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## Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain

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Bankruptcy, at first glance, may be thought of as a procedure geared principally toward relieving an overburdened debtor from "oppressive" debt. Yet this discharge-centered view of bankruptcy is correct neither from an historical perspective nor from a realistic appraisal of the presence and operation of most of the provisions in the federal bankruptcy laws over the years.<sup>1</sup> For although discharge of the debtor (and such related issues as "exemptions" that enable an individual debtor to keep assets out of the bankruptcy pool) may well be the motivating *cause* of a majority of bankruptcy cases,<sup>2</sup> most of the bankruptcy *process* is in fact concerned with creditor-distribution questions. Assets are marshalled so that they can be allocated among those holding claims against the debtor or the debtor's property. Claims are determined so that participants in the allocation process may be assembled. And the rules governing priorities determine who, among the claimants, will get what and in what order.

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1. See W. HAWKLAND & P. LOISEAUX, *CASES AND MATERIALS ON DEBTOR-CREDITOR RELATIONS* 461 (1978) ("Although not clearly recognized by the end of the eighteenth century, the right to be discharged has now been firmly established . . ."); J. MACLACHLAN, *BANKRUPTCY* 16-17, 20-21 (1956) (historically, discharge not an important element of bankruptcy policy); see also Bankruptcy Act of 1800, ch. 19, § 36, 2 Stat. 19, 31 (repealed 1803); Bankruptcy Act of 1867, ch. 176, § 33, 14 Stat. 517, 533 (repealed 1878); Levinthal, *The Early History of English Bankruptcy*, 67 U. PA. L. REV. 1, 14 (1919); Riesenfeld, *The Evolution of Modern Bankruptcy Law*, 31 MINN. L. REV. 401, 406 (1947).

2. J. MACLACHLAN, *supra* note 1, at 15-17.

Although the Bankruptcy Code<sup>3</sup> specifies some of these priority rules, the claimants who fare best in the bankruptcy process hold special entitlements under applicable non-bankruptcy law.<sup>4</sup> The priorities enunciated in the Bankruptcy Code itself deal largely with the allocation of rights among persons not entitled to preferential treatment outside of bankruptcy.<sup>5</sup>

Despite the importance and durability of such distributional rules, no normative theory has been developed against which these inter-creditor bankruptcy rules could be examined.<sup>6</sup> This Article will attempt to supply that theoretical analysis by exploring the role bankruptcy should play in shaping rules for distributions among creditors, and then testing certain existing rules against the resulting model.<sup>7</sup> First, the Article provides a justification for the time-honored proposition that non-bankruptcy entitlements, such as security interests, should be recognized in bankruptcy.<sup>8</sup> This justification is developed by using a hypothetical model that I call the "creditors' bargain" in a simple setting where all debts are assumed to be already due and owing. Second, the Article applies that model by considering the role bankruptcy should play in dealing with debts that are not yet due and owing. I call this the phenomenon of "temporal" concerns in bankruptcy.<sup>9</sup> The Article examines two important distinctions made by

3. The Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-15,1326 (Supp. III 1979) [hereinafter cited by Bankruptcy Code § only].

4. See 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.2 (1965) (policy determination that "[t]he Bankruptcy Act itself should provide principally a procedural framework for carrying out the liquidation. The determination of which property interests . . . were to be recognized . . . was to be left to state law."); Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013, 1035 (1953) ("apparent purpose" of the bankruptcy laws is to provide a system for the effectuation of state-created rights).

5. See generally Bankruptcy Code § 507.

6. Neither REPORT OF THE COMMISSION ON BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93rd Cong., 1st Sess. pt. 1, at 61-84 (1973) ("A Philosophical Basis for a Federal Bankruptcy Act") nor Shuchman, *An Attempt at a "Philosophy of Bankruptcy,"* 21 U.C.L.A. L. REV. 403 (1973) provides a cohesive normative approach that can be used with precision to examine the rights of creditors *inter se*.

7. This Article, because it deals integrally with reorganizations, will be limited to an examination of *business* debtors, usually in the corporate form. Many of the conclusions, however, would be applicable as well to individual debtors, who may also use Chapter 11, Bankruptcy Code § 109(d). But because of potential normative differences, this Article should not be understood as dealing, directly, with the situation of individual debtors and their creditors. For example, liquidating corporations do not need the bankruptcy process to get a discharge, since state limited-liability rules for shareholders provide the functional equivalent. See Bankruptcy Code § 727(a)(1). But in cases where a corporation continues to operate, state limited-liability rules do not provide an effective substitute to bankruptcy discharge. In those reorganization cases, the Bankruptcy Code provides its own discharge. See Bankruptcy Code § 1141(c), (d).

8. The discussion will refer only to consensually negotiated entitlements. Other forms of non-bankruptcy entitlements—such as nonconsensual liens—might raise distinct concerns. Some issues surrounding state-created priorities and statutory liens effective only in bankruptcy are discussed *infra* pp. 901-07.

9. By "temporal" concerns, I mean long-term contractual arrangements. For example, temporal concerns would arise with respect to a loan that, apart from a default (including a "bankruptcy

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the Bankruptcy Code: between lenders and executory contract-holders on the one hand,<sup>10</sup> and between liquidation and reorganization on the other hand.<sup>11</sup> Justifications for these distinctions are then examined in light of the creditors' bargain model. Finally, the Article explores why the Bankruptcy Code refuses to recognize state-created priorities and statutory liens effective only in bankruptcy despite the fact that it generally recognizes other non-bankruptcy entitlements.<sup>12</sup>

### I. Individual Rights in a Collective Proceeding: An Initial Examination of Bankruptcy as a Creditors' Bargain

A longstanding slogan is often used in discussing the non-discharge-related rules of bankruptcy law:<sup>13</sup> "equality is equity."<sup>14</sup> But this phrase explains little. It fails to deal, even roughly, with the plain fact that all bankruptcy laws to date accord substantial respect to non-bankruptcy entitlements.<sup>15</sup> The slogan "equality is equity" similarly fails to explain sat-

clause" default), would not be due and owing until some point in the future—say, five years from now. A loan that was substantially due and owing today, however, would not give rise to temporal concerns. The issues arising in connection with non-temporal loans are dealt with in the first part of this Article.

10. Holders of executory contracts and unexpired leases face possible "de-acceleration" in both a bankruptcy liquidation and a bankruptcy reorganization. Bankruptcy Code § 365. See *infra* pp. 880-92.

11. This inquiry is invited by the Bankruptcy Code's treatment of lenders. The Bankruptcy Code automatically accelerates the maturities of extensions of credit (whether secured or unsecured) in a Chapter 7 liquidation, yet provides the debtor with an ability to de-accelerate these maturities in a Chapter 11 reorganization. Compare H.R. REP. NO. 595, 95th Cong., 1st Sess. 353-54 (1977) (discussing Bankruptcy Code § 502(b) and noting that "bankruptcy operates as the acceleration of the principal amount of all claims against the debtor") with Bankruptcy Code § 1124(2) (in Chapter 11, a class of claims is unimpaired if, *inter alia*, the maturity of each such claim is reinstated). See *infra* pp. 881-83.

12. Related questions, such as the justification *vel non* for the various "avoiding powers" of a trustee (or lack of avoiding powers, such as the trustee's inability to reinstate contracts following an eve-of-bankruptcy termination, see *In re Beck*, 5 Bankr. 169 (Bankr. D. Hawaii 1980)), will not be analyzed in this Article. For an attempt to justify the preference system using what may be considered a creditors' bargain theory, see Note, *Preferential Transfers and the Value of the Insolvent Firm*, 87 YALE L.J. 1449 (1978); cf. 3 W. COLLIER, BANKRUPTCY ¶ 60.01, at 744 (14th ed. 1975) (if creditors and debtors could deal with impunity with debtor's assets up to the date of bankruptcy, only "tag ends" of unencumbered assets would remain). For a recent critical look at preference law as applied, see McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249 (1981).

13. If the bankruptcy process was concerned *solely* with discharge and its related issues, bankruptcy law would need to define the effect of discharge and, perhaps, specify which of a debtor's existing assets would be free of the claims of creditors. Beyond that, however, the method of allocating non-exempt assets among claimants would not be relevant to these discharge-centered issues. Bankruptcy's long-standing interest in creditor-oriented distributional questions suggests, however, that the bankruptcy process is in fact motivated by additional concerns. See Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1, 9 (1940) ("Whatever purposes bankruptcy attempts to carry out, it does by working on the creditors primarily . . .").

14. See *Canright v. General Finance Corp.*, 35 F. Supp. 841, 844 (E.D. Ill. 1940); see also *Simonson v. Granquist*, 369 U.S. 38 (1962); *Kuehner v. Irving Trust Co.*, 299 U.S. 445 (1937); *Worsley v. Demattos*, 96 Eng. Rep. 1160, 1161 (K.B. 1758); McCoid, *supra* note 12, at 260-61.

15. Bankruptcy Code § 725 (prior to general distribution, trustee shall dispose of property "in

isfactorily why bankruptcy would ever be an occasion for altering the non-bankruptcy allocation of assets among creditors.<sup>16</sup> Bankruptcy law's beguiling slogan has been little more than a banal reminder that equals are to be treated equally in bankruptcy: the important determination of who those "equals" are is often not resolved under bankruptcy law.<sup>17</sup>

A more profitable line of pursuit might be to view bankruptcy as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position.<sup>18</sup> It is this approach that I characterize as the "creditors' bargain." This view provides an illuminating vantage point from which to analyze bankruptcy law's treatment of many non-bankruptcy entitlements, and a focus from which to examine the deviations made in the name of bankruptcy policy.

### A. *The Creditors' Bargain and Unsecured Creditors*

First, consider a world in which a debtor could consensually create only one class of claimants, called "unsecured creditors." These unsecured creditors would enjoy typical state-law collection rights of attachment, execution, and so forth, but would not (at least prior to the time such collection rights are pursued) have the sort of property interests in or priority rights to any of their debtor's collateral that are enjoyed by secured creditors. In addition, assume for the moment that all these unsecured claim-

which an entity other than the estate has an interest, such as a lien"); *Butner v. United States*, 440 U.S. 48, 54 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law."); *In re Telemart Enterprises*, 524 F.2d 761, 763 (9th Cir. 1975) (bankruptcy law reflects general policy of recognizing property interests); *cf.* *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 161-63 (1946) (validity of claims of creditors generally decided under state law, unless in conflict with federal policy and equitable principles); REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, *supra* note 6, pt. 1, at 70 ("[F]or the most part, [claims arising in the open credit economy] should be recognized in the bankruptcy process.")

16. For an illuminating discussion of this point, see Eisenberg, *Bankruptcy Law in Perspective*, 28 U.C.L.A. L. REV. 953 (1981). For justification of federal bankruptcy rules as a form of risk-spreading compulsory insurance, see P. COLEMAN, *DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY* 13 (1974) (legislators wanted insolvent's property distributed equitably because spreading losses among all creditors might prevent collapse of any one of them).

17. See 2 G. GILMORE, *supra* note 4, § 45.2, at 1286-88.

18. Recent work, although incomplete and tentative, hints at such an approach. See, e.g., Ang & Chua, *Coalitions, the Me-First Rule, and the Liquidation Decision*, 11 BELL J. ECON. 355 (1980); Weistart, *The Costs of Bankruptcy*, 41 LAW & CONTEMP. PROBS. 107 (Autumn 1977); *cf.* Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1250-54 (1981) (discussing development of corporate reorganization laws in terms of developing efficient procedures to aid creditors). *But cf.* Bulow & Shoven, *The Bankruptcy Decision*, 9 BELL J. ECON. 437, 454 (1978) (treating bankruptcy as decision made when "coalition of claimants with negotiating power can gain from immediate liquidation"). The focus on bankruptcy as a law of collection from failing debtors may be viewed as consistent with the general historical development of bankruptcy. See J. MACLACHLAN, *supra* note 1, at 15; 2 J. STORY, *COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES* § 1113, at 50 n.2 (4th ed. 1873).

