

THROUGH CHAPTER 11 WITH GUN OR CAMERA, BUT PROBABLY NOT BOTH: A FIELD GUIDE

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If I have not seen farther than I do,
It is because giants were standing
on my shoulders.

I. INTRODUCTION

There are two lines of modern bankruptcy scholarship, sometimes mischaracterized as the “economic” and the “other.” The distinction is important, but the names are not quite right. The real distinction is between those who think that the bankruptcy process can be neatly modeled, and those who do not. Call them “clarifiers” and “complicators.” I offer these names for convenience only, and at the risk of seeming pejorative. I hope I will not be misunderstood here, because the fact is that I think both lines of endeavor have helped us to understand bankruptcy law. The clarifiers have been identified with economics—more precisely, with finance—because the clarifications they undertake to offer come from the genre of economics. But I think that this identification is more epiphenomenal than essential: I think it is perfectly conceivable that one might do “clarifying” scholarship from the standpoint of, say, an abstract model of justice in moral philosophy.

The “complicators” risk suffering more from the name I just gave them: here I refer to scholars who are not so much seeking actively to complicate, but rather resisting the clarification, insisting that an activity as alive as bankruptcy is simply not amenable to any conventional trope. Their numbers are diverse: they include allies as unlikely as Elizabeth Warren and David Gray Carlson; perhaps their dominant voice (if they have one) is Donald Korobkin. Their positive programs differ, and are not easily summarized; their negative program is perhaps best captured in Nietzsche’s

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jibe about "Egyptianism."¹

The purpose of this paper is to offer some clarification in the interest of complication. As much as I admire some of the law and economics scholarship, my sympathies are with those who believe that bankruptcy is, in the end, richer than its models. I think that the way to make this point is to try to specify some of the numberless tasks that bankruptcy is called upon to perform, coupled with some suggestions of their complications and ambiguities. What I offer here, then, is a typology—a field guide, of sorts—to show some of the various tasks that bankruptcy is called upon to perform, and how it undertakes to perform them. By clarifying things in this way, I hope to make it less clear that bankruptcy will reduce itself to a simple model.

Because it is the focal point of most recent discussion, I focus my attention on Chapter 11. But, as I will show, it is impossible to extricate Chapter 11 from its place in the Bankruptcy Code as a whole; hence, a number of my examples will necessarily derive from a number of other parts of the Bankruptcy Code.

II. THE "NATURE" OF BANKRUPTCY

As a preliminary matter, let me say a few words about what bankruptcy (as distinct from Chapter 11) "is." At the risk of repeating myself too often, my ultimate point is that bankruptcy "isn't" in any internally self-contained sense. But in order to make that point, I need to suggest some of the various overlapping meanings that the term may denote. To understand this point, consider these cases:

CASE 1A: Guillemot, an individual, owes \$800,000 to unsecured creditors. All debts were incurred at a time when he sincerely expected to pay them, and had good reason for this expectation. He has no prospect of any future earnings.

CASE 1B: Auklet is a corporation, formerly a manufacturer and distributor of widgets. Auklet has ceased operation and has no prospect of beginning anew. It has \$5 million in debts and perhaps \$1 million in assets—leftover inventory, forklift trucks, an unexpired, valuable long-term leasehold, customer lists, and so forth.

1. FRIEDRICH NIETZSCHE, *TWILIGHT OF THE IDOLS 1*, quoted in M. FOUCAULT, *LANGUAGE, COUNTERMEMORY, PRACTICE* 156 (1977), cited in David Gray Carlson, *Philosophy in Bankruptcy*, 85 *MICH. L. REV.* 1341, 1389 n.140 (1987).

CASE 1C: Vireo, an individual, operated as a broker. Over the years, he handled large quantities of money in a variety of complex transactions. Those who did business with him believe that he kept most of his accounts in his head. Lately he has not been meeting his obligations as they come due. Evidence (and rumors) about his difficulties abound. It appears that he is reducing inventory and turning his hard assets into cash. Some say that he has been concealing money via sham transactions. There is reason to believe that he is favoring some creditors over others.

CASE 1D: Flycatcher is a corporation actively engaged in the manufacture and sale of widgets. It owes \$5 million to creditors, all unsecured. It would be worth \$4 million if it could be sold as a going concern. The individual components would yield a total of only \$1.5 million in liquidation.

All four of these examples bear the marks of familiar bankruptcy cases. Yet their relationship to the bankruptcy process is more complex than may appear at first blush. Taking them in turn, Guillemot's case seems to represent the most typical case of all: an individual with debts beyond his capacity to repay, who will seek bankruptcy relief in order to get the bankruptcy discharge. Probably the vast majority of bankruptcy cases represent no more than this. Indeed, it may be that the power to give a discharge is the only thing really unique to the "bankruptcy power" conferred by the Constitution on Congress.² Yet if we take the long view, the discharge is not the most typical sort of bankruptcy, but the least. The discharge came late to the bankruptcy party. In its modern form, it arrived in American bankruptcy law only in 1898. Two hundred years ago, no one would have thought to take bankruptcy voluntarily as a form of relief.

Auklet suggests a more traditional use of the bankruptcy power: a mechanism for the "orderly" (whatever that means) collection and disposition of assets.³ It is readily conceivable that the managers (or the creditors) will decide that the best thing to do with the assets of Auklet is to put the firm under the control of the court, so that an independent trustee may collect the assets and distribute them to the creditors as their interests may appear. Yet such a result is not inevitable, either from the standpoint of the creditor or from that of the debtor. It is entirely conceivable, in principle, that the old managers will simply undertake the collection and distribution on their own initiative. Such a result may be cheaper for the

2. U.S. CONST. art. I, § 8, cl. 4.

3. I do not mean to suggest any antipathy to the idea of orderliness. My present point is only that it can mean many things, depending on the particular premises.

creditors who, if they trust the managers, may be delighted to avoid the extra expense of a bankruptcy proceeding. It may accommodate the managers, who may be delighted with the prospect of a few weeks' extra employment during the liquidation of the company.

