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Through Bankruptcy with the Creditors' Bargain Heuristic

Robert E. Scott†

Cases, Problems, and Materials on Bankruptcy. DOUGLAS G. BAIRD & THOMAS H. JACKSON. Little, Brown & Company, Boston, Mass., 1985. Pp. xxix, 1049. $31.00.

It is a commonplace, but nonetheless true: the study of bankruptcy has attained a new respectability in American law schools. After years of modest enrollments and few genuine scholarly contributions, bankruptcy courses are now fully subscribed and many young academics are turning their attention to the technical complexities and conceptual underpinnings of modern bankruptcy law. A number of factors contribute to this new-found glamour. Most obviously, the enactment of the new Bankruptcy Code has fueled scholarly interest in reporting its modifications and changes and in exploring its theoretical unity. Simultaneously, there has been increasing resort to the bankruptcy process to resolve vexing conflicts between the societal interest in reducing the costs of business failure and the allegedly overriding interests in preserving collective bargaining agreements,[1] compensating victims of defective

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† Lewis F. Powell, Jr. Professor of Law, University of Virginia. I would like to thank Michael Dooley and Paul Stephan for helpful comments. I am also indebted to Erin Kellerman (J.D. 1986) for her research assistance in the preparation of this essay. Ms. Kellerman contributed in important ways to the discussion of risk sharing and general average in Part II.

[1] Section 365(a) of the Bankruptcy Code, 11 U.S.C. § 365(a) (1982) [hereinafter cited without cross-reference], permits a trustee to reject, with the bankruptcy court's approval, the executory contracts of the debtor business. A bankruptcy procedure that permits the unilateral termination of a collective bargaining agreement permits an employer to do what otherwise would be a serious unfair labor practice under § 8(d) of the National Labor Relations Act, 29 U.S.C. § 158(d) (1982). Nevertheless, the courts have uniformly treated labor agreements as executory contracts and held that the agreements could be rejected in a Chapter 11 reorganization proceeding. *See, e.g.,* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 522 n.6 (1984); *In re* Brada Miller Freight Sys., 702 F.2d 890, 894 (11th Cir. 1983); Local Joint Executive Bd. v. Hotel Circle, Inc., 613 F.2d 210, 212-14 (9th Cir. 1980); Brotherhood of Ry., Airline & S.S. Clerks v. REA Express, 523 F.2d 164, 168-69 (2d Cir.), *cert. denied,* 423 U.S. 1017 (1975), *and cert. denied,* 423 U.S. 1073 (1976); Shopmen's Local Union No. 455 v. Kevin Steel Prod., 519 F.2d 698, 706 (2d Cir. 1975). The Bankruptcy Amendments of 1984 added section 1113 to the Bankruptcy Code, 11 U.S.C.A. § 1113 (West Supp. 1986), which requires the debtor to make a proposal to the union regarding modifications to the collective bargaining agreement before seeking rejection of the agreement. The bankruptcy

products,[2] and insuring the removal of toxic waste and other environmental hazards.[3] Finally, and most significant, the bankruptcy process vividly illustrates the tensions between the various maximization and distributional norms that underlie modern theories of legal regulation.[4]

Many scholars have contributed to the renewed academic interest in bankruptcy.[5] Among them, Douglas Baird and Thomas

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court can approve the rejection of the agreement only if the debtor makes the required proposal, the union refuses to accept the proposal "without good cause," and "the balance of the equities clearly favors rejection" of the agreement. *See generally* Note, *Rejection of Collective Bargaining Agreements Under the Bankruptcy Amendments of 1984,* 71 VA. L. REV. 983 (1985) (arguing that a bankruptcy court should require a showing of necessity before permitting rejection of a collective bargaining agreement).

[2] A.H. Robins Co. and Johns-Manville Corp. have filed bankruptcy petitions to reduce their liability for product liability claims. When A.H. Robins filed for reorganization, the company faced roughly 12,000 product liability claims asserted by women who had used the Dalkon Shield birth control device. *See Robins Runs for Shelter,* TIME, Sept. 2, 1985, at 32. When Johns-Manville filed its Chapter 11 petition, 16,500 claimants had suits pending against the company alleging exposure to asbestos. One source predicted that the number of asbestos suits might reach 52,000. *See Manville's Bold Maneuver,* TIME, Sept. 6, 1982, at 17. In addition to Johns Manville, two other manufacturers of asbestos, Amatex Corp. and Unarco Industries, have filed bankruptcy petitions. *See In Re* Amatex Corp., 30 Bankr. 309 (Bankr. E.D. Pa. 1983); *In re* UNL Indus., 29 Bankr. 741 (N.D. Ill. 1983), *appeal dismissed,* 725 F.2d 111 (7th Cir. 1984). For a representative sampling of the scholarly debate surrounding such petitions, see Roe, *Bankruptcy and Mass Tort,* 84 COLUM. L. REV. 846 (1984); Schwartz, *Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship,* 14 J. LEGAL STUD. 689 (1985); Note, *Mass Tort Claims and the Corporate Tortfeasor: Bankruptcy Reorganization and Legislative Compensation Versus the Common-Law Tort System,* 61 TEX. L. REV. 279 (1983).

[3] In response to the increasing costs of cleaning up hazardous waste, several disposal companies have filed for bankruptcy protection. *See, e.g.,* Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection, 106 S. Ct. 755 (1986); Ohio v. Kovacs, 105 S. Ct. 705 (1985); Penn Terra Ltd. v. Department of Envtl. Resources, 733 F.2d 267 (3d Cir. 1984); *In re* T.P. Long Chemical, Inc., 11 COLLIER BANKR. CAS. 2D (MB) 1246 (Bankr. N.D. Ohio 1985). For a representative sampling of the scholarly debate, see Baird & Jackson, Kovacs *and Toxic Wastes in Bankruptcy,* 36 STAN. L. REV. 1199 (1984); Hennigan, *Accommodating Regulatory Enforcement and Bankruptcy Protection,* 59 AM. BANKR. L.J. 1 (1985); Hoffman, *Environmental Protection and Bankruptcy Rehabilitation: Toward a Better Compromise,* 11 ECOLOGY L.Q. 671 (1984); Rosenbaum, *Bankruptcy and Environmental Regulation: An Emerging Conflict,* 13 ENVTL. L. REP. (ENVTL. L. INST.) 10,099 (1983).

