

A WORLD WITHOUT DEBT

BARRY E. ADLER*

“That we might live in a world without bankruptcy law or any similar collective procedure is not as far-fetched or as ridiculous as it might seem at first glance to those of us who are immersed in its intricacies every day.”¹ This is the conclusion of Douglas Baird in an article titled *A World Without Bankruptcy*. In that article, Baird imagines what the world would be like if there were no bankruptcy law. He hastens to add, however, that “[t]he reason for engaging in this thought experiment is not that it is either wise or at all likely that we abandon bankruptcy law. I think neither is the case. Rather the point of the exercise is to isolate bankruptcy issues from other issues.”²

In this paper I borrow not only the structure of Baird’s title, but the structure of his argument as well. I imagine not only a world without bankruptcy, but a world without debt. In my thought experiment, a world without either is efficient. I do not believe such a world is as far-fetched as it may at first glance seem to those of us immersed in the intricacies of bankruptcy. I *do* think it is wise, in principle, to do away with bankruptcy law. I believe firms might, in response, do away with debt. I agree with Baird that the abolition of bankruptcy is unlikely. But my guess is that this is unfortunate, because when I attempt to “isolate bankruptcy issues from other issues,” I find no bankruptcy issues.

In Part I of this essay, I give a brief description of the collective action problem that Baird identifies as *the* bankruptcy issue for corporate debtors.³ I do so not because I believe the reader needs the refresher. Rather, I do so because a statement of the standard version collective action problem is a necessary preface to my explanation of why I think there is no such problem and, consequently, why I think there is in principle no need for corporate bankruptcy.

In Part II, I explain why I believe there is no collective action problem

* Professor of Law, University of Virginia. I thank Bob Rasmussen and George Triantis for helpful comments on an earlier draft.

1. Douglas G. Baird, *A World Without Bankruptcy*, LAW & CONTEMP. PROBS., Spring 1987, at 173, 174.

2. *Id.*

3. As will become clear, my arguments apply only to corporate debtors.

and give what I believe is an essentially simple explanation of a world without debt. In such a world, I envision "Chameleon Equity" firms, which necessarily differ from traditional firms only in their substitution of preferred equity for debt, but may also differ in their ability to use many tranches of claims in a hierarchical capital structure. This is a brief reprise of arguments I have made elsewhere. Given recent criticisms—which, as I explain in Part III, I believe are largely misunderstandings—of my earlier work, I hope to take this opportunity to clarify my ideas.

In Part III, I respond directly to the criticisms of a world without debt. These criticisms suppose that firms with traditional debt and, therefore, subject to bankruptcy provide their investors with certain benefits that a firm in a world without debt could not provide. I explain that a firm without debt might differ from a traditional firm only in the investors' inability to collect individually. Therefore, inasmuch as the sole *proper* role of bankruptcy reorganization of a firm with debt is to solve the collective action problem, a firm without debt could well forgo costly bankruptcy.

Finally, in Part IV, I admit the limits inherent in my view of appropriate bankruptcy policy. Wholly apart from the character of initial investor contracts, bankruptcy is conceivably valuable because it serves society's distributional objectives or because it allows a judge to make decisions for a firm *ex post* using information that no one has *ex ante*. If there is great value, apart from collective action, to a bankruptcy reorganization proceeding, the elimination of debt that I propose might be counterproductive, given that the principal advantage of a debtless world would be the *avoidance* of a bankruptcy reorganization. However, if bankruptcy offers benefits other than collective action, it is not clear to me why government does not provide these benefits outside the bankruptcy setting.

Part V concludes that a world without debt would, in principle, be a world without the need for bankruptcy. Little would be lost. Although I confess that I may have gone too far in my zeal for a simple story, no argument I have seen convinces me that I have.

I. THE COLLECTIVE ACTION PROBLEM

At its core, bankruptcy supplants individual creditor debt collection remedies with a "collectivized debt collection device."⁴ In theory, bankruptcy's collectivized proceeding is superior to individual creditor

4. THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 7 (1986).

actions because individual creditors have perverse incentives to act in their own interests, even if those interests disserve the creditors' collective interest. Thus, bankruptcy is beneficial to the extent it protects creditors from their own worst instincts.⁵

