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Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?

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BANKRUPTCY AND THE ENTITLEMENTS OF THE GOVERNMENT: WHOSE MONEY IS IT ANYWAY?

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A debate between two groups of scholars has dominated bankruptcy scholarship for the past decade. The first group, often referred to as the creditors' bargain theorists, argues that creditors' agreements with debtors create entitlements to payment; the proper role of the bankruptcy system, therefore, should be to benefit creditors by enforcing rules to which creditors would have agreed before bankruptcy. The second group of scholars contends that the goals of the bankruptcy system should not be limited to the interests of creditors. Instead, they maintain that the bankruptcy system, as a part of our country's wider system of social protection, should further a variety of social interests. Professor Mann joins the debate by providing a theoretical justification for the position that the bankruptcy system should pursue distributive goals beyond the enforcement of the creditors' bargain. Specifically, Professor Mann examines principles of distributive justice and explains that the government's role in creating and supervising the bankruptcy system entitles it to any value created by that system above what would have been created by state-law remedies. Focusing on utilitarian and autonomy-based perspectives, he suggests that creditors are entitled only to what they could have expected to receive in the absence of a bankruptcy system, and that the government may use any additional value to further any of its legitimate interests.

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Take your hand out of my pocket, baby;
I ain't got nothin' belong to you.
. . . .
I don't mean to do nobody wrong;
I just want what belong to me.[1]

INTRODUCTION

Since Congress adopted the Bankruptcy Code (Code) in 1978, this country has experienced a dramatic upsurge in the frequency of bankruptcy, for both individuals and businesses.[2] Although that upsurge conforms to Congress's goals of making this country's bankruptcy system more accessible,[3] the academy has greeted the increased frequency of bankruptcy (especially in business cases) with a noted lack of enthusiasm.

One of the most dominant themes of the criticism of the bankruptcy system under the Code is that the Code's provisions effectively transfer wealth from the creditors of a business—who frequently have bargained for repayment—to the owners and managers of the failed business.[4] From the perspective of the critics, any such transfer takes

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1 Sonny Boy Williamson (Rice Miller), Keep Your Hands Out of My Pocket, on The Essential Sonny Boy Williamson (MCA Records 1993) (originally issued on Chess LP 1536).

2 See Teresa A. Sullivan, Elizabeth Warren & Jay L. Westbrook, The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts, 17 Harv. J.L. & Pub. Pol'y 800, 818-20 (1994) (citing evidence that annual rate of nonbusiness bankruptcy filings rose from 95 per 100,000 in 1970 to 266 per 100,000 in 1990); Edward I. Altman, Corporate Financial Distress and Bankruptcy 14-16 (1993) (citing statistics indicating rise in business bankruptcies); Elizabeth Warren, The Untenable Case for Repeal of Chapter 11, 102 Yale L.J. 437, 443 & n.20 (1992) (estimating rise in corporate bankruptcies of 2000% over last 20 years); see also Samuel L. Bufford, What Is Right About Bankruptcy Law and Wrong About Its Critics, 72 Wash. U. L.Q. 829, 830-32 (1994) (analyzing frequency of various types of bankruptcy filings during 1993).

3 E.g., H.R. Rep. No. 595, 95th Cong., 1st Sess. 5 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 5966 [hereinafter House Report] (characterizing features of prior law as "arbitrary and of limited utility" and suggesting that revised statute would "mak[e] a business reorganization a quicker, more efficient procedure, and provid[e] greater protection for debtors, creditors, and the public interest"); id. ("This bill makes bankruptcy a more effective remedy for the unfortunate consumer debtor."); see Michael Bradley & Michael Rosenzweig, The Untenable Case for Chapter 11, 101 Yale L.J. 1043, 1044 (1992) ("In Congress' view, easier access to the protections of Chapter 11 would enhance social welfare . . . .").

4 The most prominent exposition of the issue appears in Bradley & Rosenzweig, supra note 3. From their perspective, "[f]iling a Chapter 11 petition, in effect, is a way to keep control of the firm free from the intrusive monitoring of creditors, thereby permitting management to extract wealth from the firm's various security holders." Id. at 1076-77. Their proposal that the Code's reorganization provisions should be repealed, id. at 1078-89, was covered widely in the general media. See Lynn M. LoPucki, Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig, 91 Mich. L. Rev. 79, 80 nn.5-6 (1992) (citing articles in, among other places, the *New York Times* and the *Washington*

money out of the pockets of the creditors, who are entitled to the money, and puts it in the hands of debtors (or their management), who are not entitled to it. Two factors explain the increasing attention on business bankruptcies. The first—which keeps bankruptcy in the public eye—is the nature of the cases, which have involved some of our nation's largest businesses: companies like A.H. Robins, Johns Manville, LTV, Continental Airlines, Eastern Airlines, Braniff, and Texaco.[5] The second—which has drawn academic attention—is the limited ability of judges or creditors to gain any effective control over debtors in those proceedings.[6] That problem has manifested itself most prominently in the debtor's retention of practical control over decisions about its future operations; it is all but unheard of for any party other than the debtor to propose a plan of reorganization.[7] Fur-

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Post). But the criticism did not start—or end—with Bradley and Rosenzweig's article. For similar academic criticisms of the Code's reorganization provisions, see, e.g., Barry E. Adler, Bankruptcy and Risk Allocation, 77 Cornell L. Rev. 439, 440-42 (1992) (arguing that risk-sharing theory cannot explain how bankruptcy reallocation offers investors better bargain than bargain to which the parties actually agreed); Raymond T. Nimmer, Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions, 36 Emory L.J. 1009, 1084 (1987) ("In the context of the corporation's bankruptcy, the public investor in a troubled corporation has no particular equitable or legal right superior to the creditor whose debt may go unpaid. Protecting the shareholder at a cost of injury to the creditor is often unjustifiable."); Robert K. Rasmussen, Debtor's Choice: A Menu Approach to Corporate Bankruptcy, 71 Tex. L. Rev. 51, 76 (1992) ("It is clear . . . that equity holders often participate in a reorganization even where there is little probability that they are contributing firm-specific skills to the reorganized enterprise."); David A. Skeel, Jr., Markets, Courts, and the Brave New World of Bankruptcy Theory, 1993 Wis. L. Rev. 465, 515 (referring to "the hold up power currently wielded . . . by the shareholders of a Chapter 11 debtor [in a nonclosely held corporation case]").

5 See John D. Ayer, Down Bankruptcy Lane, 90 Mich. L. Rev. 1584 (1992) (book review). Ayer suggests that many of those filings are attributable to "the disintegration of the old network of oligopolies that sustained the American economy through so many comfortable decades." Id. at 1589. If that is so—and he persuades me—then there is every reason to believe that those large filings will continue. As I write, Orange County recently has commenced what must be one of the largest governmental bankruptcies to date, and TWA has just emerged from its second reorganization case of the decade. See Bankruptcy Court Clears TWA Reorganization Plan, Wall St. J., Aug. 7, 1995, at B8 (discussing rapid confirmation of TWA's 1995 plan of reorganization); Seth Mydans, Orange County's Long Prosperity Appears Dented but Not Undone, N.Y. Times, Dec. 13, 1994, at A1 (discussing impact of Orange County's bankruptcy).

6 It has not been a surprise that debtors currently have more control over reorganization proceedings than they did under the prior bankruptcy laws. Many features of the Code were designed to enhance the powers of the debtor and its management. See Bradley & Rosenzweig, supra note 3, at 1044 & nn.6-8 (summarizing new rules favorable to debtor). What has been a surprise is the unbounded nature of the control and the results to which it has led. See infra notes 7-8 and accompanying text.

7 See Lynn M. LoPucki & William C. Whitford, Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies, 1991 Wis. L. Rev. 11, 31 n.67 [hereinafter LoPucki & Whitford, Venue] (empirical study of large bankruptcies indicating that debtors retained exclusive right to propose plan throughout entire proceed-

thermore, the debtor with surprising frequency manages not just to dictate the new business plan, but even to retain an ownership interest under that plan, without regard to whether the plan calls for repayment of the creditors.[8]

The criticisms of the effectiveness of the bankruptcy system are part of a larger debate about its proper goals. Many scholars—working under the mantle of the celebrated "creditors' bargain" theory associated with Doug Baird and Tom Jackson[9]—argue that the system can be justified only to the extent that it benefits creditors by enforcing rules to which creditors would agree as a hypothetical prebankruptcy bargain.[10] The scholars working under that paradigm view a

ing in 79% (34 of 43) of cases, including 12 of the 13 cases filed in Southern District of New York); Lynn M. LoPucki & William C. Whitford, Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies, 139 U. Pa. L. Rev. 125, 139 (1990) [hereinafter LoPucki & Whitford, Equity's Share] (portion of same empirical study indicating that plans opposed by debtors were approved in less than 5% (2 out of 43) of cases); Lynn M. LoPucki, The Debtor in Full Control — Systems Failure Under Chapter 11 of the Bankruptcy Code? (pt. 2), 57 Am. Bankr. L.J. 247, 253-57 (1983) (empirical study suggesting rarity of creditor-proposed plans in small cases).

8 See LoPucki, supra note 7, at 263-66 (empirical study of cases from Western District of Missouri suggesting that small debtors almost uniformly retain ownership of company if it successfully reorganizes, without regard to whether creditors are fully paid); see also Jerome R. Kerkman, The Debtor in Full Control: A Case for Adoption of the Trustee System, 70 Marq. L. Rev. 159, 165-83 (1987) (reaching similar conclusion based on study of cases from Eastern District of Wisconsin). Although the old owners receive less in the reorganizations of large, publicly traded companies, where it is highly unlikely that the shareholders possess any particular skill necessary to the reorganization of the company, it is still common for old owners to receive some distribution even when creditors go unpaid. See LoPucki & Whitford, Equity's Share, supra note 7, at 141-43 (empirical study of bankruptcy reorganizations of large, publicly held companies showing that owners of equity received distributions in 70% (21 out of 30) of cases in which creditors were not fully repaid); see also Allan C. Eberhart, William T. Moore & Rodney L. Roenfeldt, Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings, 45 J. Fin. 1457, 1459-64 (1990) (study of 30 large cases filed between 1979 and 1986); Julian R. Franks & Walter N. Torous, An Empirical Investigation of U.S. Firms in Reorganization, 44 J. Fin. 747, 752-60 (1989) (study of 30 large cases filed between 1970 and 1983); Lawrence A. Weiss, Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims, 27 J. Fin. Econ. 285, 290-99 (1990) (study of 37 filings between 1980 and 1986).

9 The theory is most completely and elegantly set forth in Thomas H. Jackson, The Logic and Limits of Bankruptcy Law (1986). Its broad purveyance has been aided by its use as the analytical framework of a prominent casebook published at about the same time, Douglas G. Baird & Thomas H. Jackson, Cases, Problems, and Materials on Bankruptcy (1985), and by a widely discussed book review, Robert E. Scott, Through Bankruptcy with the Creditors' Bargain Heuristic, 53 U. Chi. L. Rev. 690, 694-95 (1986) (reviewing Baird & Jackson, supra).

10 See, e.g., Jackson, supra note 9, at 15-17 (weighing costs and benefits to creditors of using individual system of creditor remedies rather than collective system of debt-collection law); Douglas G. Baird, The Uneasy Case for Corporate Reorganizations, 15 J. Legal Stud. 127, 127 (1986) ("An analysis of the law of corporate reorganizations should properly begin with a discussion of whether all those with rights to the assets of a firm . . . would bargain for [a corporate reorganization] if they had the opportunity to negotiate at the time of their initial investment.").

creditor's agreement with a debtor as creating an entitlement to payment, which generally should be respected by the bankruptcy system.[11] In their view, the only justifiable occasion for altering a prebankruptcy entitlement is where the alteration would benefit creditors as a group by increasing their total recovery.[12] Hence, those scholars condemn bankruptcy rules that redistribute value to parties who did not have priority under state law, because that redistribution intrudes improperly on the entitlements of the creditors.[13]

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11 See Baird, supra note 10, at 128-35. Baird starts from "the principle that, as a first approximation, the owner of an asset may use or transfer it as he pleases," id. at 128-29, and reasons from that principle to the conclusion that the creditor has a "right," which arises out of the creditor's bargain with other participants, "to withdraw [its] contribution to a firm." Id. at 132. The focus on creditor "entitlements" is a hallmark of the creditors' bargain school. See, e.g., Jackson, supra note 9, at 27-29 (discussing how to accommodate "nonbankruptcy entitlements" in bankruptcy proceeding); Thomas H. Jackson & Robert E. Scott, On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain, 75 Va. L. Rev. 155, 155 (1989) ("The cornerstone of the creditors' bargain is the normative claim that prebankruptcy entitlements should be impaired in bankruptcy only when necessary to maximize net distributions to the creditors as a group . . . ."); Scott, supra note 9, at 694-95 ("Secured creditors, for example, 'paid' for the[ir] entitlements by accepting a lower rate of return, and should thus retain the benefits of the initial bargain . . . . [T]he Bankruptcy Code should . . . honor . . . secured creditors' state law entitlements and preven[t] redistribution from secured creditors to unsecured creditors and the debtor."); Lucian A. Bebchuk, A New Approach to Corporate Reorganizations, 101 Harv. L. Rev. 775, 788-97 (1988) (explaining how his proposal is "perfectly consistent with the entitlements of the participants [in the reorganization]").

For similar formulations that do not use the "entitlements" language, see Douglas G. Baird, Revisiting Auctions in Chapter 11, 36 J.L. & Econ. 633, 635-36 (1993) (suggesting that assets in bankruptcy should be "allocated in a way that was consistent with the original debt contracts"); Douglas G. Baird & Thomas H. Jackson, Bargaining After the Fall and the Contours of the Absolute Priority Rule, 55 U. Chi. L. Rev. 738, 743 (1988) ("[T]he senior creditor, having the exclusive right to the firm's assets following foreclosure, should be able to convey an interest in them to anyone it pleases."); see also James W. Bowers, Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution, 26 Ga. L. Rev. 27, 59 n.85 (1991) (stating, with respect to Bankruptcy Code's treatment of secured creditors, that the "Bankruptcy Code . . . simply refuses to distribute other people's property to the creditors of the debtor but instead distributes property to those who own it").

12 For example, Doug Baird and Tom Jackson argue: "Bankruptcy law should change a substantive nonbankruptcy rule only when doing so preserves the value of assets for the group of investors holding rights in them. . . . Changes in substantive rules unrelated to preserving assets for the collective good of the investor group . . . run counter to the goals of bankruptcy." Douglas G. Baird & Thomas H. 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, 100-01 (1984); see Jackson & Scott, supra note 11, at 155 (arguing that alteration of entitlements is appropriate "only when necessary to maximize net asset distributions to the creditors as a group"); Scott, supra note 9, at 692 (same).

13 See Jackson & Scott, supra note 11, at 155-56 (arguing that alteration of entitlements is "never" a proper means "to accomplish purely distributional goals"); Scott, supra note 9, at 692 (same).

Another viewpoint—generally identified with Elizabeth Warren and her frequent coauthor Jay Westbrook—sees bankruptcy in a completely different light.[14] From their perspective, bankruptcy law is not an isolated legal construct designed solely to further the interests of creditors.[15] Rather, it is a piece of the entire fabric of law in our society.[16] As such, it should be fashioned, just like any other aspect of our legal system, to further all affected social interests as best it can.[17] Accordingly, they see no problem at all with bankruptcy rules that provide for a distribution to parties who would have received nothing under prebankruptcy rules, provided that there is some policy justification for the redistribution.[18] Hence, much of Elizabeth Warren's scholarship is devoted to identifying the policy principles that are reflected in the existing features of the Code, but do not duplicate the results that creditors would obtain under state law.[19]

The principal problem with the debate to date is that the participants are talking past each other.[20] As outlined above, the creditors' bargain theorists assert that their framework best fulfills the goals of a

14 Like the creditors' bargain perspective, the perspective of Professors Warren and Westbrook forms the framework for a prominent casebook, Elizabeth Warren & Jay L. Westbrook, The Law of Debtors and Creditors: Text, Cases, and Problems (2d ed. 1991).

15 Elizabeth Warren, Bankruptcy Policy, 54 U. Chi. L. Rev. 775, 787 (1987) ("[T]he revival of an otherwise failing business . . . serves the distributional interests of many who are not technically 'creditors' but who have an interest in a business's continued existence.").

16 As their casebook puts it: "[B]ankruptcy . . . must . . . be seen in its place as a part of a system of social protection that includes unemployment benefits, welfare, and medical care." Warren & Westbrook, supra note 14, at 397-98. For a concrete example, see Teresa A. Sullivan, Elizabeth Warren & Jay L. Westbrook, As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America 173-75 (1989) (discussing relation between bankruptcy discharge and absence of universal health insurance).

17 See Elizabeth Warren, Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336, 340 (1993) ("Will the law-and-economics crowd admit that more than allocative efficiency is at stake? . . . Can we find ways to deal with conflicting goals that will, for example, account for increased inefficiency while meeting important distributive goals?").

18 Warren, supra note 15, at 788 ("The older employee, the regular customer, the dependent supplier, and the local community are important; and bankruptcy attends to many of their concerns, regardless of whether they have rights recognized at state law.").

19 The most useful summaries of the goals she discerns in the Bankruptcy Code appear in Warren, supra note 17, at 352-78; Warren, supra note 15, at 789-93; see also David A. Lander, Musings During a Symposium Afternoon, 72 Wash. U. L.Q. 905, 906-12 (1994) (summarizing ways in which bankruptcy law reflects compromise between interests of creditors and other social policies). Another important difference between the creditors' bargain perspective and the Warren and Westbrook perspective is that Professors Warren and Westbrook place a heavy emphasis on empirical research and strongly criticize creditors' bargain theorists for producing scholarship that has no "factual basis" and proceeds "without reference to reality." Elizabeth Warren & Jay L. Westbrook, Searching for Reorganization Realities, 72 Wash. U. L.Q. 1257, 1259, 1260 (1994). That difference between the two groups of scholars is not directly relevant to the analysis in this Article.

20 The tenor of the conversation is most readily discerned from an exchange between Elizabeth Warren and Doug Baird in the *University of Chicago Law Review*. Compare

bankruptcy system considered in isolation; Elizabeth Warren argues that the creditors' bargain framework does not satisfy society's general goals. Accordingly, the creditors' bargain theorists tend to dismiss Elizabeth Warren's work with the suggestion that she has not provided an adequate foundation for inclusion in the bankruptcy system of the goals that she discerns in the current system.[21]

This Article attempts to make two contributions to that debate. First, it responds to the criticism of the Warren and Westbrook perspective by articulating a theoretical justification for the distributive aspects of the system so important to that perspective. Specifically, I conclude that the government's role in creating and supervising the bankruptcy system entitles it to use any value created by that system to further any legitimate interests of the government. The second purpose of the Article is to illustrate the limitations of the entitlement-based rhetoric of the creditors' bargain theorists. My argument, like theirs, starts from the entitlements of the parties that exist before the bankruptcy system comes into play. My analysis, however, takes account of all the players in the bankruptcy system—not only the claimants on the firm, but the government as well. When the efforts of the government are taken into account, it becomes clear that the entitlements of the creditors cannot by themselves justify a bankruptcy system limited to furthering the goals of the creditors. Any such justification must be gleaned from more particularized consideration of the relevant social policies.

To bring the issues into focus, Part I sketches this country's debt-collection system, highlighting the separation of that system into a state-remedies system and a federal bankruptcy system, as well as the role bankruptcy laws play in affecting the distribution of values from the bankrupt's estate. Part II discusses the principles of distributive justice that determine when an entity has an "entitlement" to property. Because it would accomplish little to argue, by rejecting entitlements entirely, that the creditors' bargain theorists err in relying on entitlements, that Part disregards egalitarian perspectives on distributive justice, which do not give significant protection to entitlements, and focuses instead on utilitarian and autonomy-based perspectives,

Warren, supra note 15, with Douglas G. Baird, Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren, 54 U. Chi. L. Rev. 815 (1987).

21 See Adler, supra note 4, at 442 n.9 (characterizing Warren's scholarship as offering an "amorphous defense . . . based on what some perceive to be general principles of equity and fairness"); Baird, supra note 20, at 834 ("Warren has not faced our theory squarely."); Robert K. Rasmussen, An Essay on Optimal Bankruptcy Rules and Social Justice, 1994 U. Ill. L. Rev. 1, 5 ("Missing from the pleas for a bankruptcy law committed to fostering various values is an underlying theory of social justice that explains how, and why, these concerns should be addressed.").

which do give significant protection to entitlements. Finally, Part III evaluates the bankruptcy system in light of the principles about entitlements developed in Part II. Specifically, Part III explains why the government's role in creating and operating the bankruptcy system entitles the government to a share of any value that exceeds the value creditors would have obtained if claims against the debtor had been resolved under nonbankruptcy procedures. Because the government has an entitlement to that value, creditors cannot justly complain of unfair treatment if the government chooses not to give all of that value to them.

I
THE DEBT-COLLECTION SYSTEM

The bankruptcy system is but a single feature of our country's system for the enforcement and collection of debts.[22] Accordingly, any useful picture of the role of the bankruptcy system must be drawn against the backdrop provided by the system as a whole. A detailed discussion of the law of debt collection, however, would contribute nothing to the purposes of this Article. It is enough to lay the foundation for Parts II and III of the Article by discussing two brief points: the division of our country's debt-collection system into two tiers (the state-remedies system and the bankruptcy system); and the ways in which the bankruptcy system can alter the results that would occur under the state-remedies system.

A. *The Two Subsystems*

The system for enforcing the collection of debts in this country commonly is divided into two related subsystems: the state-remedies system and the bankruptcy system.[23] The state-remedies system has two principal features of relevance to this Article. First, it contemplates a separate procedure for the liquidation of debts between each creditor and debtor, which would result (if the creditor prevails) in a judgment in favor of the creditor in the amount of the debt.[24] Second,

[22] Cf. Warren, supra note 15, at 778 ("The debtor-creditor system is itself part of a larger, integrated order of public enforcement of promises between individuals.").

[23] See generally Lynn M. LoPucki, A General Theory of the Dynamics of the State Remedies/Bankruptcy System, 1982 Wis. L. Rev. 311. Although there is a considerable body of relevant nonbankruptcy federal law, I adopt the practice of referring to the entire nonbankruptcy system as the state-remedies system. For a general survey of the procedures for collecting debts under that system, see Warren & Westbrook, supra note 14, at 51-184. For a particularly critical assessment of the system's inefficiencies, see William C. Whitford, A Critique of the Consumer Credit Collection System, 1979 Wis. L. Rev. 1047, 1049-72.