[4] While variously described, the major challenge for legal regulation is to harmonize the societal interest in having both guns and butter—that is, pursuing wealth maximization as well as distributional objectives.

[5] While asking forgiveness for errors of omission, any list of seminal scholarship should include (in addition to the work of Baird and Jackson): Clark, *The Duties of the Corporate Debtor to Its Creditors,* 90 HARV. L. REV. 505 (1977); Coogan, *Confirmation of a Plan Under the Bankruptcy Code,* 32 CASE W. RES. L. REV. 301 (1982); Countryman, *Executory Contracts in Bankruptcy: Part I,* 57 MINN. L. REV. 439 (1973); Eisenberg, *Bankruptcy Law in Perspective,* 28 UCLA L. REV. 953 (1981); LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System,* 1982 WIS. L. REV. 311; McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt,* 67 VA. L. REV. 249 (1981); Roe, *Bank-*

Jackson are the two legal academics most closely identified with efforts to reconceptualize modern bankruptcy law. In a series of articles, some authored jointly,[6] others individually,[7] they have set the terms of the scholarly debate for the next decade. The centerpiece of that scholarship is the creditors' bargain heuristic. Using the model of a hypothetical creditors' bargain, Baird and Jackson have demonstrated that the parties affected by a potential bankruptcy procedure would agree in advance to a collectivization process in order to maximize the total pool of assets and to resolve vexing prisoner's dilemma problems. The cornerstone of this theory is the normative claim that pre-bankruptcy entitlements should be impaired in bankruptcy only when necessary to maximize net asset distributions to the creditors as a group, and never to accomplish purely distributional goals.[8]

The creditors' bargain conception is a powerful heuristic, one which illuminates much of the logic of bankruptcy. Nonetheless, it is only partially successful in rationalizing current bankruptcy law. Indeed, Baird and Jackson have isolated numerous instances where current features of the bankruptcy process violate this maximization norm.[9] My purpose in this essay is not to offer a scholarly

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ruptcy and Debt: A New Model for Corporate Reorganization, 83 COLUM. L. REV. 527 (1983); Roe, *Bankruptcy and Mass Tort,* 84 COLUM. L. REV. 846 (1984); Schwartz, *Products Liability, Corporate Structures and Bankruptcy: Toxic Substances and the Remote Risk Relationship,* 14 J. LEGAL STUD. 689 (1985); Shuchman, *An Attempt at a "Philosophy of Bankruptcy,"* 21 UCLA L. REV. 403 (1973).

[6] Baird & 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 (1984); Baird & Jackson, Kovacs *and Toxic Wastes in Bankruptcy,* 36 STAN. L. REV. 1119 (1984); Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain,* 38 VAND. L. REV. 829 (1985).

[7] Baird, *The Uneasy Case for Corporate Reorganizations,* 15 J. LEGAL STUD. 127 (1986); Baird, A World Without Bankruptcy (unpublished manuscript) (on file with the author); THOMAS JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (forthcoming 1986); Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum,* 14 J. LEGAL STUD. 73 (1985); Jackson, *Avoiding Powers in Bankruptcy,* 36 STAN. L. REV. 725 (1984) [hereinafter cited as *Avoiding Powers*]; Jackson, *Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain,* 91 YALE L.J. 857 (1982) [hereinafter cited as *Creditors' Bargain*].

[8] *See Avoiding Powers, supra* note 7, at 727-31; *Creditors' Bargain, supra* note 7, at 868-71.

[9] Jackson discusses a number of instances in which bankruptcy law "systematically ignores" the creditors' bargain vision. For instance, courts exhibit a tendency to grant less than adequate protection to secured parties' claims in reorganization proceedings. *See Creditors' Bargain, supra* note 7, at 872-77. Similarly, bankruptcy law grants the debtor and the bankruptcy trustee broad freedom to choose a non-acceleration-based compensation standard for both lenders and executory contract holders. *Id.* at 879-91. Even more striking deviations from the creditors' bargain model are found in section 544(b) of the Bankruptcy Code, and in the doctrine of Moore v. Bay, 284 U.S. 4 (1931) (allowing trustee to avoid entirely interests a subrogated creditor could have avoided only to the amount of his claim).

assessment of the creditors' bargain conception or to attempt to harmonize the maximization norm with the persistent redistributional tendencies of bankruptcy law.[10] Rather, I mean to focus solely on the pedagogic utility of such a unified conceptual theme as it is embodied in the Baird and Jackson casebook, *Cases, Problems, and Materials on Bankruptcy.*[11]

Reviewing casebooks is a low-ceiling endeavor. In part, my willingness to undertake such a thankless task was fueled by self-interest. Having also authored a casebook with a strong conceptual focus,[12] I was eager to assess the merits of teaching materials that project a single vision. At the outset I should dispose quickly of some basic pedagogic concerns. The substantial strengths of the Baird and Jackson book derive from an inspired organizational structure and equally flawless selection of the principal cases that, in sequence, expose the basic themes underlying the bankruptcy process. Unfortunately, this analytic and thematic clarity is eroded by the authors' aversion to the declarative sentence[13] and the proliferation of conceptually simplistic and distracting problems.