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ants extend credit on a short-term basis.<sup>19</sup> Are there any reasons to believe that this unitary group of creditors would favor the existence of a government-imposed system providing for the collective treatment of claims against a common debtor?

To examine this, it is worth considering a simple hypothetical. *D* has a small printing business. Potential creditors estimate that there is a twenty percent chance that *D* will become insolvent.<sup>20</sup> At the point of insolvency, the business is expected to be worth \$80,000 as an operating entity and \$60,000 if sold piecemeal. *D* borrows \$50,000 from each of two creditors, *C1* and *C2*. *C1* and *C2* expect to spend \$2,000 each in pursuit of individual creditor remedies should *D* become insolvent and fail to repay them. Are there any reasons to believe that under these circumstances *D*, *C1*, and *C2* would jointly agree to contract for a collective liquidation system to deal with the twenty percent chance that *D* will not be able to pay *C1* and *C2* in full? From the creditors' point of view (and ultimately from *D*'s, since inefficiencies in a non-collective system will be charged back to *D*—either wholly or in part—in the form of higher credit costs),<sup>21</sup> three reasons suggest themselves: reduction of strategic costs; increased aggregate pool of assets; and administrative efficiencies.<sup>22</sup>

### 1. Reduction of Strategic Costs

A collective system that treats all claimants standing in the same relationship to the debtor alike has the virtue of substituting a sum "certain"<sup>23</sup> for the uncertain amount that might be realized under an individualistic creditors' remedy system. This has two advantages, even in a case where

19. The complications introduced by consideration of longer term extensions of credit will be discussed in detail after the simple model is established. See *infra* pp. 878-901.

20. For present purposes the model is static. I assume that *D*'s investment decisions will not change, and that *D* will not otherwise misbehave or make the business more risky. See *infra* notes 44 & 52.

21. At a number of points in this Article, I will talk about "advantages" to the creditors. In almost every such case, however, the analysis is not complete without noting how these cost savings may get passed on to the debtor. The extent to which these savings are passed on depends on the elasticities of supply of and demand for credit. See Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS. 13 (Autumn 1977); Weston, *Some Economic Fundamentals for an Analysis of Bankruptcy*, 41 LAW & CONTEMP. PROBS. 47 (Autumn 1977).

22. A collective process does not seem to be necessary to protect a debtor's right to a discharge. A system could be designed in which a debtor could do such things as announce that henceforth future assets would be free of prior claims. Then the creditors could fight among themselves over the debtor's "old" assets (however defined) for satisfaction of their claims. The debtor, however, may view a collective process as preferable to numerous lawsuits. To the extent that the creditors enjoy advantages from a collective system, a debtor also benefits through lower credit costs, and favors a collective system for that reason, see *supra* note 21.

23. As the discussion indicates, the advantage of a collective system is not that it provides, *ex ante*, a fully determinable sum, but only that one form of uncertainty (relative entitlements *vis-a-vis* other creditors) is eliminated.

the assets will inevitably be sold on a piecemeal basis. First, it eliminates strategic costs that would otherwise be associated with a race to the courthouse. Second, even if no such race would occur, the collective proceeding reduces variance in recoveries—which is itself a virtue to risk-averse creditors.

Consider, first, the incentives for a race and the associated strategic costs. *C1* and *C2*, in our hypothetical, have each loaned *D* \$50,000. Each of *C1* and *C2* knows, however, that if the other creditor gets to the courthouse first (or to *D* first, to persuade *D* to pay voluntarily), that other creditor will collect \$50,000, leaving only \$10,000 for the “slower” creditor.<sup>24</sup> Absent a prior agreement, this situation presents a classic example of the game theorists’ “prisoner’s dilemma.”<sup>25</sup> The central feature of a prisoner’s dilemma is rational individual behavior that, in the absence of cooperation with other individuals, leads to a sub-optimal decision when viewed collectively.<sup>26</sup> This occurs whenever certain rules are in the interest of an entire class of persons but, because of an inability to reach a collective solution, each class member acts out of immediate self interest in such a way that a less efficient solution results. This is precisely what occurs in our hypothetical. Each creditor, unless assured of the other’s cooperation, has an incentive to take advantage of individual collection remedies, and to do so before the other creditor acts. Unless each creditor individually attempts to “beat out” the other, that creditor will fare worse than the other. Yet this race not only creates costs for the individual creditors (such as frequent checking of the courthouse records for evidence of actions against the debtor by other creditors), it is also likely to lead to a premature termination of a debtor’s business, because each creditor will consider only that creditor’s own advantage from racing, instead of the disadvantages imposed on creditors collectively.<sup>27</sup> Thus, each creditor must participate in collectively non-optimal “advantage-taking” simply to avoid being taken advantage of. This creates a race to use individualistic remedies, even though it is not in the creditors’ collective interest to use them at

24. Use of these numbers assumes that the individualistic remedies system would inexorably lead to piecemeal dismemberment of *D* in the absence of some sort of an agreement between *C1* and *C2*. This assumption will be relaxed later. See *infra* pp. 864-65.

25. See R. LUCE & H. RAIFFA, *GAMES & DECISIONS* (1957); A. RAPOPORT & A. CHAMMAH, *PRISONER’S DILEMMA* (1965). For a reasonably non-technical introduction to game theory, see generally J. WILLIAMS, *THE COMPLETE STRATEGIST* (1966).

26. See, e.g., P. SAMUELSON, *ECONOMICS* 482-83 (8th ed. 1970); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 *STAN. L. REV.* 819, 859-62 (1981).

27. For these reasons, there are costs to a race system that make it less desirable for the creditors as a group. If the game results are zero sum, then there is no prisoner’s dilemma. See Gilson, *supra* note 26, at 860-61. Even risk-neutral creditors, however, are likely to find themselves in a form of prisoner’s dilemma. See *infra* note 28 & pp. 864-65.

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all.<sup>28</sup>

An assumption of creditor risk-aversion facilitates the exposition of the logic of collective action. If both *C1* and *C2* have a fifty percent chance of winning through the use of individualistic remedies, then each faces a fifty percent chance of being paid in full (\$50,000) and a fifty percent chance of being paid only \$10,000. But if *C1* and *C2* agree to share equally in the event of *D*'s misfortune, each could be assured of \$30,000. If *C1* and *C2* are risk-averse, one would expect them, prior to extending credit to *D*, to agree on a distributional system in the event of *D*'s insolvency in which each would receive this partial, but certain, payment of \$30,000. The reduction of uncertainty would itself be viewed as a virtue by *C1* and *C2* and, therefore, by *D* as well, who would get lower aggregate credit costs.

Several of the key assumptions lurking in the above analysis might appear questionable. First, if *C1* and *C2* also have a number of other investments (with borrowers other than *D*), the uncertainty as to who will prevail against *D* may appear diversifiable and thus unimportant.<sup>29</sup> Diversification is generally a response to an unavoidable risk, however, and here the risk can be eliminated *ab initio*. Moreover, diversification is a response to risk-aversion, not to the more general point that use of individualistic remedies leads to a collectively undesirable race. The individual "advantage-taking" behavior described above would lead each creditor to incur the costs associated with participating in the remedies race, whether or not that creditor were diversified.<sup>30</sup> Consequently it would still be in the interest of all creditors to avoid these costs by providing for a procedure to institute a mandatory collective system.<sup>31</sup>

A second troublesome feature of the analysis is that a collective system seems to require a homogeneous pool of creditors. If *C1*, for example, were a more astute observer of *D*'s behavior, or had closer relations with

28. A collective agreement would avoid the costs associated with this race only if individual creditors could not avoid the collective proceeding by precipitous conduct. A damage or a specific performance-type rule could be fashioned to protect the collective proceeding. Bankruptcy law, by enabling the trustee (as representative of the creditors) to undo pre-bankruptcy collections through his "preference" power, effectively creates a specific performance rule that not only makes the collective system mandatory but also acts as a deterrent against the sort of "race" that would otherwise occur. See Clark, *supra* note 18, at 1251; Note, *supra* note 12; see also *infra* note 148.

29. See J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 60-65 (4th ed. 1977).

30. This incentive will be particularly troublesome if we assume that this advantage-taking behavior will result in a smaller pool of assets than would exist if the creditors acted collectively. See *infra* pp. 864-65.

31. Moreover, the diversification challenge is overstated. All that it implies in any event is that *C1* and *C2*, if able to diversify fully, would be indifferent between an individualistic system and a collective system. Some creditors, however, may be unable to achieve, in a cost-effective fashion, the degree of diversification necessary to remove the cost of uncertainty. The amount of diversification required to minimize the uncertainty cost may be quite large. See Langbein & Posner, *Market Funds and Trust Investment Law*, 1976 AM. B. FOUND. RESEARCH J. 1. We may expect that some creditors (those not sufficiently diversified) would favor a collective system, while diversified (or easily diversifiable) creditors would be indifferent between the two systems.

*D*, *C1* might know ahead of time that she had a better than even chance of winning any race against *C2*, and hence would be unwilling to enter into a collective proceeding agreement in which she would share equally with *C2*. Homogeneity, however, is not an essential element of a justification for a collective system. First, the prisoner's dilemma analogy suggests that all creditors have some incentive to avail themselves of their individual remedies as soon as possible. Because of the resulting race, many of the special advantages held by *C1* are likely to be worthless. Participation in, or monitoring against, that race, however, will be costly for *C1* as well as for other creditors. Second, limitations on the availability of individual creditor remedies may weaken *C1's* advantages.<sup>32</sup> Finally, even if *C1* does in fact have "advantages" that give her a greater than fifty percent chance of being the first to be paid, those elements of uncertainty and associated increased costs that remain could be eliminated by a collective proceeding. Their elimination, even when coupled with a pro rata treatment of the entitlements of *C1* and *C2*, would, accordingly, still be advantageous to all concerned.

## 2. *Increased Aggregate Pool of Assets*

The use of individualistic remedies may lead to a piecemeal dismantling of a debtor's business by the untimely removal of necessary operating assets. To the extent that a non-piecemeal bankruptcy process (whether in the form of liquidation or reorganization) is likely to increase the aggregate pool of assets, its substitution for individualistic remedies may be advantageous to the creditors as a group. In the above hypothetical, for example, keeping *D's* printing business in one piece increases the pool of assets available to *D's* creditors by \$20,000. Whether or not *D's* printing business should be sold to a third party as a going concern (*i.e.*, "liquidated" at its highest value use), or "reorganized,"<sup>33</sup> it is obviously to the joint advantage of *C1* and *C2* to keep the entity alive. Again, however, *C1* and *C2* face a classic prisoner's dilemma: they are jointly better off if they act collectively, but if they are unable to act collectively, rational individual behavior will require collectively non-optimal advantage-taking on the part of each.<sup>34</sup> It is true that an agreement to act collectively could theoret-

32. For example, judicial liens may not be available until a debt has matured, and certain types of judicial assistance are sometimes limited to particular claims. These rules may frustrate or delay *C1's* ability to take advantage of special talents.

33. A reorganization involves more than simply keeping a business alive; it also involves a process whereby the original claim holders and interest holders become "owners" of the business. See *infra* pp. 893-95.

