WHAT IS RIGHT ABOUT BANKRUPTCY LAW AND WRONG ABOUT ITS CRITICS

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I. INTRODUCTION

My comments in this paper focus on the papers in this Symposium by Professors Barry Adler;[1] James Bowers;[2] and Philippe Aghion, Oliver Hart and John Moore (Aghion-Hart-Moore).[3] I argue that the central points of these papers are gravely mistaken because they completely misunderstand the character of the bankruptcy caseload and procedures, they ignore some important purposes of bankruptcy reorganization, and they misstate the success rate for reorganizations. I have chosen these papers for comment for two reasons: they recommend radical changes in bankruptcy law, and they are based on the thinnest knowledge of bankruptcy practice. Incidentally, they also all take an economics approach to law.

My perspective differs from that of these principal authors in two respects (apart from no longer being a full-time law professor). First, I am a bankruptcy judge in the Central District of California,[4] which in 1993 received 10.6% of the nation's bankruptcy cases (92,396 cases), including 12.5% (2504 cases) of the Chapter 11 cases. My docket at the end of 1993 contained 6229 cases, which included 2208 Chapter 7 cases, 390 Chapter 11 cases, and 3631 Chapter 13 cases. During 1993 I was assigned 5094 new cases, including 2621 Chapter 7 cases, 150 Chapter 11 cases, and 2323 Chapter 13 cases. During nearly nine years on the bench in this district, I have handled nearly 40,000 cases, including nearly 2000 Chapter 11 cases. I think that this perspective provides a fair view of the bankruptcy

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1. Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811 (1994).

2. James W. Bowers, *Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses*, 72 WASH. U. L.Q. 955 (1994).

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

4. One of the papers is written by Professor Jack Ayer, *see* John D. Ayer, *Through Chapter 11 With Gun or Camera, But Probably Not Both: A Field Guide*, 72 WASH. U. L.Q. 883 (1994), who does have experience as a bankruptcy judge. Indeed, he was my predecessor on the bankruptcy bench in the Central District of California, where he served for one year, 1982-83, while on sabbatical from the University of California at Davis. The bankruptcy caseload in my district has increased by 172% since his departure, while the size of the bench has increased by only 75%.

world as it actually exists in the United States.

Second, I teach bankruptcy law in Eastern Europe. Last March I taught a week of seminars in Romania, and a year earlier I taught a week-long seminar for bankers in Hungary. Although our Constitution and Bill of Rights traditionally have been our most important legal exports, Chapter 11 of our Bankruptcy Code has become the next most important in recent years. Bankruptcy reorganization is an idea that is especially popular in Eastern Europe, including Russia.

II. THE BANKRUPTCY UNIVERSE

Although the title of this Symposium is The Interdisciplinary Conference on Bankruptcy and Insolvency Theory, many of the papers are limited to a discussion of corporate reorganizations under Chapter 11 of the Bankruptcy Code. Some papers are limited to a much smaller portion of the bankruptcy universe, and at least two are confined to a portion that is minuscule. I begin with a sketch of the universe, so that we can see the importance of the articles to the bankruptcy world if their recommendations are adopted. As we shall see, some would make little difference at all.

Even though the bankruptcy system directly controls a substantial segment of the economy, there is a severe shortage of scientifically collected empirical data. In consequence, to a substantial extent we have no better information than the impressions of the most central participants in the system. This is the principal motivating factor in the initiation of the Chapter 11 research project described by Professors Warren, Westbrook, and Sullivan in this Symposium.[5]

In this section, I examine the total number of bankruptcy filings under various chapters. I then estimate the number of corporate filings, which were made principally under Chapter 11, and the success rate for Chapter 11 cases (of which I presume that corporate debtors have their proportionate share).

A. Total Bankruptcy Caseload

In 1993 there were 875,170 bankruptcy cases filed in the United States, which were distributed under four chapters of the Bankruptcy Code as

5. Elizabeth Warren & Jay Lawrence Westbrook, *Searching for Reorganization Realities*, 72 WASH. U. L.Q. 1259 (1994); Teresa A. Sullivan, *Methodological Realities: Social Science Methods and Business Reorganizations*, 72 WASH. U. L.Q. 1291 (1994). This study, which I had a substantial role in developing, is funded by the Endowment for Education of the National Conference of Bankruptcy Judges.

follows:

Chapter 7	602,980
Chapter 11	19,174
Chapter 12	1,243
Chapter 13	251,773
Total	**875,202**

In addition, there were a handful (the number of which is unreported) of Chapter 9 cases, and another handful (the number of which is also unreported) of ancillary proceedings to foreign bankruptcy cases filed under Bankruptcy Code § 304. Apparently, the total number of ancillary proceedings and Chapter 9 cases was 32 (the difference between the total in Table 1 and the sum of the other numbers).

B. Corporate Filings

There are some striking gaps in our knowledge about corporate Chapter 11 filings. For example, there are no statistics on the number of Chapter 11 cases filed by corporations. This is surprising because a number of the papers in this Symposium apply only to corporate Chapter 11 cases, and the number of corporate Chapter 11 cases directly affects the significance of these papers. We can determine whether the recommendations made by these authors to repeal or amend the Code are worthwhile only if we know whether corporate Chapter 11 cases are a significant part of the bankruptcy universe.

