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A WORLD WITHOUT BANKRUPTCY
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I

INTRODUCTION

...Congress's exercise of the bankruptcy power was far from inevitable. Indeed, for much of the nineteenth century, there was no federal bankruptcy statute at all. That we might live in a world without bankruptcy law or any similar collective procedure is not as far-fetched or as ridiculous as it might seem at first glance to those of us who are immersed in its intricacies every day. This article will take problems that have been the focus of much of the recent debate in bankruptcy law and ask how these issues would be approached if no bankruptcy law existed.

The reason for engaging in this thought experiment is not that it is either wise or at all likely that we abandon bankruptcy law. I think neither is the case. Rather, the point of the exercise is to isolate bankruptcy issues from other issues. One of the most troublesome aspects of most modern discussion of bankruptcy law, both academic and judicial, is the reliance upon unarticulated notions of 'bankruptcy policy.' Imagining the world without bankruptcy law gives us an opportunity to identify precisely what it is that bankruptcy law adds to our legal regime and hence what bankruptcy policy is or should be. This article will show that much of what is usually thought of as 'bankruptcy policy' is not bankruptcy policy at all, but rather an issue of general concern that must first be grappled with before the special problems that arise by virtue of a bankruptcy proceeding are confronted. Recognizing that a problem involves the rights of tort victims or the hazards of toxic wastes and not bankruptcy policy does not make the problem go away, but it does identify with greater clarity the relevant stakes...

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III

THE REHABILITATION OF CORPORATE DEBTORS

In the century that followed the introduction of discharge in bankruptcy, relieving individuals of overwhelming debt came to be thought a good in its own right. Bankruptcy's discharge, as it developed in the eighteenth century, became less of a carrot to induce cooperation by debtors. Merchants, Blackstone observed, needed to borrow, and they should not be left destitute if, as a result of honest entrepreneurial effort, they could not repay what they owed. Bankruptcy discharge policy was directed towards merchants. Only gradually were the benefits of a

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7 The Bankruptcy Act of 1800, 2 Stat. 19, was repealed in 1803. The Bankruptcy Act of 1841, 5 Stat. 440, was repealed after only eighteen months. Congress passed another bankruptcy statute in 1867, 14 Stat. 517, and repealed it in 1878. The Bankruptcy Act of 1898 survived, with substantial amendments, until 1979. For a history of bankruptcy law in this country, see C. WARREN, BANKRUPTCY LAW IN UNITED STATES HISTORY (1935).

27 For an illuminating discussion of changing attitudes towards merchants and credit, see Weisberg, Commercial Morality, the Merchant Character, and the History of the Voidable Preference, 39 STAN. L. REV. 3 (1986).

28 [A]t present the laws of bankruptcy are considered as laws calculated for the benefit of trade, and founded on the principles of humanity as well as justice and to that end they confer some privileges, not only on the creditors, but
bankruptcy discharge extended to everyone. During the same period, however, bankruptcy discharge became less important for merchants. Entrepreneurs ceased to need bankruptcy to protect them in the event that their businesses collapsed. The rise of the limited liability corporation and the business trust allowed entrepreneurs to begin businesses without putting their entire net worth at risk.

Today, managers who file a chapter 7 petition on behalf of their corporation cannot possibly share the same motivations as an individual debtor who wants to be released from past obligations. The managers represent the shareholders of the corporation, who already have limited liability under state law. Any assets that the shareholders have not contributed to the firm are insulated from the claims of the firm's creditors. If the corporation fails, the shareholders lose only what they have invested, but no more. The shareholders are free to take their remaining assets—including, of course, their human capital—and invest them in another enterprise.

The stockholders of a failed corporation enjoy a fresh start quite apart from bankruptcy law. When the owners of a corporation decide to wind it up outside of bankruptcy under state law, specified procedures must be followed. Under these procedures, the shareholders of the corporation are not liable for its debts. On the other hand, they are not entitled to anything until all of the creditors are paid in full. The equity owners are the residual claimants, standing at the end of the line. Everyone with rights to a firm's assets—banks, tort victims, shareholders, and, indeed, many others—may be thought of as 'owners' of the corporation. They all have at least a contingent right to reach the firm's assets and the income they generate. Some have priority over others. Secured creditors—bondholders—have priority over general creditors, who have priority over preferred shareholders, who have priority over common shareholders. Some of these parties are called creditors and some of them equityholders. Their attributes vary, but they all share something in common too—they are species of 'owners.'