Having paid homage to the reviewer's traditional role, however, I intend to focus in this essay on only one feature of the Baird and Jackson book: its single-minded pursuit of the creditors' bargain vision. My thesis can be simply stated: a conceptual heuristic—such as the creditors' bargain—is an optimal method for analyzing a complex subject for two apparently contradictory reasons. First, the creditors' bargain heuristic has great explanatory

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Jackson observes that from the perspective of a creditors' bargain model, "the Bankruptcy Code's embodiment in section 544(b) of the holding . . . of *Moore v. Bay* is unfortunate [and] the general thrust of section 544(b) is unprincipled." *Avoiding Powers, supra* note 7, at 749-50.

[10] I have suggested elsewhere that a relational theory of secured financing—one that reconceptualizes security as a means of effecting socially beneficial pre-bankruptcy control over the business venture—relieves much of the apparent incompatibility between the maximization and distributional norms. *See* Scott, *A Relational Theory of Secured Financing,* 86 COLUM. L. REV. (forthcoming 1986) [hereinafter cited as *A Relational Theory*]. Indeed, the creditors' bargain heuristic is not necessarily inconsistent with a bankruptcy process that embraces both risk sharing and purely distributional features. *See* Scott, *Bankruptcy Sharing Rules and Pre-Bankruptcy Entitlements,* 72 VA. L. REV. (forthcoming 1986).

[11] D. BAIRD & T. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY (1985).

[12] A. SCHWARTZ & R. SCOTT, COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES (1982).

[13] Baird and Jackson's tendency to string together series of puzzling and frequently rhetorical questions often seems a parody of the classical Socratic style that the intellectual aspirations of the book so clearly reject. For an extreme illustration of this phenomenon, see the "Problem" on page 87 which contains 13 consecutive Socratic questions. Perhaps the authors are eager to package their work as a "traditional" casebook. In any event, this seemingly minor flaw leads to student reactions far more critical than the materials warrant.

power, thus revealing the hidden themes in a system of seemingly diverse legal rules. Second, as with any heuristic, it suffers from significant distortions and limitations, and in the process of appreciating those limitations the subtleties of the legal terrain can be better understood.

I develop this thesis in Part I of the essay. A review of the basic creditors' bargain theme illustrates its extraordinary power as a method of understanding and justifying prominent features of bankruptcy law. Part II introduces an alternative heuristic which can be seen as either a complementary or a competing vision. This vision highlights the limits of any single heuristic and demonstrates the value of a richer conception of the bankruptcy process. Yet, such additional themes can be introduced successfully only if the student previously has been grounded in bankruptcy theory. Thus, I conclude that the Baird and Jackson conceptual framework is a significant advance in the teaching of the bankruptcy law even for those who do not share their unqualified commitment to the creditors' bargain heuristic.

I.

The central premise underlying the creditors' bargain vision is that bankruptcy is a foreseeable risk that can be (and is) borne individually by the various claimants of any business enterprise, including secured and unsecured creditors, shareholders, and managers. The calculation of this risk thus influences individual creditors' decisions as to whether security should be taken and on what terms. The assumption that the risk of bankruptcy is allocated among individual claimants through mutually beneficial executory contracts suggests that the Bankruptcy Code should respect prebankruptcy entitlements as recognized under state law. Secured creditors, for example, "paid" for these entitlements by accepting a lower rate of return, and should thus retain the benefits of the initial bargain by receiving an equivalent value for their collateral in bankruptcy. Unsecured creditors obtain a higher interest rate by forgoing security, but in so doing assume a greater risk that their claims will not be fully satisfied upon default and subsequent bankruptcy. State law recognizes this relationship by giving secured creditors with perfected claims priority over unsecured creditors.[14] Therefore, the Bankruptcy Code should also honor this relationship by maintaining secured creditors' state law entitlements

[14] *See* U.C.C. § 9-301(1)(a) (1977).

and preventing redistribution from secured creditors to unsecured creditors and the debtor.[15]

This basic argument is supported by several further observations. First, the recognition of a different method of distributing entitlements in bankruptcy will necessarily create perverse incentives that motivate parties to use the bankruptcy process strategically. Unsecured creditors and debtors will opt for bankruptcy when their share of the bankruptcy estate exceeds the value of their entitlements under state law. Secured creditors, on the other hand, will prefer state law if deprived of state law entitlements in bankruptcy. The parties will maneuver strategically to obtain the most favorable outcome, thus generating unnecessary social costs. The effects of these perverse incentives are enhanced because parties bargain in the shadow of both state and bankruptcy law and can exploit provisions unfavorable to the opposing side as a means of obtaining a favorable readjustment of the bargained-for entitlement. Uniformity between state and bankruptcy law alleviates these problems.[16]

The second justification for the preservation of pre-bankruptcy entitlements in bankruptcy is that secured creditors would otherwise be unwilling to join in a bankruptcy process from which they derive no personal advantage. Yet, the mandatory inclusion of secured creditors is necessary for unsecured creditors to enjoy the fruits of collective action. Bankruptcy provides creditors with a collective forum which solves a classic prisoner's dilemma problem[17] and provides an increased pool of assets for distribution to unsecured creditors generally. Thus, for example, the bankruptcy

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[15] For a more detailed summary of the creditors' bargain conception, see generally Note, *The Proper Discount Rate Under the Chapter 11 Cram Down Provision: Should Secured Creditors Retain Their State Law Entitlements or Should These Entitlements Be Redistributed to Unsecured Creditors and the Debtor?*, 72 VA. L. REV. (forthcoming 1986).

