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# Bankruptcy and Economic Recovery

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## Introduction

To measure economic growth or recovery, one traditionally looks to metrics such as the unemployment rate and the growth in GDP. And in terms of figuring out institutional policies that will stimulate economic growth, the focus most often is on policies that encourage investment, entrepreneurial enterprises, and reward risk-taking with appropriate returns. Bankruptcy academics that we are, we tend to add our own area of expertise to this stable— with the firm belief that thinking critically about bankruptcy policy is an important element of any set of institutions designed to speed economic recovery. In this paper, we outline the crucial role we believe bankruptcy plays in advancing a robust economy, while also identifying several areas in which we believe bankruptcy law—and practice—could be improved so as to enhance bankruptcy's role in economic growth, including its recovery from periods of recession. Along the way, we suggest that a standard (and appropriate) baseline metric for successful economic policies, namely employment, if carried outside its macro focus so as to become an independent bankruptcy policy (as it often is), carries with it—usually inadvertently— the potential to undermine bankruptcy's key role in facilitating economic growth.

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## I Bankruptcy and Economic Growth

We start by outlining our underlying proposition: An effective free market/entrepreneurial economy depends on the existence of an effective bankruptcy process. This is so because, while entrepreneurial innovation is usually conceived of in terms of its successes—encouraging the flow of funds to new businesses and ideas driven by the prospect of riches—the reality is that the prospect of large returns for risk-taking also means the necessary potential for failure and loss. The correlation between risk and return has a downside as well as an upside; thus, in anything resembling a free-market/entrepreneurial economy, rewarding successful risk-taking requires consequences to unsuccessful risk taking. Only in Lake Wobegon—or a society where government bailouts are the norm—can all ventures succeed. The natural opposition to bailout by those who have faith in the reward and punishment nature of markets, whether of financial firms or industrial firms-or, indeed, of categories of creditors—is borne from the realization that bailouts distort incentives, and interfere with important market mechanisms for monitoring and disciplining firms.

Modern bankruptcy law primarily exists[2] to help reduce the frictions that otherwise would impede assets from moving to their highest-and-best use. Even those who think this is too narrow a description of the purposes of bankruptcy law would almost certainly agree that it is a, if not the, *primary* purpose. When a firm is insolvent—when its liabilities exceed its assets at fair valuation—and the creditors realize that not all of them will be paid in full, the creditors have incentives to demand

[2] Here we speak of its role for firms and other commercial ventures. We set aside the separate policy, applicable for human beings alone, of a "fresh start."

payment, or use available judicial procedures to seize assets, sooner rather than later. "First-come, first-served" is a sensible policy for solvent firms, but it creates externalities—a common pool problem—for insolvent firms.[3] This use of individual creditor remedies will result in the assets of a firm being pulled apart, and the firm dismantled. But not all insolvent firms should be liquidated; there is a recognized distinction between economic failure (a firm should be shuttered) and financial failure (liabilities exceed assets). Sometimes, the assets are being used in their highest and best use, and it would be inefficient to have creditors, lacking a coordination mechanism, pull the firm apart, "saving" some creditors but imposing costs to the creditors as a group—and society.

A simple example of the distinction between insolvency and financial failure is perhaps helpful. When Johns Manville filed for bankruptcy in the early 1980s when it appeared to be solidly solvent, in fact it was, on a deeper look, hopelessly insolvent. The insolvency was due, in significant part, to crushing liability in tort for its manufacture of asbestos, generally 20 to 40 years earlier—the time-frame for asbestosis to reveal itself. It would take time for the tort creditors to manifest themselves, but it was clear as of 1982 when it filed that—over time—Johns Manville simply could not pay bank, trade, and tort creditors alike. By the 1980s, Johns Manville was no longer manufacturing asbestos; it was a diversified building-supply company. If it did not have the crushing tort liability based on products it produced in its past, there was every reason to believe that one would want Johns Manville to continue doing just what it

[3] This was first explored in a systematic fashion in Thomas Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 Yale L.J. 857 (1982). While the author may regret the phrase "creditors' bargain," which has taken on a life of its own (often as used by critics), the central point of bankruptcy as a response to externalities remains core.

was doing—producing (non-asbestosis-based) building supplies. But as the realization of this massive tort liability "overhang" spread, it would have made it impossible for Johns Manville to continue in business without a collectivizing process such as bankruptcy, as its consensual creditors would have demanded payment, so as to finish ahead of the tort creditors (whose claims were often still latent or disputed), and new lenders and suppliers would become increasingly leery of Johns Manville. Bankruptcy, by collectivizing the creditors, stopping the use of individual creditor remedies, and giving priority to post-bankruptcy creditors who dealt with Johns Manville, allowed the thorny issues of "who got what" to be separated from the simpler issue of the "highest and best" use of the assets—that is, continuing the business Johns Manville was in.[4]

There is a second frictional problem that bankruptcy is designed to respond to—although, as we shall discuss, we believe it is less effective in terms of this goal. And that is to shift control (and ownership) from the old equity owners to the creditors. In an insolvent firm, the old equity owners are the wrong decision-makers. They have every incentive to take extravagant risks—since the (small) possibility of enormous returns becomes the only way in which the equity will see their interests return "to the money."[5] In effect, at this time, they are playing with "other people's money" for their own potential benefit. Equity owners of an insolvent business have incentives not only to string things along as long as possible, but also to increase the riskiness of the firm's

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[4] This isn't to say that accomplishing this was "simple." Many of the asbestosis claimants were unknown, and awkwardly fit with the Bankruptcy Code's definition of a "claim" under Bankruptcy Code § 105. See generally Mark Roe, *Bankruptcy and Mass Tort*, 84 **Colum. L. Rev.** 846 (1984); **Thomas Jackson, The Logic and Limits of Bankruptcy Law** 47-54 (Harv. U. Press 1986); **David Skeel, Debt's Dominion: A History of Bankruptcy Law in America** 217-21 (Princeton U. Press 2001).
[5] This is different from "retain *any* value," as—absent a control-shift mechanism that wipes equity out—equity *always* has a positive value. This is a consequence of limited liability, which prevents equity from ever being worth less than nothing. Thus, even the remotest upside possibility creates positive value for equity.

business. Bankruptcy responds to this concern by allowing the creditors to commence—or force—a proceeding in which the transfer of residual ownership claims passes from the equity to the creditors.[6]

Thus, bankruptcy plays a crucial role in undergirding the mobility of assets to their highest and best use; it is an essential component of any market-based economic system, and hence an important element to enhance policies for economic growth and economic recovery. The question, which we turn to next, is whether bankruptcy's policies and practices are, by and large, sufficient, or whether there are ways in which consideration should be given to tweaking bankruptcy, so as to strengthen bankruptcy's important role in facilitating economic growth.[7] Although we will suggest a variety of possible adjustments, overall U.S. bankruptcy law works quite well.

## II Bankruptcy Law and Practice: Two Problems and Some Suggested Remedial Steps

At the start of the 21st century, American bankruptcy law is probably the best in the world separating the consequences of insolvency from impeding the placement of assets in their most productive use.[8] Part of this is due to long experience with

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[6] As with collectivization, this is almost impossible to "write" as a contract term—as a form of an "option" contract giving creditors equity control rights upon insolvency—although it might be more plausible as a nonbankruptcy legal rule.

[7] Our focus in this paper will be on larger firms—without defining precisely what we mean by that. Our focus is not on sole proprietorships, or "mom & pop" stores, or the numerous restaurants that come and go, although some of our ideas may be relevant to them as well. While we do not propose reinstating the old, pre-1978 bankruptcy laws, which includes separate frameworks for small and publicly held firms (Chapter XI for the former, Chapter X for the latter), there are ways in which large, publicly-regulated (and oftentimes publicly-traded) companies should be thought of differently from the very small businesses that line Main Street.