To illustrate, assume a debtor firm operates a business worth more as a going concern than if its assets were sold piecemeal. That is, the assets are worth more as parts of the debtor's business than they are distributed separately to become parts of other businesses. Assume further that the debtor is subject to obligations even greater than the value of the firm as a going concern and that the debtor is in default on those obligations. The debtor has insufficient assets to pay all creditors in full, so each creditor has an incentive to collect on its debt before the debtor's assets are depleted by other creditors' collections. In the absence of bankruptcy law, this creditors' race to the assets likely would divide those assets piecemeal, with each race winner taking a piece of the debtor large enough to satisfy its own claim. As a result, the creditors would take from the debtor assets worth in the aggregate only the piecemeal liquidation value. At the time of such a race, the creditors would prefer to keep the debtor's assets intact to preserve the higher going-concern value. But, without bankruptcy law, each creditor would know that it could be left without recourse to any assets if it delayed its own action on the mere hope that the creditors would both find one another and agree to act collectively. This dilemma of coordination is the collective action problem.⁶

Bankruptcy solves the collective action problem by disallowing individual creditor action.⁷ A bankruptcy court supervises the use and disposition of the debtor's assets and can hold the assets together to maximize their value.⁸ The court then divides the value of the assets among creditors in an orderly fashion, either through the sale of the assets to a third party and the distribution of sale proceeds,⁹ or through the

5. See generally *id.* at 1-19.

6. *Id.*

7. A bankruptcy petition automatically stays any individual creditor action against a debtor. 11 U.S.C. § 362 (1988).

8. The Bankruptcy Code contains a number of provisions designed to maximize the value of the debtor as a going concern. See, e.g., 11 U.S.C. § 721 (1988) (allowing the court to authorize the bankruptcy trustee to operate the business of the debtor if such operation is in the best interest of the estate); 11 U.S.C. § 1108 (1988) (providing that in the case of a reorganization proceeding, the trustee or the debtor may operate the business of the debtor unless the court orders otherwise); 11 U.S.C. § 363 (1988) (providing the court with the power to supervise transactions outside the ordinary course of business).

9. See 11 U.S.C. §§ 725-726 (1988).

distribution of interests in a debtor freed from prebankruptcy obligations.¹⁰ In no instance does an individual creditor have an opportunity unilaterally to withdraw vital assets.

In the illustration above, for example, the bankruptcy court would prohibit individual creditor action, and could sell the debtor's business as a going concern or distribute securities in the firm with an aggregate worth equal to the value of the firm as a going concern. This sale or distribution would thus preserve the debtor's going-concern surplus. Such bankruptcy intervention is thought to reflect the "hypothetical creditors' bargain," or the solution the creditors would reach could they solve their coordination problems.¹¹ Accordingly, bankruptcy's solution to the collective action problem is the chief justification for its elimination of individual creditor remedies.

Dean Baird summarizes this analysis as follows: "We may not desire a world without bankruptcy because the self-interest of creditors leads to a collective action problem, and a legal mechanism is needed to ensure that the self-interest of individuals does not run counter to the interests of the group."¹² Baird laments the attempt by some to view bankruptcy as doing more:

One of the most troublesome aspects of most modern discussion of bankruptcy law, both academic and judicial, is the reliance upon unarticulated notions of 'bankruptcy policy.' . . . [M]uch of what is usually thought of as 'bankruptcy policy' is not bankruptcy policy at all, but rather an issue of general concern that must first be grappled with before the special problems that arise by virtue of a bankruptcy proceeding are confronted.¹³

II. A WORLD WITHOUT DEBT

It is useful to distinguish *bankruptcy* policy, i.e., collective action policy, from issues of general concern. Legal provisions directed to the latter need not be part of an insolvency regime. Moreover, if, despite Baird's specula-

10. See 11 U.S.C. §§ 1101-1174 (1988).

11. The illustration is simplistic. In an actual example, there may be subsidiary benefits that derive from bankruptcy's solution to the collective action problem. These include the elimination of direct costs from the avoided race to the debtor's assets and the provision of a presumably efficient common forum for disputes over those assets. All these savings, of going-concern surplus and collection costs, must be compared to the costs of bankruptcy, some of which are briefly described below. For a comprehensive description of the basic hypothetical bargain model, see JACKSON, *supra* note 4, at 1-19.

12. Baird, *supra* note 1, at 184.

13. *Id.* at 174.

tion, there is no need for a legal mechanism to ensure that the self-interest of individuals does not run counter to the interests of the group, there is no need for any sort of special insolvency regime. My argument here, born of a thought experiment about a world without debt, is that there *is no need* for any legal mechanism to ensure collective action, and thus, no need for corporate bankruptcy law or any special insolvency regime.