[24] See LoPucki, supra note 23, at 348.

the state-remedies system distributes the debtor's property on a first-come, first-served basis: The first creditor to receive a judgment and execute it against the property of the debtor will be the first to get paid.[25] The only avenue for a creditor seeking to avoid the last-second rush is to take a security interest in assets of the debtor, so that the creditor has a first priority to the extent of the value of its collateral.[26] Accordingly, a new creditor that secures its debt with sufficient collateral would be paid in full, even if earlier creditors remain unpaid.[27]

The second part of the debt-collection system, the bankruptcy system, is created by the Bankruptcy Code.[28] The Code establishes two main types of proceedings: liquidation proceedings (under chapter 7 of the Code),[29] in which the assets of the debtor ordinarily are liquidated and the proceeds distributed to creditors; and reorganization proceedings,[30] in which the obligations of the debtor ordinarily are adjusted and the debtor (or a successor enterprise) continues in operation.[31] The bankruptcy system rejects both of the features of the

25 See David G. Epstein & Steve H. Nickles, Debt: Bankruptcy, Article 9 and Related Laws 720 (1994) ("State law puts a premium on prompt action by creditors: the first creditor to attach the debtor's property . . . is the one most likely to be paid."); Warren & Westbrook, supra note 14, at 59 ("First in time, first in right."); LoPucki, supra note 23, at 355 ("[P]riority is given to unsecured creditors in the order in which they take action to collect their debts."); Warren, supra note 15, at 782 ("In the race of the diligent, the slower creditor always runs the risk that by the time it arrives, the assets will be depleted.").

26 See LoPucki, supra note 23, at 354.

27 See Lynn M. LoPucki, The Unsecured Creditor's Bargain, 80 Va. L. Rev. 1887, 1917 (1994); see also LoPucki, supra note 23, at 337-38 (discussing strategy of creditors of W.T. Grant to extend new loan to failing debtor, provided that debtor grant collateral securing both new loan and existing, previously unsecured, loans).

28 The Bankruptcy Code constitutes Title 11 of the United States Code.

29 11 U.S.C. §§ 701-766 (1988). For a short introduction to the dynamics of liquidation proceedings ("straight bankruptcy"), see Warren & Westbrook, supra note 14, at 225-26, 407-09.

30 Reorganization proceedings for businesses ordinarily proceed under chapter 11 of the Code, 11 U.S.C. §§ 1101-1174 (1988). For a short introduction to the dynamics of reorganization proceedings, see Warren & Westbrook, supra note 14, at 427-35. The Code also contains a variety of other specialized nonliquidation procedures. For example, chapter 9, 11 U.S.C. §§ 901-946 (1988), establishes special procedures for the adjustment of debts of municipalities described in id. § 109(c), which apply to the bankruptcy of Orange County discussed supra in note 5. The Bankruptcy Code also includes a chapter for wage-earner plans for individuals (chapter 13, id. §§ 1301-1330). Although chapter 13 differs in significant respects from chapter 11, I include it as a type of reorganization proceeding because it does not provide for liquidation of the assets of the debtor. Because criticisms of the Code have been directed at problems with chapter 11 proceedings, the portions of this Article discussing reorganization cases focus on chapter 11 proceedings. Because chapter 13 (and, to some extent, chapter 9) contains similar provisions, see infra notes 162, 168, my analysis applies to proceedings under chapter 13 as well.

31 The reference to the two types of proceedings established by the Code imposes something of an arbitrary distinction on the system as it operates in practice, because it is

state-remedies system identified above. First, when a party files a petition in bankruptcy,[32] an automatic stay brings to a halt the separate state-remedy proceedings under which creditors seek to liquidate and collect their debts.[33] The bankruptcy court then proceeds to conduct coordinated proceedings to liquidate any claims against the debtor that have not yet been liquidated.[34] Second, after the claims have been liquidated, the assets are distributed in accordance with a priority scheme established by the Code. That scheme provides for priority payment to a few creditors specified by the statute,[35] and then for pro rata payments of any remaining funds to general unsecured creditors, without regard to the timing of their attempts to enforce their claims in the state-remedies system.[36] The ratable distribution policy is advanced by provisions of the Code that allow the debtor (or its representative) to recover for the benefit of the debtor's estate certain

entirely possible to have a liquidating reorganization under chapter 11 (in which the business is kept alive just long enough for disposition of its assets) or a reorganizing liquidation under chapter 7 (in which the business is liquidated only in the sense that it is sold and the sales proceeds are distributed to the claimants). See John D. Ayer, Through Chapter 11 with Gun or Camera, but Probably Not Both: A Field Guide, 72 Wash. U. L.Q. 883, 892-94 (1994) (explaining why "the distinction between Chapters 7 and 11 seems to be a blur"); see also William C. Whitford, What's Right About Chapter 11, 72 Wash. U. L.Q. 1379, 1388-90 (1994) (discussing how chapter 11 proceedings aided satisfactory liquidation of Baldwin-United).

32 Although 11 U.S.C. § 303 (1988) permits filings by creditors in certain cases, the overwhelming majority of bankruptcy cases are filed by debtors. See Susan Block-Lieb, Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small, 57 Brook. L. Rev. 803, 804 n.6, 863-64 (1991) (table and graphs demonstrating changes in rate of involuntary filings from 1970 to 1988); Sullivan, Warren & Westbrook, supra note 2, at 813 & n.59 (citing evidence that involuntary bankruptcies in 1992 accounted for "only 15 of every 10,000 filings"); see also LoPucki & Whitford, Venue, supra note 7, at 24 (empirical study indicating that 14% (6 out of 43) of large, publicly held bankruptcy filings were involuntary).

33 11 U.S.C. § 362(a) (1988); see Warren & Westbrook, supra note 14, at 407 ("Filing bankruptcy halts the state law 'race of the diligent,' which can be time-consuming and expensive for the initiating creditor and can waste the debtor's remaining assets."). For a general discussion of the automatic stay, see Douglas G. Baird, The Elements of Bankruptcy 193-213 (rev. ed. 1993).

34 For a general discussion of the claim liquidation process, see Baird, supra note 33, at 83-94.

35 Priorities in a liquidation case are established by 11 U.S.C.A. § 726 (West 1993 & Supp. 1995) (which incorporates by reference a schedule of priorities described in id. § 507). The priorities established by that section are implicitly incorporated (with minor changes) in the reorganization and wage-earner chapters of the Code by provisions prohibiting confirmation of a plan over the objection of a creditor that would receive less under the plan than it would receive if the debtor were liquidated under chapter 7. 11 U.S.C. §§ 1129(a)(7)(A)(ii), 1129(a)(9), 1322(a)(2), 1325(a)(4) & (5) (1988).

36 See Executive Director, Comm'n on the Bankruptcy Laws of U.S., Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1st Sess. 75 (1973) (identifying equality of distribution as foundational principle of bankruptcy law); Epstein & Nickles, supra note 25, at 720 ("Bankruptcy law . . . emphasizes equality of treatment, rather than a race of diligence.").

payments made shortly before the debtor filed for bankruptcy, if the payments were made to creditors in satisfaction of preexisting debts (preferences)[37] or if they were made for less than reasonably equivalent value (fraudulent conveyances).[38]

B. *The Effects of the Bankruptcy System*

The first question presented by the existence of a separate federal system is whether it is needed. If the state-remedies system adequately provides for liquidation and enforcement of debts, why have a bankruptcy system?[39] To understand the arguments in favor of a system, it is necessary to summarize the effects of the system. For analytical purposes, it is useful to consider two types of effects: ways in which the system can increase the values available for distribution (enlarging the pie); and ways in which the system alters the distribution (reslicing the pie). With respect to the first type of effect, it is possible that the bankruptcy system does not in fact increase the values available for distribution to claimants on the firm.[40] That possibility is not important to this discussion, however, because I do not undertake to evaluate the actual effects of the system.[41] Rather, the purpose of this section of the Article is to identify the ways in which the system is designed to increase values, so that subsequent sections of the Article can consider whether a system that successfully

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[37] 11 U.S.C. § 547 (1988); see Baird, supra note 33, at 165-93.

[38] 11 U.S.C. § 548 (Supp. V 1993); see Baird, supra note 33, at 142-64.

[39] The question is not purely rhetorical. There was no federal bankruptcy law for almost half of this country's history. See Richard C. Sauer, Bankruptcy Law and the Maturing of American Capitalism, 55 Ohio St. L.J. 291, 296-97 (1994) (discussing three early American bankruptcy statutes). Although there has been a federal bankruptcy law since enactment of the Bankruptcy Act in 1898, bankruptcy laws were in effect only in three isolated periods before 1898: from 1800 to 1803; from 1841 to 1842; and from 1867 to 1878. Id. See generally Charles Warren, Bankruptcy in United States History (1935) (surveying history of American bankruptcy law).

[40] See, e.g., Baird, supra note 10, at 145-47 (challenging value of bankruptcy reorganization proceedings); James W. Bowers, The Fantastic Wisconsylvania Zero-Bureaucratic-Cost School of Bankruptcy Theory: A Comment, 91 Mich. L. Rev. 1773, 1791-92 (1993) (arguing that costs of bankruptcy system exceed benefits); Bradley & Rosenzweig, supra note 3, at 1078-88 (arguing that reorganization provisions of Code should be repealed). Another way in which the bankruptcy system might decrease the values available for distribution, not to my knowledge discussed in the literature, was offered to me independently by several readers of drafts of this Article: It is possible that the bankruptcy system undermines the values available for distribution in the long run by limiting the potential for the development of better systems of liquidation and reorganization that, in the absence of bankruptcy, could be available under state judicial processes or consensual nonjudicial processes. See infra note 147 (discussing the effect that argument has on my analysis).

[41] The empirical evidence necessary to evaluate the system's effectiveness does not yet exist. See infra note 63 (explaining relation between this Article's analysis and actual results of proceedings under the Code).

achieved those goals would comport with principles of distributive justice.

1. Enlarging the Pie

The bankruptcy system can increase the values available for distribution to claimants in four separate ways: providing a superior method for liquidating assets; coordinating the collection efforts of the creditors; controlling insolvent debtors; and preserving going-concern value.[42]

The most likely way for the bankruptcy system to increase the values available for distribution comes from the likelihood that the bankruptcy system can liquidate the assets of the debtor more efficiently than the state-remedies system can.[43] Where the state-remedies system allows assets to be sold at the request of a single creditor, without regard to the interests of other creditors,[44] the bankruptcy system delegates the authority to conduct sales to a trustee responsible to creditors as a whole.[45] Furthermore, the bankruptcy system replaces the rigid and unproductive procedures that characterize state execution sales with a flexible process that allows the trustee to proceed in the manner most likely to produce the greatest net recovery.[46] Those procedures are likely to benefit creditors not only by reducing the expenses of sale[47] but also by increasing the amount of

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42 The four-part schema used in the text is drawn from the similar frameworks outlined in Lynn M. LoPucki, Strategies for Creditors in Bankruptcy Proceedings §§ 1.6-1.9 (2d ed. 1991), and in Warren, supra note 17, at 344-52.

43 See LoPucki, supra note 42, § 1.6, at 12 ("A primary purpose of the bankruptcy system is to provide a more efficient and effective method of liquidating debtors' assets."); Warren, supra note 17, at 345-46 (discussing "specialized, yet flexible collection system" created by interaction of state and federal law).

44 See LoPucki, supra note 23, at 330.

45 See LoPucki, supra note 42, § 1.6, at 13-14 (discussing role of trustee in bankruptcy proceedings); Warren & Westbrook, supra note 14, at 408 (same); Warren, supra note 17, at 346-47 (same). In a reorganization case, a trustee is appointed only upon a showing of misconduct by the debtor or some other reason why appointment of a trustee would benefit the creditors. 11 U.S.C. § 1104(a) (1988). If a trustee is not appointed, the debtor (referred to as the debtor in possession) can exercise the powers and responsibilities that otherwise would fall to the trustee. Id. § 1107(a). See generally Epstein & Nickles, supra note 25, at 1037-40 (discussing powers and responsibilities of debtor in possession).

46 See LoPucki, supra note 42, § 1.6, at 12-14 ("The purpose [of bankruptcy sale procedures] is to aggregate interests of debtor and creditor alike by obtaining the highest possible net price."); Warren & Westbrook, supra note 14, at 407 (noting that state collection procedures tend to "waste the debtor's remaining assets"); Whitford, supra note 23, at 1051-60 (highlighting unnecessary costs and loss of value inherent in state-law process).

47 The expenses of sale may be reduced not only by improvements in the sale procedures, but also by the removal of the debtor's incentive to fight desperately to defer execution on its assets, an incentive that can increase the expense of collection in the state-remedies system substantially. See LoPucki, supra note 23, at 348 ("Defenses are interposed not for the purpose of reducing the creditor's recovery, but to gain time."); Warren,

the recovery they receive from the sale; that is especially likely in cases that involve illiquid assets, as to which the forced-sale procedures of state law are particularly harmful.[48]

The total creditor recovery also should be enhanced by the features of the bankruptcy system that help creditors to coordinate their collection efforts.[49] The coordination has two benefits. It destroys the need for each separate creditor to incur collection costs that duplicate the costs incurred by others,[50] and it can limit the incentives for unduly aggressive collection efforts. As Elizabeth Warren explains:

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supra note 17, at 345 (commenting that state-remedies system's "effectiveness in dealing with a recalcitrant debtor may be questionable"); Elizabeth Warren, Further Reconsideration, 80 Va. L. Rev. 2303, 2306 n.8 (1994) (offering example of exceptionally "wily" debtor's resistance to collection).

48 See LoPucki, supra note 4, at 100-01. Jim Bowers cogently argues that the bankruptcy system in fact does not liquidate assets more effectively than the state system. James W. Bowers, Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure, 88 Mich. L. Rev. 2097 (1990). Bowers makes two main points. He argues first that bankruptcy itself is expensive, and to that extent unlikely to be more cost-effective than the state-remedies system. Id. at 2109; see also Bowers, supra note 40, at 1773-92 (arguing that scholarship of LoPucki and Warren ignores bureaucratic costs of bankruptcy administration); Karen H. Wruck, Financial Distress, Reorganization and Organizational Efficiency, 27 J. Fin. Econ. 419, 433-35 (1990) (explaining how value of debtor companies may be increased outside of bankruptcy). Second, he argues that financial distress gives debtors an incentive to operate their businesses more thriftily, and that their superior knowledge enables them to do so in a manner that liquidates their assets more effectively than either creditors or the bankruptcy trustee can. Bowers, supra note 40, at 2113-41. I disagree with Professor Bowers's conclusions. I believe that his analysis gives inadequate weight to the incentives that the managers of an insolvent business have to further goals that do not maximize the value of the business. See, e.g., Bradley & Rosenzweig, supra note 3, at 1052-53 (describing "incentive [of managers of businesses nearing bankruptcy] to adopt increasingly risky investment/production strategies, leading, at the extreme, to the adoption of strategies having a negative net present value"); Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. Rev. 669, 683-84 (1993) (noting that when "a marginally solvent company engages in high risk investment, the risks are borne primarily by creditors while the benefits accrue primarily to shareholders"). For a telling real-world example, see In re Tri-State Paving, 32 B.R. 2, 3 (Bankr. W.D. Pa. 1982) (describing how managers of debtor withdrew all funds from corporate bank account and expended them gambling in Las Vegas, allegedly in effort to resuscitate corporation's fortunes).

49 See LoPucki, supra note 42, § 1.9, at 22-24 (explaining how bankruptcy can coordinate creditors' collection efforts); Warren, supra note 17, at 346-48 (explaining how Code "reduces the costs of collection from a troubled debtor by collectivizing creditor activities").

50 See Jackson, supra note 9, at 16 (describing how collective proceeding can eliminate "costs of racing against other creditors"); Warren & Westbrook, supra note 14, at 407 ("[T]he state law 'race of the diligent' . . . can be time-consuming and expensive for the initiating creditor . . . ."); LoPucki, supra note 23, at 347-48 (explaining how "the bankruptcy subsystem is able to eliminate substantial duplication of procedures that routinely occur in the state remedies subsystem"); Warren, supra note 17, at 346 ("By replacing the competitive state law collection systems, in which each creditor engages in separate moni-

> State law rewards creditors for racing to grab assets and thereby encourages behavior that dismantles debtors in distress and precipitates business failures that might have been averted if the creditors had been more patient. The state system distributes benefits to aggressive creditors rather than cooperative ones; it thus tends to raise business failure rates generally.[51]

By staying creditor efforts to gain priority, the bankruptcy system brings to an end the "first in time, first in right" system of state law, under which each creditor has an incentive to act as quickly as possible to secure a priority for itself. Once that incentive is removed, creditors are in a position to act cooperatively to further the maximization of the estate for the benefit of all.

Third, the bankruptcy court's ability to monitor and control the debtor can increase the overall recovery by limiting the ability of the debtor and its management to engage in misconduct that might be difficult or impossible to discover and prevent without direct judicial supervision.[52] The main mechanism for this is the formal disclosure requirement of the bankruptcy system,[53] which generally should be more useful than informal disclosures made before bankruptcy, if only because disclosures automatically will be available to all claimants, not just the claimants whose claims are of a sufficient size to justify the expenditures necessary to acquire the information. Similarly, the judicial supervision of the debtor's disclosures makes it risky for the debtor or its management to provide false information.[54] Also, the ability of the bankruptcy court to invalidate improper transactions, together with the availability of federal criminal sanctions for serious wrongdoing,[55] limits the incentive

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toring and collection activities, with a collective-action system, the bankruptcy mechanism attempts to achieve significant cost savings.").

51 Warren, supra note 17, at 351; see also Jackson, supra note 9, at 125-26 (similar discussion); Douglas G. Baird, A World Without Bankruptcy, Law & Contemp. Probs., Spring 1987, at 173, 183 ("Without a collective bankruptcy proceeding, each creditor will tend to rush towards the debtor's assets when the best course is patience."). But see Barry E. Adler, A World Without Debt, 72 Wash. U. L.Q. 811, 814-18 (1994) (arguing that creditors can solve their collective-action problems without bankruptcy).

52 See LoPucki, supra note 42, § 1.8, at 21 ("The overall effect of restrictions and limitations on debtor conduct... is to create an atmosphere in which debtors engage in intentional wrongdoing far less frequently...."); Warren, supra note 17, at 347-50 (explaining how "[s]avings are... realized by imposing stiff requirements on debtors"). But see Baird, supra note 11, at 645-46 (arguing that "the monitoring mechanism that exists in bankruptcy is necessarily much cruder than the one that exists outside").

53 See LoPucki, supra note 42, § 1.8, at 19 (describing formal disclosure required of debtor at commencement of case).

54 See id. at 19-20.

55 The Supreme Court's recent decision in Hubbard v. United States, 115 S. Ct. 1754 (1995), has limited the exposure of the debtor for false statements. Id. at 1757-65 (plurality opinion of Stevens, J.) (overruling United States v. Bramblett, 348 U.S. 503 (1955), and

of the debtor to harm the estate once bankruptcy has been filed.[56]

Finally, the bankruptcy system can preserve going-concern values that would be lost if a business were liquidated.[57] Although negotiation among the claimants can reorganize a struggling business without intervention of the bankruptcy system in some cases, the bankruptcy system provides several tools that aid restructurings. First, the chapter 11 proceeding greatly enhances the power of creditors to change management.[58] Second, the Code's framework for considering and adopt-

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holding that 18 U.S.C. § 1001 (1988) does not proscribe false statements made to judicial entities); see *Hubbard*, 115 S. Ct. at 1765-66 (opinion of Scalia, J., concurring in the judgment and in the overruling of *Bramblett*). Federal criminal sanctions for fraudulent conduct, however, continue to constrain the debtor's conduct in the bankruptcy proceeding. See LoPucki, supra note 42, § 1.8, at 21 (discussing possibility of prosecution under 18 U.S.C.A. §§ 152-154 (West 1993 & Supp. 1995)).

56 See LoPucki, supra note 42, § 1.8, at 20-21 (noting that debtors who engage in fraudulent conduct may be subject to fines or imprisonment).

57 See LoPucki, supra note 42, § 1.7, at 14-17. Preserving going-concern value is the classic justification for reorganization proceedings. See, e.g., Robert C. Clark, The Interdisciplinary Study of Legal Evolution, 90 Yale L.J. 1238, 1250-54 (1981) (discussing evolution of reorganization procedures and growing emphasis on efforts to capture excess of going-concern value over liquidation value); Warren, supra note 17, at 350 & n.34.

The bankruptcy system would be responsible for preservation of the going-concern value whether the firm formally reorganized or instead was preserved long enough to allow a sale of the business as a whole. Several commentators favor procedures that produce a sale without resort to chapter 11, on the theory that such procedures avoid the costs of reorganization without sacrificing the going-concern value. See Jackson, supra note 9, at 223 (concluding that sale of company as a whole in chapter 7 proceeding would be as effective as reorganization proceeding under chapter 11); Barry E. Adler, Financial and Political Theories of American Corporate Bankruptcy, 45 Stan. L. Rev. 311, 323-33 (1993) (proposing contingent, or "chameleon," equity); Philippe Aghion, Oliver Hart & John Moore, The Economics of Bankruptcy Reform, 8 J.L. Econ. & Organization 523, 532-36 (1992) (proposing modified auction procedure); Baird, supra note 10, at 139 (proposing auction to third parties); Bebchuk, supra note 11, at 781-88 (proposing auction-like procedure among existing claimants); Rasmussen, supra note 4, at 55-68 (suggesting that bankruptcy be available only to extent consistent with agreement among parties forming debtor); Mark J. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganizations, 83 Colum. L. Rev. 527, 559, 593-97 (1983) (proposing that bankruptcy courts rely on market to value reorganizing businesses). For detailed criticism of several of those proposals, see Skeel, supra note 4, at 477-91; see also Robert K. Rasmussen, The Ex Ante Effects of Bankruptcy Reform on Investment Incentives, 72 Wash. U. L.Q. 1159, 1190-1206 (1994) (evaluating the effect enactment of various reform proposals would have on prebankruptcy incentives). Even if those procedures were feasible, the preservation of the going-concern value would still be attributable at least in part to the shelter provided by the bankruptcy court.

58 See LoPucki, supra note 4, at 105; see also LoPucki & Whitford, supra note 48, at 699-701, 723-37 (studying management's ability to remain in control through bankruptcy proceeding); Stuart C. Gilson, Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default, 27 J. Fin. Econ. 355, 362-86 (1990) (same); cf. Stuart C. Gilson & Michael R. Vetsuypens, Creditor Control in Financially Distressed Firms: Empirical Evidence, 72 Wash. U. L.Q. 1005, 1005-24 (1994) (empirical study suggesting that creditors control decisions about removing and compen-

ing a plan offers a considerable improvement on nonbankruptcy opportunities for negotiation among the affected parties. The existence of a coordinated proceeding makes it easier and less expensive for the parties to come together for realistic negotiations.[59] Furthermore, the voting provisions of chapter 11 enhance the likelihood that a plan of reorganization can be adopted.[60] Absent those provisions, a single holdout creditor could scuttle (or at least raise the cost of) a reorganization that would increase the recovery of all creditors over what they would get if the assets were liquidated.[61] To be sure, it is difficult to determine in advance whether any particular plan of reorganization will produce benefits for creditors.[62] But chapter 11 is

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sating managers in distressed firms); William C. Whitford, Comment, 72 Wash. U. L.Q. 1027, 1027-28 (1994) (commenting on Gilson & Vetsuypens, supra) (explaining that creditor control of management of distressed firms is not unambiguously positive, because it alters investment incentives of firms).

59 See Ayer, supra note 31, at 888-92 (noting role of automatic stay and confirmation provisions in coordinated proceedings).

60 See 11 U.S.C.A. § 1129 (West 1993 & Supp. 1995) (outlining requirements for confirmation of reorganization plan). For analysis of the strategies a creditor should pursue in considering whether to vote for a plan, see LoPucki, supra note 42, §§ 10.11 at 572-80 (analyzing plan from perspective of unsecured creditor), 11.11 at 639-61 (analyzing plan from perspective of secured creditor).