I have two sets of data from which to make a ballpark estimate of the number of Chapter 11 cases filed by corporations in 1993. The first is my list of pending Chapter 11 cases, which I compile from Chapter 11 petitions forwarded from the clerk's office. It shows that I have 43 Chapter 11 cases assigned to me in 1994 that are still pending as Chapter 11 cases. Of the 43 cases, 14 (33%) are corporate debtors.[6] Second, my colleague, Judge Lisa Fenning, has recently published a study of the Chapter 11 cases assigned to her for the calendar years 1992 and 1993, which principally

6. This number is imperfect because it excludes the cases originally filed under Chapter 11 but subsequently dismissed, converted to another chapter, or transferred to another judge or court.

focuses on the real estate cases.[7] I counted the number of corporate debtors in her 1992 data base, and found that 44 of 160 petitions (27.5%) were filed by corporations. There are no other known data on this subject.

Averaging these two numbers, I conclude that approximately 30% of the Chapter 11 cases (perhaps 5750 cases) were filed by corporations in 1993. Thus, the universe of corporate Chapter 11 cases is 0.657% of the bankruptcy caseload, or about one case in 152.

I have somewhat better data (although a bit old) on the number of Chapter 7 cases filed by corporations. I have a list of all cases filed in Los Angeles in the last half of 1987, which we used to assign cases to six new judges who were appointed to my court in 1988. I examined a sample of 1000 Chapter 7 cases, and found that 16 (1.6%) were filed by corporations. It is probably a good assumption that the distribution of corporations in the Chapter 7 caseload is nearly the same today. It is a bit more of a stretch to assume that the nationwide rate is similar to that in the Central District of California, but the figure is probably close, since the Central District of California's 1993 filings were 10.6% of the nation's bankruptcy caseload. Thus, I conclude that approximately 10,000 of the 602,980 Chapter 7 cases filed nationwide in 1994 were filed on behalf of corporations.

To summarize, in 1993 there were approximately 5750 corporate Chapter 11 cases filed, and another 10,000 corporate Chapter 7 cases, for a total of approximately 15,750 corporate bankruptcy cases.[8] These cases constituted 1.80% of the total bankruptcy filings for 1993. Surprisingly, only 86 of these cases were filed by publicly held corporations, and probably only 16 were listed on the New York or American Stock Exchange.[9]

We should be very careful about recommending changes in bankruptcy law that are designed to correct alleged faults affecting such a small percentage of bankruptcy cases. Even if we limit our changes to Chapter 11 cases, we must not inadvertently change the law applicable to the remaining 70% of the Chapter 11 cases filed by noncorporate debtors, unless there are reasons not disclosed in these papers that support such changes.

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7. *See* Lisa Hill Fenning & Brian Tucker, *Profile of Single Asset Real Estate Cases*, L.A. COUNTY BAR ASS'N, COMM. L. & BANKR. SEC. NEWSL., Summer, 1994, at 4.

8. We should have much better statistics on the filing rate of corporate debtors at the conclusion of the study described by Professors Sullivan, Warren, and Westbrook in their papers, *supra* note 5.

9. This figure is based on the data collected by Bradley and Rosenzweig, which produced 162 corporations listed on the New York and American Stock Exchanges that filed bankruptcy petitions under Chapter 11 in the decade ending in 1989, for an average of 16 filings per year. Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1059 (1992).

C. *Success Rate in Chapter 11*

There is a basic misconception about the success rate of Chapter 11 cases. It is true that only approximately 17% of Chapter 11 cases result in the confirmation of a plan, and that perhaps a third of these plans are liquidation plans.[10] Indeed, there are a fairly large number of plans, perhaps 30% or 40%, that do not pay out according to the proposal approved by the court. From these numbers, one could conclude that the success rate of Chapter 11 cases is less than 10%. Such a conclusion, however, is clearly false, and draws its appeal from a perversely narrow view of the nature of Chapter 11 success.

Defining success in Chapter 11 requires much more analysis and debate than it has heretofore received. As a first approximation, I propose that success be defined as the achievement of the results sought, or the avoidance of the results unwanted, by the debtor at the time of filing. For example, the debtor may want to sell the business, because the debtor cannot make it profitable. After the filing, a sale is arranged and the case is dismissed. Alternatively, the debtor may be attempting to avoid foreclosure by the principal secured creditor on the principal real estate asset in the bankruptcy estate. The loan is restructured, or a sale is arranged to a better-financed purchaser, and the case is dismissed.

Results of this kind are common in Chapter 11 cases, and frequently occur in single-asset real estate cases, even though they do not comply with bankruptcy theory.[11] However, such cases are all excluded from the tally of successful Chapter 11 cases, according to the conventional counting method.

The real success rate for Chapter 11 cases is probably in the range of 40%. This estimate is based on my experience with nearly 2000 Chapter 11 cases that have been on my docket: no data have been collected on this

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10. *See, e.g.*, Bowers, *supra* note 2, at 963.

11. Indeed, such success stories are even more common in Chapter 12 and Chapter 13 cases, which have eluded the study of most bankruptcy scholars, with the exception of Professors Sullivan, Warren, and Westbrook, in recent years. Professors Sullivan, Warren, and Westbrook have published the main results of their large consumer bankruptcy study in book form: TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA (1989). *See also* Teresa A. Sullivan et al, *Folklore and Facts: A Preliminary Report From the Consumer Bankruptcy Project*, 60 AM. BANKR. L.J. 293 (1986); Teresa A. Sullivan et al., *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981-1991*, 68 AM. BANKR. L.J. 121 (1994) (providing a preliminary update ten years after their first empirical study of consumer bankruptcy debtors).

subject.[12]

III. THE PURPOSES OF BANKRUPTCY

I do not intend to explore in detail the purposes of bankruptcy law in this article.[13] However, I do devote some attention to two important purposes of bankruptcy law that often escape the attention of bankruptcy commentators: first, bankruptcy is essentially reorganization, even for cases filed under Chapter 7; second, bankruptcy functions as a safety net to avoid a meltdown of the economy. Before discussing these important purposes of bankruptcy, it is necessary to describe the typical bankruptcy case.

