BANKRUPTCY LAW FOR PRODUCTIVITY

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I. INTRODUCTION ..................................................................................52
II. PRODUCTIVITY MEASURES OF BANKRUPTCY ..................................54
   A. The Fresh Start Policy as a Productivity Reviver ..........................55
   B. The Potential for Reorganizations as a Productivity Restorer ..........67
   C. Tort Victim Trust Funds as Productivity Restorers .....................78
   D. Other Productivity Restoring Provisions, Interpretations, and Arguments ..................................................83
      1. Rejection of Counter-Productive Obligations Not To Compete .............................................................83
      2. The Priority of Tort Claims During Reorganization ..........86
      3. The Non-Avoidability of Long-Term Loan Payments ..........87
III. BANKRUPTCY LAW'S UNIQUE ROLE IN RESTORING PRODUCTIVITY INCENTIVES THREATENED BY INSOLVENCY ..........88
   A. The Infeasibility of Non-bankruptcy Law's Addressing Financial Failure .....................................................91
   B. The Necessity that a Single Legal Field Address the Consequences of Financial Failure ...............................92
IV. CONCLUSION ..................................................................................95

The accepted economic function of bankruptcy law is that it resolves collective action problems between self-interested creditors. This Article argues that this collective-action-resolving function is only one of a multitude of expressions of an overarching economic motivation of bankruptcy law. Bankruptcy law seeks to avoid productivity-destroying consequences of insolvency. The principal expressions of this policy are more prominent features of the bankruptcy system than its collective-action-resolving provisions. The fresh start policy avoids the destruction of individual productivity incentives. The reorganization chapter avoids misallocations and false liquidations

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due to credit crunches and disrupted markets. The creation of trust funds for future victims of past torts solves the erroneous liquidation incentive that a vicious cycle of tort-driven insolvencies creates. The priority of tort claims during the reorganization cures wasteful incentives for sub-optimal care. None of these fundamental choices is explained as a solution to creditors' collective action problem. Moreover, the resolution of the creditors' collective action problem prevents the destruction of value, becoming itself one more expression in this group of avoiding the economic distortions that insolvency may cause. In closing, I argue that bankruptcy law must address these concerns because they require a study of the debtor's relations in their totality that state law is unlikely to be able to perform. The desired regulatory competition should be provided in the context of the structure of the federal judiciary.

I. INTRODUCTION

Bankruptcy law is considered a gloomy subject because of the destruction of value and economic activity with which bankruptcies are associated. Bankruptcy law should be viewed as the spring season of our legal system, when renewed growth replaces the winter of insolvency. In this Article, I will argue that bankruptcy law is essential for economic productivity and growth because it revives productive capacity that is destroyed as a consequence of financial failure. I will proceed to transform this from a positive, descriptive thesis into a normative guide and aspiration: not only does bankruptcy law revive productivity, but bankruptcy law should be interpreted and designed with the goal of reviving productivity.

The productivity incentives that bankruptcy law creates share a feature. The debtor's financial impasse destroys productivity—either production incentives or outright productive capacity—that would otherwise contribute to social welfare in ways that the debtor does not internalize.¹ Insolvency destroys productivity in various ways and bankruptcy law revives it. Moreover, I argue, this is the pinnacle of the contributions to social welfare that bankruptcy law

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¹ Thus, an essential component of this thesis is that each individual does not fully internalize his own contribution to social welfare. This becomes obvious if we think that every gain from trade is split between the individual and his counter-parties. The individual only benefits from part of the total gain produced. An equivalent and obvious application is the illegality of suicide attempts and euthanasia. Voluntary death removes an individual's contribution from society, but the individual is not allowed to make the decision to remove herself because the individual does not take into account the sum of the benefits of its contributions to society.
provides. When settings are identified in which productive capacity has been destroyed because of the debtor's economic downturn, it is the proper role of bankruptcy law to restore it. Therefore, bankruptcy law must be interpreted and designed with this purpose.

The contribution of this Article is to supplement the "creditors' bargain" model of bankruptcy law that has been furthered by Douglas Baird and Thomas Jackson. According to Baird and Jackson, bankruptcy law solves collective action problems. Without bankruptcy law, creditors would engage individually in actions that are not beneficial to creditors as a group. The principle that should guide the interpretation and design of bankruptcy rules, argue Baird and Jackson, is the solution of such collective action problems. This Article at least adds the revitalization of productivity as a fundamental principle of bankruptcy. The two goals—solution of the collective action problem and productivity revival—are not in conflict because resolving the collective action problem is an expression of saving productivity, that which would be destroyed by creditors' asset-grabbing. Thus, the thesis of this Article is that the phenomenon on which Baird and Jackson focus is but one of the expressions of the bankruptcy policy of restoring productivity that is threatened by insolvency. Moreover, I will argue that if we compare the importance of these two goals, the multitude of the expressions of productivity revival dominate in explaining bankruptcy law. Not only are creditors able in theory and in practice to overcome their collective action problems, not only can collective action problems be solved by voluntary arrangements, but their resolution's contribution to social welfare is minor when compared with that of the various other expressions of productivity revival due to good bankruptcy law.

Part II discusses bankruptcy law provisions that revive productivity. The fresh start policy prevents pauperism and idleness. The reorganization process prevents destruction of going-concern value at circumstances of financing constraints, credit crunches, or information asymmetries that would prevent the realization of full value in a sale of the business as a going concern. The fresh start policy and the existence of the reorganization process—neither of which solve the collective action problem of the creditors—are the major examples of bankruptcy law provisions that revive productivity. Another provision is the creation of trust funds for future tort claimants harmed by past conduct. Without such a bankruptcy solution that prevents repeated insolvencies and reorganizations, there would be a false incentive to liquidate firms and destroy their going-concern value and productivity. One more
productivity-restoring bankruptcy measure is the rejection of non-compete obligations by individual debtors, as in *In re: Register*,\(^2\) which functions in ways similar to the fresh start policy. On similar grounds, I have argued for flexible interpretation of the new value exception in the context of reorganization plans of family-operated businesses.\(^3\) Similarly focused on productivity is the treatment of tort claims during the reorganization. Insolvency destroys the equity-holders’ incentives to avoid accidents. By giving tort claimants administrative expense priority, the Supreme Court in *Reading v. Brown*\(^4\) restores the incentive for care and prevents the destruction of social value by accidents. Even cases that seem to validate the collective action view of bankruptcy law, such as *Union Bank v. Wolas*,\(^5\) are better explained as tending toward productivity revival. Thus, Part II makes the descriptive contribution that bankruptcy law does revive productivity that insolvency has destroyed.

In the law and economics context, that productivity is desirable is self-evident and practically tautological. Part III proceeds to argue that since the threat to productivity is due to consequences of the debtor’s financial failure, it is appropriately addressed by bankruptcy law. Whether regulatory competition would facilitate achieving this goal is a different question that does not interfere with the conclusion by Part III that bankruptcy law should indeed restore and maintain productivity incentives. The desired regulatory competition should be provided within the context of the structure of the federal judiciary.

### II. PRODUCTIVITY MEASURES OF BANKRUPTCY

My positive thesis is that bankruptcy law restores productivity incentives beyond preventing destruction of productive capacity by the creditors’ collective action problem. Therefore, I will first lead the reader through an array of bankruptcy provisions that illustrates this “productivity revival” function. Even though this tour will show that my descriptive thesis is correct, it may still attract a normative objection. Those convinced that bankruptcy law should do no more than solve the collective action problem might argue that bankruptcy is not the appropriate area of law for this function to be performed. Each productivity-reviving bankruptcy provision should, they might argue, be delegated to some field of substantive law (other than bankruptcy). This objection is false because all the pro-

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2. 96 Bankr. 73 (Bankr. M.D. Tenn. 1989).
3. *See infra* note 46.
ductivity-restoring functions of bankruptcy law are intimately related to bankruptcy. Their relation to bankruptcy is due to the fact that they are responses to economic decline, the economic and financial adversity that caused the destruction of the productivity.

The productivity-reviving features of bankruptcy law will be illustrated from several provisions. The most fundamental is the cornerstone of individual bankruptcy in the United States, the fresh-start policy, according to which the honest individual debtor has a right to discharge unpaid debts, and this right is not waivable. It is important to note that there is no collective-action explanation for the fresh start. The second illustration is the very existence of the reorganization process. The reorganization is not only a recent addition to bankruptcy law in response to large practical pressure, but it has also been widely emulated in other legal systems. It is important to note that the champions of the collective action exegesis of bankruptcy law argue against the necessity of a reorganization chapter. That a reorganization can avoid the destruction of productive capacity, of course, explains this fundamental piece of bankruptcy law. The third illustration is the often misunderstood creation of trust funds for unknown victims of past torts. All these provisions are so radical and have such a profound impact on economic activity that the positive statement that bankruptcy law revives destroyed productivity incentives needs no further support. A walk through bankruptcy interpretation, however, provides several additional examples.

A. The Fresh Start Policy as a Productivity Reviver

Unlike other fundamental bodies of law that have changed mostly incrementally from their medieval and ancient counterparts, bankruptcy law's change is dramatic, making contemporary bankruptcy law almost the opposite of the shape it had for centuries, which consisted primarily of devices to satisfy creditors rather than to support debtors through a potentially temporary downturn.

The two major breakthroughs of contemporary bankruptcy are the fresh start and reorganization law. Both are unexplained by collective action and both address productivity by reviving it. Thus, they are the perfect examples of the secondary nature of solving the

6. See infra note 81 and notes 31-34 and accompanying text.
7. See infra note 31.
creditors' collective action problem and of the primacy of productivity revival as functions of bankruptcy law.

"Fresh start" is a term that refers to the policy of forgiving, or "discharging," the debts of honest insolvent individuals. This principle of modern U.S. bankruptcy law is presented as being a far cry from the brutal history of creditors' remedies in medieval Europe and in Anglo-American law. This impression is furthered by comparisons with ancient Roman Law which initially had the debtor go into his creditors' servitude or have his life be at his creditors' mercy. This impression of a history of brutal collection devices is false. Soon, Roman law—under either Augustus or Cesar—witnessed a humane development and allowed debtors to perform cessio bonorum, cede their assets to their creditors and avoid servitude or dismemberment.

This humane attitude retreated somewhat during the resurrection of Roman Law in medieval Europe. Insolvency was considered a sin accompanied by severe shaming penalties. French and Italian debtors wishing to take advantage of cessio bonorum had to appear, often in central locations, naked or in prescribed states of undress and perform shaming rituals, such as hitting their backs or buttocks against specific stones or statues. Only Dutch law stood out for not requiring shaming and affording debtors the possibility of repeated declarations of cessio bonorum. Still, the availability of cessio bonorum was very lenient compared to the British and German remedies of incarceration, execution, or ear-cutting.¹⁰

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9. Practically every book and article that presents the historic framework of the bankruptcy discharge contrasts it with England and Ancient Rome. See e.g., Andrew J. Duncan, From Dismemberment to Discharge: The Origins of Modern American Bankruptcy Law, 100 COM. L.J. 191 (1995); Charles Jordan Tabb, The Historical Evolution of the Bankruptcy Discharge, 65 AM. BANKR. L.J. 325 (1991) ("Bankruptcy has been around for almost half a millennium in Anglo-American jurisprudence, yet the discharge as we know it in the United States did not exist until the turn of this century.") (footnote omitted). The lenience of cessio bonorum, discussed in the text below, is even considered inap-osite with the argument that it should be thought of as part of insolvency law as opposed to bankruptcy law, but this claim is clearly a formalistic fallacy based on a non-existent distinction. This sorry distinction, which survives in England, is based on the further narrowness of English law which, like other European legal systems, gave bankruptcy capacity only to merchants. Since the cessio bonorum was available without regard to merchant capacity, it was segregated into its own distinct category of insolvency law. See, e.g., id. at 327 n.11 ("It is probably more accurate to identify the well-known Roman cessio bonorum, which provided for the release of the debtor's person but not his debts upon the making of a voluntary assignment for his creditors' benefit, as a predecessor of the insolvency laws, and not of the bankruptcy laws.").