61 As Doug Baird and Tom Jackson put it: "Under the 1978 Bankruptcy Code, consent can be given through a classwide vote of creditors. A single uncompromising creditor's objection is not sufficient to prevent the participation of shareholders." Baird & Jackson, supra note 11, at 738; see also LoPucki & Whitford, Equity's Share, supra note 7, at 131-34 (discussing congressional decision to make bargaining more important under Bankruptcy Code than it had been under Bankruptcy Act); Charles J. Tabb, The Future of Chapter 11, 44 S.C. L. Rev. 791, 805-06 (1993) (discussing importance to any reorganization system of provisions allowing group of creditors that approves reorganization to bind dissenting holdout creditors); cf. Ashton v. Cameron County Water Improvement Dist., 298 U.S. 513, 541 (1936) (Cardozo, J., dissenting) ("Experience makes it certain that generally there will be at least a small minority of creditors who will resist a composition, however fair and reasonable, if the law does not subject them to a pressure to obey the general will."); House Report, supra note 3, at 220, reprinted in 1978 U.S.C.C.A.N. at 6180 (expressing doubts about feasibility of nonbankruptcy workout because it "requires near universal agreement of the business's creditors"). For a more theoretical evaluation of the dynamics of negotiation in bankruptcy, see generally Douglas G. Baird & Randal C. Picker, A Simple Noncooperative Bargaining Model of Corporate Reorganizations, 20 J. Legal Stud. 311 (1991).

62 Indeed, many commentators believe that the expenses of the proceedings generally exceed their benefits. See, e.g., Adler, supra note 57, at 315-18 (summarizing costs of reorganization proceedings); James W. Bowers, Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses, 72 Wash. U. L.Q. 955, 958-64 (1994) (presenting empirical evidence in support of argument that reorganization proceedings do not preserve going-concern value, but instead diminish values available for liquidation); Bowers, supra note 40, at 1791-92; Rasmussen, supra note 4, at 83-84, 88-89 (examining arguments that costs of chapter 11 exceed its benefits). The existing empirical evidence, however incomplete, tends to undermine the claims that chapter 11 is extravagantly expensive. See, e.g., Baird, supra note 11, at 641-44 (evaluating empirical evidence regarding direct and indirect costs of reorganization proceedings); Theodore Eisenberg, Baseline Problems in Assessing Chapter 11, 43 U. Toronto L.J. 633, 648-49 (1993) (compar-

designed to deal with that problem by barring confirmation of a plan unsatisfactory to creditors unless the debtor can establish that the plan preserves for each creditor at least the value that would be recovered if the firm were liquidated under chapter 7.[63]

2. *Reslicing the Pie*

As I noted in the opening paragraphs of the Article, the bankruptcy system as it actually operates does much more than alter the values available for distribution. It also alters the way in which those values are allocated, furthering goals and policies not important to the state-remedies system.[64] Those alterations start with the effective redistribution in favor of debtors and other claimants that has been the

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ing time for conducting chapter 11 proceedings to time for conducting receiverships under pre-chapter 11 law and concluding that chapter 11 does not lengthen the delay); Rasmussen, supra note 57, at 1160-61 nn.7-8 (citing studies); Whitford, supra note 31, at 1381-82 (expressing doubt that any proposed alternative to chapter 11 would be less expensive); see also Steven N. Kaplan, Federated's Acquisition and Bankruptcy: Lessons and Implications, 72 Wash. U. L.Q. 1103, 1117-23 (1994) (case study of bankruptcy of Federated Department Stores indicating that indirect costs of bankruptcy are relatively small even in largest cases); Weiss, supra note 8, at 288-90 (empirical study suggesting that direct costs of bankruptcy are about three percent of book value of firm's assets). But see Adler, supra note 51, at 816 n.17 (arguing that indirect bankruptcy costs are disproportionate to benefits of bankruptcy).

63 11 U.S.C. § 1129(a)(7)(A)(ii) (1988). The Code's requirement that creditors receive at least as much in a reorganization proceeding as they would receive in a hypothetical liquidation proceeding does not prove that creditors in fact receive as much, if only because there is no way to ensure that the debtor under a confirmed plan actually will make all of the payments called for by the plan. Cf. Susan Jensen-Conklin, Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law, 97 Com. L.J. 297, 326, 329 (1992) (empirical study suggesting that few debtors make payments required under chapter 11 plans that extend payout period beyond 12 months). For an economic model suggesting that creditors should receive more in reorganization proceedings than they would if firms were liquidated, see Michelle J. White, Does Chapter 11 Save Economically Inefficient Firms?, 72 Wash. U. L.Q. 1319, 1338 (1994). For a fascinating empirical study suggesting that reorganizations in Japan preserve going-concern value and arguing that the same results should hold true in this country, see Theodore Eisenberg & Shoichi Tagashira, Should We Abolish Chapter 11? The Evidence from Japan, in Current Developments in International and Comparative Corporate Insolvency Law 215, 244-52, 254-55 (Jacob S. Ziegel ed., 1994), reprinted in 23 J. Legal Stud. 111, 140-48, 149-154 (1994).

The great difficulty in determining exactly what results the system produces is not immediately relevant to the analysis of this Article, which focuses on the proper goals of a bankruptcy system. If a properly designed bankruptcy system would require the payments called for by § 1129 (and I believe that it would), a demonstration that proceedings under the Code do not cause those payments to be made does not implicate the goals of the system; it simply demonstrates a need for revising the procedures to ensure that creditors receive the payments called for by the goals of the system.

64 The most complete articulation of the redistributive effects of the Code appears in Warren, supra note 17, at 352-61. For more critical assessments of the Code's redistribution of value, see, e.g., Adler, supra note 4, at 446-54; Rasmussen, supra note 4, at 70-71.

subject of criticism of chapter 11,[65] but they do not end there. Indeed, many other provisions of the Code appear to call for a distribution that differs from the distribution that would have occurred if the debtor had been liquidated in the state-remedies system. The most prominent are provisions that limit the compensation for the creditor's delay in receiving payment,[66] provisions that alter state-law priorities by granting priority to federally favored claimants,[67] and the discharge, which cuts off the creditors' right to pursue the debtor.[68]

II
ENTITLEMENTS TO PROPERTY

This Article evaluates the "redistributive"[69] features of the bankruptcy system—the ways in which the system reslices the pie—in light

[65] See Adler, supra note 4, at 446-54 (explaining thoroughly and critically the way in which bankruptcy reorganization reallocates value from creditors to debtors); Warren, supra note 15, at 787-89 (favorably explaining redistributions effected by reorganization); see also infra notes 182-88 and accompanying text (analyzing the propriety of that redistribution). For analysis of the possibility that redistributions effected by chapter 11 further a hypothetical bargain among creditors to share risks, see Jackson & Scott, supra note 11, at 190-97. Jackson and Scott's risk-sharing argument has been the subject of considerable criticism. See Adler, supra note 4, at 463-79 (criticizing Jackson and Scott's risk-sharing argument); David G. Carlson, Bankruptcy Theory and the Creditors' Bargain, 61 U. Cin. L. Rev. 453, 479-509 (1992) (same); Robert K. Rasmussen, The Efficiency of Chapter 11, 8 Bankr. Dev. J. 319, 327-32 (1991) (same); Mark J. Roe, Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics, 75 Va. L. Rev. 219, 230-37 (1989) (same).

[66] See Adler, supra note 4, at 454 (discussing how denial of pendency interest reallocates value from creditor to junior claimants). I analyze the propriety of that action in infra notes 167-81 and accompanying text. For an argument that the denial of pendency interest is a "plausible means" of furthering a hypothetical bargain of creditors to share risks, see Jackson & Scott, supra note 11, at 189-90; see also supra note 65 (discussing criticism of risk-sharing hypothesis).

[67] See Warren, supra note 15, at 786 (summarizing bankruptcy provisions that "mak[e] hard choices about which creditors belong where in a financial hierarchy"); see also infra notes 210-12 and accompanying text (discussing propriety of those provisions under the analysis described in this Article).

[68] 11 U.S.C. §§ 727, 944(b)-(c), 1141(d) (1988); id. at § 1328 (Supp. V 1993). There are certain exceptions to the discharge, set forth both in the previously cited provisions and in 11 U.S.C.A. § 523 (West 1993 & Supp. 1995), but the availability of a discharge remains a significant feature of bankruptcy for individuals. For a general discussion of the discharge, see Baird, supra note 33, at 31-61. For a brief discussion of the propriety of the discharge under this Article's analysis, see infra notes 213-18 and accompanying text.

[69] My use of the term "redistributive" does not indicate that I believe that the "reslicing" necessarily deprives creditors of anything to which they are entitled. Cf. Robert Nozick, Anarchy, State, and Utopia 149-50 (1974) (discussing value judgments that can be implicit in references to "distribution" and "redistribution"). I use the term only to refer to those features of the bankruptcy system that cause parties to receive a greater share of the benefits (or a smaller share of the losses) arising out of the firm's failure than they would receive (or bear) if the firm were liquidated in the state-remedies system, without implying any "entitlement" to receive what they would receive under the state-remedies system.

of the ways in which the system might enlarge the pie. The purpose of the project is to determine whether the government's role in any enlargement of the total recovery could justify the effect on creditors of the redistributive features of the system. To answer that question, I must consider whether the creditors or the government have an entitlement to the portion of the proceeds that the government redistributes. Resolution of that issue, in turn, requires analysis of the concept of an entitlement.

Because the concept of an entitlement is not unique to any single philosophy, it is difficult to write definitively about the sources and boundaries of entitlements.[70] The analysis of this Article does not, however, require a comprehensive and exhaustive theory of entitlements. Rather, it is enough to describe two simple and relatively noncontroversial rules customarily accepted in those theories that emphasize entitlements: (a) individuals have an entitlement to the fruits of their labor; and (b) individuals acquire entitlements in property through a consensual exchange with the prior holder of the entitlements.[71]

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[70] A complete discussion of entitlements would consider the views of scholars who completely reject the concepts of entitlements and property rights, based on their view that the legal system's use of such concepts is simply a disguise for its adoption of rules designed to further the interests of those who hold power in a society at any given time. See, e.g., Thomas C. Grey, The Disintegration of Property, in Nomos XXII: Property 69, 73-79 (J. Roland Pennock & John W. Chapman eds., 1980) [hereinafter Nomos XXII] (explaining how conceptions of property in Anglo-American legal system have developed to accommodate needs of increasingly sophisticated market economies that the system governs); Michael E. Tigar, The Right of Property and the Law of Theft, 62 Tex. L. Rev. 1443, 1451-75 (1984) (arguing that expansion of law of theft to cover interference with ownership, as opposed to possession, together with subsequent expansion to cover new types of property, reflected use of law as "an ideological construct designed to protect a particular system of social organization"); see also Jeremy Bentham, The Theory of Legislation 111-14 (Richard Hildreth trans., 1931) (from the French of Etienne DuMont) (the Principles of the Civil Code pt. I, ch. VIII) (arguing that there is no inherently justifiable expectation that property will be protected; all such expectations are created by legal institutions); P.J. Proudhon, What Is Property: An Inquiry into the Principle of Right and of Government 12 (Benj. R. Tucker trans., 1890) (1840) (presenting spirited argument that "property is robbery"). Because the purpose of this Article is to explore the implications of entitlements-based analysis for the bankruptcy system, I do not consider in this Article the arguments those scholars have advanced about the inevitable contingency and manipulability of any concept of entitlements.

[71] My discussion, like the bulk of the literature on entitlements, proceeds on the assumption that an entitlement in property includes relatively complete control over possession, use, and disposition of the property. Cf. 2 William Blackstone, Commentaries on the Laws of England *1 (describing property as "that sole and despotic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe"). That assumption is neither inevitable nor even particularly accurate. See, e.g., Lawrence C. Becker, Property Rights: Philosophic Foundations 18-20 (1977) [hereinafter Becker, Foundations] (discussing 11 possible separate elements of ownership); Lawrence C. Becker, The Moral Basis of Property Rights, in

To illustrate the way in which those rules are derived, this Part of the Article sketches three different perspectives on distributive justice, focusing on the role that entitlements have in each perspective. I order the perspectives based on the level of protection each affords entitlements. Hence, I start with the egalitarian perspective (which affords entitlements little or no respect), and then proceed to the utilitarian perspective (which can afford indirect protection to entitlements, to the extent that recognizing entitlements increases utility or wealth). The third perspective protects entitlements directly, for reasons arising out of the autonomy of the individuals who hold them. The Part concludes that the two rules stated in the preceding paragraph arise naturally out of either of the two perspectives that afford significant recognition to entitlements. Finally, because the third perspective provides the most direct and complete protection for entitlements, I adopt that approach as the basis for the analysis of entitlements in bankruptcy that I present in Part III of the Article.

A. Egalitarian Perspectives

No discussion of distributive justice can be complete without taking into account the egalitarian theory articulated by John Rawls in his 1971 book *A Theory of Justice*.[72] Because the analysis of this Article does not draw on Rawls's theory, it is important to explain why.[73] *A Theory of Justice* articulates a perspective dominated by Rawls's celebrated "difference principle."[74] Under that principle, "[s]ocial and economic inequalities are to be arranged so that they are . . . to the greatest benefit of the least advantaged."[75] Because that perspective

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Nomos XXII, supra note 70, at 187, 189-92 [hereinafter Becker, Moral Basis] (offering revised list of 13 elements of ownership); see also, e.g., id. at 207-09 (discussing circumstances where right to transfer property has been limited); Robert C. Ellickson, Property in Land, 102 Yale L.J. 1315, 1344-62 (1993) (discussing examples of group ownership of property). Notwithstanding the limited accuracy of that assumption, it is called for by the purpose of this Part of the Article: to develop the most robust plausible concept of entitlements, so as to evaluate the claims that creditors plausibly could base on a theory of entitlements.

72 John Rawls, A Theory of Justice (1971).

73 "Political philosophers now must either work within Rawls' theory or explain why not." Nozick, supra note 69, at 183.

74 Rawls, supra note 72, § 13, at 83.

75 Id. Rawls has elaborated his general theory of justice in a more recent work, John Rawls, Political Liberalism (1993). That work does not, however, significantly alter the portions of his analysis at issue in this Article. See id. at 338-39 (explaining that propriety of recognizing private ownership of property is not of foundational importance to Rawls's theory of political liberalism). See generally Symposium on Political Liberalism, 94 Colum. L. Rev. 1813 (1994) (discussing varying perspectives on *Political Liberalism*).

Rawls is not, of course, the only philosopher to draw on egalitarian concerns in formulating a theory of distributive justice. For a general discussion and typology of the various types of egalitarian considerations, see Larry S. Temkin, Inequality ch. 2, at 19-52 (1993).

judges the justice of any distribution of goods in society not by reference to the justice of the transactions that resulted in the distribution, but by reference to the question whether each individual has received "his due,"[76] it is—to adopt the terminology of Robert Nozick—a patterned perspective.[77] To put it another way, Rawls is not directly concerned about the way in which a particular distribution of goods arose; rather, the key point for his analysis is the pattern of the distribution itself. In particular, the question for Rawls with respect to any society in which wealth is not shared equally is whether the society's inequalities tend to increase the wealth of the poorest above what they would have in a strictly egalitarian society.[78] For that reason, the respect afforded entitlements in an egalitarian framework like that of Rawls is quite small: If one person has more wealth than other individuals, then it is just to take the wealth from the wealthy person unless that person can show that protection of the wealth contributes in some material way to the benefit of those who have less. That is so without regard to the manner in which the person acquired that wealth.[79]

Because such an egalitarian perspective gives little weight to the protection of entitlements, it is not a useful tool for the purposes of this Article.[80] This Article's attempt to explicate the implications of

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[76] Rawls, supra note 72, § 48, at 313.

[77] See Nozick, supra note 69, at 153-60 (explaining distinction between patterned and historical perspectives).

[78] Rawls, supra note 72, § 13, at 83.

[79] See, e.g., id. § 48, at 314 (explaining that "even the best economic arrangements will not always lead to the more preferred outcomes"); id. § 48, at 312 (rejecting propriety of making a "distribution according to effort"); Rawls, supra note 75, at 298 (arguing that the "right to hold and to have the exclusive use of personal property" should not include the "right to participate in the control of means of production and natural resources").

[80] Other authors, however, have used Rawls's approach to analyze the justice of bankruptcy. The most elegant of those applications appears in Bob Rasmussen's recent *University of Illinois Law Review* article, Rasmussen, supra note 21. Rasmussen concludes that parties considering bankruptcy issues from behind Rawls's "veil of ignorance" would reject the current system and instead choose a more economically efficient system of bankruptcy. See id. at 16-41. Although Rasmussen's analysis is consistent with Rawls's assumption of rationality on the part of the decisionmakers selecting principles to organize society from behind the veil of ignorance, my impression is that Rasmussen's ultimate conclusion is at odds with the conclusions Rawls would reach if he applied his analysis in this area. One of the clearest (and for me most problematic) features of Rawls's writings is his belief that rational decisionmakers acting "behind the veil" would *not* choose to organize society in the most allocatively efficient manner, even if that method of organization would produce the greatest wealth for all. See, e.g., Rawls, supra note 72, § 48, at 314 (stating that "even the best economic arrangements will not always lead to the more preferred outcomes"). Rasmussen's analysis—which argues that the decisionmakers behind the veil *would* prefer an economically rational bankruptcy system—thus seems to me to rest on an opinion regarding the preferences of rational decisionmakers that differs from Rawls's opinion. That difference of opinion does not in any way undermine the force of Rasmussen's arguments in the abstract, but it does suggest that Rawls would not accept them. By contrast, Donald

the entitlement-based rhetoric of the creditors' bargain theorists would not be advanced by an argument that the reliance of those theorists on entitlements is invalid under a Rawlsian perspective that gives no significant weight to entitlements.[81] Rather, to meet their ideas squarely, it is necessary to evaluate the implications of the creditors' entitlements under theories that afford the greatest plausible respect to entitlements. To that end, I turn now to discussion of perspectives from which entitlements are important.

B. Utilitarianism and Related Perspectives

Because one of the main purposes of this Article is to analyze the implications of the entitlement-based rhetoric of the creditors' bargain theorists, it would be ideal to analyze that question from the perspective adopted by the creditors' bargain theorists. But to my knowledge none of the writings of the scholars in that field has explained directly the underlying theory of justice in which they ground the entitlements to which they refer.[82] It is difficult to draw inferences about the views creditors' bargain theorists would hold on that point, but their appar-

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Korobkin's more general effort to provide a philosophical grounding for bankruptcy law reaches a result that seems to me more similar to the views that Rawls expounds in *A Theory of Justice*. See Donald R. Korobkin, Contractarianism and the Normative Foundations of Bankruptcy Law, 71 Tex. L. Rev. 541 (1993) (presenting normative justification for bankruptcy law founded on contractarian principles); see also Donald R. Korobkin, Rehabilitating Values: A Jurisprudence of Bankruptcy, 91 Colum. L. Rev. 717, 762-87 (1991) (advocating "value-based" perspective on bankruptcy law, under which bankruptcy proceedings should be designed to facilitate "discourse of the community" regarding appropriate means of rehabilitation); cf. Karen Gross, Taking Community Interests into Account in Bankruptcy: An Essay, 72 Wash. U. L.Q. 1031, 1031-48 (1994) (arguing, without reliance on Rawls, that bankruptcy system should take account of interests of whole community).

81 Interestingly, Tom Jackson introduces his formulation of the creditors' bargain hypothesis with an original-position thought experiment of the type associated with Rawls's analysis. See Jackson, supra note 9, at 15-17; see also Rawls, supra note 72, §§ 20-25, at 118-50 (explaining his original-position analysis). I do not believe, however, that the brief use of that hypothetical (or the casual citation to Rawls at Jackson, supra note 9, at 17 n.22) suggests that Jackson accepts the types of principles of distributive justice that Rawls articulates. The emphasis of the book (like the analysis of Doug Baird in Baird, supra note 10, at 128-35) is much more on the entitlements that creditors secure by their agreements than on concerns about an egalitarian distribution of wealth among all the members of society. See, e.g., Jackson, supra note 9, at 27-29 (discussing how to accommodate "nonbankruptcy entitlements" in a bankruptcy proceeding); Jackson & Scott, supra note 11, at 155-56 ("[P]rebankruptcy entitlements should be impaired . . . only [to aid creditors] and never to accomplish purely distributional goals."); supra note 11 (discussing reliance that creditors' bargain theorists place on entitlements). Hence, I find it quite unlikely that Jackson or Baird would be persuaded of the justice of the existing system, even if they were presented with definitive arguments that it furthered a distribution of wealth conforming to Rawls's principles. For a thorough criticism of the difficulties of deriving Jackson's conclusions from principles like those of Rawls, see David G. Carlson, Philosophy in Bankruptcy, 85 Mich. L. Rev. 1341 (1987) (reviewing Jackson, supra note 9).

82 For a discussion of the extent to which creditors' bargain theorists rely on entitlements, see supra note 11.

ent membership in the law-and-economics movement,[83] coupled with that movement's emphasis on the importance of maximizing wealth,[84] suggests that those theorists would be attracted to utilitarianism and related perspectives, because those perspectives would organize a society in the way that maximized utility or some similar concept such as wealth.[85]

1. *An Introduction to Utilitarian Perspectives on Distributive Justice*

Utilitarian perspectives commonly are divided into two classes: act-utilitarianism and rule-utilitarianism. The first of these "is the view that the rightness or wrongness of an action is to be judged by the consequences, good or bad, of the action itself."[86] Because act-utilitarianism focuses on the consequences of each specific action, it does not accept the propriety of adopting generally beneficial rules that should be followed without question. Rather, from the perspective of an act-utilitarian, "to refuse to break a generally beneficial rule in those cases in which it is not most beneficial to obey it seems irrational and to be a case of rule worship."[87] Because only the most

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83 See, e.g., Warren, supra note 17, at 336-37 (characterizing work of Tom Jackson and Doug Baird as providing "a skilled, but narrow law-and-economics challenge to the bankruptcy laws").

84 See, e.g., infra note 92 (discussing Richard Posner's advocacy of wealth maximization as the ultimate organizing principle for social justice).

85 Notwithstanding the argument made in the text, it happens that references to wealth maximization as a goal of the bankruptcy process are a relatively uncommon feature of the works of creditors' bargain theorists. Interestingly, to the extent those references appear at all, they generally are found in the works of Bob Scott. See, e.g., Jackson & Scott, supra note 11, at 156 (referring to "the key bankruptcy objective of maximizing the welfare of the group"); id. at 156 n.2 (referring to "the central goal of maximizing the deployment of assets to all claimants"); Scott, supra note 9, at 692 (stating that creditors "agree in advance to a collectivization process in order to maximize the total pool of assets"). By contrast, Doug Baird's writings in particular appear to rely directly on entitlements, rather than wealth maximization. That judgment is supported by the frequency in his work of conclusions that rest explicitly on the need to protect the interests of the bargaining creditors, without any reference to wealth increases that might result from that protection. See, e.g., Baird, supra note 10, at 145 (concluding that process for corporate reorganization might be inappropriate not because reorganizations are costly, but because investors would not want them); Baird & Jackson, supra note 11, at 787 (same conclusion for current absolute priority rules).