Once one takes account of what happens to the owners when a corporation dissolves, there is no 'debtor' left to feel sorry for. There may be a fight between two creditors or between creditors and the shareholders, but these should not be thought of as creditor-debtor fights. There may be a fight between different owners of a firm, but that is something quite different. We might care about the rights of particular owners. We might also care about others, such as employees, who might be affected by the failure of a firm. But the idea that a 'fresh start' for the corporation is a good in itself is nonsense. A corporation is a judicial but otherwise fictitious being created by the state at the behest of individuals who want to pool assets in a common enterprise. Because anyone—including those who have founded other corporations, successful or not, in the past—can go out and get a corporate charter for less than a hundred dollars, no one should be too troubled if a particular corporate charter is torn up. There is nothing to be sentimental about. Corporations and people are not the same.

In a market economy—indeed, in any economy—firms fail. But the failure of a firm is not necessarily a bad thing. Consider the following example. A restaurant in a small town serves heavy, overpriced food that few want. There is a rapid turnover of employees. Waiters come and go particularly quickly because the absence of business means that there is little in the way of tips. The owner of the restaurant is unhappy because he is losing money and all his friends always complain to him about the food and prices at his restaurant. He was much happier in his old job as a bank loan officer.

This restaurant is a firm that has failed. Firms that fail, however, do not disappear without a trace. A restaurant of some kind may continue at the same site. Perhaps a more skillful restauranteur will come in and buy the old owner

also on the bankrupt or debtor himself. On the creditors; by compelling the bankrupt to give up all his effects to their use, without any fraudulent concealment: on the debtor; by exempting him from the rigor of the general law, whereby his person might be confined at the discretion of his creditor, though in reality he has nothing to satisfy the debt: whereas the law of bankrupts, taking into consideration the sudden and unavoidable accidents to which men in trade are liable, has given them the liberty of their persons, and some pecuniary emoluments, upon condition they surrender up their whole estate to be divided among their creditors.

W. BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND superscript *472.


See, e.g., CAL. GOV'T CODE § 12201 (West Supp. 1986) ($70).
out. Alternatively, the old owner can bring in a new partner, borrow additional money, change his menu, or hire a new chef. Alternatively, the building that housed the restaurant may be put to a different use and the equipment sold for use in another restaurant.

In contemplating a world without bankruptcy, a crucial question to be considered is whether the set of legal rules outside of bankruptcy law are wanting, whether they fail to ensure that firms that should survive do survive and that those that should not, such as bad restaurants, do not. The common answer is that the dynamics of private bargaining that would exist in a world without bankruptcy would make everyone worse off. The banks, the trade creditors, and the owner, for example, would not take account of the workers who would lose their jobs if the firm failed. Moreover, those involved in the negotiations might be so consumed with their self-interest that they would not allow the owner to take steps less drastic than the wholesale liquidation of the entire business.

This answer, however, is composed of two dramatically different elements, only one of which supports an argument for a bankruptcy law or some other collective creditor remedy. No one doubts that a bankruptcy proceeding serves, in part at least, as a debt-collection device. Sometimes creditors are better off in bankruptcy than outside it. Without a collective bankruptcy proceeding, each creditor will tend to rush towards the debtor's assets when the best course is patience. For example, all the creditors might agree, if they were able to meet and bind one another, that it was in their best interest to give the restaurant owner a second chance. The restaurant might work with a new chef and a new menu, and the value of a successful restaurant—even discounting for the chance of a second failure—is much greater than the value of a restaurant's equipment sold piecemeal. But only a collective proceeding, such as the one federal bankruptcy law provides, might give these diverse owners the chance to pursue such a goal. Only such a collective proceeding might be able to restrain individual creditors from trying to obtain payment in full even if it meant that the restaurant did not survive as a restaurant and all the other creditors were left much worse off.

In short, we may not desire a world without bankruptcy because the self-interest of creditors leads to a collective action problem, and a legal mechanism is needed to ensure that the self-interest of individuals does not run counter to the interests of the group. But some justifications for the law of corporate reorganizations go far beyond this. They focus not on what is in the interest of the creditors and others with legal rights to the assets of the firm as a group, but rather on what is in the interest of society at large. These justifications assume that the occasion on which creditors need to invoke bankruptcy law in order to solve a collective-action problem is also the occasion for taking account of not merely the creditors' interests, but also those of others, such as employees who will lose their jobs if a hardware store replaced the restaurant.

This view of why bankruptcy law is needed suffers from an obvious difficulty: It may be impossible to discover what course best advances society's interests at large. Even if one wants to save jobs, it does not follow that allowing a bad restaurant to fold reduces the number of jobs in the economy. The hardware store that replaced the restaurant might, in fact, hire more people. The person who bought the restaurant equipment might open another restaurant in a different city, become very successful, and need to hire more workers than the owner of the bad restaurant.