Moreover, even if there is need for an independent third party to liquidate and distribute the estate, it is not inevitable that the third party be a bankruptcy trustee. Informal assignments for the benefit of creditors probably occur in all states, and are regulated (if lightly) in some. In particular cases, a state-law receiver may perform the same role.

One source of perplexity is the relationship between state and federal payout schemes. The Bankruptcy Code accords certain creditors priority in bankruptcy distribution. Many nonbankruptcy statutes, state and federal, define priorities for collective liquidations outside the bankruptcy court. These nonbankruptcy schemes present a conundrum. It is axiomatic that bankruptcy respects rights established under state law. Yet if bankruptcy carries over the state-law priority scheme, what exactly is the point of the bankruptcy? A number of courts have wrestled with this difficulty, seemingly without providing a full resolution.⁴

So, a bankruptcy is not a necessary precondition for an orderly distribution.⁵ As for the discharge aspect—with respect to Auklet, a discharge is neither necessary nor possible. It is not possible because the Bankruptcy Code prohibits a discharge for a liquidating corporation.⁶ It is not necessary because a corporation is a limited liability entity that receives its own “discharge” when it is wound up.

An added complication is that even if Auklet goes into bankruptcy, the creditors may prefer to leave existing management intact (so as to minimize expense) rather than to suffer the appointment of a trustee. They may be able to do so, but only under the pretense that the business is “reorganizing” rather than liquidating. This is so because the Code permits the debtor (i.e., the former managers) to remain in possession with the powers and

4. See, e.g., *Butner v. United States*, 440 U.S. 48, 51-57 (1979) (holding that state law, not federal rules of equity, is determinative of whether security interests in property extend to the rents and profits derived from that property); *In re Loretto Winery Ltd.*, 898 F.2d 715, 718-19 (9th Cir. 1990) (noting that federal bankruptcy law recognizes social, economic, or political policies that require deviation from a rule of equity and that it recognizes state statutory liens which meet certain criteria). See also Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain*, 91 YALE L.J. 857, 905-06 (1982) (commenting on the confusion surrounding the role of state rights in federal bankruptcy decisions).

5. Nor sufficient either, I suspect, but that is another story.

6. 11 U.S.C. §§ 727, 1141(d)(3) (1988).

obligations of a trustee—but only if the case is administered under Chapter 11, the reorganization chapter of the Code.⁷

The relevance of Vireo's case to the bankruptcy process is easy to demonstrate. On its face, this is precisely the case where creditors (and the sovereign) might want to deploy an independent officer to take charge of the debtor's affairs. Such an officer might be given the power to prevent the dissipation or concealment of assets, and to serve some principle of "equity" in distribution. In short, the officer would fulfill precisely the mandate of the traditional bankruptcy trustee. Yet it is worth noting that some or all of these processes may occur even if bankruptcy never intervenes. Many nonbankruptcy laws are designed to prevent the dissipation of assets. Laws prohibiting fraudulent transfers and bulk transfers are perhaps the most obvious. Laws restricting the payment of corporate dividends fall into the same class. Laws allowing for the sequestration of assets pending litigation, or for the examination of debtors or third parties, may serve the same function.

Conceding that nonbankruptcy devices may be sufficient to police against dissipation or wrongdoing, it is still commonly thought that the bankruptcy process is necessary to set aside preferences in the interest of "equitable distribution." Apparently, this is not quite right. California confers the power to avoid a preference on a state-law assignee.⁸ No court has held that a nonbankruptcy preference avoidance law is impermissible in the face of the constitutional bankruptcy power.

If the going-concern value exceeds the value in liquidation, as in Flycatcher's case, a somewhat more subtle problem is presented. At first blush, it would seem that all parties should agree that there are good reasons to preserve the going-concern value, even though the old residual owners will receive nothing. On the other hand, it is likely that individual creditors, left to their own devices, will be motivated to collect their claims piecemeal—and entirely possible that piecemeal liquidation by some creditors will destroy the going-concern values otherwise available to all. This is commonly supposed to be a good reason for filing a Chapter 11 case—that is, to get the protection of the automatic stay, preventing unilateral creditor action pending sale. This is indeed a good reason for filing a bankruptcy, but it does not follow that the case must be filed in Chapter 11.⁹

7. See discussion *infra* pp. 892-93.

8. CAL. CIV. CODE § 3439.07 (West 1986).

9. See discussion of Case 3A *infra* pp. 892-93.

All of these cases, then, make plausible claims on a system of bankruptcy administration, although none makes a really convincing claim to be the "essence" of bankruptcy. The plot thickens when one recognizes that these various purposes may overlap, interweave, and sometimes conflict. It is easy to imagine, for example, an individual who needs the protection of a discharge, but who serves also as the repository of certain going-concern values. And it is entirely conceivable that this individual may have dissipated or concealed estate property in a manner that thoroughly frustrates creditors. Yet, despite their animosities, the creditors may be impelled to work with him for some supposed larger good: such is the healing power of money. Indeed, treating bankruptcy as a form of theater, the most compelling performances may occur when the parties cordially despise each other, yet understand that they must work together anyway.¹⁰

It is possible to identify any number of places where this conflation of motives and purposes may distort the law. We leave discussion of these until we have examined some of the internal tensions in Chapter 11 itself.

III. CHAPTER 11

A. *The Paradigm Case*

Consider, first, what may be the model of a Chapter 11 bankruptcy.