It is worth speculating that the resistance to the “fresh start” of *cessio bonorum* during the middle ages in Christian Europe is likely related to Christian outlawing of interest. Non-payment by a debtor is much more obnoxious if the creditor could neither have charged this debtor an interest rate premium for this eventuality nor have adjusted accordingly the rates charged to future debtors. Indeed, if interest is available, the discharge or *cessio bonorum* of the occasional debtor is part of the business environment and the cost of doing business. By contrast, the prohibition of interest as usury precludes the development of credit markets and institutional lending. Lending becomes a rare favor and non-payment is a disgraceful affront (contrast modern institutionalized lending, where lending is an ordinary transaction and discharge is part of the cost of doing business).

Contemporary bankruptcy scholars contrast the American practice of discharge to the English institutions from which it departed. The innovation of discharge seems much more ordinary if the comparison is not with a brutal system such as the medieval English one, which was not even rivaled by the German one in this count, but with other legal systems which also had greater experience with commerce. The *cessio bonorum* of later Roman Law was followed by Italian city-states of commercial success such as Padua or Venice. *Cessio bonorum* did retreat with the adoption of the civil codes that substituted Roman law in continental Europe, but it was not replaced by anything like the English debtors’ prison. Creditors’ collection powers simply remained in effect because of the absence of a mechanism for discharge. While incarceration thus resurfaced as a remedy, its use never took the pervasive character it had in England. England’s debtor prisons are famous from history and historical fiction.

83 (1996) (detailing the European revival of *cessio bonorum* in the Middle Ages).

11. See supra note 9.

12. The size and institutional structure of London’s debtor prisons is extraordinary. King’s Gate prison, one of the two principal prisons, held a debtor population of about 700 but allowed wealthy debtors to live outside the prison, even allowing an editor of the Times to live and commute to work between 1803 and 1808. For 10 years until 1816 a Mr. Best was able to keep horses, servants, and have seaside vacations. See Ian P.H. Duffy, BANKRUPTCY AND INSOLVENCY IN LONDON DURING THE INDUSTRIAL REVOLUTION 74 (1985); see also Duncan, supra note 9, at 214-15 (1995).

13. See Israel Treiman, Acts of Bankruptcy: A Medieval Concept in Modern Bankruptcy Law, 52 HARV. L. REV. 189 (1938). Historical fiction is wont to take advantage of debtor prisons for the narrative. For an example of historical fiction containing references to the debtor prison (or “sponging house” where the debtor was squeezed like a sponge to pay creditors), see the chain novel of Patrick O’Brien with the protagonists Captain Audrey and doctor/spy Maturin. As
The loan forgiveness that is a principal feature of contemporary bankruptcy law did not come into being as a measure of lenience or equity. The statute of 4 Anne inaugurated discharge as a collection device.\textsuperscript{14} Discharge was the carrot used to buy debtors' cooperation, and non-discharge and punishments, including the death penalty, were the deserts of debtors who would try to hide assets.

Today's bankruptcy discharge is a far cry from a collection device. While it is still limited to honest debtors, the Supreme Court has elevated it into a fundamental policy of bankruptcy law with \textit{Local Loan Co. v. Hunt}.\textsuperscript{15} The Illinois legislature had allowed the creation of security interests encumbering future earnings. Thus, the debtor in \textit{Local Loan}, who had encumbered future earnings, argued that this security interest contradicted fundamental bankruptcy policy. The Supreme Court agreed, stressing the incentive effects of the fresh start:

From the viewpoint of the wage earner there is little difference between not earning at all and earning wholly for a creditor. Pauperism may be the necessary result of either.\ldots{} The new opportunity in life and the clear field for future effort, which it is the purpose of the bankruptcy act to afford the emancipated debtor, would be of little value to the wage earner if he were obliged to face the necessity of devoting the whole or a considerable portion of his earnings for an indefinite time in the future to the payment of indebtedness incurred prior to his bankruptcy.\textsuperscript{16}

In other words, without the fresh start the debtor might be pushed to pauperism, and the debtor's productivity incentives would suffer. The revival of the debtor as a productive member of society is a fundamental bankruptcy policy. Further study of the consequences of the fresh start policy has revealed more incentive effects than seen by the Supreme Court in 1934. Moreover, the closer study has also

\textsuperscript{14} 4 Ann., c. 17 (1705) (Cambridge ed. of English statutes).
\textsuperscript{15} 292 U.S. 234 (1934). Although the fresh start is a fundamental policy of bankruptcy law, it is not a constitutional right. United States v. Kras, 409 U.S. 434, 446 (1973) ("There is no constitutional right to obtain a discharge of one's debts in bankruptcy," and a debtor who can not pay the filing fee is not entitled access to bankruptcy protection).
\textsuperscript{16} \textit{Local Loan}, 292 U.S. at 245.
allowed us to see the incentive effects and the surrounding arguments more clearly.

The "pauperism" to which the Supreme Court refers in *Local Loan* is a simple concept. Material remuneration is a leading motivator for individuals to work. Insolvency causes the destruction of this incentive to work, and bankruptcy with the benefit of debt discharge restores it. The failed debtor enters again the ranks of the productive.

The fresh start policy is not without its perceived disadvantages, the principal being an increase in interest rates. Lenders, the argument goes, receive less in total repayments because of the fresh start policy. While that may be dubious as a matter of fact—demoralized borrowers may well anticipate their failure and give up—it is appealing in theory. The simplest reaction of lenders would be to increase interest rates so as to be compensated for the loans they will not collect.

A simple example shows this effect. A lender who faces an opportunity cost of capital of 10% will have to charge more than 10% to break even. If the failure rate is one in a hundred each year, the 99 surviving debtors must cover the 110% that the lender lost (capital plus interest), which works out to an additional 1.11% of interest annually per debtor.

The first misleading attribute of this example is that borrowers fail even without the fresh start policy. Part of the recipe for successful lending is to estimate accurately the probability of each borrower’s failure (or of each group of borrowers) and compensate with an appropriate interest rate. Moreover, several reasons argue that the increase in the odds of repayment without the fresh start policy would be negligible. Not only do behavioral and evolutionary arguments suggest that debtors make every effort to fulfill their obligations, 17 but evidence from the success of individuals’ reorganization plans suggests they are small. 18 If indeed repealing the fresh start

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17. Todd Zywicki, *Bankruptcy and Reciprocity: An Evolutionary Analysis of Promise-Keeping, Norms, and Bankruptcy Law* (draft 2000) (on file with author). Similarly, the number of bankruptcy filings is found by Michelle White to be surprisingly small, see Michelle J. White, *Why Don’t More Households File for Bankruptcy?*, 14 J. L. ECON. & ORG. 205 (1998) (arguing that, through state exemption laws and federal bankruptcy discharge, as many as 15% of American households would benefit financially from filing for bankruptcy relief).

18. My rough estimate of the effect of narrowing the discharge is that interest rates might drop by less than one-tenth of 1%, about 0.08%. The estimate of repayments of consumer debt that might be possible if the fresh start were relaxed can be extrapolated, with a great deal of caution, from the estimates of the effect of placing more debtors in Chapter 13 plans instead of Chapter 7 liquidations. Gordon Bermant and Edward Flynn estimate the repayment
would get for lenders about 3 cents out of every dollar lost in bad lending, its effect on interest rates can be estimated. Suppose loans have an average duration of 5 years and unsecured credit costs 10% more than safe secured lending. These 10 percentage points over 5 years produce 61.1% which covers 5 years' losses for lenders. Without the fresh start these losses would have been 3% less, and the interest rates would need to cover 0.5% over 5 years, so the annual rate due to risk would drop from 10% to 9.3%, a rounding error at best. Thus, the idea that the fresh start policy costs us all substantial interest rate premiums is unsupportable.

Lenders, however, have much better reactions to debtor failure than increasing rates. Lenders can keep abreast of their borrowers' affairs, and can protect themselves with contractual clauses. Monitoring debtors and covenants that impose safe conduct protects creditors from the incentive that debtors have to reduce their efforts when part of the risk of their failure burdens the creditors. Covenants and monitoring prevent the previously industrious debtor from lowering his guard.

An example of the beneficial effect of the use of covenants uses a covenant that prevents the diversion of value to psychic gains of the debtor, to which the creditors do not share. Suppose that the debtor can exchange $10,000 of earnings into a subjective benefit worth $10,000 to the debtor, but which cannot be appropriated by the creditors. An example of such a benefit would be stature in the community, which may be achieved through leisure. A covenant that would prevent such a diversion of value would be worth $10,000 to the creditors as a group.

Thus, the fresh start policy does more than motivate failed debtors to re-enter the ranks of the productive, it also motivates creditors. Creditors are led to filter their debtors, i.e., to choose the

that is plausible by sending more debtors to Chapter 13 to about $1 billion per year, based on 1997 data. The Federal Reserve's time series on consumer debt indicates that total consumer debt fluctuated during 1997 between $1993 billion and $1221 billion. Using the smaller amount of consumer debt, suggests that increasing repayments by $1 billion will allow creditors to reduce interest rates by 0.08% (1/1,221). Even if we take the maximum of the range of estimates of additional repayments provided by the credit card industry, $5.1 billion (despite the fact that the Bermant & Flynn study estimates that even if no expenses were allowed and all of debtors' income were used for repayment, repayments would be about $3.76 billion) the effect on interest rates is still a trivial 0.43%.

more able and those who have better prospects, and thus allocate society's scarce capital according to productivity. The fresh start policy also motivates creditors to help the debtor, to innovate in the methods of reviewing their debtor's performance, and to refine the contractual provisions of loans. All these effects lead to ever more increased productivity. Interest rate decreases, by contrast, confer no indirect gains for capital allocation and no incentive to improve the lending market, its monitoring habits, and contracts.

The only credible—but still false—counter-effect to these numerous productivity consequences of the fresh start is the tendency it induces for increased reliance on wealth as opposed to productivity. The fresh start prevents lenders from being satisfied from the debtor's future income. The possibility exists that the debtor files for bankruptcy in anticipation of an upturn. The debtor surrenders all assets, gets a discharge, and enjoys the brighter future. Lenders can counter by relying on—and encumbering, if possible—existing assets. This bias can be pernicious because it prevents the equalizing effect of credit. Instead of lending to each according to ability and prospects, an easy discharge policy may lead to lending according to existing wealth. The effect is to rob society of the contribution of the able poor, who can no longer finance their ideas by borrowing according to abilities. This consequence is indeed dire and should question the desirability of the fresh start, but it does not materialize in fact as is proven by the flourishing of venture capital. It does motivate, however, some of the several exceptions to discharge, most notably the non-dischargeability of student loans.19

There is little evidence or even complaint by lenders of strategic bankruptcies in anticipation of future success outside student loans. While the success-anticipating filing is plausible in theory, in practice it requires unusual foresight coupled with poor luck in the immediate past as well as cunning. While such a setting may arise, it appears that it has either been sufficiently rare in commercial settings or lenders can counter it. Student loans are different and the practice of filing for bankruptcy immediately out of school was popular until student loans became non-dischargeable.20 The predictability of future success of the medical student, however, is completely different from that of the entrepreneur, who may well need access to credit in the future. Moreover, a borrowing enterprise will usually have a body of assets on which it depends for its daily operations. A

bankruptcy that would relieve the entrepreneur of future liability at the price of losing those assets may well be too costly if the future depends on continuity of the business.