A. The Typical Bankruptcy Case

The typical bankruptcy case in the United States involves a dispute between a debtor and the debtor's principal secured creditor. Such a case is filed because the principal secured creditor is trying to foreclose on the only real property owned by the debtor. Other creditors are bit players in this game, and any benefits that they may receive are incidental. This scenario applies to the vast majority of bankruptcy cases filed under all chapters of the Bankruptcy Code.[14]

The most critical hearing in a typical bankruptcy case is the relief from stay hearing, which is the most common kind of proceeding in a bankruptcy court. I typically have nearly one hundred such hearings a week. At issue is whether the debtor's house (or other single asset real estate) continues to enjoy the protection of the automatic stay. If the court grants relief from stay, the bankruptcy case usually ceases to have any purpose for the debtor.[15]

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12. Presumably this lack of information will be filled in with the results of the Chapter 11 project that Professors Sullivan, Warren, and Westbrook are undertaking. *See* Warren & Westbrook, *supra* note 5; Sullivan, *supra* note 5.

13. For such a discussion, see generally Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987).

14. Professor Baird recognizes that the typical business Chapter 11 fits this model. *See* Douglas G. Baird, *The Reorganization of Closely Held Firms and the "Opt Out" Problem*, 72 WASH. U. L.Q. 913, 914 (1994).

15. One should not assume that the secured creditor who obtains relief from the automatic stay under § 362 completes a foreclosure. The statistics in Los Angeles County suggest that actual foreclosures occur in less than 10% of the cases in which relief from stay orders are granted. Secured lenders continue to do deals after obtaining relief from stay: they do not want the property, and are not in the business of managing such property profitably. Their business is lending money and obtaining payment in return so that they can lend it again. Lenders figure that it is a good year if they have not taken a loss on foreclosed property.

Professor Baird is one of the few participants in this Symposium who recognizes what a typical Chapter 11 case looks like.[16] The typical firm in financial difficulty has a simple capital structure, he recognizes, which includes a single secured creditor (usually undersecured) with a security interest in all of the firm's assets, and a small group of unsecured trade creditors.[17] Noncorporate debtors have a similar debt structure.

Baird also correctly perceives that creditors often control both the debtor's decision to file and the timing of such filing. As Baird notes, the single large secured creditor frequently makes this decision.[18] In addition, tax collectors precipitate a substantial number of bankruptcy filings by taking action such as levying on a debtor's bank account or garnishing a paycheck. Debtors usually do not voluntarily file bankruptcy: it is not strategic behavior to gain an advantage over creditors, except in very isolated instances. Debtors file because they are pushed into bankruptcy either by their principal (and frequently only) secured creditor who threatens to foreclose on their only piece of real estate, or by the taxing authorities.

B. *Bankruptcy as Reorganization*

1. *Present cases*

Reorganization is a pervasive feature of bankruptcy. In addition to Chapter 11 cases, which constitute 2.2% of the bankruptcy caseload, Chapter 13 cases for individual debt adjustment constitute 28.8% of the bankruptcy caseload, and Chapter 12 cases add 0.1% more. Thus, 31.1% of bankruptcy filings are specifically intended as reorganization cases.[19]

Chapter 7 cases, like those under the other chapters of the Code, are filed principally to reorganize the debtor's secured debt. Like debtors filing under other chapters, Chapter 7 debtors file to save their real estate from foreclosure by their secured creditors. Indeed, saving homes is the primary goal of most consumer bankruptcy cases, both under Chapter 13 and Chapter 7. In contrast, liquidation is a quite unusual purpose for filing a bankruptcy petition under any chapter of the Bankruptcy Code, even under Chapter 7.

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16. Baird, *supra* note 14, at 915-16.
17. *Id.* at 915.
18. *Id.* at 926.
19. *See supra* table at p. 831.

2. *Reorganization History*

The use of bankruptcy to restructure secured debt is not a new development in reorganization law. Indeed, reorganization has focused largely on secured creditors from its outset.

Reorganization as we know it grew out of the railroad receiverships of the nineteenth and early twentieth centuries, largely in state court and without the benefit of unifying federal law. Because state law was inadequate to deal with railroad insolvencies, railroad reorganization provisions were among the first reorganization provisions added to the Bankruptcy Code.[20]

C. *Bankruptcy as an Economic Safety Net*

Bankruptcy reorganization served another role when it was first introduced, and may still serve this role today. One of the unrecognized policies of bankruptcy law is to provide a safety net for the national economy. It prevents secured creditors from collectively starting a downward spiral of foreclosures and bank failures that could result in the failure of the entire economy, as it nearly did in 1933.