CASE 2: Veery, Inc. is the world's largest maker of mandolin picks. It owes \$2.7 million to OldBank, secured by Blackacre, on which its factory is located. It owes \$4 million to LoanCo, secured by inventory and receivables. It owes \$2 million to a variety of unsecured trade creditors. Blackacre would sell for \$3.5 million. The inventory and receivables carry a book value of \$3.5 million. Veery always kept current on all of its claims until last year, when a series of calamities caused its operating cash flow to fall. Cash flow has since risen to historic levels, but the episode left Veery with an extraordinary backlog of debt. Veery engaged in several ad hoc devices to continue operating under the burden. It slowed payment on trade debt (from 30 days to 45 days, then to 60 days). On occasion it paid particularly importunate creditors to preserve the continuation of necessary supply lines, or to prevent levy on critical assets. In a few cases, it was able to make

10. In this vein, a number of observers have remarked on the comparison to, or contrast with, divorce. As a practical matter, it probably would be a convenience for the client if the divorce court were built next door to the Chapter 13 court. But in both cases, the task is to allocate assets and blame on a substrate of disappointment. An unstudied aspect of the relationship concerns the place of involuntary bankruptcy. See *infra* pp. 893-94 & n.21.

deals with individual creditors, scaling down old obligations in exchange for ready cash.

Veery's contract with LoanCo provides that LoanCo will lend no more than eighty percent of the book value of the inventory and receivables. Veery has been out of ratio for months. LoanCo let things slide at first, knowing that it had to show some flexibility if it intended to preserve the customer relationship, and if it expected to get full value out of the collateral (see below). Veery is certain, however, that LoanCo will call the loan soon. About two months ago, Veery called an informal meeting of creditors and proposed a compromise: for all outstanding unsecured debt, it would pay forty cents on the dollar now with the balance paid in three annual installments of twenty cents on the dollar per year. To all appearances, a large number of Veery's creditors want to take the deal, but there is some vigorous dissent.

This case, if any, bears the earmarks of an old-fashioned "paradigm Chapter 11 bankruptcy." The debtor is a moderate-sized firm. In terms of current cash flow, the debtor seems able to operate without difficulty. The problem arises because of an (allegedly) isolated episode of misfortune. The burden seems to have fallen most harshly on "the trade"—unsecured creditors, typically suppliers.¹¹

To understand this case, it is useful to begin by understanding that everyone has motivations that may not be obvious to the untutored eye. For example, the debtor's strongest card is the threat of suicide—the threat of going down with guns blazing and flags flying, taking the loot with it to Davey Jones' locker.¹² The business is almost certainly worth more as a going concern than in liquidation. Unsecured creditors may thus regard it as worth their while to accept a partial settlement rather than to force termination of the business. The same reasoning may also apply to LoanCo, even though LoanCo is nominally secured: inventory and receivables evaporate fastest in the liquidation of a business of this sort. Indeed, LoanCo may stand not only as the largest secured creditor of the

11. A lawyer I know, with more compassion than may be apparent at first blush, calls them "the poor bums in polyester." His point is helpful in understanding bankruptcy negotiation. The point is that the trade creditors are typically far less likely to be arriving in Porsches, wearing Brooks Brothers or Gucci, and far less likely to be sending their kids to fancy Eastern colleges, than anyone else in the room—their own lawyers, their adversaries' lawyers, the bankers, or even, as if adding insult to injury, the representatives of the debtor itself. Yet, it is the trade creditors who are being invited to make a large voluntary surrender of their legal rights.

12. I have heard Elizabeth Warren describe it as a case where the creditor is trying to push the debtor off a twenty-story building while the debtor is threatening to jump.

business, but also as the largest unsecured creditor. LoanCo may even find it in its interest to “lend into the problem”—seemingly throwing good money after bad—in order to salvage its position.¹³ OldBank, on the other hand, appears to be fully secured and indeed may not even be pressing hard for payment, because it knows that there is enough collateral to satisfy its claim.

Veery’s case makes a particularly appealing argument in favor of Chapter 11, for two overlapping reasons. First, the facts suggest the kind of case in which “reasonable people” (whoever they are) might well want to reach agreement to preserve going-concern values in any event. Second, there is no specific suggestion of moral culpability here—the kind of culpability that might argue in favor of liquidation as a kind of “punishment.” Taken together, these facts argue strongly for some sort of collective settlement, whereby the debts are reduced and the business continues under the old residual equity ownership.

The motivations for a collective settlement are so powerful that it may be possible to reach a settlement out of court. Yet, there are many factors that impel the case towards bankruptcy jurisdiction. Most, if not all, involve the so-called “holdout problem.” That is, out of court, there are any number of ways in which a dissenting minority can scotch the wishes of a unified majority. Chapter 11 provides the structure to impose an allocation that state law does not afford. The most obvious example may be the mandate to impose “equity of distribution” on unsecured creditors, supplanting the “grab law” of state collection procedures.¹⁴ Although this might be the most obvious motive, it is far from the most important. Far more interesting, perhaps, are the cases where the dissenter, by unilateral action, can scotch the entire effort (as, for example, by levying on the hypothetical essential device that the factory needs to make the firm go), or the cases where the holdout, by virtue of being a holdout, can put herself in a position to be bought off by the debtor.

13. The skill involved here is what passes under the name of “workout management,” or, more likely, something like “special procedures” or some other suitably opaque name for the management of troubled debt. The place of good workout management is highly equivocal in bank hierarchy; one does not want to admit that one needs good workout managers, and yet possession of such skills may be the triumph of the banker’s craft. One thinks of the old Soviet Union boasting that it had the best AIDS treatment facilities in the world, but no AIDS patients. “It doesn’t take a genius to loan \$30 million,” as the saying goes, “but it may take a genius to collect it.”

14. I am aware, of course, that there is an immense body of literature surrounding the nature and meaning of the concept of fairness in bankruptcy jurisdiction. But I think the street language is sufficient for my current purpose.

The Bankruptcy Code provides devices, not normally available at state law, to deal with holdout problems of this sort. For example, the automatic stay of § 362 embargoes unilateral action,¹⁵ while the confirmation provisions of Chapter 11 provide for imposing the plan on a dissenting minority.¹⁶

But there is difficulty with the suggestion that Chapter 11 merely replicates what “any reasonable person” would want. It tends to make truth a matter of majority vote, and to obscure any discussion of what sorts of reasons might be proper for dissenting from a particular course of action. To take just one instance, it is likely that some unsecured creditors need the debtor as a continuing customer, while others do not. Those who need the debtor may be willing to sacrifice far more of their past claim than those that do not. Dissent under these circumstances might be found “improper” under some general principle or other, but it can hardly qualify as “unreasonable.” Matters of this sort tend to sort themselves out, if at all, in debates over classification.

