

# REHABILITATION, REDISTRIBUTION OR DISSIPATION: THE EVIDENCE FOR CHOOSING AMONG BANKRUPTCY HYPOTHESES

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It is important to know *why* we adopt any particular statute or rule. The language in which we must express our rules has limitations, and the number of possible future circumstances in which the rule may arguably be relevant is very large. One of the fundamental skills of lawyering involves interpreting any rule so that it achieves the purposes for which it was adopted, and is applied only at the time and in the circumstances it was meant to address and in ways likely to achieve the intended effects. Bankruptcy law has been a staple feature of the American legal landscape for almost 100 years. It is slowly becoming apparent, however, that nobody really understands why we have adopted bankruptcy legislation.

Before 1980, bankruptcy policy was regarded as fundamentally distributional: it was thought to exist principally in an equality principle.<sup>1</sup> Even much recent bankruptcy scholarship consists of analysis of doctrine to determine whether it is consistent with that principle.<sup>2</sup> In 1981, however, Thomas Jackson developed the argument that bankruptcy could best be understood as a response to inefficiencies created by the operation of nonbankruptcy creditors' remedies under which every creditor is

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\* Professor of Law, Louisiana State University Law Center. I have chewed over various ideas in this paper with Michael Bradley, John Church, D. Bruce Johnsen, Andy Kleit, Dean Lueck, Lucy McGough, Michael Rosenzweig, and Myron Slovin, so much that I can no longer identify which of them inspired which thought. I regret creating the confusion which results in denial to them of the credit they are individually due, and willingly shoulder the blame for the errors they could not prevent me from committing. Conversations I had with Bill Whitford and Steve Kaplan were also very helpful to me. Thanks, folks.

1. See, e.g., 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 a foundational principle of bankruptcy law); 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.2 (1965) (same).

2. See, e.g., David Gray Carlson, *Successor Liability in Bankruptcy: Some Unifying Themes of Intertemporal Creditor Priorities Created by Running Covenants, Products Liability, and Toxic-Waste Cleanup*, LAW & CONTEMP. PROBS., Spring 1987, at 119 (applying the equality principle as between present and future claimants); Charles Jordon Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981 (1992) (arguing that even payments made in the ordinary course of business ought to be regarded as voidable preferences in deference to the equality principle).

potentially subjected to external costs imposed by the behavior of other creditors.<sup>3</sup> Over the next decade, however, the insight that bankruptcy could be understood as a product of concerns over economic efficiency began to be undermined. In a series of seminal works,<sup>4</sup> Jackson and his collaborator, Douglas Baird, showed that discrete applications of the existing Bankruptcy Code failed to take the form that the efficiency hypothesis predicted.

As of about 1990, then, there were two competing academic visions of bankruptcy law which shared a belief that bankruptcy law was basically justifiable. Some believed that efficiency was an attractive justification for bankruptcy law, and were, therefore, inclined to argue that the existing statute and its interpretation had simply gone wrong. Since a bankruptcy policy was, in principle, efficient, all that was needed was some tinkering with our actual statute in order to fix up the inefficient anomalies. Business bankruptcies, after all, were the focus of much of this academic attention, and efficiency arguments seemed to have a natural affinity with corporate and commercial matters such as those addressed by bankruptcy legislation.

Others remained comfortable with the traditional distributive view, and were inclined to be unconcerned with whether bankruptcy law was efficient or not. When confronted with the tension between the existing law and the ethics of efficiency, most bankruptcy teachers simply opted for the law and assumed that even though they were inefficient, because the bankruptcy doctrines existed, they were also somehow justified.

Late in the 1980s and early in the 1990s, the basic agreement that bankruptcy law could be justified (or even well understood) began to unravel. The underpinnings of the original conclusion (that bankruptcy could, in principle, be seen as a response to a suboptimal nonbankruptcy remedies system) were continually reexamined and called into question,<sup>5</sup>

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3. See Thomas H. Jackson, *Bankruptcy, Nonbankruptcy Entitlements and the Creditors' Bargain*, 91 YALE L.J. 857 (1982) (arguing that multiple creditors racing to collect out of the debtor's assets create a classic common pool problem which is solved by bankruptcy law's creation of a mandatory collective remedy).

4. See generally THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986); DOUGLAS G. BAIRD & THOMAS H. JACKSON, *CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY* (1985).

5. See, e.g., Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); 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) [hereinafter Bowers, *Murphy I*]; 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 (1991)

until the proposition that there could be an efficiency principle underlying bankruptcy began to lose its credibility. Members of the first camp began to conclude that given its obvious defects, the case for bankruptcy law had become so weakened that drastic overhaul or even outright repeal ought to be considered.<sup>6</sup> This view actually hit the headlines in the financial and popular presses<sup>7</sup> when the results of one empirical study (by Professors Bradley and Rosenzweig) seemed to show that investors had been made much worse off by the adoption of the 1978 Code.<sup>8</sup>

That the scholarship of the late '80s and early '90s tended to show that Chapter 11 was both theoretically and empirically inefficient did not discourage the Chapter's defenders. One critic of the Bradley and Rosenzweig empirical study,<sup>9</sup> for example, urged that the findings Bradley and Rosenzweig had reported simply be ignored,<sup>10</sup> even though many of their most significant findings replicated those of other financial studies.<sup>11</sup> Even granting that Chapter 11 appears to have disastrous consequences for investors, Professor Warren, along with other critics, also argued that Chapter 11's apparent punishment of investors does not undermine its ultimate utility because other stakeholders may have gained more than investors lost.<sup>12</sup> This study addresses that new redistributive view of bankruptcy in its two most typical versions—which I denominate the

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[hereinafter Bowers, *Murphy II*].

6. See generally Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811 (1994); Baird, *supra* note 5; Bowers, *Murphy I*, *supra* note 5; Bowers, *Murphy II*, *supra* note 5; Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992); Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319 (1991).

7. See, e.g., Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669, 671 n.14 (1993) (collecting references to articles in the financial press); Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley & Rosenzweig*, 91 MICH. L. REV. 79, 80 nn.5-6 (1992) (same). These issues have been heard in the popular press as well, including the front page of the *New York Times*. *Critics of Bankruptcy Law See Inefficiency and Waste*, N.Y. TIMES, Apr. 12, 1993, at A1.

8. Bradley & Rosenzweig, *supra* note 6.

9. Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992).

10. *Id.* at 439.

11. See Truman A. Clark & Mark I. Weinstein, *The Behavior of the Common Stock of Bankrupt Firms*, 38 J. FIN. 489 (1983) (reporting results of event study showing significant abnormal negative returns to securities of firms making bankruptcy announcements); Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315 (1990) (same); Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule*, 37 J. FIN. ECON. 1457 (1990) (same).