Financial markets have produced a much stronger counter-argument to the lend-to-wealth effect of the fresh start policy. With the advent of venture capital, the financing of entrepreneurial ideas seems extraordinarily easy, even in circumstances where the entrepreneur could appropriate a great fraction of the value of the enterprise because it still consists of mostly unimplemented ideas. The success of venture capital, particularly in jurisdictions that do not strictly enforce agreements not to compete, proves that prospective success does not give rise to an opportunity to abuse creditors. The potential to abuse venture capitalists is greater than the potential to abuse creditors because the entrepreneur does not have to file for bankruptcy and give up assets; the entrepreneur simply resigns from the old and starts a new company. That the venture capital industry thrives despite this easy double-cross shows that this kind of opportunistic behavior is either rare or controllable.

The fresh start policy is also supported by arguments that are founded on systematic errors. An urge to take one more entrepreneurial chance can be considered to be similar to a gambling addiction. Debtors might also be subject to systematic optimism regarding their chances of success and, therefore, borrow excessively. Debtors may also ignore or devalue their future welfare and, therefore, willingly expose their future self to excessive liability. The fresh start addresses all these biases by conditioning the borrowing on the lender's estimate of the debtor's future. The lender, of course, is not subject to these biases. Moreover, all these effects distort the allocation of capital because loans would go to the risk-loving, the overoptimistic, and the shortsighted, respectively, as a consequence of the biases founded on the gambling urge, overoptimism, and disregard of future. Therefore, the fresh start policy serves productivity even if it is seen as no more than a response to systematic errors.

Before closing, it is important to note that Local Loan's empha-

21. Indeed, some argue that the lax enforcement of agreements not to compete in California contributed to the proliferation of venture capital by allowing entrepreneur mobility. See Ronald J. Gilson, The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete, 74 N.Y.U. L. REV. 575, 607-08 (1999) (discussing California's refusal to enforce non-competition clauses against employees). A better claim would be that agreements not to compete shackle entrepreneurs to failed ventures, but even that would not be sufficient, for entrepreneurs would only have to move to California for their second venture.

esis on the incentive effects of fresh start makes productivity restoration a principal bankruptcy policy dating from 1934. Productivity recurs as a justification of bankruptcy interpretation by the Supreme Court, as in Reading Co. v. Brown, which is discussed below. By contrast, the collective action solution of avoiding races has only recently been used, for example in Union Bank v. Wolas and still without nearly as unambiguous an acknowledgement of its importance. Moreover, Wolas also revives productivity, as we will see.

It is also important to note that the productivity protection that flows from Local Loan is absolute. The debtor could avoid the consequence of his pledge of wages by changing jobs. But, presumably, his current job was where he was most productive, and a switch would entail costs. The fresh start ensures that the debtor's productivity does not diminish at all, and that no relocation and retraining expense is triggered by the debtor's financial failure.

Contemporary law and economics analysis seems to doubt the propriety of the fresh start, focusing on the notion that debtors should be allowed to make the decision to waive their fresh start. From a microeconomic perspective, debtors should be entitled to bargain over the dischargeability of their debts. Some have credibly argued that systematic errors and biases distort that exchange. Individuals may be systematically overoptimistic and overestimate their chance of success, with a result of exchanging their discharge on the cheap. This argument, however, applies to numerous other exchanges—notably gambling—that may be regulated but are not prohibited. If, indeed, fairness of consideration were society's concern, a simple tax or fee on waivers of discharge could correct the discrepancy. Credit card companies, for example, that solicit waivers of discharge could be obligated to pay a fee for each waiver they receive or solicit, inducing them to give less of an interest-rate break to customers and leading to correct decisions about the waiver of discharge. A fear of errors does not explain a policy that prohibits

24. See infra text accompanying notes 69-72.
26. After noting that by avoiding races, an exception from avoidance does promote the interests of all creditors by enhancing their collective value, the Court further notes: "Thus, . . . we must recognize that [availability of the ordinary course of business exemption] does further the policy of deterring the race to the courthouse and . . . may indirectly further the goal of equal distribution as well." Id. at 162.
27. See infra notes 73-75 and accompanying text (discussing the non-avoidability of regular payments on long term loans).
28. See Jackson, supra note 22, at 225-79.
individuals from waiving the benefit of the bankruptcy discharge.

From the macroeconomic perspective of preserving the productivity of the economy, however, bargains that may destroy one party’s productivity incentives involve an externality. The subjective calculation of the costs of their incapacitation by debtors does not take into account its effect on others. Each productive entity is a nexus in the web of economic activity. Every transaction gives rise to consumer and producer surplus. Every transaction accelerates the velocity of money. And every transaction that exchanges product for cash leads to more transactions, more productivity, and consumer and producer surplus. The removal of a productive individual from this economic web has consequences that match Maynard Keynes’ notion about the multiplier. Just as Keynes held that the restoration of economic activity has an effect greater than the spending it requires, so the destruction of an individual’s economic activity has an effect greater than the production that does not occur.

The graphical representation of this is illustrative. Consider a graph of aggregate production quantity along the x-axis and average price level on the y-axis, presenting aggregate supply and demand. The removal of individuals from economic activity initially only reduces supply, pushing the downward-sloping supply line to the left. The result is a new equilibrium at a reduced quantity but at a higher price. The incapacitated debtors, however, also are removed from consumption. The result is that demand also is reduced and moved left. The equilibrium is at a yet lower quantity but at a price that may be equal to the initial. The double reduction in total product is an effect similar to Keynes’ multiplier, and is due to the fact that the incapacitated debtors do not only stop most of their production but also most of their consumption. A further crucial effect regards total surplus. The total consumer and producer surplus is significantly reduced.
This Figure illustrates the effect of discharge on total consumer and producer surplus. When all members of society are productive, supply is large, illustrated by the Supply line. Since all members are economically active, they are also active as consumers, their demand being the Demand line. Total production quantity is HQ and the average price level is P. The economic incapacitation that is caused by non-dischargeable crushing debt implies that some members will no longer participate in production or consumption. The aggregate supply after this debt-induced incapacitation is illustrated by the Low Supply dashing line. The intersection of this with the Demand would be where supply and demand would reach equilibrium if economic incapacitation did not influence demand. The individuals who no longer produce also do not have the funds to engage in consumption. The aggregate demand drops to one indicated by the Low Demand dashing line. Price (may) remain unchanged at P. Total quantity produced drops to LQ, even though the direct reduction in
production due to the incapacitation would have only reduced production to MQ and slightly increased price to P'. The additional reduction in production due to the impact of economic incapacitation on demand illustrates an effect similar to that of the multiplier. In this case, where supply and demand have equal slope, albeit of opposite sign, the multiplier has a value of 2, slightly higher than actual estimates.\textsuperscript{29} The real loss in terms of welfare, however, is the lost consumer and producer surplus, the shaded area between the different lines of supply and demand. When bankruptcy law provides a fresh start, it returns the crushed debtors to production, resurrects their contribution to supply and demand, and restores the destroyed surplus to society.

This Figure only begins to illustrate the distortions caused by financial incapacitation. One more very significant consequence regards optimal allocation of skills in production. The incapacitated individuals would employ their effort in its highest valued use. When they depart from production, the market will readjust to still provide at least part of the same product. This implies, however, that someone else would deliver that service, who by definition would not be the lowest cost producer in the highest valued service. The misallocation is a chain reaction. The individual who fills in for the incapacitated partly departs his own occupation, causing one more increment of misallocation, and so on.

The financial incapacitation of an individual burdens the economic system. The multiplier and allocative distortions indicate that the effect on total product quantity (as measured, for example, by GNP or GDP) and aggregate surplus will be greater than the lost product of the individual. The parties to the loan contract, in their microeconomic calculation of the costs and benefits of a term that waives the discharge to them, will not consider the external macroeconomic harm to the economy from the debtor's incapacitation.

In sum, the fresh start policy does much more than prevent pauperism. The discharge ensures the productivity of each individual and of the economy.

\textsuperscript{29} See, e.g., WILLIAM J. BAUMOL & ALAN S.BLINDERS, MACROECONOMICS: PRINCIPLES AND POLICY 183 (8th ed. 1999) (stating "[i]n actuality the multiplier is under 2!" despite that the analysis based on marginal propensity to consume produces and estimate of a multiplier of 10).
B. The Potential for Reorganizations as a Productivity Restorer

The existence of a reorganization chapter in bankruptcy law is neither universal, nor is its desirability universally conceded. Contrary to the silent assumption of much of the related literature, a reorganization chapter is not necessary to avoid liquidations of going concerns. Liquidations were avoided in the United States before the existence of a reorganization chapter by means of the equitable receivership. Evidence from legal systems without a reorganization chapter indicates that liquidations are routinely avoided by the senior creditor’s choice to purchase the firm in a forced sale.30 Like the fresh start policy, attempts to reorganize so as to continue the going concern appear as collection devices, creditor self-help that is still practiced in legal systems that do not have a reorganization chapter. The inclusion of reorganization in bankruptcy law is a fairly recent innovation, with less than a century of experience. The international experience is even shorter with all reorganization codes post-dating Chapter 11 and being largely similar.31

Reorganizations began as a collection device because they began at the creditors’ initiative—in stark contrast to current practice where Chapter 11 is initiated in practically every case by the debtor, and in contrast to the current debate where creditors oppose the “excessive” ability of debtors to try to reorganize. Reorganization law traces its origins in “equitable receivership,” a practice started in the 19th century in the case of insolvent railroads.32 Railroads in the budding American landscape were uniquely suited to demonstrate to creditors that a restructuring of only the claims against the railroads would produce more value than a liquidation. The setting was compelling because the tangible assets of those firms were long strips of land, mostly rural or wild, that were organized as a network with service, passenger and cargo nodes—the railroad stations.

The nominal value of the land may often be comparable or inferior to the value of the railroad’s “rolling stock,” its cars and engines, which may not be available to satisfy creditors, for example because it may be leased. On the claimants’ side, the obligations that were driving the insolvency were to bondholders, who were completely unable to take charge of either the firm or the collateral, as they were not only distant but abroad and acted through their bankers, such as the legendary J.P. Morgan & Co.33

In this almost unique setting, bondholders would see that their best hope for realizing some value was not to foreclose against the land, but to leave it in its current use as a railroad. They could buy the land at foreclosure, but two very different options opened up. One alternative that creditors had was to take the land they bought and to ignore the organization of the railroad. In this case they would take the land and continue searching for assets and suppliers so as to set up a new railroad.

The second alternative was to contribute the value of the land toward the creation of a new railroad that would be a successor to all the assets and relations of the failed one. This process, only slightly atypical, was the essence of equitable receivership. Equitable receivership is clearly archaic compared with modern reorganization. Equitable receivership did not provide for a continuous legal entity and the foreclosure formalities had to be maintained. The spark of the reorganization spirit, however, was already present. Despite the new corporate entity and despite the foreclosure sale, the business remained intact. Despite all the shuffling of legal relations in form, the substance was that the claims against the business changed character, but that the business itself remained unaffected. Major problems that modern reorganization law would resolve, such as the hold-out incentive of the last creditor who has to agree with the reorganization, remained unresolved, but they were also ingeniously circumvented by dissolving the original debtor corporation.34


34. The problem of holdouts was also avoided by the deep insolvency—whether in fact or appearance. If the auction of the collateral did not produce funds to cover the secured creditors’ claims, the unsecured creditors were out of the money. Thus, their cooperation would not be needed and they would not have the opportunity to threaten a holdout. The typical class of secured creditors was likely not to be subject to the holdout problem. If secured creditors were the usual bondholders, their bond indenture would resolve this collective action problem by requiring voting rather than unanimity, for collective decisions. Renewing and amending numerous contracts, by contrast, requires una-
The desirability of the reorganization chapter has recently been questioned. The leader of this attack is none other than Professor Douglas Baird, of the Baird and Jackson team, the leaders of the school that sees bankruptcy law as a solution to the creditors' collective action problem. The essence of the argument is that reorganizations are not justified by the creditors' collective action problem. The creditors' incentive to grab assets and, thus, perhaps destroy value, is solved by the automatic stay at the moment of the filing of the petition. The choice of a liquidation or reorganization procedure has no consequence, not even on a corporate debtor's going-concern value. Baird argues that a petition triggering a liquidation through Chapter 7 in no way implies the loss of any value for the creditors compared to a Chapter 11 petition, because the firm can be sold as a going concern in Chapter 7. Since the liquidation would maximize the proceeds, if the firm were worth more as a going concern than in liquidation, that is how it will be sold in Chapter 7. As a result, not only is there no loss of value for society, but if Chapter 11 entails greater costs of administration than Chapter 7, these economies also argue against Chapter 11.