[16] *Id.*

[17] To illustrate how the prisoner's dilemma applies to an insolvent debtor, assume that no collective proceeding exists by which creditors can collect their claims. When creditors sense that the debtor is having financial difficulty, they will all attempt to collect their claims immediately. The reason is simple: those who delay risk non-recovery of their debts if other creditors grab first and exhaust the available pool of assets. However, if the going-concern value of the firm exceeds its liquidation value (a likely assumption when assets are sold piecemeal), the creditors as a group stand to gain by forgoing collection of their individual claims to enhance the pro rata recovery of all creditors collectively. Unfortunately, absent a collective procedure, the creditors of an insolvent debtor are too numerous and too diverse to reach the optimal result through private bargains. This, then, is a classic prisoner's dilemma situation in which rational individual behavior leads to inferior results because parties are unable to reach mutually beneficial bargains. *See* A. SCHWARTZ & R. SCOTT, *supra* note 12, at 806-07.

trustee may invalidate certain pre-bankruptcy transfers through the power to avoid preferences. This and other avoidance powers serve to protect the collective process by invalidating individual collection efforts undertaken shortly before bankruptcy. Furthermore, Chapter 11 of the Bankruptcy Code authorizes a procedure in which a debtor may continue in business when the firm's going-concern value exceeds its liquidation value. This Chapter provides unsecured creditors with the enhanced value that results from a "sale" of the business to its former owners. Such an increase in net asset value would occur whenever the existing owners of the firm are better able to assess the firm's going-concern value than are third party buyers in a liquidation sale.[18] In sum, substantial increases in *total* creditor wealth are available through the collective process of bankruptcy. But these gains can be realized fully only if the secured creditors are made at least indifferent as between state law and bankruptcy law.

Armed with this clear and coherent vision, the student of bankruptcy can develop a conceptual understanding of the bankruptcy process that yields a deeper appreciation of its nuances—an understanding that cannot be achieved by the most careful reading and re-reading of the statutory provisions and explanatory commentary. More importantly, the maximization norm permits one to predict important features of the bankruptcy process. Thus, for example, Baird and Jackson begin their book with the question: who may properly be a debtor in a bankruptcy proceeding?[19] It becomes obvious to the student that this question is an exercise in drafting rules to prevent the strategic use of the bankruptcy process. Because the creditors' bargain conception is not perfectly replicated in the bankruptcy process, there are opportunities for parties to attempt to employ bankruptcy for ends other than those directed by the maximization norm. The statutory provisions prescribing the number and requisite characteristics of creditors entitled to file involuntary petitions,[20] the types of claims they must hold,[21] and the discretionary authority given to the bankruptcy court to dismiss petitions under section 305 are all screening devices designed to filter out strategic manipulations of the bankruptcy process.

Once a bankruptcy petition is properly filed, the creditors'

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[18] *See* D. Baird & T. Jackson, *supra* note 11, at 601-08.
[19] *See id.* at 47-122.
[20] *See* Bankruptcy Code § 303.
[21] *Id.*

bargain heuristic illuminates the central process of bankruptcy: the identification of the eligible claimants and the estate to be distributed.[22] Indeed, from the perspective of bankruptcy as a maximization process for creditors, this procedure would be extraordinarily simple were it not for the problem of time. Baird and Jackson explore the various dimensions of the inter-temporal problems that generate a much more complicated bankruptcy process. The first temporal problem arises because insolvency (and any resulting bankruptcy) does not occur instantly. Thus, some parties are able to anticipate its onset and to grab the assets necessary to satisfy fully their individual claims in violation of the maximization norm. The trustee's avoidance powers, especially the preference power in section 547, are mechanisms for reaching back in time to preclude individual advantage-taking just prior to the filing of a bankruptcy petition.[23]

The second temporal problem raises a parallel concern. Insolvency and bankruptcy proceedings do not begin instantly, and they do not end instantly either. Therefore, the legal rulemaker faces the vexing problem of collectivizing the estate for distribution to claimants holding pre-bankruptcy entitlements, while at the same time permitting the debtor-in-possession or bankruptcy trustee to deal with post-bankruptcy relationships as though no insolvency proceedings were underway.[24] Separating these two purposes is the basic goal of section 362 and the automatic stay. Thus, for example, section 362(a) identifies those events that can be characterized as violations of the maximization norm by pre-bankruptcy creditors. On the other hand, section 362(b) is designed to insure that attempts to resolve the prisoner's dilemma do not impair the debtor's relationship with post-bankruptcy claimants who should be unaffected by the bankruptcy process.[25]

By focusing on the bankruptcy process as a sorting out of assets and liabilities over time, Baird and Jackson are able to point with increased clarity to some of the anomalies of bankruptcy law, such as the treatment of executory contracts under section 365.[26] The creditors' bargain conception suggests that the Bankruptcy Code's treatment of executory contracts, especially the right of the

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[22] *See* D. Baird & T. Jackson, *supra* note 11, at 123-217. Baird and Jackson are in fact quite skeptical of the need for Chapter 11 proceedings. *See infra* text accompanying notes 28-31.

[23] *See* Baird & Jackson, *supra* note 11, at 219-359.

[24] *Id.* at 361-546.

[25] *Id.* at 362-64.

[26] *Id.* at 451-521.

trustee to assume defaulted contracts, represents a violation of the premises underlying the maximization norm.[27]

Once temporal problems are resolved, the liquidation procedure in bankruptcy follows as a relatively straightforward exercise in distributing the remaining assets among the various claimants.[28] The most interesting implications of the creditors' bargain heuristic, however, are raised by Chapter 11 and the reorganization procedure. A creditors' bargain perspective challenges the traditional justification for a Chapter 11 proceeding since a Chapter 7 liquidation can include (in addition to piecemeal transfers) the sale of the business to a third-party buyer as a going concern.[29] The principal justification for a reorganization procedure that is consistent with the maximation norm thus must rest on the assumption that third-party buyers cannot readily value certain firms because of the unique contribution of specialized actors such as the owner-manager and relational financers. If such valuation problems are acute, then a reorganization procedure in which the firm is, in essence, sold to the original claimants through a restructuring would enhance total creditor wealth. But this defense of reorganization as a wealth-maximizing process rests on problematic empirical assumptions.[30] To the contrary, much of the Chapter 11 procedure seems designed to effect redistributional rather than maximization goals.[31]

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[27] *See* Bankruptcy Code § 365(a), (b)(1), (e). The Code's invalidation of ipso facto clauses in bankruptcy under § 365(e) causes holders of executory contracts (and lessors) to be treated differently from other lenders who are permitted to accelerate their debts upon default. Thus, the executory contract holder is denied access to the market to value its accrued rights. Since, absent bankruptcy, one who breaches a contract forfeits all accrued rights in the executory contract, section 365 is denying these claimants a pre-bankruptcy entitlement.