12. Warren, *supra* note 9, at 467.

“Rehabilitative” and “Pure Redistribution” hypotheses, respectively—and argues that neither is consistent with the existing empirical data concerning corporate reorganizations. It then proposes a new thesis about bankruptcy which is inspired not only by the existing data, but also by new theoretical insights: that measures which avoid some kinds of market failures, such as externalities, entail their own kinds of costs, e.g., by fostering holdout behavior.<sup>13</sup> The new thesis—that bankruptcy law tends to waste resources—I denominate the “Dissipative” thesis.

### I. THE REHABILITATIVE HYPOTHESIS

Chapter 11’s defenders are often vague about which stakeholders received the gains that offset the losses that Chapter 11 imposed on investors. More commonly, scholars who support the stakeholder benefit position assert that Chapter 11 was meant to avoid the liquidation of financially distressed businesses, thus preserving a valuable feeling of community and security in the minds of the firm’s employees, suppliers and customers.<sup>14</sup> These, we are left to surmise, are the beneficiary stakeholders and benefits of a policy to rehabilitate businesses.

The rehabilitative hypothesis is not necessarily redistributive. It has been urged on grounds that sound like arguments for allocative economic efficiency. For example, the legislative history of the Bankruptcy Code suggests that rehabilitation tends to keep assets specialized to an industry, in their best uses, instead of permitting them to gravitate to inferior uses when they are sold for scrap.<sup>15</sup> The most generalized efficiency claim travelling under the guise of a rehabilitation hypothesis is the traditional “going-concern value” theory, recently readvocated by Theodore Eisenberg

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13. See, e.g., Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987) (arguing that the Trust Indenture Act’s prohibition of bondholder votes on core terms distorts holdouts in a bond workout). But see Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. & ECON. 595 (1993) (arguing that parties could contract out of the holdout problem if they were permitted to opt out of the Bankruptcy Code).

14. See, e.g., Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 603 (1993). See also Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541, 552-58 (1993) (urging this role for Chapter 11); Bradley & Rosenzweig, *supra* note 6, at 1043-44 (discussing the evidence from the legislative history that Congress intended Chapter 11 to serve rehabilitative purposes in order to save jobs and troubled businesses from being liquidated).

15. See, e.g., Bradley & Rosenzweig, *supra* note 6, at 1043 n.2 (citing the congressional debates on this point).

and Shoichi Tagashira,<sup>16</sup> which justifies Bankruptcy's corporate reorganization provisions on the grounds that even bankrupt firms are worth more as going concerns than their assets are worth when liquidated piecemeal. Since under nonbankruptcy creditors' remedies law, and even under Chapter 7, assets are liquidated, it follows from this theory, a nonliquidating remedy, such as a corporate reorganization, is justifiable because it is likely to return more to claimants as a group. The size of those extra returns is, in theory, at least equal to the going-concern value saved when the liquidation is avoided.

The claim that Chapter 11 saves going-concern values generates a prediction that markets ought to value firms which are eventually liquidated less than firms which are reorganized, and indeed, the only study available which collects such data seems to indicate that to be the case. A recent event study<sup>17</sup> of the market's reaction to the Chapter 11 filing announcements of 81 firms taking Chapter 11 between 1979 and 1991 which eventually reorganized in Chapter 11 found that investors lost about 25% of their equity value in the three-day window ending on the day of the filing announcement. In contrast, the loss to equity of the 20 firms whose cases were eventually converted to Chapter 7 liquidations was almost 40%.

It would be wrong to conclude from these findings that if going-concern value was saved, however, that Chapter 11 deserves the credit. The same study disaggregated the above findings into two groups: losses to firms which attracted bids in the market for corporate control during their Chapter 11 proceedings, and those which reorganized on a stand-alone basis, without ever having been bid for. The event window losses to firms which reorganized on a stand-alone basis without receiving a market bid were statistically indistinguishable from the losses suffered by investors in the firms which liquidated. The clear implication of these findings is that *if there is any going-concern value, it is not Chapter 11 which saves it; the only thing that saves going-concern values, when they exist, is the financial market.*

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16. Theodore Eisenberg & Shoichi Tagashira, *Should We Abolish Chapter 11? The Evidence From Japan*, 23 J. LEGAL STUD. 111 (1994). This study reports Japanese officials' estimates of going-concern values for small firms undergoing composition proceedings in Japan. *Id.* at 134. The estimated surpluses are so large that, the authors conclude, creditors in Japan experience gains even if only a small percentage of the debtor firms actually perform the obligations under their plans. *Id.* at 144. The study does not report any market valuations of the surpluses, however, and acknowledges that the estimates are subject to variability among estimators unrelated to financial concerns. *Id.* at 126-30.

17. Myron B. Slovin et al., *Bankruptcy Resolution, Creditors Holding Private Debt and the Market for Corporate Control: Market-Based Evidence from Chapter 11 Filing Announcements* (Sept. 11, 1994) (on file with the *Washington University Law Quarterly*).

An even more general, yet similar, sort of claim is made by Lynn LoPucki and Elizabeth Warren. They suggest that firms which must use markets to weather their financial storms, must pay the high transaction costs which exist in our highly imperfect real world markets. Even if there is no going-concern value to be saved, they argue that claimants are made better off as a group if an administrative remedy is found for their problems which, because it permits bankrupt firms to stay out of those expensive markets, does not necessitate incurring those high transaction costs.<sup>18</sup> Under this view, Chapter 11 can be justified as an efficiency measure because it prevents firms and their assets from being liquidated at low prices, or sold in markets which, because of their imperfections, impose high transaction costs.<sup>19</sup>

This efficiency view of the possible rehabilitative goals to be served by the enactment of Chapter 11 predicts that the residual claimants of those firms which take Chapter 11 but are not put into play in markets (and therefore, are not subjected to the high transaction costs that the efficiency version of the rehabilitative argument posits) will fare better than similar claimants of firms which *are* in play. My colleagues' event study<sup>20</sup> of the market's reaction to the Chapter 11 filing announcements produced results that conflict with the high-transaction-cost market hypothesis. Bids for control of forty-seven of those firms were made in the Chapter 11 proceedings—putting the bankrupt firm “in play” in the market for corporate control. In the three days ending with the Chapter 11 filing announcements of those firms, however, their shareholders suffered abnormal returns which were forty percent greater (less negative) than the returns to firms which were not put “in play” in their eventual Chapter 11 proceedings.<sup>21</sup> Thus, the market not only seems to predict which firms will be put on the market, but it also appears to predict that the firms put on the market will lose less of their value than those that do not receive bids for control during their reorganization and so are spared the expensive opportunity of market participation.<sup>22</sup>

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18. LoPucki, *supra* note 7, at 109; Warren, *supra* note 9, at 474.

19. There is an implicit assumption in this type of argument that the alternative to the markets, i.e., bankruptcy judges and procedures, are relatively free of any bureaucratic equivalent of transaction costs. See James W. Bowers, *The Fantastic Wisconsin Zero-Bureaucratic Cost—School of Bankruptcy Theory: A Comment*, 91 MICH. L. REV. 1773 (1993).