[8] As one of us has noted, "[b]ankruptcy law in the United States is unique in the world. Perhaps most startling to outsiders is that individuals and businesses in the United States do not seem to

bankruptcy law, and the American system of adhering to the "rule of law," meaning that bankruptcy's rules are known in advance and usually adhered to in reality. And part of it in the consequence of a history of remarkable innovation—such as the equity receivership for railroad reorganizations in the late 19th and early 20th Century—that led us to use bankruptcy as a utilitarian tool, rather than as a device of shame and punishment. What has emerged is a set of rules such as the automatic stay provisions that impose an across the board standstill the moment a company files for bankruptcy; provisions permitting the debtor to assume executory contracts—contracts with material performance left on both sides—even if they are in default; reach-back rules that permit the debtor to retrieve transfers that were made shortly before bankruptcy; and priority rules, that all generally fit within the broader notion that bankruptcy law has something important to say about the separation of financial failure from economic failure. Perhaps less obvious, but no less important, in terms of bankruptcy's effectiveness, are its rules permitting a company's existing managers to continue running the business in bankruptcy[9]—an outgrowth of the same long-standing, and non-punitive, notion that bankruptcy exists to rehabilitate (where it makes sense) rather than punish; its generous terms for new financing (thus ensuring that businesses that should continue, can continue);[10] and its growing facilitation of market-based interventions and valuations.[11]

view bankruptcy as the absolute last resort, as an outcome to be avoided at all costs." **David Skeel, Debt's Dominion**, *supra* note 4, at 1.

[9] Bankruptcy Code §§ 1104, 1107.

[10] Bankruptcy Code § 364.

[11] See *infra*, pp. 28-30.

But, as good as it is—and despite significant improvements in bankruptcy's facilitation of the highest-and-best use of assets by largely separating the question of what to do with assets from the question of who got the value of those assets—bankruptcy law, and the shift of control that it brings, continues in our view to suffer from at least two structural problems. First, as a general matter, bankruptcy is likely to occur too late; earlier interventions would facilitate better achievement of its goals. Second, bankruptcy law and practice has always faced a conflict—or at least a tension—between making efficient asset decisions and preserving jobs (the latter being, perhaps ironically, one of the key metrics of an economic recovery). We would like to explore each problem, and offer some ways in which changes could be made so as to reduce, although almost certainly not eliminate, both.

### A The Delayed Commencement of a Bankruptcy Case—and What to Do About It

While bankruptcy permits both voluntary petitions—cases commenced by the debtor—and involuntary petitions—cases commenced by three or more unsecured creditors,[12] it is well-recognized that the vast majority of reorganization cases for firms are, in fact, commenced by the debtor with the voluntary filing of a petition under Section 301.[13] But this statistic almost certainly obscures the underlying dynamics. This is a consequence of the layering of ownership rights to a firm and the reality that decisions as to what to do with the assets of the firm are normally made by the equity owners, through their agents, the managers. For the typically solvent firm, this

[12] Bankruptcy Code §§ 301, 303.
[13] Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number is Not Too Small*, 57 **Brooklyn L. Rev.** 803 (1991).

location of decisionmaking rights is not particularly problematic. Equity is, at least for a large range of actions, "playing with its own money," in the sense that it reaps the benefits of good decisions (as equity is entitled, in an unlimited fashion, to the upside value of a firm), and—at least for a while—pays the price of bad decisions (as equity is the first to have its value stripped as a firm declines in value). While imperfect, it is enormously practical, and comes closest to replicating the decisions that an owner of the assets without competing demands on them would make.[14]

This, however, changes as a firm begins a slide towards insolvency—towards a world in which its assets are insufficient to pay all of the fixed (creditor) claims against it. By the time of insolvency, equity is, in a very real sense, no longer playing with its own money, but with the money of the creditors. At the moment of insolvency, the creditors pay the price of bad decisions—any diminution in the value of the firm will fall directly on them—while the benefit of good decisions redound to the equity—any increase in the value of the firm goes directly to them. This changes the incentives of decisionmaking in a major way.[15] Rather than making decisions that have the highest expected value (within the risk tolerance of a typical investor), equity is likely (a) to increase risk in its investment decisions and (b) make risky decisions even if they don't have a similar expected value, risk aside. This is the natural incentive of a group that, at this point, gains all the upside value of such decisions (as the residual owner) but

[14] Sometimes referred to as a "sole owner." See Douglas Baird & Thomas Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 104-109 (1984).

[15] The incentives begin to change before the actual point of insolvency. As a firm slides towards insolvency, it is more and more the case that the benefits go to equity while the burdens increasingly fall on creditors. There is no momentary "light switch"—although identifying a moment prior to insolvency the switch control is itself complicated. Precisely the ease of using "insolvency" as the moment to switch control is at least a part of the problem of delay that we are examining in this section of our paper.

pays none of the price of declining values (as limited liability leaves equity in a situation in which they can do no worse than lose the investment it has made)—but it is increasingly the wrong incentive for the owners of the firm as a group. It distorts decisionmaking away from the kind of decisions that would be made by a firm with a single class of owners.

Even outside of bankruptcy, courts have recognized and wrestled with this problem. Although directors of a corporation ordinarily owe fiduciary duties to shareholders and the corporation, but not to creditors, their duties expand to include creditors when a firm is insolvent.[16] The precise contours of this duty, and the point at which it is triggered, however, are unclear—courts speak of the "zone of insolvency" or "vicinity of insolvency." Courts in Delaware, the most important jurisdiction for corporate law, have been reluctant to give creditors broad powers to enforce these duties.[17]

One can see in bankruptcy a more decisive solution to this concern. Even though the debtor (*e.g.*, managers) may remain "in possession" in a Chapter 11 reorganization,[18] two things change. First, the decisions of the debtor fall under judicial scrutiny during the time of the bankruptcy proceeding itself. And, second, the

[16] A Delaware court signaled that the directors of an insolvent or nearly insolvent corporation may owe duties to creditors in Credit Lyonnais Bank Nederland v. Pathe Communications Corp., 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991). The *Credit Lyonnais* case prompted a flurry of commentary on the nature and scope of the duty.

[17] Most recently, the Delaware Supreme Court ruled that creditors can sue derivatively—that is, on behalf of the corporation—to enforce directors' duties when a corporation is nearly insolvent, but that they cannot enforce the duties directly. North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d (Del. 2007).

[18] Thus allowing those with the most knowledge about the debtor to continue (presumptively at least) to run the ship. In this respect, this sharply differentiates U.S. bankruptcy law from that of many other nations—and, indeed, from the "orderly liquidation authority" of Dodd-Frank for financial institutions.

end-point of the bankruptcy proceeding results in a reshuffling of the ownership claims against the debtor's assets. Under the absolute priority rule,[19] the equity will lose its interest in an insolvent company, and the creditors will become the new equity owners of the firm.[20] The faster the bankruptcy proceeding occurs, the less time there is for strategic decisionmaking during the bankruptcy proceeding.[21] Thus, bankruptcy can be seen as a legal rule—or mechanism—for converting ownership from the old residual owners (equity) to a new class of residual owners (the creditors).

The reason for a legal rule to accomplish this change of ownership is integrally related to the other, well-recognized, major purpose behind bankruptcy law—the substitution of a collective creditor collection mechanism for the nonbankruptcy "first-

[19] In general, the absolute priority rule (or APR) provides that each senior class of claimants—starting with secured creditors—get paid in full before any value can be distributed to the next junior class of creditors. It is embodied in Bankruptcy Code §§ 725, 726, 1129(b)(2). There has recently been a challenge to the absolute priority rule's allocation of value between secured creditors and unsecured creditors—arguing that it doesn't replicate the nonbankruptcy priority rights of these classes of creditors. See Anthony Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. Chi. L. Rev. 759 (2011). The merits of that challenge is a story for another day. Suffice it to say for present purposes that it acknowledges that it is proposing a change to existing practices and tradition—and that our sense is that the case against the current understanding of the operation of the absolute priority rule is not beyond challenge.

[20] This vastly simplifies what can become a complex process—in terms of new sources of investment, valuation issues, class-wide voting rights, and the like. These complications can shift value, although—as we will discuss in a bit—increasingly shortened bankruptcy proceedings and reliance on market-valuations push in the direction of (a) a shift in ownership and (b) a distribution based on the absolute priority rule.