In addition, embracing a 'rehabilitation' goal as a matter of bankruptcy policy does little to resolve many bankruptcy disputes. For example, one of the most common disputes in bankruptcy law is over the question of priorities. When there are not enough assets to go around, some creditors are not going to be paid in full. There is nothing bankruptcy law can do to change this, regardless of what goals it embraces. A dispute over priorities, moreover, has nothing to do with the question of whether a firm should stay in business to save jobs. A rehabilitation goal of bankruptcy should not, to pick an example, lead one to favor denying secured creditors the time value of their claims during the pendency of a bankruptcy proceeding. If secured creditors are paid more, general creditors are paid less and vice-versa. The priority question, however, should have nothing to do with the question of whether the restaurant remains in business and jobs are saved. How the assets are used may, of course, determine how valuable

31 For a discussion of bankruptcy law as a common-pool problem, see D. BAIRD & T. JACKSON, supra note 3, at 31-35.
they are, but how assets are used is independent of who gets them.\textsuperscript{32} Even if one embraces a general rehabilitation goal for bankruptcy law, the law will often have little to say with respect to the many bankruptcy disputes that arise over rights to particular assets rather than the use to which the assets are put.

These observations about having a rehabilitation goal in bankruptcy, however, pale beside the one that is fundamental. The central failing of modern bankruptcy scholarship, however, is that it assumes away the threshold question, which is whether mitigating the effects of firms that fail should be a peculiar concern of bankruptcy law. Firms often fail without a bankruptcy petition ever being filed.\textsuperscript{33} Indeed, a firm can fail without defaulting to its creditors. A plant can close its doors and leave its workers without jobs even when it can pay all its creditors. Bankruptcy arises when a firm cannot meet its obligations and the creditors cannot resolve their competing claims without a collective proceeding. Given the narrow range of cases involving failed firms that are bankruptcy cases, it seems strange to worry about problems like those of former workers in bankruptcy and not elsewhere.

If the law forces those with rights to a firm’s assets to consider the interests of workers who might lose their jobs, it should not matter whether the owners of the firm choose to take advantage of the bankruptcy laws. Requiring those with rights against a firm’s assets to take account of the interests of the workers is tantamount to giving the workers rights to the firm’s assets. It seems odd, however, to create such rights, but have them recognized only in the minority of cases, such as those cases in which the failing firm is in a bankruptcy proceeding. The reasons for using bankruptcy or some other collective creditor remedy have little to do with whether workers who may lose their jobs when the firm fails should have any rights in the matter. There is no reason to live in a world that divides those who worked for failing firms into two categories and protects those in one but not the other. Even if there were some types of workers we wanted to protect and others we did not, it should not turn on whether the creditors or managers of the workers’ firm invoked one kind of legal procedure rather than another to rearrange the financial structure of the firm.

Indeed, creating rights in a piecemeal fashion by recognizing some rights in bankruptcy, but not elsewhere, brings significant costs of its own. To the extent that the existence or the extent of substantive rights turns on whether one is inside of bankruptcy, some creditors or managers will use or threaten to use a bankruptcy proceeding even when there is no reason to collectiveize the debt-collection process. One cannot think that a firm should be able to repudiate a collective bargaining agreement in bankruptcy, but not elsewhere, and then be surprised if a firm chooses to use bankruptcy to repudiate a collective bargaining agreement and for no other reason.\textsuperscript{34} Firms that simply want to rid themselves of collective bargaining agreements might be denied the use of the bankruptcy process on the ground that such firms act in ‘bad faith.’ It makes more sense, however, to decide what obligations a firm in *186 financial trouble should have with respect to its collective bargaining agreements and to hold these obligations constant inside and outside of bankruptcy.

The existence of our bankruptcy law offers policymakers an opportunity to advance change or reform without squarely debating what they are doing. In a world without bankruptcy, the question of who should have rights to a firm’s assets would have to be faced directly. There seems little doubt that Congress could, if it wanted to (and if it acted prospectively), give workers a lien on the assets of a firm or allow firms in financial trouble to repudiate collective bargaining agreements. A law could provide that when any firm liquidated or when its assets were put to a substantially different use, the workers who would lose their jobs as a result would have a right to some fraction of their annual salary, adjusted by the length of their service. Congress could create a regulatory agency and require any firm that wanted to liquidate or change the existing deployment of its assets to go before the agency and make a showing of hardship before implementing its plans. There are any number of other possible laws that might have a similar effect. Such laws may be undesirable for a number of reasons. Other laws might advance the same interests at far less cost. But all of these reforms are possible outside the context of a bankruptcy proceeding. Indeed, they would be possible even if there were no bankruptcy law at all as it is traditionally understood. The justification for

\textsuperscript{32} This problem is discussed at length in Baird & Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 51 U. CHI. L. REV. 97 (1984).
\textsuperscript{33} See Baird, The Uneasy Case for Corporate Reorganizations, 15 J. LEGAL STUD. 127 (1986).
\textsuperscript{34} See, e.g., In re Tinti Construction Co., 29 Bankr. 971 (Bankr. E.D. Wis. 1983).
preserving the jobs of workers or allowing management to escape from collective bargaining agreements should not be that it vindicates bankruptcy policy, but rather that it is sound policy as a general matter.