Chapter 11 may have further defects that are not as explicit. For example it is structured with a presumption for reorganization while the choice of whether to liquidate or continue a business should not be biased. The argument that Professor Baird makes most often is that social policy concerns that do not regard bankruptcy nevertheless influence reorganization law. In the context of

nimity, which gives contract creditors the incentive to hold out and threaten destruction if they do not receive privileged treatment.

35. See, e.g., Baird, Uneasy Case, supra note 8 (arguing that Chapter 11 is unnecessary because firms can be sold as going concerns in Chapter 7); Easterbrook, supra note 8.

36. Douglas G. Baird, A World Without Bankruptcy, 50 LAW & CONTEMP. PROBS. 173 (1987); Douglas G. Baird, Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren, 54 U. CHI. L. REV. 815 (1987). Although Baird makes this argument from the premise that collective action problems are the principal justification of bankruptcy provisions, it can also be made with no such assumption by using public choice theory. Bankruptcy law, the argument would go, is easier for special interests to capture than a legal field that applies every day. Thus, labor may be able to cause a rent-extracting redistribution in its favor through reorganization law that it would not be able to obtain in a general law about protecting labor in cases of plant closings, for example. From the perspective of this Article the question becomes how productivity incentives are restored by reorganization law. While I consider Baird's view of bankruptcy oversimplified—particularly since I argue in this Article that the collective-action justification is secondary to restoring productivity—I do not oppose his argument on the basis of productivity restoration. Granting labor more protection in the context of a reorganization than out of that context does not serve a productivity-restoring function. However, some additional power to employees
the wastefulness of Chapter 11, the argument has been made that Chapter 11 and, more generally, the bankruptcy regime, should be a default arrangement. Parties would be free to contract out of bankruptcy and design their own arrangements for the case of insolvency.\textsuperscript{37} In a similar vein, others have proposed schemes that would effectuate an automatic transfer of the firm depending on its valuation by the market.\textsuperscript{38} The practicing bar, motivated by similar concerns, has crafted transactions that preclude the debtor's voluntary bankruptcy filing.\textsuperscript{39} Thus, reorganization law is attacked from every direction in economic analysis of law and economic reality. It is considered unjustified, and both its mandatory nature and its actual shape are seen as defective. The thesis of this section is that a reorganization chapter prevents false liquidation decisions at times of recessions or credit crunches, and in firms involving large, subjective private benefits of control. The normative implication is that a mandatory reorganization chapter is desirable, but the ideal form that a reorganization chapter should have is not within the scope of this Article. Thus, objections to the current form of Chapter 11 in the United States are not relevant.

The view that Chapter 11 is superfluous, however, is predicated

may be desirable, because it may allow society to account for the dislocation costs of employees in deciding whether to liquidate or reorganize. That employees will expend resources to obtain new jobs is a cost that liquidation imposes and it should be part of the reorganization calculus. The following example illustrates.

A firm's employees will spend, in aggregate, $500,000 in expenses and lost earnings to get new jobs. If reorganization appears less desirable than liquidation because the firm's assets would raise $400,000 more in liquidation after the relocation costs, the reorganization that is disadvantageous to creditors would be socially preferable.


39. This limitation is usually accomplished by charter amendment. The debtor is required to amend its charter so that a voluntary bankruptcy filing requires unanimity of the board of directors. Then, the lender is given voting power to elect one "independent" director, whose only role is to oppose a bankruptcy filing. The debtor can still arrange to enter bankruptcy by means of a friendly involuntary petition, the validity of which is disputed. See Harold S. Novikoff & Barbara S. Kohl, Bankruptcy "Proofing": Bankruptcy Remote Vehicles And Bankruptcy Waivers, 23 ALI-ABA COURSE MATERIALS J. 37 (1999); Robert Dean Ellis, Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights, 24 J. CORP. L. 295 (1999). It is interesting to note that equity receivership may undermine severely the very popular attempts to create bankruptcy-proof "special purpose vehicles" and remote entities so as to avoid Chapter 11. Even non-business trusts, that do not have the capacity to be debtors in bankruptcy by statute, may well be included in an equitable receivership proceeding.
upon the notion that resolving collective action problems is the chief role of bankruptcy law, perhaps even its only role. Since the thesis of this Article contradicts this view, the role of Chapter 11 and reorganization law in general must be determined by studying its fundamental functions. If we find that one of the theories explains more of the role that Chapter 11 plays, an argument can be formed that this theory serves better the function of explaining Chapter 11, even though this observation alone neither shows its social desirability nor justifies it from a normative perspective.

The fundamental function of reorganization law is that it effectuates a change in the claim structure—debt as well as equity—of the debtor firm. In this feature, reorganization law is similar to the pre-reorganization law practice of equitable receivership. Unlike equitable receivership, however, the corporate entity remains the same and, therefore, no change takes place in the formalities of asset ownership and contract counter-parties. Change is also unlikely with respect to control of the firm, with the old management team usually remaining in place as debtor-in-possession. The debtor has further advantages, such as the exclusive right to propose a plan during the first 120 days and then negotiate it without a competing plan for 60 more days.

Despite these advantages, reorganization law does not contemplate the survival of firms without going-concern surplus. Provisions in reorganization law give any dissenting creditor a veto right to block a reorganization plan that does not provide this creditor with at least as much as in a liquidation.\(^40\) Thus, despite the fact that the bankruptcy code allows voting for the approval of plans,\(^41\) raising the possibility that a small dissenting creditor may be in the minority of an accepting class, nevertheless, if retaining the firm as a going concern is disadvantageous, the outvoted creditor can still block the plan.

The fundamental features of reorganization law do give the impressions projected by the collective-action-motivated objectors, but only partly. While their arguments imply that reorganization law keeps wasteful firms in operation, in fact, reorganization law does not allow the continuation of enterprises that would be worth more liquidated. Thus, there is no systemic bias in favor of preventing


\(^{41}\) See id. § 1126(a). The voting that the code contemplates separates the claims in classes of not dissimilar claims, id. § 1122(a), and requires a 2/3 majority by amount and absolute majority by count within each class, id. § 1126(c). Without voting, every creditor would have to approve the alteration of their contract for the reorganization. Voting removes the incentive that the last creditor being solicited has to hold out and to threaten to derail the reorganization.
liquidations compared to a perfectly operating market without reorganization law. The debtor, however, does have great bargaining power, and every firm does get a chance at reorganization by filing for Chapter 11, as opposed to other bankruptcy systems that require approval by the creditors or the courts before a reorganization may be sought, or where continuation of the going concern depends on creditors financing a purchase of the enterprise by the equity-holders, as the Swedish evidence suggests would be the practice without a reorganization chapter. In both creditor-approved reorganizations and creditor-financed buyouts, some firms that should have survived may be dissolved by error, because creditors could not reach an agreement, for example.

The transition into reorganization law addresses two crucial concerns. First, it eliminates the hold-out incentive of the last creditor to threaten to upset the reorganization. Voting ensures that any recalcitrant creditor will be outvoted. In this aspect, without reorganization law, small creditors' power is excessive. It is also important to note that the incentive to hold out is a collective action problem since the hold-out threatens to destroy the going-concern surplus for the aggregate of all creditors. This much of reorganization law is desirable even for those who think that bankruptcy law's only role is to resolve collective action problems.

42. French law, for example, had the court determine the eligibility of the debtor for reorganization. See Richard L. Koral & Marie-Christine Sordino, The New Bankruptcy Reorganization Law in France: Ten Years Later, 70 AM. BANKR. L.J. 437, 448-49 & n.60 (1996). German law, for example, required an affirmative vote of the creditors from 1927 to 1935. See Maximilian Schiessl, On the Road to a New German Reorganization Law—A Comparative Analysis of the Draft Proposed by the Insolvenzrechtskommission and Chapter 11 of the Bankruptcy Code, 62 AM. BANKR. L.J. 233, 237 & n.27 (1988).

43. See Strömberg, supra note 30.

44. Unless, of course, one truly believes accurate prices can be obtained in a forced sale of the business as a going concern; no creditor acquiescence is required. Note, however, that for the creditors to be adequately protected, the trustee must conduct two sets of auctions, each contingent on the other's outcome. The trustee must sell the firm as a going concern contingent on that price being greater than the aggregate of the sale of the firm's assets. Then the trustee must sell the assets, conditional on their aggregate proceeds exceeding the going concern value. The uncertainty associated with such auctions will necessarily dampen buyers' willingness to bid and lower both sets of prices, to the creditors' detriment. Thus, the Baird recommendation is in conflict with Professor Baird's own agenda of maximizing creditors' returns. Paradoxically, if the chilling effect is equal in the auction of both the firm and of the individual assets, then the decision whether to liquidate will be made correctly from a social perspective, and, therefore, would satisfy this article's concern of avoiding false liquidations. This would not make the process desirable, however. The reduced proceeds would lead to higher interest rates and, thus, reduced produc-
The second crucial but little-noticed concern apparent in reorganization law regards the concern that false decisions may be made regarding liquidation versus continuation of the business. This is a concern that does not emanate from a single provision but from numerous arrangements of reorganization law in combination with the reality of imperfect information, subjective and differing valuations, financing constraints, and credit crunches during recessions. All

Credit crunches are the temporary funding constraints that appear in recessionary environments. The recession reduces the productivity of assets—for example, it reduces the rents that landlords can charge—and the result is a reduction in the market prices for assets. The result is reduced ability of individuals and firms to raise funds through their assets, either by borrowing against them or by selling them. This reduction regards both the amount that can be raised as well as the willingness to raise it. The reduced willingness would require a market imperfection leading to a reduced willingness to sell. This, in turn, becomes unwillingness to take the risk of a forced sale by borrowing.

Two recent credit crunches have provided econometricians with ample evidence to study their effects. In 1997-98 a major crisis struck developing nations globally, but it started from East Asia and is remembered by that name. In the United States the real estate market was hit by a severe crisis in 1989 to 1992.