Picture a country where nearly 25% of the working population is unemployed.[21] For many Americans, their only food is a piece of bread and a bowl of broth handed out after a wait in a long line. The stock market has lost almost 85% of its value.[22] Denied reelection, the president is preparing to move out of the White House on his last day in office. He had promised that prosperity was just around the corner, but there were no corners to be found. The new president in a few days will close down the banking system, and nobody knows whether the banks will ever reopen. Something appears about to happen to the economy, and total collapse is the most likely prospect.[23]

Cleaning off his desk, the president comes across the last bill to arrive

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20. *See* Act of March 3, 1933, ch. 204, Pub. L. No. 72-420, 47 Stat. 1467, 1474-82 (repealed 1938).

21. In 1933 the unemployment rate was 24.9%. FREDERICK E. HOSEN, THE GREAT DEPRESSION AND THE NEW DEAL 257 (1992).

22. On October 1, 1929, before the October crash of 1929, the Dow Jones Industrial Average closed at 342.57. On March 3, 1933, Herbert Hoover's last day in office, the average was 53.84, a decrease of 84%. DOW JONES & CO., INC., THE DOW JONES AVERAGES 1885-1990 (Phyllis S. Pierce ed., 1991).

23. For a discussion of the last days of the Hoover administration, see SUSAN ESTABROOK KENNEDY, THE BANKING CRISIS OF 1933 129-51 (1972).

from Congress, a substantial revision of the bankruptcy law, which will add reorganization provisions for farmers, railroads, and individuals (especially guarantors).[24] Signing the bill is the president's last chance to do some good for the economy.

Much about the causes of the Great Depression was not understood in early 1933. Congress did understand a piece of it, however. It had watched the banks foreclose on real estate in a down economy, and had watched the banks themselves disappear, taking with them the life savings of many people when the banks could not resell the foreclosed properties at a sufficient price to cover their loans. Left to their state-law rights, it appeared that the banks had nearly closed down the economy and put a quarter of the nation's workers out of work. Congress crafted a law to stop this process. In his last official act,[25] President Herbert Hoover signed the bill that gave us bankruptcy reorganization.[26]

The 1933 amendments to the Bankruptcy Act provided for the reorganization of individual debtors,[27] farmers, and railroads.[28] The amendments, enacted three days before the new President Franklin D. Roosevelt closed the entire banking system,[29] are generally considered to be the first introduction of reorganization into bankruptcy law. Two 1934 amendments added § 77B for corporate reorganizations[30] and § 80 for municipal debt

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24. *See* HERBERT HOOVER, THE MEMOIRS OF HERBERT HOOVER: 1920-1933 THE CABINET AND THE PRESIDENCY 273 (1951).

25. *See Signs Bankruptcy Bill*, N.Y. TIMES, March 4, 1933, at 2.

26. For a collection of Hoover administration bankruptcy policy statements, see RAY LYMAN WILBUR & ARTHUR M. HYDE, THE HOOVER POLICIES 486-94 (1937). *See also* S. DOC. NO. 65, 72d Cong., 1st Sess. (1932) (reprinting a message from the President on, *inter alia*, bankruptcy); H.R. DOC. NO. 522, 72d Cong., 2d Sess. (1933) (same).

27. *Id.* at 1467-70. As a reorganization provision, § 74 of the Bankruptcy Act, authorizing "compositions and extensions" was rudimentary, and probably contemplated only a redivision of distribution by vote of the creditors, or a delay in payment. It was in many respects similar to § 12 of the original Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, 549-50 (repealed 1938), and to the 1874 amendment to the 1867 Bankruptcy Act as well, Act of June 22, 1874, ch. 390, 18 Stat. 178, 182-84 (repealed 1878). On the 1874 amendment, see Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 360-61 (1991).

28. Act of March 3, 1933, ch. 204, Pub. L. No. 72-420, 47 Stat. 1467 (repealed 1938).

29. President Franklin D. Roosevelt closed the banks on March 6, 1933. When the banking system was closed, nobody knew whether the banks would ever open again. *See* KENNEDY, *supra* note 23, at 158. In fact, they began to reopen 7 days later. *Id.* at 180. I have heard people who remember the occasion say that it was the most dramatic event in their lifetimes, surpassing the end of the Second World War, the first human walk on the moon, and the fall of the Berlin wall.

30. Act of June 7, 1934, ch. 424, Pub. L. No. 73-296, 48 Stat. 911, 912-24 (amended 1938, repealed 1978).

adjustments.[31]

The 1933 amendments federalized railroad reorganization practice, which had previously occurred principally in state courts. The farmer reorganization and corporate provisions were also a clear departure from earlier bankruptcy law, as was the corporate reorganization provision added by the 1934 amendment. The provision for individual reorganizations, on the other hand, was not remarkably different from provisions in existing bankruptcy law.

An economic safety net is one of the features of bankruptcy reorganization that makes it a powerful idea, particularly in weaker economies like Hungary, Romania, and Russia. Their markets are far from perfect. Our markets are also far from perfect, especially in a weak economy. Chapter 11 protects vital businesses, protects jobs and communities, gives debtors an opportunity to wait out an economic downturn, and avoids a catastrophic destruction of economic values. In short, bankruptcy reorganization is part of the safety net that prevents secured creditors in a weak economy from collectively precipitating a downward spiral leading to a total economic collapse.

IV. THE SYMPOSIUM PAPERS

Let us now look at some of the papers in this Symposium in light of the foregoing comments.

A. Cases to Which Papers Are Applicable

The foregoing analysis of the kinds of bankruptcy cases sheds light on the impact of the recommendations of some of the papers in this Symposium. For some of the papers, the impact is remarkably small.