20. Slovin et al., *supra* note 17.

21. Returns were -21% for the firms receiving bids, but -36% for those whose Chapter 11 proceedings were impervious to the market. *Id.* at 20-21.

22. *Id.*

Even when markets, high transaction costs and all, intervene to assist the owners of bankrupt firms, however, they apparently do not save those owners from harms which Chapter 11 itself imposes on them. Owners of firms which are bid for in the unregulated market for corporate control do better than do the owners of firms bid for in Chapter 11 proceedings. Because in the normal market bidders must compete with each other in order to acquire target firms, the value of bidder firms does not increase (and indeed, normally falls) as a result of the bidding.<sup>23</sup> Obstacles which Chapter 11 apparently puts in the way of bidders trying to acquire firms in bankruptcy, however, result in positive abnormal returns to the bidding firms. Chapter 11 apparently discourages potential competition among bidding firms and thus awards gains to bidders that exceed the normal competitive return bidders earn in unobstructed markets. While in those markets, the target company's shareholders capture the gains that result from the bidding, in Chapter 11, the bankrupt firm's owners must share more of the gains with the bidder. In other words, the Chapter 11 process itself imposes higher transaction costs than the unobstructed market imposes.

On the other hand, advocates of the rehabilitative purposes of Chapter 11 have also framed their arguments in distributive terms. The U.S. Supreme Court, for example, has suggested that bankruptcy law historically was intended to benefit certain stakeholders at the cost of secured creditors.<sup>24</sup> Professor Elizabeth Warren has advanced an explicitly redistributive view of bankruptcy policy.<sup>25</sup> Most of us have also met a bankruptcy lawyer who feels strongly that insolvent businesses ought to be kept afloat for as long as senior creditors can be milked for the costs of doing so.<sup>26</sup>

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23. *Id.* at 22.

24. In *United Savings Assoc. of Texas v. Timbers of Inwood Forest Assoc., Ltd.* (*In re Timbers of Inwood Forest Associates, Ltd.*), 484 U.S. 365, 373 (1988), the Court spoke to the claim by a secured creditor that the automatic stay provisions of the Bankruptcy Code should not be construed to give unsecured claimants, in effect, an involuntary, interest-free loan of the collateral for the period of the bankruptcy proceedings: "Section 506(b)'s denial of postpetition interest to undersecured creditors merely codified pre-Code bankruptcy law, in which that denial was part of the conscious allocation of reorganization benefits and losses between undersecured and unsecured creditors." *Id.*

25. See Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 353 (1993) [hereinafter Warren, *Policymaking*] ("Equality—and deliberate deviations from equality—stand at the center of bankruptcy policy.").

26. This is a plausible interpretation of the argument made by Professor Gross in this Symposium. Karen Gross, *The Need to Take Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994).

All legal rules have both efficiency and distributional consequences that are not always easy to separate from each other,<sup>27</sup> so it is unimportant whether the rehabilitation hypothesis is classified in either category. The evidence shows that Chapter 11 is not very successful either in rehabilitating businesses or in sparing them the necessity of having to resort to capital and asset markets. The best that two of rehabilitation's most prominent defenders have been able to say is that "Chapter 11 is not a *complete* failure."<sup>28</sup> Professors LoPucki and Whitford studied all of the Chapter 11 cases of firms with \$100 million in assets filing for and emerging from Chapter 11 in the first decade of the Bankruptcy Code. The findings upon which they base their conclusion are summarized below in Table I:

TABLE I  
The LoPucki and Whitford Data Recapitulated

Total Number of Firms Studied: . . . . .	43
Less:	
Firms totally liquidated in Chapter 11 . . . . .	5
Firms substantially liquidated except for NOLs . . . . .	6
Firms which "shattered" in Chapter 11 . . . . .	13 <sup>29</sup>
Non-shattered firms sold to third parties in Chapter 11 . . .	1 <sup>30</sup>
Firms which shattered immediately after confirmation . . . .	3
Non-shattered firms which refiled within 5 years . . . . .	5 <sup>31</sup>
Firms for which information was not available . . . . .	1
Total . . . . .	<u>34</u>
Firms apparently unqualifiedly rehabilitated in Chapter 11: <sup>32</sup> . . . .	9

27. See, e.g., Robert E. Scott, *Chaos Theory and the Justice Paradox*, 35 WM. & MARY L. REV. 329 (1993); Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 YALE L.J. 1211, 1212 (1991) (examining the distributive and efficiency aspects of pareto optimality).

28. LoPucki & Whitford, *supra* note 14, at 611 (emphasis added).

29. LoPucki and Whitford classify a firm as "shattered" if its "core business" fails to survive Chapter 11 in a largely intact condition. *Id.* at 602. They list 18 companies as "shattered" in their Appendix 2 at page 615. I arrived at 13, however, by eliminating five firms which they also list as having liquidated (FSC, KDT, Seatrain Lines, Technical Equities, and Sambo's Restaurants). I am especially grateful to Professor Whitford for saving me the embarrassment of overlooking this potential double counting.

30. LoPucki and Whitford, *supra* note 14, at 603 n.21, observe that seven firms were sold to third parties. Six of this number, however, overlap the number already listed as liquidated in this table. The only firm which was sold off but not listed as liquidated was Energetics, which is the firm I list here.

31. The "non-shattered" classification comes from Part A of LoPucki and Whitford, *supra* note 14, app. 2, at 615, and the refilers are listed at 608 n.42. The refilers are Continental Airlines, Wilson Foods, Salant, Anglo Energy, and Lionel.

32. This figure should probably be regarded as a maximum since LoPucki and Whitford report that data was not always available with which to classify firms as "shattered" or not. It thus remains



These results show that Chapter 11 is not sparing bankrupt firms from being bought or sold in our imperfect and expensive markets, or from liquidating assets in those markets, and that rehabilitation was unqualifiedly accomplished<sup>33</sup> in only twenty-one percent of the megabankruptcies LoPucki and Whitford studied. Even so, LoPucki and Whitford were unable to attribute even these modest successes to Chapter 11: "Of course, it is entirely possible that financial rehabilitation could have been achieved even more successfully or at lesser cost by some other procedure, but that conclusion would be difficult to establish empirically."<sup>34</sup>

A review of another recent study of the postconfirmation performance of 197 public companies filing Chapter 11 concludes: "The evidence does not indicate that the Chapter 11 reorganization plays an effective role in rehabilitating distressed firms."<sup>35</sup> The data on court-supervised reorganizations for smaller, unlisted firms over the same time period were similarly embarrassing to the rehabilitative thesis. Apparently only about seventeen percent of such firms ever even reach the stage of confirmed plans,<sup>36</sup> and about one-third of the confirmed plans are liquidating plans, leaving a net

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possible that the 43 firms from which the 9 successful surviving firms figure is inferred include some firms which shattered, but which were not recognized by LoPucki and Whitford as shattered due to the unavailability of other information. See LoPucki & Whitford, *supra* note 14, at 603 n.22, 605.