Before beginning this argument, I want to address the possibility that neither the risk of insolvency from debt nor bankruptcy law matter much. The classic story of the collective action problem, and bankruptcy law as its solution, labors under the assumption that firms have debt held by a great number of dispersed creditors. In a paper presented at this conference, Baird questions whether this situation describes the typical firm.¹⁴ Many firms, he observes, operate without significant debt in their capital structure or with a single dominant creditor.¹⁵ Such firms either do not become insolvent or do not face a collective action problem in the event of insolvency. I do not quibble with this observation. But the classic collective action story may be true for some firms. I devote my attention to these firms.

I assume that there *might* be a collective action problem because some firms rationally issue fixed obligations to a large number of investors. A firm might rationally issue fixed obligations because such obligations can simultaneously allow managers to hold a significant portion of a firm's residual claim and subject managers to the consequences of payment default, including, perhaps, dismissal. The result could be more productive managers.¹⁶ A firm might rationally issue its fixed obligations to a large number of investors if no single lender would be willing to provide all

14. See Douglas G. Baird, *The Reorganization of Closely Held Firms and the "Opt Out" Problem*, 72 WASH. U. L.Q. 913 (1994).

15. *Id.* at 915, 919. For a full discussion of benefits arising from a financing strategy that produces a single dominant creditor, see Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986).

16. This is a simplification of a complicated issue. Compare, e.g., Michael C. Jensen & William H. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312-20 (1976) (noting the residual claimant's incentive to maximize wealth) with Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 653 (1984) (suggesting that managers who have a substantial investment in their firms may be reluctant to invest the firm's assets wisely if the investment in question is risky). See also Elizabeth Strock et al., *Managers, Owners, and the Pricing of Risky Debt: An Empirical Analysis*, 49 J. FIN. 453 (1994). Suffice it to say here that it *may* be rational for *some* firms to invest their managers with a substantial residual interest and to have those managers face the risk of financial ruin for failure to meet fixed obligations.

financing at all times. (This might be the case for some large issuers.) Or a firm might rationally prefer to have multiple financing sources so as not to vest in any lender the opportunity to behave strategically with respect to subsequent loans that only an existing lender, given better information, could efficiently provide. Thus, the world I imagine is not limited to the simple firm Baird describes.

The world without debt that I propose is a world *with* fixed obligations that a firm might issue to numerous investors. I imagine eliminating only a single feature of traditional debt: the right of an individual fixed-obligation claimant to collect. This one feature is significant because it is *the* feature of debt that creates the collective action problem and the need for bankruptcy reorganization law.

My approach is simple. The justification for bankruptcy is the need to prevent individual creditor collection. I imagine a world in which firms issue obligations like debt in every respect except the one that creates the need for bankruptcy. I then ask what might be gained and what might be lost. Firms that issue fixed obligations to multiple investors might benefit from a debt-free capital structure by avoiding the expense of restructuring, through bankruptcy or other means. This expense can be significant, at least under current bankruptcy law, which divides an insolvent firm's value through claimant negotiations that often deteriorate into an imbroglio.¹⁷ Taking as given the desire to protect insolvent but viable firms, it is not clear that anything significant might be lost by eliminating collection rights.

Elimination of debt, and with it the creditor's right to collect, might cost little because there is an alternative *collective* remedy of which fixed-obligation claimants could avail themselves. In an earlier paper, I argued

17. For an estimate of bankruptcy reorganization's direct costs, see Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 289 (1990) (estimating costs to be about 3% of the firms' assets). For what is likely the limiting estimate of reorganization's indirect costs, from one prominent case, see David M. Cutler & Lawrence H. Summers, *The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation*, 19 RAND J. ECON. 157 (1988) (finding costs running into the billions of dollars). For a broader estimate of indirect costs, see, e.g., Sanjai Bhagat et al., *The Costs of Inefficient Bargaining and Financial Distress*, 35 J. FIN. ECON. 221 (1994). There are, moreover, indirect costs that will not be reflected in ex post measurements of financial distress costs. That is, there are costs from the tendency of expensive bankruptcy proceedings to reallocate a firm's value from high- to low- priority claims, thus reducing the value of high-priority claims to firms that wish to issue such claims. See, e.g., Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 476-79 (1992); Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy*, 72 WASH. U. L.Q. 1213 (1994).

that a firm could, in principle, replace debt with preferred equity.¹⁸ This substitution could create what I call a "Chameleon Equity" firm. Such a firm would retain the benefits of fixed obligations, but would avoid the negative consequences of creditor coordination failure—notably postdefault dismemberment of a viable firm—by eliminating individual creditor collection. In the simplest Chameleon Equity firm, if insolvency (defined as asset value less than fixed obligations) led to default, default would eliminate the preinsolvency common-equity class and would convert the lowest priority fixed-obligation class to common equity. Any remaining preferred-equity class would survive unaffected. At any given time, management would represent the then current common-equity class.¹⁹

Thus, in the illustration from Part I, the general creditors would become the equity class and *automatically* hold securities worth the firm's entire going-concern value. A court would not need to provide the collective remedy because there would be no individual remedy in the first place. Nothing else would have to change.