The most striking paper in this respect is that of Professor Adler,[32] both in the breadth of his conclusions and in the limited number of cases actually affected by his analysis. First, his conclusions: he unabashedly states, "I *do* think it is wise, in principle, to do away with bankruptcy law."[33] It appears that he recommends the repeal of the entire Bankruptcy Code, although he explains in a footnote[34] that his arguments apply only to corporate debtors. It further appears that his arguments apply only to

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31. Act of May 24, 1934, ch. 345, Pub. L. No. 73-251, 48 Stat. 798, 798-803 (declared unconstitutional in Ashton v. Cameron County Water Improvement Dist., 298 U.S. 513, 532 (1936)).

32. Adler, *supra* note 1.

33. *Id.* at 811 (emphasis in original).

34. *See id.* at 811 n.3.

debtors in Chapter 11 cases. In addition, Professor Adler's analysis is limited to those corporate debtors who have issued fixed obligations to a large number of investors.[35] He proposes to solve problems relating to at most a handful of cases in which debtors have issued contractual obligations in fixed amounts to a large number of creditors.[36] Professor Adler proposes to substitute "chameleon equity" for such debt,[37] and thus to eliminate the need for bankruptcy law.

The specificity of Adler's proposal necessarily limits his universe to a very small subset of bankruptcy cases. There probably are fewer than 100 Chapter 11 cases filed by publicly held corporations each year,[38] and only a portion of those qualify for "chameleon equity." In the nearly 2000 Chapter 11 cases that have crossed my docket in nine years on the bench, I do not think that I have ever had such a case, and certainly I have not had as many as ten.

Let us generously suppose that there are 25 cases a year nationwide that fit into this category. Obviously, these 25 cases would not create the "debtless world" and the disappearance of the need for corporate bankruptcy (let alone all bankruptcy) that Adler believes would result from the adoption of his proposal. Clearly, the repeal of the entire Bankruptcy Code for the supposed benefit of 25 corporations per year, and to the detriment of more than 875,000 other debtors who file bankruptcy cases, is unwarranted.

Professor Bowers' analysis applies to an even smaller subset of the bankruptcy universe than that of Professor Adler. His analysis applies only to Chapter 11 cases filed by corporations listed on the New York or American Stock Exchanges, which typically amounts to 16 cases per year.[39] If bankruptcy reorganization is bad for such companies, Congress could easily amend § 109[40] to exclude them from eligibility for Chapter 11,[41] and the bankruptcy world would proceed with little change.

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35. *Id.* at 815.

36. *Id.* at 816.

37. *Id.* at 816-17.

38. For example, the yearly average of Chapter 11 bankruptcies in the Bradley and Rosenzweig study is 16. Bradley & Rosenzweig, *supra* note 9, at 1059.

39. Bowers, *supra* note 2, at 966; *see supra* note 38.

40. 11 U.S.C. § 109 (1988) (defining who may be a "debtor" under the Bankruptcy Code).

41. Indeed, from 1938 to 1978 the Bankruptcy Act, which preceded the Bankruptcy Code, provided a separate Chapter, Chapter X, for corporate bankruptcies. *See* 11 U.S.C. §§ 501-672 (1976) (repealed 1978). Corporations were also permitted to file for reorganization under Chapter XI, 11 U.S.C. §§ 701-799 (1976) (repealed 1978), and Chapter X was little used.

Bowers' failure to consider the limited application of his analysis leads Bowers to overstate his conclusions. He states:

> The most widely replicated finding in the empirical literature about bankruptcy reorganization is that equity in filing firms loses a huge proportion of its value relative to the market in an astonishingly short period surrounding the bankruptcy filing date.[42]

There are no such data, except for the minute subclass of publicly traded firms. It would be very foolhardy to develop bankruptcy policy or to revise bankruptcy law based on such a thin slice of bankruptcy life.

The papers by Rasmussen and Aghion-Hart-Moore apply to a somewhat broader number of bankruptcy cases. The Rasmussen paper would apply to the 5750 corporate reorganization cases, and the Aghion-Hart-Moore paper would include these cases plus the 10,000 Chapter 7 corporate cases. This is still a rather thin slice of the bankruptcy pie.

B. *Noncontractual Debt*

There are two principal types of noncontractual debt that play a large role in the bankruptcy process: tax and tort debts. A substantial number of bankruptcy cases, both under Chapter 11 and under other chapters, result from the failure to pay the fisc.[43] In addition, a number of cases involve tort debts, such as environmental cleanup obligations. While tort debts are relatively uncommon, tort creditors are usually dominant in cases involving such claims.

The advocates of market solutions to insolvency do not deal adequately with noncontractual debt. Adler's and Bowers' papers are clearly limited to bondholder debt, and Rasmussen's paper also appears to be limited to such debt. While somewhat broader, the Aghion-Hart-Moore paper is limited to contract debt and ignores tax and tort debts.

While tax and tort debt is not substantial in more than half of the Chapter 11 cases, there is an important minority of cases in which such debt is overriding.[44] Baird at least recognizes the problem.[45] To be fair, the present bankruptcy statute also does not deal with environmental

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42. Bowers, *supra* note 2, at 968-69.

43. There are no data on the number of bankruptcy cases filed in response to tax problems. I know from my docket, however, that the number is substantial, perhaps in the range of 5-10% of all cases.

44. This problem is explained in detail in Kathryn R. Heidt, *The Changing Paradigm of Debt*, 72 WASH. U. L.Q. 1055 (1994).