The East Asian financial crisis of 1997-98 is a characteristic example of a credit crunch, with the forced sales attenuated due to the governmental character of many of the liabilities involved. A “bubble” in asset prices (stocks and real estate) had formed due to very high growth expectations by the market. Loans were made based on such asset valuations. Upon the burst of the bubble the borrowers and lenders found themselves insolvent, capital fled the infected economies, slashing the value of their currency, and the induced economic freeze hampered the raising of foreign exchange and taxes. See, e.g., Anna Gelpern, Systemic Corporate and Bank Restructuring in Financial Crisis, 34 INT'L L. 283 (2000); Dafei Chen, Note, Acute Symptoms of Chronic Problems: Japan's Procrastination In Solving Its Banking Crisis, The Current Situation and a Future Perspective, 9 MINN. J. GLOB. TRADE 269 (2000).

these problems suggest that false prices may be obtained in forced auctions, particularly during recessionary periods. False prices undermine not only the confidence in the decision whether to reorganize or liquidate, but also the belief that sales will lead to optimal resource allocations. The reorganize-or-liquidate decision is undermined by false prices because the false outcome may command the higher price at the auction. Even if the reorganize-or-liquidate decision is made correctly, however, the potential for false prices undermines the desirability of the allocation of the sold item by the auction. The auction is supposed to lead to an allocation of the asset to the user—the buyer—who values it the most. When confidence in prices is lost, lost also is the confidence that the asset will go to the highest-valuing user. Reorganization law prevents both errors by obviating auctions.46

Even if it fails on every other count, reorganization law does avoid auctions. By design, reorganization law implies that forced liquidations are circumvented. A look back at the practice of equitable receivership reminds us that it did not avoid auctions. Equitable receivership operated in essence through an auction that the secured creditors conducted, in which auction the new firm, organized for the benefit of the secured creditors, would be the high bidder.47 The dispute would be whether the price at which the secured creditors bought at the auction was fair, since the secured creditors appeared to be the only bidders.48 The question becomes what func-

46. Here lies the contradiction with most proposals to simplify Chapter 11; they all rely on auctions or “market” tests of one form or another. The same error lies with an overbroad reading of Bank of America v. 203 N. LaSalle St. Partnership, 526 U.S. 434 (1999), that would apply its “market test” requirement to every cramdown that uses the new value exception. Properly read, 203 N. LaSalle only regards the use of the new value exception for entities that are not family firms, because the use of the new value exception in the context of family firms may involve fresh start questions. See Nicholas L. Georgakopoulos, New Value, Fresh Start, 3 STAN. J.L. BUS. & FIN. 125 (1997) (cited in 203 N. LaSalle, 526 U.S. at 446).


48. See Paul D. Cravath, The Reorganization of Corporations: Bondholders’ and Stockholders’ Protective Committees; Reorganization Committees; and the
tion is served by avoiding auctions, and whether this function should be performed by reorganization law.

The evidence from legal systems without a reorganization chapter shows that buybacks of the equity financed by the creditors also do not avoid auctions. The Swedish evidence shows repurchases of the firm take place inside the liquidation process.\(^{49}\) The accounts from both Sweden and the era of equity receivership in the United States indicate that the senior creditors use their power in liquidation proceedings to freeze out the unsecured creditors.\(^{50}\)

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**Voluntary Recapitalization of Corporations, in Some Legal Phases of Corporate Financing, Reorganization and Regulation** 153, 201-02 (1917). Cravath discusses how the dispute with the dissenting (junior) creditors will be about the propriety of the price fixed for the foreclosure sale. His advice is to set that price high enough not to be unfair to dissenters, but low enough that any payments to dissenters that it forces are minimized.


49. Cravath eloquently illustrates the hold-up power of equity-holders, even after Northern Pacific Railway Co. v. Boyd, 228 U.S. 482 (1913), had formed the absolute priority rule so as to prevent the participation of equity before junior debtholders: “But still [after Boyd], in most large reorganizations, the stockholders knock loudly at the door for participation, and it is still the preference of most bondholders’ committees to afford them participation, partly to avoid the dissatisfaction, litigation and delay which might result from their exclusion ...” Cravath, supra note 48, at 195.

Cravath points to an ingenious way to hamstring unsecured creditors despite Boyd’s mandate that they must receive value before equity-holders. Id. at 196-97. The reorganization plan would provide for three classes of equity. The most junior class is common stock, next is preferred stock, and finally, but most notably, is senior preferred stock. Cravath’s proposed reorganization plan gives the preferred stock to the unsecured creditors, satisfying a narrow interpretation of Boyd’s mandate. But the old equity-holders receive not only the common stock, but also the senior preferred! Furthermore, Cravath acknowledges that perhaps all classes of equity could be issued at a discount. If so, equity-holders would receive the senior preferred at a discount, hence they would obtain value ahead of the unsecured creditors.

An example illustrates how Cravath’s stratagem might subvert the spirit of Boyd to the detriment of unsecured creditors. Suppose the failed firm has $100m of assets that produce $20m annually in an environment with a 10% discount rate. This implies that the value of the firm as a going concern is $200m and that the firm should not be liquidated but reorganized. The secured claims are $150m, and the unsecured are $100m. Going-concern value was not well understood at that time. Therefore, the plan would start from the premise that the firm is worth $100m and that only the secured creditors’ claims were in the money. The abuse Boyd sought to stem must have been that the secured creditors would propose a plan valuing the firm at $150m and, after raising $10m new capital from the old equity-holders, the firm would reinstate the secured creditors’ $150m secured claim and give all the equity to the old equity-holders. Now that we understand going-concern value, we recognize that such a plan freezes the unsecured creditors out of $50m of value to which they are entitled: that which would remain after the secured credit of $150m were subtracted from the going-concern value of $200m.
In an environment of perfect markets and perfect knowledge and rationality, of course, nothing could be gained from avoiding auctions. Auctions in an environment of perfection would lead to optimal allocation of resources, since the highest-valuing user would always obtain the asset and the comparison of liquidation value and going-concern value would be unbiased and lead to the correct outcome. Moreover, in a world of perfect markets, the forced sales and the prices obtained in forced sales would have no different effects than negotiated sales and would have no cascade effect on the value of other assets.

A world of imperfect information, valuation discrepancies and subjectivity, financing constraints and credit crunches, however, is very different. Avoiding auctions may have beneficial effects. The reorganize-or-liquidate decision might be made more accurately, the allocation of resources without auctions may be preferable, and panics or selling cascades may be avoided.

Imperfect auctions can distort the decision whether to reorganize the firm in both directions. Imperfect information will, of course, lead bidders for the firm to discount its value as a going concern. The firm's assets are unlikely to involve valuation of comparable dif-

Cravath's answer to Boyd would probably produce a plan along the following lines. Again the firm would be valued at $150m and it would raise $10m not only from the old equity-holders but probably also the old unsecured creditors. Suppose each group would contribute $5m. After raising the $10m the firm would issue the three classes of equity. The senior preferred would be issued at a discount, so that the first, say, $4m of the equity-holders' contribution would buy $32m of senior preferred. The unsecured creditors might receive some amount of ordinary preferred, assume $10m for their $5m contribution, and the equity holders might receive the common stock worth $15m ($200m value plus $10m contribution less $150m secured claims less $32m senior preferred less $10m preferred equals $18m) in exchange for their remaining $1m contribution. This plan would give value to the unsecured creditors, who appeared to be out of the money, upholding the letter of Boyd. Nevertheless, the treatment of unsecured creditors is in no way generous. They were in the money to the tune of $50m that would remain after subtracting the $150 secured debt from the going-concern value of $200m. They would receive in the reorganization value of $5m by being given a claim worth $10m after paying $5m for it. The equity-holders were out of the money not only in appearance, but also in substance—after accounting for the full going-concern value. Nevertheless, they would receive value of $45m, $32m in senior preferred equity and $18m in common for both of which they would pay $5m.

Cravath's narrative shows how equity receivership could be used by the senior creditors to strip the claims of unsecured creditors while letting the equity-holders maintain control in the reorganized firm. The court opinions that we have—from the leading cases of Boyd and Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939), in the Supreme Court and down to other courts—show that this potential was put into full effect.

For the general model of why senior creditors freeze out unsecured creditors and an application of this analysis in Sweden, see Strömberg, supra note 30.
ficulty. The resulting discount of the bidding for the firm as a going concern creates a bias in favor of false liquidations. In the case of assets that are hard to value, however, this bias may be reversed so that it favors reorganizations.

Subjective valuations produce the same problem of false reorganization decisions. The problem takes its most complex form in the case of the family enterprise, the control of which has purely subjective sentimental value for its controllers. Similar problems will arise in numerous other situations, however, such as the ownership of sports teams, restaurants, prestige wineries,51 or various other businesses that exhibit high amounts of non-monetary benefits of control. In all these cases the liquidation decision is inherently problematic because it entails the loss of an asset—the subjective value of the business. In cases of perfect markets a buyer who shares this subjective valuation will likely be induced to bid for the going concern and liquidation will likely be avoided. If the markets are imperfect, however, if the subjective valuation is not widely shared, and if those who share it cannot raise the necessary funds, liquidation may well appear preferable. The potential for error is much greater if the determination whether to auction the firm or its assets is made before ascertaining the existence of others with a similar subjective valuation or the quality of the financial markets to which they can resort. Thus, auctions can distort the liquidation decision in firms with high subjective values of control.

In addition to the above distortions of the decision whether to liquidate the firm, auctions in imperfect markets are also less likely to have their desirable consequences for allocation of resources. The confidence in the allocation by auction is due to the most productive user's ability to finance a high bid. At a time of disrupted markets, this kind of erroneous auction outcome is more likely than at normal times. A reorganization procedure, hopefully, improves the odds of allocating the control of the resources to their most productive user at a time that an auction may produce a false allocation.

The benefit of avoiding auctions is even more pronounced at times of panics and selling cascades. A selling cascade is the result of a sudden price drop combined with forced sales that are triggered by the price drop. The ultimate example occurs in a securities market crash. The root cause is that a significant fraction of the participants have borrowed using their securities as collateral. Since their securities are collateral for their loans, a drop in prices exposes lenders to the risk of loss. The lenders' response is to liquidate the

collateral, i.e., to sell securities. This further devalues the sold securities, triggering more forced sales. The cascade of price drops leading to sales leading to price drops is a frequent phenomenon that has shaped securities regulation.\textsuperscript{52} Reorganizations cannot eliminate cascading sales. Nevertheless, avoiding the forced auctions does avoid aggravating the cascade and fueling the panic. Some courts have even acknowledged that this concern did contribute to their approving a reorganization. The following statement is telling:

\begin{quote}
[T]he solution [to the plethora of single-asset filings in this recession] is not to make every reorganization \ldots into a liquidation by denying equity holders the right of participation. \ldots Refusing to permit [them] an opportunity to invest destroys any incentive which might exist for capital contribution. Without fresh capital infusion, little hope exists for reorganizing deflated assets in a bad market.\textsuperscript{53}
\end{quote}

A cascade of panic selling was in full swing in the real estate market and the court neither wants to aggravate it, nor has confidence in the valuation that this market produces. Needless to say, the court would also have no confidence that an auction would produce either a proper value or desirable resource allocation.

In sum, reorganization law's principal advantage over equitable receivership is not that it preserves going-concern surplus, because equitable receivership procedures could also preserve going concerns. The main contribution of reorganization law is the avoidance of auctions at times of market disturbances. In other words, reorganization law improves on equitable receivership by avoiding waste while reviving productivity: wasteful liquidation decisions, wasteful allocation decisions, and dangerous selling cascades or panics are avoided, while going-concern value is preserved.

\section*{C. Tort Victim Trust Funds as Productivity Restorers}

The fresh start policy and the potential for reorganizations are the defining features of bankruptcy law. That they are unexplained by collective action while conforming with productivity revitalization should be sufficient to propel revitalization to the leading theory of bankruptcy law. Revitalization, however, exists in many more bankruptcy provisions. Taking a closer look at them not only bolsters the impression of the importance that revitalization has in bankruptcy law, but it also shows the variety of ways in which it can

\textsuperscript{52} The Securities Act of 1933 and the Securities Exchange Act of 1934 were indirect results of the market crash of 1929 that some believe led to the great depression. The Sherman Act (antitrust) and the Williams Act (tender offer regulation) are two more examples of regulation following crashes.

be pursued, and assists in the design and interpretation of bankruptcy rules to promote revitalization.

The technological change that led to the improvement of the safety of various products or practices also led to mass tort claims due to the newly recognized danger of the older technology. Mass torts led to a major development in bankruptcy law. Firms of great success and long standing found themselves under crushing liability for past products or practices. The erstwhile giants found themselves in bankruptcy. Asbestos insulation manufacturers,54 aircraft builders,55 and pharmaceutical companies56 are typical candidates for mass torts that lead to bankruptcy.

The quandary presented to the bankruptcy system is best exemplified by asbestos. Insulation materials containing asbestos were in production for decades, if not centuries. At some point it became apparent that inhaling asbestos would cause a host of illnesses of the respiratory system, which collectively can be called asbestosis. Although the production of asbestos stopped immediately, manufacturers could not retract products they had already circulated.