34. This illustrates a species of the "common pool" problem. The problem arises with common pool resources, such as oil. Individual owners of drilling rights tapping into this pool have incentives to remove as much oil as each such owner possibly can even though the value of the pool would be



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ically be negotiated after a precipitating event (i.e., after *C1* has taken the steps necessary to acquire a judicial lien). By acquiring a judicial lien, *C1* has assured herself of \$50,000 prior to the advent of these negotiations. *C2*, however, is faced with losing the difference between \$30,000 and \$10,000 if he cannot convince *C1* to keep the entity together. This provides a \$20,000 bargaining chip for *C1* and *C2* to allocate among themselves through negotiations carried out after *C1*'s attachment but before the ultimate foreclosure.

The bargaining, however, will be costly.<sup>35</sup> This bargaining with *C1* could be avoided if the remaining creditors were able to act collectively and repurchase the asset at the foreclosure rate of \$50,000, or replace it for \$50,000. In any case in which there is a large number of such creditors, not only would free-rider problems make any collective agreement after one creditor has attached almost impossible,<sup>36</sup> but subsequent creditors would still have incentives to "beat out" the remaining creditors by using their individual remedies and collecting first on the remaining assets.<sup>37</sup> For these reasons, *ex post* deals capable of preserving the debtor's "going concern" value, while possible, would not be very likely in a large number of cases. Such an agreement would be much more likely *ex ante*. Neither *C1* nor *C2* would know at that time which one will be the first to attach.<sup>38</sup> They do know, however, that the total pool of assets available to satisfy their claims may be increased through collective action. For those reasons, one would expect them to agree to a collective system that deterred the sub-optimal behavior of the prisoner's dilemma, and allowed *C1* and *C2* to capture and share the "going concern" value of *D*'s business—the difference between the worth of *D*'s assets in a piecemeal sale and the worth of those assets as a continuing business.<sup>39</sup>

maximized by a slower withdrawal. The solution to a number of "common pool" problems has been statutory "compulsory unitization"—a result that parallels the compulsory collective proceeding solution to the present problem. See generally Sweeney, Tollison, & Willett, *Market Failure, The Common Pool Problem, and Ocean Resource Exploitation*, 17 J.L. & ECON. 179 (1974). As before, the *ex post* incentives to achieve the advantages that come from being first may lead to a more-rapid-than-optimal resort to individual creditor remedies, and a more rapid destruction of the debtor's going concern value than would otherwise be the case. See *supra* pp. 861-63.

35. This is an example of bilateral monopoly. See R. POSNER, *ECONOMIC ANALYSIS OF LAW* 45 (2d ed. 1977); Arrow, *The Organization of Economic Activity: Issues Pertinent to the Choice of Market Versus Nonmarket Allocation*, in 1 *THE ANALYSIS AND EVALUATION OF PUBLIC EXPENDITURES: THE PPB SYSTEM*, 91st Cong., 1st Sess. 47 (1969).

36. J. HIRSCHLEIFER, *PRICE THEORY AND APPLICATIONS* 537-38, 561-64 (2d ed. 1980); R. POSNER, *supra* note 35, at 45-46; see also Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1170-72 (1981); Grossman & Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980).

37. See *supra* pp. 861-64.

38. See *supra* p. 864.

39. This agreement would need to provide not only for a collective proceeding, but also for a deterrent or policing device to keep creditors from attempting to avoid the collective proceeding by

### 3. *Administrative Efficiencies*

Issues such as the precise amount of the debtor's assets and the nature and extent of secured claims must be resolved in virtually every collection proceeding. We have posited that *C1* and *C2* would each spend \$2,000 in an individual collection proceeding. In a number of cases, it is likely that *C1* and *C2* will attempt to collect their claims at roughly the same time. This would happen if, for example, *D* were insolvent and had announced that he was implementing his discharge right. A single inquiry into recurring collection questions is likely to be less expensive than the multiple inquiries necessary in an individualistic remedies system.<sup>40</sup> If a collective proceeding costs *C1* and *C2* a total of \$3,000, for example, its use would save *C1* and *C2* \$500 each. At the time of negotiating the creditors' bargain, this reduced cost would be viewed as a clear advantage of a collective process.<sup>41</sup> Consequently, in the event of *D*'s insolvency, we would expect to see *D*, *C1*, and *C2* prefer a collective system, and therefore agree to the inclusion of a procedure for implementing such a system in their *ex ante* bargain.

The three considerations I have described above make it likely that a general unsecured creditor will agree to a collective system in lieu of a scheme of individualistic remedies. No single creditor, however, would agree to be bound to this collective system unless it were a compulsory system binding all other creditors: to allow the debtor to contract with other creditors on an opt-out basis would destroy the advantages of a collective proceeding.<sup>42</sup>

Although we would expect to see a mandatory collective proceeding as a standard feature of the creditors' bargain, no *ex ante* meeting of the creditors will, realistically, take place. A debtor's pool of creditors changes over time and even the debtor is unlikely to know who the creditors of the business will be at any point in the future.<sup>43</sup> As a result, the creditors themselves cannot be expected to negotiate this agreement,<sup>44</sup> even though

"gun jumping." See *supra* note 28.

40. See Weistart, *supra* note 18, at 109.

41. The single inquiry may also be less expensive for *D*, since it would reduce expenditures associated with creditor collection of claims and increase *pro tanto* the pool of assets available for the creditors.

42. See *supra* notes 28 & 39.

43. This is likely to be true with respect to consensual creditors; it is almost certainly true with respect to non-consensual creditors, such as tort claimants.

44. Nor could we expect the debtor to do it for them, by including a procedure for implementing a collective proceeding as a standard contract feature. First of all, a debtor's incentive to take advantage of creditors would make consistent inclusion of this clause implausible. See generally O. WILLIAMSON, *MARKETS AND HIERARCHIES* 26-28 (1975); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 125-31 (1979); White, *Public Policy Toward Bankruptcy: Me-First and Other Priority Rules*, 11 BELL J. ECON. 550, 556-

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it would be in their joint interest to do so. A federal bankruptcy rule solves this problem by making available a mandatory collective system after insolvency has occurred.

It is important, however, not to overstate the role of the collective system imposed by the government. The *presence* of a bankruptcy system does not mandate its *use*. The realization that a creditor could always initiate the bankruptcy process<sup>45</sup> would deter attempts in any non-bankruptcy collective proceeding to provide any creditor with less than the minimum obtainable in a bankruptcy proceeding. The availability of a mandatory collective system in which distributions are governed by a set of statutory rules is, therefore, important because it stipulates a minimum set of entitlements for claimants that, in turn, provides a framework for implementing a consensual collective proceeding outside of the bankruptcy process.<sup>46</sup> One would normally expect to see consensual deals among creditors outside of the bankruptcy process attempted first,<sup>47</sup> at least to the extent that there are potential cost savings in remaining outside of the formal bankruptcy process,<sup>48</sup> since those savings could be consensually allocated. The formal bankruptcy process would presumably be used only when individualistic "advantage-taking" in the setting of multi-party negotiations<sup>49</sup> makes a consensual deal too costly to strike<sup>50</sup>—which may occur frequently as the number of creditors increases.

But because the bankruptcy rules set the stage against which consensual collective proceedings will be negotiated outside of bankruptcy, it is important that those rules be drawn in a fashion that is likely to minimize incentives for inefficient recourse to a collective proceeding.<sup>51</sup> These rules

62 (1980). In some respects, the situation is analogous to the public corporation context, where government-imposed general corporation rules regulating the relationship between owners and managers are necessary in view of the inability to achieve optimal results through consensual bargaining, due to the large number of stockholders. See Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997 (1981). Secondly, the debtor does not bargain consensually with a number of his claimants, such as non-consensual tort creditors.

45. This would be subject to rules governing creditor initiation of the bankruptcy process. See *infra* p. 892.

46. See Moore, *Foreword*, 41 LAW & CONTEMP. PROBS. 1, 9 (Autumn 1977).

47. Such workouts are, in fact, commonly observed. See, e.g., Coogan, Brode, & Glatt, *Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills*, 30 BUS. LAW. 1149, 1154-60 (1975); Krause, *Insolvent Debtor Adjustments Under Relevant State Court Statutes as Against Proceedings Under the Bankruptcy Act*, 12 BUS. LAW. 184, 185 (1957).

48. The extent of these cost savings would depend not only on the relative costs, in the abstract, of the two proceedings, but also on the extent to which the costs of a formal bankruptcy proceeding could be externalized, because a portion of court costs are picked up by the taxpayers as a group. Most of the costs of the bankruptcy process, however, are borne by the participants themselves. See Bankruptcy Code §§ 326-331, 503(b)(1) & (2), 507(a)(1), 726(a)(1).

49. See *supra* p. 865.

50. See *Discussion of the Economics of Bankruptcy Reform*, 41 LAW & CONTEMP. PROBS. 123, 171 (Autumn 1977) (comment of Mr. Coogan).

51. See Ang & Chua, *supra* note 18.

should be clear and determinable, so as to be ascertainable at low cost in any negotiated non-bankruptcy collective process. The remaining sections of this Article will consider the form some of these rules should take.

### B. *Property Claimants and the Creditors' Bargain*

To this point, we have assumed that all creditors were similarly situated in that they all held unsecured claims. Our scope will now be expanded to include creditors whose contracts afford them superior rights *vis-a-vis* other creditors.<sup>52</sup>

Consider, for purposes of this discussion, the utility of the creditors' bargain model in dealing with consensually secured claimants. In this discussion, it is a key assumption that consensually negotiated security interests have aggregate efficiencies: that a secured party is at least as well off with a security interest (and a concomitantly lower return on the investment) as without; that unsecured creditors are also at least as well off (having a riskier investment but a concomitantly greater return); and that the debtor's total cost of credit has been reduced because of efficiencies in allowing secured credit. Consequently, from an *ex ante* position, the debtor and the creditors would view it as in their joint interest to behave in a fashion that will keep the efficiencies of such consensually negotiated security interests.<sup>53</sup>

Assuming that other creditors would consent to the existence of secured creditors, we can now turn to the question of whether those secured creditors would consent to be bound by a collective proceeding. Fully secured creditors<sup>54</sup> are not direct beneficiaries of either the "reduction of strategic costs" or the "increased aggregate pool of assets" advantages of a collective proceeding previously explored.<sup>55</sup> Moreover, fully secured creditors are less likely to view "administrative efficiencies"<sup>56</sup> as a reason to support a

52. These superior rights may result from a consensual agreement between the creditor and the debtor or may be conferred by state law. The conferral of superior rights by state law is discussed *infra* pp. 901-07. The model being developed will, for the most part, treat a firm as having only secured and unsecured creditors. The possibility of distinct treatment between other classes (for example, creditors and equity-interests) will not be discussed in detail, although an analysis of the issues in these situations would be similar. As holders of the residual, however, equity-holders may have additional incentives to engage in risk-preferring activities that lead to non-optimal bankruptcy decisions. *Cf. White, supra* note 44 (incentive effects on firm's investment decisions whenever creditors are paid ahead of equity-holders).

53. See Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981). *But see* Schwartz, *supra*, at 30-33 (possible advantage-taking of uninformed unsecured creditors by secured creditors).

54. The discussion assumes that the creditors were assured of being fully secured at all times. This assumption makes the following discussion simpler, as it allows us to deal with polar cases.

55. See *supra* pp. 861-63.

56. See *supra* p. 866. Fully secured creditors would also be able to pass the costs of collection back to the debtor and hence, at least in part, to the unsecured creditors. See *infra* note 58.

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collective proceeding because at least some of these administratively difficult issues, such as the availability of assets and the priorities of competing claimants, have previously been negotiated away.