86 J.J.C. Smart, An Outline of a System of Utilitarian Ethics, in Utilitarianism: For and Against 3, 9 (1973); see Rolf E. Sartorius, Individual Conduct and Social Norms 12 (1975) (presenting similar definition).

87 Smart, supra note 86, at 10. All would not agree with the statement in the text that act-utilitarians by definition oppose the adoption of general rules. Rolf Sartorius presents a comprehensive vision of an act-utilitarian system under which individuals generally should comply with social norms. Sartorius, supra note 86, ch. 4, at 51-80. Even Sartorius acknowledges, however, that "the very best law that could be enacted might be one which was sometimes justifiably disobeyed." Id. at 55. Accordingly, his system would not support the types of rules about entitlements that are essential to this Article.

impoverished notion of a valid entitlement would accept a definition of validity limited to specific cases in which protection of the entitlement was "most beneficial," any system of entitlements founded on act-utilitarianism would be quite limited.[88]

Rule-utilitarianism, by contrast, offers a much more promising basis for protecting entitlements, precisely because of the "rule worship" that an act-utilitarian decries. "Rule-utilitarianism is the view that the rightness or wrongness of an action is to be judged by the goodness and badness of the consequences of a rule that everyone should perform the action in like circumstances."[89] As P.S. Atiyah explains:

> The rule utilitarian takes the position that it is not usually possible or desirable (on utilitarian grounds) to weigh up the probable consequences of every single act which we are called upon to perform. What the utilitarian should do is to adopt general rules of conduct of a utilitarian character. These rules will be adopted because it is found that on balance, and in general, adherence to them does more good than adherence to any other relevant rule. When called upon to make a decision as to a particular action, the utilitarian is then absolved from the necessity of deciding what is likely to be best on the whole: he should simply comply with the rule.[90]

2. *Entitlements and Utilitarian Perspectives*

Starting from that perspective, a rule-utilitarian can justify a system of entitlements by reasoning that a system that protects and enforces entitlements in property adds to the utility or wealth of humanity. The traditional argument is that individuals can secure a reasonable degree of happiness only if they can acquire, possess, and use things, and that they can have security in their right to use and possess things only if society grants and protects entitlements in those things.[91] For economically oriented utilitarians, who tend to adopt a

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[88] Smart, supra note 86, at 10.

[89] Smart, supra note 86, at 9; see Sartorius, supra note 86, at 12 (presenting similar definition).

[90] P.S. Atiyah, Promises, Morals, and Law 80 (1981).

[91] See, e.g., David Hume, A Treatise of Human Nature bk. III, pt. II, § II, at 489 (L.A. Selby-Bigge ed., 1888) (1739-40):

> [W]hen [people] have observ'd, that the principal disturbance in society arises from those goods, which we call external, and from their looseness and easy transition from one person to another; they must seek for a remedy, by putting these goods, as far as possible, on the same footing with the fix'd and constant advantages of the mind and body. This can be done after no other manner, than by a convention enter'd into by all the members of the society to bestow stability on the possession of those external goods . . . .

See also Becker, Foundations, supra note 71, at 57-58 (summarizing traditional utilitarian justification for property rights). For an explanation of the necessity for general rules to narrower focus on economic gains (that is, wealth),[92] the same conclusion can be reached based on the argument that protection of entitlements helps individuals and society to maximize wealth.[93]

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protect property, rather than an evaluation of the consequences of protection on a case-by-case basis, see Hume, supra, bk. III, pt. II, § II, at 497 ("Property must be stable, and must be fix'd by general rules. Tho' in one instance the public be a sufferer, this momentary ill is amply compensated by the steady prosecution of the rule, and by the peace and order, which it establishes in society."); see also id., bk. III, pt. II, § III, at 502-03 (making similar argument).

92 The most thoroughly developed perspective that focused expressly on wealth (rather than utility) was presented by Richard Posner in a widely noted series of articles and a book, all published around 1980. Richard A. Posner, Utilitarianism, Economics, and Legal Theory, 8 J. Legal Stud. 103, 119-27 (1979) [hereinafter Posner, Utilitarianism]; Richard A. Posner, The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication, 8 Hofstra L. Rev. 487, 487 (1980) [hereinafter Posner, Ethical Basis] ("[A] society which aims at maximizing wealth . . . will produce an ethically attractive combination of happiness, of rights (to liberty and property), and of sharing with the less fortunate members of society."); Richard A. Posner, A Reply to Some Recent Criticisms of the Efficiency Theory of the Common Law, 9 Hofstra L. Rev. 775 (1981) [hereinafter Posner, Reply]; Richard A. Posner, The Economics of Justice 65-76 (1981) [hereinafter Posner, Justice]. Chapters 3 and 4 of *The Economics of Justice* are based in part on the earlier articles in the *Journal of Legal Studies* and the *Hofstra Law Review*. See Posner, Justice, supra, at viii-ix. Because the articles were revised "extensive[ly]" for inclusion in the book, id. at viii, this Article includes parallel citations to the book and the earlier articles when appropriate.

Although Posner derived his wealth-maximization perspective from utilitarianism, he argued that it was superior to utilitarianism, contending that his focus on wealth enabled his perspective to avoid problems that afflict classical utilitarian theory. See Posner, Justice, supra, at 76-87; Posner, Utilitarianism, supra, at 127-35 (parallel passage); see also Posner, Justice, supra, at 66 ("Wealth is positively correlated, although imperfectly so, with utility, but the pursuit of wealth, based as it is on the model of the voluntary market transaction, involves greater respect for individual choice than in classical utilitarianism."). For the purposes of this Article, it is enough to treat Posner's perspective simply as a variant of rule-utilitarianism.

93 See Nozick, supra note 69, at 177 (summarizing arguments for protection of property rights); Posner, Justice, supra note 92, at 69 ("[T]he [wealth-maximization] principle ordains the creation of a system of personal and property rights that ideally would extend to *all* valued things that are scarce."); Harold Demsetz, Toward a Theory of Property Rights, Am. Econ. Rev., May 1967, at 347, 350-59, reprinted in The Economics of Legal Relationships: Readings in the Theory of Property Rights 23, 26-35 (Henry G. Manne ed., 1975) (arguing that property rights arise to limit costs of negotiating to eliminate externalities); Ellickson, supra note 71, at 1322-32 (developing more detailed arguments based on analysis of Demsetz); Svetozar Pejovich, Towards an Economic Theory of the Creation and Specification of Property Rights, 30 Rev. Soc. Econ. 309, 310-16 (1972), reprinted in The Economics of Legal Relationships: Readings in the Theory of Property Rights, supra, at 37, 38-44 (arguing that creation of system of property rights increases ability of society to make productive use of its resources); Posner, Utilitarianism, supra note 92, at 125 (arguing that pursuit of wealth maximization requires system of property rights covering all valued things that are scarce); Carol M. Rose, Possession as the Origin of Property, 52 U. Chi. L. Rev. 73, 74-88 (1985) (arguing that possession justifies an entitlement because of efficiency benefits arising out of notice of claim that possession gives to third parties); see also Douglass C. North, Structure and Change in Economic History 102-12 (1981) [hereinafter North, Structure and Change] (arguing that development of private property rights spurred economic development in ancient Greece and Rome). But see Duncan Kennedy & Frank

Furthermore, it is easy to develop a system founded on that perspective that would recognize both of the rules for entitlements that I propose in this Article. Indeed, Richard Posner has developed just such a system. First, he reasoned that entitlements should be vested in the way that will minimize the transaction costs of reallocating them to those who value them most highly.[94] Because Posner believes that individuals generally value their own labor more highly than others do, he concludes that it saves the transaction costs of individuals' reacquiring their own labor if society vests individuals with an initial entitlement to their own labor.[95] Accordingly, under that reasoning, individuals would be entitled to the fruits of their own labor.[96]

Similarly, Posner's system allowed a party to acquire an entitlement through consensual exchange, but only if the acquiring party

Michelman, Are Property and Contract Efficient?, 8 Hofstra L. Rev. 711, 715-39 (1980) (arguing that system of private property cannot be deduced from wealth-maximizing goals).

The view that individual ownership of property would increase wealth is not a new one. See, e.g., St. Thomas Aquinas, Summa Theologiae IIa IIae Q. 66, art. ii, reply (n.d.) ("each person is more careful to take care of anything that is allotted to him alone than of anything which is owned in common or by many, because everyone avoids the work that pertains to commonly owned goods and leaves it for another" (my translation)); The Politics of Aristotle bk. II, ch. ii, §§ 1-5 (1262b-1263a), at 48-51 (Ernest Baker trans., Clarendon Press 1961) (n.d.) (arguing that system of private property ownership is preferable to system of communal ownership). The idea that a government actually would create and enforce wealth-maximizing rules should not be pressed too far, given the incentives governments have to define property rights in a profoundly inefficient manner. See North, Structure and Change, supra, at 24-32. As North explains, "[t]he state . . . will encourage and specify efficient property rights only to the extent that they are consistent with the wealth-maximizing objectives of those who run the state." Id. at 33-34. For a theoretical explanation of the reasons why inefficient systems of property rights persist, see Douglass C. North, Institutions, Institutional Change and Economic Performance (1990) [hereinafter North, Institutions].

94 Posner, Justice, supra note 92, at 71 ("If transaction costs are positive . . . , the wealth-maximization principle requires the initial vesting of rights in those who are likely to value them most, so as to minimize transaction costs."); Posner, Utilitarianism, supra note 92, at 125 (parallel passage).

95 See Posner, Justice, supra note 92, at 71-72; Posner, Utilitarianism, supra note 92, at 125-26; see also Richard A. Epstein, Simple Rules for a Complex World 59 (1995) (arguing that rule giving individuals ownership of their own labor "establishes at very low cost a rule of ownership over all labor—and removes the need for . . . any ministry of labor to assign people to particular tasks").

96 See Posner, Justice, supra note 92, at 77 n.57 (discussing rights of inventors to their inventions); Posner, Utilitarianism, supra note 92, at 129 n.80 (parallel passage); see also Hume, supra note 91, bk. III, pt. II, § III, at 509 & n.2 (arguing that "the fruits of our garden, the offspring of our cattle, and the work of our slaves, are all of them esteem'd our property, even before possession," but stating that "[t]his source of property can never be explain'd but from the imaginations; and one may affirm, that the causes are here unmix'd").

deals with the rightful owner.[97] From his perspective, consent was the key element to enforcement of entitlements transferred by exchange.[98] The reason, however, does not rest on any moral significance attributed to the individual's consent,[99] but simply on the view that consent by a transferor to an exchange indicates that the consenting party values the items it will receive in the exchange more highly than the items it gives up.[100] Hence, Posner concludes, a consensual exchange by definition must be wealth-increasing.[101] A key premise of that analysis is that the consent must be the consent of the owner; no transfer can be valid without the consent of the owner.[102]

3. *Problems with Utilitarian Perspectives*

For two reasons, however, I find utilitarian perspectives to be an unsuitable vehicle for my project. First, perspectives founded on the desire to maximize utility or wealth do not protect entitlements directly, but only "as a means to an end."[103] For that reason, the protection that they afford to entitlements is inevitably incidental. Whenever a particular circumstance arises in which it is not clear that protection of an entitlement is immediately beneficial, even a rule-utilitarian will be subject to the temptation to articulate an exception to the general rule, under which the entitlement would not be protected. The greater the number of the exceptions, the closer the system comes to approach act-utilitarianism, rather than rule-utilitarianism.[104] Indeed, the tendency (and need) to adopt such exceptions is generally offered as one of the most prominent problems

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97 See also Hume, supra note 91, bk. III, pt. II, § IV, at 514 ("[P]ossession and property shou'd always be stable, except when the proprietor consents to bestow them on some other person.").

98 See Posner, Justice, supra note 92, at 89 ("Consent . . . is the operational basis of Pareto superiority."); Posner, Ethical Basis, supra note 92, at 490 (parallel passage).

99 For a discussion of the significance consent has in systems that focus directly on the autonomy of the individual, see infra note 142.

100 Posner, Justice, supra note 92, at 88 ("If A sells a tomato to B for $2 and no one else is affected by the transaction, we can be sure that the utility to A of $2 is greater than the utility of the tomato to him . . . ."); Posner, Ethical Basis, supra note 92, at 489 (parallel passage); see also Epstein, supra note 95, at 76 ("[W]hen A surrenders anything [in a voluntary exchange] (be it labor or material goods) he will value it less than the thing that he receives in exchange.").

101 See Posner, Justice, supra note 92, at 88-90 (arguing that consensual exchange necessarily creates situations of Pareto superiority); Posner, Ethical Basis, supra note 92, at 488-90 (parallel passage); see also Epstein, supra note 95, at 71-73 (arguing that rule enforcing voluntary exchanges increases wealth of society).

102 See Posner, Justice, supra note 92, at 70 (arguing that rights in property cannot be transferred or extinguished without owner's consent).

103 Becker, Foundations, supra note 71, at 57; see Posner, Justice, supra note 92, at 71 ("[T]hese rights are not transcendental or ends in themselves.").

104 See Atiyah, supra note 90, at 81-82:

with a rule-utilitarian system.[105] For the purposes of this Article, the tendency to permit other interests to undermine the validity of entitlements saps the value of a utilitarian system for the same reason that Rawls's difference principle undermines the capacity of his system to provide a rigorous foundation for entitlements.[106]

Second, the moral repugnance of the implications of an unbounded adoption of utilitarian and wealth-maximizing perspectives leads me to doubt that those perspectives actually reflect the views of creditors' bargain theorists. By seeking to further utility or wealth without any respect for human autonomy, those perspectives lead to results that do not seem likely to appeal to those scholars. The classic objection is the "slavery" hypothetical: If some individuals are happier or more productive as slaves than as free individuals (even after taking account of the decrease in satisfaction those individuals might incur from being slaves), is it then just to enslave them?[107] For a person following a completely utilitarian perspective, the answer must be yes.[108] But even Richard Posner—certainly a scholar known for his devotion to a vigorous pursuit of wealth maximization[109]—retreated from his advocacy of a wealth-maximization perspective on distributive justice, based on his conclusion that a philosophical system that countenances a result so "contrary to the unshakable moral intuitions of Americans" fails "the ultimate test of a moral... theory."[110] Given

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> [T]he rule utilitarian must concede that a rule to cover [a] special situation will, in the end, produce more good than a lack of such a rule. We thus find that rules will have to be broken down into further and smaller sub-rules and sub-sub-rules, until, in the end, we reach the position of having to have a special rule for every case. At that stage, of course, rule utilitarianism and act utilitarianism merge.

105 See Smart, supra note 86, at 11-12 (presenting similar argument against rule-utilitarianism); see also Atiyah, supra note 90, at 70 ("The utilitarian must concede that a promise ought not to be kept where more good can be done by breaking it than by keeping it. He will want to make many important qualifications and add a number of caveats to this concession . . . but in the end he must stand by it.").

106 See supra notes 72-81 and accompanying text.

107 See, e.g., Ronald M. Dworkin, Is Wealth a Value?, 9 J. Legal Stud. 191, 209-11 (1980) (criticizing wealth-maximization perspective because of its compatibility with forced labor and slavery); see also Richard A. Posner, The Problems of Jurisprudence 376 (1990) (discussing same problem).

108 See Posner, Justice, supra note 92, at 86 (suggesting permissibility of slavery under his analysis); Richard A. Posner, Overcoming Law 23 (1995) (commenting that "implications of typical utilitarian and economic thinking [include] enforcing contracts of self-enslavement"); see also Richard A. Posner, Law and Economics *Is* Moral, 24 Val. U. L. Rev. 163, 172-73 (1990) (discussing circumstances in which slavery would maximize wealth). But cf. Sartorius, supra note 86, at 155-57 (arguing that act-utilitarian system can accommodate paternalistic legislation, which would refuse to enforce contracts of self-enslavement).

109 See, e.g., supra note 92; supra notes 94-102 and accompanying text.

110 Posner, supra note 107, at 377; see also Posner, Utilitarianism, supra note 92, at 110 (explaining, at the time he first proposed his wealth-maximization perspective, that "an

Posner's prominence in the law and economics community, his unwillingness to push the wealth-maximization perspective to its logical limits suggests that it would not be appropriate for me to proceed on the assumption that creditors' bargain theorists would follow that perspective.[111]

Those readers who do not find my objections to utilitarianism troubling could proceed directly to Part III of the Article, which analyzes the justice of the bankruptcy system under the rules for entitlements articulated above. For those who are troubled by my objections, Part II.C considers perspectives that attempt to explain why a system protecting individual autonomy might be "valued for itself rather than just for its contribution to prosperity."[112]

C. *Autonomy-Based Perspectives*

1. *An Introduction to Autonomy-Based Perspectives on Distributive Justice*

For a system that protects entitlements directly, the place to start is the libertarian theory presented by Robert Nozick in his 1974 book *Anarchy, State, and Utopia*.[113] In that work, Nozick argues that a distribution of property is just if two conditions are met: first, that all property in the society initially was acquired justly (that is, under principles of justice in acquisition); and second, that all subsequent trans-

ethical theory . . . can be rejected [if] the theory yields precepts sharply contrary to widely shared ethical intuitions"). For similar sentiments, see Robert Nozick, The Nature of Rationality 72 (1993) (describing as one of the principal tools of philosophical arguments in favor of a proposition the presentation of "its consequences, which are acceptable and so support it"); Lloyd L. Weinreb, Oedipus at Fenway Park 160 (1994) ("Furthermore, the 'fit' of a theory of rights with the way in which we talk and think about rights in our ordinary lives is itself a test, albeit not a conclusive one, of the soundness of the theory."). Posner's revised views on the subject are similar:

> [H]ypocritical and incoherent as our political ethics may frequently be, we do not permit degrading invasions of individual autonomy merely on a judgment that, on balance, the invasion would make a net addition to the social wealth. And whatever the philosophical grounding of this sentiment, it is too deeply entrenched in our society at present for wealth maximization to be given a free rein.

Posner, supra note 107, at 379-80. As the Conclusion of this Article suggests, the philosophical grounding offered by this Article is consistent with a public policy firmly devoted to wealth maximization, subject only to the types of limitations acknowledged by Posner in the quoted discussion. The question for me, however, to which I turn in Part II.C, is how to analyze those limitations.

111 See also supra note 85 (discussing limited extent to which creditors' bargain theorists refer to wealth maximization as goal of their analysis).

112 Posner, supra note 107, at 379.

113 Nozick, supra note 69.

fers of property were just (that is, in accordance with principles of justice in transfer).[114]

The centrality of entitlements to Nozick's perspective is evident from his terminology, which divides theories of distributive justice into "historical" or "entitlement-based" perspectives and "patterned" or "end-state" perspectives.[115] Nozick calls his principles historical because they evaluate the justice of any distribution solely by consideration of the past occurrences that have led to the distribution, with a view to determining whether those occurrences created entitlements that justify the existing distribution of property. A "patterned" system, by contrast (like Rawls's system discussed in Part II.A), focuses not on the way in which a distribution arose, but on the pattern of the distribution itself. An easy way to illustrate the difference is to consider the questions important to the two perspectives. A historical perspective focuses on prior misconduct: Has anyone acquired property through some sort of misconduct that would justify redistribution of the property? A patterned perspective focuses on maldistribution: Does anyone have less—or more—than a fair share?[116]

As Nozick recognizes, the most immediate difficulty with his general perspective is that no society can satisfy the conditions he outlines for a just distribution of property (just initial acquisition, coupled with just transfers).[117] Accordingly, he proposes to add to his initial statement principles of rectification of injustice, which would justify government actions designed to alter entitlements so as to rectify past injustices.[118] But even with that modification, a historical perspective cannot provide a conclusive justification of any society's distribution

114 Id. at 150-82.

115 See id. at 153-60 (explaining that distinction).

116 Nozick's determination to apply a historical perspective reflects a considered rejection of the patterned system set forth by Rawls in *A Theory of Justice*, supra note 72. Nozick devotes a substantial portion of his book to the task of explaining why he believes that his perspective is superior to that of Rawls. Nozick, supra note 69, at 183-231 (respectfully criticizing Rawls, supra note 72). Nozick regards utilitarian perspectives (presumably including Posner's related wealth-maximization perspective) as end-state perspectives. See Nozick, supra note 69, at 154-55. Nozick's lack of respect for utilitarian-derived perspectives is evident from the difference between the respectful and detailed treatment he accords Rawls and his off-hand dismissal of utilitarian norms. See id. at 62, 153-55, 202; see also id. at 177 (contrasting his own analysis with utilitarian justifications for property rights); cf. Posner, Utilitarianism, supra note 92, at 103 n.3 (acknowledging "tendency in modern philosophy to treat utilitarianism dismissively").

117 "Some people steal from others, or defraud them, or enslave them, seizing their product and preventing them from living as they choose, or forcibly exclude others from competing in exchanges. None of these are permissible modes of transition from one situation to another." Nozick, supra note 69, at 152; see also Epstein, supra note 95, at 63 ("[I]n a world filled with private violence and political corruption, it often happens that the great chain of title is broken beyond recognition.").

118 Nozick, supra note 69, at 152-53.

of wealth. Because it is impossible to identify and rectify all past injustices (even if it is possible to identify principles that explain and limit the alteration of present entitlements as a way to rectify past injustices), it is not feasible to apply entitlement-based principles to demonstrate the justice of any distribution of wealth across all members of a society.

The intractability of that problem is not, however, fatal to the goals of this Article. This Article does not attempt to consider the global justice of distributions of wealth in our society; rather, it attempts to isolate a portion of our legal system—the bankruptcy system—and evaluate the justice of certain actions taken within that system, namely the redistributive actions that arise from federal bankruptcy legislation.[119] To examine that question, it is enough to determine whether those specific actions accord with principles of justice.[120]

Of course, it is possible that a bankruptcy system that would be just, standing alone, would be unjust in the context of our society if it exacerbated the effects of past injustice reflected in the existing distribution of wealth in our society.[121] But that possibility does not concern me here, because of the difficulty of designing a bankruptcy system that would have a systematic relation to those lingering effects. First, no plausible rule governing the distribution of the proceeds of bankruptcy will provide a just rectification of all the past injustices in the distribution of entitlements to property in our society. Furthermore, given the wide range of income and wealth held by parties playing the various roles in a bankruptcy proceeding, it is not clear that any bias favoring one party over another would even tend to rectify

119 Robert Rasmussen took a similar tack in his recent article evaluating bankruptcy issues from Rawls's perspective. See Rasmussen, supra note 21, at 41 ("[R]ather than skewing the optimal approach to bankruptcy law, we should instead focus our attention on the unjust aspects of society and work to change them.").

120 For a general discussion of the propriety and usefulness of considering the justice of entitlements by examination of particular situations—rather than from the perspective of society as a whole—see Nozick, supra note 69, at 204-06; cf. F.M. Scherer & David Ross, Industrial Market Structure and Economic Performance 37-38 (3d ed. 1990) (arguing that when there is insufficient information to determine whether improving efficiency of one sector of economy might cause overall harm because of inefficiencies in other sectors of economy, best course is to remove inefficiencies in sector under examination); Yew-Kwang Ng, Towards a Theory of Third-Best, 32 Pub. Fin. 1, 2-8 (1977) (same). But see Bruce A. Ackerman, Social Justice in the Liberal State 185-86 (1980) (arguing that Nozick's practice of considering "microsituations" is "myopic").