[21] Management, once a bankruptcy proceeding has commenced, may have strong incentives to begin to please the likely new equity owners of the firm—the old creditors. Moreover, the Bankruptcy Code has procedures for ousting the "debtor in possession" upon creditor petition. Bankruptcy Code § 1104. Even so, the period "during" a bankruptcy proceeding almost certainly continues a conflict in purposes between the prior equity owners and the creditors that appear in a number of ways. While it may no longer have the same control that it did outside of bankruptcy, equity still have incentives to use whatever mechanisms it has (a) to delay the final day of reckoning and (b) to push for riskier asset-deployment decisions. Recent changes in reorganization practice suggest that, at least since the enactment of the Bankruptcy Code in 1978, the balance of power has shifted towards creditors, even within a debtor-in-possession model. For discussion of the shift and its significance, see Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751 (2002); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Bankruptcy*, 152 U. Penn. L. Rev. 917 (2003).

come, first-served" individualistic collection mechanism. The same concerns that are seen in the individualistic creditor collection "race" upon insolvency—"I need to collect sooner rather than later, because someone is going to be left holding the bag, and I don't want it to be me," and the potential destruction of going concern value that can result—exist with respect to the shift in control as well. While equity can act collectively, unsecured creditors generally cannot. If there was a single unsecured creditor, there would be no need for bankruptcy. But unsecured creditors are an amalgamation of commercial lenders, trade creditors, tort claimants, workers (and retirees) with health care claims, and other dispersed and uncoordinated individuals and firms. Given that dispersion, there is no effective way to write, or implement, a set of contractual provisions that either "collectivize" or "change ownership." An option—or legal requirement—to convert from a creditor claim to an equity ownership right (and eliminating the old equity interests) is possible, but tricky. Without implementing a bankruptcy-like judicial proceeding, it requires clear valuations, not just of assets but of claims (many of which may be disputed, contingent, or unliquidated). Having the rule, but then requiring these issues to be sorted out in court doesn't end up sounding much different to us than current bankruptcy practice.[22]

[22] This isn't to say that this alternative has been vigorously supported as an alternative to bankruptcy. The foundational work here is Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 **Yale L.J.** 1043) (1992); Barry Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 **Stan. L. Rev.** 311 (1993). Concerns about this approach were early sounded by one of us. David Skeel, *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 **Wisc. L. Rev.** 465. Interestingly, this debate has been "dusted off" in modern garb as proposals for "opt-in" solutions for significant financial institutions post-2009 abound. See John Coffee, *Systemic Risk After Dodd Frank: Contingent Capital and the New Regulatory Strategies Beyond Oversight*, 111 **Colum. L. Rev.** 795 (2011). Our preliminary concerns with this new garb are expressed in Thomas Jackson & David Skeel, *Dynamic Resolution of Large Financial Institutions*, 2 **Harv. Bus. L. Rev.** 435 (2012).

Thus, bankruptcy supplies the "rule" (or rules) that the uncoordinated creditors could not otherwise easily achieve—"collectivization" in terms of asset distribution to the creditors and "ownership shift" from equity to creditors in terms of asset determination. Both exist for what can be seen as a single goal: Effective decisionmaking over the firm's assets and future.[23]

But, as with the physics concept that the observation will affect the thing being observed, this bankruptcy rule (or rules) itself changes behavior. While three or more individual creditors have the right, under certain circumstances, to commence a bankruptcy proceeding,[24] there is the immediate question of whether individual creditors perceive it as preferable to commence a case—in which they share in the assets collectively—or to pursue their individual creditor remedies, get paid in full, and depart. The fear that the incentives are clearly to "exit" rather than commence an involuntary bankruptcy proceeding, leads to a well-known second-level bankruptcy response, known as preference law. Pursuant to it, such actions by creditors are subject to being unwound if done within 90 days of bankruptcy.[25] This reduces, but does not necessarily eliminate, the creditor's incentive to attempt to exit rather than commence

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[23] One of us has argued that bankruptcy also has a liquidity-providing role. Kenneth Ayotte & David Skeel, *Bankruptcy Law as a Liquidity-Provider*, **U. CHI. L. REV.** (unpublished manuscript, forthcoming 2013). We put this issue aside for the purposes of the current discussion.

[24] Bankruptcy Code § 303(b)(1). Since 1978, the standard for an involuntary petition has been demonstrating, upon challenge, that "the debtor is generally not paying such debtor's debts as such debts become due," Bankruptcy Code § 303(h)(1). The prior "balance sheet" insolvency test was eliminated (as were "acts of bankruptcy"), on the ground that it was too ambiguous. The "generally not paying" debts test, while perhaps more easily shown, arguably itself exacerbates the problem, and an insolvent debtor, by liquidating assets, can—in theory—pay debts well into insolvency. (The same was true in the case of Johns Manville, discussed earlier.) In many cases, as we discuss shortly, however, the need to borrow money to continue to pay off creditors becomes the device that tends to collapse the two standards.

[25] Bankruptcy Code § 547. The reach-back period is one year if the creditor is an "insider" within the meaning of Bankruptcy Code § 101(31).

an involuntary case, as the creditor still "wins" if it collects its payment (or security interest) and 90 days pass without a bankruptcy petition being filed. All preference law does is return the debtor and the creditor to the status quo. It is like saying "if you cut in line, and we catch you, we will return you to where you would have been had you not cut in line." It does not, itself, eliminate the incentive for creditors to prefer an asset grab over the commencement of a bankruptcy case.[26]

And, at least observationally, involuntary petitions against firms are significantly an exception, rather than the rule.[27] This leaves voluntary petitions, and the concern we have already noted, that equity have every reason not to pull the bankruptcy trigger, as it becomes the triggering mechanism for them losing their right to the upside value of the firm. So, creditors don't seem to have an incentive to start a bankruptcy proceeding. And equity doesn't seem to have an incentive to start a bankruptcy proceeding.

Given this state of affairs, then, why do we observe bankruptcy proceedings at all? We suspect that the usual scenario, at least with large firms, is the insistence of *new* creditors that equity (and management) file for bankruptcy as a condition of receiving new credit. Because of the sharp division between pre-petition creditors and post-petition creditors, a firm needing liquidity that is also facing insolvency (even if there is a solid going concern underneath) is likely to be met with an insistence by new lenders that it file for bankruptcy, as a condition of receiving the new funds (which, in

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[26] This is complicated by the introduction of real-world costs—both in terms of collecting in the first instance and in terms of litigation expenses if the creditor wants to contest a preference assertion by the debtor once a bankruptcy case commences.
[27] See note 13, *supra*.

bankruptcy, would be entitled to "administrative expense" priority—i.e., priority senior to all pre-petition unsecured claimants).[28] The question is whether this mechanism is timely enough to get bankruptcy cases to commence at about the right time, rather than too late—since, as we have shown, none of the other incentives are likely to lead to timely bankruptcy proceedings.

We are skeptical that this triggering mechanism is effective in getting bankruptcy cases to start on time. In part that is because the optimal time for bankruptcy probably isn't the moment of insolvency, but somewhat earlier—when equity's incentives begin to get distorted from those of a solvent residual owner in the slide towards insolvency. In part that is because information flows from the debtor tend to lag reality. By the time a potential new lender realizes that it should insist on a bankruptcy filing as a condition of making a loan, it is likely that the firm should have already been in bankruptcy.[29]

If this is so, then bankruptcy could be improved by getting cases to start even somewhat earlier. The trick, as always, is how to accomplish this, without making the cure worse than the disease. We think there is no silver bullet, but there are a series of steps that are worth exploring.