We live in a world in which we face many tough issues of social policy and in which we for too long have made altogether casual assumptions about ownership of assets and the priority of those with rights to them. But these issues have nothing to do with bankruptcy law, and we should treat them in our world as we would treat them in a world without bankruptcy.

B. Bankruptcy Procedure

It is one thing to point out that substantive issues should be the same whether they arise in or outside of bankruptcy. But one cannot pretend that the procedures in bankruptcy are the same as they are elsewhere. The whole point of a bankruptcy proceeding is to change procedures so that creditors and others with rights to the firm's assets can act collectively. This naturally raises the question of what principles should guide procedures in bankruptcy, a question made particularly important because the drafters of the Bankruptcy Code left the issue of procedure to later rulemaking and case-by-case adjudication. The Supreme Court faced this issue in Commodity Futures Trading Commission v. Weintraub. In that case, a firm had filed a bankruptcy petition and the trustee wanted information in the possession of the firm's lawyer. The lawyer refused to disclose the information on the grounds of the attorney-client privilege of the corporation. The trustee asserted that he, not the management of the firm, had the right to waive the privilege of the corporation. The trustee did not contend that he could waive any personal privileges held by the managers as individuals.

As long as the corporation exists, someone ought to have the power to assert or waive privileges on its behalf. The question before the Court was one of determining how to identify this person. The Court resisted the temptation to balance the purposes of the attorney-client privilege against vaguely articulated notions of bankruptcy policy. Instead, it compared the substantive changes brought about as a result of the bankruptcy proceeding and the appointment of the trustee with changes that might come about under nonbankruptcy law. The Court observed that because the trustee operated the business and had powers that were similar to the managers of a firm under nonbankruptcy law, the appropriate analogy under nonbankruptcy law was the replacement of old management by new management.

The organizing principle of the law of corporations is that the day-to-day control of the assets should be in the hands of the residual claimants. Shareholders run the affairs of a solvent corporation. They gain a dollar if the corporation gains a dollar; they lose a dollar if the corporation loses a dollar. Because they stand at the margin, they have control over management and the managers owe a duty to them. Treating the trustee as new management may seem to be a shift away from the nonbankruptcy rule because the trustee looks out for the interests of the general creditors rather than the shareholders. But when a firm is insolvent, the residual claimants are the general creditors, not the shareholders. By contrast, the shareholders are unaffected by the changing fortunes of the firm. Except in the most extraordinary circumstances, they will get nothing, regardless of whether the fortunes of the firm rise or fall.

If a firm is insolvent, the shareholders should no longer be in the picture. If the general creditors are not going to be paid in full, the shareholders should not get anything. Those who control any rights that may increase or decrease the value of the firm's assets should therefore be the general creditors. General creditors, as represented by the trustee, cannot be trusted to look out for the interests of the shareholders, but when the firm is insolvent and there is a day of reckoning, the shareholders' interests should not be looked out for.

47 Weintraub, 105 S. Ct. at 1990.
48 Id. at 1993-95.
As a first approximation, the trustee will waive the attorney-client privilege if it will improve the fortunes of the firm. Hence, the trustee's incentive is not at odds with the interests 'of the corporation' if by 'interests of the corporation' we mean the interests of those whose rights matter. The old managers will not want the trustee to be able to waive the corporation's attorney-client privilege because the trustee will not care whether the waiver will benefit either the old managers or the shareholders they represented. There is no reason to think, however, that the trustee will waive the privilege when it is contrary to the interests of those who will share in the firm's assets. The unhappiness of the old managers is no different from their unhappiness when there is a hostile takeover. Ownership of assets changes when a bankruptcy petition is filed just as when there is a hostile takeover. In the case of a takeover, it is a purchase of stock in the marketplace; in the case of a bankruptcy proceeding, the filing of the petition effectively changes the ownership. Allowing the trustee to waive the attorney-client privilege puts the right exactly where it belongs: in the hands of the residual claimant, someone who, when he looks out for those he represents, will also look out for the interest of everyone else who matters. Doing this preserves the nonbankruptcy rule. That it makes some people unhappy should not matter here any more than it matters when ownership interests change outside of bankruptcy.

The Court's recognition in Weintraub that a trustee in bankruptcy is the analogue of new management ensured that the bankruptcy proceeding disturbed the rights and obligations of all the players as little as possible. Weintraub is a near perfect illustration of the theme that has sounded throughout this article. It is possible—and, indeed, desirable—to imagine the world without bankruptcy law. Bankruptcy law works against a backdrop of other rights. It can be best understood and disputes in bankruptcy can best be understood when this principle is kept in mind.

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