121 The concern with the pattern of distribution of wealth as part of consideration of the appropriate extent of rectification is not inconsistent with a historical perspective. See Nozick, supra note 69, at 153 n.*.

those past injustices.[122] Accordingly, I seriously doubt the possibility of accomplishing anything substantial through giving concerns about rectification a major role in the design of the bankruptcy system.

Of course, there may be individual cases where a particular bankruptcy rule would operate to rectify past injustices in an appropriate manner. In such a case, the principles of justice in rectification that had been applied to make that determination would support the justness of the rule in question. This Article, however, does not attempt to identify specific situations of that nature. Instead, it considers whether more general principles of justice in acquisition and transfer can justify the redistributive aspects of the bankruptcy system as a whole. To answer that question, I now consider the role of entitlements under those principles.

2. *Entitlements and Autonomy-Based Perspectives*

Writers who work from an autonomy-based perspective have no difficulty in justifying a system of private property, not because of any value or wealth such a system creates, but because of the intrusions on fundamental liberties that would be necessary to prohibit private property. As Lawrence Becker explains, the argument is that any "effective prohibition of [the acquisition, control, and use of property] would require a comprehensive and continuous abridgment of people's liberty which (even if it were possible to carry out) is at best unjustifiable and at worst flatly prohibited by the existence of political liberties to which people are entitled, morally."[123] The following sections explain how perspectives on entitlements derived from that type of argument include the two rules for entitlements that I apply in Part III of this Article: (a) people have an entitlement to the fruits of their labor; and (b) people can acquire entitlements through a consensual exchange, but only if the exchange is with the prior holder of the entitlement.

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[122] The fact that a party is a debtor does not mean that rules favoring it necessarily will increase the wealth of those who have less of the property in our society. Especially in chapter 11 proceedings, the equity interests of the debtor may be owned by individuals who are just as wealthy or poor as the individuals who own the equity interests in the entities that are creditors in such proceedings. See Marcel Kahan, The Qualified Case Against Mandatory Terms in Bonds, 89 Nw. U. L. Rev. 565, 571 (1995) ("Since an investor may invest in either stocks or bonds, and indeed in both, distributional concerns as between stockholders and bondholders are not significant in determining the optimal legal regime."); cf. LoPucki & Whitford, Equity's Share, supra note 7, at 183-84 (stating that free trading of interests in debtors as well as claims against debtors makes it difficult to ascertain whether redistribution in favor of debtor would favor "less powerful" individuals).

[123] Becker, Foundations, supra note 71, at 75 (summarizing the argument that political liberty requires recognition of entitlements); see Becker, Moral Basis, supra note 71, at 193-94 (same); J. Roland Pennock, Thoughts on the Right to Private Property, in Nomos XXII, supra note 70, at 171, 172-76.

a. Entitlement to the Fruits of Labor. Probably the least controversial proposition about entitlements is that individuals justly are entitled to the fruits of their own labor. That principle dates back at least to John Locke, who stated it in the late seventeenth century in his "Second Treatise on Civil Government."[124] Although the "Second Treatise" is best-known for Locke's controversial argument that people can obtain rights in property through being the first to possess it,[125] his discussion of property rights in the "Second Treatise" also focuses on entitlements arising out of labor. On that point, Locke starts from the premise that "every man has a property in his own person" and reasons from that premise to the related idea that we "properly" may say that every man owns "[t]he labour of his body."[126]

124 John Locke, An Essay Concerning the True Original, Extent and End of Civil Government (J.W. Gough ed., 1946) (6th ed. 1764). That work, commonly known as the "Second Treatise on Government," appears to have been published anonymously in 1690. See id. at xxxix (Note on the Text). The first edition attributed to Locke appeared in 1694. See id. The later edition that is cited here took account of a number of corrections to the text Locke made during the years after the initial publication. See id.

125 Id. § 27, at 15 ("Whatsoever, then, he removes out of the state that nature hath provided and left it in, he hath mixed his labour with, and joined to it something that is his own, and thereby makes it his property."). Locke's views on that point are notoriously difficult. See, e.g., Nozick, supra note 69, at 174-75:

> [W]hy isn't mixing what I own with what I don't own a way of losing what I own rather than a way of gaining what I don't? If I own a can of tomato juice and spill it in the sea so that its molecules (made radioactive, so I can check this) mingle evenly throughout the sea, do I thereby come to own the sea, or have I foolishly dissipated my tomato juice?

See also Becker, Foundations, supra note 71, at 24-31 (expressing similar criticism); Epstein, supra note 95, at 60 ("If allowed to add labor at all, the person should at most get a lien on the common property equal to the value added by the labor in question."); Richard A. Epstein, Possession as the Root of Title, 13 Ga. L. Rev. 1221, 1226-27 (1979) (making similar point).

126 Locke, supra note 124, § 27, at 15; see Becker, Foundations, supra note 71, at 32-56 (thoroughly discussing and critiquing Locke's labor theory of property acquisition). Although there is little dispute about Locke's basic point that individuals are entitled to the fruits of their labor, modern thinkers tend to be uneasy with Locke's reasoning, either because of its theological underpinnings, see Richard A. Epstein, Takings: Private Property and the Power of Eminent Domain 10 (1985) (discussing theological underpinnings of Locke's theory of ownership), or because of its close relation to Marx's labor theory of value, see Bertrand Russell, A History of Western Philosophy 635 (1945) (explaining labor theory as "the doctrine that the value of a product depends upon the labour expended upon it" and attributing theory to Marx). For a thoughtful evaluation of the labor theory on its own terms, see Epstein, supra note 125, at 1221, 1225-30. Epstein concludes that possession itself—rather than the labor that might go into the acquisition of possession—should be considered the basis of entitlements. Id. at 1238-43. But see Anthony T. Kronman, Contract Law and Distributive Justice, 89 Yale L.J. 472, 494 (1980) (criticizing draft of Epstein's article from perspective that "it is a mistake to think that the fact of possession has any moral significance in itself"). For a more instrumental explanation, see Randy E. Barnett, The Function of Several Property and Freedom of Contract, Soc. Phil. & Pol'y, Winter 1992, at 62, 82-85 (arguing that granting entitlement to first possessor furthers principle that society should organize "control of resources [in accordance with] the

Because Locke's analysis of property rights rests on the idea that individuals own their own labor, it is an easy step for Locke to conclude that an individual has an entitlement to things that he creates by his labor, "the work of his hands," in Locke's terms.[127] As Locke explains, the individual's capacity through "invention and arts" to improve on the materials found in the state of nature is "the great foundation of property," and the things an individual created through that labor were "perfectly his own, and did not belong in common to others."[128]

Building on that point, it is plausible to say that an individual who makes an object more valuable—whether by discovering its location or a new use for it, or by applying labor to it to increase its productivity—has created a new value that should belong to the laboring individual.[129] Although there has been considerable debate about the appropriate boundaries of the entitlements an inventor should get for being the first to discover a particular idea,[130] it should be easy to see

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dispersal of . . . knowledge," because a person's decision to undertake the efforts required to take possession reveals valuable knowledge held by individual).

[127] Locke, supra note 124, § 27, at 15. John Stuart Mill reached a similar conclusion:

> The institution of property, when limited to its essential elements, consists in the recognition, in each person, of a right to the exclusive disposal of what he or she have produced by their own exertions . . . . The foundation of the whole is the right of producers to what they themselves have produced.

John S. Mill, Principles of Political Economy bk. II, ch. II, § 1, at 218 (W.J. Ashley ed., 1909) (1848). But see Weinreb, supra note 110, at 122-24 (arguing that individuals are not entitled to fruits of their labor and contending that reasoning offered by Locke and Nozick on this question "is not even superficially plausible").

Because Mill generally is interpreted as a utilitarian, I should explain why I cite his analysis here (in a section regarding autonomy-based theories of entitlements), rather than earlier (in the section regarding utility-based theories of entitlements). The answer lies in his general rejection of considerations of utility as the historical basis for property rights. See Becker, Foundations, supra note 71, at 59 & n.1 (discussing Mill's views on that issue). Accordingly, although Mill obviously kept utilitarian concerns constantly in view, see, e.g., Mill, supra, bk. II, ch. II, § 6, at 233 ("When private property in land is not expedient, it is unjust."), I am not alone in treating the relevant portions of Mill's work on principles of political economy as an explication and development of Locke's thinking on these issues. See, e.g., Becker, Foundations, supra note 71, at 47 (analyzing "Locke-Mill labor theory"); Becker, Moral Basis, supra note 71, at 193 (discussing "Locke-Mill version of the labor theory").

[128] Locke, supra note 124, § 44, at 23.

[129] Israel M. Kirzner, Entrepreneurship, Entitlement, and Economic Justice, in Reading Nozick: Essays on Anarchy, State, and Utopia 383, 403-06 (Jeffrey Paul ed., 1981) (arguing that Nozick's framework should be modified to include such a principle); see Mill, supra note 127, bk. II, ch. II, § 5, at 230 (noting that a party that undertakes "labour and outlay" to improve property "must have a sufficient period before him in which to profit by them; and he is in no way so sure of having always a sufficient period as when his tenure is perpetual").

[130] Nozick appears to believe that it is just to limit the rights of inventors to a specific period of time (as modern patent laws do), to take account of the likelihood that some other party subsequently would have discovered the invention covered by a patent. See

the general point that a person should receive some entitlement if, for example, the person "synthesizes a new substance (out of easily available raw materials)" or discovers the existence of oil or other valuable natural resources that previously were unknown.[131]

The primary difficulty with that conclusion is the difficulty of taking account of the entitlements of previous owners: the entitlements previous parties may have in the raw materials used to make the new substance or in the land where the oil is located. To begin with, it seems clear that the prior owner's claim of entitlement must limit the entitlement of the laboring party to the value added to the object.[132] Furthermore, the need to protect the preexisting entitlements in many circumstances would justify further limitations on the entitlement of the laboring party. For example, if an individual applies labor to an object, knowing of the ownership rights of the existing owner and not

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Nozick, supra note 69, at 181-82; cf. Posner, Reply, supra note 92, at 793 (suggesting that "[t]he patent system may actually overcompensate an inventor by giving him the total market value of the invention for seventeen years even though his contribution may just have been to bring the product or process to market a few days before some competing inventor").

Kirzner rejects any such limitations on the entitlements of an inventor:

> First, we must maintain that one who *might* at a given date have "created" an object *ex nihilo* has hardly been hurt by the fact that a second individual in fact "created" the object first, at an earlier date. It was the latter individual who was the "creator" not the former. A finders-"creators," finders-keepers ethic cannot, it must be maintained, confer any claim on those who *might have*—but did not in fact—"create."
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> ... [A]cceptance of a finders-"creators," finders-keepers ethic confers just title on the discoverer-"creator" not in the negative sense (that such title involves no injustice to others) but in the positive sense that justice requires that the "creator" be recognized as the owner of what he has "created"; to deny the "creator" title would be to inflict injustice on him.

Kirzner, supra note 129, at 404; see also Mill, supra note 127, bk. II, ch. II, § 6, at 233 ("It is no hardship to any one to be excluded from what others have produced: they were not bound to produce it for his use, and he loses nothing by not sharing in what otherwise would not have existed at all."). Whatever the merits of Nozick's views regarding inventors, I see nothing in his work that indicates that he would reject Kirzner's proposal to recognize entitlements in favor of entrepreneurs who "create" value by discovering the value of items in the marketplace. Protecting that type of creation seems entirely contemplated by Nozick's framework. See Nell W. Senter, Nozick on Property Rights: To Each According to Marginal Productivity, 19 Ariz. L. Rev. 158, 160 & n.7 (1977) (discussing Nozick's commitment to "a capitalist market system").

131 The examples are Kirzner's. Kirzner, supra note 129, at 401, 403.

132 See Nozick, supra note 69, at 175 ("Why should one's entitlement extend to the whole object rather than just to the *added value* one's labor has produced?"). That formulation leaves the additional problems of determining the amount of the added value and liquidating the asset in a way that allows distribution of the value to those with entitlements. Those problems are beyond the scope of this Article, which attempts only to discern just foundations for the goals of the bankruptcy system. I leave for another day attempts to determine the extent to which the procedures actually further the goals of the system.

bothering to seek consent from that party, the laboring party might be entitled to nothing. Richard Epstein explains:

> It is easily understandable why B does not receive any legal protection in the event that he makes the improvement with full knowledge of the ownership rights of A, for with such knowledge his conduct is little more than an effort to exact payment from A for work performed without his consent. Such efforts can only undercut A's claim to be the sole owner of the property in question, and must therefore be rejected.[133]

That limitation, however, does not seem to arise out of the fundamental nature of the entitlement, but rather out of the context in which the labor is applied. If the laboring party acts justly in applying its labor—if it acts with consent, for example—I see no basis for reducing its entitlement below the value it has added.[134]

b. Entitlement Through Consensual Exchange. A second basic principle of entitlements is the principle that a person can acquire entitlements to property through a consensual exchange, if the person deals with the existing owner of the property in question.[135] Locke, for example, argues that an exchange justly transfers the entitlements of the parties, because it has no effect on the common stock available for other individuals:

> [I]f he . . . bartered away plums that would have rotted in a week, for nuts that would last good for his eating a whole year, he did no

133 Epstein, supra note 125, at 1226 n.7; Richard A. Epstein, The Ubiquity of the Benefit Principle, 67 S. Cal. L. Rev. 1369, 1380 (1994) ("It is better that you ring my doorbell for permission before cutting my lawn instead of cutting the lawn and then ringing the doorbell and demanding compensation for the work done.").

134 See Becker, Foundations, supra note 71, at 53-54 ("When it is beyond what morality requires them to do for others, people deserve some benefit for the value their (morally permissible) labor produces . . . ."); Becker, Moral Basis, supra note 71, at 193 (presenting argument that "when labor produces something of value to others—something beyond what morality requires the laborers to produce—then the laborer deserves some benefit for it"). As I discuss below, I believe that the government's role in our society includes the power to apply its labor to property held by individuals and to retain increases in value, without regard to the wishes of the owner. See infra notes 152-59 and accompanying text. Nozick, of course, would reject such a broad role for the government. See infra note 158 (discussing inconsistency between role Nozick would accept for government and role of government in our society).

135 Israel Kirzner argues—at least in the context of market transactions—that the rule is properly viewed as an extension of the labor principle, on the theory that an entrepreneur who purchases an object from its owner because he has discovered that he can resell it at a profit has "found" or "created" the additional value represented by the profit on the transaction. See Kirzner, supra note 129, at 396-400. To the extent that argument focuses on entitlements growing out of knowledge, it resembles the justification for the first-possession rule advanced in Barnett, supra note 126, at 82-85. Barnett's argument, however, appears to differ from Kirzner's analysis, in arguing for an entitlement not as a moral right arising directly out of the discovery, but rather as an instrumental means to encourage the acquisition of knowledge. See id.

> injury; he wasted not the common stock, destroyed no part of the portion of goods that belonged to others, so long as nothing perished uselessly in his hands. Again, if he would give his nuts for a piece of metal, pleased with its colour, or exchange his sheep for shells, or wool for a sparkling pebble or a diamond, and keep those by him all his life, he invaded not the right of others . . . .[136]

Similarly, John Stuart Mill conceived of property as including not only things that an individual produced by his own faculties, but also "whatever he can get for them in a fair market; together with his right to give this to any other person if he chooses, and the right of that other to receive and enjoy it."[137] Those formulations make it clear that the common understanding of the right to obtain entitlements by exchange applies only to exchanges with a party that owns the entitlements in question.

Nozick's framework includes a similar acknowledgment of the justice of an individual's acquisition of entitlements through consensual exchanges with existing owners.[138] That is most evident in his discussion of a hypothetical regarding Wilt Chamberlain, which forms the centerpiece of his criticism of patterned systems of distributive jus-

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136 Locke, supra note 124, § 46, at 25. Locke curiously suggests that the individual's rights in the plums and nuts are limited by the proviso that the individual not allow them to rot. He apparently concludes that no individual has any claim to perishable property that the individual allows to go to waste. The main explication of that view, which Locke grounds in theological arguments, appears in id. § 31, at 17. Locke's views on that point are known for their obscurity. Bertrand Russell notes that "[s]ome of Locke's opinions are so odd that I cannot see how to make them sound sensible" and offers as an example Locke's view "that a man must not have so many plums that they are bound to go bad before he and his family can eat them; but he may have as much gold and as many diamonds as he can lawfully get, because gold and diamonds do not go bad." Russell, supra note 126, at 636-37. Russell attempts to explain the apparent inconsistency by suggesting that Locke's views regarding the propriety of permitting unbounded accumulation of precious metals were influenced "by the gains to civilization that were due to rich men, chiefly as patrons of art and letters." Id. at 637. Whatever the merits of that explanation, it is clear that Locke's comments about plums cannot plausibly be construed as support for any egalitarian constraint on the accumulation of wealth. See Locke, supra note 124, § 46, at 25 ("[H]e might heap up as much of these durable things as he pleased, the exceeding of the bounds of his just property not lying in the largeness of his possessions, but the perishing of anything uselessly in it."). A clearer statement of Locke's anti-egalitarian views was added in the 1714 edition of the "Second Treatise": "[I]t is plain that the consent of men have agreed to a disproportionate and unequal possession of the earth; they having, by a tacit and voluntary consent, found out a way how a man may fairly possess more land than he himself can use the product of . . . ." Id. § 50, at 26; see id. § 50, at 26 n.1 (discussing provenance of that passage as well as earlier version of it).

137 Mill, supra note 127, bk. II, ch. II, § 3, at 221; see id. bk. II, ch. II, § 1, at 220 ("The right of property includes then, the freedom of acquiring by contract. The right of each to what he has produced implies a right to what has been produced by others, if obtained by their free consent . . . .").

138 See Kirzner, supra note 129, at 384-86 (discussing Nozick's acceptance of principle that party has just claim to entitlement received in voluntary transfer).

tice. In the example, Chamberlain receives more money than anyone else in the society because of the voluntary decision of basketball fans to pay extra to see Chamberlain play.[139] Nozick continues:

> If the people were entitled to dispose of the resources to which they were entitled . . . , didn't this include their being entitled to give it to, or exchange it with, Wilt Chamberlain? Can anyone else complain on grounds of justice? . . . After someone transfers something to Wilt Chamberlain, third parties *still* have their legitimate shares; *their* shares are not changed. By what process could such a transfer among two persons give rise to a legitimate claim of distributive justice on a portion of what was transferred, by a third party who had no claim of justice on any holding of the others *before* the transfer?[140]

Again, Nozick's discussion of entitlements gained through consensual exchange excludes claims of "a third party who had no claim of justice" to the transferred object. Thus, it does not exclude claims of parties who had claims to the transferred object. Accordingly, under Nozick's analysis, a party secures a complete entitlement only if it secures a valid consent from all of those who have claims to the object.[141]

One difficulty with Nozick's analysis is that he does not undertake to explain precisely why a consensual exchange transfers valid entitlements. In my view, the best answer to that question is that the consent of the currently entitled party justifies removing the entitlement from the currently entitled party and transferring it to the exchanging party.[142] Use of consent as the basis for recognizing the

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[139] Nozick, supra note 69, at 161.

[140] Id. at 161-62.

[141] For a magisterial articulation of the circumstances in which libertarian principles would consider consent to have been coerced, see Kronman, supra note 126, at 475-97; see also Melvin A. Eisenberg, The Bargain Principle and Its Limits, 95 Harv. L. Rev. 741, 748-85 (1982) (discussing circumstances when it is unconscionable to enforce bargain). For an interesting argument that consent is valid even if it has been coerced, but that the coercing party is precluded from enforcing the obligation, see Atiyah, supra note 90, at 22-23 (discussing Grotius's treatment of that issue).

[142] For a presentation of such an argument founded directly on entitlement theory, see Randy E. Barnett, A Consent Theory of Contract, 86 Colum. L. Rev. 269, 291-300 (1986); see also Barnett, supra note 126, at 73-79 (situating consent justification for enforcement of contracts in more general theory of contract and property rights). Interestingly, Posner made a similar point several years earlier, in a hypothetical explanation of an argument that he thought would appeal to Nozick:

> Suppose we consider consent an ethically attractive basis for permitting changes in the allocation of resources, on Kantian grounds unrelated to the fact that a consensual transaction is likely to increase the happiness at least of the immediate parties to it. We are then led, in the manner of Nozick and [Richard] Epstein, to an ethical defense of market transactions that is unrelated to their effect in promoting efficiency either in the Pareto sense or in the sense of wealth maximization.

validity of entitlements received through a consensual exchange supports the notion that a consensual exchange grants an entitlement only if the exchanging party deals with all of the owners. If the exchanging party does not deal with all of the owners, then one of the owners has not granted the consent necessary to justify divestiture of its entitlement.[143]

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In sum, although no complete theory of entitlements has gained acceptance, there seems to be little controversy about two basic rules, which can be derived from either utilitarian principles or autonomy-based principles: (a) individuals are entitled to the fruits of their labor; and (b) individuals can secure entitlements through a consensual exchange, but only to the extent the exchange is with the existing owner.

III
ENTITLEMENTS IN BANKRUPTCY

The next question to consider is how the bankruptcy system fares under the rules for entitlements discussed in Part II. This Part looks at that question and reaches two related conclusions: first, that creditors do not have an entitlement to all of the proceeds of bankruptcy,

Posner, Ethical Basis, supra note 92, at 490; see Posner, Justice, supra note 92, at 90 (parallel passage); see also Anthony T. Kronman, Wealth Maximization as a Normative Principle, 9 J. Legal Stud. 227, 235 (1980) (agreeing with Posner that "[t]he Pareto principle . . . may be interpreted as expressing a voluntarist ideal").

The question why a consensual exchange justly transfers entitlements is closely related to the question why the law enforces promissory obligations, a question on which there is a rich literature of explanations, many of which are closely related to the consent justification articulated by Randy Barnett. See, e.g., Atiyah, supra note 90, at 177-84 ("suggesting that promising may be reducible to a species of consent, for consent is a broader and perhaps more basic source of obligation"); John Finnis, Natural Law and Natural Rights 298-308 (1980) (arguing that promise should be enforced when it "is knowingly made with the intention of being taken as creative of [an] obligation"); see also J. Raz, Promises and Obligations, in Law, Morality, and Society: Essays in Honour of H.L.A. Hart 210, 211, 218-23 (P.M.S. Hacker & J. Raz eds., 1977) (arguing that promises create obligations "not because promising is an intentional action, but because it is the communication of an intention to undertake an obligation, or at any rate to create for oneself a reason for action"). But see Hume, supra note 91, bk. III, pt. II, § V, at 516-25 (arguing that promises create obligations not for moral reasons, but only because of human conventions). Those consent-related explanations can be distinguished as a class from Barnett's analysis in their limited use of entitlements theory as the foundation for their analysis. See Barnett, supra, at 299-300 (arguing that use of entitlements theory is novel element of his analysis).

143 See Barnett, supra note 142, at 298 ("[T]he moral requirement of consent mandates that others take the interests of the rights holder into account when seeking to obtain the rights she possesses."); cf. Posner, Justice, supra note 92, at 70 (arguing that entitlements "cannot be extinguished or transferred without the owner's consent").

even if they have bargained with the debtor for an unrestricted promise of payment out of all of the assets of the debtor; and second, that the government is entitled to a portion of the proceeds of bankruptcy because of its role in creating or preserving them.