[28] *See* D. BAIRD & T. JACKSON, *supra* note 11, at 547-600.

[29] *Id.* at 601-08.

[30] In order to increase total creditor wealth through a Chapter 11 reorganization there must be: a nontrivial number of enterprises wherein various claimants have made investments in the firm that are difficult to value; the gains in asset value resulting from a reorganization must exceed the costs (including the distributional costs) of the reorganization procedure; the net gains to such "value-impacted" firms must exceed the net costs that reorganization imposes on those firms for which a third-party sale would realize a larger aggregate asset pool.

[31] The redistributional effects of Chapter 11 are largely indirect. They provide leverage to unsecured creditors and residual claimants in the plan negotiation process. Thus, for example, section 1121 grants the debtor, for 120 (plus 60) days, the exclusive right to propose a reorganization plan. Studies on agenda influence confirm the key leverage this provides the debtor (and existing management) in negotiations over restructuring the firm. *See* Levine & Plott, *Agenda Influence and Its Implications*, 63 VA. L. REV. 561 (1977). In addition, section 1124(2) permits a plan to cure and compensate a holder of a claim in which the debtor has previously defaulted, and thus treats the claim as unimpaired for purposes of

It is, then, in the context of Chapter 11 that the student must confront the limitations of the creditors' bargain heuristic. Baird and Jackson's exposition to this point is such a powerful demonstration of the effectiveness of the maximization norm that one is led inevitably to search for alternative or complementary themes that might successfully rationalize these "anomalous" aspects of federal bankruptcy. Given the force of the creditors' bargain argument, how can we explain the persistence of redistributional impulses in bankruptcy? One obvious answer is that the bankruptcy process reflects a genuine tension between the maximization objective and a competing distributional norm: that all participants should share (at least in part) in the unanticipated or "common" risks of business failure. Under this conception, bankruptcy sharing can be seen as a response to an unanticipated common disaster for creditors, much like a hurricane or an earthquake.[32] This competing vision—that bankruptcy embraces risk-sharing solutions for certain unanticipated risks—provides a useful counterpoint with which students can explore both the strengths and limitations of the creditors' bargain heuristic.[33]

It is tempting to suggest that teachers who wish to enrich the basic creditors' bargain conception will be overwhelmed by the power of the Baird-Jackson theme as it progresses inextricably through the casebook. My experience, however, is that the authors' success in presenting a unified and coherent vision of bankruptcy frees the instructor to offer speculative and provocative alternative explanations for features of the bankruptcy process that do not fit the Baird-Jackson vision. In Part II of this essay, I hope to illus-

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securing plan approval. This denies to such claimants the current market value of their claim, thus impairing the pre-bankruptcy entitlement. Finally, the inherent ambiguity (and resulting discretion) of efforts to fix the firm's value permits courts to approve reorganization plans that, in fact, deny certain claimants the *full* value of their pre-bankruptcy entitlements. The many problems that prevent an "accurate" valuation of a reorganized firm are discussed in A. SCHWARTZ & R. SCOTT, *supra* note 12, at 806-09.

[32] *See A Relational Theory, supra* note 10; *see also* PETER COLEMAN, DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY, 1607-1900, at 13 (1974) (colonial bankruptcy rules justified as a form of risk-spreading compulsory insurance).

[33] Bankruptcy law has never purported to grant absolute recognition to pre-bankruptcy entitlements. The stated policy of the federal courts interpreting bankruptcy law has been to accord *substantial* respect to state-created rights unless they conflict with federal policy and equitable principles. *See* Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 161-63 (1946); REPORT OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93d Cong., 1st Sess. pt. I, at 78 (1973) ("*For the most part* [prior claims] should be recognized in the bankruptcy process.") (emphasis added) [hereinafter cited as COMMISSION REPORT].

trate that point by turning to a tentative elaboration of a common disaster model as an alternative (or complementary) theme that enriches the maximization norm.

II.

The creditors' bargain model does little to explain the risk-sharing aspects of the federal Bankruptcy Code. In particular, the rules governing the adequate protection of secured creditors,[34] the treatment of executory contracts,[35] the trustee's avoidance powers,[36] and most especially the reorganization procedures in Chapter 11,[37] do not fit easily into this model. Either these Code provisions are arbitrary (or misguided), or there is some other notion motivating these bankruptcy rules. An analogy to the law of admiralty, in particular the law of general average, may provide insights into an underlying risk-sharing theme in bankruptcy law.

The notion of general average is part of the admiralty rules of all maritime nations, and its antecedents can be traced to Roman law.[38] The basic principle underlying general averaging is that if a ship loaded with precious cargo should founder at sea, the captain may take whatever steps are necessary to prevent the ship and cargo from sinking altogether. All owners involved in the sail will contribute to the general average expense according to their percentage of ownership.

There are several theoretical bases for a general average rule. One justification, for example, might rely on a hypothetical bargain analysis. If at the time of contracting for the shipping of goods all

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[34] Bankruptcy Code § 361. Exactly what constitutes adequate protection is unclear. Section 361's definition includes a replacement lien, periodic cash payments, or the "indubitable equivalent" of the secured creditors' interest in the property. Pre-Bankruptcy Code case law strongly suggests that valuation problems will frequently result in protection that is less than completely compensatory. *See, e.g., In re* Bermec Corp., 445 F.2d 367 (2d Cir. 1971); *In re* Yale Express Sys., 384 F.2d 990 (2d Cir. 1967); *see also* A. SCHWARTZ & R. SCOTT, *supra* note 12, at 806-10.

[35] *See supra* note 27.