In a more complex firm, one with a variety of fixed-obligation priorities, no court would have to preserve the higher obligations' priority. The senior obligations would retain their priority because they would survive complete with fixed claims. This would free the firm to adopt a tiered hierarchy of priority classes that would keep the firm almost eternally solvent and almost eternally subject to significant fixed obligations. In the end, every claimant would get the priority for which it contracted. And, although there would be questions of default and liability, as there are now in traditional firms, there would be no postinsolvency restructuring expense. A Chameleon Equity firm would have to bear the initial transaction costs of adopting the Chameleon Equity structure. But it is difficult to imagine that these costs would be, in the long run, anything but trivial additions to the current costs of contracting for corporate charters and bond covenants.²⁰ Corporate bankruptcy seems unjustified.

I am not so naive as to believe that abolition of bankruptcy or firm

18. See Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993).

19. This insight, to the extent it is an insight, is built on a discussion of collective action among bondholders in Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987).

20. I elaborate on this point in Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. (forthcoming 1994). In Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669, 720 (1993), Korobkin describes these costs as "immense," at least because he neglects the possibility that the contracts could become standard form much like bond covenants under the current regime.

selection of a Chameleon Equity structure is imminent or even possible. In my original paper on Chameleon Equity, I described a list of legal and other impediments to a Chameleon Equity structure. These include tax, commercial, corporate, and tort law. I also offered a public choice explanation for the persistence of these impediments.²¹ Nevertheless, *in principle*, a world without debt or bankruptcy, and with contractual solutions to the collective action problem, seems an efficient world.

III. A RESPONSE TO CRITICS

Unfortunately, the simplicity of the observations discussed above has been obscured somewhat by the firestorm over a paper by Michael Bradley and Michael Rosenzweig, titled *The Untenable Case for Chapter 11*.²² In this paper, written contemporaneously with my original Chameleon Equity paper, Bradley and Rosenzweig suggest that in a world without bankruptcy a firm would issue creditors "contingent equity," which would convert to the residual claim against the firm if the firm defaulted on its debt. In their proposal, they quite explicitly decline to remove the right of individual collection against the firm from the creditors who would hold contingent equity.²³ Their proposal, therefore, does not offer a solution to the collective action problem at the heart of the supposed need for bankruptcy law.²⁴

Consequently, despite the fact that both the Bradley and Rosenzweig team and I place an adjective before the word "equity," and both propose a transfer of an insolvent firm to its fixed-obligation claimants (a transfer, it should be noted, that bankruptcy also accomplishes), our proposals of market alternatives to bankruptcy could not be more dissimilar.²⁵ The proposals differ at their core—on the question of individual creditor

21. See Adler, *supra* note 18.

22. See Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992). For evidence of the firestorm, see Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79, 80-81 & nn.5-6 (1992).

23. Bradley & Rosenzweig, *supra* note 22, at 1085 n.98.

24. I noted this in my original paper on Chameleon Equity, see Adler, *supra* note 18, at 332-33, as have others elsewhere. See, e.g., LoPucki, *supra* note 22, at 101-03.

25. Neither the Bradley and Rosenzweig team nor I should claim originality for the idea that a fixed obligation might turn into a residual claim without benefit of a bankruptcy proceeding. See, e.g., Robert C. Merton, *The Financial System and Economic Performance*, 4 J. FIN. SERVICES RES. 263 (1990); Note, *Distress-Contingent Convertible Bonds: A Proposed Solution to the Excess Debt Problem*, 104 HARV. L. REV. 1857 (1991). The novelty of Chameleon Equity is its potential for entire change of corporate debtor-creditor relationships and the consequent freedom to include substantial numbers of fixed-obligation priority classes.

collection. Yet at least two skilled scholars, Bob Rasmussen and David Skeel, have confused my proposal with the Bradley and Rosenzweig proposal.²⁶ And other skilled scholars, including Lynn LoPucki, Donald Korobkin, and Elizabeth Warren have attacked market alternatives to bankruptcy reorganization generally on grounds that may damn “contingent” equity but do not condemn “Chameleon” equity.