A. *Thesis: The Limited Importance of the Debtor's Promise*

The key to any analysis of the entitlement a creditor has to a share of the proceeds of bankruptcy is the creditor's agreement with the debtor. It is the agreement that gives the creditor any claim to a portion of the entitlements of the debtor; absent an agreement, the creditor would have no claim.[144] But whatever the scope of the entitlement the creditor secures by means of a consensual exchange with the debtor, the creditor's entitlement does not extend to include the entire proceeds of bankruptcy. The creditor's entitlement—because it is based on an exchange with the debtor—can be no greater than the entitlement of the debtor. And the entitlement of the debtor cannot extend to all of the proceeds of bankruptcy, for the simple reason that some portion of those proceeds cannot plausibly be attributed to the assets and labor of the debtor, because a portion of the proceeds results from the application of the assets and labor the government has devoted to the bankruptcy system.[145] That portion—the gains from bankruptcy—is subject to a valid claim of entitlement on the part of the government.[146]

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144 By limiting itself to claims based on an agreement, the text departs from complete accuracy, because creditors do have certain claims that do not arise out of an agreement; consider claims based on a statute. Because those claims do not rest on an agreement with the debtor, they must rest instead on the exercise of some government power to remove entitlements from the debtor and allocate them to the creditor. Because the entitlements represented by such claims thus rest directly on the exercise of government power, it is difficult (assuming fair notice of the rule, see infra note 146) to see how the creditor would have a just contention that the entitlements were violated if the government decided (as it has) that the claims were limited in certain respects by bankruptcy. Even if the creditor could support such a contention, I can see no reason why it would make a statutory claim stronger than a claim based on an agreement.

Tort claims (a category in which I include all noncontractual common-law claims) are harder to analyze. To the extent that one views tort claims as redressing violations of entitlements, they would stand on the same footing as claims based on agreements, which seek enforcement of entitlements obtained by consent. Cf. Nozick, supra note 69, at 71-73 (discussing fundamental prohibition on "boundary-crossing acts"). If, by contrast, one views tort claims as nothing more than a nonstatutory mode of governmental regulatory power, they would stand on the same footing as statutory claims. Because neither tort claims nor statutory claims seem to stand on a stronger footing than claims based on agreement, the discussion in this Article focuses on claims based on agreement.

145 For a summary of the principal reasons why there might be gains from bankruptcy, see supra notes 42-63 and accompanying text.

146 It is important to emphasize that the limitation this Article articulates on the creditor's entitlement is wholly separate from any limitation that might be based on notice to the creditor. For example, the government might be entitled to alter the creditor's rights to

Consider a promise by a debtor to pay $100 to a creditor, coupled with an agreement that the debtor would deliver all of its assets to the creditor to the extent necessary to satisfy the debt. After making the promise, the debtor goes into business with its next-door neighbor. After some time, the business is worth $100. If the creditor attempted to collect the $100 debt by taking the $100 business, that attempt would fail, because the rights of the creditor would be limited to the debtor's interest in the business; the debtor's consent to the arrangement could not give the creditor an entitlement in the assets of the neighbor. The proceeds of bankruptcy are analogous to the value of that joint business. Without the commitment of the government personnel and resources that design, enact, implement, and operate the bankruptcy system, the value available for distribution under the bankruptcy system would not exist. The debtor and its creditor would be left to carve up the values that could be recovered in a liquidation under the state-remedies system.[147]

a thoroughly draconian extent if it gave adequate notice of the rules calling for those alterations before the time of the creditor's agreement. See LoPucki & Whitford, Equity's Share, supra note 7, at 180 (justifying redistributive results of bankruptcy by pointing out that creditors lend their money "in a world where they have every reason to believe that ... [their state-law entitlements] will not be strictly enforced"). In my view, no justification that relies on notice can provide an entire justification for any system, because notice cannot justify the original enactment of the system, much less application of the system to arrangements that predated the enactment. The difficulty of relying on notice to justify the original enactment is that the system itself—even if it limited only subsequent arrangements—might intrude unduly on the owner's ability to derive benefits from its preexisting entitlements. See, e.g., Hodel v. Irving, 481 U.S. 704, 712-18 (1987) (holding that Congress violated Takings Clause because statute that deprived Indians of the right to bequeath certain property deprived them of ability to make effective use of their property); cf. Hadacheck v. Sebastian, 239 U.S. 394, 409-14 (1915) (discussing ordinance that prohibited future use of particular parcel of land as brick yard notwithstanding owner's investment of $800,000 to develop brick yard on that land). Any concerns about the justice of the original enactment in turn cast doubt on the justice of relying on the notice afforded by that enactment as a justification for current redistributive treatment. In any event, thorough analysis of the scope and propriety of limitations of that sort are beyond the scope of this Article. For the classic analysis of the need for the government to give notice before it alters legal rules, see Louis Kaplow, An Economic Analysis of Legal Transitions, 99 Harv. L. Rev. 511 (1986).

147 I use the state-remedies system as the baseline for comparison because the purpose of my analysis is to determine what goals it would be just for the bankruptcy system to pursue. See also infra note 163 (explaining two steps by which I make that comparison). As this subpart explains, my analysis treats the bankruptcy system as a single action by the government, superimposed on the state-remedies system, and then considers whether the benefits the system might create justify the burdens the system seems to impose. Cf. Epstein, supra note 133, at 1406 ("The trick here is to find a way to ensure that for each government action, taken separately, there is reason to believe that state coercion provides each citizen with equal or greater benefits than the burdens imposed."). To analyze those benefits and burdens, it is necessary to compare the results that the bankruptcy system is designed to reach with the results that would occur under the debt-collection system as it

A key point of that analysis is the close relation between the entitlement of the government and the limitation on the entitlement of the creditor, both of which derive directly from the rules for entitlements developed in Part II. The creditor's claim rests on the rule that a party can secure an entitlement through a consensual exchange, but that rule applies only when the party making the transfer had a complete entitlement to the property in question.[148] Because the debtor had no entitlement to the entire proceeds of bankruptcy, the creditor could not secure a complete entitlement to those proceeds by means of an agreement with the debtor.[149] Conversely, the government's entitlement—the source of the limitation on the debtor's ownership that produces the limitation on the creditor's entitlement—rests on the rule that a party is entitled to the fruits of its labor.[150] Because the gains from bankruptcy are attributable (at least in part) to application of the resources and efforts of the government, the government has an entitlement (at least in part) to those gains.[151] To the extent that the

would exist in the absence of the bankruptcy system. As I mentioned supra at note 40, one difficulty in identifying the underlying state-remedies system baseline is evaluating the long-run effects of the bankruptcy system. For example, it is likely that the state-remedies system would function much better if the bankruptcy system were not there, for the simple reasons that there would be intense pressure to reform the state-remedies system and for parties to develop contractual and nonjudicial methods for enforcing obligations, including methods that might allow the debtor at the time of its formation to determine what types of insolvency proceedings would be used upon financial distress. See Rasmussen, supra note 4, at 55-68 (arguing that parties should be entitled to determine the procedures for liquidation and reorganization by agreement among themselves); see also Bowers, supra note 62, at 958-64 (arguing that reorganization proceedings diminish values that would have been available for liquidation under state-remedies system). For my analysis to be consistent, I believe that the baseline against which the results of the bankruptcy system are compared should be the actual recoveries that would be available in the long run under the state-remedies system as it would be if there were no bankruptcy system. For a brief discussion of what such a system might look like, see Baird, supra note 51, at 175-86.

I do not think, however, that use of a long-run baseline would aid creditors very much. If the state-remedies system improved dramatically in the absence of a bankruptcy system, it probably would be because many of the value-increasing devices of the Code were incorporated into state-remedies systems. In that event, the states would have the same entitlement to redistribute money that my argument maintains the federal government now has, so the creditors would be no better off than they would be under the analysis of this Article, which proceeds for simplicity by comparing the bankruptcy system to the existing state-remedies system.

148 See supra notes 135-43 and accompanying text.

149 To put it more colloquially: "[Y]ou can't spend what you ain't got; you can't lose what you ain't never had." Muddy Waters (McKinley Morganfeld), You Can't Lose What You Ain't Never Had, on The Chess Box (MCA Records 1989).

150 See supra notes 124-34 and accompanying text.

151 I see no relevance to the fact that the government is an entity rather than a natural individual. To the extent that the rules for entitlements derived in Part II properly should be limited to natural individuals, the government's entitlement would continue undiminished because of the government's position as an agent for the individuals who are mem-

government is entitled to those gains, neither the debtor nor its creditor can be entitled to them.

For me, the most difficult problem with that thesis is identifying what it is that entitles the government to apply its labor to the debtor's property. Even if we accept Nozick's proposal to limit the labor-based entitlement to the value added by the efforts of the laboring party,[152] we still have to find some basis for allowing the interference in the debtor's entitlements. Absent some justification for that interference, we would be sanctioning a system in which any officious intermeddler could secure a partial interest in the property of another by walking onto a parcel of property and performing services that increase the value of that property.[153] In my view, the solution to that problem lies in the role we have ceded to government in our society.[154] Although political philosophers for thousands of years have debated the proper role of government, the contours of the actual role

bers of the society it governs. Cf. Becker, Foundations, supra note 71, at 8-9 (discussing circumstances in which institutions can hold rights to property).

152 See supra note 132 and accompanying text.

153 See supra note 133 and accompanying text (discussing Epstein's view that allowing party entitlement for applying labor to object with knowledge of A's claim of ownership "can only undercut A's claim to be the sole owner of the property in question, and must therefore be rejected").

154 It is not plausible to rely on consent as a justification for the government's actions. Although the party that files a bankruptcy petition may consent to the government's intervention, the other parties have not consented, except to the extent that one could imply consent from their failure to resolve the problem in a way that would make it impractical for the debtor to seek relief in bankruptcy. See, e.g., Douglas G. Baird, The Reorganization of Closely Held Firms and the "Opt Out" Problem, 72 Wash. U. L.Q. 913, 917-25 (1994) (arguing that creditors readily can force debtors into structures that would limit harms creditors could suffer in bankruptcy); see also Stuart C. Gilson, Kose John & Larry H.P. Lang, Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default, 27 J. Fin. Econ. 315, 338-40 (1990) (empirical study suggesting characteristics that predict success of attempts to negotiate restructurings without aid of bankruptcy court). The failure to insist on those types of mechanisms does not seem to me enough to justify implying consent to the government actions reflected in the bankruptcy system.

For the economically oriented, the analysis by William Landes and Richard Posner of the law of salvage may provide a useful analogy to government intervention in bankruptcy. They argue that courts properly grant salvors a priority right of payment out of the value of a ship that they save because of the high transaction costs of negotiating a voluntary agreement in those circumstances. William M. Landes & Richard A. Posner, Salvors, Finders, Good Samaritans, and Other Rescuers: An Economic Study of Law and Altruism, 7 J. Legal Stud. 83, 90 & n.18 (1978). Accordingly, they conclude that "an 'officious' tender of assistance is one that occurs in a setting of low transaction costs. Since a coerced exchange is inefficient in such a situation, the law should refuse to enforce it." Id. at 90 n.16. For similar reasons, the government's intervention in a bankruptcy proceeding cannot be characterized as "officious," given the high transaction costs of securing agreement among all the parties as to how it would be best to proceed. However feasible it may be for owners, managers, and consensual creditors to reach an agreement regarding what should happen to a firm on insolvency, see Rasmussen, supra note 4, at 55-68 (arguing that parties to of government in this society are clear, at least with respect to the relevant question. In this society, the government has the power, and the right, to act on property with or without the consent of the existing owner, and without any claim for compensation by the owner beyond the value of the entitlements as they existed before the government's actions.[155]

For example, few would challenge the right of our government to take two pieces of land that adjoin a river, compensate the owners for the preexisting value of the parcels, and then retain the profits from building a bridge across the river at that point.[156] The government's entitlement in a bankruptcy proceeding is no different. With or without the consent of the creditors or other individuals with entitlements to the assets of the enterprise, the government in the circumstances outlined by the Code acts to increase the amounts that can be recovered from the failed enterprise beyond the amounts the parties could have recovered for themselves.[157] The government accordingly has an entitlement to those increased values no different from its entitlement to charge tolls to those who wish to cross its bridge.

In sum, any argument that it is inappropriate for the government to apply its resources to the debtor's property without consent must make a general attack on the relatively unconstrained role this society

formation of a firm should be entitled to select procedures for dealing with insolvency), it is not normally feasible to produce such an agreement with involuntary claimants.

155 See U.S. Const. amend. V (Takings Clause); see also U.S. Const. art. I, § 8, cl. 4 (authorizing Congress to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States"). The best illustration of the broad range of the government's general power in our society probably is found in the writings of one of the most prominent critics of the breadth of that power. See Epstein, supra note 126, at 107-45 (critically discussing scope of police power in modern American constitutional doctrine); id. at 161-81 (discussing desuetude of Fifth Amendment's limitation of taking of private property for public uses).

156 The fact that there might be profits does not suggest that the government undercompensated the owners for the parcel. It might be true for a variety of reasons (including its experience in bridge construction and in building and locating the roadways that would give the bridge value) that the government is better placed to build and operate a bridge than two separate owners of the parcels of land from which the bridge would be built. Hence, the government might be able to secure a better return from the parcels than the private owners and thus make a profit even if it paid the preexisting value of the land to the previous owners.

157 That analysis suggests that Congress justly could enact a bankruptcy system under which the government would place an entity in reorganization proceedings without the consent of its owners or creditors. Although such a provision would be novel in the ordinary bankruptcy context, it is a fundamental feature of the system for reorganizing failed financial institutions in our economy. See 12 U.S.C.A. § 1464(d)(2)(A) (West 1993 & Supp. 1995) (allowing Director of the Office of Thrift Supervision to appoint a receiver for federal savings association for several reasons, including "insolvency" or "unsafe or unsound condition to transact business"); cf. Fahey v. Mallonee, 332 U.S. 245, 248-54 (1947) (holding that owners of failed thrift were not deprived of due process by ex parte appointment of conservator for thrift).

has ceded to its government.[158] Because I see no reason that such a general attack should proceed against the bankruptcy system alone (while leaving in place considerably more intrusive governmental powers, such as the power to enact taxes on income),[159] I think it is appropriate to proceed here on the assumption that the government's actions in operating the bankruptcy system are not the type of "officious" intermeddling that cannot justify an entitlement for value added. Hence, in evaluating the fairness of the bankruptcy system within our existing society, I accept the authority of the government to act to improve property without the consent of the owner, but only to the limited extent necessary to recognize the government's entitlement to any increase in value attributable to the government's actions.

B. Application: The Scope of the Government's Entitlement

The next task is to apply my thesis to the bankruptcy system as it exists and, in particular, to consider whether the existing redistributive features of the bankruptcy system can be justified by the entitlements that the government possesses under my thesis. Because the bankruptcy processes for reorganization and liquidation raise different issues, I consider them separately. I start with the problem of reorganization, which first drew me to consider these questions.

1. Reorganization

The most direct effect creditors experience from reorganization proceedings comes from the plans courts approve in those proceedings. My analysis strongly supports the propriety of the Code's provisions setting requirements for approving plans.[160] The premise of chapter 11 of the Code is that by keeping businesses alive the bankruptcy system can preserve a going-concern value that could not be obtained absent the reorganization provisions of the Code.[161] The

158 Robert Nozick presented an elegant argument against a broad role for government in *Anarchy, State, and Utopia*. Nozick, supra note 69, at 292-94 (summarizing his doubts about propriety of a more-than-minimal state). My decision to consider the justice of the bankruptcy system against the backdrop of the existing society, coupled with the broad power of government that exists in our society, explains the apparent incongruity between the broad government-favoring conclusions of this Article and Nozick's arguments against broad government power.

159 Cf. Rasmussen, supra note 21, at 41 ("[R]ather than skewing the optimal approach to bankruptcy law, we should instead focus our attention on the unjust aspects of society and work to change them.").

160 For ease of exposition, this section focuses on reorganization proceedings under chapter 11. For the reasons outlined infra at note 162, the conclusion the text reaches with respect to proceedings under chapter 11 generally should apply to proceedings under chapter 13 (and, to some extent, chapter 9) as well.

161 The House Report on the bill that became the Bankruptcy Code argues:

values that could have been obtained without reorganization—the liquidation values—are reserved for the creditors by a provision that bars confirmation of any plan of reorganization without a finding that under the plan each objecting creditor will receive at least as much as it would have received if the enterprise had been liquidated.[162]

For the reasons explained in Part III.A, the entitlement of the creditor does not extend to the value of the property available for distribution in a reorganization that exceeds the value that would have been available if the debtor had been liquidated.[163] That value—the

> The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. . . . If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.

House Report, supra note 3, at 220, reprinted in 1978 U.S.C.C.A.N. at 6179. See generally supra notes 57-63 and accompanying text (discussing how bankruptcy system could preserve going-concern value).

162 11 U.S.C. § 1129(a)(7)(A)(ii) (1988); see also supra note 63 (discussing possibility that bankruptcy system does not fulfill promise of § 1129). The Code contains similar restrictions on approval of plans for wage-earners under 13 U.S.C. § 1325(a)(4)-(5) (1988). The provision codifying that rule is omitted from the list of chapter 11 plan requirements incorporated by reference into chapter 9's provisions for adjustment of the debts of municipalities. See 11 U.S.C. § 901(a) (1988). The legislative history suggests that the omission was not intended to have any substantial effect but instead reflects the differing position of a municipality. Because it is not feasible to liquidate a municipality, it is not useful to require as a condition of confirmation of a plan that creditors receive more than they would receive if the municipality were liquidated. See House Report, supra note 3, at 400, reprinted in 1978 U.S.C.C.A.N. at 6356. Accordingly, the statute substitutes a requirement that the plan be "in the best interests of creditors." 11 U.S.C. § 943(b)(7) (1988).

163 Given the prominence of proposals calling specifically for repeal of chapter 11 of the Code (see supra note 4), it is useful to consider separately the marginal value of the reorganization system, by considering the values obtained with that system in place to the values that would be obtained in a liquidation under the Code. To complete the analysis of the bankruptcy system against a baseline of the state-remedies system, see supra note 147 (discussing why I use recoveries under the state-remedies system as the baseline for comparison), I turn infra in Part III.B.2 to consideration of the marginal value of the liquidation provisions of the Code, by comparing the recoveries under those provisions (the baseline for comparison in this section) with the recoveries under the state-remedies system.

Because of the structure of my analysis as outlined in the preceding paragraph, the text does not directly consider whether reorganization provides a marginal value in comparison to the state-remedies system. Cf. Bradley & Rosenzweig, supra note 3, at 1079-80 & 1079 n.85 (arguing that values obtained in reorganization are less than values that would be obtained in out-of-court restructurings without bankruptcy system). Because the Code does not require the bankruptcy court to determine what would have been received under the state-remedies system, the statutory framework does not answer that question with the directness that it answers the question I consider (i.e., whether bankruptcy reorganization produces value over and above bankruptcy liquidation). Accordingly, my analysis cannot provide a determinate answer to that question, any more than it can provide a determinate answer in Part III.B.2 to the question of whether the values obtained under the liquidation provisions of the Code exceed the same hypothetical baseline. That problem does not trouble me significantly, however. If liquidation proceedings increase the values available gains from reorganization—is not attributable to the efforts of the creditor.[164] Rather, it arises from the actions of the debtor's management in continuing to operate the business, together with the effect of the bankruptcy system in preserving the business's chance to survive.[165] The creditor's bargain with the debtor may entitle it to any value attributable to the actions of the debtor and its management, but the government's role in creating and preserving those gains gives it an entitlement to some share of any gains from reorganization. Hence, the government is entitled to a say in disposing of that value, which it might exercise in several ways: by taking some portion of the value for itself through taxes or fees, by delivering it to the creditors, or by allowing the management or owners of the debtors to retain it. The key point, however, is that the creditor has no right to complain that it has been treated unjustly solely because the government elects to follow some course other than giving the creditor the entire value of the reorganized enterprise.[166]

To be sure, reorganization proceedings affect a creditor even before the plan is confirmed whenever they delay the creditor's right to proceed against the debtor. To that extent, it can be said that the creditor's capital continues to fund the debtor's business, in the sense that the creditor is compelled to continue to extend financial support to the debtor whenever the creditor is not repaid in full at the time the bankruptcy proceeding commences. For the most part, however, the Code compensates the creditor for that type of involuntary financing, at least if the creditor has adequate collateral. First, the Code will not

for distribution over the values that would be available under the state-remedies system (and there are many reasons to believe that they might, as discussed supra at notes 42-63 and accompanying text), and if the reorganization values exceed the bankruptcy liquidation values (as required by § 1129), then the reorganization values in most cases should exceed what could be recovered under the state-remedies system.

164 It is important to distinguish between the creditor that has a claim against the debtor based on prepetition occurrences and a party that advances funds to the debtor after the petition. To the extent that its loan aids preservation of the value of the enterprise, the postpetition lender does have a claim to some of the going-concern value. The postpetition lender, however, contributes its capital pursuant to a consensual exchange and should have no entitlement to anything beyond the agreed compensation.

165 Several commentators have noted the propriety of allocating interests in the reorganized enterprise among the various participants in the reorganization. See Baird, supra note 10, at 143 (suggesting that it "will not be easy" to "allocat[e] gains" attributable to the various parties that are "adding value" to the reorganization); Bebchuk, supra note 11, at 788-97 (explaining how his proposal is "perfectly consistent with the entitlements of the participants [in the reorganization]"). Neither Baird nor Bebchuk, however, discusses how to account for the value added by the government.

166 Cf. Baird & Jackson, supra note 11, at 743 ("[T]he senior creditor, having the exclusive right to the firm's assets following foreclosure, should be able to convey an interest in them to anyone it pleases.").

allow the debtor to consume the creditor's collateral, because the court can allow the debtor to use the collateral only if the debtor provides "adequate protection" to the creditor.[167] Similarly, if the court confirms a plan under which the creditor's claim is not paid in full at the time of confirmation, the plan must provide for interest payments to ensure that the entitlement of the creditor is not diminished through deferral of payment under the plan.[168]

That leaves the question of whether the bankruptcy system provides proper compensation to the creditor for the period of delay between the filing of the petition and confirmation of the plan. Here the system is less generous. The Supreme Court has concluded that the Code does not in terms require the payment of interest on secured claims during the pendency of the proceeding except to the extent that the creditor's collateral has a value greater than or equal to the value of the creditor's claim.[169] But the significance of that decision is undermined considerably by the Code's general enforcement of provisions providing for security interests in the rents and other revenues arising out of the creditor's collateral.[170] Because the Code enforces such provisions, creditors who reach appropriate agreements with their debtors receive full compensation for delay, at least in the ordinary case in which the collateral on which the creditor is relying produces income commensurate with a fair return on its value.[171]

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167 11 U.S.C.A. § 362(d) (West 1993 & Supp. 1995); 11 U.S.C. §§ 363(e), 364(d) (1988); see id. § 361 (defining protection as adequate only if it protects the creditor from any deterioration in the value of its collateral).