[36] *See supra* note 9. In addition to 544(b), section 544 (a)(3), the so called "bona fide purchaser" test of avoidability, gives the trustee power to invalidate security interests in realty that no unsecured creditor could avoid outside of bankruptcy.

[37] *See supra* note 31; *see also infra* text accompanying notes 47-51.

[38] *See* G. GILMORE & C. BLACK, THE LAW OF ADMIRALTY 244 (2d ed. 1975). Gilmore & Black trace the earliest recorded evidence of general averaging to the Digest of Justinian: "[I]f merchandise is thrown overboard to lighten the ship, the loss occasioned for the benefit of all must be made good by the contribution of all." DIG. JUST. 14.2.1 (Monro trans. 1909); *see also* J. DONALDSON, C. STAUGHTON & D. WILSON, LOWNDES & RUDOLF'S THE LAW OF GENERAL AVERAGE AND THE YORK-ANTWERP RULES 3-4 (British Shipping Laws vol. 7, 10th ed. 1975) (tracing the practice of general average back to pre-classical times).

interested parties were required to bargain over the optimal responses to perils at sea, they would collectively agree that the captain should have the authority to make necessary sacrifices of the cargo or the vessel and that all parties should bear the losses pro rata. In essence, at the moment danger becomes imminent, each participant in the voyage would consent to a sacrifice of some of his property rights in order to preserve the remainder, and furthermore, all other parties would agree to effect a ratable compensation to the losers out of the property that is left.

Agency theory offers a complementary rationale to explain why parties would agree ex ante to this unusual form of risk sharing. Under agency principles, the captain is the agent of all of the principals participating in the venture. When a perilous situation arises, it is in the interests of all participants that when the captain responds, he takes all interests equally into account; that is, that he effects whatever sacrifice is necessary to promote the *joint interests* of all participants in the voyage.[39] One method of approximating the cooperative result is to encourage the captain to act *as if* there were only one owner in the enterprise. If the ownership interests were "integrated," it would not matter whose property was sacrificed because all of the participants would bear the loss as joint venturers.

Under agency theory, therefore, the purpose of general average rules is to dissipate the captain's conflict between self-interest and duty at the moment of sacrifice. At that critical time, the captain must decide if he should jettison the cargo or cut off the mast. But, absent a sharing rule, a bias invades the captain's judgment. The captain has an interest in preserving the ship for the benefit of the owner, his employer. Moreover, any adversely affected cargo owners will predictably claim that the captain overlooked a less costly method of sacrifice if the captain has jettisoned their property. Thus, the captain also is motivated to minimize any subsequent claims that his judgments were flawed. To be sure, a critic of gen-

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[39] The joint-cost-minimization solution (or mitigation principle) is the most likely outcome of a hypothetical bargain between contracting parties charged explicitly with designing a policy to cope with uncertain future conditions. *See* Goetz & Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligations,* 69 VA. L. REV. 967, 972-73 (1983). I have suggested elsewhere that the conditions for such relational contracting arise whenever the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impracticable because of either the uncertainty of future contingencies or the complexity of any required responses. *See* Goetz & Scott, *Principles of Relational Contracts,* 67 VA. L. REV. 1089, 1090-95 (1981). In such relational environments, all parties will benefit if they agree in advance to rules—such as general average—that will reduce expected future costs.

eral average might maintain that since merchants and shipowners can obtain insurance, the captain's bias is irrelevant. The insurance payout should have the same effect as general averaging without the unnecessary complication and friction. But third-party insurance suffers from a moral hazard that will unnecessarily increase the premium costs. If the captain's conflicting interests are sufficiently strong at the moment of crisis, he will make jettison decisions that are inconsistent with the joint interests of the parties. Hence, the general average calculation is the optimal form of insurance because it encourages the captain to make the most efficient jettison possible.[40]

It is this same kind of self-interest bias that bankruptcy law seeks to avoid. When it appears that a business is about to founder, creditors attempt to "grab" the available assets for their individual benefit to the detriment of the group as a whole. This behavior creates the familiar prisoner's dilemma, similar to the dilemma faced by the captain of a ship when peril approaches. In the bankruptcy analogue to general average, a dominant secured creditor—such as a general financing bank—is equivalent to the ship's captain struggling in high seas.

Other events on the "eve of bankruptcy" appear to parallel events on the "eve of general average sacrifice" as well. Examining the elements at risk on any nautical voyage, the requirements of general average allowance and the mechanics of the general average computation can best illuminate this similarity. Three things are at risk on a nautical voyage. First, the ship belonging to its owner is at risk. Second, the cargo or goods on board belonging to merchants are at risk. Third, the freight—the compensation the captain receives for the safe passage of the goods to their final destination—is at risk. Similarly, three things are at risk on a business "voyage." Just as shipowners provide the vehicle necessary for the nautical venture, so too do the owners of a company provide a corporate shell, complete with state licenses, assets, and goodwill as a vehicle for the venture. Just as merchants load their cargo on a ship in one port expecting to gain a profit on their wares at another port, so too do creditors "load" their credit onto a company expecting a higher rate of return. And just as the captain of a ship

[40] This argument is merely a variant on the theme that liquidated damage and penalty clauses permit contracting parties to insure more efficiently against the difficulty in valuing losses associated with contract breach. *See* Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 578-83 (1977).

expects a freight payment for the safe passage of goods from port to port, so too do secured creditors expect compensation for the monitoring and other financial services they provide the corporate venture.[41]

In short, the corporate shell is like a ship in that both are worth the present capitalized value of all future earnings less working expenses. Creditors are equivalent to the cargo on a ship in that they extend credit to this particular venture in anticipation of an optimal return on their investment. Secured creditors represent the captain of the ship; they expect a premium in return for effectively monitoring the debtor's business decisions and for providing other financial services associated with the monitoring function. This premium is similar to the captain's freight payment upon reaching the final destination with ship and cargo intact.