The first is to pick up on one of the (few) good ideas that emerged out of the Dodd-Frank Act's regulations for significantly important financial institutions: Living

[28] Bankruptcy Code § 364.
[29] There is a robust legal debate about this. See Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 Va. L. Rev. 1199 (2005); Robert Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 Wash. U. L.Q. 1159 (1994); Barry Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. Chi. L. Rev. 575 (1995); Barry Adler, *Bankruptcy and Risk Allocation*, 77 Cornell L. Rev. 439 (1992).

wills.[30] At least for firms over a certain size, a requirement that the firm have, on file, and subject to review and challenge, a document, regularly updated, specifying how a bankruptcy proceeding would unfold, would have important benefits. Most significantly, these procedures, spelled out in advance and known to creditors and regulators, would remove some of the uncertainty about what would occur if and when a bankruptcy case commences. The most obvious objection to the living will approach is the added cost of creating and updating the resolution plan. Although this is a legitimate concern, it is important to recognize that preparing a living will for even a very large corporation would not be nearly as complex as for the systemically important financial institutions that have recently prepared living wills as required by the Dodd-Frank Act. A living will requirement for some subset of the largest firms not only could facilitate the bankruptcy case itself, but conceivably the reduction in uncertainty would make the case more palatable to creditors, if not to the debtor itself. It would also facilitate a potential role for the SEC or other regulators in terms of the commencement of the case, an idea we introduce shortly.

The second, we believe, is to reintroduce the possibility of the filing of an involuntary petition based on the debtor's balance-sheet insolvency or unreasonably small capital. That is, add to the existing "cash flow" test for involuntary bankruptcy, a provision permitting the filing of an involuntary petition that can withstand challenge based on "balance sheet" insolvency. The reasons for its removal—that balance sheet insolvency is difficult to ascertain; that creditors will abuse their ability to file based on

[30] The Dodd-Frank Act requires that every systemically important financial institution file a rapid resolution plan indicating how it would respond to financial distress, including the steps it would take to minimize the risk of systemic spillover effects. Dodd-Frank Act section 167(d).

such a test—seem not to have passed the test of time. While balance sheet insolvency may be difficult to ascertain, so, too, may be a standard of generally not paying debts as they become due, particularly when the debtor may be selectively paying some (favored) creditors while ignoring others.[31] Moreover, at least for larger firms, the true problem does not appear to be the possibility of abusive filings, but delayed filings. While reintroduction of a balance sheet insolvency test will not, itself, significantly solve the problem, it is at least a step in the right direction.[32]

The third, and related to the first two, would be to permit the SEC, or other identified primary government regulator, to file an involuntary petition on the same basis as creditors—and subject to the same right of the debtor to challenge the filing.[33] This idea has been floated as a part of a proposed Chapter 14 for the nation's largest financial institutions, in terms of giving the FDIC the right to file involuntary petitions under a balance sheet insolvency test,[34] and we believe it deserves broader consideration, precisely because the concerns identified in Chapter 14 are not themselves limited solely to *financial* institutions. Moreover, involving the SEC (or primary regulator) at the commencement of the bankruptcy case may provide it with a

[31] To continue with the Johns Manville example: When there are latent tort creditors, it would be possible to "generally pay debts as they become due" to existing, liquidated, creditors for quite some time, even though the firm was hopelessly insolvent in a balance sheet sense.

[32] If one wanted to proceed cautiously, one could limit invocation of this balance sheet insolvency test to creditors holding, in the aggregate, more than five percent or $1 million in claims (or some such similar numbers).

[33] We recognize that there may be a certain irony in this suggestion. The great innovation of 1938's Chandler Act was the prominent role of the SEC in reorganizations under Chapter X—a role that was largely repudiated in the Bankruptcy Code of 1978. **David Skeel, Debt's Dominion**, *supra* note 4, at 119-123, 160-183. We do not anticipate the SEC having the same power to dictate the reorganization process that it had under Chapter X; and unlike with Chapter X, the parties would retain principal decision making authority.

[34] "Bankruptcy Code Chapter 14: A Proposal," February 2012 (Resolution Project sub-group of the Working Group on Economic Policy at the Hoover Institution). In the interest of disclosure, both of us are members of the Resolution Project and played a role in the drafting of the Chapter 14 proposal.

role within the court-supervised process that will mitigate "side door" efforts by government to intervene to bail the firm out or to save jobs later down the line—issues that we take up in the next part of this paper.

Moving to perhaps somewhat more radical, or at least controversial, suggestions, we believe it is worth considering—albeit with caution—a modest series of incentives and penalties to nudge the primary players to commence a more timely bankruptcy proceeding. Let us suggest three, although there are surely others.

(1) Consider adding an incentive—a bounty—for the debtor—through its equity decisionmakers—to file a bankruptcy proceeding rather than delay in the hopes of striking gold. We are thinking of something that would preserve, in a successful reorganization, a small portion of value—and hence upside—for the old equity holders. For example, consider a regime in which equity would retain a percentage of the difference in value between the going concern value of the assets (as determined by a market-driven valuation process) and the piecemeal liquidation value of the assets, with the size of the percentage determined inversely with respect to how insolvent the firm was.[35] Thus, for example, a firm that files at the tipping-point of insolvency—when assets and liabilities are in equipoise—that successfully reorganizes might allocate 10% of the difference between going-concern and liquidation value to equity,[36] whereas a firm that files at a point when liabilities exceed assets by a significant amount would not allocate any value to equity. This idea is, admittedly, somewhat

[35] One of us proposed a similar strategy for encouraging timely initiation of bank insolvency proceedings some years ago. David A. Skeel, Jr., *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 Tex. L. Rev. 723 (1998).
[36] The reason for the allocation is pragmatic, not principled. It is not based on any underlying sense that the nonbankruptcy world should, for example, limit creditors to their liquidation values in any form of reorganization.

crude[37] and subject to considerable measurement problems.[38] But to the extent there is thought to be a cost to the current system—late commencement of bankruptcy cases—that causes a destruction in value, the question is whether such a bounty would produce benefits that exceeded its easy-to-imagine costs.[39] We think that, sensibly designed, there is a plausible case that the answer to this is "yes."

(2) One could, in parallel fashion, consider a bounty for the actual creditors who filed an involuntary petition that was either unchallenged or that withstood challenge. Again, to avoid perverse incentives, the bounty would probably need to be modest, but enough to encourage at least some offset to the natural inclination of creditors to see little reason to do anything other than seeking payment (or security) rather than the commencement of a bankruptcy proceeding. For illustrative purposes, we are thinking of something along the following lines: a payment of 105% of the payment ultimately received by other unsecured creditors to the creditors who file an involuntary petition, but in no case more than two percent of the aggregate payments going to the class of unsecured creditors.[40] This alternative has the added advantage of avoiding the need to rely on a valuation made by the court.

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[37] For one example, to again pick on Johns Manville, the past tort liability, by the time it became known, may have put Johns Manville completely under water. Even so, as the magnitude of the emerging liability unfolded, a rule such as we discuss in text conceivably could have led to a somewhat earlier bankruptcy filing.

[38] Even with a going-concern sale of the business, which determines the going-concern value, who determines the hypothetical liquidation value? We would lean towards a court-determined liquidation value, led by a court-appointed valuation expert, but this admittedly reintroduces some of the court-determined valuation issues that (intentionally) dominated early reorganizations under the 1978 Bankruptcy Code and that recent practices have tended to deviate from.

[39] See, for example, Barry E. Adler, Bankruptcy and Risk Allocation, 77 Cornell L. Rev. 439 (1992)(arguing that permitting shareholders to recover in bankruptcy increases ex ante risk taking incentives).

[40] To ensure that creditors filing an involuntary petition don't first receive partial payments, wait out the preference period, and then commence an involuntary case, it would be possible to limit the

(3) As has been noted, other than the transaction costs of receiving a preferential payment and the associated costs of needing to return the payment, preference law's deterrent effect is limited—or, at least, incomplete. It has been observed before that it seems to be commonplace that a bankruptcy case is commenced shortly after the running of the preference period on a large payment, and that this is probably more than a coincidence.[41] The creditor's interests—particularly a creditor with influence over the debtor—are (a) to receive payment and (b) delay bankruptcy until 90 days have passed. While it makes no sense to penalize all preferences—too many are innocent or inadvertent (well beyond the safe-harbor rules of Section 547)—it would be possible to create a deterrent rule that attempted to separate the advertent from the inadvertent preference. It would make considerable sense, we believe, to consider adding a modest penalty—perhaps five or ten percent of the amount of the preference received—for any creditor who receives a preference with "actual intent to avoid an imminent bankruptcy proceeding."[42] While bright-line rules have a great deal of virtue, particularly in terms of administrative simplicity and avoidance of wasted litigation costs, the "actual intent" test appears elsewhere,[43] while the incremental penalty is small enough so as to make its invocation unusual except in the case of either

bounty payments to creditors who had not received a preferential payment within six months of the commencement of the bankruptcy case. We tend to think this unnecessarily complicates things, and the complementary adoption of our next proposal—placing a penalty on intentionally opt-out preferences—would be sufficient.