The confusion between my proposal and the Bradley and Rosenzweig proposal apparently has caused critics to miss the key distinction that Baird, in *A World Without Bankruptcy*, admonishes us to observe: the distinction between “bankruptcy issues” and “other issues.”²⁷ In combining “contingent” with “Chameleon” equity, Rasmussen and Skeel have given the amalgam properties that Bradley and Rosenzweig leave undiscussed and that I relegate to nonbankruptcy consideration. That is, Rasmussen and Skeel attribute other characteristics to their own version of the “contingent-Chameleon” equity structure and then criticize their strawman. They would not have made this mistake had they focused on the only essential element of Chameleon Equity: elimination of individual collection rights.

A. Secured Credit Issues

The first illustration of these misunderstandings is Rasmussen’s treatment of secured credit. Rasmussen states that the costs of “contingent-Chameleon” equity include:

the cost of reducing some of the benefit that is associated with secured credit. Current explanations for secured credit focus on the secured creditor’s ability to monitor the specific assets in which it holds a security interest. Contingent equity is tantamount to giving the secured creditor a security interest in the entire firm rather than in the specific assets that it intends to monitor.²⁸

Bankruptcy reorganization grants priority in distribution to the extent of collateral value. With respect to the unsecured portion of an undersecured loan, bankruptcy awards a creditor assets or new claims ratably as on an unsecured claim.²⁹

Rasmussen’s criticism of the “contingent-Chameleon” equity structure

26. See Robert K. Rasmussen, *Debtor’s Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 98 n.201 (1992) (describing the proposals as “essentially the same”); David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 475 (describing, as an amalgam, the “contingent/chameleon equity proposal”).

27. Baird, *supra* note 1, at 174.

28. Rasmussen, *supra* note 26, at 99.

29. See 11 U.S.C. § 506(a) (1988).

would be a valid criticism of Chameleon Equity if there were something inherent in the scheme that required ratable entire-firm, rather than asset-specific, priority. However, there is not. A Chameleon Equity firm might place secured claimants in its highest priority investor class. In this case, priority disputes among individuals in the class of secured creditors would not arise until the firm had passed through insolvency of all lower priority classes. The Chameleon Equity contracts could provide that, at this point, each secured creditor could call for a cash auction of its collateral, with the respective proceeds to reduce each obligee's claim. If directly by, or through management elected by, claim-amount vote³⁰ the firm outbid others for items of collateral, the firm would continue. The continuing firm would be subject to any new claims issued for financing of the asset purchases. The previously undersecured claimants would receive equity shares proportional to their respective undersecurity. If the firm did not outbid the market for the collateral, the auction would liquidate the firm.³¹ Thus, Chameleon Equity could accommodate the asset-specific priority with which Rasmussen is concerned.

It is true that such an auction would generate restructuring costs that Chameleon Equity is designed to save. But the auction would not occur unless a firm had dissipated *all* of its initial equity and lower priority fixed-obligation capital. Therefore, the auction would likely take place only when the firm had failed so completely that a bankruptcy proceeding would do no more than conduct the same auction.³² Put simply, it seems unlikely that facilitation of asset-specific priority is a *bankruptcy*—i.e., collective action—function. In any case, the Chameleon Equity structure could solve the collective action problem and save firms the expense of bankruptcy or any collective process while still preserving asset-specific priority for firms that became insolvent but retained value in excess of their

30. Fully secured and oversecured claimants would be indifferent between continuation and liquidation, because they would be cashed out in either case. Undersecured claimants would have the correct, and likely the same, incentives for continuation or liquidation. To protect against the firm's overbidding induced by a creditor with an interest in the auctioned property, initial contracts could prevent such a creditor from voting for a bid, or for a representative that would bid, on the creditor's collateral. At least if that were deemed insufficient or unworkable, initial contracts could prohibit the firm from paying the creditor an amount in excess of the next highest bid.

31. This contractual alternative supplements the possible alternatives I discussed in my original Chameleon Equity paper. See Adler, *supra* note 18, at 327. The proposal here more precisely aligns the investors' collective voice with the investors' collective interest.

32. Indeed, a substantial number of firms that file for Chapter 11 bankruptcy reorganization liquidate soon thereafter. See, e.g., Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437, 451 (1993).

highest priority investors' claims.