Despite the elimination of asbestos manufacturing, asbestos-containing products would remain in existence. Thus, the asbestos produced in the past may never cease causing new injuries and adding to the manufacturers' liability. Asbestos manufacturers were, essentially, facing an infinite future stream of asbestosis plaintiffs.

The easy question was whether asbestos manufacturers should be liquidated or reorganized. The essential test is whether the firm is worth more as a going concern than the value of its component parts. Since every productive asset is valued by discounting or capitalizing its future productivity, the above is equivalent to saying that the productivity of the firm is greater than the productivity of its components: the product of the aggregation, the firm, is greater than the aggregated product of its parts. For the firm in bankruptcy, economic and social reasoning suggest that the firm, although insolvent, need not be dismembered by a liquidation, but that the assets should stay together and the firm should remain intact as a productive unit. This was manifestly so in the case of many firms that had manufactured asbestos.

To be satisfied from the analysis that the firms should not be

54. See, e.g., In re UNR Indus., Inc., 725 F.2d 1111, 1113 (7th Cir. 1984) (referring to bankruptcies pending in other courts of other asbestos manufacturers, Johns Manville and Amatex).
liquidated but reorganized, however, overlooks their unique future: the interminable stream of future tort claims. Their prospect alters dramatically the incentives of the claimants, both shareholders and creditors that participate in the reorganization process. To visualize their reaction we must determine the shape of plausible but simplified reorganization plans and examine claimants’ reactions.

Reorganization plans that keep the enterprise intact only rearrange the claims against the firm. By converting some debt claims into equity, a reorganization plan will alleviate the financial deadlock of a debt load that cannot be serviced, and that destroys the firm’s productivity by absorbing funds that should go to productive but discretionary uses, such as maintenance, operation, or research.

Not all debt is equally likely to be converted into equity. The conversion is a fundamental impairment of the debtholders’ contract and expectations. Instead of cash or low-risk debt that can be valued with significant precision, they receive volatile stock of uncertain value. Debtholders with seniority that would have allowed them to be paid in full are unlikely to experience a conversion into equity. Their claims may even be paid in cash, obtained from the issuance of new debt of equivalent seniority. The debtholders who are most likely to consider attractive a reorganization plan that offers them equity in the reorganized firm are the most junior ones. Among the most junior claimants are the tort creditors.

Thus, a very likely feature of the reorganizations that asbestos manufacturers would undergo was that some debt claims would be converted into equity claims. This conversion is likely to include the tort creditors.

If the manufacturers were truly insolvent in the balance-sheet sense, they would have more debt than assets. No value would be available for the old equity. In such cases, an appropriate and likely action would be a reorganization, which would cancel the old equity and convert junior creditors to the equity-holders of the reorganized firm. This is a simplification worth pursuing. Although it leads to extreme consequences, it also shows the essence of the reorganization: equity-holders lose value and control to junior creditors. This is true even if the equity participates in the reorganized firm, as long as some debt is converted into equity. This new equity dilutes the ownership and control of the old equity-holders.

Carrying this simplified view of reorganizations to the asbestos manufacturers, we see that their reorganizations would substitute tort claimants for old equity-holders. Apply this chain of events to the first wave of asbestos-driven bankruptcy filings. If reorganization doctrine were applied without adapting to the special circumstances, asbestos manufacturers would experience a routine substi-
tution of their old equity-holders by tort claimants.

The problem posed by the interminable future stream of asbestosis claimants becomes, now, apparent. In a few more years, the reorganized firms would again be insolvent, because of the liability to new asbestosis claimants. After a second reorganization, the passage of a few years will lead to one more repetition. If bankruptcy law did not address the problem of the interminable claims, the future of asbestos manufacturers would be an interminable stream of reorganizations. Whether and how bankruptcy law should address this vicious cycle of reorganization and future claim accumulation becomes obvious by its consequences for productivity.

The consequences of the impending vicious cycle are its incentives on the first post-reorganization equity-holders. Participants in the first reorganization would, of course, be able to predict the impending vicious cycle. Equity claims would no longer represent a claim to all the future of the firm. The future of the firm is limited because in a few years the firm would be insolvent again. The foreseeable liability and insolvency due to future tort claims also severely restrict dividends by virtue of fraudulent transfer law. The equity-holders' claim is simply a claim on the dividends that could legally be distributed until the next insolvency.

The magnitude of this problem is clearer in an example. Suppose that the firm has constant profits of $10 million annually and would have been valued by the market at 10 times earnings (i.e., by using a 10% discount rate). Accumulating asbestosis claims would render the firm insolvent in five years and force a bankruptcy filing in nine. The most value that the reorganization shareholders could extract would be the first 5 years' dividends (because of the four year reach back of fraudulent transfer law, which coincides with the time of insolvency). The shares that would have been worth $100 million (at 10 times earnings) can extract maximum cash dividends of $50 million. Discounting those to their present value at the time of the reorganization would show that the impending tort claims imply that the first wave of tort claimants—the reorganized firm's shareholders—lose over half of the value of their shares.

Crafty planning, however, could alleviate this predicament of the reorganized firm's equity-holders. Although the firm is worth more to society as a going concern, the shareholders cannot realize

57. Fraudulent transfers are defined and remedied by the UNIF. FRAUDULENT TRANSFERS ACT, 7A Pt. II U.L.A. 266 (1999) ("UFTA"). Dividends are transfers from the firm to the shareholders without consideration. Any such transfer, if the firm is insolvent, is fraudulent and avoidable for the benefit of the firm's creditors, most notably the tort creditors. UFTA §§ 4-5. The creditors' action is usually time-barred four years after the transfer. Id. § 9.
58. UFTA § 9.
this value. They will reconsider the decision to maintain the firm as a going concern. The aggregation of the values of the firm’s assets will be compared to the value of the few years’ worth of dividends that can be extracted. Letting the vicious cycle run its course will be found wanting, and the firm may well be dissolved. Dissolving the firm, however, destroys its going-concern value. Since we have posited that the assets are worth less than the firm, the decision to liquidate destroys productive value.

One could counter, of course, that the equity-holders could sell the assets of the firm as a group. This would allow them to receive the going-concern value of the enterprise. This scheme, however, is precluded by the doctrine of successor liability. Even if the buyer only contracts to acquire the firm’s assets, if those remain aggregated the buyer will not avoid the liability that the same assets caused under the mantle of their previous corporate owner.69 Thus, the buyer of all the assets would be aware that he would inherit the equity-holders’ predicament. Naturally, the firm would not be able to extract from this buyer the going-concern value of the enterprise.

The full extent of the destructive effect of the dissolution of the firm is obvious if we continue the previous example. Suppose the firm’s assets are worth $60 million. The shareholders, who cannot obtain the $100 million that the firm is truly worth as a going concern, will prefer $60 million to the $50 million in dividends, which have an even lower discounted value. By liquidating, they destroy $40 million in productive capacity.

Bankruptcy law, of course, cannot stand as an idle witness to such a destruction of productivity. The solution has been to include the future tort claimants in the current bankruptcy. The future claims are estimated and a trust fund is created for the benefit of the future claimants.69

The massive constitutional problems of addressing claims of unknown victims cannot be ignored. One must also bear in mind that the perpetuation of the enterprise through this solution does abate the incentive effects of tort law. Thus, the type of future tort claimants that can be addressed by bankruptcy trust funds is severely limited. Not only must the wrongdoing lie in the past, but it probably must be unintentional and unforeseeable.61

Once again, bankruptcy law acts as the restorer of productivity. If bad fortune leads a firm to a position of facing an interminable stream of future claims from the firm’s past conduct, incentives get

59. For an attempt to avoid this outcome through bankruptcy, see In re Fairchild Aircraft Corp., 184 B.R. at 910.
60. See In re UNR Indus., 725 F.2d at 1111.
61. Epstein, 58 F.3d at 1573.
distorted. The firm’s owners face an incentive to liquidate it, ignoring its going-concern value and, therefore, the social gains that the enterprise produces. Bankruptcy law cures this distortion through future claimants’ trust funds.

D. Other Productivity Restoring Provisions, Interpretations, and Arguments

Extensions of the productivity-restoring functions of the fresh start policy can be found in several locations of bankruptcy law. One of the most fascinating ones is the treatment of non-compete obligations in the context of executory contracts.62 After rejection, we will see the productivity effect of the priority that tort claims receive during the bankruptcy proceeding and, finally, the consequences for productivity of the fact that payments of long-term loans may be in the ordinary course of business and, therefore, not avoidable.

1. Rejection of Counter-Productive Obligations Not To Compete

Executory contracts are contractual relations that still have substantial performance pending from both contracting sides. Their treatment in bankruptcy is sensitive. Such pending obligations may either be advantageous for the debtor or for the counter-party. In the former case they should remain in force so as to enhance the value of the estate. In the latter case, the contract should be converted to an obligation, which should be satisfied ratably from the assets of the insolvent debtor.

Executory contracts are awarded this conditional treatment in bankruptcy through “assumption” and “rejection.” The trustee or debtor-in-possession makes the decision whether to assume or reject executory contracts, depending on whether they are advantageous or not. The assumption or rejection mechanism works quite well, but some significant uncertainties remain. The most notable one regards the contours of rejection—how many obligations may be rejected along with the executory contract.

The problem of distinguishing rejectable from surviving obligations is largely one of establishing the consequences of the debtor's breach of the executory contract.63 Thus, transferred property rights cannot be reacquired by rejection. The situation is more complex, however, because several courts, influenced perhaps by the “rejection” terminology, have eliminated various obligations of debtors


63. See JACkSON, supra note 22, at 108-13.
that debtors could not avoid by breach.

The most notable example is that of Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., which allowed the debtor's rejection to reverse the granting of an intellectual property license. While the Lubrizol ruling has been corrected by legislation, the same trap remains ready to snare other courts that apply § 365. With this fear in mind the National Bankruptcy Review Commission suggested replacing “rejection” with “election to breach” in the wording of § 365.

The courts' expansion of rejectable obligations beyond those that could be avoided by the debtor's breach cannot be judged by the formalistic concept of whether it corresponds to a contractual breach. Courts may be able to mold § 365 to serve bankruptcy goals rather than simply applying contract law. A glance at the case law shows that § 365 has indeed been adapted so as to promote bankruptcy goals.

The classic example is In re Register, which featured a debtor couple who had given a promise not to compete in the context of a franchise contract. The Registers became franchisees of Silk Plants, etc., Franchise Systems, Inc. (“Silk Plants”). Although the opinion is silent, we can easily imagine that Silk Plants provided training, guidance and, probably, some supervision. In exchange, Silk Plants received some fraction of the Registers' profits as well as other payments and, perhaps, provided supplies, equipment, or services to the business.

When the Registers failed financially and entered bankruptcy, they sought to reject their executory contract with Silk Plants. The immediate question, of course, was which of their obligations the Registers could breach. They could cease making payments to Silk Plants; they could stop purchasing supplies, equipment, services, or anything else from Silk Plants. The Registers could not, however, unilaterally alter their obligation not to compete. Were the Registers to violate their non-compete obligation outside bankruptcy, Silk Plants would be able to obtain injunctive relief.

Nevertheless, the bankruptcy court allowed the non-compete obligation to be rejected as part of the executory franchise contract. Thus, the Registers were able to obviate, through bankruptcy, a

64. 756 F.2d 1043 (4th Cir. 1985).
67. 95 Bankr. 73 (Bankr. M.D. Tenn. 1989).
non-monetary obligation that would have always bound them in non-bankruptcy law. That bankruptcy would alter substantive rights is paradoxical. After all, a cornerstone of bankruptcy theory is United States v. Butner,68 where the Supreme Court stated that the rights created by non-bankruptcy law would not be altered without a justification based on bankruptcy policy. The bankruptcy policy behind rejection is the equal treatment of creditors from ordinary contracts with the creditors from executory contracts. Why alter substantive rights so as to allow debtors such as the Registers to escape their obligations?