These observations ignore, however, the aggregate advantages that will accrue to the debtor and all the creditors<sup>57</sup> from minimizing the debtor's total credit costs. Unsecured creditors have several reasons for desiring a collective proceeding. Consider first the "increased aggregate pool of assets." If a secured creditor could remove collateral from the debtor's estate and remain outside of any collective proceeding this advantage would be diminished or lost. One would expect, therefore, that the unsecured creditors would be willing to pay a secured creditor at least something to agree to join in the collective proceeding. Moreover, while a secured creditor might otherwise be indifferent to the administrative efficiencies associated with a collective proceeding (because a secured creditor's costs of collection are often contractually allocated to the debtor),<sup>58</sup> the debtor and the creditors as a group will benefit as a result of *ex ante* adjustments for the elimination of such costs. Since costs passed on to the debtor by a secured creditor would increase the secured creditor's claim, they would, *pro tanto*, reduce the pool of assets available for the unsecured creditors and thereby increase their costs of credit. As a result, the unsecured creditors would in fact be sensitive to these costs. The introduction of secured creditors into the model, accordingly, should not make a difference: we would still expect the debtor and the creditors (including secured creditors) to select a system in which the aggregate collection costs would be minimized.<sup>59</sup>

The system in which collection costs are best minimized remains the collective proceeding. Since the advantages of secured credit would be weakened to the point of being lost if a secured creditor could be forced to participate on a *pro rata* basis with unsecured creditors in any bankruptcy proceeding,<sup>60</sup> maintaining these advantages requires respecting a secured creditor's ability to be paid first from the assets constituting the secured creditor's collateral. But this is not inconsistent with a mandatory collec-

57. Who gains the advantages will depend, in part, on the elasticities of the supply of and demand for credit. See *supra* note 21. The secured creditor, however, is not precluded from being such a beneficiary.

58. U.C.C. § 9-504(1)(a) (1972) expressly permits contract provisions that pass on to the debtor a secured party's expenses of collection.

59. There are at least two ways of fashioning the argument. The first is to assume that creditors already know their non-bankruptcy entitlements, and, possessing those entitlements, attempt to agree, consensually, to a collective proceeding. This is the descriptive approach of the text, although it is subject to some limitations. See *infra* note 62. It would be equally possible to invoke the Rawlsian "veil of ignorance" by assuming that the debtor and his creditors are trying to fashion a system that would maximize the group's collective welfare before their entitlements are known. See J. RAWLS, A THEORY OF JUSTICE 136-42 (1971) (imposition of "veil of ignorance" on those bargaining). The ultimate resolution, however, seems the same using either approach.

60. See Schwartz, *supra* note 53, at 34.

tive system: the unsecured creditors, for the reasons we have just explored, would view a secured creditor's ability to ignore the collective proceeding as a cost of credit. It is, therefore, in the joint interest of the unsecured creditors (and hence in the debtor's interest as well) to have a secured creditor included in the collective proceeding. A secured creditor, on the other hand, would have no reason to object to such an inclusion *if* left as well off as before.<sup>61</sup> Thus, the mandatory inclusion of a secured creditor in the collective asset-disbursement process, even if that creditor's preferential entitlements were respected, would produce a net benefit: the secured creditor would be no worse off than before and the unsecured creditors could be made better off.<sup>62</sup>

Consider the hypothetical examined earlier,<sup>63</sup> except allow *C1* to be a creditor with a security interest in *D*'s printing press, the principal piece of *D*'s business equipment. This press could be sold for \$50,000 on the open market. By virtue of this security interest, *C1* is "assured" of receiving \$50,000, the amount of *C1*'s loan. If *C1* is able to proceed independently of *C2*, however, thereby forcing a piecemeal liquidation, *C2* will

61. The premise of Kaldor-Hicks efficiency—that a move is desirable if the "winners" could compensate the "losers," even if no such compensation occurs—suggests, in the abstract, that the advantages of a collective proceeding might warrant its implementation even if the entitlements of secured creditors were not recognized. See Hicks, *Foundations of Welfare Economics*, 49 *ECON. J.* 696 (1939); Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 *ECON. J.* 549 (1939); see also Coleman, *Efficiency, Utility and Wealth Maximization*, 8 *HOFSTRA L. REV.* 509 (1980) (a reasonably accessible discussion of Kaldor-Hicks efficiency in legal context). The effects of a collective system in which the value of secured creditors' non-bankruptcy entitlements was not respected suggests, however, that such a system, in addition to potentially involving inter-personal utility comparisons, would be *less* desirable than a system that respected the value of those entitlements. Reducing the entitlements of secured creditors in bankruptcy will presumably reduce some of the advantages of secured credit in the first place. See *supra* note 60. Thus, a collective system that recognized those entitlements would be superior to one that did not. Secondly, the ability to threaten secured creditors with a diminution in their non-bankruptcy entitlements by threatening bankruptcy might lead to strategic behavior and non-optimal bankruptcy decisions. See, e.g., Muris, *Opportunistic Behavior and the Law of Contracts*, 65 *MINN. L. REV.* 521, 532-52 (1981); Posner, *Gratuitous Promises in Economics and Law*, 6 *J. LEGAL STUD.* 411, 421-24 (1977).

62. Cf. Ang & Chua, *supra* note 18 (inefficient liquidation decisions made when non-bankruptcy rights not respected). A collective proceeding that allocates all of the gains to the unsecured creditors is not, of course, the only system possible. One alternative would be for gains to be allocated equally among all creditors. Indeed, in an actual consensual bargain, it is unlikely that secured creditors would agree to the bargain unless they received *some* of the gains resulting from that bargain. The model used here goes no further than to show that the secured creditor would be *indifferent* between the two systems and hence is, in that respect, a bit at odds with a true creditors' bargain model. But a model where the gains are allocated entirely to the unsecured creditors has certain advantages. First, such a system (as represented by Chapter 7 of the Bankruptcy Code) is easy to operate. Moreover, since many (if not most) secured creditors face at least *some* possibility of being an unsecured creditor, the interests of secured parties are not unidimensional. Finally, state law effectively prohibits secured creditors from ever being paid more than in full. Debtors have non-waivable redemption rights and forced-sale rights, and surplus proceeds on disposition of the collateral must be returned to them. See, e.g., U.C.C. §§ 9-501(3), 9-502(2), 9-505, 9-506 (1972). There is unlikely to be a bankruptcy-related reason to upset that state law determination, which sets a maximum on a secured creditor's entitlement.

63. See *supra* p. 861.

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receive only \$10,000. If *C1* and *C2* proceed collectively (and sell *D*'s business as a going concern), *C2* would receive \$30,000. Thus, at the time *C1* attempted to collect by foreclosing on *D*'s printing press, we would expect *C1* and *C2* to negotiate an agreement to proceed collectively, with *C2* paying *C1* between \$0 and \$20,000 to agree to this.<sup>64</sup> Exactly as before, however (when *C1* and *C2* were both unsecured, but *C1* had just attached), the uncertainties of these negotiations, plus the inevitable "free rider" problems that would arise if there were multiple unsecured creditors, make an *ex ante* agreement preferable.<sup>65</sup> Under such an agreement, *C2* would assure *C1* of her ability to get her full \$50,000, while *C1* would agree to protect *C2*'s ability to get the \$30,000, by agreeing to keep *D*'s assets "together" so that they could be sold for \$80,000 (again, through a going concern liquidation or a reorganization).<sup>66</sup>

This suggests that there is nothing "unfair" about recognizing a secured creditor's prior entitlements in bankruptcy.<sup>67</sup> Instead, it is exactly the sort of agreement we would expect to see negotiated voluntarily once the issue of the *existence* of secured credit were decided. To the extent there are advantages to secured financing, respecting the non-bankruptcy priority of secured creditors is a necessary corollary of protecting those advantages. Moreover, a secured creditor has already "paid" for this prior entitlement—really a higher probability of being repaid—through receipt of a lower return. Conversely, the unsecured creditors have already been "paid" for allowing this prior entitlement and they receive a higher rate of return because of their lower priority position.<sup>68</sup> The creditors' bargain model, then, provides a satisfying theoretical explanation of why bankruptcy law should make a fundamental decision to honor negotiated non-bankruptcy entitlements.

## II. Non-Temporal Applications: Applying the Model to the Bankruptcy Code

Historically the bankruptcy process has recognized non-bankruptcy en-

64. This bargaining process could be circumvented if the creditors were able to act collectively. See *supra* p. 865. The problems of actually obtaining such consensual agreement remain, however.

65. See *supra* pp. 864-65.

66. *C1*'s "payment" for this agreement may be in the form of a higher interest rate. Conversely, *C2* would be expected to "pay" for this collective advantage, perhaps by receiving a lower interest rate. This, of course, is not the only possible agreement. See *supra* note 62.

67. Jackson & Kronman, *supra* note 53, at 1148 ("Since creditors remain free to select their own debtors and to set the terms on which they will lend, there is no compelling argument based on considerations of fairness for adopting one legal rule . . . rather than another . . ."); see also Ang & Chua, *supra* note 18; Meckling, *supra* note 21, at 15-16; cf. Eisenberg, *supra* note 16, at 956-59 (justifying adherence to non-bankruptcy rules absent clear evidence that they encroach on some bankruptcy-related policy).

68. See Jackson & Kronman, *supra* note 53, at 1147-48, 1153-55; cf. Eisenberg, *supra* note 16, at 965 ("both groups know the rules of the game when they extend credit").

tlements, and, to that extent, the law seems generally consistent with the normative theory just developed. It is not necessarily true, however, that bankruptcy law faithfully mirrors the normative theory in all respects. For it remains true that the *nature* of a secured creditor's non-bankruptcy entitlements are changed in bankruptcy.<sup>69</sup> A secured creditor is not necessarily paid upon the institution of a bankruptcy proceeding, nor is a secured creditor necessarily allowed to resort to his back-up right to realize on his collateral.<sup>70</sup> To measure whether, and to what extent, the existing bankruptcy process deviates without adequate justification from a recognition of non-bankruptcy entitlements, even in the case of non-temporal loans, it is necessary to examine in greater detail the actual operation of the provisions of the Bankruptcy Code.<sup>71</sup> Although those provisions protect, in theory, the value of a creditor's non-bankruptcy entitlements, in actual application it appears that this value-equivalence is consistently undermined.

#### A. "Indubitable Equivalence" and the Invitation to Fudge

Consider the following set of facts: *D*'s printing press (in which *C1* has a security interest) can be sold for \$50,000.<sup>72</sup> *D*'s other business assets can be sold for \$10,000. But the value of keeping all of the assets together is \$80,000, \$20,000 in excess of their individual values. (Assume also that *D*'s printing press cannot readily be replaced on the open market—that is, *D* cannot buy a new press for \$50,000 without substantial delay and, therefore, cannot protect the \$80,000 value in that fashion.) In this instance, the creditors' bargain model would suggest that the efficient solution would be to pay *C1* \$50,000 in cash, and to have *D* keep the printing press. *D* should keep the collateral because the benefits to *D*'s business, and to *D*'s unsecured creditors, exceed the benefits that *C1* would enjoy exerting her individual default right to receive \$50,000 in cash. But the

69. This is also true of unsecured creditors who are precluded from resorting to their individual rights to obtain property upon the institution of the collective bankruptcy system. See *supra* pp. 861-66.

70. See Bankruptcy Code § 362(a). In a liquidation proceeding, the "automatic stay" affects a creditor's substantive rights only until the assets are actually disbursed. See Bankruptcy Code § 725. In a reorganization proceeding, however, the deferral of substantive rights may last longer. See Bankruptcy Code § 1129(b)(2)(A), discussed *infra* pp. 882-86.

