107 *The Yale Law Journal* (1998) p. 1807 (suggesting that firms make an *ex ante* choice for a bankruptcy regime in their contracts with lenders).

for a specific bankruptcy regime may be limited to firms that have a capital structure that already includes an implicit bankruptcy choice.[79]

5. CONCLUSION

This paper has shown that the comparative efficiency of the creditor- and debtor-oriented bankruptcy regimes cannot be viewed separate from the governance structures of firms. Relating creditor- and debtor-oriented bankruptcy regimes to the governance structures of firms leads to a revision of the tradeoffs that are often used to characterize the comparative efficiency of both regimes. Instead of providing for offsetting efficiencies in general, creditor- and debtor-oriented regimes essentially offer optimal bankruptcy regimes for different types of firms. This is not to say that the complementarities that exist between corporate bankruptcy regimes and governance structures constitute first-best solutions. To be sure, bankruptcy regimes that complement corporate governance structures of firms also come with their downsides and can be best characterized as second-best solutions in an imperfect world. However, it may be difficult to draft a bankruptcy framework that performs better than these second-best solutions.

At least two implications follow from the analysis provided in this paper. First, the reformulation of the tradeoffs made by creditor-oriented regimes in relation to SMEs suggests that there is no evident need to change these regimes with a view to enhancing the possibilities for business reorganization. Yet, by hypothesis a high level of protection of creditors' rights in general in combination with a debtor-oriented bankruptcy procedure that is responsive to the governance structure of SMEs may have a positive impact on the comparative efficiency of a debtor-oriented regime. This hypothesis raises additional questions for comparative corporate bankruptcy law. For instance, does Chapter 11 in

---

[79] But see Westbrook, loc. cit. n. 50, at p. 843. Westbrook states with respect to 'secured contractualism' that adoption thereof 'would require wholesale adoption of dominant security interests, a state quite foreign (literally as well as figuratively) to the United States market'. I disagree. Westbrook does not distinguish between different types of firms. As a result, he does not recognize that relational bank lending, often including a concentration of security interests with the relational lender, has important benefits for the type of SME discussed in this paper.

the case of small firm bankruptcies allow concentrated secured bank lenders to continue to fulfill an important informational role and, thereby, influence bankruptcy decision-making? Will the recent amendments to English insolvency law turn out to have a limited effect on the role of the concentrated bank lender in the resolution of financial distress, now that the concentrated lender may still influence bankruptcy decision-making by using its rights to appoint an administrator? Does the introduction of bankruptcy procedures aiming at business rescue in jurisdictions that until recently had creditor-oriented regimes have an impact on the role of concentrated relational bank lenders in the turn-around of insolvent businesses?

Second, the comparative advantage of a debtor-oriented regime with respect to the large publicly-held firm that functions in a market-based system mainly lies in the continued functioning of *ex post* market correctives. The open-ended character of Chapter 11 in combination with a continued functioning of the market for corporate control seems to provide for a mechanism to reallocate the residual right of control *ex post* if a firm's capital structure does not provide for an *ex ante* mechanism to effect such change of control. This, however, also limits the comparative efficiency of a debtor-oriented regime to market-based corporate governance systems. This posits the question of whether in blockholder-based systems, such as can be found on the continent of Europe, debtor-oriented bankruptcy regimes have any advantages. The analysis in this paper only briefly touched on publicly-held firms with concentrated debt structures by suggesting that concentrated debt structures have an affinity with creditor-oriented regimes. In particular, it did not consider at length the relationship between blockholder-based corporate governance structures and bankruptcy regimes. Nor did the analysis consider the relationship between bankruptcy regimes and a blockholder-dominated firm with a dispersed debt structure. These and other ownership structures, however, raise additional questions on the proper relationship between corporate bankruptcy law and corporate governance, which will be addressed in subsequent work.