33. Professor Whitford, in conversations and correspondence with me, had urged a point from these numbers that was not clearly argued in the work from which the numbers are taken, but which is suggested in his contribution to this Symposium. William C. Whitford, *What's Right About Chapter 11*, 72 WASH. U. L.Q. 1379 (1994). The point is this: some of the firms which were liquidated were actually sold off as operating businesses, and thus might be classified as financially rehabilitated in the process as well. However, the evidence that these successful rehabilitations-by-sale would or could not have occurred in a Chapter 7, or even in the market for corporate control entirely outside of bankruptcy law has not yet been systematically assembled by any of Chapter 11's proponents, a point Whitford seems to have recognized in empirical work he has done on the question. See *infra* text accompanying note 34.

34. LoPucki & Whitford, *supra* note 14, at 609 n.49. Difficult or not, the Slovin et al. study, *supra* note 17, provides some interesting empirical evidence relevant to the question. Their results from examining a larger sample of publicly traded debtors suggest that if there is any real rehabilitation going on out there, it is the market, and not Chapter 11, which ought to get the credit. "Thus, our evidence indicates that firms that emerge from bankruptcy via a stand-alone reorganization without having received a control bid have a very high rate (47%) of post-exit failure. This suggests that, in the absence of control bids, the effectiveness of bankruptcy proceedings as a mechanism for rehabilitating financially distressed firms is questionable." *Id.* at 25.

35. Edith S. Hotchkiss, *The Post-Bankruptcy Performance of Firms Emerging from Chapter 11*, 50 J. FIN. (forthcoming 1995) (finding that 40% of emerging firms continued in financial distress, with over 16% filing Chapter 11 again).

36. See LoPucki & Whitford, *supra* note 14, at 601 n.13; Warren, *Policymaking*, *supra* note 25, at 373 n.98.

rehabilitation rate at a maximum level in the neighborhood of ten percent.<sup>37</sup> Thus, the rehabilitative form of the redistributive hypothesis is undermined as a plausible theoretical justification for Chapter 11 by the weakness of the empirical support for any claim that it is accomplishing its alleged justificatory purposes. Indeed, Professor Warren, one of the rehabilitative hypothesis's most prominent proponents, concludes that the data are so discouraging for the thesis that Chapter 11's justification must be sought elsewhere<sup>38</sup>—which brings us to our next hypothesis.

## II. THE PURE REDISTRIBUTIVE HYPOTHESIS

Even if Chapter 11 bankruptcies are not accomplishing indirect redistributions through rehabilitations, the possibility exists that they accomplish redistribution more directly. Chapter 11 may be taking the assets of bankrupt firms away from the undeserving rich and giving them to the deserving poor. Although redistributing the assets of failing firms seems like a peculiar way to assist poor people, the case for a redistributive explanation for Chapter 11 has some impressive foundations. Congress<sup>39</sup> and the U.S. Supreme Court,<sup>40</sup> for example, both seem to have espoused a redistributive position. Bankruptcy law imposes an explicit priority scheme.<sup>41</sup> To doubt the law's redistributive *intent*, then, will inevitably give a *lawyer* pause. On the other hand, a lawyer is likely to want to know a good deal more about bankruptcy law's redistributive policy mandates than he is likely to find in the formulations of those principles by those who are advancing them.<sup>42</sup>

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37. See Warren, *Policymaking*, *supra* note 25, at 373 n.99.

38. *Id.* at 374-75 ("The bankruptcy process nonetheless had a significant impact on the businesses that filed for chapter 11 but never confirmed a reorganization plan. The distributional objectives of the Code were clearly in play.").

39. "[R]eorganization, in its fundamental aspects, involves the thankless task of determining who should share the losses incurred by an unsuccessful business and how the value of the estate should be apportioned among creditors and shareholders." S. REP. NO. 989, 95th Cong., 2d Sess. 11, *reprinted in* 1978 U.S.C.C.A.N. 5796.

40. See *supra* note 24 (discussing *United Savings Assoc. of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365 (1988)).

41. See, e.g., 11 U.S.C. § 507 (1988).

42. This is particularly true with respect to reorganization bankruptcies in which distributions are governed by plans for which terms are not mandated by the statute. See 11 U.S.C. § 1141 (1988). The distributions made under such plans are influenced by the sorting of the various claimants into differing classes which will receive different treatment, but the guidelines for determining class membership are exceedingly vague. For a discussion, see William Blair, *Classification of Unsecured Claims in Chapter 11 Reorganizations*, 58 AM. BANKR. L.J. 197 (1984).

The credibility of a pure redistributive claim suffers from a basic doubt that those desiring redistributive goals would choose to pursue them by redistributing the assets of bankrupt firms. Most advocates for the redistributive position have never been very explicit about who Chapter 11's actual distributive beneficiaries are, or even who they ought to be. This vagueness in their positions makes the distributive claim a difficult one to evaluate empirically. Professor LoPucki does suggest that the well-known losses to stockholders caused by Chapter 11 announcements could be justified if Chapter 11 redistributed wealth from investors to trade and bank creditors.<sup>43</sup> Professor Warren is explicit in arguing that Chapter 11's legislative intent is to take wealth from publicly traded claims and redistribute it to holders of private debt.<sup>44</sup> Jackson and Scott have also argued that the wealth being redistributed ought to be that which belongs to the secured creditors.<sup>45</sup> The latest data we have on these questions seem to show, however, that Chapter 11 does not provide any of those distributive outcomes, and raises serious empirical doubts about whether Chapter 11 is actually accomplishing much in the way of wealth redistributions.<sup>46</sup>

The pure redistributive claim is subject to serious theoretical objections as well. The rights which bankruptcy legislation grants and takes away from participants in Chapter 11 cases are mostly modifications of expectations which arise from market exchanges.<sup>47</sup> In truth, the participants in Chapter 11 bankruptcies are nearly all involved as the result of consensual transactions. Since transaction costs were low enough to create the relationship which led to the participation in the first instance, it is likely that the relationships among the typical participants in Chapter 11 proceedings occur in an environment of relatively low transaction costs.

The Coase theorem<sup>48</sup> holds that when transaction costs are low enough, changes in legal rights do not effect the deployment of resources. Put another way, if bankruptcy law changes the relative rights of prospective

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43. LoPucki, *supra* note 7, at 85-88, 94.

44. Warren, *supra* note 9, at 469-71.

45. 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, 187-90 (1989) (claiming that apparent wealth redistributions from secured creditors in favor of lower priority claimants is arguably justifiable as a risk-sharing insurance measure).

46. See *infra* text accompanying note 54.

47. There are nonconsensual creditors in Chapter 11 proceedings, but no one is arguing that Chapter 11 is justified because it was designed to redistribute wealth either to or from these particular parties. Nothing in Chapter 11, for example, limits the bankruptcy remedies and relief to debtors who have nonconsensual creditors.