A bankruptcy policy explains this expansive rejection. Some debtors are allowed to avoid some obligations through an exceptionally broad interpretation of their right to reject contracts. This broad rejection power is not an error. It is justified by the bankruptcy goal of restoring productivity incentives.

The rejection of the obligation not to compete restores the Registers' productivity incentives in a way that is not very different from that of the fresh start. But for the fresh start, debtors would have little incentive to earn income. Their earnings would, in essence, accrue to their creditors' benefit, since their creditors would be able to execute against them. Similarly, but for the rejection of their obligation not to compete, the Registers would be unable to apply their training in making silk flowers.

Of course, debtors with non-compete obligations are able to engage in other activities. The Registers may not make silk flowers but they can engage in any other productive activity without any interference from Silk Plants. Thus, the survival of the obligation not to compete does not destroy all productivity incentives; it only destroys the productivity that the debtor has in the prohibited activity.

If the debtor were more productive in a different activity, however, pursuing the rejection of the non-compete obligation would be pointless. Debtors would try to reject only if the barred activity is the most remunerative one they have, in other words, their most productive one. In the Registers' example, without their silk-flowers-making skills, the Registers may become part of the unskilled labor pool. The productivity destroyed by the survival of the non-compete obligation, is the incremental one that the barred activity offers compared to the next best one for each debtor. The highest productivity can only be obtained if the non-compete obligation is extinguished in bankruptcy. That is what rejection accomplishes, in perfect agreement with Local Loan, which, as we saw, ensured that the debtor could remain in the job that maximized his productivity without relocation and retraining costs being triggered by his finan-

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cial failure.\textsuperscript{69}

2. The Priority of Tort Claims During Reorganization

\textit{Reading v. Brown}\textsuperscript{70} involved the priority of tort claims against a corporate debtor due to a fire. The fire occurred during the reorganization and the issue was whether the tort claimants would be ordinary creditors or have administrative expense priority.\textsuperscript{71} If they received administrative expense priority, their claims were likely to be paid in full at the expense of a smaller distribution to unsecured creditors, while if they did not receive priority they would be paid the same number of cents on the dollar as the unsecured creditors.\textsuperscript{72}

In order to resolve this problem, the Supreme Court turned to the effect that administrative expense treatment would have. Although the Court did not choose to speak about precaution incentives, as modern economic analysis of law would have, it used their surrogate, the incentive to purchase insurance. Unless unsecured creditors bore the full brunt of the liability, the incentive of their representative, the trustee, to insure would be inadequate. Therefore, the tort creditors should receive administrative expense priority. Since the analysis is the same in substance regardless whether the focus is on insurance or precaution, let us use as an illustration an $800 expense that would eliminate fire damage liability, without specifying whether this is an $800 insurance premium or an $800 sprinkler system.

Suppose that the fire is a 1\% chance and it causes $100,000 liability to tort claimants. Suppose the debtor has $200,000 in assets and $400,000 of unsecured claims before the fire. Compare the trustee's incentives to spend the $800 depending on the priority of the tort claims.

If the tort claims do not receive priority, they will be added to the unsecured claims. Thus, the $200,000 of assets will be distributed to $500,000 of claims, each creditor receiving 2/5 of their claim or 40\%. The trustee compares not spending the $800, in which case creditors receive 50\% with a 99\% probability and 40\% with 1\% probability or an expected payout of 49.9\% (99\%*50+1\%*40). To this the trustee compares spending the $800, and have creditors receive 50\% of 199,200 in every case, which would be equivalent to a 49.8\% distribution of the $200,000. The trustee, as a faithful representative, makes the choice that benefits the principals, the creditors. The in-

\textsuperscript{69} See supra text accompanying note 16.
\textsuperscript{70} 391 U.S. 471, 473 (1968).
\textsuperscript{71} Id. at 473-74.
\textsuperscript{72} The addition of the tort claim, however, will cause a dilution of the unsecured creditors' claims.
urance or precaution expense will not be undertaken.

The value of Reading v. Brown is greater than avoiding an occasional carelessness. Without priority for tort claims, precautions are virtually never taken. More importantly, however, productivity takes center stage in bankruptcy interpretation. Reading v. Brown stands out for using an analysis of effective accident avoidance in the interpretation of bankruptcy law. Effective accident avoidance, of course, is a component of productivity because it implies reduced waste: in this application it eliminates wasteful accidents, but it may also eliminate wasteful care.

3. The Non-Avoidability of Long-Term Loan Payments

Union Bank v. Wolas is considered to be the case that shows the supremacy of resolving collective action problems over the principle of equal distribution to the creditors, two candidates for superiority as principles of bankruptcy interpretation. These principles came into conflict over the avoidability of payments on long-term loans. If such payments by the debtor were avoidable, that would promote equality because the long-term loan creditor would receive the same number of cents on the dollar as other creditors for the avoided fraction of their claims.

The issue in Wolas was whether regular payments on long-term loans were avoidable as preferential or whether they fit within the regular course of business exception. The conflict between these two treatments of long-term loan payments was seen by the court as a conflict between equal distribution and avoiding a collective action problem.

Equal distribution between creditors is promoted by considering payments to be avoidable. The long-term creditor would have to return the payments received within the preference period (usually 90 days before the filing). This would produce a greater amount in the estate for equal distribution.

Allowing the long-term creditor to retain the preferential payments provides this creditor with some security. Effectively, the receipt of these payments allows the lender to extend some lenience to the debtor. Without this ability to retain the preferential payments, the lender has an additional reason to call the loan early or to not be lenient in case the debtor has violated loan covenants—typically covenants relating to the debtor's financial condition. The result is that by virtue of the avoidance of preferential payments, an incentive is created in the long-term creditor to precipitate an earlier failure of the debtor. Therefore, allowing the long-term creditor to re-

74. Id. at 152.
tain the payments reduces the incentive to race to the assets. Because this function is similar to avoiding races for solving the collective action problem—the creditor grabbing assets and making the aggregation of all creditors worse off—this function was considered a solution of the collective action problem.

A closer look, however, reveals that the principal function of considering long-term loan payments not preferential is productivity. First, the setting is not one where collective value is being destroyed by the lender. Lenience gives the debtor a chance to recover, but it also allows the debtor to take further risks with the creditors' money. Putting an earlier end to debtor's decline does not destroy creditors' aggregate value and may well preserve it. Taking away this chance is not equivalent to foreclosing on one of the machines in a chain of production. For the long-term lender's incentive to produce a value-destroying race it must influence yet another creditor to make a value-destroying move. That is a different reaction that should not confuse us here. It should be prevented by the web of bankruptcy provisions that resolve collective action problems.

The purpose of postponing the debtor's failure, thus, is not to resolve any creditors' collective action problem. Justice Stevens stated that avoiding the creditors' race also promotes equal distribution.76 The intuitive leaning of the Court in favor of giving the debtor an extra chance can be explained more persuasively as an effort to avoid anticipatory bank ruptcies, i.e., financial failures caused, not from true failure, but that are a result of creditors anticipating a future financial failure. The productivity justification for avoiding anticipatory failures is obvious: the cost of a bankruptcy process should only be incurred in cases of true failures. Anticipatory bankruptcies raise the specter of error. From this perspective, Wolas is one more of the numerous provisions that avoid anticipatory bankruptcies.

III. BANKRUPTCY LAW'S UNIQUE ROLE IN RESTORING PRODUCTIVITY INCENTIVES THREATENED BY INSOLVENCY

It is clear from the above survey of bankruptcy provisions that bankruptcy law restores productivity. Bankruptcy law in this way counteracts the sinister secondary consequences of economic and financial decline, namely the occasional destruction of productivity. The positive, descriptive aspect of the thesis that this Article advances has been proven.

Having shown that bankruptcy law does revive productivity, this section argues that this is a proper function to assign to bank-

75. See supra note 24.
Bankruptcy law. It is an appropriate function because it is desirable, because it is a role dominated by bankruptcy law in the current division of legal fields or specialties, and because there are scale advantages to having a single legal discipline address productivity restoration out of insolvency.

The restoration of productivity incentives should need no defense or justification. Productivity is the intermediate goal in the quest toward preference satisfaction. To the extent we measure welfare by the degree of preference satisfaction, we must realize that there are two ways to achieve it. Increasing productivity is the one that is intuitive. The alternative would be to control and, essentially, constrain preferences, a method that is not widely adopted outside the orders of self-denying spirituality.

The devil's advocate would take the position that most, if not all, fields of law can be seen as designed to enhance productivity. Corporate law, for example, enhances productivity by facilitating the formation, financing, and running of corporations; contract law promotes productivity by facilitating bargaining, agreements, and reliance investments; intellectual property law enhances productivity by providing appropriate incentives for innovation and creation. This feature of productivity enhancement, writ large, is a feature of every field of business law.

The productivity restoration of bankruptcy law, however, is not such a generalization; productivity restoration—as opposed to productivity enhancement—would not describe other legal field's role; productivity restoration is the unique contribution of bankruptcy law. The distinguishing characteristics are two. First, bankruptcy law restores productivity rather than contributing to productivity in other ways. Second, bankruptcy law restores productivity that has been lost due to financial failure.

Restoring productivity is different than other means that the law uses to further productivity. The methods that different areas of business law use to enhance productivity may not be enumerable because new fields may arise. The law of commercial paper, for example, promotes productivity by facilitating transactions. Security

76. One could claim that leisure is a preference that is not satisfied by increasing productivity, but that is obviously false. As productivity increases, more time can be made available for leisure. This corresponds with the fact that the technological improvements of the last 200 years have resulted in additional leisure time. Forced leisure, which is the situation in which debtors may find themselves in a bankruptcy system without a fresh start, is uneconomical. Consider, hypothetically, that the debilitated debtor could discharge debts and would then return to work. Obviously, the amount of leisure that the debtor sacrifices to work is worth less to the debtor than the proceeds from employment: the goods that the wages for this work can buy.
interests in personal property and in reality enhance productivity by facilitating the financing of various transactions. The law of mergers and acquisitions enhances productivity by facilitating strategic mergers and preventing wasteful ones. The list goes on, but no other area of law seems to address primarily lost productivity.

Some areas of law may seem to have a secondary focus on restoring productivity. For example, one may think that contract law does restore productivity when it uses a measure of damages that allows efficient breaches. This may be considered a restoration of productivity because the breaching party’s incentives to take the “efficient” action are restored to what they would have been without contract law. Some forms of self-defense law may be interpreted similarly; they allow actions that would be chosen anyway if the legal system had not started intervening by banning violence. Not only is productivity restoration not a primary function of the law in these cases, but the restoration is unrelated to a destruction that is due to a financial failure. Bankruptcy law, by contrast, restores productivity that is destroyed (or threatened) by financial failure, that is, insolvency either in the balance sheet sense of debt exceeding assets or in the equity sense of inability to service ones’ debt. For example, the collective action problem of the creditors destroys value only in case of insolvency. If the debtor were not insolvent the debtor would repay the debt rather than lose the value. The fresh start policy restores the incentive to work, but that incentive is destroyed by insolvency. Reorganization law restores continuous operation as going concerns to firms, but cessation is only threatened in cases of insolvency (combined with recessions, credit crunches or high subjective values of control, as we saw above). 77 The creation of trust funds for unknown tort claimants also restores continuation incentives, and again cessation is only a concern in cases of insolvency. The administrative expense priority of postpetition tort claims restores the incentive for care, which was only a concern in or near insolvency. 78 A similar analysis applies to all the functions of bankruptcy law that were discussed in this Article and to many more that were not—such as avoidance powers or executory con-

77. See supra text accompanying note 45.

78. Corporate law helps in cases of insolvency without bankruptcy filings by imposing a change in the fiduciary duties of the board. In and near insolvency, the beneficiary of the board’s fiduciary obligations cease to be the shareholders—they shift to the creditors. See Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991), reprinted in 17 Del. J. Corp. L. 1099 (1992). Of course, this does not make the law of fiduciary obligations one that primarily regards restoring productivity incentives threatened by insolvency.
tracts.  