45. Baird, *supra* note 14, at 915 n.2.

contamination in an acceptable fashion: a legislative solution is needed. On the other hand, the provision for tax debt, which permits the debtor to stretch it out over six years with or without the consent of the taxing authority,[46] is workable in most cases.

There is another vice in the view that a bankruptcy system should respect contractual rights and priorities.[47] Tort claimants are disadvantaged by such a system, because they have no opportunity to protect their position against contractual claimants. Tax claimants, in contrast, are protected for the most part in comparison with contract claimants, but only because they enjoy a statutory priority for payment under Bankruptcy Code § 507(a)(8).[48] Indeed, tort claimants with unliquidated claims in the A.H. Robins and Manville cases firmly believe that they received much less favorable treatment than the contract claimants, even under present bankruptcy law. Except for Professor Adler, whose paper espouses the view that tort claimants should be paid ahead of all other creditors[49] (even those with secured claims), this problem appears to inhere in all of the papers under discussion here.

C. Bankruptcy and Consensual Remedies for Insolvency

Adler takes the position that parties should be permitted to contract for their remedies in the event that a party becomes insolvent, and that such consensual provisions should make bankruptcy law unnecessary.[50] This is not a new or untried proposal: we have vast experience with it, and we have bankruptcy law because it does not work.

Parties have always been free to contract for their rights in the event of insolvency, absent statutory or case law limitations. In the history of the United States, for example, parties were free to contract on this subject unrestricted by bankruptcy law before 1898, except during those brief periods when federal bankruptcy legislation was in effect.[51]

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46. 11 U.S.C. § 1129(a)(9)(C) (1988).

47. At least Rasmussen and Aghion-Hart-Moore hold this view. *See* Aghion et al., *supra* note 3, at 852; Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159 (1994).

48. 11 U.S.C. § 507(a)(8) (1988).

49. Adler, *supra* note 1, at 826.

50. *See id.* at 821.

51. While the Constitution from its outset authorized Congress "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States," U.S. CONST. art. I, § 8, cl. 4, this power lay dormant for most of the nineteenth century. The first bankruptcy law was enacted on March 4, 1800, and repealed on December 19, 1803; the second was enacted on August 19, 1841, went into

When we look at contracts from those eras when there was no federal bankruptcy law, we do not find that contracting parties negotiated for better rights than we now provide under bankruptcy law. In fact, we adopted bankruptcy law in large part to remedy the failure of contracting parties to negotiate adequate solutions to insolvency problems. In simple terms, we have bankruptcy law because it provides *much* better solutions to these problems than the parties are able to provide on their own, in the vast majority of cases.

Indeed, the secured creditor community does a good job of protecting its interests by contract and by state legislation outside of bankruptcy: it does such a good job that bankruptcy law is needed to protect insolvent debtors from the secured creditor industry. Secured creditors write their own remedies, including the right to foreclose on their security upon default and the right to collect attorney fees from their borrowers.

Bankruptcy law has always been conceived as an involuntary impairment of contract rights. As the United States Supreme Court has stated:

> [T]here is, as respects the exertion of the bankruptcy power, a significant difference between a property interest and a contract, since the Constitution does not forbid impairment of the obligation of the latter. The equitable distribution of the bankrupt's assets, or the equitable adjustment of creditors' claims in respect of those assets, by way of reorganization, may therefore be regulated by a bankruptcy law which impairs the obligation of the debtor's contracts. Indeed every bankruptcy act avowedly works such impairment. While, therefore, the Fifth Amendment forbids the destruction of a contract it does not prohibit bankruptcy legislation affecting the creditor's remedy for its enforcement against the debtor's assets, or the measure of the creditor's participation therein . . . .[52]

Many countries in the world today have no bankruptcy law or have only liquidation bankruptcy provisions. If an economy is better off without a bankruptcy scheme, we would expect to find that those countries that lack bankruptcy law would have a more functional economy and a competitive advantage in comparison with the United States. Similarly, we would expect to find that those with only liquidation bankruptcy law would have more functional economies and competitive advantages compared to the

effect on February 2, 1842, and was repealed on March 13, 1843; the third bankruptcy law was enacted on March 2, 1867, and repealed effective June 7, 1878. *See* F. REGIS NOEL, A HISTORY OF THE BANKRUPTCY CLAUSE OF THE CONSTITUTION OF THE UNITED STATES OF AMERICA 124-56 (1918). Except for these periods totalling 15 years, there was no federal bankruptcy law in the United States for more than 100 years after the adoption of the Constitution.

52. Kuehner v. Irving Trust Co., 299 U.S. 445, 451-52 (1937).

United States.

The reality is exactly the reverse. Notwithstanding a bankruptcy law that has been continuously in force in the United States for almost a century, and reorganization law that has been in force for more than sixty years, the United States has one of the healthiest economies in the world.

Furthermore, bankruptcy law, and especially reorganization bankruptcy, is one of the most important exports of legal ideas from the United States. Many nations, such as Germany, the United Kingdom, and Canada, have recently adopted or are seriously considering the adoption of a reorganization system like our Chapter 11.

Bankruptcy reorganization is an idea that is especially popular in Eastern Europe, including Russia. Both Hungary and Russia have recently adopted reorganization laws, and such proposals are under consideration in Romania and Estonia. One of the largest economic hurdles facing these countries is the need to privatize former state-owned industries and to convert these entities into economically viable businesses. Liquidation is not a feasible alternative: in Romania, for example, 90% of the economy belongs to formerly state-owned industries, and 70% of their debts are owed to the government. Thus, liquidation would return the assets to the government and reverse the privatization effort.