48. See Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

another way, if bankruptcy law changes the relative rights of prospective transacting partners,<sup>49</sup> they will alter the terms of their prospective deals to contract around the legal alteration insofar as it is possible, if the costs of the modifying transaction are low enough.<sup>50</sup> Thus, if it is the intent of Chapter 11, as Jackson and Scott assert, to dilute the legal rights of secured creditors and redistribute the wealth associated with those rights to other parties, then prospective secured lenders will charge more for the extension of credit. It is likely to be almost impossible, then, to redistribute the wealth of secured parties generally to any other group unless the transaction costs associated with the striking of high interest rate secured loans are significantly different from the costs of confecting lower rate loans.

This theoretical difficulty with the redistributive hypothesis is verified in the results of my colleagues'<sup>51</sup> event study.<sup>52</sup> As of the time of this Symposium, they had assembled a sample of 106 Chapter 11 announcements by exchange-listed firms between 1980 and 1989. From reports in the *Wall Street Journal* and the *New York Times*, they were able to identify 266 creditors whose shares traded on stock exchanges associated with 81 of the bankrupt firms. The creditor claims were subdivided into 76 creditors with *secured* claims against 34 filing firms, and 190 *unsecured* claims against 67 filing firms. Thirty-three of these latter claimants were identifiable as trade creditors, the remainder being financial institutions. These claimants and firms were further separated into two additional categories: one in which the Chapter 11 proceedings were actually concluded, and the other in which the petitioning firm's case was ultimately converted to a Chapter 7 and it was liquidated. My colleagues then computed the *abnormal* returns to the stocks of these various creditor firms and the debtor firms themselves for the three-day period ending with the

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49. That is, there may have been a one-time wealth redistribution in 1978 when Chapter 11 was adopted, which would have affected the relative wealths of parties bound to contracts at that time. The point made here is thus limited to the cases of parties who contract with knowledge that Chapter 11 *will* apply to their dealings.

50. This theoretical point is addressed in detail in Harold Demsetz, *Wealth Distribution and the Ownership of Rights*, 1 J. LEGAL STUD. 223 (1974). The validity of the theory also seems to have been empirically established for the effect Chapter 11s have in modifying the absolute priority rule. See Eberhart et al., *supra* note 11 (confirming small deviations from absolute priority and finding that the deviations were anticipated by investors ex ante).

51. Slovin et al., *supra* note 17.

52. For an easily accessible but detailed description and analysis of the validity of event study techniques, see RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT ch. 6 (1993).

bankruptcy filing.<sup>53</sup> Their results provide a number of interesting inferences about the plausibility of a pure redistributive thesis.

A convincing argument that pure redistribution is really meant to occur in any bankruptcy reorganization, for example, must assume that those from whom wealth is taken are likely to come from the highest nonbankruptcy priority levels. Indeed, Jackson and Scott are explicit in asserting that it is likely to be the secured creditors who will pay and the unsecured creditors who will receive the redistributions.<sup>54</sup> If the proponents of pure redistribution are correct, the announcement of bankruptcy filings ought to produce significant negative impact on the values of high priority secured creditors who will be taxed with paying out the redistribution. Likewise, the value of the low priority creditors ought to be increased (or at minimum, adversely affected to a significantly lesser extent) if they will be the beneficiaries of significant redistributions.

The findings are, however, exactly to the contrary. The market predicts that the value of the rights that secured creditors will receive as a result of any bankruptcy is approximately equal to the nonbankruptcy value of the secured creditors' claims.<sup>55</sup> On the other hand, unsecured creditors, who

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53. My colleagues' study first constructed a measure of the "normal" fluctuation of the shares of the debtor firms and creditor firms with respect to the market during a period several months in advance of the bankruptcy announcements. The measure of normal fluctuation relative to the market is technically named the "Beta" ratio. A firm whose share value normally goes up 1% when the market advances 1% or down 1% with a market decline in that amount has a Beta of 1. See GILSON & BLACK, *supra* note 52, at 99-104. Their study then compared the fluctuations of the same shares during the three-day event period with the normal returns. This technique thus uses the market itself, and the normal behavior of the stocks being followed, as a control group. The fluctuations that exceeded the normal Betas were used to arrive at an estimate of the effect on the market of the news that one of the creditor firm's debtors had declared bankruptcy. The abnormal returns, the only part of the stock's movement that cannot be explained by the forces which cause changes in the values of the stock market as a whole, are thus the market's unbiased prediction of the effect the bankruptcy will have on the creditor firms. Slovin et al., *supra* note 17.

54. See *supra* note 45.

55. In fact, the shares of secured creditors do suffer abnormal declines in the three-day window ending with the debtor firms' bankruptcy announcements, but these declines are near zero (-0.02% when debtor firms reorganize in Chapter 11), and are *not statistically significant*. Slovin et al., *supra* note 17, at 18. Technically then, the deviations from zero could, likely as not, have occurred by chance alone.

The situation that received academic attention and raised the issue of whether Chapter 11 was inefficiently devaluing the claims of secured creditors almost always involved undersecured creditors. See, e.g., 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 (1984). The data reported here are consistent with the assumption that secured creditors, aware *ex ante* of this effect of Chapter 11, are simply taking much more care to remain oversecured. The costs of these provisions of Chapter 11 then, are felt in the reduction in the quantity

fall in the bottom priority level, are almost fifty times more adversely affected than are secured creditors,<sup>56</sup> and the negative impacts on the values of their securities when their debtors declare bankruptcy is statistically significant at the 99% level of confidence. The market thus seems to be predicting that the unsecured creditors' contracts, which require them to absorb the losses of the bankrupt debtor's ventures, will be enforced against them. In short, the market seems to think that the high priority claimants will not be forced to redistribute much value to the lower priority claimants. And likewise, the market does not seem to be predicting that the position of low priority claimants will be improved because their claims will now be dealt with in a Chapter 11 proceeding.

While violations of the absolute priority rule have been documented in reorganization proceedings,<sup>57</sup> the market seems to have discounted the value it assigns to the creditor for this effect long in advance of the time of the bankruptcy announcement. Such losses as the violations of contracted-for priority do impose on creditors *ex post* are thus likely to have been impounded into the price of the credit *ex ante*.<sup>58</sup> While the evidence is not conclusive, the pure redistributive hypothesis seems to be belied by a reasonable interpretation of the data we now have on the question.

### III. ZEROING IN ON A BANKRUPTCY THEORY

The most widely replicated finding in the empirical literature about bankruptcy reorganization is that equity in filing firms loses a huge

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of secured credit available to debtors. After some initial doubts, *see* Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1982), there seems to be a growing consensus that secured lending serves valuable functions, and can be justified as an efficient practice. Bowers, *Murphy II*, *supra* note 5, at 57-68; F.H. Buckley, *The Termination Decision*, 61 UMKC L. REV. 243, 284 (1992); Hideki Kanda & Saul X. Levmore, *Explaining Creditor Priorities*, 80 VA. L. REV. (forthcoming 1994). Thus, the loss of borrowing capacity to debtors is potentially a seriously inefficient outcome. Indeed, this reduction in the borrowing power of debtors might credibly be considered a matter of concern for those who view corporate reorganizations as a response to insufficient liquidity of the debtor firms. Had their borrowing power not been cut back by Chapter 11, debtors might have used secured borrowing to escape their liquidity crises.