168 11 U.S.C. § 1129(a)(7)(A) (1988). For analogous provisions in chapter 13, see 11 U.S.C. § 1325(a)(4)-(5) (1988). For a lucid explanation of the present-value concept contained in those provisions, see Warren & Westbrook, supra note 14, at 312-13; see also LoPucki, supra note 42, § 16.8.2, at 957-60. Of course, it is possible that a judge will not require an interest rate sufficiently high to compensate the creditor for the delay. The possibility of such an error, however, affords no basis for condemning the Code's provisions allowing deferred payment. See supra note 63 (explaining that this Article investigates goals bankruptcy system pursues, not its efficacy in reaching them). For evidence that an analogous provision of Japanese law in fact results in creditors' receiving more than they would through liquidation, see Eisenberg & Tagashira, supra note 63, at 235-37, reprinted in 23 J. Legal Stud. at 132-34.

169 United Savings Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 369-82 (1988); see also United States v. Ron Pair Enters., 489 U.S. 235, 241-42 (1989) (holding that § 506(b) requires payment of pendency interest to the extent that value of creditor's collateral exceeds creditor's claim); 11 U.S.C.A. § 1322(e) (West 1993 & Supp. 1995) (chapter 13 debtor is required to pay interest on amounts necessary to cure prepetition defaults only to extent required by applicable nonbankruptcy law).

170 11 U.S.C. § 552(b) (1988); see LoPucki, supra note 42, § 3.5.11, at 23 (2d ed. 1991 & Supp. 1995).

171 See LoPucki, supra note 42, § 3.5.10 (discussing strategies creditors can use to ensure adequate postpetition compensation); John C. McCoid II, Pendency Interest in Bankruptcy, 68 Am. Bankr. L.J. 1, 9 (1994) (arguing that § 552(b) allows creditor to receive at least rough compensation for delay in right to realize on collateral).

In many cases, however, creditors will have no collateral or have security interests in collateral that will not directly produce income commensurate with its value: equipment is the most obvious example. One could argue that even in cases where the creditor receives no current return, the failure to pay pendency interest[172] does not derogate from the entitlement of the creditor. If it would take the creditor as long to obtain payment under state law as it would take the bankruptcy court to conclude its proceedings (whether by confirming a plan or lifting the stay), the bankruptcy system would not intrude on the creditor's entitlement. That is so because the creditor in both cases would be likely to receive the total value of its collateral, and nothing more. In either case, the creditor effectively would begin receiving interest at the end of the interim period: either under the plan, or through the opportunity to earn a return on the asset it acquired through exercise of its remedies.[173] Hence, the creditor's recovery is hindered only if the bankruptcy system takes longer to confirm a plan than the state-remedies system requires for a foreclosure (or other state-law remedy).

But the existing empirical evidence makes it difficult to suggest that the bankruptcy system—epitomized, after all, by the automatic stay—moves as quickly as the state-remedies system. Whatever the benefits of the bankruptcy system as a whole, it is plain that delay is a significant problem with the current operations of chapter 11.[174] To the extent that those delays deprive the creditor of the ability to receive what it would have received outside of bankruptcy, the creditor has a serious argument that it has been treated unfairly and is entitled to relief.[175]

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172 By pendency interest, I mean interest for the period between the date of the bankruptcy filing and the date the creditor starts receiving interest under the plan (or is allowed to proceed to foreclosure). The more common term—postpetition interest—would include the period after the plan has been confirmed. The creditor already receives compensation for the period after confirmation, as explained supra at note 168 and accompanying text.

173 The idea is that the creditor could sell the asset after taking it through the state-remedies system, and then receive a return by investing the proceeds of the sale.

174 See Lynn M. LoPucki, The Trouble with Chapter 11, 1993 Wis. L. Rev. 729, 739-45 (presenting empirical evidence regarding delays in chapter 11); see also Jackson, supra note 9, at 181-90 (arguing that payment of interest during pendency of reorganization proceeding is necessary to protect creditors' state-law entitlements); McCoid, supra note 171, at 15-19 (concluding that denial of pendency interest is inappropriate).

175 See Crocker Nat'l Bank v. American Mariner Indus. (In re American Mariner Indus.), 734 F.2d 426, 429-32 (9th Cir. 1984) (holding that undersecured creditors are entitled to interest during the pendency of bankruptcy proceeding). Under my analysis, that conclusion would not hold for those who both (a) adopt a patterned perspective on distributive justice, and (b) conclude that the denial of pendency interest brings the net distribution of wealth in society closer to one that is acceptable. For the reasons explained supra at note 122, I reject clause (b) of that argument, because general economic prefer-

That is not to say that all creditors are entitled to interest commencing on the date of the petition. As the discussion in the preceding paragraphs indicates, the inability of the creditor to receive interest under the existing rules may reflect the inability of the creditor to convince the debtor to grant it a security interest in income arising out of its collateral; the bankruptcy system need not protect a creditor from its inability to secure adequate collateral from the debtor. Moreover, payment of pendency interest commencing on the date of bankruptcy would give a creditor more than it would have received absent bankruptcy, because it would ignore the delay, expense, and uncertainty that the creditor would have faced in the state-remedies system (especially if the creditor is unsecured or undersecured).[176] Nothing in the entitlement analysis of this Article requires a result that would grant the creditor the benefits of a consolidated and streamlined proceeding without acknowledging any entitlement to the government for the efforts that produced that proceeding. It does, however, suggest that the system should give the creditor something similar to what the creditor would have received without the proceeding.[177]

My entitlement analysis does not require the choice of any particular remedy, only some system for providing the creditor what it would have recovered in the absence of bankruptcy. Hence, Congress could provide a partial remedy if it enacted procedural reforms designed to shorten the delays in chapter 11.[178] To the extent that procedural reforms cannot remove the delay in the creditor's ability to

ences for debtors over creditors, or for unsecured creditors over secured creditors (the preferences apparently furthered by the denial of pendency interest) would not be likely to have any substantial and discernible ameliorative effect on any maldistribution of wealth in our society.

176 See Rasmussen, supra note 4, at 70 n.69 ("[A] creditor has no right to complain if the delay caused by bankruptcy replicates the delay that the creditor would have had to bear under state law."); see also Jackson, supra note 9, at 185 (acknowledging that foreclosure and sale under state law "may take time," particularly if the debtor is "recalcitrant"); Baird & Jackson, supra note 12, at 114-15 (same).

177 See supra Part III.A.

178 For one small reform, see 11 U.S.C.A. § 362(d)(3) (West 1993 & Supp. 1995) (conditioning continuation of the automatic stay in single-asset real estate cases on debtor's beginning to pay pendency interest within 90 days after filing of petition, unless court extends period or concludes that debtor has "filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time"). For scholarly proposals to redress the delay, see Lynn M. LoPucki & William C. Whitford, Preemptive Cram Down, 65 Am. Bankr. L.J. 625, 633-35 (1991) (arguing that bankruptcy courts should enter preemptive cram down orders that would remove equity's bargaining position early in cases where there was no likelihood that equity would be entitled to participate in plan of reorganization); LoPucki & Whitford, Venue, supra note 7, at 48 (arguing that Congress should limit discretion of bankruptcy judges to extend time during which the debtor has exclusive right to propose plan of reorganization).

realize on its collateral, however, the creditor should be entitled to compensation at least for the excess of the delay the creditor experienced in bankruptcy over the delay that it would have experienced in the state-remedies system.[179] Of course, to the extent that delay is attributable to the debtor,[180] a requirement that the debtor begin paying interest on all secured claims at the time the bankruptcy is filed might afford the most effective incentive to accelerate the proceedings.[181] The choice, however, would be up to Congress. All that my analysis suggests is that a bankruptcy system that does not provide compensation for that delay has deprived the creditor of something that cannot be justified by the government's role in the bankruptcy system.

The most significant implications of my entitlement analysis for reorganization proceedings relate to the so-called absolute priority rule. That rule is a doctrine of bankruptcy law, now codified in § 1129 of the Code,[182] which generally prohibits an owner or junior creditor from receiving anything under a plan for reorganizing a debtor if an objecting senior creditor is not paid in full.[183] The rule rests on the

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179 The Ninth Circuit adopted that approach in *Crocker*, 734 F.2d at 429-32, 435, but that conclusion was rejected by the Supreme Court in United Savings Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 372-82 (1988) (holding that debtors need not pay interest on undersecured claims during the pendency of a bankruptcy proceeding).

180 Many commentators believe that the delays that plague chapter 11 are attributable to the debtor's incentive and ability to delay those proceedings and bargain for results to which it is not entitled under the Code. See, e.g., Adler, supra note 4, at 448-51 (explaining when "[e]quity's desire for delay is meaningful"); Bebchuk, supra note 11, at 780, 780 n.19 ("When the value of the reorganized company is lower than the total value of creditors' claims, the equityholders might have nothing to lose and something to gain from a delay."); Bradley & Rosenzweig, supra note 3, at 1076-77 ("Filing a Chapter 11 petition, in effect, is a way to keep control of the firm free from the intrusive monitoring of creditors, thereby permitting management to extract wealth from the firm's various security holders." (citation omitted)); LoPucki, supra note 174, at 732-37 (discussing problems of delay in chapter 11 proceedings); Rasmussen, supra note 4, at 76 ("It is clear . . . that equity holders often participate in a reorganization even where there is little probability that they are contributing firm-specific skills to the reorganized enterprise."); Skeel, supra note 4, at 515 (referring to "the hold up power currently wielded . . . by the shareholders of a Chapter 11 debtor [in a nonclosely held corporation case]"). For empirical analysis of the problem focusing on the role played by management in reorganizations of large, publicly held companies, see LoPucki & Whitford, supra note 48, at 723-42; LoPucki & Whitford, Equity's Share, supra note 7, at 147-51.

181 Cf. McCoid, supra note 171, at 17 (discussing incentive effects of rules regarding pendency interest).

182 11 U.S.C.A. § 1129 (West 1993 & Supp. 1995).

183 The best general treatment of the absolute priority rule and its history continues to be found in John D. Ayer, Rethinking Absolute Priority After *Ahlers*, 87 Mich. L. Rev. 963 (1989). For differing perspectives on the implications for the rule under chapter 11, see Charles W. Adams, New Capital for Bankruptcy Reorganizations: It's the Amount that Counts, 89 Nw. U. L. Rev. 411, 422-44 (1995) (arguing that analysis of absolute priority rule should focus on purpose of reorganization proceeding to restore equity cushion of

view that the senior creditor has an absolute right to be paid in full before the junior creditor or shareholder receives any payment at all.[184] The absolute priority rule has received considerable scrutiny in recent bankruptcy scholarship, largely because it is clear that shareholders under the current Code receive more under confirmed chapter 11 plans than the absolute priority rule would permit.[185] Furthermore, the Supreme Court repeatedly has been called on to consider whether there is a "new-value exception" to the absolute priority rule, which would allow the prior owners of the failed enterprise to receive an ownership interest in the reorganized business if they contribute adequate new value to the reorganized business.[186]

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debtor); Baird & Jackson, supra note 11, at 775-81 (evaluating absolute priority rule in light of dynamics of negotiation of reorganization proceeding); Bruce A. Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 Stan. L. Rev. 69, 107-11 (1991) (evaluating absolute priority rule in light of auction theory); Elizabeth Warren, A Theory of Absolute Priority, 1991 Ann. Surv. Am. L. 9, 11-37 (offering broad theory of absolute priority as part of overall system of transferring ownership of insolvent enterprises).

184 The term "absolute priority" apparently was adopted to distinguish the rule from a system of "relative priority," which would allow interests with claims of lower priority to share in the estate, provided they received less than claims of higher priority. See 6A Collier on Bankruptcy ¶ 11.06 (James Wm. Moore & Lawrence P. King eds., 14th ed. 1977); James C. Bonbright & Milton M. Bergerman, Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization, 28 Colum. L. Rev. 127, 130-31 (1928) (articulating distinction between absolute and relative priority); see also Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 119 (1939) (holding that plan violated absolute priority rule of then-extant bankruptcy statute, even though "the relative priorities of the bondholders and the old . . . stockholders are maintained").

185 See supra note 8; see also Rasmussen, supra note 57, at 1177 (explaining that many recent bankruptcy reform proposals are designed to ensure that absolute priority rule is respected in practice).

186 See U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership, 114 S. Ct. 681 (1994) (granting certiorari to decide whether new-value exception exists), case dismissed as moot, 115 S. Ct. 386, 394 (1994); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 203 n.3 (1988) (declining to decide whether new-value exception exists, based on conclusion that plan at issue violated Code even if new-value exception exists). For academic discussions, see Adams, supra note 183, at 424-44 (arguing that new-value exception should be applied in light of purpose of reorganization proceeding to restore equity cushion of debtor); Ayer, supra note 183, at 999-1024 (summarizing history of the new-value exception and arguing that it is rarely proper to apply that exception); John D. Ayer, Bankruptcy as an Essentially Contested Concept: The Case of the One-Asset Case, 44 S.C. L. Rev. 863, 890-903 (1993) (distinguishing between cases where old owners are highest bidders for company and cases where old owners want to retain ownership without submitting to competitive bidding); Baird & Picker, supra note 61, at 325-28 (arguing that new-value exception helps to truncate unproductive bargaining between shareholders and creditors); Markell, supra note 183, at 101-03 (arguing that enactment of Code did not repeal new-value exception); Nimmer, supra note 4, at 1072-78 (arguing that even noncash contributions should satisfy the new-value exception); Rasmussen, supra note 4, at 76-78 (discussing problems with recognizing new-value exception); Warren, supra note 183, at 39-42 (explaining why language of Code requires recognition of some form of new-value exception). I served as an assistant to the Solicitor General representing the United States as an amicus curiae in the *Bonner Mall* case. The views set forth in this Article about the absolute priority rule (and

My entitlement analysis indicates that principles of distributive justice do not require the absolute priority rule. The funds that the absolute priority rule guarantees to creditors go beyond the baseline entitlement to what the creditors would have received if the enterprise were liquidated.[187] Accordingly, questions about the general propriety and proper extent of the rule are for debate as a matter of social policy; the creditor has no entitlement to the rule in any form.[188]

2. *Liquidation*

Application of my entitlement analysis to the liquidation process is less determinate, because there is no occasion in the liquidation process to determine what would have happened absent the intervention of the bankruptcy system: whatever would have happened, the court

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other issues) do not reflect the views of the Department of Justice or any other agency of the United States.

187 Under my analysis, that baseline is preserved by the "best-interests-of-creditors" test discussed supra at note 162 and accompanying text.

188 The first step in resolving questions about the propriety and extent of the absolute priority rule requires determining what policy the government should attempt to advance in disposing of its entitlement. Even if one resolves that step by accepting wealth maximization as the policy goal, the questions remain difficult. Among other things, a complete analysis would have to consider whether a system that does not respect absolute priority imposes excessive "forum-shopping" costs by encouraging debtors to resolve disputes in bankruptcy rather than the state-remedies system. See, e.g., Jackson, supra note 9, at 21-27 (arguing that existence of bankruptcy rules that favor debtors more than analogous state rules results in forum shopping); Baird, supra note 20, at 824-28 (same). The key problem with the forum-shopping argument is that it ignores the tactical advantages the bankruptcy system gives to secured creditors by destroying at a stroke the practical leverage unsecured creditors could use to secure payment outside of bankruptcy. See LoPucki, supra note 27, at 1945-46 (explaining that removing rights of unsecured creditors in bankruptcy would increase incentives for secured creditors to forum shop). Hence, a thorough analysis of the forum-shopping problem would have to consider not only the incentives bankruptcy gives to debtors (as against secured creditors), but also the countervailing incentives that bankruptcy gives to secured creditors (as against unsecured creditors).

Another factor that weighs against an absolute rule of absolute priority is the likelihood that deviations from absolute priority have a positive effect on the incentives facing the managers of insolvent businesses. The most obvious effect is that deviations from absolute priority can improve the managers' incentive to operate a firm profitably even after the firm becomes insolvent. See, e.g., Baird & Picker, supra note 61, at 317-18 (pointing out increased incentive for profitable operations that arises from absolute priority rule); Katherine H. Daigle & Michael T. Maloney, Residual Claims in Bankruptcy: An Agency Theory Explanation, 37 J.L. & Econ. 157, 189-91 (1994) (same); Rasmussen, supra note 57, at 1178-86 (same); Susan Rose-Ackerman, Risk Taking and Ruin: Bankruptcy and Investment Choice, 20 J. Legal Stud. 277, 281-92 (1991) (same); Whitford, supra note 31, at 1384 n.17 (explaining how deviations from absolute priority can improve management incentives). Those deviations also could decrease the managers' aversion to filing bankruptcy, which might decrease the losses of inefficient operation during the prebankruptcy period. See Baird, supra note 11, at 650-51 (discussing possible gains from decreasing managers' aversion to filing bankruptcy); Rasmussen, supra note 57, at 1187-90 (same).

must liquidate the assets.[189] Accordingly, unlike a reorganization proceeding, a liquidation proceeding does not identify and segregate the gains from the proceeding. Hence, it is more difficult to determine whether the intrusions of the system on the interests of creditors cut into preexisting values that the creditors would have secured without the aid of the bankruptcy system. Nevertheless, some tentative conclusions are possible.

For analytical purposes, it is useful to start by following the Code's practice of dividing claims into two groups: secured and unsecured. Claims are secured to the extent of the value of the creditor's interest in collateral given to secure them; all other claims or portions of claims are unsecured.[190]

a. Secured Claims. The Code's treatment of secured claims in liquidation proceedings is not controversial, because (subject to the problem about compensation for delay discussed above[191]) it generally promises the creditor whatever it would have received under state law.[192] If the claim exceeds the value of the collateral, the trustee might determine that the property "is of inconsequential value and benefit to the estate" and then abandon it.[193] If the trustee abandons the property, the creditor is then free to pursue its state-law remedies.[194] If the trustee does not abandon the property, then the property cannot be sold without the creditor's consent or provision by the court for adequate protection of the creditor's interest in the prop-

189 One limited exception is the bankruptcy court's power to abstain under 11 U.S.C. § 305(a)(1) (1988) if it finds that "the interests of creditors and the debtor would be better served by such dismissal or suspension." See generally David G. Epstein, Steve H. Nickles & James J. White, Bankruptcy § 2-10 (1993) (discussing judicial interpretations of § 305(a)).

190 The division of claims into the secured and unsecured categories is made pursuant to 11 U.S.C. § 506(a) (1988). The most important point about that division is to notice that the division does not reflect ordinary usage, because it limits a creditor's secured claim to the value of its collateral. For example, a creditor that holds a $200,000 mortgage on a home worth $150,000 has a secured claim for only $150,000; the remaining $50,000 of the obligation is an unsecured claim.

191 See supra notes 169-81 and accompanying text. That problem afflicts creditors in liquidation proceedings just as it does creditors in reorganization proceedings.

192 The textual statement also must be qualified to reflect the possibility—inherent in any system that relies on judicial valuation—that creditors will not in fact receive the values the statute promises them. That problem is not, however, of direct relevance to this Article, which investigates the goals of the bankruptcy system, not its efficacy in fulfilling them. See supra note 63.

193 11 U.S.C. § 554(a) (1988).

194 When the trustee abandons the property, the creditor readily should be able to secure relief from the stay under 11 U.S.C.A. § 362(d)(2) (West 1993 & Supp. 1995).

erty.[195] Adequate protection, in turn, requires full preservation or payment to the creditor of its lien, but nothing more.[196]

b. Unsecured Claims. Unsecured claims present much more complex issues. The basic problem, mentioned at the beginning of this section, is that the system does not require the bankruptcy court to determine what creditors would have received in the absence of a bankruptcy proceeding. Accordingly, although there is reason to believe that the system as a whole provides some benefits to unsecured creditors,[197] it is difficult to tell whether it is benefitting any particular creditor, or even the creditors as a group in any particular case.[198] Because my analysis recognizes a right in the government to control a portion of the proceeds of bankruptcy only when those proceeds exceed the values that would have been obtained outside of bankruptcy, determining the baseline recovery of the creditors is crucial to my analysis.

One way to deal with that problem is to adopt a "bird-in-the-bush" approach, which focuses on the contingency of any particular creditor's enforcement of its unsecured claim under the state-remedies system. If the claim is still unsecured, then whatever the financial position of the debtor, it is possible (perhaps likely) that the creditor would receive nothing under the state-remedies system, be-

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195 11 U.S.C. § 363(e) (1988).

196 Id. § 361. The Code does not in terms require disposition either by sale or abandonment, but effectively reaches that result by requiring in id. § 725 that the trustee, before distribution of the estate, "dispose of any property in which an entity other than the estate has an interest, such as a lien."

197 See supra notes 42-63 and accompanying text.

198 The distinction between benefits for a particular creditor and benefits for creditors as a group raises a difficult question. Section 1129 requires a determination that the reorganization promises each individual creditor more than the creditor would receive under a liquidation. As the text points out, chapter 7 does not promise the creditor more than it would receive under the state-remedies system. Indeed, in many cases, it clearly offers less. See, e.g., 11 U.S.C. § 547 (1988) (providing for invalidation of transfers that would have been respected under state law). The traditional justification for those provisions is the utilitarian point that those provisions produce benefits for all creditors that outweigh the harms inflicted on any particular creditor. It is not, however, consistent with a strictly autonomy-based approach to entitlements to accept an alteration of the rights of one based solely on a gain that accrues to the group as a whole. Nevertheless, I have a strong instinct to accept the validity of such provisions based on two factors: the benefits that bankruptcy can offer to unsecured creditors as a group; and the practical difficulties of their securing those benefits through actual agreements.

I am not sure, however, that my instinct can be reconciled with this Article's analysis. One resolution might arise out of my view that the difficulties of concluding that any particular creditor would have received anything under the state-remedies system requires protection of the entitlements of the group as a whole. See infra notes 200-02 and accompanying text. That group-oriented basis for protection might support a justification for group-oriented reallocations like § 547.

cause other creditors might pursue their claims more quickly and liquidate (or obtain security interests in) all assets of the debtor.[199] To put it more colloquially, if your claim is still "in the bush," then you really have nothing at all. Under my entitlement analysis, then, unsecured creditors would not have an entitlement to any share of the proceeds of bankruptcy, and the government (subject to the entitlement of the debtor) justly could exercise dominion over any of those proceeds that were not subject to valid entitlements of secured creditors.

An alternative approach focuses on the entitlement of unsecured creditors as a group. Even if it is difficult to predict what—if anything—any individual unsecured creditor would receive under the state-remedies system, it is likely to be true in some cases that at the time the bankruptcy system intervenes the debtor owned some body of assets not dedicated to the claims of secured creditors, which would have been liquidated under the state-remedies system to satisfy the claims of unsecured creditors.[200] Arguably, the unsecured creditors have an entitlement—as a group—to the amount that they would have received if the bankruptcy system had not intervened.[201]

I prefer the latter, broader approach. My effort considers the justice of the bankruptcy system as a whole, and the fairness of that system as a whole should turn on whether the system improperly deprives creditors of money to which they are entitled as a group. I see little to say in favor of a bankruptcy system that could be supported only under a "bird-in-the-bush" approach. That approach would justify a system that would take assets that unsecured creditors

199 That likelihood is exacerbated by the dramatic inefficiencies of the coercive aspects of the state-remedies system. Because the expenses of pursuing a debtor under that system are great, particularly when considered in light of the amount of the underlying debt recovered, it is unlikely that the state-remedies system allows creditors to convert more than a tiny fraction of the debtor's assets into value available for repayment of obligations. See supra note 46 (citing sources that discuss the problems with state-remedies system).