D. *Swapping Debt for Equity*

Professor Adler adopts the recommendation made famous by Bradley and Rosenzweig[53] that reorganization should be accomplished by swapping debt for equity. While Adler's proposal is somewhat different, it shares certain basic deficiencies.

The debt-equity swap advocated by Professor Adler (and by Bradley and Rosenzweig) would be a disaster in the typical business reorganization case. Banks, which would receive the equity in most cases, usually do not have the background and experience needed to run the businesses that they finance: this is not their area of expertise.

Furthermore, the systematic conversion of debt into equity will imperil the banking system in the same way that it was imperiled in the Great Depression, because banks would lose the cash flow necessary to pay out deposits and to make new loans. For this reason, we adopted a system of regulation in the 1930s that prohibits banks and insurance companies from

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53. Bradley & Rosenzweig, *supra* note 9.

holding significant amounts of stock in nonbank firms.[54]

Furthermore, neither Adler nor Bradley and Rosenzweig have given any reason why default should trigger the elimination of all debt. Even reorganization rarely accomplishes this, and it appears that there is little to recommend such a result.

E. The Alleged Mixed Problems of Reorganization

The paper by Professors Aghion, Hart and Moore[55] is simply wrong in its principal thesis. The main point of Aghion-Hart-Moore is that Chapter 11 is flawed because it mixes two different issues: the determination of who should get what in the reorganization and the decision of what should happen to the bankrupt company.[56] As an empirical matter, their supposition is false for most Chapter 11 cases. In consequence, the drastic solution that they propose is unnecessary, and would radically alter the character of reorganization available under Chapter 11.

Apparently Aghion-Hart-Moore believe that Chapter 11 mixes these two issues because they are unfamiliar with the Chapter 11 process as it works in actual cases. They apparently assume that both of these issues are determined in the plan formulation process, and that they must both be resolved in plan negotiation. For most Chapter 11 cases, this is not true.

Aghion-Hart-Moore see the decision on what should happen to the debtor as a choice between two alternatives: reorganization or liquidation. While the alternatives are frequently this limited, especially for single asset real estate cases, there are usually additional alternatives in larger cases that the Aghion-Hart-Moore model apparently cannot accommodate. However, it is easier to show the falsity of the Aghion-Hart-Moore assumption using the bipolar model.

The issue of whether to liquidate or reorganize is normally resolved relatively early in the case, and rarely is decided in the context of the adoption of a plan. This issue is brought before the court on a motion to convert to Chapter 7, which may be brought by the United States Trustee or by any party in interest at any time.[57] Such a motion is frequently brought (and granted) early in a case, if the debtor does not meet the requirements of the United States Trustee (these requirements typically

54. Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms: Empirical Evidence*, 72 WASH. U. L.Q. 1005, 1005 (1994).

55. Aghion et al., *supra* note 3.

56. *Id.* at 850.

57. *See* 11 U.S.C. § 1112(b) (1988).

include reporting financial transactions in weekly and monthly reports, establishing debtor-in-possession bank accounts, and providing evidence of insurance). After several months a creditor may make a motion to convert for failure to make progress toward proposing a plan or to take appropriate steps toward reorganization. If a case is still under Chapter 11 at the time that a plan is proposed for negotiation, this usually is because reorganization is a viable alternative that should be pursued, rather than an open question to be negotiated in the plan itself.

The plan, in contrast, poses the issue of who should get what in the case. Curiously, Aghion-Hart-Moore want to take the power to negotiate this issue away from the parties, and impose a legislative solution similar to the statutory distribution provision for Chapter 7 cases.[58] Instead of a comprehensive distribution scheme, however, they propose a simplified program in which there are no priorities or security interests: all creditors receive a single type of asset, equity, which varies only in amount. While the Chapter 7 priority system is certainly open to criticism, the simplistic program of Aghion-Hart-Moore does not appear to be an improvement.

Furthermore, we have historically thought it better to permit the parties to negotiate a deal between themselves rather than to impose a distribution scheme on them. In fact, Aghion-Hart-Moore's proposal is at odds with their own position that "in an ideal world,"[59] debtors and creditors would anticipate the possibility of default and specify as part of their initial contract what should happen after default.[60]

Aghion-Hart-Moore recognize that their scheme will transfer the assets of a debtor to the bank in the typical Chapter 11 case. We do not need a complicated new scheme to accomplish this result: Chapter 7 accomplishes it quite efficiently. Aghion-Hart-Moore fail to take notice that this was the problem to be solved by introducing reorganization in the first place in

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58. *See* 11 U.S.C. § 724(b) (1988).

59. It is far from clear why a world would be ideal in which debtors and creditors have to specify what should happen after default. It would at least be better, in my view, to provide a standard resolution to such problems (along the model of the Uniform Partnership Act), and to save the enormous transaction costs of negotiating these features in every contract. The more interesting question is whether the parties should be permitted to contract out of the standard solutions, or whether they should be mandatory (as in the present Bankruptcy Code).

I am sure that Aghion-Hart-Moore think that an ideal world is one without transaction costs. Such a world is imaginary, but it is not ideal in any sense, except for those who do not want to think about the costs of transactions.