56. Mean negative returns to all unsecured creditors of filing debtor firms whose Chapter 11 plans are eventually confirmed are -0.95%. Slovin et al., *supra* note 17, at 18.

57. *See* Eberhart et al., *supra* note 11; Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990). Absolute priority does not seem to be honored in the terms of nonbankruptcy workouts either. Julian R. Franks & Walter N. Torous, *How Firms Fare in Workouts and Chapter 11 Reorganizations* (1991) (unpublished manuscript), *quoted in Managing Financial Distress and Valuing Distressed Securities: A Survey and Research Agenda*, FIN. MGMT., Autumn 1993, at 60, 71 (Kose John ed.).

58. *See* Eberhart et al., *supra* note 11.

proportion of its value relative to the market in an astonishingly short period surrounding the bankruptcy filing date. Bradley and Rosenzweig, for example, report that in the five-day window ending at the filing date, filing firms lose approximately 30% of their value relative to the market as a whole.<sup>59</sup> If markets are capable of generating unbiased estimates of firm values, this result is astonishing—unless in the cases of most bankrupt firms, the filing is linked to a discovery that the expected demand for the firm's output has abruptly shrunk or that its expected production costs have suddenly taken a huge jump. Since the studies seem to show that filing firms experience large and continuous losses for the two or three years preceding their filing,<sup>60</sup> and that impending defaults are frequently announced publicly long before any bankruptcy filings,<sup>61</sup> the theory that a sudden change occurs in the markets for the firm's inputs and outputs seems implausible.<sup>62</sup> What then might explain the sudden dramatic losses which the financial studies observe?

The drop might evidence the fact that Chapter 11 will redistribute the property of the equityholders to some other stakeholder group. Bradley and Rosenzweig, for example, identify managements as the transferees.<sup>63</sup> Both economic theory and the available evidence discussed above cast serious

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59. Bradley & Rosenzweig, *supra* note 6, at 1093 tbl. A.3. This finding has frequently been replicated. See sources cited *supra* note 11. Slovin et al., *supra* note 17, break down this finding into additional informative categories which will be discussed below. See *infra* text following note 74.

60. See, e.g., Bradley & Rosenzweig, *supra* note 6, at 1065 tbl. 5; Michael Bradley & H. Nejat Seyhun, *Corporate Bankruptcy and Insider Trading*, tpls. I & II (July 1993) (unpublished manuscript, on file with the *Washington University Law Quarterly*).

61. Gilson et al., *supra* note 11, at 329 (identifying prebankruptcy events which gave notice of actual or impending defaults in a large sample of firms which either restructured privately or filed for Chapter 11).

62. Indeed, for many firms, the market seems able to predict that bankruptcy proceedings will occur in the future, well in advance of the announcement that the firm has actually filed. See, e.g., *infra* text following note 72. Bradley and Seyhun described their findings as follows:

Our finding that corporate insiders sell their holdings prior to filing bankruptcy is inconsistent with the notion that corporate managers are unexpectedly thrust into Chapter 11. The fact that there are absolutely no trades in the 30 days preceding a filing suggests that managers have at least a one-month lead-time. We also find that prior to filing, the insiders of filing firms sell significantly more shares than the insiders of firms that experience financial distress but do not file a bankruptcy petition. This suggests that filing is a more accurately anticipated (endogenous) event than other events that cause a significant fall in a firm's stock price. . . . Our results indicate that 1) filing bankruptcy is a strategic, management decision; 2) corporate managers understand the effect that filing will have on their firm's stock price and they sell their holdings in order to avoid significant capital losses; and 3) the interests of managers and stockholders are less aligned in a bankruptcy proceeding than they are under more normal circumstances.

Bradley & Seyhun, *supra* note 60, at 4-5.

63. Bradley & Rosenzweig, *supra* note 6, at 1049.

doubts on the validity of redistributive explanations, however. That leaves only two competing explanations from which to choose. Consequently, narrowing the choice between these explanations should be the top priority on the bankruptcy research agenda.

In order to understand these alternatives, consider the following model:

$$V = p_w(V_w) + p_b(V_b)$$

Where:

- $V$  = the market value of the firm's equity;
- $p_w$  = the anticipated probability that an out-of-bankruptcy-court workout or liquidation will occur;
- $V_w$  = the anticipated present value of the income stream that the firm will earn after the out-of-bankruptcy resolution;
- $p_b$  = the anticipated probability of a Chapter 11 reorganization or bankruptcy liquidation;
- $V_b$  = the anticipated present value of the firm's prospective income stream after the bankruptcy results; and
- $p_w + p_b = 1$

The one thing we know for sure is that when the firm files bankruptcy,  $p_w$  suddenly drops to zero and  $p_b$  suddenly grows to equal 1. Thus, the impact of  $V_w$  on the market price is totally eliminated. The sudden drop in  $V$  can be explained in only two ways. First, we could assume that  $V_b = V_w$  (more or less)<sup>64</sup> and that the filing of a Chapter 11 petition signals the existence of private unfavorable information about both values such that, on average, bankrupt firms were all drastically overvalued by the market on the date of the filing. I will refer to this explanation as the "overvaluation" hypothesis. The competing possibility is that  $V_w \neq V_b$ , in which case if  $V$  declines, then  $V_w > V_b$ , an explanation which I denominate the "dissipative" hypothesis. I shall first consider the dissipative hypothesis before considering the evidence for the overvaluation hypothesis in detail below.

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64. Gilson et al., *supra* note 11, at 344, find as an empirical fact that the losses to firms which resolve their problems privately are significantly smaller than the losses to firms using Chapter 11, a finding which suggests that  $V_w > V_b$ , and is therefore inconsistent with an assumption that the two values are (roughly) equal to each other. In this regard, see also Robert J. Gertner & David Sharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189 (1991), and Stuart Gilson, *Bankruptcy, Boards, Banks, and Blockholders*, 27 J. FIN. ECON. 355 (1990) (reviewing data on voluntary out-of-bankruptcy workouts).



### A. *The Dissipative Hypothesis*

Some have suggested that  $V_b$  should exceed  $V_w$  because, among other reasons, Chapter 11 permits debtor-in-possession financing, which can act as a cure for the well-known Myers underinvestment incentive hypothesis: that the firm's equityholders will underinvest in net positive present value projects because they must share the gains with the preexisting creditors.<sup>65</sup> The model presented here, however, suggests that if this justification for Chapter 11 was in fact widespread in its application, we would rarely see the declines in  $V$  which the studies find.