[41] **Barry Adler, Douglas Baird & Thomas Jackson, Cases, Problems and Materials on Bankruptcy** 353 (4th ed. 2007).

[42] This might be coupled with an extended preference period for such preferences in the case of significant lenders—or significant preferences—to get at the "big creditor [who] can twist the debtor's arm, bleed the debtor dry, and then prop it up for ninety-one days," *id.*, even though the creditor isn't formally an insider under Bankruptcy Code § 101(31).

[43] E.g., Bankruptcy Code § 548(a)(1)(A); see also Bankruptcy Code § 550(b).

large—or flagrant—violations. In addition, its presence is perhaps as valuable for its "in terrorem" effects as for its actual ex post impact.

Finally—and before leaving the topic of improving bankruptcy's role in facilitating economic recovery and growth through improving ways to ensure that a bankruptcy proceeding doesn't commence too late—we should note a more general issue. Both of us have written, together and separately, about concerns we have had with the whole-sale exception of qualified financial contracts from bankruptcy's automatic stay and preference provisions.[44] Among our objections is a belief that by attempting to insulate counterparties—often the most sophisticated of entities involved with a debtor—from the consequences of bankruptcy, these safe harbors have weakened the incentives of some of the most effective monitors of the firm from doing precisely that monitoring. Good monitoring carries positive externalities. It protects not just the creditors doing the monitoring, but the broader group of creditors as well. And the signal sent by a counterparty who bears costs in bankruptcy of efforts to withdraw from the debtor or shore up its position, may be one of the most effective ways for other creditors to realize that a bankruptcy proceeding is inevitable, and should be started sooner rather than later.

Our point in mentioning this here is that the lesson isn't just about counterparties to qualified financial contracts, or the effects on monitoring of protecting them from the consequences of bankruptcy. The point may be generalized. Rules that

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[44] These exclusions generally appear in Bankruptcy Code §§ 362(b)(7), (17), (27); 546(e) - (g), (j); 559-562. Our concerns can be found in Darrell Duffie & David Skeel, *A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements*, at http://ssrn.com/abstract=1982095; David Skeel & Thomas Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 Colum. L. Rev. 152 (2012).

interfere with effective creditor monitoring, or the free-flow of visible information, interfere with a positive externality that is one of the better ways to have creditors understand what might be going on as a firm slides towards insolvency. Keeping those mechanisms—and channels of information—open is, itself, one of the most effective ways we know of to ensure that knowledge is disseminated and bankruptcy proceedings commence on (or at least closer to on) time. One needs to think twice about ex ante rules that protect particular creditors from bankruptcy's impact, as well as from any sense that there will be ex post bailouts or protections of particular creditors, which have similar impacts on monitoring and the consequent dissemination of information to the creditors as a group.

### B A Conflict of Goals: The Efficient Use of Assets vs. "Saving Jobs"

In our view, effectively addressing the two structural issues we have addressed—the common pool problem and the optimal decisionmaker problem—is the most important contribution bankruptcy can make to economic recovery, the focus of this book. But it is also almost certainly the case that most people, looking at measures of economic recovery, will pay particular—although, obviously, not exclusive—attention to issues of job creation and employment levels. Appropriately so.

Why, then, have we not really focused on issues of jobs and employment? There is a specific reason for that. Throwing in an explicit focus on jobs into bankruptcy, at least as an independent policy (or one that takes on a life of its own), we believe, more often than not, causes an unintended conflict with the issue of asset deployment that, at least for firms, bankruptcy is so uniquely suited to address. While we believe the concern about jobs—and job preservation—is pervasive, and seems almost impossible to keep out of bankruptcy at one level or another as an independent focus or policy, we also think that heightened attention to its disruptive effects when used as an independent focus of bankruptcy is at least a worthwhile, albeit partial, palliative. To be sure, in the case of a successful reorganization, the two policies—economic efficiency and job preservation (if not growth)—tend to merge. But where the economic decision about what to do with a firm's assets points to a possible liquidation, the two policies tend to come into conflict.

We take seriously the issue of job creation—and the dislocations caused by job termination—but think pressing this into bankruptcy as an independent policy along asset deployment, asks too much of bankruptcy. The issue of jobs, if inconsistent with the issue of asset-deployment, should generally be addressed transparently and humanely through other vehicles. Bankruptcy's solutions for the use of assets are necessarily "micro," whereas too often the focus on "jobs" in bankruptcy has unintended, and indeed perverse, "macro" implications. In this part of the paper, we will attempt to explain why this is so—but only after a short primer on the history of bankruptcy reorganization and a concern about jobs.

1. Bankruptcy and Jobs: A Brief Primer

Bankruptcy's core statutory rules—again, when the focus is on firms—are concerned with requiring creditors to work for the collective benefit of all, rather than focus on saving their own hides, and then distributing the results according to the principle of absolute priority, which means senior creditors get paid in full out of assets to which they have senior claims prior to junior classes receiving anything on account of their claims or interests.[45] This can be seen, perhaps most clearly, in the distribution rules in Chapter 7, the so-called "liquidation" chapter. Rules that apply to all bankruptcy proceedings—reorganizations and liquidations alike—include basic "collectivizing" rules. Thus, as we noted earlier, the automatic stay stops individual creditor collection efforts.[46] Incomplete—executory—contracts that potentially have a net value to the debtor are treated like assets, and thus counterparties are prohibited from terminating the contract.[47] Preferences—eve-of-bankruptcy payments to (particularly) unsecured creditors are treated as efforts to opt-out of bankruptcy, in conflict with the collectivization rule, and are thus unwound if done within 90 days of bankruptcy (or one year in the case where the recipient is an "insider" with presumably better knowledge of a forthcoming bankruptcy).[48] And the assets that have been "collectivized" are then sold (prototypically, in piecemeal fashion) and the proceeds are distributed to the claimants according to the absolute priority rule.[49]

But the genius of bankruptcy's rules doesn't shine in the prototypical liquidation under Chapter 7. The assets are liquidated—which would have occurred outside of bankruptcy as well. There is a more even distribution among creditors of the value of those assets—the basis of the now almost timeless phrase "equality is equity"—than would have occurred outside of bankruptcy, but the systemic economic benefits of that are not particularly clear.

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[45] As we saw in the prior part, related to this is a shift in decisionmaking from equity to creditors. For present purposes, we can safely set this related policy aside.
[46] Bankruptcy Code § 362.
[47] Bankruptcy Code § 365.
[48] Bankruptcy Code §§ 547 (preferences); 101(31) (insider).
[49] Bankruptcy Code §§ 725, 726.

Where bankruptcy proves its weight in gold is in the reorganization arena. Here, the "collectivizing" rules have real consequence. If the assets are worth more together, they can be kept together. Unlike the prototypical Chapter 7, where the issue is inter-class distribution, but the asset use inside and outside of bankruptcy is more or less the same, Chapter 11 rather dramatically changes the asset use outcome from outside of bankruptcy to inside of bankruptcy. It is the ability (but not the requirement) to keep the assets together that makes bankruptcy an essential tool in a free-market/entrepreneurial economy, concerned with moving assets to their highest-and-best use. In theory, these assets (kept together) could be allocated exactly the same way as they were in Chapter 7, strictly according to the principles of the absolute priority rule.

When the economic decision is to keep the firm together as a going concern, there is at most a muted conflict with the interests of workers (or the surrounding community). The (existing) workers get what they want—or, at least, as much as they could reasonably hope for under the circumstance. When reorganization "works" because it keeps assets from being ripped apart, there is likely to be a large congruence between the decision what to do with assets and the spill-over effects on workers and others. But when a firm faces not only financial but economic failure—meaning that its assets would be better deployed elsewhere than in the continuation of the firm—the interests of creditors and the interests of (existing) workers almost certainly diverge. It is here where the legal landscape created by the Bankruptcy Code matters in terms of how it addresses this divergence in interests.