Turning to the matter of “culpability,” there are a variety of complications. For instance, the above story was told as if the misfortunes landed on the debtor out of the sky, unforeseeable and unpreventable. This is surely the way the old managers may tell the story, and it may be true. However, prudent creditors will scrutinize this version. Indeed, their views as to continuation may very well depend on whether or not they believe that the debtor is part of the solution or part of the problem. And here a new set of complications arises, for the very idea of “culpability” needs unpacking. It may be that the old managers, though well-intentioned, were “the cause” of the problem because of their mismanagement. Or it may be that they were scoundrels or charlatans. The creditor’s calculus may differ markedly depending on which way he interprets culpability in the particular case. Ironically, the creditor may be more motivated to work with a “manageable scoundrel”—e.g., by putting in an independent controller or CEO—than with a well-meaning incompetent.

But there is a greater difficulty with this “paradigm case,” and that is whether any lawyer now living has ever actually seen it. Perhaps some

15. 11 U.S.C. § 362 (1988). Consistent with the general theme being developed here, it is worth noting that the automatic stay serves two rather different purposes. One is to protect the debtor and her “fresh start.” The other is to protect the estate and its property. On principles set forth above, it is easy to imagine cases that implicate one of these principles but not the other.

16. 11 U.S.C. § 1129(a)(7) (1988). One result is, of course, that a creditor who wants to control a case may do so by buying up just enough debt to ensure that she cannot be voted down.

have. There are certainly no precise records classifying Chapter 11 bankruptcies on principles like those set down here. However, anecdotal evidence suggests that the paradigm case is not only rare but may well be entirely nonexistent. To get a better fix on Chapter 11, it is necessary to review a number of other cases, beginning with the next set.

B. The Meaning of "Reorganization"

A central difficulty in devising a core meaning for Chapter 11 concerns the concept of "reorganization." The drafters do not define it. Their failure to do so seems to be intentional, and that may have been a wise decision. Compare these two cases:

CASE 3A: Bobolink is a retail clothing dealer whose products have gone out of fashion. He is not able to cover ordinary operating expenses, to say nothing of debt service. Easter is approaching and creditors generally concede that they would get more money if the business continues to operate at retail through the upcoming Easter season. A substantial body of creditors agree that present management, though it has lost its fashion touch, is otherwise neither incompetent nor dishonest. A substantial majority of creditors agree to advance new credit to permit the debtor to operate through the Easter season. The creditors intend that the debtor will collect as much as it can through retail sales and liquidate the remaining assets by any means possible thereafter.

CASE 3B: Meadowlark is a seemingly prosperous retailer of health foods. One day a delivery person arrives to find the store padlocked. Inquiry discloses that existing owners have simply abandoned the property and disappeared. Nonetheless, suppliers, who know each other and establish contact easily, determine that Meadowlark is a viable business that will yield more in operation than in liquidation. They therefore agree to seek a means to continue the operations with creditors enjoying their ordinary priority and the equity interest, if any, remaining in the old equity owners.

Each of these cases has a good claim on the jurisdiction of the bankruptcy court, yet their positions seem almost the opposite of what the drafters envisioned. Bobolink clearly offers an opportunity for a "going-concern liquidation." Bankruptcy will provide a mechanism for keeping creditors at bay while the liquidation goes forward. In terms of ordinary bankruptcy parlance, we think of liquidation as the province of Chapter 7, where the trustee is enjoined to collect assets, to reduce them to cash, and

to distribute them to creditors as their interests may appear.¹⁷ Yet, liquidation is authorized in Chapter 11.¹⁸ And Chapter 11 has at least two potential advantages over Chapter 7 in this case. Initially, this is a case that requires the business to continue to operate (at least for a time); operation is the rule in Chapter 11, while in Chapter 7 it is the exception.¹⁹ Probably more importantly, the Code requires a trustee in every Chapter 7 case, while in Chapter 11, the norm is that the debtor remains in possession, with the powers and obligations of a trustee.²⁰ While there is a good deal of analytical uncertainty over the precise role of the debtor-in-possession (DIP), this seems to be a case where retaining the DIP is in the interest of all.

Meadowlark is, in a sense, just the reverse: a case where the old equity owners seem to have abandoned their position, even though they may have an interest in the continued operation of the business. Ordinarily, in a business of this sort, if there were any need for a bankruptcy, the DIP would continue to operate the business pending its sale as a going concern. Here, a DIP is impossible, yet a going-concern sale seems to make the most sense. Thus, the appropriate course seems to be to appoint a trustee and to let her sell the property as is, distributing proceeds to claimants as their interests may appear. Such a scenario is possible under Chapter 11—indeed, Chapter 11 pretty clearly foresees it. Yet on the facts of this case, it will perhaps be easier in Chapter 7.

Thus, the distinction between Chapters 7 and 11 seems to be a blur. We think of Chapter 7 as the “liquidation” chapter, and Chapter 11 as the chapter for the preservation of the going concern. But liquidation is possible in Chapter 11, and there is no barrier against using Chapter 7 to preserve the values of the going concern. About the only (relevant) thing that can be done in Chapter 11 but cannot be done in Chapter 7 is the satisfaction of creditor claims by the issuance of stock. But even this may be less of a barrier than meets the eye: if the old creditors really want the business in Chapter 7, they may very well be able to reach it by forming a company to buy the property from the trustee.

Indeed, Bobolink may be that rarest of all bankruptcy birds—a case where an involuntary bankruptcy makes sense. There is an irony here: there was a time when there was no such thing as a voluntary bankruptcy,

17. 11 U.S.C. § 704 (1988).

18. 11 U.S.C. § 1123(b)(4) (1988).

19. 11 U.S.C. §§ 1108, 721 (1988).