On the other hand, if bankrupt firms are more likely to be subject to the converse of the Myers effect, the so-called Jensen and Meckling risk-alteration effect (under which equity is likely to undertake risky gambles with the creditors' money<sup>66</sup>),  $V_b$  would be expected to be less than  $V_w$  and the drop in  $V$  would be understandable. Indeed, I hypothesize that the very act of filing Chapter 11 is itself a risk alteration. The common sense source of this instinct is obvious: investors control their agents' gambling propensities by adopting protective contractual terms. The universal implied term is: if you default, then I come and take the assets away (so you will not be able to gamble with them). Chapter 11, if it accomplishes one thing, emphatically repeals the effects of such contract terms for considerable periods of time.<sup>67</sup> The risk-alteration hypothesis is also a credible explanation for why managements file Chapter 11 despite the significant drop in  $V$  that the filing will likely cause.<sup>68</sup>

The risk-alteration explanation for the drop in  $V$  can be recast in terms of the creation of the environment for rent-seeking. Imagine a regime in which, when you and I are disputing our boundary line, the law suspends

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65. George G. Triantis, *A Theory of the Regulation of Debtor-In-Possession Financing*, 46 VAND. L. REV. 901 (1993). This explanation may account for some of the small proportion (7%) of firms whose equity securities rise in value during the short event windows surrounding their bankruptcy filing announcements in the findings of Slovin, Sushka, and Waller. Slovin et al., *supra* note 17, at 16.

66. This incentive works from the realization that the low priority residual claimants capture gains from taking large risks, while the losses are placed on the higher priority claimants. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Cost, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

67. See, e.g., 11 U.S.C. § 362 (1988) (imposing an automatic stay or injunction against any creditor action to take away assets).

68. In other words, managements will opt for Chapter 11 only in cases in which a desperate gamble (with someone else's money) with only a faint hope of some success is the best available alternative for equityholders. Thus, one would expect to see only a small portion of Chapter 11s "succeed," a view that finds considerable support in the data. See *supra* text accompanying note 31.

the previous surveys and deeds under which the boundary was initially established and replaces them with an interim rule which holds that the boundary is now plus or minus 60 feet from the line passing between our respective driveways. I will now take steps to gain control over the full 60 feet north of where I had previously stopped mowing, and you will expend a lot of resources trying to acquire my garage. In the course of our dispute, we can be expected to dissipate much of the value of the 120-foot-wide strip of land in such activity. Something not too different from that behavior occurs in Chapter 11 proceedings. If equity's contractual rights have all been lost by declines in the fortunes of the business, then competing in a rent-seeking arena offers equity the only attractive alternative to simply writing off the preexisting losses. All previous contract and property rights are put in suspension by the automatic stay and a process to establish new rights commences in which outcomes are variable to the extent of the significant discretion of the bankruptcy court. The filing of the Chapter 11 thus announces to the world that the value of the firm is about to be significantly dissipated. To restate the problem in terms of still another vocabulary, the effect of many of Chapter 11's provisions is to raise transaction costs by making the enforcement of preexisting property rights expensive.<sup>69</sup> A drastic increase in transaction costs explains the drop in  $V$  for filing firms unless the equity of almost all bankrupt firms is substantially and systematically overvalued by the market, a prospect which is questioned below.

### B. *The Overvaluation Hypothesis*

The semi-strong version of the efficient markets hypothesis holds that actual market values are unbiased assessments of value in light of the publicly available information.<sup>70</sup> The market price, then, may "overvalue" the firm, considering that unfavorable but private information might exist about the firm's prospects. Accordingly, the Chapter 11 filing may be viewed as some sort of a signal that such information exists. The filing itself, however, does not give the market's players much to go on in deciding by how much they should reduce the values of their bids. An investor needs to know more than that a stock is overvalued. She needs to decide *by how much*. Thus, the simple fact that derogatory private

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69. Douglas Allen, *What Are Transaction Costs?*, 14 RES. L. & ECON. 1 (1991) (arguing that transaction costs are the costs of enforcing property rights).

70. RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 270 (2d ed. 1984).

information, which is not accurately accounted for in pre-filing market values, might exist is not a very satisfying explanation for the relatively precipitous drop in securities prices over the very brief periods surrounding a bankruptcy filing.

Undoubtedly, there are cases in which negative private information can explain significant overvaluations. The firm which has invested and borrowed heavily to develop a promising but speculative potential prospect (e.g., the drug that cures lung cancer in rats) and finds out after having made the investment that the prospect does not live up to its previous promise (because, for example, its curative potency turns out to be rat-specific—it cured laboratory rats, but was ineffective in people) may owe much of its market value to the prospect, and the filing can be seen as a signal that the prospect did not pan out.

None of the “thick description” work done on failing firms, however, has reported that, as a group, they share characteristics like these. Indeed, had any studies shown that bankruptcy was actually a signal that the firm’s projects all had negative net present value, the case for Chapter 11 would not have been established. Firms whose investments cannot be made profitable are *economically* inviable, and not merely *financially* distressed. No set of legal rules or institutions is going to save such firms. A reorganization of their financial affairs and capital structure will not make such firms economically viable.

There is another reason to question whether, if distressed firms are actually overvalued by the capital market, an administrative resolution of their problems in a proceeding like Chapter 11 is justifiable. Firms with shares which are overvalued by financial markets are the very ones which, it seems reasonable to expect, would sell equity claims against themselves for more than those claims are actually worth, and thus raise from the market a significant profit from the overvaluation. Overvalued firms are the very ones which markets ought to be able to assist best in the process of recapitalizing, and accordingly, ought to consist of the class which least needs administered legal remedies.

Finally, there is a growing amount of empirical evidence and theoretical analysis which is inconsistent with an overvaluation hypothesis. Filing firms usually have been in default of many of their obligations or have sent out other negative signals for a significant period of time before a crisis arises which demands a Chapter 11 filing. Many bankrupt firms’ troubles have been reported in the newspapers (or in the SEC’s 10K files) days and

weeks (or even, in cases like Robins or Manville, years) before the filing.<sup>71</sup> In such cases, the overvaluation hypothesis requires that the marginal buyers and sellers who set the pre-filing market prices must be assuming that there is private *favorable* information (e.g., that management has a promising strategy for dealing with the known problems) that causes the overvaluation.

On the other hand, the market might rationally assume that if there is any private *good news*, the firm will find it in its own interest to disclose the information. Thus, investors should rationally assume that any private information is likely to be unfavorable, and should discount their willingness to bid in the market by the appropriate amount for unknown unfavorable information. Just what amount is added to the discount they might make on account of unspecified unfavorable private information signalled by a Chapter 11 filing is a mystery, unexplained by the overvaluation hypothesis.

Also, it seems reasonable to believe that in many, if not most cases, the determinants of  $V$  are difficult to keep secret for long periods from earnest information seekers. A significant portion of the firm's anticipated value is doubtlessly estimated by investors as functions of the market demand for the firm's outputs and the market supplies of its inputs. Neither of those types of information is likely to remain wholly in the private domain of the firm over long periods of time, particularly for the large number of firms in the industries documented in the studies showing drastic drops in actual  $V$ .