71. The creditors' bargain theory suggests only that it may be necessary to keep the collateral, so that the debtor's "going concern" value may be captured (or the other advantages of a collective proceeding may be realized). It does not, itself, explain why a secured creditor is not entitled to be paid, in cash, immediately after the initiation of a bankruptcy proceeding. To explain, as the theory does (and as the Bankruptcy Code itself implies, see § 362(d)(2)) that the aggregate maximizing solution is to leave property with the estate when it is "necessary to an effective reorganization," does not answer the question of how a secured creditor's pre-bankruptcy rights are protected.

72. Market value is the proper measure of an asset's value from the point of view of the secured creditor, because a debtor can require the secured creditor to *sell* the asset or the debtor may *redeem* the asset. See *supra* note 62.



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collective process may then be viewed as a redemption of *C1*'s property rights in the printing press. This may be done in one of two ways. *D* may do it directly, by putting out bids (including among the unsecured creditors) for someone to lend *D* \$50,000 to pay off *C1* in return for a security interest in the printing press, which, freed of *C1*'s interest, would become available for such a secured loan.<sup>73</sup> Alternatively, *C1* could be required to make the loan herself by being given the marketplace rate for such a loan. If *C1* is no longer the more efficient lender, this would induce *C1* to assign the claim and its associated security to the efficient marketplace lender,<sup>74</sup> allowing *C1* to gain her \$50,000 that way.

While the Bankruptcy Code does not preclude application of either of the two alternatives, neither is used, except perhaps on rare occasions. In the situation represented by the above hypothetical, the Bankruptcy Code, consistent with the creditors' bargain model, would allow *D* to keep the printing press: it would be "necessary to an effective reorganization"<sup>75</sup> in the sense that *D*'s estate would be worth \$20,000 more by virtue of keeping the printing press. *C1*, however, is not necessarily paid \$50,000 in cash (although in theory *C1* could be); instead, *C1* is entitled only to the "indubitable equivalent"<sup>76</sup> of her right to take the printing press and thereupon realize \$50,000.

We still have not strayed very far from the learnings of the creditors' bargain model; indeed, the "indubitable equivalence" standard at least purports to preserve the value of the non-bankruptcy entitlement. The conceptual underpinnings of the principle of indubitable equivalence seem to require that *C1* receive something in the bankruptcy proceeding so as to leave *C1* indifferent as between receiving \$50,000 in cash, today, and leaving \$50,000 "on loan" to *D*, secured by *D*'s printing press.<sup>77</sup> This

73. *C1* might, of course, be one of those bidders.

74. It would be difficult to choose between these two alternatives. If there is no particular reason to believe that *C1* will again be the efficient lender, it would normally seem better to have *D* negotiate directly with potential new lenders. This is so because, depending on the needs or desires of a particular lender, loan terms may be optimized from *D*'s perspective when *D* does the negotiating himself (there is no reason to assume that *D*'s contract with *C1* necessarily contains an optimum set of terms for a secured loan made by another lender). *Cf.* Jackson & Kronman, *supra* note 53, at 1150-61 (discussing factors leading particular lender to make a secured loan). The phenomenon of repeat lending, however, suggests that it is in fact likely that *C1* and *D* would again be the optimal parties to a loan agreement. *C1* and *D*, for example, may well have informational advantages concerning each other that would lead them to continue to deal on much the same terms as before. In that event, it may be more efficient simply to give *C1* the marketplace rate for such a loan.

75. Bankruptcy Code § 362(d)(2). This should be the case even where the debtor's property is being sold as a "going concern."

76. Bankruptcy Code § 361(3). This rather odd statutory language comes from Judge Learned Hand's opinion in *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935). *See* S. REP. NO. 989, 95th Cong., 2d Sess 127-28, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5913.

77. *See* H.R. REP. NO. 595, *supra* note 11, at 339 (purpose of Bankruptcy Code § 361 is to ensure that secured creditor receives essentially what was bargained for); *id.* at 342 (automatic stay does not affect rights of creditors but instead simply stays enforcement of those rights pending orderly

would have to be an amount equal, in *C1*'s eyes, to *C1*'s other investment opportunities for \$50,000.<sup>78</sup> To achieve that equivalence, the amount would also have to be sufficient compensation for the risks of having outstanding a loan securing a debt owing from a person in *D*'s position. Included in any calculation of the "correct" level of this compensation should be the recognition that if *C1* is no longer the most efficient lender, *C1* may assign the loan contract and security to the lender who is. In that case, the level of compensation should be calculated on the basis of *C1* receiving \$50,000 by such assignment (which *C1* could then invest in some venture in which she was the efficient lender). For that reason, indubitable equivalence ultimately requires only that *C1* be compensated on the basis of the market rate for secured loans to such a debtor.<sup>79</sup>

Despite this theoretical harmony, the indubitable equivalence standard ultimately is the device through which adherence to the creditors' bargain model is systematically ignored. The hypothetical satisfaction of an entitlement through a court-determined indubitable equivalent seldom achieves the results dictated by application of the creditors' bargain model,

examination of debtor's and creditor's rights); *In re Anchorage Boat Sales*, 4 Bankr. 635 (Bankr. E.D.N.Y. 1980) (secured creditor must receive compensation equivalent to having today amount equal to value of the collateral that could be reinvested); see also *In re Alyucan Interstate Corp.*, 12 Bankr. 803, 807-09 (Bankr. D. Utah 1981) (adequate protection protects value of bargain); *In re Graydon*, 8 Bankr. 475 (Bankr. S.D. Fla. 1981) (general discussion of adequate protection); cf. *In re Landmark at Plaza Park, Ltd.*, 7 Bankr. 653 (Bankr. D.N.J. 1980) (Bankruptcy Code § 1129(b) case discussing providing present value equivalence). *Contra In re American Mariner Indus.*, 10 Bankr. 711 (Bankr. C.D. Cal. 1981) (undersecured creditor not entitled to compensation for loss of use of money during stay). The concept of indubitable equivalence described in the text of this Article appears to be consistent with Judge Hand's original use of the phrases "adequate protection" and "indubitable equivalence." He wrote:

It is plain that "adequate protection" must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.

*In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935). See also *In re New York, New Haven & Hartford R.R.*, 147 F.2d 40, 48 (2d Cir. 1945) (fair and equitable treatment requires banks to be classified as secured creditors to extent that they would have realized on their collateral had they not been restrained from selling).

78. Payment of interest on the loan up to the value of the collateral, therefore, seems called for as a matter of "indubitable equivalence," even if it were not directly recoverable under Bankruptcy Code § 506(b). *In re Anchorage Boat Sales*, 4 Bankr. 635 (Bankr. E.D.N.Y. 1980). The unsecured creditors are, in effect, "redeeming" from *C1* her right to receive \$50,000 today because to do so is *pareto superior*. See *supra* p. 870 & note 61. This reasoning is not limited to the case of secured creditors. If any bankruptcy case involved sufficient assets to pay the unsecured creditors in full and still return something to the equity interests, the unsecured creditors should likewise be paid for the "redemption" of their individual rights (of execution and so forth) on the ground that to do so is *pareto superior*. In this situation, interest is expressly allowed, see Bankruptcy Code § 726(a)(5), although the "legal rate of interest" is probably inadequate. Absent a case in which there would otherwise be assets available to the equity interests, paying interest on the unsecured creditors' claims would be a gesture without meaning, as it would have no inter-class consequences.

79. Plus the costs associated with assignment. These costs may, of course, be quite high.

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principally because the current standard requires no reference to available market-pricing mechanisms.<sup>80</sup> Even cases discussed with approval in congressional reports illustrate the inadequacy, in creditors' bargain terms, of the indubitable equivalence standard as applied.<sup>81</sup>

It is likely, therefore, that the compensation that is deemed to be "adequate protection" will rarely provide the secured creditor with the indubitable equivalent of realizing, at the point of bankruptcy, the market value of the item in which that creditor has a security interest.<sup>82</sup> This has two consequences. First, a secured creditor with knowledge of the increased risk of undercompensation at the time of making a loan will be expected to charge the debtor for this risk. This will lead to an increase in the cost of secured credit.<sup>83</sup> Second, it may lead to a distorted evaluation of the relative merits of reorganization versus piecemeal liquidation. For example, if the "going concern" value of the printing press, when used in conjunction with *D's* business, is \$49,000 (and, hence, the going concern

80. It is possible, of course, to overcompensate the secured creditor as well. But it seems safe to say that secured creditors rarely do better in the bankruptcy process than they do in the marketplace. See Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHIL. L. REV. 565 (1950); Scott, *Bankruptcy, Secured Debt, and Optimal Capital Structure*, 32 J. FIN. 1, 14 (1977); see also *infra* note 81 (discussing *In re Bermec Corp.* and *In re Yale Express System*); cf. Kronman, *Specific Performance*, 45 U. CHIL. L. REV. 351 (1978) (in case of "unique" goods, uncertainty may impose "an unacceptably high risk of undercompensation on the injured promisee").

81. The court in *In re Yale Express System*, 384 F.2d 990 (2d Cir. 1967), refused to allow Fruehauf Corporation, a secured creditor, either to take possession of its collateral (trailers and truck bodies) or to collect rental payments during the reorganization of Yale Express System despite the fact that the collateral was depreciating. Instead, Fruehauf was deemed protected since "the trustee has offered to fix the value of the security interest claimed by Fruehauf so that its position in any reorganization will be unaffected by possible depreciation." 384 F.2d at 992. This case was cited approvingly by H.R. REP. NO. 595, *supra* note 11, at 338-40. Commentators, however, have pointed out the inadequacy of this solution, because Fruehauf was not compensated for the risk that no viable reorganization would emerge. Murphy, *Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings*, 30 BUS. LAW. 15, 33-46 (1974); Rosenberg, *Beyond Yale Express: Corporate Reorganization and the Secured Creditor's Rights of Reclamation*, 123 U. PA. L. REV. 509, 528-29 (1975). Nor was Fruehauf to be compensated for the interest that was accruing because of the delay itself. The court in *In re Bermec Corp.*, 445 F.2d 367 (2d Cir. 1971), cited approvingly by S. REP. NO. 989, *supra* note 76, at 53-54, granted Pacar Financial Corporation, a secured creditor, payments equal "to the actual current depreciation of the value of the rolling stock" in lieu of a right to repossess or a right to collect rentals during Bermec's reorganization. *In re Bermec Corp.*, No. 71-B-291 (Bankr. S.D.N.Y.), *aff'd*, 445 F.2d 367 (2d Cir. 1971). Yet this surely fails to provide the "indubitable equivalent" of an immediate right to foreclose: it gives, for example, no compensation for the lost time value of money. Indeed, at least as a first approximation, the rental amounts were a good surrogate for depreciation plus interest on the loan.

82. See *In re El Patio, Ltd.*, 6 Bankr. 518 (Bankr. C.D. Cal. 1980) (applying the adequate protection test of the Bankruptcy Code). The largest problem in *El Patio* is a clear under-estimation of the value of the collateral because of a refusal to consider the possibility (apparently substantial at the time of the decision) that a regulatory approval would markedly increase the value of the collateral. *Id.* at 520-21. The court did, however, properly allow the secured party to collect rentals on the property. *Id.* at 522. Cf. *Butner v. United States*, 440 U.S. 48 (1979) (entitlements to rentals decided under state law).