Not all losses will trigger a risk-sharing response, however. Before any of the affected interests has a right to general average contribution, three requirements must be met.[42] First, there must be a common danger that is inevitable except by voluntarily incurring the loss of a portion of a whole to save the rest. Second, in an attempt to avoid the peril, part of the joint concern must be jettisoned. Third, the attempt to avoid the common peril must be successful.

Analogous events may occur in bankruptcy. The imminent threat of a business failure owing to unanticipated contingencies is a "common danger" that under many conditions will inevitably occur unless creditors agree to sacrifice a portion of their claim in order to save the enterprise. To be sure, the normal risks of business failure, just as the normal risks of a maritime adventure, are not common risks, and the interest that sustains the loss must bear it alone.[43] Risk-sharing contribution requires both an unantici-

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[41] In addition to monitoring efforts, there is substantial evidence that secured creditors provide their debtors with valuable financial inputs, especially financial coordination and experienced financial management. *See A Relational Theory, supra* note 10.

[42] *See* Barnard v. Adams, 51 U.S. (10 How.) 270, 303 (1850); G. GILMORE & C. BLACK, *supra* note 38, at 245.

[43] There is no right of general average contribution in the ordinary case of loss through marine mishap. *See* G. GILMORE & C. BLACK, *supra* note 38, at 246. Thus, by analogy, the impulse to risk sharing must derive not from insolvency that results from foreseeable contingencies, but rather from unanticipated or "common" perils. *See, e.g.*, Columbian Ins. Co. v. Ashby & Stribling, 38 U.S. (13 Pet.) 331, 338 (1839); J. DONALDSON, C. STAUGHTON & D. WILSON, *supra* note 38, ¶ 37, at 19 (York-Antwerp Rule A (1974): "There is a General Average act when, and only when, any extraordinary sacrifice or expenditure is intentionally and reasonably made or incurred for the common safety for the purpose of preserving from peril the property involved in a common maritime adventure.").

pated peril *and* the sacrifice of individual rights in order to rehabilitate the enterprise. Thus, risk sharing in bankruptcy is justified only where unsecured creditors or residual claimants "jettison" some or all of their claims against the debtor in order to avoid the common danger through reorganization. The general creditors' agreement to sacrifice some of their entitlements improves the prospects for a successful reorganization and increases the value of the enterprise whenever going-concern value exceeds the value of a piecemeal liquidation. Perhaps, therefore, a case for general average contribution exists in bankruptcy as well as admiralty.

The mechanics of the general average apportionment insure that all interested parties will share equally in the loss. The value of each contributing interest is multiplied by a fraction, the numerator of which is the sum of the general average expense, and the denominator of which is the sum of the contributing values.[44] For example, assume the following facts:[45] the ship is valued at \$1000. The captain jettisons a mast worth \$5. Cargo is worth \$1000, of which \$100 worth is jettisoned. The value of the freight (the anticipated compensation for safe carriage) is \$100 and \$10 is lost. Thus, the sum of the contributing values is \$1000 + \$1000 + \$100 or \$2100. The sum of the general average expense is \$5 + \$100 + \$10 or \$115. The ship must assume \$1000 x \$115/\$2100 or about \$55 of the burden. The cargo must also contribute about \$55 (\$1000 x \$115/\$2100). The freight owes \$100 x \$115/\$2100 or \$5. Since the ship bore less than its fair share of the loss (in jettisoning the mast worth only \$5), it must pay the difference between its actual loss and its fair share to the cargo and freight. (\$100 cargo jettisoned − \$55 cargo's share = \$45 to the cargo; \$10 freight lost − \$5 freight's share = \$5 to the freight). In this scheme no one is made whole; all suffer equally.

Applying general average in admiralty is much like applying the equality norm in bankruptcy.[46] While equity dictates that losses should be borne equally in bankruptcy, the problem is deciding which parties are equal. If general average contribution were employed, the claimants would be required to share an amount equal to the value of each creditor's interest multiplied by the total

[44] *See, e.g.*, Pacific Freighters Co. v. St. Paul Fire & Marine Ins. Co., 109 F.2d 310, 312 (9th Cir. 1940).

[45] The example is derived from G. GILMORE & C. BLACK, *supra* note 38, at 247.

[46] A major goal of the Bankruptcy Code is to ensure equal treatment of all creditors. *See* 3 J. MOORE & L. KING, COLLIER ON BANKRUPTCY, ¶ 60.01, at 743 (14th ed. 1977); COMMISSION REPORT, *supra* note 33, pt. I, at 76-79.

loss over the total amount contributed to the venture. For instance, assume the general and secured creditors loan the venture $1000. Assume further that an unpredictable technological change results in substantial business losses, and only $800 is left to pay the creditors. (Thus, total creditor losses are $200.) The secured creditors contribute an additional $500 that includes "freight" charges for monitoring services and financial advice. (Thus, total contributions to the venture are $1500.) In return for these services the secured creditors are promised a priority position, thus they initially suffer no losses.

According to general average principles, when a common danger (unforeseeable insolvency) is imminent, these losses should be shared among the claimants in proportion to their contributions to the venture, if by doing so the peril (liquidation) can be avoided. Under such a regime, if reorganization is successful, the general creditors should suffer only $133 in loss ($1000 x $200/$1500). The secured creditors, while permitted additional "freight" compensation for insuring business success ("safe passage") with the available credit ("goods intact"), must forfeit some of their compensation because the venture failed (some of the cargo was lost at sea). The secured creditors should forfeit $67 of their secured interest ($500 x $200/$1500). This $67 will go to augment the estate for the benefit of the unsecured creditors (compensation for the cargo owners). Thus, the secured creditors, while entitled to both "cargo" and "freight" values, forfeit a little of each. They will still come out better than the unsecured creditor who is entitled only to "cargo" values.