The framework of the 1978 Bankruptcy Code, as originally conceived, assumed assets would be sold in Chapter 7, the liquidation chapter, but presumptively reorganized pursuant to a negotiated plan rather than sold in Chapter 11, the reorganization chapter.[50] If it was obvious that assets truly needed to be liquidated, the procedures of Chapter 7 were optimal, and the plight of workers (or communities) got little, if any, attention. But the incentives to use Chapter 11, and its negotiation framework, even for firms that were unlikely to reorganize, were strong. As we have already seen, almost all bankruptcies are (so-called) "voluntary," and debtors have enormous incentives to try to keep things going, if not outside of bankruptcy, then inside of it.

Without a premise that assets would be sold, the structure of Chapter 11 necessarily built itself around issues of valuation, conflicts over valuation, and their resolution. The solution written into the Bankruptcy Code of 1978 was an extended period for the debtor (in possession, usually) to have to formulate and file a plan of reorganization, and during such time no other party in interest could file a competing plan.[51] There was then an additional period to solicit acceptances and a vote on the plan.[52] Valuation disputes would be resolved by the bankruptcy judge.[53] Individual creditors would be protected by a "liquidation" standard;[54] only a class of creditors could

[50] Enough so that if a reorganization looked to be infeasible, the structure seemed to assume that the case would be converted to Chapter 7. See Bankruptcy Code § 1112(b).
[51] Bankruptcy Code § 1121(b) (120 days). The period may be reduced or extended (up to a total of 18 months). Bankruptcy Code § 1121(d). That limit on extensions was added in 2005; prior to that time, there was no limit on possible extensions.
[52] Bankruptcy Code § 1121(c)(3) (presumptive total of 180 days).
[53] Bankruptcy Code §§ 1128, 1129.
[54] Bankruptcy Code § 1129(a)(7)(A)(ii).

invoke the absolute priority rule by voting against the plan.[55] And, even then, the resolution of that would turn on valuation issues (over the firm as a whole and over the claims against the firm being issued) that were being resolved by a bankruptcy judge, not by the market.

In the early years after the adoption of the Bankruptcy Code of 1978, reorganization proceedings under Chapter 11, following these procedures and instincts, were likely to be lengthy and driven by valuation disputes. The "exclusivity period"—the period in which the debtor (in possession) had to file a plan of reorganization—was routinely extended beyond 120 days, often to a period exceeding (sometimes greatly exceeding) a year. Not only did delay—potentially advantageous to equity, just as it was outside of bankruptcy[56]—continue, but the lack of resort to, or reliance on, market-valuations meant that the bankruptcy judge was making the "live or die" valuation decisions about whether a firm should continue or be liquidated and whether the firm's valuation included enough for a greater participation by creditors, or even equity.

Not surprisingly, faced with the role of potential executioner, bankruptcy judges were inclined to be optimistic about going concern possibilities, and thus valuations. Doing so had two salutary—from the perspective of the bankruptcy judge—benefits: Participation rights could be extended so that more could be around to share in a potential upside than otherwise, and the firm was "kept alive," which clearly reduced the (visible) stress on the workers, the suppliers, and the community that oftentimes surrounded the bankruptcy judge. And these instincts were fueled by a long-standing

[55] Bankruptcy Code § 1129(b).

[56] Although, importantly, the decisions of the debtor in possession were now subject to judicial oversight.

notion that a goal of a bankruptcy reorganization was to "preserve jobs" (rather than—or at least in addition to—finding the highest-and-best use of assets).[57] Optimistic, non-market-driven valuations allowed this to occur, which often meant that the firm ultimately failed to survive (although, of course, fortunes can change—it is a part of the fundamental idea that valuations have upsides and downsides alike), but it meant that the bankruptcy judge was not perceived as the executioner.

Moreover, when prominent bankruptcy decisions were perceived to be destructive of jobs, or the rights of workers, Congress oftentimes stepped in with a fix, to ensure that the rights of workers, and the focus on jobs, was *not* lost in bankruptcy. Prominent examples of this include Section 1113, constraining the ability to reject collective bargaining agreements in bankruptcy[58] and Section 1114, constraining the ability to reduce retiree health care benefits in bankruptcy.[59] In these cases, it would

[57] This is an important part of the disagreement in the now-classic "debate" between Elizabeth Warren and Douglas Baird in 1987 over the purposes of bankruptcy law, primarily in terms of its role in deviating from nonbankruptcy priorities and entitlements. See Elizabeth Warren, *Bankruptcy Policy*, 54 **U. Chi. L. Rev.** 775 (1987); Douglas Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 **U. Chi. L. Rev.** 815 (1987). And it reflects, as well, the reality that bankruptcy law has never been the pure produce of academic analysis, but has always reflected the tugs and pulls of various political perspectives and groups. See **David Skeel, Debt's Dominion**, *supra* note 4, at 14-20.

[58] Enacted in 1986, in response (primarily) to *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984) (unilateral rejection under Bankruptcy Code § 365 of a collective bargaining agreement did not violate the National Labor Relations Act).

[59] Added in 1988 as a part of the Retiree Benefits Bankruptcy Protection Act of 1988, in response to LTV Corp.'s termination of health and life insurance benefits of 78,000 retirees during its 1986 bankruptcy. See generally *In re Visteon Corp.*, 612 F.3rd 216 (3rd Cir. 2010). The actions (or decisions) that prompted these Congressional responses were not necessarily correct as a matter of bankruptcy policy. There is a strong case to be made that the "attributes" of workers under a collective bargaining agreement, in particular, are such that neither the firm, nor its creditors, can unilaterally change the terms of those agreements during its life outside of bankruptcy. And, under the principle that "attributes, not labels" control, first prominently given recognition in *Chicago Board of Trade v. Johnson*, 264 U.S. 1 (1924), the rejection of collective bargaining agreements in bankruptcy may have been mistaken—just as the rejection of auto franchise agreements may have been incorrect, given the nature of state franchise laws, in the recent bankruptcies of Chrysler and General Motors. But our point isn't the abstract "correctness" of the decisions, as a matter of

be hard to argue with the perception that decisions that focused solely on the highest-and-best use of assets were running headlong into other political and policy considerations.

At almost the same time, efficiency considerations about the best use of assets began to erode some of the formal structure and rules of Chapter 11, particularly in its reliance on exclusivity periods, negotiation, and judicial "umpiring" over valuation. Whether in response to creative lawyering, academic criticism, or judicial awareness—or, very probably, all three—while the formal structure of the Bankruptcy Code of 1978 as it applied to reorganizations did not change in significant respects, practices pursuant to it did.[60] Creditors began to push for "going concern sales" of the firm—and hence for market-based valuations of the assets of the firm. A general bankruptcy provision, almost certainly originally thought to apply generally in Chapter 7 and to the sale of stray, unwanted, assets in Chapter 11, began to be used in Chapter 11 as a vehicle for the sale of the firm as a whole.[61] Almost simultaneously—and indeed, in a practical sense, related— lenders began to exert increasing control over the case by including stringent covenants in their loan agreements with the debtor. Indirectly and at times directly, these covenants effectively cut back on a debtor's exclusivity period.

Together, these two changes had several dramatic effects. First and foremost,

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bankruptcy law and policy, but the obvious Congressional response to decisions that were perceived to be "worker unfriendly."

[60] See **David Skeel, Debt's Dominion**, *supra* note 4, at 213 ("[l]aw-and-economics scholars and their insights had remarkably little influence on the 1994 commission . . . but actual bankruptcy practice has taken on many of the market-oriented characteristics that these scholars have advocated").