83. While there will also be a decrease in the cost of unsecured credit, as those creditors also adjust for their decreased risk, presumably some of the advantages of secured credit would be lost in the process. See Schwartz, *supra* note 53, at 34.

value of *D*'s business is \$59,000), it would be sensible to sell the printing press for \$50,000. This move would increase the value of *D*'s estate by \$1,000. But if the unsecured creditors<sup>84</sup> are able, by keeping the printing press and giving *C1* "inadequate protection," to reduce the expected value of *C1*'s claim to \$48,500, they have an incentive to keep the printing press and try to reorganize *D*'s business, even though the creditors as a whole would be better off by selling the printing press and going ahead with a piecemeal liquidation.<sup>85</sup> The threat of giving *C1* such inadequate protection, in reality, becomes a "bargaining chip" in the unsecured creditors' hands—they can attempt to use it to extract from *C1* some of the \$1,500 in benefits that she would get from a piecemeal liquidation by having *C1* "bribe" them to agree to such a liquidation. This scenario involves complex, costly, and potentially intractable negotiations in order to decide which form of collective proceeding to use.<sup>86</sup> A secured creditor, moreover, to avoid being forced to bribe the unsecured creditors, may also engage in strategic behavior by, for example, realizing on the collateral earlier than would be collectively optimal, so as to "beat out" the unsecured creditors and foil their ability to do this.<sup>87</sup>

Avoidance of these "eve-of-bankruptcy" negotiations resulting from attempted advantage-taking and concomitant threats of inefficient uses of the bankruptcy process, or strategic behavior to avoid such advantage-taking would, therefore, appear preferable. This could be accomplished by the creditors agreeing, *ex ante*, among themselves, to respect the value of *C1*'s non-bankruptcy entitlements by means of true "adequate protection" (probably by resort to a market-pricing mechanism). But, for practical reasons,<sup>88</sup> it will be virtually impossible to have all of a debtor's creditors who are in existence at the time of these "eve-of-bankruptcy" negotiations actually reach this result by prior consensual agreement. Consequently, the failure of bankruptcy law itself to provide, as an "off the rack" rule,<sup>89</sup> the sort of agreement that one would predict would be reached if such an

84. The unsecured creditors in a Chapter 7 proceeding may be represented by a trustee elected by unsecured creditors (excluding creditors with interests "materially adverse" to other unsecured creditors). Bankruptcy Code § 702.

85. See Posner, *supra* note 61, at 421-24; see also Ang & Chua, *supra* note 18; White, *supra* note 44, at 563-64 (management, equity holders, and large lenders may keep failing firm operating because of possibilities for redistribution away from long-term creditors and towards themselves, rather than because continued operation is best use of firm's assets).

86. See *supra* p. 865. Some of these difficulties may be alleviated if the trustee is the sole negotiator for the unsecured creditors.

87. See *supra* pp. 862-65 (discussing the problems inherent in a "race").

88. See *supra* p. 866.

89. The term "off the rack" rule comes from Goetz & Scott, *Liquidated Damages, Penalties, and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 588 n.87 (1977); see also Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982).

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*ex ante* agreement were possible, leads to an inefficient system. The point is not so much that secured creditors are unable to adjust for the bankruptcy result but that this adjustment process may lead to a sub-optimal amount of secured credit, with correspondingly greater credit costs for the debtor.<sup>90</sup>

It is particularly puzzling that bankruptcy law not only does not postulate a reason for straying from the creditors' bargain model with respect to this *ex post* reallocation, but does not even appear to sanction the reallocation at all, except in an under-the-table fashion. In retrospect, the related concepts of "adequate protection" and "indubitable equivalence" suffer not so much from theoretical disharmony with the creditors' bargain model, as from inadequate statutory firmness that permits—perhaps nurtures—the belief among bankruptcy judges that adequate protection can be granted without reliance on market-pricing mechanisms. In this respect, it tracks the theoretical consistency but practical disharmony of the absolute priority rule.<sup>91</sup> In both instances the gulf between theory and practice seems to stem principally from the under-utilization of available market devices for providing realistic adequate protection.

### B. *Concluding Comments on Non-Temporal Bankruptcy Entitlements*

The indubitable equivalence standard provides protection for holders of secured claims that in theory is entirely consistent with the creditors' bargain model. And insofar as non-temporal questions are concerned, the Bankruptcy Code remains faithful to this theoretical protection for a secured creditor.<sup>92</sup> The Bankruptcy Code starts with a mandate that a secured creditor be granted "adequate protection" from the effects of the automatic stay during the time that the property is held by the bankruptcy estate.<sup>93</sup> At any sale of property pursuant to Bankruptcy Code section 363, a secured creditor's lien will follow the collateral that secures the loan unless "the price at which such property is to be sold is greater than the aggregate value" of the lien, or unless the secured creditor can "bid in"

90. See *supra* note 85; see also *supra* p. 876 (discussing inefficient bankruptcy decisions that may result from "eve of bankruptcy" negotiations).

91. For a discussion of the gap between the absolute priority rule as articulated and as applied, see Blum, *supra* note 80; Brudney, *The Investment Value Doctrine and Corporate Readjustments*, 72 HARV. L. REV. 645, 679 (1959); Friendly & Tondel, *The Relative Treatment of Securities in Railroad Reorganizations Under Section 77*, 7 LAW & CONTEMP. PROBS. 420 (1940); Note, *Absolute Priority Under Chapter X—A Rule of Law or a Familiar Quotation?*, 52 COLUM. L. REV. 900 (1952).

92. The protection provided by the indubitable equivalence standard may be inconsistent with the Bankruptcy Code's treatment of other state-created entitlements, as well as of temporal extensions of credit. See *infra* Parts III and IV.

93. Bankruptcy Code §§ 361, 362(c)-(d); see *supra* note 77.

the lien at the sale.<sup>94</sup> If there has not been such a sale during the course of the proceeding, Bankruptcy Code section 725 requires the trustee to dispose of secured property (and hence of secured claimants) before any distribution to priority claimants and other unsecured creditors.<sup>95</sup> Finally, in reorganizations, Chapter 11 bases payments, in present value terms, on a minimum of Chapter 7 liquidation entitlements.<sup>96</sup> Nothing in these rules is theoretically inconsistent with the basic creditors' bargain model previously sketched.

### III. The Complexity of Long-Term Contractual Arrangements

Thus far, in examining the applicability of our normative model to the bankruptcy process, we have been dealing with a hypothetical world in which all credit was "due and owing" as of the date of bankruptcy.<sup>97</sup> One of the most perplexing questions posed by the use of the bankruptcy process, however, is how to deal with an extension of credit (or any other contractual arrangement) in which the principal is still outstanding at the time of bankruptcy.<sup>98</sup>

In applying the creditors' bargain model to these temporal arrangements, it seems most appropriate to examine the framework that the Bankruptcy Code adopts. This framework differentiates along two different planes. First, it distinguishes between lenders (and other holders of non-executory contracts)<sup>99</sup> and persons in long-term executory contractual

94. See Bankruptcy Code § 363(f)(3), (k).

95. Bankruptcy Code § 725. If the loan is currently due and owing, these provisions will supply (in value-equivalent terms) the level of protection for such creditors in Chapter 11 as well. Bankruptcy Code § 1129(a)(7)(A)(ii). We will shortly have to deal with divergent treatment of creditors in Chapter 7 and Chapter 11, but this divergence only occurs when temporal (*i.e.*, non-currently due) extensions of credit are involved.

96. Bankruptcy Code § 1129(a)(7)(A)(ii).

97. Either it was already due and owing or it was callable at any time.

98. The "macro" question of whether indebtedness should be treated as matured for purposes of corporate reorganization has received a longstanding examination in the literature, principally focusing on the relative merits of the "absolute priority rule," the "relative priority rule," and the "investment value doctrine." For some of the debate, see, e.g., Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganization: New Directions*, 67 HARV. L. REV. 553 (1954); Blum & Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651 (1974); Blum, *The "New Directions" for Priority Rights in Bankruptcy Reorganizations*, 67 HARV. L. REV. 1367 (1954); Bonbright & Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127 (1928); Clark, *Fair and Equitable Reorganization of Investment Companies*, 53 B.U. L. REV. 1 (1973); Frye, *The "Fair and Equitable" Doctrine: Are Liquidation Rights a Realistic Standard During Corporate Reorganization?* 20 CATH. U.L. REV. 394 (1971).

Recently, economists have begun to focus their attentions on at least some of these rules (although rarely focusing expressly on temporal concerns). See, e.g., Kim, McConnell, & Greenwood, *Capital Structure, Rearrangements and Me-First Rules in an Efficient Capital Market*, 32 J. FIN. 261 (1977); Warner, *Bankruptcy, Absolute Priority, and the Pricing of Risky Debt Claims*, 4 J. FIN. ECON. 239 (1979); White, *supra* note 44. The analysis here focuses not only on "micro" issues—individual debts—it focuses also on liquidation as well as on reorganization.

99. Bankruptcy law uses the concept of an "executory" contract in a special way. "Executory"

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relationships with a debtor, such as a lessor under a long-term lease. Second, the Bankruptcy Code distinguishes between liquidation proceedings and reorganization proceedings.

With respect to lenders in long-term arrangements with a debtor, the Bankruptcy Code treats a right of acceleration of principal fundamentally differently in a Chapter 7 liquidation proceeding (whether piecemeal or going concern) than in a Chapter 11 reorganization proceeding. The right of acceleration enjoyed by contract holders in long-term contractual arrangements with a debtor, on the other hand, is treated the same by the Bankruptcy Code in both a liquidation proceeding and a reorganization proceeding. Is there a satisfactory explanation for this different treatment of long-term lenders and other contract-holders? Can bankruptcy law's occasional refusal to recognize non-bankruptcy entitlements in any general category of cases involving either lenders or executory contract-holders be squared with bankruptcy law's general recognition of non-bankruptcy rights?<sup>100</sup> It is these questions that this section addresses, first by focusing on the executory contract versus non-executory contract plane and then by focusing on the liquidation versus reorganization plane.

### A. *Lenders and Executory Contract-Holders: The Role of Acceleration*

"De-acceleration" reflects a principle embraced by the Bankruptcy Code in a number of instances, both in its liquidation and in its reorganization provisions. This principle is that the advent of the bankruptcy process is not a proper occasion for the assertion of greater (or different) rights than existed against the debtor, under applicable non-bankruptcy law, the moment before bankruptcy.<sup>101</sup> This may be seen implemented in at least two disparate areas. First of all, it determines, to a significant extent, the treatment of persons holding executory contracts and unexpired leases in bankruptcy.<sup>102</sup> Second, it deals with attempts by a state to prefer certain claimants inside of the bankruptcy process through

generally refers to a contract in which performance remains due, to some material extent, on *both* sides. See, e.g., *Jenson v. Continental Finance Corp.*, 591 F.2d 477, 481 (8th Cir. 1979); Countryman, *Executory Contracts in Bankruptcy* (pt. 1), 57 MINN. L. REV. 439, 460 (1973). A loan, accordingly, is not an executory contract once the credit has been extended. Accord H.R. REP. NO. 595, *supra* note 11, at 347. What is an executory contract, however, may turn, in part, on a judge's perceptions of bankruptcy goals. See *In re Jolly*, 574 F.2d 349, 351 (6th Cir. 1978); *In re Booth*, 19 Bankr. 53 (Bankr. D. Utah 1982).

100. See *supra* pp. 858, 859-60. In the non-temporal context, this general recognition of non-bankruptcy rights is theoretically consistent with the creditors' bargain model treatment of non-discharge-related issues in bankruptcy. See *supra* pp. 861-78.

101. The de-acceleration principle clearly is at odds with the general recognition of non-bankruptcy entitlements in bankruptcy. See *In re Telemart Enterprises*, 524 F.2d 761 (9th Cir. 1975).