This risk-sharing model may help explain what is at work in certain sections of the Bankruptcy Code. For example, the pressures toward bankruptcy sharing are most frequently manifested in bankruptcy reorganizations where security interests in specific assets are converted into deferred cash payments. The key to the conversion process is the choice of an appropriate discount rate. Courts animated by a maximization norm will adopt a discount rate that is similar to the current market rate of interest—the rate such creditors would receive under state law.[47] On the other hand,

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[47] Assuming the presence of an acceleration clause, secured creditors are entitled to the entire outstanding principal upon default. This amount, paid either in cash or in kind by seizure of the collateral, can then be reinvested at the current market rate of interest. *See, e.g.*, Memphis Bank & Trust Co. v. Whitman, 692 F.2d 427, 429 (6th Cir. 1982); *In re* Scovill, 18 Bankr. 633, 634 (Bankr. D. Neb. 1981) (adopting a discount rate based on the current market rate of interest for similar loans in the region); *cf. In re* Landmark at Plaza Park Ltd., 7 Bankr. 653, 656-68 (Bankr. D. N.J. 1980) (rejecting reorganization plan with

courts animated by risk-sharing notions will adopt a variety of rates that vary from the current market rate for similar loans. It is clear that many courts consider redistribution from secured creditors to unsecured creditors and debtors appropriate. Thus, for instance, one commonly adopted rate is the rate owed by delinquent taxpayers. This rate is the average predominant prime rate quoted by commercial banks to large businesses.[48] In the words of one court, such a rate is "reasonably responsive to current economic conditions, is subject to periodic revisions, yet *is not an unfair burden . . . on debtors.*"[49]

Other instances of risk-sharing can be found in some of the specific rules of the Bankruptcy Code. For example, a secured creditor is not impaired under section 1124(2) if the debtor cures a previous default and reinstates the contract rate of interest despite the presence of an acceleration clause. The norm underlying this provision is made clear by a Senate report on section 1124(2):

> The intervention of bankruptcy and the defaults represent a temporary crisis which the plan of the reorganization is intended to clear away. The holder of a claim or interest who under the plan is restored to his original position, when others receive less or get nothing at all, is fortunate indeed and has no cause to complain.[50]

In sum, bankruptcy has never purported to grant absolute recognition to pre-bankruptcy entitlements. The stated policy of the federal courts interpreting bankruptcy law has been to accord *substantial* respect to state-created rights unless in conflict with federal policy and equitable principles.[51]

The preceding sketch of a common disaster theme is concededly (even determinedly) provocative and speculative. My purpose here is merely to suggest that a conceptual approach to teaching legal topics does not impair the search for richer and more varied explanations of the underlying behavior that is being regulated. In-

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below market rate repayment plan). *See generally A Relational Theory*, *supra* note 10; Note, *supra* note 15.

[48] *See, e.g.*, *In re* Caudle, 13 Bankr. 29, 37-38 (Bankr. W.D. Tenn. 1981); *In re* Ziegler, 6 Bankr. 3, 6 (Bankr. S.D. Ohio 1980). Other courts have awarded the coupon yield rate of one-year treasury bills. *See, e.g.*, *In re* Connecticut Aerosols, Inc., 42 Bankr. 706, 710-11 (D. Conn. 1984); *In re* Fisher, 29 Bankr. 542, 549-50 (Bankr. D. Kan. 1983).

[49] *In re* Ziegler, 6 Bankr. 3, 6 (Bankr. S.D. Ohio 1980) (emphasis added).

[50] S. Rep. No. 989, 95th Cong., 2d Sess. 120, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5787, 5906.

[51] *See* Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 161-63 (1946); Commission Report, *supra* note 33, pt. I, at 78.

deed, to the contrary. The maximization norm is obviously a dominant theme in bankruptcy. Its power is only enhanced by the recognition that other norms may also be influencing bankruptcy law, all of which must be explored before one can fully understand the texture (and tensions) of the bankruptcy process.

CONCLUSION

A conflict between the maximization of insolvent debtors' assets and distributional equality among claimants appears to animate bankruptcy law. Competing metaphors for the bankruptcy process that underlie each of these norms may rationalize some (or all) of this tension. The creditors' bargain vision so ably elucidated by the work of Baird and Jackson justifies the maximization norm by imagining an ex ante agreement among claimants that is reproduced in bankruptcy. The Baird and Jackson bankruptcy casebook provides a unified conception of this heuristic, enabling a student to develop a sophisticated understanding of the logic of the bankruptcy process. This understanding is not impaired by the fact that the creditors' bargain conception, like all heuristics, is subject to bias. The teachers using these materials must suggest alternative visions that may correct for some of this bias. Thus, for example, a common disaster heuristic—drawing perhaps on the analogy to general average contribution—explains the distributional norm by casting certain kinds of business failure as unanticipated calamities befalling claimants. According to this common disaster heuristic, bankruptcy has a risk-sharing function that may complement its asset-maximizing function.[52]

To be sure, the union of individual and common risks is not unproblematic. Quite possibly, the cost of accommodating both visions—especially the invitation for individual debtors and creditors to manipulate the bankruptcy process for strategic purposes—exceeds any corresponding social benefits. Furthermore, bankruptcy sharing rules may help existing victims at the expense of future participants. Any redistributional effects of bankruptcy reduce the relative attractiveness of security to creditors and thus

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[52] As the common disaster heuristic sketched above suggests, there is no necessary incompatibility between rules for asset maximization and rules for risk sharing. Risk sharing for uncertain and unforeseeable risks is a maximizing strategy for risk-averse bargainers. Sharing under such conditions reduces the dead-weight costs of uncertainty. Thus a risk-sharing scheme for certain common disasters would predictably be negotiated in the creditors' bargain whenever individual risk bearing is unlikely to produce net gains in risk avoidance.

reduce the price differential between secured and unsecured credit. Sharing assets with unsecured creditors and residual claimants thus may impose costs on potentially insolvent debtors who would otherwise benefit from a wider variance in the price of secured and unsecured credit. Nevertheless, a common disaster vision may be a useful way to understand the redistributional impulses that are unambiguously present in various provisions of the Bankruptcy Code and the decided cases.