[61] The provision is Bankruptcy Code § 363, providing for the "use, sale, or lease of property" of the estate. The major cases heralding the new era were *In re Lionel Corp.*, 722 F.2d 1063 (2nd Cir. 1983) and *In re Braniff Airways*, 700 F.2d 935 (5th Cir. 1983).. See generally Douglas Baird, *The New Face of Chapter 11*, 12 **Am. Bankr. Inst. L. Rev.** 69 (2004); Douglas Baird & Robert Rasmussen, *The End of Bankruptcy*, 55 **Stan. L. Rev.** 751 (2002).

they severed the decision as to what to do with the assets from the fights over how to distribute the value of those assets. The assets could now be sold early in a bankruptcy process, even while some fights over the validity of claims or priorities had not yet been resolved.[62] Second, and equally importantly, they substituted judicial valuations of the assets with market valuations. If the assets were worth more alive than dead, it was expected that the market bids would reflect this.[63] And, finally, without asset valuations to fight about, there was no longer much room to argue about the impact of the decision as to what to do with assets on workers or the community. A shift in practice had accomplished what hard-edged legal rules seemed to have been unable to accomplish.

2. The Lessons of Chrysler

But the story wasn't finished, as the dramatic example of the 2009 Chrysler bankruptcy reveals. For whatever reasons—natural political instincts to protect visible and numerous jobs is probably reason enough to have prompted the bailout of crisis without needing to get into more union-support-buying notions—the federal government had a keen interest in preserving the jobs of Chrysler's workers. We would assert that the resulting Chrysler sale and reorganization "saved jobs," but only in a very perverse understanding of when, how, and why jobs are, or should be, preserved.

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[62] The Bankruptcy Code explicitly allow the assets to be sold "free and clear" of many, if not most, claims. Bankruptcy Code § 363(f). For an argument that overriding doctrines of successor liability may make sense under certain circumstances, see Thomas Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 J. Legal. Studies 73, 94-97 (1985).

[63] Although we generally applaud the increased use of sales, as is evident in the text, there may be some grounds for concern when the debtor's lender is also a potential buyer or insiders of the debtor will move to the acquiring firm. See Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. Chicago L. Rev. 425, 465-67 (2006).

To understand our perspective, it is worth dropping back to the *first* Chrysler bailout by the federal government from 1980, as the dynamics are clearer—although they apply equally well to the Chrysler reorganization of 2009.[64] In the first Chrysler bailout, we were at a period in America where, through agreements brought about by political pressure, Japanese automotive companies—virtually none of whom at that time had U.S.-based plants—agreed by 1981 to "voluntarily" limit imports to the American car market,[65] and probably had begun do to so even earlier, in fear of the political reaction in Washington, D.C. Demand for those Japanese cars was well-nigh universally conceded to exceed that "voluntary" quota, which thus performed as an artificial constraint on foreign supply. Given that, whether Chrysler lived or died in the early 1980s, as a first approximation, affected not *the number* of domestic cars that would be sold—something that was largely demand-driven—but *which entity* would sell them.[66] In a fixed-demand world, the more cars Chrysler sold, meant the fewer cars

[64] The foundation for the 1980 Chrysler bailout was the passage of the Chrysler Loan Guarantee Act that gave a U.S. government guarantee to $1.5 billion in private loans to Chrysler. The loans carried an interest rate of around 10%, which was approximately four percentage points below market at the time, and the U.S. government received warrants for 14.4 million shares of Chrysler stock. In addition, the loan guarantee statute required $2 billion in commitments or concessions from "owners, stockholders, administrators, employees, dealers, suppliers, foreign and domestic financial institutions, and by State and local governments." Pursuant to pressure from the Treasury Department, most of the concessions came from lenders. Chrysler was able to pay off nearly $600 million of debts at 30 cents on the dollar and it converted nearly $700 million of debts into a special class of preferred stock. The essential public justification for the bailout was the savings of perhaps as many of 200,000 U.S. jobs by keeping Chrysler afloat. See generally **Barry Ritholtz, Bailout Nation: How Greed and Easy Money Corrupted Wall Street and Shook the World Economy** (2009); The Heritage Foundation, "The Chrysler Bail-Out Bust," at www.heritage.org/research/reports/1983/07/the-chrysler-bail-out-bust.

[65] See generally, Stephen Cohen, "The Route to Japan's Voluntary Export Restraints on Automobiles," at www.gwu.edu/~nsarchiv/japan/scohenwp.htm.

[66] There is a small "supply side" argument that Chrysler produced some cars that enhanced demand. We set this aside, because it is both unlikely to be a significant factor in any case, as well as because if Chrysler excelled at this dimension, it almost certainly wouldn't have required a bailout in 1980!

that were being sold by General Motors and Ford—the other two domestic automobile producers of any consequence.[67]

Given this, it seems uncontroversial—which is different from saying that it was clearly understood either then or now—that bailing Chrysler out in the early 1980s meant that Chrysler sold more cars than otherwise, and General Motors and Ford, fewer.[68] Assuming that Chrysler was the least-efficient producer as of 1980 (which seems reasonable in light of the 1970s—and even more so in hindsight), this story has dramatically different implications when one starts from the efficient use of assets than when one starts from a concern about jobs. From the perspective of the efficient use of assets, rescuing Chrysler was a mistake. From this perspective, we want efficient producers,[69] which Chrysler wasn't. Oligopoly concerns aside, you would want to shift production from the inefficient Chrysler to the more efficient General Motors and Ford. Chrysler would lose jobs (or close), but General Motors and Ford would presumably increase employment (as well as purchases from suppliers) as they picked up the market share previously held by Chrysler.

But this shift is exactly wrong if one's starting point is "preserving jobs." Efficient producers usually are those who have figured out how to make something at the lowest cost, which oftentimes implies equal outputs with fewer inputs—including human capital inputs. If one's highest priority is to "save jobs," it means, rather

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[67] American Motors was still in existence, as was DeLorean Motor Company.
[68] See Heritage Foundation, *supra* note 64 ("Chrysler has increased its market share *not* by making inroads into foreign competition, but by taking customers away from other domestic manufacturers").
[69] Here, we're speaking relatively—among the "Big Three." The reason for the import restrictions was largely based on the enormous efficiencies of Japanese manufactures at this time, particularly in terms of quality, over domestic manufacturers.

perversely, throttling back on the efficient producer, and propping up the inefficient producer. Moreover, the jobs that are "saved"—those of Chrysler—are highly concentrated and visible, while the jobs that are "lost"—cutbacks by General Motors and Ford—are harder to attribute to a single event (or to the government's intervention itself).[70] A political focus on "jobs" has every incentive to favor the inefficient over the efficient—which is dramatically at odds with the other recognized, and firmly-entrenched, bankruptcy policy about the efficient use of assets.

With this, we can now see clearly what occurred in Chrysler's 2009 bankruptcy proceeding—albeit with some inexplicable "nodding" by the judiciary (until the final Supreme Court action vacating all that had happened before).[71] Chrysler, again almost certainly the least efficient producer , was faced with extinction by the reality of a market that was hugely overbuilt in terms of capacity. (Annual capacity for the U.S.—

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[70] *Id.* ("[u]nrepresented and unheard was a huge 'invisible' constituency [that] included current and future laid-off Ford and General Motors workers, who never understood that their tax dollars were being used to destroy their own jobs in order to save jobs at Chrysler").

[71] While the bankruptcy judge's opinion permitting the sale under dubious procedures and restrictions was affirmed in a hasty decision by the Second Circuit, *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009) (argued on June 5, 2009, decided on June 5, 2009, with an opinion issued after-the-fact on August 5, 2009—when its reasoning could hardly contradict its already-issued judgment), the Supreme Court, on December 14, 2010, granted certiorari, vacated the Second Circuit's opinion, and directed that the Second Circuit dismiss the suit as moot. *Ind. State Police Pension Trust v. Chrysler LLC*, 130 S.Ct. 1015 (2010). As a consequence, the Second Circuit's opinion has no precedential value. *United States v. Munsingwear*, 340 U.S. 36 (1950). This rather remarkable step—since the Supreme Court in July had issued, and then lifted, a stay, following the Second Circuit's ruling (and prior to the Second Circuit's written opinion justifying that ruling), allowing the sale to be consummated, 129 S.Ct. 2275 (2009)—has led some to speculate that the Supreme Court's vacating the Second Circuit opinion six months after the Court lifted the stay allowing the sale to go forward "was an expression of its disagreement with the Second Circuit's interpretation of the requirements of § 363(b)," Fred David, *Interpreting the Supreme Court's Treatment of the Chrysler Bankruptcy and its Impact on Future Business Reorganizations*, 27 Emory Bankr. Developments J. 25, 27 (2010), found at http://www.law.emory.edu/fileadmin/journals/bdj/27/27.1/David.pdf. This is plausible, since at the time the Supreme Court lifted the stay and allowed the transaction to be consummated, the Second Circuit had not yet written its opinion explaining its reasons for affirming the bankruptcy judge's decision to allow the sale to go forward as then structured. When the Second Circuit wrote its opinion, it is possible members of the Supreme Court realized its flaws and hence took a later opportunity to vacate the opinion. Speculation, yes—but *hopeful* speculation!

domestic and foreign—was running in excess of 17 million vehicles, while steady-state demand, at least over the foreseeable future, looked as though it would be running closer to 10-13 million vehicles. Pulling close to a quarter of capacity out of the system was going to be painful, no matter how it occurred. Jobs were going to be lost. Dealers were going to be shuttered. Suppliers and communities were going to feel the impact.) Economic reality dictated that the question was not going to be "whether," but "who."