102. See Bankruptcy Code § 365; Countryman, *Executory Contracts in Bankruptcy* (pts. 1 & 2), 57 MINN. L. REV. 439 (1973), 58 MINN. L. REV. 479 (1974); Fogel, *Executory Contracts and Unexpired Leases in the Bankruptcy Code*, 64 MINN. L. REV. 341 (1980).

the device of a state-created priority or a statutory lien effective only in bankruptcy.<sup>103</sup>

Holders of executory contracts or unexpired leases with a debtor, even if they have negotiated for the right to terminate their contractual relationships in bankruptcy (or to have those relationships terminate automatically), are faced with the fact that the debtor can "deem" these contracts "unimpaired" by reinstating the original terms of the contract or lease.<sup>104</sup> But unlike the case with lenders,<sup>105</sup> this power is exercisable in both liquidation and reorganization proceedings.<sup>106</sup> Even if a particular contract or lease is not useful to the continued operation of a bankrupt enterprise, the bankrupt estate is still permitted to capture the benefits of the difference between the contract rate and the market price by assigning that contract or lease to a third party.<sup>107</sup>

Whether or not this principle has a persuasive normative justification is an important, but largely unexplored, question. The strength of its justification implicates the wisdom not only of the rules governing executory contracts, but also the separate rules governing lenders. For the acceleration right of lenders *is* respected in bankruptcy liquidations, a result that may find itself under attack by advocates of the de-acceleration principle. The Bankruptcy Code provides no explanation for this distinction between lenders and other contract holders,<sup>108</sup> and the commentators have

103. See Bankruptcy Code § 545 (statutory liens); *Elliott v. Bumb*, 356 F.2d 749 (9th Cir. 1966) (discussion of state-created priorities); Countryman, *The Use of State Law in Bankruptcy* (pts. 1 & 2), 47 N.Y.U. L. REV. 407, 631 (1972). State-created priorities and statutory liens effective only in bankruptcy are discussed *infra* pp. 901-07.

104. An executory contract or unexpired lease "may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on" insolvency, the commencement of bankruptcy, or other related contingencies. Bankruptcy Code § 365(e)(1). Bankruptcy Code §§ 365(a) & (b) permit (in cases not covered by Bankruptcy Code § 365(c)) the trustee to assume such contracts or leases (with "adequate assurance of future performance" protection if there has been a default). Bankruptcy Code § 365(f) permits (in cases not covered by Bankruptcy Code § 365(c)) the trustee to assign such contracts or leases, after assumption, "notwithstanding a provision . . . that prohibits, restricts, or conditions the assignment of such contract or . . . lease." See also Bankruptcy Code § 365(e)(1).

105. See *infra* pp. 881-83.

106. Bankruptcy Code § 365 serves two disparate functions. First, it performs the same role as the automatic stay of Bankruptcy Code § 362 with respect to executory contracts and unexpired leases. In that role, by refusing to recognize the effect of ipso facto clauses, the section assists in keeping the estate together and in preserving the other benefits gained by a collective proceeding. See *supra* pp. 861-67. In this respect, it is similar to the restrictions imposed on secured creditors in both liquidation cases and reorganization cases. This "automatic stay" function may be justifiable for the reasons already explored with respect to creditors. Second, however, Bankruptcy Code § 365 acts in a value-allocating role. It is this function that I wish to examine. For, even assuming that the justifications for the "automatic stay" are valid, the question of respecting the value of the non-bankruptcy entitlements still remains. See *supra* pp. 872-77.

107. See Scott, *supra* note 80, at 14-15 (examining distinctions in the bankruptcy treatment of lessors and secured lenders, and noting alternative means of achieving identical financial result).

108. The Bankruptcy Act of 1898 did not so differentiate. It validated the use of ipso facto clauses in executory contracts and unexpired leases. 11 U.S.C. § 110(d) (1975) (repealed prospectively, effec-



ignored the problem. Is there, however, a coherent justification for this distinct treatment of lenders, whose claims are accelerated in a Chapter 7 liquidation proceeding but whose claims may be de-accelerated by choice of the debtor in a Chapter 11 reorganization proceeding, and of contract holders, whose contracts may be de-accelerated (again by choice of the debtor) in both liquidation proceedings and reorganization proceedings?<sup>109</sup> Insights previously gained from the creditors' bargain model may be used in approaching this question. The first step is to consider whether there is any reason to differentiate, in a general fashion, between the treatment of lenders and other contract holders. The second step is to determine whether there is any reason to differentiate between a liquidation proceeding and a reorganization proceeding. It is these issues that I address in this section of the Article.

### 1. *Lenders: The Reorganization De-Acceleration Option*

Consider first the treatment of lenders in bankruptcy. A bankruptcy liquidation proceeding under Chapter 7 works an acceleration of the principal of outstanding credit, whether secured or unsecured, and bankruptcy claims are measured on the basis of that accelerated principal.<sup>110</sup> Moreover, as we have already explored, the "adequate protection" standard for secured creditors is apparently based on this accelerated-principal basis.

In moving from a Chapter 7 liquidation to a Chapter 11 reorganization proceeding, however, the Bankruptcy Code shifts focus rather dramatically. Prior to consummation of a plan of reorganization, the basic "adequate protection" standard applies.<sup>111</sup> Even at the time of the confirmation and consummation of the plan, the reorganization provisions provide, consistently enough, a liquidation-based level of entitlements:<sup>112</sup> each creditor must do as well in a Chapter 11 as in a Chapter 7 proceeding.<sup>113</sup>

tive Oct. 1, 1979). This protection, however, was in the process of being watered down by case law before the present Bankruptcy Code was enacted. See *Queens Blvd. Wine & Liquor Store v. Blum*, 503 F.2d 202 (2d Cir. 1974).

109. This is not exactly true. To the extent that the debtor is now a greater risk than before, Bankruptcy Code § 365(b) requires adequate assurance of future performance (in cases where there has been a prior default). A de-accelerated creditor, however, does not receive any direct compensation for the increased risk. The assurance is, instead, indirect: under Bankruptcy Code § 1129(a)(11) the plan must be deemed "feasible."

110. Bankruptcy Code §§ 502(b), 725, 726; H.R. REP. NO. 595, *supra* note 11, at 353.

111. At least nothing seems to call off Bankruptcy Code §§ 361 and 362, nor is there any indication that the "non-impairment" standard of Bankruptcy Code § 1124 permits "adequate protection" prior to the confirmation of the plan to be based on anything other than the accelerated principal—the portion of the "allowed claim" under Bankruptcy Code § 502 that is secured under Bankruptcy Code § 506. See *In re Silverman*, 13 Bankr. 72, 74 (Bankr. D. Mass. 1981).

112. Bankruptcy Code § 1129(a)(7)(A) requires that each holder of a claim either accept the plan or "receive or retain under the plan . . . property of a value . . . that is not less than the amount that such holder would so receive if the debtor were liquidated under chapter 7 . . . ."

113. H.R. REP. NO. 595, *supra* note 11, at 412, notes:

The implication that a reorganization under Chapter 11 must leave everyone as well off as in a liquidation under Chapter 7 is, however, quite misleading. For the Bankruptcy Code seems to allow the debtor or the trustee to choose—when it is in the interest of the estate to do so—a non-acceleration-based compensation standard for reorganizations.<sup>114</sup> Bankruptcy Code section 1124(2) deems a class of claimholders “not impaired” if, in addition to curing outstanding defaults, the original maturities of such claimholders’ contracts are reinstated. The consequence of a class of claims being considered unimpaired is dramatic—the class is “deemed to have accepted the plan.”<sup>115</sup> The Bankruptcy Code provision linking reorganization payments to the liquidation-based level of compensation states that a plan cannot be confirmed unless, with respect to each class, each claimholder has either accepted the plan or will receive, under the plan, payments whose present value equals the amount the claimholder would receive under Chapter 7.<sup>116</sup> The section thus suggests<sup>117</sup> that claimholders in an unimpaired class do not receive the liquidation-based compensation level of protection, and, because Bankruptcy Code section 1129(a)(8) is automatically satisfied,<sup>118</sup> are not entitled to the protections of the absolute priority rule.<sup>119</sup>

Paragraph (7) [of Bankruptcy Code § 1129] incorporates the former “best interest of creditors” test found in chapter 11 [sic XI], but spells out precisely what is intended. With respect to each class, the holders of claims or interests of that class must receive or retain under the plan on account of those claims or interest property of a value, as of the effective date of the plan, that is not less than the amount that they would so receive or retain if the debtor were liquidated under chapter 7 on the effective date of the plan.

114. It should be obvious that the debtor’s option to de-accelerate a lender will be used whenever the contractual rate of interest on a loan is less than the market rate of interest. Conversely, if the contractual rate of interest is greater than the market rate of interest, the loan will be paid off on an accelerated principal basis. This ability to *select* when to “de-accelerate” may skew non-bankruptcy entitlements. (Often, however, loans will be pre-payable under applicable non-bankruptcy law, which would remove this problem.) Any proponent of a plan of reorganization may select de-acceleration as a feature of his plan. But because the debtor typically has an exclusive period in which to propose a plan it seems substantially accurate to refer to the choice as “the debtor’s.” See Bankruptcy Code § 1121(c).

115. Bankruptcy Code § 1126(f).

116. Bankruptcy Code § 1129(a)(7).

117. The import of the section is not certain, as the drafting leaves open a contrary possibility. Bankruptcy Code § 1126(f) deems an unimpaired *class* to “have accepted the plan.” Bankruptcy Code § 1129(a)(7)(A) refers to *individual* claimholders. Bankruptcy Code § 1126(f) does not say that each claimholder has accepted the plan, only that the *class* has. Therefore, it is open for an individual claimant in any unimpaired class to argue that he is, nonetheless, entitled to the protection of Bankruptcy Code § 1129(a)(7)(A). See also *infra* note 119. This argument becomes difficult (albeit conceptually still possible) when the class consists of only one creditor, as is normally the case with respect to security interests. See *In re Palisades-on-the-Desplaines*, 89 F.2d 214, 217-18 (7th Cir. 1937); *Trost*, *Business Reorganizations Under Chapter 11 of the New Bankruptcy Code*, 34 BUS. LAW. 1309, 1327 (1979).

118. Bankruptcy Code § 1129(a)(8) requires, with respect to each class, that “(A) such class has accepted the plan; or (B) such class is not impaired under the plan.”