20. 11 U.S.C. §§ 1107, 701-02 (1988).

and one would no more expect the debtor to volunteer for bankruptcy than one would expect him to volunteer for a full IRS field audit or a root canal. As virtually everyone knows, voluntary bankruptcy is the norm today, and involuntary the exception. Indeed, the arguments against an involuntary bankruptcy are so compelling that the creditor in any case needs to think two or three times before proceeding at all.²¹

C. *Some Variations*

This sketch merely begins to suggest the possibilities for Chapter 11, of course. Without any pretense of being exhaustive, here are a few others:

CASE 4A: Turnstone, Inc. is the world's best-known maker of cheeseburger-shaped nightlights. Although the field is competitive, Turnstone controls a dominant market share. Sales and earnings grew briskly for several years, but about a year ago Bufflehead, a competitor, developed a new version that threatened to strip away Turnstone's market lead. Since then, Turnstone's inventory has begun to pile up on the shelves, and Turnstone has started to lose money on current operations. As its cash supply shrinks, it has tried harder and harder to hang onto money for research and development. About three weeks ago, Turnstone quit paying all but its most importunate trade creditors. Turnstone is current on its inventory and receivables line to LoanCo, but LoanCo has declared the collateral insufficient and has indicated that it will call the loan. Management is convinced that it can get back into the game if it receives a six-month grace period and a slug of new cash. Goshawk, an investor who has never been involved with Turnstone, is willing to lend the money if she can get the right security.

Turnstone bears a superficial resemblance to Veery in Case 2. In both cases, the going-concern values probably exceed the liquidation values, and in each case there may be a need for creditor coordination. The big difference is that in Turnstone, the debtor's troubles are not the result of some exogenous past event. On the contrary, Turnstone's success, if any, depends on its getting new money for the future. The most important contribution of the Bankruptcy Code will be the power it confers on the court to authorize "super priority" lending. Thus, with the court's approval, the debtor may be able to acquire new capital from Goshawk in exchange for a claim equal or superior to all existing debt.

21. My guess is that a disproportionate number of involuntary bankruptcy cases are initiated by one ex-spouse against the other. While there may be palpable issues at stake, one surmises that these cases often involve litigants who need conflict as a form of intimacy, like King Pellinore and the Questing Beast. War, says Clausewitz, is diplomacy by other means. The same may hold for the relation between bankruptcy and divorce.

CASE 4B: Titmouse runs a small factory in which it makes silk purses out of sows' ears. It owes \$3 million to LoanCo, secured by inventory and receivables. It owes \$500,000 to unsecured creditors. It conducts its business on leased premises; the lease is "at the market," i.e., neither a benefit nor a burden to the estate. It purchased all of its operating equipment from vendors who secured their sales with purchase money security interests. In all such cases, the value of the collateral equals the value of the loan. Titmouse would sell for about \$2.5 million as a going concern, but the liquidation value is no more than \$1 million.

Titmouse is another case where the solution is obvious—sell the business as a going concern. Once again, this is a deal that might be consummated outside of bankruptcy. But again, it is possible that bankruptcy will provide for a "cleaner deal"—staying unilateral creditor action while the deal is progressing, and providing for a full accounting of the disposition of proceeds. As with the earlier cases, there is no inherent reason why the bankruptcy has to be a Chapter 11, although Chapter 11 does make it easy to continue the business and permits the debtor to continue in possession, saving the expense of a trustee.

The most notable distinction between this case and the earlier cases is that the only apparent beneficiary of a bankruptcy filing is the secured creditor, because (if the numbers are accurate) there will not be anything remaining after the sale for unsecured creditors. Under a traditional view, this result argues against deploying bankruptcy jurisdiction in this case. But this argument misses an important point: even though unsecured creditors may receive nothing in this case, the mechanism provides them with something that they do not ordinarily have outside bankruptcy—the right to notice and the opportunity to be heard on important issues. This ensures, at least, that unsecured creditors will have the chance to test the assertions of value as they are alleged in the hypothetical. On a somewhat more sinister note, the use of bankruptcy may offer a certain amount of "nuisance leverage," impelling the secured creditor to pay off the unsecureds in order to make them go away.

Variants of this case may arise when the bankruptcy forum provides a more convenient arena than state law for secured creditors seeking to liquidate their claims. For example, the pervasive jurisdiction of the bankruptcy court may make it easier to collect accounts receivable than do ordinary state processes.

CASE 4C: Greenshank is a limited partnership. The general partner is a corporation. The limited partners bought their interests under pre-1986 tax

law, through which they acquired the right to deductions that would shield other income. The only asset is an apartment house, Blackacre. Greenshank acquired the apartment house for \$4.2 million with \$600,000 down and a mortgage for twenty years at ten percent. When it was no longer able to meet payments out of cash flow, Greenshank filed for relief under Chapter 11. The principal balance remaining on the mortgage was \$3.8 million. An independent appraiser says that the parties might be able to sell the property for \$3.2 million if they aggressively market it for six months.

In the past year or so, this type of case may have generated the most discussion and (in terms of court and attorney time) perhaps also the most litigation of all Chapter 11 cases. Although the property is obviously insolvent, the real problem may not be apparent to the untutored eye. That is, if the property goes to foreclosure, the investors lose not only their residual claim, but also the substantial tax deductions they have enjoyed over the years. They also face the prospect of “rollup liability”: they have to raise the money to pay taxes after the asset is gone.

Although it is easy to understand why the limited partners want protection in this case, the fact is that these debtors have perhaps the least persuasive claim on the jurisdiction of the bankruptcy court. I have discussed this case at length elsewhere, so I will not go into detail here.²² But the point is that these facts present none of the traditional justifications for a bankruptcy filing. Thus, there is no need for a discharge (the limited partnership cannot get a discharge in any event); there is no need for creditor orchestration (the senior secured claim alone exceeds the asset value); and there is no need to preserve a going-concern value (the apartment house will be an apartment house in any event). Indeed, one of the principal embarrassments to debtor-proponents in cases of this sort is their difficulty in creating enough of a semblance of creditor grievance to create the appearance of a bankruptcy case.²³

D. The Ambiguity of the “Personal”

Even taking all of this into account, there is still greater difficulty in giving a core meaning to “reorganization.” This difficulty is specifically

22. See John D. Ayer, *Bankruptcy as an Essentially Contested Concept: The Case of the One-Asset Case*, 44 S.C. L. REV. 863 (1993).