Finally, studies also cast empirical doubt on the overvaluation hypothesis. Bi and Levy<sup>72</sup> recently published a study on how the announcement of bond downgradings affected the value of the downgraded firm's stock. They report that the effects were significantly more severe for firms which ultimately filed for Chapter 11 than for firms which did not. Gilson, John, and Lang also found that the market predicted which defaulting firms would be able to work out their financial difficulties privately and which would be obliged to use Chapter 11. They found the market penalized the value of the latter firms more heavily at the time the default became public.<sup>73</sup> My colleagues obtained a similar result in the study reported

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71. See Bradley & Seyhun, *supra* note 60; Gilson et al., *supra* note 61.

72. Keqian Bi & Haim Levy, *Market Reaction to Bond Downgradings Followed by Chapter 11 Filings*, FIN. MGMT., Autumn 1993, at 156 (1993).

73. Gilson et al., *supra* note 11.

above.<sup>74</sup> Slovin, Sushka, and Waller not only measured the announcement effects on creditors of the filing firms, but also the effects on the firms themselves, and then disaggregated those findings for the ultimate bankruptcy outcomes. In the three days ending with the bankruptcy announcement, firms which eventually had Chapter 11 plans confirmed saw their shares shrink in value only two-thirds as much as the decline in value of firms eventually liquidated under Chapter 7.<sup>75</sup>

The Slovin study also shows similar results by disaggregating firms for which control bids were received in bankruptcy proceedings from those for which no such bids were received. It shows that at the time bankruptcy is filed, the firms receiving bids in the Chapter 11 proceedings suffered significantly smaller negative abnormal negative returns (mean = -21.41%) than did those for whom no bids were received (mean = -35.86%).<sup>76</sup> This latter result is consistent with the dissipative hypothesis, because the receipt of an outside bid constrains the discretion exercised by the bankruptcy judge in valuing the firm. To use my previous boundary line metaphor, it reduces the width of the land in contention between you and me from 120 feet to, say 50 feet, and thus reduces the potential rent-seeking losses.

These studies seem to show that the market knows a great deal about the proper amount by which the equity of distressed firms should be devalued. Not only does the market accurately predict when an unparticularized announcement of bad news is likely to lead to a cure at the vet's office on the one hand, or the need to send the critter to the glue factory on the other, but also it predicts, at the time when the critter enters the slaughtering pen, just what the future price of the glue will be. The assumptions underlying any credible overvaluation hypothesis must include the proposition that firms will be able to easily keep unfavorable information private. Among the sorts of unfavorable information which one would expect to fall into that class would be the information determinative not only of the likelihood that bankruptcy will eventuate, but also of eventual bankruptcy outcomes. The market seems, nevertheless, to detect considerable heterogeneity among failing firms and to value them in accordance with their ultimate financial prospects, even in the teeth of the assumptions which the overvaluation hypothesis requires us to reject.

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74. Slovin et al., *supra* note 17; see also *supra* notes 51-56 and accompanying text.

75. The mean negative return to shares of the "successful" Chapter 11 firms was -24.8%. The mean negative return to firms whose cases were eventually converted to Chapter 7 liquidations was -39.5%. Slovin et al., *supra* note 17, at 16.

76. These findings are discussed *supra* in the text accompanying note 16.

Why then should we be willing to accept a similar assumption that the market seems to considerably overvalue firms because they can keep private information that, on the average, determines about one-third of their ultimate value at the margins? In order for the overvaluation hypothesis to be credible, an additional theory is required that predicts the kinds of unfavorable information that firms are likely to be able to keep private, and that shows how the information which appears to determine values in the bankruptcy contingency differs so that it can be determined by the market. In short, the semi-strong market efficiency hypothesis, on the current state of the theory, is necessarily a lot stronger than the conservative instincts of finance scholars seem to have imagined. It is not likely, on the evidence we now have, that the filing of a Chapter 11 petition is some sort of reliable publication of previously private, unfavorable information about the firm (except the private information that the firm has chosen to subject its investors to the wealth-destroying mechanism we call Chapter 11).

#### IV. SOME CONCLUSIONS

The simultaneous existence of various alternative explanations about the purpose and effect of corporate reorganization law is indicative of a fundamental philosophical void: no one has a good explanation for why we have such a law, nor even much of a credible vision about what sorts of benefits such a law is capable of bringing to society. We are considering various possibilities precisely because we do not have any very good ideas about where we stand. The raising, evaluating, and refining of hypotheses is a description of the process of intellectual progress, however. Perhaps the day is at hand when we can develop a paradigm that lets us all understand reorganization bankruptcies.

On the information which is presently available to us, we must conclude that Chapter 11 cannot be justified as a business rehabilitation measure. It rarely works to rehabilitate firms, and investors in those firms which use markets rather than bankruptcy proceedings to rehabilitate themselves are invariably made much better off. It cannot be justified as a device to relieve distressed firms from the necessity of using our imperfect capital and asset markets to resolve their problems. The evidence is that firms must and do use those markets even within Chapter 11, and furthermore, investors in firms whose bankruptcy leaves them in play in the market for corporate control come out much better than do investors in firms who are never put up for sale. In summary, markets seem to be the only available devices which really do solve the problems of financial distress. The

bureaucratic mechanisms created by the Bankruptcy Code result in larger losses and confer few benefits to any participants other than those successful in playing rent-seeking games. In short, markets are efficient and bankruptcy procedures are not. That is the lesson of the only systematic and rigorous theory that has been applied to the problem, and the implications of the only scientific empirical evidence.

Even those who are persuaded that Chapter 11 is inefficient, however, might be able to understand it (and therefore be able to sensibly apply it in discrete cases) if it were an effective device for redistributing income. There are theoretical reasons to doubt that Chapter 11 could ever be a successful device to obtain redistributive ends, however, and the available evidence seems to show that the Bankruptcy Code is a flop as a wealth redistributor.

Nevertheless, the process of searching for a coherent, credible justification for Chapter 11 is itself illuminating. The set of property and contract rights which bankruptcy law works to alter or overturn comprises the fundamentals of our system of private property. The burden on those who advocate overturning such long-established institutions ought to be significant, particularly when the available data furnish the strongest support of hypotheses that court-supervised corporate reorganization is wealth-destroying. It is right to insist then, that the apologists for the law offer an explanatory hypothesis which is normatively attractive, theoretically coherent, and also conforms to the facts in the world (or even points to a successful historical instance of state-mandated collectives) before we grant anyone the point that our current corporate bankruptcy law is worth having. Those having discretion to use bankruptcy power to overturn nonbankruptcy arrangements, accordingly, ought to employ their authority with great humility, if not timidity, until someone comes up with a widely understood and acceptable explanation for the law, and with it a justification for the exercise of that power.