60. Aghion et al., *supra* note 3, at 850.

1933. We needed an alternative to turning the equity over to the banks, and we made it illegal for banks to own equity for any length of time.[61]

F. Efficient Markets

Much recent bankruptcy commentary is animated by the assumption that there are efficient markets in an ideal world available to solve bankruptcy problems. For example, Bowers states:

> In summary, markets seem to be the only available devices which really do solve the problems of financial distress. . . . [M]arkets are efficient and bankruptcy procedures are not. That is the lesson of the only systematic and rigorous theory that has been applied to the problem, and the implications of the only scientific empirical evidence.[62]

This statement is simply incorrect. The empirical evidence shows that most markets are far from efficient: we have bankruptcy law in large part because of this problem. Debtors need an opportunity to suspend the rights of creditors because markets are so inefficient.[63] Similarly, markets do not solve the problems of financial distress.

Adler similarly appears to assume only perfect markets: at least his analysis is unencumbered by substantial transaction costs.[64] Rasmussen and Aghion-Hart-Moore, on the other hand, attempt to address a world in which markets are imperfect and transaction costs must be paid. As Rasmussen states, "It is easy to show that any system of laws fails when compared to an ideal world. Given the complexities of the real world, it takes little imagination to demonstrate that the current state of affairs is not perfect."[65]

Bankruptcy is overwhelmingly a result of imperfect markets and high transaction costs. Permitting the functioning of imperfect markets is much of what Chapter 11 is about. Virtually no market in which bankruptcy operates is a perfect market. Waiting out an imperfect market, of course,

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61. *See* Gilson & Vetsuypens, *supra* note 54, at 1005.

62. Bowers, *supra* note 2, at 976-77.

63. Bowers gets it exactly backward in insisting that bankruptcy law defenders offer a theory that measures up to his standards before granting anyone the point that current bankruptcy law is worth having. Bowers, *supra* note 2, at 977. It is convenient to say, "I am right until someone proves me wrong, to my satisfaction." However, burdens of proof do not work that way. It is hornbook law that the burden of proof falls on the Bowers's of the world—those who want to change the status quo—rather than on those who defend it. Those who seek change must shoulder the burden of showing that their vision of the world is better than the present system. *See, e.g.*, 2 CHARLES T. MCCORMICK, MCCORMICK ON EVIDENCE 428 (John William Strong ed., 4th ed. 1992).

64. *See, e.g.*, Adler, *supra* note 1, at 817.

65. Rasmussen, *supra* note 47, at 1163.

has its hazards. It is difficult to determine in advance that a buyer will appear to make a debtor profitable and perhaps save a community. If a buyer does not appear, the delay may impose substantial costs on both secured and unsecured creditors. Nobody knows whether, on balance, the economy is better off because bankruptcy permits debtors to try to wait out imperfect markets: the data has not been collected.

G. *Choice of Bankruptcy Regimes*

Rasmussen ends his paper by recommending that Congress establish a menu of choices of bankruptcy regimes from which an entity can choose.[66] In fact, Congress has already done this. Except for those entities that are ineligible for bankruptcy altogether,[67] any debtor except a railroad or a municipality may choose Chapter 7.[68] Any debtor eligible for Chapter 7, except a stockbroker or commodity broker may choose Chapter 11.[69] Individuals who meet the debt limitation ceiling and who have regular income may choose Chapter 13.[70] Farmers who meet the debt ceiling limitations may file under Chapter 12.[71]

More than one-third of corporate bankruptcy cases, ranging from very large to very small, are filed under Chapter 11. The "one size fits all" approach to corporate reorganization is certainly open to criticism. Congress recently considered (and rejected) legislation that would have added to the Code a new Chapter 10 for small businesses.[72] Perhaps as Rasmussen suggests, more chapters should be added to the Code, to provide more alternative ways of reorganizing: the proof of the wisdom of this idea lies in its elaboration, which Rasmussen does not provide.

V. CONCLUSION

In this paper I show that the demographics of the bankruptcy caseload are quite different from the assumptions made by theoretical economists who criticize the effectiveness of the Bankruptcy Code, and particularly

66. Rasmussen, *supra* note 47, at 1208.

67. 11 U.S.C. § 109(b) (1988) (excluding from bankruptcy all banks, savings and loan associations, and insurance companies).

68. *Id.*

69. 11 U.S.C. § 109(d) (1988).

70. 11 U.S.C. § 109(e) (1988).

71. 11 U.S.C. § 109(f) (1988).

72. The final version of H.R. 5116, 103d Cong., 2d. Sess. (1994), which was signed by the President on October 22, 1994, deleted the separate Chapter 10 provision that was written into an earlier Senate draft, and included certain of its provisions under Chapter 11.

Chapter 11. While Professors Adler, Bowers, and Aghion-Hart-Moore, who represent this point of view in this Symposium, assume that corporate cases (particularly under Chapter 11) represent the essence of bankruptcy, only approximately 15,750 of the 875,202 cases filed in 1993 were on behalf of corporations and only approximately 5,750 of them were under Chapter 11. Furthermore, the universe of corporate bankruptcies of interest to Professors Adler and Bowers is limited to a very small subsection of corporate bankruptcies. Even if their views on the treatment of these cases in the bankruptcy system are correct, these views have little to do with the universe of bankruptcy cases. They also incorrectly assume a lower success rate for Chapter 11 cases than is actually the case.

Furthermore, these authors fail to understand that bankruptcy is essentially reorganization, under all chapters of the Bankruptcy Code. They also fail to grasp one of the essential purposes of bankruptcy law—to provide an economic safety net for an economic system under stress. Consensual remedies for insolvency are simply unable to deal with these problems.