23. See, e.g., *In re Windsor on the River Associates*, 24 Bankr. Ct. Dec. (CRR) 1237 (1993). See the exchange between Bruce A. Markell and me in *Issues in Litigation*, NORTON BANKR. L. ADVISER, Dec. 1993, at 1-3.

evident in the case of the closely held family corporation. Consider this case:

CASE 5: Assume the facts in any of the preceding cases and add the fact that the company president is Prez, who also owns sixty percent of the stock, with the balance being held by members of his immediate family. Prez personally guaranteed the debt of the lead secured creditor, and he is responsible by statute for certain back taxes and unpaid wages.

Even though everything else remains the same, the presence of an owner-manager almost certainly changes the dynamics of the case from the standpoint of both debtor and creditor. It is inevitable that the interests of Prez (and perhaps the interests of other insider-shareholders) will conflict with the interests of ordinary unsecured creditors in the case. Prez wants to make sure that the secured claim gets paid, along with the back taxes and unpaid wages (because he is personally liable for those claims), but he does not have nearly the same motivation to protect the unsecureds (because he is protected by the corporate veil). Under the circumstances, it seems that the inevitable course would be to make sure that Prez had nothing to do with the case after filing.

Remarkably, just the opposite seems to be the case. Again, it is hard to find precise data. But there is every reason to believe that most closely held corporate bankruptcies involve “differential debt” of some sort. Yet, the appointment of a trustee is not even remotely typical in bankruptcy cases: far more commonly, the “debtor” (which is to say, Prez) remains in position with the obligations (as the statute provides) of a trustee. It is easy to get a discussion going regarding whether this modality is within the “spirit” of bankruptcy law.

A case can easily be made for either side. On its face Chapter 11 treats the retention of the DIP as the “rule,” subject to variance “for cause.” And a good case can be made that the rule providing for the retention of the DIP is designed only to protect creditors—i.e., by obviating the need for extra cost and expense when the debtor can competently manage its own affairs. But nothing in the Code suggests that it is so limited; rather, the Code’s definition of “cause” is terminally opaque.²⁴ The necessary inference is that the drafters intended for the distinction to be vague.

Accordingly, courts have shown understandable ambivalence about whether and to what extent the DIP is really just a substitute for the trustee,

24. 11 U.S.C. § 1104(a)(1) (1988).

and to what extent a different sort of creature. The issue appears in sharp relief in the matter of avoiding powers. There is a two-year statute of limitations within which a trustee must bring preference actions. Suppose the case begins with a DIP, and a trustee is appointed later. The question arises—does the two-year statute begin again, or does the trustee's time include the DIP's time? One can approach the issue (as courts most often do) as a problem of statutory interpretation; indeed, more careful drafting could have resolved the issue long ago. However, this approach seems to be based on a misunderstanding. Suppose, instead of a trustee succeeding a DIP, the case was one in which a trustee succeeded another trustee. It is almost inconceivable that it would occur to anyone to argue that the statute of limitations, on the second appointment, begins running anew. The reason it becomes an issue in the DIP-trustee case is that everyone recognizes that the DIP is not likely to pursue voidable transfers alertly, because so many of these transfers involve some sort of collusion between the transferee and the person who now speaks for the DIP.

IV. OPERATING IN CHAPTER 11

A. The Polycentricity of the "Plan"

The foregoing suggests some of the limitations of trying to develop a core definition for Chapter 11. It is possible to throw more light on the problem by considering just how a "reorganization" might work itself out. Consider this case:

CASE 6A: Ptarmigan makes widgets, which it sells for \$100 per unit. Variable costs (supplies, wages, etc.) are \$60 per unit. There is a mortgage on its factory for \$40 million at ten percent interest. Ptarmigan has been selling 80,000 units per year. Ptarmigan estimates that it needs \$5 million for deferred maintenance, product upgrade, and the like. With the extra money, it believes that it could increase production to 115,000 units per year.

Although some things are clear from this brief statement, the case is more important for what it leaves out rather than for what it says. As it stands, Ptarmigan is losing money on every sale: the firm needs \$4 million per year for debt service alone. At the current price, it would need to sell 100,000 units per year just to break even.²⁵ Add another \$5 million in

25. 100,000 units at \$100 per unit would provide \$10 million in gross income, of which \$4 million would be used for debt service. The balance would go for operating costs.

debt and the break-even point rises to 112,500 units per year.²⁶ At this level of production, the project would seem to be modestly profitable.²⁷

This is clear enough, but everything else is open to question. Will the lender—any lender—be willing to provide the \$5 million capital infusion? That depends on the lender's appraisal of the probable outcomes, which are never as certain as they appear in this kind of hypothetical. If there is no infusion of new capital, something has to give. Three choices present themselves: (1) raise prices (to \$125 per unit);²⁸ (2) lower variable costs; or (3) reduce debt service. Price policy is within the unilateral control of Ptarmigan, so it does not normally become a part of the bankruptcy negotiation.²⁹ That leaves only two choices—reduce variable costs and/or reduce debt service. In practice, a battle often arises between “the employees” and “the banks,” each fighting for a share of a necessarily limited cash flow. Stated this starkly, it may appear that the banks have a natural (if perhaps unfair) advantage, because their claims are “on the balance sheet,” while the employees, however much they may depend on the debtor for continuing sustenance, hold claims that appear—transitorily—only “on the income statement.”

There may be something to this for rhetorical purposes, but I think there is less to it than meets the eye. What counts for both employees and banks is a term that does not appear anywhere in the accounting documents—the “opportunity cost,” the question of what the parties could do with their inputs if they did not have the present project.³⁰ Thus, suppose that the bank could not liquidate the plant at foreclosure for more than \$30 million.