But—just as in the 1980s—the insistent political focus on "saving jobs" meant rescuing the least efficient producer.[72] Had Chrysler been liquidated, perhaps through a sale of some or all of its assets to Fiat or another buyer, its then-existing secured creditors (protected in a liquidation by the absolute priority rule) may well have done better. In addition, the more efficient producers—Ford and others (now often with U.S.-based plants)—would have continued, without the ancillary need for them to reduce capacity (and jobs!) nearly as much as before. By saving Chrysler, the government may well have saved jobs, but only in the Orwellian universe where it make sense to punish the more efficient because they produce using fewer jobs than the less efficient. The government saved Chrysler jobs—a concentrated and identifiable group. To say that the government "saved jobs" overall both ignores the repercussions felt by other manufacturers in responding to a reduction in demand (and capacity) from 17 million vehicles to 10-13 million vehicles, as well as to take credit for the jobs that *are* saved by propping up the least efficient producer!

[72] That it did so by almost certainly trashing bankruptcy priority rules along the way is a part of this sad story. See Mark Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 **Mich. L. Rev.** 727 (2009); see also http://www.scribd,com/doc/14952818/Objection-to-Chrysler-Sale-Motion (brief filed on May 4, 2009 in the SDNY bankruptcy court by Chrysler's non-TARP secured lenders).

So, what does this story have to do with bankruptcy, and its role in economic growth and recovery? The result in Chrysler's 2009 bankruptcy occurred only because the government strong-armed the bankruptcy process, and the judicial system didn't resist. But the story is deeper than this. The government's intervention in Chrysler can be seen as a direct response to the changes in practice that made it more plausible to use market-valuations for Chrysler's assets. Perhaps a going-concern sale that played by neutral competitive bid rules would bring in less value than a sale of the Jeep brand to one firm, the sale of various real estate owned by Chrysler to a variety of local buyers, and the sale of one or two of Chrysler's most efficient plants to other automotive companies. But the government made it impossible to determine this. Even if the judicial system wasn't as slow as it seemed to be to respond to this abuse of bankruptcy law and policy, the government may have had its way anyway. Most of the secured lenders to Chrysler were the recipients of TARP funds. Whether through government pressure on those lenders in that capacity, or through the various other hats that the government wears (through Justice, the SEC, OSHA, the IRS, and numerous other pressure points), it is a political reality that the government will have an enormous ability to shape outcomes,[73] while claiming that it wasn't a "bailout" but a justified intervention to "save jobs."[74]

We know of no effective response to this, other than transparency, and a belief that the judicial system, more likely than not, ultimately will "get it right." That response may already be taking shape with respect to the 2009 Chrysler rescue. This is particularly so in the context of current reorganization proceedings, where market sales have become commonplace, and displacing judicial asset valuations. One can, and should, insist on clear procedures that maximize bids—that insist on a true bidding process. Recognizing the complexities of adequate information, the "lemon's" problem, and the "winner's curse,"[75] even so bidding procedures can go a long way towards minimizing these problems, and at the same time, minimizing abuses of the process, such as by artificial constraints on competing bids, which the government insisted upon in Chrysler. Markets, and judicial oversight, cannot magically get everything right, but the process can be set up in a way to maximize the possibilities that abuses will be minimized. The question is not perfection, but alternatives. Given that the alternatives to market valuations are judicial valuations or, it seems, government intervention in one way or another, we believe that the focus should be on making the

[73] See Mark Roe, "A Chrysler Bankruptcy Won't Be Quick," **Wall Street J.** May 1, 2009, at http://online.wsj.com/article/SB124113528027275219.html ("Worse, there could be a legal fight over whether the vote of Citibank and the other 'big four' creditors . . . , who together hold 70% of Chrysler's debt—should be counted toward the two-thirds threshold that would bind the company's other 42 creditors. The Bankruptcy Code requires that the votes of creditors be given in "good faith." It won't be hard for the smaller creditors to argue that Citibank and other TARP recipient's votes aren't in full good faith. In agreeing to Treasury's offer of32 cents for each $1 of their debt, the objectors would say, Citibank and some others were influenced by the fact that Treasury was keeping them afloat with federal subsidies. If this type of litigation begins, it won't be easily resolved.")

[74] Precisely as occurred in the 1980 Chrysler bailout.

[75] Ayotte & Skeel, *supra* note 63, at 465.

market mechanisms as effective as possible, buttressed by judicial oversight and review.

At the same time, the lessons from practice that have evolved away from the 1978 Bankruptcy Code's envisioned structure—one of disclosure, voting, and judicial umpiring—may also suggest that it is appropriate to streamline Chapter 11's approval rules so as to make them more amenable to a quick judicial reorganization rather than an outright sale.[76] Particularly when coupled with mandatory living wills, streamlined procedures can both protect what needs to be protected while minimizing the use of procedures for purposes of delay. While complex firms (particularly without pre-bankruptcy planning) may need the full exclusivity period,[77] most firms with living wills should need significantly less time.[78] Moreover, competing plans—or the pressure of possible competing plans—may go a long way towards reducing the use of Chapter 11 as a delaying mechanism, without needing to resort to going-concern sales under Section 363.

Thus, especially if some of our earlier proposals were implemented, we would favor reducing the exclusivity period significantly—to a presumptive 30 to 60 days—which would both enhance pre-bankruptcy planning and add a dose (or threat) of competition into the reorganization process, without necessarily resorting to Section 363 sales. We would likewise favor reducing the following solicitation and voting period

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[76] Some useful ideas are contained in Daniel Bussel & Kenneth Klee, *Recalibrating Consent in Bankruptcy*, 83 **Am. Bankr. L.J.** 663 (2009).
[77] Lehman Brothers filed its plan of reorganization on the last day of the statutorily-allowed 18 month exclusivity period. Of course, not only was Lehman Brothers extraordinarily complex, it had done zero pre-bankruptcy planning.
[78] Indeed, the increasing use of "pre-packs"—pre-packaged reorganization plans available as the firm files—is already a significant step in confirming the direction we are proposing here as a matter of statutory limits.

to a presumptive additional 30 days. With streamlined disclosure and solicitation rules, these proposals will go a long way towards making the original structure contemplated in 1978 "competitive" again with the evolving practice towards market-based sales.

## Concluding Comments

Accomplishing a world in which bankruptcy maximized its contribution to economic growth and recovery would be aided by a clear understanding that one can only ask bankruptcy to do so much. If it is to allocate assets to their highest and best use, it probably should not be asked, as a matter of an independent policy, to save jobs as well. Rather, that concern should be the focus of other legal rules and government policies, whose advantages and trade-offs are open and accessible, rather than hidden in a complex, and (speaking politically) difficult to understand procedure. If the government was to provide assistance (whether training grants or other forms of economic assistance) to Chrysler workers who lose their jobs as a result of a liquidation of Chrysler, that decision can be argued on its own merits. The irony of the failure to do so is that the workers of the other auto manufacturing firms that inevitably lost jobs as a result of the Chrysler bailout, never had the opportunity for a discussion about similar assistance to them.