It is possible that Rasmussen's concern is not about secured claimants *lacking* a priority interest in specific collateral, but in their *having* a priority interest in assets that do not serve as collateral. Saul Levmore has suggested that certain items of collateral serve as focal points for monitoring. Levmore argues that general creditors may benefit from secured creditor monitoring of these focal points.³³ Perhaps Rasmussen believes that entire-firm priority would sap a secured creditor's incentive to monitor individual focal points. Skeel clearly raises this concern.³⁴

If the incentive to monitor is diminished, all might lose as a result. However, Chameleon Equity is sufficiently flexible to address the problem. If investors in a Chameleon Equity firm chose to limit a secured claimant's priority to the value of collateral, they could place secured claims in a low-priority class, but give each claimant the right to demand an auction for its collateral in the event of default on a secured or, for that matter, *any* claim. The result would mimic bankruptcy's valuation of collateral in the event of the firm's insolvency. Again, there would be costs associated with auctioning the collateral. However, the remainder of the firm's assets and claims would survive or be transformed according to contract without need to determine the firm's going-concern value through a bankruptcy proceeding or a general auction. In contrast to one of these broader endeavors, the wholly or partially *piecemeal* sale of assets, back to the firm or to third parties, could entail easy valuation and consequent low cost given the potential fungibility of isolated items or limited groups of assets. The unique integrated system of assets that comprises a going concern could be far more difficult to value and sell.³⁵

Because the offer of asset-specific priority does not implicate a collective action problem, and because Chameleon Equity necessarily differs from debt subject to bankruptcy *only* in its treatment of collection, Chameleon Equity can accommodate asset-specific priority. There is, therefore, no bankruptcy issue here.

33. See Saul X. Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 *YALE L.J.* 49, 56-57 (1982).

34. See Skeel, *supra* note 26, at 487-90.

35. Important costs of an auction for a going concern stem from strategic and other difficulties in determining the concern's true value. See generally Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 *J.L. & ECON.* 633 (1993).

B. *Dealing with Illiquidity Crises*

There is also no bankruptcy issue raised by objections to “contingent” or “Chameleon” equity on the ground that it lacks flexibility to deal with a solvent firm’s liquidity crisis. LoPucki, Korobkin, and Skeel make much of the fact that the equity interest in a solvent “contingent” or “Chameleon” equity firm might sacrifice its equity cushion for failure to make payments as they came due.³⁶ One might think that a solvent firm could simply raise new funds by pledging or selling existing assets. But as LoPucki puts it in his critique of contingent equity:

In traditional bankruptcy theory, an asset is said to be ‘illiquid’ when its value cannot be easily converted to cash. If the owner is forced to sell an illiquid asset under pressure of time, in a market in which there are too few buyers, or to buyers who must make major expenditures to evaluate the asset, the sale price may be considerably less than the actual value of the asset. . . . In the [zero transaction cost world of contingent equity], the problem of illiquidity does not exist. Because the markets are assumed to be perfect, anything that has value can be sold for that value, immediately and costlessly.³⁷

In real life, LoPucki and others argue, illiquidity exists. Bankruptcy reorganization law, they add, permits a judge to solve the liquidity problem by valuing the assets without recourse to imperfect markets. But, again, this function of a bankruptcy court is not a collective action function. Therefore, Chameleon Equity could provide the benefit without a bankruptcy proceeding.

Implicit in this response is the assumption that bankruptcy provides no savings of evaluation costs, even supposing that evaluation requires “major expenditures.” This assumption seems valid because, as Jim Bowers points out, there is no reason to believe a judge can evaluate assets more parsimoniously than potential purchasers.³⁸ The benefit of bankruptcy, then, must be in the time the bankruptcy process gives equity to make its case.

However, a Chameleon Equity firm could provide time as well. A Chameleon Equity firm could establish in its charter a delay of any

36. See LoPucki, *supra* note 22, at 100; Korobkin, *supra* note 20, at 716-19; Skeel, *supra* note 26, at 483-84.

37. LoPucki, *supra* note 22, at 100.

38. See James W. Bowers, *The Fantastic Wisconsin Zero-Bureaucratic-Cost School of Bankruptcy Theory: A Comment*, 91 MICH. L. REV. 1773, 1784-86 (1993).

transformation until the firm were in default for some specified period. If the firm were solvent, equity would use the delay to raise funds and retire the arrearages (or to cure a technical default). Only if, at the end of the period, the firm could not raise the capital (including the amount needed to remedy any technical default) would equity lose its stake in the firm.³⁹ At that point, it would be correct to characterize the firm as insolvent, not merely illiquid, because, even without the pressure of time, no one would have been willing to pay more for the firm than the firm owed. Even under a bankruptcy regime, there must be a day of reckoning for equity if debt is to be a real obligation. There is no need for bankruptcy here.