That bankruptcy law does play a unique role in restoring insolvency-threatened productivity does not necessarily mean that this is the optimal state of affairs. Perhaps bankruptcy law should be divided into separate fields or partly delegated to state legislatures.

A. The Infeasibility of Non-bankruptcy Law Addressing Financial Failure

Having shown that bankruptcy law revives productivity and the desirability of the revival of productivity lost to financial failure does not necessarily mean that this role should continue to be played by bankruptcy law. One could argue that productivity revival could be addressed by non-bankruptcy law. I will offer two counter-arguments. The all-encompassing nature of financial failure requires that it be addressed not only by a single court, but also by a single body of law. Unlike, for example, the easily separable corporate law disputes, issues that arise from financial failure can be separated neither in groups nor from other affairs of the debtor. Bankruptcy disputes would need to be separated into groups if those involving collective action problems were to be resolved separately from those involving productivity revival. Separation from other affairs of the debtor would be necessary for the reorganization of a corporate debtor.

Several cases illustrate that separating productivity revival from collective action solutions is not only difficult but also undesirable. Bankruptcy law is a skeleton of rules that takes body and spirit by their interpretation. Bankruptcy interpretation is guided by the several overarching policies of bankruptcy law. While some expressions of productivity revival are central—as the fresh start policy and the facilitation of reorganizations undoubtedly are—they neither necessarily dominate nor expel every other concern. Certainly, the resolution of creditor collective action problems and preserving equal treatment between similarly situated creditors remain and will remain important criteria for bankruptcy interpretation. Nevertheless, in an expansive understanding of productivity revival, they all do become subsumed in it. Resolving collective action prob-

79. The trustee's avoidance powers prevent a threat to productivity that derives from the collective action problem. By threatening avoidability, the law prevents creditor attempts to collect on the eve of insolvency. Executory contracts restore productivity by preventing anticipatory breaches by the debtor who is sliding into insolvency. A breach would give rise to a claim that in bankruptcy is paid some number of cents on the dollar, which is equivalent to the effect of rejection of an executory contract. Thus, since the debtor (as debtor-in-possession or through the trustee) can make the rejection decision after the filing, the incentive for the anticipatory breach is eliminated.
lems avoids the destruction of productive resources by creditors. Equal treatment avoids races of creditors to destructively grab assets before the filing and, thus, avoids the same productivity destruction.

Because productivity revival appears to be an overarching interpretive feature, bankruptcy law is a subject that should still remain a single body of law. A division would open the possibility of conflicts that would be easily soluble using bankruptcy's single overarching principle of productivity restoration. Conflicts that are difficult to solve may also arise, particularly between legal fields. Those can be sent to a higher court. But the higher court's time should not be taken with conflicts that would not arise in a unified field or that are easy to solve because of the unity of the field. Thus, efficient use of senior courts' time argues that bankruptcy law should remain intact.

B. The Necessity that a Single Legal Field Address the Consequences of Financial Failure

The above arguments show that productivity revival is uniquely the role of bankruptcy law, but the question remains whether bankruptcy law should remain a single field or be divided. A possible division that is pertinent to the arguments of this Article would separate the collective action resolving functions from the productivity reviving functions. Thus, the solution of the collective action can be part of a proposed federal bankruptcy regime, and the revival of productivity part of state insolvency law. The main objections to such a line of thinking are three: (1) its undesirability due to interdependence of problems due to insolvency; (2) the productivity-reviving nature of resolving collective action problems; and, (3) the constitutional mandate for a single federal bankruptcy regime.

The interdependence of problems due to insolvency suggests that they should not only be resolved by a single court, the bankruptcy court, but also under a single body of interpretive principles, those of bankruptcy law. Financial failure is an event that touches every aspect of the firm's relations and all its obligations. The adjustment, adjudication, or other resolution of any one of them would necessarily influence the status of many others. Typical examples can be taken from the provisions that were discussed above. The decision to reject a contract involves fresh start concerns. The decision to allow the formation of a trust fund in favor of future tort claimants involves not only all current creditors and equity-holders but also future creditors and equity-holders. The decision to allow a reorganization attempt, similarly, influences current and future creditors and equity-holders.

Because such decisions of bankruptcy adjudication are all-
encompassing, their separation from any segment of other bankruptcy issues is likely to leave the decision-making court without background information vital to reaching the correct decision. Continuing the above examples, imagine that the court deciding whether to allow a reorganization does not have the information that most of the debtor's creditors are involved in many other similar cases, information that suggests a recession or cascading sales. In a case involving the rejection of a non-compete obligation, imagine if the court did not have the information either that only the injunction creditor opposed its rejection, or that most other creditors opposed rejection as well. Such knowledge adds texture to the court's information and improves the quality of its decisions. Dividing bankruptcy disputes will reduce such knowledge. Moreover, their interdependent nature recommends that all these disputes be decided under common principles.

Bankruptcy disputes also cannot be divided by task, separating collective-action-resolving provisions from productivity-reviving ones. The essential reason for this indivisibility by task is that the two functions act together. The resolution of collective action problems revives productivity. Insolvency creates the collective action problem, which threatens to destroy value. Resolving the collective action problem prevents this destruction of value. The resolution of the collective action problem restores, therefore, the incentive not to destroy value and productivity that the debtor maintains during solvency. During solvency, of course, the debtor will not allow the foreclosure sale of an instrumental item of the enterprise. The debtor, who would bear the loss of value of the enterprise during solvency, will satisfy the creditor rather than suffer the loss. The insolvent debtor has neither the same ability to repay, nor the same incentive to avoid the loss in value.

Finally, the productivity-restoring function of bankruptcy law cannot be delegated to state insolvency law due to the retention of bankruptcy jurisdiction in Congress by the U.S. Constitution. Moreover, the Supreme Court has consistently implicitly considered the productivity revival a function of federal bankruptcy law.

This argument is not as simple as it appears above. Although the Constitution retains bankruptcy jurisdiction for the federal legislator, it is conceivable that Congress will choose to narrow bankruptcy law. Congress could attempt to narrow bankruptcy law by repealing the productivity-restoring portions of the Bankruptcy code and only enacting provisions that resolve the collective action problem.80 The Supreme Court, however, repeatedly has protected the

80. In a way, the repeated attempt to condition Chapter 7 on a means test may be considered such a move.
principal productivity-restoring functions of bankruptcy law despite lack of legislative cooperation. The Supreme Court has protected in such conditions the right to a fresh start and reorganization under equitable receivership, doubtless the two principal productivity restoring functions of bankruptcy law.

The right to a fresh start was protected against encroachment by state law despite the silence of the federal legislator in Local Loan Co. v. Hunt.81 When Local Loan was analyzed above, the silence of Congress was not discussed. Standard statutory interpretation, however, implies permissiveness from silence. Thus, the fact that Congress had not prohibited the creation by state law of security interests and assignments of wages that would restrict the fresh start should imply that such state laws should be upheld. The Local Loan decision, as we saw, did the opposite. It struck down state law constructs that interfered with the fresh start. In the process, the fresh start was not simply elevated into a bankruptcy law principle. Since the Supreme Court did not draw its authority to strike down the state restriction of the fresh start in the statute, the Court could be considered to have applied directly the constitutional mandate for federal bankruptcy law. In such a case, the right to a fresh start is an integral part of a constitutional guarantee of a federal bankruptcy common law. Since restoring productivity incentives is an integral component of bankruptcy law, the jurisdictional provision of the constitution could be considered to take an indirect substantive character, and become a guarantee of a fresh start to individuals.82 Congressional attempts to curtail this implicit substantive protection could, then, be rendered moot either because the repeal of the federal bankruptcy common law would not only have to be explicit but would also be interpreted narrowly, or because they would be considered unconstitutional for repealing the minimum content of bankruptcy law, the existence of which would be constitutionally mandated.

As if to confirm this judgment, the federal judiciary had been providing a venue for another productivity-restoring function of bankruptcy law, reorganizations, well before 1938, when Congress added reorganization procedures to the Bankruptcy Act of 1898.83

82. This guarantee of productivity-restoring bankruptcy law, however, must be distinguished from an individual constitutional right of productivity restoration, which the Supreme Court declined with United States v. Kras, 409 U.S. 434 (1973).
Reorganizations, as we saw above, were conducted under the fiction of a foreclosure following the procedure of equity receivership. Although the jurisdictional basis for the equitable receivership was the enforcement of out-of-state judgments, the substance was to enable insolvent businesses to reorganize.

IV. CONCLUSION

I have argued that bankruptcy law revives productivity, and that this productivity revival is desirable. I have argued that reviving productivity that was lost to financial failure is appropriately addressed by bankruptcy law; the necessary regulatory competition can be provided within the structure of the federal judiciary. The normative implications that the Article defended were very general: The fresh start has a place in bankruptcy law implied that it should be provided with few limitations. A liberal discharge policy does not mean immunity from debt. Several features of the current bankruptcy landscape cannot be reconciled even with a liberal discharge policy. Typical examples are the unlimited exemptions that every state law affords to debtors who can afford the necessary planning. Attempts to curtail the excesses of this system, however, may enroach too far into the beneficial aspects of the fresh start. Means tests that would condition the discharge on low income, for example, could blunt the productivity incentives of the most productive members of society.

Reorganizations were shown to be desirable in various settings: if the debtor firm’s control has value that is highly idiosyncratic, in credit crunches, selling cascades, or recessions. Reorganization law appears insensitive both to the existence of these conditions and to its positive contribution. It is a simple matter to require some such control. Future research should be motivated by the goal of reaching a general solution to the central problem of reorganization law, establishing how forcibly to discontinue insolvent businesses.

While this analysis agreed with the shape of tort law within bankruptcy, as it is molded by Reading v. Brown, rejection of executory contracts and the new value exception did leave room for improvement. Courts should continue to provide fresh start features to debtors through those means. The new value exception should be used for the provision of fresh start incentives to small family-owned businesses, as I have argued elsewhere.

The value of the realization that bankruptcy law is about restoring productivity also helps appraise various reform proposals of academic origin. For example, Bebchuk and Fried have argued for the

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84. See supra text accompanying notes 26-28.
85. Georgakopoulos, supra note 46.
erosion of the priority of secured credit, an erosion which will mitigate the cost that secured credit places on creditors (non-adjusting creditors) who cannot respond to the reduction of unencumbered assets of the debtor.\textsuperscript{86} This proposal appears unassailable until we consider productivity revival issues. The eroded priority of secured creditors may make them more likely to commence a value-destroying race to the assets and perhaps false liquidations. The reduced borrowing ability of individuals may hamper their risk-taking. The reduced potential of firms to borrow with purchase-money security interests may induce false liquidations.\textsuperscript{87} These concerns, if substantiated, would argue for the abandonment of the proposal or for major alterations, for example, by allowing full priority of purchase-money security interests and of home mortgages.


\textsuperscript{87} A firm in financial difficulty is the primary candidate for purchase-money security interest ("PMSI") financing, since solvent firms can find other means of financing. But if the firm is insolvent and the secured creditor's priority is not full, then the PMSI lender will not enjoy the full value of the collateral and is, therefore, unlikely to make the loan or will charge extraordinarily high interest rates. The result is that a firm that is in financial difficulties will find itself less able to obtain new equipment and is more likely to fail. A related argument against the erosion of priority that focuses on PMSI is made by Steven L. Schwarz, The Easy Case for the Priority of Secured Claims in Bankruptcy, 47 Duke L.J. 425 (1997).