26. That is: $100(x) = \$4.5 \text{ million} + 60(x)$, so $x = 112,500$.

27. Since Ptarmigan must continue to pay variable costs regardless of how many units it produces, its net cash flow after debt service would be $2,500 \times \$40 = \$100,000$. If 10% is the required rate of return, then the capitalized value of this income stream is \$1 million. All of this assumes that the inputs are accurately priced; but see the discussion of opportunity cost *infra* note 30 and accompanying text.

28. $\$10 \text{ million} \div 80,000 = \125 . This assumes that you can raise prices without losing demand. Baldly stated, this is doubtful. But according to standard economic lore, if Ptarmigan is a “price-seeker” rather than a “price-taker,” there is no reason in principle to assume that the price given in the problem maximizes income; the maximizing price may be higher or lower than \$100.

29. This is not to say that prices are irrelevant to the bankruptcy process; think of the bankruptcy-driven airline fare wars. My only point is that pricing does not occupy the same primacy in the bankruptcy debate.

30. Just as an aside, I speculate that the notion of opportunity cost may be the single most important concept in the development of modern finance, at least as it presents itself in law. It underlies the Coase Theorem, well established as the single most important rhetorical trope. And it is the principal distinction between the lore of modern finance (on the one hand) and traditional accounting (on the other). The problem becomes important for lawyers when they try to cope with the conflicting insights of these two communities.

Then it makes sense to continue with the present project, even if it means scaling down the implied capital value, as long as the resultant value exceeds \$30 million. Similarly, the employees' attitude may well depend on what other alternatives they have if this business fails.

The preceding observation is readily apparent if one reflects on some of the major bankruptcies of the 1980s. Some cases—Campeau is perhaps the most obvious example—seem to have been the result of nothing more than absurd overleveraging, where a balance sheet adjustment left behind a functional, solvent business. Other cases—Continental I is the paradigm—were driven by the income statement, where the case was resolved on the backs of the employees. Still other cases—Wheeling Pitt is perhaps notorious here—seem to have presented an instance of a state-of-the-art plant (with attendant balance sheet liabilities) and a costly, inefficient labor force, both of which had to be scaled down in order for the business to survive.

For the sake of simplicity, I cast this as a conflict between capital and labor. But the model fits other cases as well. For labor, substitute the suppliers—the “credit surfers,” (to use Lynn LoPucki's apt phrase) who ride from cycle to cycle on the waves of unsecured credit, always behind the senior secured debt, often the *de facto* coventurers with the debtor, a kind of quasi-equity.

B. “More Time”

As judge's jobs go, there is good reason to believe that the bankruptcy judge's job, taken day for day, is one of the most interesting. Most of the sheer dreariness takes place in the clerk's office and never comes to the judge's attention. There are none of the gut-wrenching, soul-wrenching personal issues that might be found in, say, domestic relations or criminal sentencing. There are, as the saying goes, “no problems that money won't solve.” There is none of the tedium that must result from dealing, for example, with the same drunk driving case, or auto accident, or drug crime day in and day out.

In an important paper, Richard Levin put his finger on one good reason why this is so.³¹ Levin pointed out that the core job of the bankruptcy judge is prospective, not retrospective. She is recurrently called on to make an estimate of whether and when a particular debtor can be restored to

31. Richard B. Levin, *Towards a Model of Bankruptcy Administration*, 44 S.C. L. REV. 963 (1993).

solvency. This necessarily involves her in a universe of evidence and conceptual structure well beyond that which confronts the ordinary judge. One can make too much of this, of course: all judges deal with the future, as well as the past, and some do so a lot. However, it is doubtful that any judge confronts the future so much in her regular work.

Why is the bankruptcy judge so involved in the future? The answer is straightforward: the debtor always gains from more time. If the value of the assets goes down, she only loses what she has. If they go up, her return is potentially infinite. It is easy to formalize this point. As many observers have noted, the position of the residuary equity owners in a leveraged corporation is a call option, with the payoff value of the debt serving as the strike price.³² A corollary point, also demonstrable as a matter of option theory, is that the call option holder also gains value from an increase in volatility. The combined teaching of these points is that the debtor always has a motivation to take the assets and run another risk. The basics of this intuition are clear to anyone who spends much time around the bankruptcy court. The conventional formulation is that to let the debtor continue in business after bankruptcy is, in effect, “gambling with other people’s money.” I think that there is an element of truth in this formulation, but it is sufficiently limited so as to be substantially misleading. To explore the point, consider the following example:

CASE 6B: Towhee, Inc. is a debtor in a Chapter 11 case. The only asset is \$10 in the bank. The trustee can invest the money in any one of three projects (A, B, and C), each of which has two possible returns, with a fifty percent chance of each return.³³ The probability-weighted³⁴ expected returns (gross present values) are as follows:

32. The general analytics of option pricing, and the implications for residuary equity, can be found in any standard textbook on corporate finance. *See, e.g.*, RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* (1981). The mirror image of this “equity option” problem arises when the equity owner tries to scale down the secured claim as he may be permitted to do under Chapter 11, *see* 11 U.S.C. § 1129 (1988), but not under Chapter 7, *see* *Dewsnup v. Timm*, 112 S. Ct. 773 (1992), nor under Chapter 13, *id.*

33. The binomial-return model seems “too simple,” but it is no worse than any other stylized model. If the binomial model works, then there is every reason to infer that the same would hold true of a continuous probability distribution. Compare the treatment of options under the binomial option pricing model and under the Black-Scholes option pricing formula, discussed in BREALEY & MYERS, *supra* note 32, at 438-41.