C. *Removing Incumbent Management*

LoPucki also claims that bankruptcy is useful in ridding firms of bad managers. In criticizing contingent equity, he says:

In the world of imperfect markets and transaction costs, extricating the productive resources of a failed business from the managers and owners who presided over the failure can be difficult. Failed owners and managers commonly cling to their positions, dispute default on bases both real and imagined, and hunker down in place until the appeals have been exhausted and the sheriff comes to eject them on the day of reckoning. Particularly bitter ones sometimes lay waste to everything they cannot take with them as they begin to evaporate. [William] Whitford and I have argued elsewhere that chapter 11 plays a crucial role in removing failed management and shifting ownership and control of large, publicly held companies to their true residual owners. It does these things in a manner that is emotionally less than satisfying but strikingly effective. Tainted managers are nearly certain to be removed; control of an insolvent company almost invariably changes hands.⁴⁰

That bankruptcy reorganization replaces “tainted” managers is not, however, a tribute to the bankruptcy process. Bankruptcy does establish a negotiation procedure by which creditors, with court approval, can change management. But a creditor or a creditor group, rather than the court, is almost invariably the agent for change. LoPucki himself provides the evidence for this, noting “heavy creditor involvement in the sacking of these managers.”⁴¹ In a Chameleon Equity firm, the fixed-obligation

39. I made this point, though without emphasis, in my original Chameleon Equity article. See Adler, *supra* note 18, at 325. See also Bowers, *supra* note 38, at 1785 n.49.

40. LoPucki, *supra* note 22, at 104-05 (citations omitted).

41. *Id.* at 96 nn.55-56.

claimants would take control of an insolvent firm and could sack the managers directly. No court could interfere. True, there could be a great number of such claimants, few of whom would have a large enough interest to get involved with managerial decisions. But in a Chameleon Equity firm, the same claimants who now pressure courts to remove management could make a change by simply outvoting the managers.

There is, of course, the potential for some firms that interested claimants would be too few to remove entrenched management—a problem of collective action. A Chameleon Equity firm might solve the problem, however, by disenfranchising manager shares following insolvency and a class transformation. The firm's initial contracts could also require that the firm's managers publicly disclose, in advance of any election, information they might otherwise strategically conceal. These suggestions, adapted from ideas in an Aghion, Hart, and Moore paper presented at this Conference,⁴² demonstrate that Chameleon Equity is flexible enough to mimic, without the costs of reorganization or firm auction, not only the beneficial features of existing bankruptcy law, but of proposals for reform as well.

D. *Comparing the Costs*

So far I have addressed, and I hope refuted, claims that bankruptcy is superior to Chameleon Equity because bankruptcy provides benefits that Chameleon Equity could not provide. However, critics have also argued that Chameleon Equity would impose costs that bankruptcy does not. Certainly, this is true of the initial contracting transaction costs, which would be borne by all firms up front, not only by those firms that became insolvent at the time of insolvency. But, as noted, contracting transaction costs might well become trivial.⁴³

Beyond contracting transaction costs, LoPucki and Warren, for example, identify other costs of a contingent equity structure, costs that a Chameleon Equity firm would suffer as well. As LoPucki puts it: "In a world with transaction costs, debtors might well inadvertently or strategically agree to contracts whose inconsistencies precluded their simultaneous strict enforcement. Indeed, sorting out inconsistencies among the rights of competing creditors is frequently cited as one of the primary purposes of chapter 11."⁴⁴ My main point here is that Chapter 11 need *not* serve this

42. See Philippe Aghion et al., *Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849, 872 (1994).

43. See *supra* note 20 and accompanying text.

44. LoPucki, *supra* note 22, at 102 (citations omitted). See also Warren, *supra* note 32, at 474-77.

purpose. As I explained in my original Chameleon Equity paper, firms should be able to publicly bind themselves not to permit individual creditor collection.⁴⁵ Public notice of this commitment would also bind third parties and Chameleon Equity would prevent dismemberment, whatever the inconsistencies in the debtor firm's promises to investors. These inconsistencies certainly would arise, just as inconsistent claims among secured creditors arise under the current regime, and litigants would expend resources resolving the inconsistencies. But there is no reason to have a bankruptcy proceeding to resolve inconsistent claims. That is, if there is no collective action problem, an issue of inconsistent claims is not a bankruptcy issue.

It would be possible to go on in this way, identifying criticisms apparently applicable to Chameleon Equity and explaining that Chameleon Equity is flexible enough to mimic a supposed advantage of bankruptcy's solution to the collective action problem, and without all the costs of bankruptcy's collective process or of any other ex post restructuring. However, I hope the above examples adequately illustrate the general proposition that Chameleon Equity is flexible enough to mimic *any* bankruptcy advantage, and at less expense.

IV. A DIFFERENT VIEW OF BANKRUPTCY

There is, finally, the need to confess that my view of bankruptcy is not the only view. I have treated each bankruptcy benefit described above as the product of an implicit ex ante investors' bargain, and have argued that an *explicit* ex ante bargain, one that does not include ex post judicial intervention, better serves investors' collective interest. Contrary to my view, bankruptcy may be seen as a mechanism to alter initial contracts or to provide ex post adjustments that investors would not or could not provide ex ante.