200 To be sure, with the rise of Article 9 of the Uniform Commercial Code, the level of unencumbered assets held by insolvent debtors is becoming vanishingly small. See LoPucki, supra note 27, at 1931-33 (discussing effect of Article 9 on extent to which insolvent debtors have unencumbered assets). The possibility that assets would remain unencumbered nevertheless remains sufficiently likely to merit analysis. Of course, to the extent that there are no unencumbered assets available for unsecured creditors under the state-remedies system, then it is clear that they have no entitlement to present in the bankruptcy system, and thus cannot complain of any ill treatment they receive under that system.

201 That amount may be considerably less than the value of the unencumbered assets, which must be reduced by the costs of pursuing those assets through the state-remedies system. Those costs—in accordance with the analysis set forth in this Article—fairly would include any sums the state justly retains or redistributes to compensate it for its actions in creating and maintaining the state-remedies system. I offer a brief discussion of the extent to which the state could gain any such entitlements in the Conclusion.

would have recovered under the state-remedies system and rely on the difficulties of determining precisely how they would have been distributed to justify transferring them to other parties, who (by hypothesis) would have recovered nothing whatsoever under the state-remedies system. A system like that looks less like a just system for dealing with financial distress than it does a shell game, explaining to each unsecured creditor in turn: "There were some assets available for one of you, but you're not the right person, so you take nothing."[202]

The question, then, is whether the current system conforms to the entitlements of unsecured creditors.[203] By contrast to the respectful treatment afforded secured creditors,[204] unsecured creditors fare quite poorly in the bankruptcy system. For purposes of this Article, I will consider three distinct limitations on the rights of unsecured creditors: subordination to administrative expenses; subordination to favored claimants; and limitations on pursuit of the debtor and its assets.[205]

The subordination of the claims of unsecured creditors to administrative expenses[206] is readily explicable under my theory. The premise of the proceeding is that the operation of the proceeding will result

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202 Given the currently deplorable condition of the state-remedies system, see, e.g., Whitford, supra note 23, at 1049-72 (outlining inefficiencies of state-remedies system for collecting debts); supra note 46 (citing other sources criticizing state collection procedures), even the broader approach adopted in the text would leave the bankruptcy system considerable leeway to operate. Conversely, significant reforms of the state-remedies system might dramatically decrease the overall benefits of the bankruptcy system and, to that extent, limit the justification for the redistributive features of that system as it currently exists. That does not in my view undermine my analysis. If it were clear that all of the possible benefits of bankruptcy really could be obtained in the state-remedies system, I would agree that there would be no good reason to have the separate federal system.

203 A problem that I cannot resolve in this Article is how to determine the "entitlements" of the creditors under state law. For various reasons, creditors that are similarly situated under the formal provisions of state law might as a practical matter have had dramatically different likelihoods of collection in the absence of bankruptcy. See LoPucki, supra note 27, at 1938-47 (discussing "cash-flow surfing"); Carlson, supra note 65, at 462-63 ("Anyone with practical experience knows that general creditors vary widely in terms of their ability to collect from a debtor."). My analysis does, however, suggest that the government could not credibly argue that it was creating value in the bankruptcy system for creditors who received less under that system than they would have received under the state-remedies system, even if the state-remedies recovery would have been based not on formal legal entitlements, but instead on skillful use of practical leverage.

204 See supra Part III.B.2.a.

205 Another important limitation on the right of unsecured creditors is their inability to receive interest to compensate them for the delays imposed by the bankruptcy proceeding. The discussion of the propriety of the provisions of the Code that limit the availability of interest during the course of reorganization proceedings (supra notes 167-81 and accompanying text) applies in this context as well.

206 11 U.S.C.A. § 726(a)(1) (West 1993 & Supp. 1995) (granting priority to creditors that have priority under id. § 507(a)(1)).

in an increased recovery, which will benefit the unsecured creditors.[207] To the extent that those expenses create a value that would not otherwise have been available, the unsecured creditors have no entitlement to the value, and it is only fair for the government to dispose of the value as it sees fit. The reasonableness of the government's decision to pay the expenses of creating the value is evident from the customary state rule requiring payment of expenses of an execution sale out of the proceeds of the sale.[208] That decision is bolstered by the strong reasons to believe that disposition of property for the benefit of unsecured creditors will be conducted much more efficiently in a bankruptcy proceeding than it would have been in the state-remedies system.[209]

The second relevant aspect of the liquidation proceeding is the Code's subordination of the claims of general unsecured creditors to the claims of various specified favored claimants, without regard to whether the federally favored claimants would have had priority under the state-remedies system.[210] That subordination reflects a patent policy determination by Congress that the favored claimants have some special characteristic that justifies elevating them to a superior position.[211] Under my entitlement analysis, that action can be justified only if its effects are limited to values created by the bankruptcy system. Given the difficulty of determining precisely what value—if any—would have been available for payment under the state-remedies system, I see no obvious way of determining empirically whether the effects of the priority provisions are appropriately limited. My theory does, however, give some definition to the relevant inquiry: A bankruptcy system can justify provisions elevating favored creditors (other than administrative creditors) to priority status only if those provisions do not depress the recovery of general unsecured

207 As explained supra in Part III.B.2.a, the secured creditors generally receive nothing more from the proceeding than they would have received without the aid of the bankruptcy proceeding. Thus, the administrative expenses do not benefit them. To the extent that the estate expends funds to benefit a secured creditor, the Code requires payment of the expenses by the secured creditor. 11 U.S.C. § 506(c) (1988).

208 See, e.g., Epstein & Nickles, supra note 25, at 11 (explaining that after conducting execution sale sheriff typically gives net proceeds to creditor "after paying the costs of the sale").

209 See supra notes 42-56 and accompanying text.

210 See 11 U.S.C.A. § 726 (West 1993 & Supp. 1995) (granting priority to claimants described in the various subsections of id. § 507(a)(2)-(8)).

211 For a good discussion of the policy arguments for and against the preferences for claims held by employees and governmental entities, see Susan J. Cantlie, Preferred Priority in Bankruptcy, in Current Developments in International and Comparative Corporate Insolvency Law, supra note 63, at 413, 424-49.

creditors below the recovery they would have received as a group in the absence of a bankruptcy system.[212]

Finally, the bankruptcy system limits the creditors' rights of enforcement by allowing the debtor to retain certain assets, exempt from the claims of the creditors,[213] and also by granting a discharge, which protects all future assets of the debtor from the claims of the creditors.[214] To the extent that those provisions limit the creditors' ability to pursue a debtor in a way that decreases the creditors' recovery below what they would have secured under the state-remedies system, this Article's analysis offers no justification for those provisions.[215] That failure of justification, however, in my view does not cast doubt on the propriety of the discharge, which I would justify in a different way. I suggest that the discharge does not rest on a desire to provide economic assistance to those in financial distress, but on deeply felt concerns about the limits our society wishes to place on coercive actions to collect debts.[216] To the extent that those provisions rest on

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[212] Logically, one could approach the problem in one of two ways. First, one could attempt to determine the size of the redistribution effected by the priority provisions. It does not appear to be large. See Baird, supra note 33, at 93 (arguing that priorities for tax claims are likely to be "irrelevant," because of common presence of tax liens, and that remaining priorities "do not loom large"). Second, one could attempt to limit the use of liquidation proceedings to cases where there is some plausible reason to believe that the proceedings will produce some value beyond the values that would be received under the state-remedies system. Cf. 11 U.S.C. § 305(a)(1) (1988) (permitting abstention if the court determines that "the interests of creditors and the debtor would be better served by such dismissal or suspension"); Jackson, supra note 9, at 202 (suggesting that Bankruptcy Code requires multiple creditors for filing of involuntary petition to ensure that case presents collective-action problem that can be remedied by bankruptcy system).

Furthermore, even if the values redistributed by the priorities exceeded the marginal benefits of the proceeding, my analysis does not require a conclusion that the system is unjust. The government could justify its action in some other way, for example based on a determination that the grant of priority rectifies some previous injustice in allocating entitlements. Other more general justifications are possible as well, such as the notion that the government's generally beneficial activities justify an action limiting the rights of creditors to recover their debts. My purpose here, however, is to consider the possibility of justifying the bankruptcy system by itself, without reference to other government actions.

[213] 11 U.S.C.A. § 522 (West 1993 & Supp. 1995).

[214] See supra note 68.

[215] See also Jackson, supra note 9, at 225 (arguing that policy of discharge "has nothing to do with the rights of claimants inter se or with the notion that bankruptcy exists to solve a common problem. . . . Discharge thus represents a substantive bankruptcy policy designed to upset nonbankruptcy entitlements.").

[216] It is easy to say that our society today would not countenance enslavement of a defaulting debtor, even if the debtor consented to enslavement as a remedy for breach of contract. See U.S. Const. amend. XIII, § 1 (prohibiting slavery and involuntary servitude); see also IX The Oliver Wendell Holmes Devise History of the Supreme Court of the United States: Alexander M. Bickel & Benno C. Schmidt, Jr., The Judiciary and Responsible Government: 1910-1921, at 820-907 (1984) (discussing Supreme Court's development of rules prohibiting "peonage," or debt slavery). Does it go too far to say that our society

concerns of that sort, they can be supported by analogy to Nozick's "moral side constraints," which absolutely forbid certain types of actions—however just the underlying motivation for those actions—if the actions intrude unacceptably on the liberty of the individual.[217] The application of those constraints to bankruptcy, however, is a topic for another day.[218]

Conclusion: Looking Back and Pressing On

The thesis of this Article is a simple one: There is nothing inherently unfair or surprising about the operation of a reorganization system that diverts value from creditors to further other social goals. That thesis, however, together with the analysis I use to support it, presents but a single step in the process of examining the debt-collection system in our country. For the analysis to be complete, it would require extension in two different directions: examination of entitlements to values added by the state-remedies system and evaluation of the policy ends that the bankruptcy system should pursue.

A.

First, it would be useful to look back at the state-remedies system that serves as the baseline for my analysis. The most obvious question

also would resist rules that absolutely barred a discharge of debts? Cf. Theodore Eisenberg, Bankruptcy Law in Perspective, 28 UCLA L. Rev. 953, 986-89 (1981) (arguing that Thirteenth Amendment would not be offended by absence of discharge in bankruptcy). Those who find a discharge inappropriate should review the conditions for debtors in England during the nineteenth century, see, e.g., Charles Dickens, The Life and Adventures of Nicholas Nickleby, ch. 46, at 695-96 (Penguin Books 1986) (1839) (describing how prison conditions for debtors could be worse than those for felons), and consider whether they can imagine toleration of those conditions in this country.

217 See Nozick, supra note 69, at 28-35. As Nozick's discussion makes clear, see id. at 30-31, the concept is closely related to the categorical imperative articulated by Immanuel Kant, which requires each individual to "[a]ct in such a way that you treat humanity, whether in your own person or in the person of another, always at the same time as an end and never simply as a means." Immanuel Kant, Grounding for the Metaphysics of Morals *429 (James W. Ellington trans., 3d ed. 1993) (1785).

218 My comments regarding discharge in this Article are brief and intended only to illustrate the structure of the analysis proposed in this Article. A full analysis of the question would have to explain why Europeans accept the general absence of a discharge from their insolvency laws. See Teresa A. Sullivan, Elizabeth Warren & Jay L. Westbrook, The Use of Empirical Data in Formulating Bankruptcy Policy, Law & Contemp. Probs., Spring 1987, at 194, 198 n.8 (citing 1 J. Dalhuisen, Dalhuisen on International Insolvency and Bankruptcy § 1.07[1], at 2-132.2 to 2-132.4 (1986)). It also would have to address the analyses of the discharge by other scholars, including Jackson's grounding of the discharge in the likely inadequacies of a debtor's heuristic capacities that result in an underestimation of risk, see Jackson, supra note 9, at 237-43, and Eisenberg's argument that debtors are better situated to bear the ultimate risks of insolvency than their creditors, see Eisenberg, supra note 216, at 981-83.

to consider in that area is whether my analysis would entitle the governments operating that system to alter their procedures so as to redistribute (or confiscate) the values added by the existence of that system.

I could respond to that question by concluding that my analysis does not apply outside the bankruptcy context, based on the idea that the government's role in the bankruptcy process is not the same as its role in other judicial contexts. For one thing, it is clear that the government's role in bankruptcy is quite different from the government's role in providing a judicial system to protect the individual rights that inhere in a system of ordered liberty. If protection of those rights is a predicate for the existence of a just society, the government would have a duty to ensure in some way that those rights were protected,[219] and thus it could not charge for protecting them.[220] Similarly, there is a significant (although less clear-cut) distinction between the role that courts play in the bankruptcy system and the role that they play in the state-remedies system. In general, one could characterize the state processes as being limited to providing an arbiter to ensure the preservation of individuals' entitlements by holding parties to their promises.[221] By contrast, the bankruptcy system can be viewed as involving the government as an economic regulator responding to market failure. It is entirely possible that the government's entitlement to extract value generated by its activities might be greater in the latter situation than in the former.[222]

219 The idea that the government must protect those rights by providing a judicial system gains support from state constitutional provisions that require the government to maintain a judicial system open to all. On that point, see Pennzoil Co. v. Texaco, Inc., 481 U.S. 1, 11-12 & nn.10-11, 15-16 (1987) (discussing open-courts provision of the Texas Constitution, Tex. Const. art. I, § 13). For a thoughtful argument that the Fourteenth Amendment obligates the government to protect the basic rights of individuals, see Steven J. Heyman, The First Duty of Government: Protection, Liberty and the Fourteenth Amendment, 41 Duke L.J. 507 (1991).

220 Cf. Becker, Foundations, supra note 71, at 53-54 (explaining that entitlement based on labor applies only when labor goes "beyond what morality requires").

221 Cf. American Airlines, Inc. v. Wolens, 115 S. Ct. 817, 824-26 (1995) (holding, in context of preemption claim, that state-court procedures for enforcing contracts do not constitute "enact[ment] or enforce[ment] [of] any law," because those procedures do nothing more than enforce intent of parties). For a fascinating explanation of the flaws in that reasoning, see id. at 832-34 (O'Connor, J., dissenting) (discussing ways in which contract law enforces public policies distinct from intent of the parties). But cf. Melvin A. Eisenberg, The Limits of Cognition and the Limits of Contract, 47 Stan. L. Rev. 211, 225-58 (1995) (arguing that many contract doctrines traditionally characterized as departures from intent of parties can be explained as efforts to take into account limits of human cognition).

222 Cf., e.g., Reeves, Inc. v. Stake, 447 U.S. 429, 436 (1980) (explaining more lenient Commerce Clause restrictions that apply to activities of state as market participant than as market regulator).

On the other hand, if the arguments in the preceding paragraph are not persuasive, I simply could agree that the logic of my analysis is applicable to other portions of the judicial process, at least in the commercial context. Although many (indeed, most) of those with whom I have discussed that question find that answer shocking, I do not see anything troubling about it, for three separate reasons. First, if parties gain value from the state's operation of a dispute-resolution system, why is it so unreasonable for the state to capture some portion of that value?[223] To put it another way, why is it so clear that parties are entitled to a judicial system that subsidizes their commercial operations?[224] Second, I doubt that the state judicial systems as they currently operate could raise revenue by large fee increases, because I doubt that the state systems add significantly to the net value creditors could secure from contractual agreements in the absence of a state-remedies system. If the states raise charges so that they are charging an amount that exceeds the value that they add, wealth-maximizing creditors would respond by structuring their arrangements so as to limit the need to rely on the state-remedies system for enforcement.[225]

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[223] The conceptualization of the state's decision to provide a judicial system as a market transaction is a common feature of Doug North's work. See, e.g., North, Institutions, supra note 93, at 23 (explaining how "the state trades a group of services, which we shall call protection and justice, for revenue").

[224] Cf. Richard A. Posner, Economic Analysis of Law 578-82 (4th ed. 1992) (analyzing limited extent to which judicial systems pass on their costs to those who use system); Steven Shavell, Alternative Dispute Resolution: An Economic Analysis, 24 J. Legal Stud. 1, 8 (1995) ("[P]arties who use the courts do not at present pay the full costs of the public services that are . . . rendered to them.").

[225] See Warren, supra note 47, at 2306-07 (footnote omitted):

> If we have a state law system that creates a collection background that makes it exceedingly difficult for a creditor to collect on an outstanding debt, we necessarily create a circumstance in which some creditors will try to opt out of that system to enhance their collection leverage by other means.

See also Baird, supra note 154, at 917-25 (arguing that creditors easily could arrange for their debts to be structured in a way that would make bankruptcy unlikely, and that creditors would do so if bankruptcy became unduly expensive). Creditors have a number of mechanisms to resolve their disputes that do not call upon the resources of the state. Creditors could take possession of collateral to ensure compliance, could require the debtor to deposit collateral with a third party, or could agree to private dispute-resolution procedures such as mediation or arbitration. For an entertaining argument in favor of a system that encourages private development of legal systems, see John Hasnas, The Myth of the Rule of Law, 1995 Wis. L. Rev. 199, 220-32 (arguing that "as long as the law remains a state monopoly, there will always be a political struggle for its control"). Those procedures might not offer as efficient a system for resolving disputes as the classic judicial process, and their current effectiveness rests in part on the backdrop of the state-remedies system that stands behind them, but the inadequacies of the existing state processes suggest that the advantages of the system operated by the states are not enormous. See, e.g., Sullivan, Warren & Westbrook, supra note 16, at 305 (empirical study indicating that creditors rarely use state-remedies system to collect debts against individuals; only 4% of creditors (616 out of more than 15,000) had filed suit against debtor before bankruptcy began); Whitford, supra note 23, at 1051-56 (arguing that creditors rely much more frequently on bargaining

Third, any argument that it is inappropriate for the state to redistribute the value it creates by enforcing contracts must rest on the premise that the state-remedies system for contract enforcement should operate simply by enforcing the arrangement to which the parties have agreed. That premise, however, is not at all descriptive of the current system.[226] Thus, to the extent state contract law already works to further public policies rather than the intent of the parties, application of my analysis to justify the use of contract law in that way is not in the least revolutionary, but rather explanatory.

B.

The second area for extension of my analysis is to press the analysis onward to consider what types of policies the government should pursue with the entitlements it garners from its creation and operation of the bankruptcy system. The principal issue to be considered on that score would be whether the existing redistributive features of the bankruptcy system increase or decrease the wealth of society as a whole.[227] If the system disposes of its entitlements in a way that results in a total social wealth that exceeds the wealth that society would have if the government simply left the entitlements for the creditors, the system should be applauded, not criticized. To find out whether those redistributive features of the system reduce wealth, it would be necessary to extend the economic analysis of those redistributive features of the system beyond what has been the traditional focus of creditors' bargain theorists—the effects the system has on the creditors and other claimants on the firm. Hence, it would be necessary to consider the effects on communities and individuals who are not claimants on the firm;[228] effects on companies that deal with the firm; and the effects on the vigor and nature of the competition in the in-

with defaulting debtor than they do on coercive collection methods); House Report, supra note 3, at 220, reprinted in 1978 U.S.C.C.A.N. at 6179 ("Most business arrangements, that is, extensions or compositions (reduction) of debts, occur out-of-court." (footnote omitted)).

226 Justice O'Connor's recent dissent in American Airlines, Inc. v. Wolens, 115 S. Ct. 817, 832-34 (1995) (discussed supra at note 221), provides an unusually frank judicial acknowledgment of this point, a point that to my mind completely devastates the analysis of the Court in that case.

227 As I explain supra at note 122, I doubt that any resolution of general issues of bankruptcy policy is likely to alter significantly the distributional effect of the system. Nevertheless, the decision whether to pursue wealth-maximizing goals in the bankruptcy system would remain an important element of future work under the framework proposed in this Article.

228 See Carlson, supra note 65, at 475-78 (suggesting that analysis of creditors' bargain theorists is incomplete because of their failure to consider effects bankruptcy system has on parties who are not claimants on the firm).

dustry in question.[229] Furthermore, a complete analysis also would evaluate the effects those redistributive features have on prebankruptcy activity in the economy. Those effects fall into two general classes: effects on the incentives that influence management and creditors during the period before bankruptcy;[230] and effects on the market for the initial extension of credit.[231] Again, I can do nothing to resolve those questions here. I only point them out to illustrate the place the analysis offered in this Article would have in a comprehensive analysis of the bankruptcy system.

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The complexity of the questions that this Article leaves unanswered shows much that remains to be done. I hope that the things left unsaid do not undermine the principal purpose of this Article: to present a plausible philosophical basis for the government's use of the bankruptcy system as an instrument of social policy. In light of my analysis, creditors' bargain theorists no longer can proceed on the as-

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229 For a valuable examination of that issue, see Larry H.P. Lang & René M. Stulz, Contagion and Competitive Intra-Industry Effects of Bankruptcy Announcements: An Empirical Analysis, 32 J. Fin. Econ. 45 (1992) (empirical analysis of effect of bankruptcy announcements on stock prices of competing firms); see also Warren, supra note 17, at 344 n.17 (discussing how more successful airlines would prefer that less successful ones went out of business immediately, enabling survivors to increase market share); International Inst. of Tourism Studies, George Washington Univ., The Bankruptcy Virus in the U.S. Airline Industry: Causes and Cures (1993) (analyzing causes of frequent bankruptcies in airline industry and effect of those bankruptcies on competitors in industry).

230 See supra note 188 (discussing effects absolute priority rule might have on such incentives).

231 On that point, I am skeptical of the conventional view that any feature of the bankruptcy system that increases the risk to creditors has an adverse effect on the economy because it will increase the general price of credit. See, e.g., William H. Meckling, Financial Markets, Default, and Bankruptcy: The Role of the State, Law & Contemp. Probs., Autumn 1977, at 13, 19-24 (articulating conventional view). First, it is entirely possible that features that increase the risk to creditors will have positive effects on the incentives of management and creditors. See supra note 188. Second, I doubt that the kinds of rules at issue work a sufficiently significant alteration of the recovery that a creditor would expect at the time of the initial loan to support a prediction of any cognizable effect in the market for the initial extension of credit. On that point, I am influenced heavily by empirical work conducted by Michael Schill. See Michael H. Schill, An Economic Analysis of Mortgagor Protection Laws, 77 Va. L. Rev. 489, 500-15 (1991). His work examines differences in state mortgagor protection laws (which seem to me dramatically more significant than the types of changes at issue here) and concludes that they did not cause a statistically significant effect on the market for the initial extension of credit. For a very pessimistic model of the effect bankruptcy might have on interest rates, see Franks & Torous, supra note 8, at 765-68 (using economic model to conclude that bankruptcy effects would cause interest-rate increase of about 109 basis points, on the assumptions that (a) it takes two years in a bankruptcy case for creditors to gather sufficient information to evaluate the situation, and (b) costs of bankruptcy are so large that they consume entire value of estate by the end of a three-year period).

sumption that creditors have any bargained-for "entitlement" to all the proceeds of bankruptcy. Conversely, those who seek a more inclusive bankruptcy policy have a tool to structure and justify their attempts to remake or explain the system.