34. Let me dispose of a technicality here. It is an axiom that creditor-investors will prefer less risk to more and demand compensation for bearing increased risk. But for present purposes, it is perfectly possible to treat the probability-weighted sum as a certainty equivalent—i.e., a present value in which the sums have already been discounted for risk.

$$\text{Project A} = 0.5(\$45) + 0.5(\$55) = \$50;$$

$$\text{Project B} = 0.5(0) + 0.5(\$120) = \$60;$$

$$\text{Project C} = 0.5(\$10) + 0.5(\$80) = \$45.$$

Suppose that the debts equal \$75. As a matter of total probability-weighting, the debtor is insolvent in any event, which would suggest that the assets “belong to” the creditors. But until the hammer has fallen, making the transfer final, the picture appears more complicated. To see how this can be, consider the differential payouts for each of the two parties, equity and debt. First, here are the probability-weighted values of the prospective returns to debt:

$$\text{Project A} = \$50 \text{ (just as in the earlier case);}$$

$$\text{Project B} = 0.5(0) + 0.5(\$75) = \$37.50;$$

$$\text{Project C} = 0.5(\$10) + 0.5(\$75) = \$42.50.$$

And now, to equity:

$$\text{Project A} = 0;$$

$$\text{Project B} = 0.5(0) + 0.5(\$45) = \$22.50;$$

$$\text{Project C} = 0.5(0) + 0.5(\$5) = \$2.50.$$

To understand the implications of these numbers, first consider the case where the only available choices are A and C. Debt will clearly prefer A over C because it has the higher probability-weighted value, measured either from the standpoint of debt alone (\$50 over \$42.50), or from the standpoint of the assets of the firm taken as a whole (\$50 over \$45). Equity, of course, will favor C over A, because that is the only project under which it has any chance of recovery.

In a conventional Chapter 11 scenario, chances are that the court will side with debt rather than equity, ruling that equity’s rights will be cut off, and this might well be the right decision. But it is one thing to identify the decision, and quite another to name the reason. If the court decides that equity has no rights because (as is so often the grounds of decision) equity has no “property,” or because (identically) the property “belongs” to debt, then it is being circular: the plaintiff wins because he has property, and has property because he wins. Equity does have a definable interest—the contingent upside. Whether it will be permitted to assert or vindicate that interest is a separate matter. If the court decides that creditors win because, e.g., a contractual or statutory termination has expired, then the court may or may not be correct, but at least it is being coherent.

But suppose that, instead of being presented with A and C, the court is

presented with A and B. It seems to me that these facts present quite a different problem. Once again, of course, debt will favor Project A, the less volatile alternative and the one offering the creditors the higher return. Meanwhile, equity, as the holder of an out-of-the-money option, will readily prefer the more volatile B, which is the only one that gives it any chance of recovery.

The difficulty is that this time, the more volatile project is the more valuable one, not merely from the standpoint of equity but also from the standpoint of the assets taken as a whole. If the court decides for creditors in this case, it must recognize that it is doing so to satisfy the creditors' taste for risk aversion at the expense of the values of the asset pool as a whole.³⁵

If this instance seems trivial or uninteresting, consider the case where the debts are not \$75, but \$55. In this case, the relevant payoffs are as follows, first for debt:

$$\text{Project A} = 0.5(\$45) + 0.5(\$55) = \$50;$$

$$\text{Project B} = 0.5(0) + 0.5(\$55) = \$27.50;$$

$$\text{Project C} = 0.5(\$10) + 0.5(\$60) = \$35.$$

And for equity:

$$\text{Project A} = \$0;$$

$$\text{Project B} = 0.5(0) + 0.5(\$65) = \$32.50;$$

$$\text{Project C} = 0.5(0) + 0.5(\$20) = \$10.$$

As between A and C, creditors will prefer A, and the court is likely to go along with them, for all the same reasons. As between A and B, creditors will again favor A and equity will favor B, but with a difficulty—if the choice is B, then the company is solvent in the balance sheet sense (assets > liabilities). Under standard rhetoric, if the court favors A over B, it is, in effect, permitting the creditors to gamble with the debtor's money, rather than the other way around. The difficulty here may lie in the definition of solvency: we treat solvency as if it were a "snapshot"; either the debtor is solvent, or she is not. Numbers like those in this

35. Here is a complication. The cost to creditors in shifting from A to B is $\$50 - \$37.50 = \$12.50$. But the gain to equity is $\$22.50 - \$0 = \$22.50$. Thus, if the initial position is A, then it is rational for equity to pay debt any price up to \$22.50 to induce debt to shift from A to B. And at any price above \$12.50, it is rational for debt to take the inducement. The spread ($\$22.50 - \12.50) represents the "decision space" between two indifference curves where there is room for a Pareto-maximizing exchange. The numbers seem right, but I cannot identify any actual case where this logic seems to have been a factor.

example make it clear that solvency is perhaps better understood as a continuum, although nothing in the law allows this kind of choice.

V. CONCLUSION

This paper could be a lot longer. There are many other shadowy distinctions in bankruptcy law—boundaries that are at least intricate, and at most permanently contested. Some of them have been written about at length elsewhere. For example, in a series of articles, I explored the nondistinction between “security interest” and “lease,” noting, *inter alia*, the anomalous way in which the distinction plays out in bankruptcy court.³⁶ David Gray Carlson has written an important article on the distinction (if there is one) between “contract” and “rule” in the reorganization process—a “contract” being something that is reducible to a dollar liability, a “rule” being something that the debtor must abide by in any event.³⁷ Robert Weisberg has detailed the overlapping and often conflicting mandates that arise from the two different motivations for preference law—the motive of promoting “equity” among creditors on the one hand and the motive of punishing the debtor on the other.³⁸ There are other potential topics that do not seem to have received the attention they deserve.

But that is not this paper. This paper is, to repeat: there is no “essence” to Chapter 11. Rather, Chapter 11 serves a variety of purposes, overlapping and superficially similar, yet often in tension. But it does not follow that one must lament this kind of ambiguity. Rather, there is good reason to believe that the drafters intended just this sort of thing.

36. See John D. Ayer, *On the Vacuity of the Sale/Lease Distinction*, 68 IOWA L. REV. 667 (1983); John D. Ayer, *Further Thoughts on Lease and Sale*, 1983 ARIZ. ST. L.J. 341.

37. David Gray Carlson, *Bankruptcy Theory and the Creditors' Bargain*, 61 U. CIN. L. REV. 453 (1993).

38. Robert Weisberg, *Commercial Morality, The Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3 (1986).