Elizabeth Warren has been a leading voice in expressing that the Bankruptcy Code is, by design, a law intended to redistribute value so that corporate constituents other than high-priority claimants share in the value of an insolvent firm.⁴⁶ There is indeed substantial evidence that bankruptcy has a redistributive effect.⁴⁷ Warren argues that a contractual insolvency regime, such as Chameleon Equity, would sacrifice this redistributive

45. Adler, *supra* note 18, at 336-39.

46. See Warren, *supra* note 32, at 467-71.

47. See, e.g., Weiss, *supra* note 17.

tendency.

Warren is right, of course, that a contractual regime would frustrate the goal of legally imposed redistribution from high- to low-priority claimants. This is tautological. The question is whether such redistribution serves or disserves social policy.⁴⁸ It may be, for example, that society should redistribute wealth *ex post* from debt security holders to employees and trade creditors, who may have a noncontractual investment in the firms they serve. And bankruptcy reorganization may accomplish this by keeping alive firms that the creditors as a group would liquidate. But, as Baird noted in an earlier exchange with Warren, it is not clear why *bankruptcy* law should provide this benefit to employees and trade creditors.⁴⁹ Why, for example, should there not be rules prohibiting all firms from closing plants, firing employees, and discontinuing trade relationships? It seems wasteful to require a bankruptcy reorganization when government could directly provide special treatment of favored corporate constituents.

Similarly, I argued in my original Chameleon Equity paper that the law should provide nonconsensual claimants with highest priority, but should do so without disturbing a Chameleon Equity firm's essential character.⁵⁰ The idea is that nonconsensual claimants of a contractually established Chameleon Equity firm would, by law, take the firm's highest priority class. Each claimant would have the right to vote its claim if the class ever voted, but would lack individual collection rights.⁵¹ Warren also worries that nonconsensual creditors may suffer at the hands of investors, but she sees a solution in bankruptcy reorganization's distributive tendencies.⁵² Her solution to the problem of nonconsensual claimants is too limited and, given the costs of bankruptcy reorganization, wasteful.

There is another argument (alluded to in Part III above), also divorced from collective action, that bankruptcy reorganization is beneficial because of its *ex post* consequences. The supposed benefit is a product of judicial expertise. The Chameleon Equity structure would remove an insolvent firm from the supervision of a court, which may know what is good for a firm

48. In addition to bankruptcy redistribution's *ex post* effects, with which Warren is concerned, it has been argued that such redistribution enhances overall efficiency. I summarize and critique such arguments in Adler, *supra* note 20.

49. Compare Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987) with Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987).

50. Adler, *supra* note 18, at 338-40.

51. See *id.* at 339-40.

52. See Warren, *supra* note 32, at 472-74.

better than the investors that would be in control postinsolvency. Such removal could be inefficient. As Warren puts it, bankruptcy reorganization provides an opportunity for collective supervision, supported by the power of the court, to ensure that assets remain in place, that only ordinary business transactions occur, and that additional financing agreements and contract obligations are undertaken only after notice to the creditors and a hearing before the court. It imposes extensive disclosure obligations on the debtor, so that creditors can monitor the debtor and make more informed decisions than they could if the debtor were not in bankruptcy.⁵³

The essence of Warren's argument appears to be that court supervision improves the operation and enhances the value of a bankrupt firm. Consistent with this argument, one might imagine that a bankruptcy court could beneficially revise a Chameleon Equity firm's capital structure that appeared wise to the investors at the firm's inception, but appeared to be a burden at a time the firm became unable to satisfy its lowest priority fixed obligations. Assuming this is so, why have court supervision only of bankrupt firms? Perhaps we should set the bankruptcy bench loose on investment decisions and capital structures of the Fortune 500. Once again, even under the Herculean assumption that investors do or should value judicial intervention—firms do not, for example, voluntarily subject themselves to periodic disinterested control even though they may anticipate strategic conflict among investors—it is hard to see why government control over internal corporate affairs should be a *bankruptcy* issue.

IV. CONCLUSION

In *A World Without Bankruptcy*, Douglas Baird asks what I believe to be the appropriate question for analysis of any bankruptcy provision: Does the provision address a collective action problem? Provisions that do not likely are not properly part of bankruptcy law. Because a world without debt likely could efficiently eliminate the collective action problem itself, it seems no regulatory provision is properly part of bankruptcy law.

53. *Id.* at 475.