119. The “fair and equitable” standard of Bankruptcy Code § 1129(b) applies when “all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan . . . .” Moreover, the section only imposes the “fair and equitable” requirement on “each

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For example, assume that *SC* loaned *D* \$100,000 in 1975, with an annual interest rate of eight percent (payable monthly) and with an original maturity of 1990. The loan is secured by a mortgage on *D*'s equipment, which at all times is worth in excess of \$100,000. *D* files for bankruptcy in 1982. If the property were sold (in a liquidation or otherwise), *SC* would be entitled to realize \$100,000, which *SC* would then be free to reinvest by, for example, loaning the money out to a new borrower at the then-current (1982) interest rate of sixteen percent. Yet application of Bankruptcy Code section 1124(2) to reinstate *SC*'s loan, with its eight percent interest rate and 1990 maturity, will mean that the expected value of *SC*'s claim in *D*'s reorganization is substantially less than \$100,000. To that extent, *D*'s estate benefits at *SC*'s expense and *SC* does not do as well in a Chapter 11 reorganization as in a Chapter 7 liquidation.<sup>120</sup>

### 2. Lenders vs. Executory Contract-Holders

This de-acceleration treatment of lenders in Chapter 11 is consistent with the treatment of executory contract-holders. Executory contract-holders, however, face de-acceleration in both a Chapter 7 liquidation and a Chapter 11 reorganization. To explore this different treatment, compare the status of a contract-holder with the status of a lender. Say that *D* has two principal assets (called "Asset 1" and "Asset 2"), each with a fair market value (and a "going concern" value) of \$100,000. *D* also has two major lenders (*C1* and *C2*), each of whom has an outstanding loan to *D* of \$100,000, at ten percent interest, maturing in 1990. At the time the loans were made, the prime rate of interest on loans of a similar duration

class of claims or interests that is impaired under, and has not accepted, the plan." Since a de-accelerated class is, by definition, not impaired, the "fair and equitable" test would not apply to it. See Orr & Klee, *Secured Creditors Under the New Bankruptcy Code*, 11 U.C.C. L.J. 312, 318 (1979). One court, however, has refused to hold that a creditor who already held a judgment of foreclosure was not impaired when it was de-accelerated, on the express ground that it was thereby "forced to . . . make a forced investment in a risky enterprise under a management demonstrated to the lien holder to be unreliable." *In re Antilles Yachting*, 4 Bankr. 470, 474 (Bankr. D. V.I. 1980). There were particular facts, however, which suggested that the creditor would have sold the property before bankruptcy but for an agreement with the debtor to delay. The treatment of accelerated loans in Chapter 13 may be different, since Bankruptcy Code § 1322(b)(5) makes no reference to reinstating the maturity in addition to curing defaults. See *In re La Paglia*, 8 Bankr. 937 (Bankr. E.D.N.Y. 1981). But see *DePierro v. Taddeo*, No. 81-5053 (2d Cir. July 20, 1982) (can de-accelerate a pre-petition acceleration in Chapter 13); *In re Davis*, 15 Bankr. 22 (Bankr. D. Kan. 1981) (same). This reasoning might be applicable to Bankruptcy Code § 365(b), since that section does not discuss reinstating the original maturity. Several courts, relying on Chapter 13 cases, have held that de-acceleration is not possible under Bankruptcy Code § 1124(2) if a judgment of foreclosure was entered prior to bankruptcy. See *In re Monroe Park*, 18 Bankr. 790 (Bankr. D. Del. 1982); *In re Saint Peter's School*, 16 Bankr. 404, 409-10 (Bankr. S.D.N.Y. 1982). But see *In re Hewitt*, 16 Bankr. 973, 977 (Bankr. D. Alaska 1982).

120. If the converse were true and the loan was made at 16 percent while the present interest rate was only 8 percent, the trustee would not exercise his de-acceleration option. See *supra* note 114. This may not be very significant if the debtor could prepay the debt under applicable non-bankruptcy law. In that case, one would often expect the debtor to have re-financed at the lower rate.

was seven percent; that rate is now seventeen percent. *D* also has various trade creditors (collectively "*TC*"), with currently-due claims amounting to \$100,000.

In a Chapter 7 liquidation proceeding, *D*'s trustee would sell Asset 1 and Asset 2 for an aggregate of \$200,000. This \$200,000 would then be distributed among *C1*, *C2*, and *TC* (each the holder of a \$100,000 claim)<sup>121</sup> *pro rata*, with the result that each of *C1*, *C2*, and *TC* would receive \$66,667.<sup>122</sup>

In Chapter 11, however, as we have observed, *D*'s trustee could de-accelerate *C1*'s and *C2*'s loans.<sup>123</sup> If the present value of their de-accelerated right of payment was \$50,000 each, then, in reorganization, *C1* and *C2* would each receive payments with a present value of \$50,000, and *TC* would receive payments with a present value of \$100,000.<sup>124</sup>

What would the result be if *D*'s trustee could de-accelerate *C1*'s and *C2*'s loans in a Chapter 7 liquidation proceeding as well?<sup>125</sup> As we have seen, absent de-acceleration, *D*'s trustee would realize \$200,000 by liquidating Asset 1 and Asset 2. *C1*, *C2*, and *TC* would each receive \$66,667. But, with an ability to de-accelerate and assign the loans, *D*'s trustee could now offer potential purchasers a financing package. By way of example, the trustee could sell the two assets for \$150,000—\$50,000 in cash, and the remainder in the form of an obligation to pay *C1* or *C2* \$100,000, in 1990, at ten percent interest. If this ten percent interest rate were sufficiently below the market rate of interest for such obligations, so that the present value of the \$100,000 obligation maturing in 1990 were \$50,000, the cash sales price of \$100,000 and the financed sales price of \$150,000 would be the same, in present value terms. Assuming both assets were sold using this financing package, *D* would be rid of the obligations to both *C1* and *C2*. *C1* and *C2* would each receive the right to a payment stream worth \$50,000. *D*, moreover, would receive \$50,000 in cash from each of Asset 1 and Asset 2, and could use that \$100,000 to pay *TC* (*D*'s only remaining creditor) in full. In this way, the liquidation result would be harmonious with the reorganization result considered in the previous

121. *C1*'s and *C2*'s principal would be accelerated for purposes of the claim. Bankruptcy Code § 502; H.R. REP. NO. 595, *supra* note 11, at 353.

122. Bankruptcy Code § 726(b).

123. Bankruptcy Code § 1124(2).

124. This conclusion must be qualified. See *supra* note 104. There is also a question of whether Chapter 11's classification requirement would allow this. See Bankruptcy Code § 1122. In any event, this would hold true if *C1* and *C2* were secured creditors and could be separately classified as such.

125. Since this example involves a liquidation proceeding, to effectuate this de-acceleration, the trustee would also need to have the right to assign the de-accelerated loans. See Bankruptcy Code § 365(f). Assignment of executory contracts and unexpired leases is discussed later. See *infra* pp. 896-201.

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paragraph.<sup>126</sup>

Assume now that Asset 1 and Asset 2 are held by *D* under long-term leases, and *C1* and *C2* are the lessors. The rental rate for these leases is below market, so that the difference, in present value terms, between the value of each leasehold at the current market rate (\$150,000) and the cost of that leasehold at the contract rate (\$100,000) is \$50,000. If *C1* and *C2* have the right to terminate the leases upon *D*'s bankruptcy,<sup>127</sup> *C1* and *C2* can either remove Asset 1 and Asset 2 from *D*'s estate, and negotiate a new lease with a third party for \$150,000 each, or negotiate another lease with *D* for \$150,000. In either case, *C1* and *C2* receive \$50,000 that they would not have received but for bankruptcy and *TC* gets (out of these assets at least) nothing. If, however, *D* has the right to de-accelerate and assign *C1*'s and *C2*'s leases in bankruptcy, *D* will be able to sell each lease (of Asset 1 and Asset 2) for the lease rate/market rate differential of \$50,000. By de-acceleration, therefore, *D* will be able to garner \$100,000 for *TC* (and concomitantly reduce the value of what both *C1* and *C2* would receive, if able to accelerate, by \$50,000).<sup>128</sup>

So viewed, the consequence of de-acceleration, in either a liquidation or a reorganization, is a reallocation of asset values from *C1* and *C2* (whether secured lenders, unsecured lenders, or contract-holders) to *TC* in equal and opposite amounts. Is there anything that justifies this *ex post* reallocation? And, even if there is, is there any reason for according different treatment to contract holders than to lenders?

In discussing de-acceleration of lenders, the Senate Report explains that this process of unimpairment should cause no consternation: "The holder of a claim or interest who under the plan is restored to his original position, when others receive less or get nothing at all, is fortunate indeed and has no cause to complain."<sup>129</sup> This comment is apparently premised on the unstated view that bankruptcy is a fortuitous event allowing the lender to achieve a "windfall" by accelerating a debt that has a below-market interest rate.<sup>130</sup> Presumably, this is also the unarticulated rationale behind

126. If *C1* and *C2* were made secured lenders, a similar result would follow. Absent de-acceleration and assignment (the situation in liquidation) *C1* and *C2* would each receive \$100,000 and *TC* would receive nothing. But de-accelerating *C1*'s and *C2*'s loans would result in each of them receiving \$50,000 (the present value of the de-accelerated loan contracts) and in *TC* receiving \$100,000.

127. See *infra* pp. 887-892.

128. The same result would occur in a reorganization if *D* kept the leases after de-acceleration, instead of assigning them to a third party. In that event, *D* would "save," in present value terms, \$50,000 per lease over current market rentals for comparable assets. This savings would enable *D* to pay *TC*, in present value terms, \$100,000 more than otherwise.

129. See S. REP. NO. 989, *supra* note 76. The ability to de-accelerate applies to unsecured creditors as well as to secured creditors. An unsecured creditor, however, would generally be de-accelerated only when unsecured creditors were being paid in full. It seems plausible to treat such unsecured creditors as sharing many of the same attributes as secured creditors.

130. This "windfall" rationale appears to apply both to liquidation proceedings under Chapter 7

Bankruptcy Code section 365's de-acceleration of executory contracts and unexpired leases.<sup>131</sup>

But this justification is unsatisfying. It suggests, first of all, that a de-acceleration option should be available in a Chapter 7 liquidation as well as in a Chapter 11 reorganization proceeding, allowing the trustee to treat a below market loan as an asset of the estate, thereby entitling him to "assign" the loan with collateral (if a secured loan) or otherwise (if an unsecured loan).<sup>132</sup> More importantly, it is inaccurate to say that reinstatement of contract terms is all that *C1* or *C2* is "entitled to" since it was but a "fortuity" (for *C1* and *C2*) that *D* went into bankruptcy. For this is a "fortuitous event" that *C1* and *C2* have bargained for: in essence, *C1* and *C2* have received an option to call in their respective loan (or contract) and to reloan or release it at the then-market rate for such a loan or contract.<sup>133</sup> The lender or contract-holder has already paid for this option (just as a secured lender, for example, has paid for other entitlements that are recognized in bankruptcy). It is difficult, as a consequence, to view the below-market loan or contract somehow as an "asset" of the debtor that the debtor (or other creditors) is entitled to on the ground of preventing windfalls. Moreover, neither section 365 nor section 1124 of the Bankruptcy Code is evenhanded in its treatment of the event. To the extent that there has been an exogenous change in the world, such a change may be viewed as random from the point of view of the contracting parties. But de-acceleration is left to the discretion of the trustee, who will presumably choose to exercise his right of de-acceleration only when the loan rate or contract rate is below market.<sup>134</sup>

Dismissing the potential rights of *C1* and *C2* by referring to them as "windfalls," then, obscures analysis. The relevant question is whether *C1* and *C2*, on the one hand, or *TC* (*D*'s other creditors), on the other hand, should be "benefited," *ex post*, by the value of *C1*'s and *C2*'s below-

and to reorganization proceedings under Chapter 11. Bankruptcy Code § 1124(2), however, is applicable only in a Chapter 11 reorganization proceeding.

131. Fogel, *supra* note 102, at 349 ("The fact that section 365(e) invalidates bankruptcy clauses in liquidation cases as well as rehabilitation cases indicates that Congress intended to deny the nonbankrupt party to an executory contract or unexpired lease any windfall from the fortuity of the debtor's bankruptcy. . . .")

132. As already noted, this option is available in liquidation as well as in reorganization against the holders of executory contracts, but not against creditors holdings loans. The operation of this de-acceleration principle (whether in or out of reorganization) may have consequences apparently not imagined by the draftsmen of the Bankruptcy Code. Since executory contracts to make loans are not enforceable by the trustee, Bankruptcy Code § 365(c)(2), *see supra* note 99, holders of such contracts avoid de-acceleration completely. Bankruptcy Code § 1124(2), therefore, may lead to long-term loans being divided into shorter segments, in an attempt to preserve future segments as "executory" within Bankruptcy Code § 365(c)(2).

133. For an accessible introduction to options and their uses, see Black, *Fact and Fantasy in the Use of Options*, 31 FIN. ANALYSTS J. 36 (July-Aug. 1975).

134. This is, at best, a skewing of expectations. *See supra* note 114.

market loans or leases. Assuming acceleration was provided for in the contract, both *C1* and *C2* have effectively bargained for an "option": the right to call in the loan (or contract). Once *ex ante* adjustments are considered, nothing we have yet seen supports the conclusion that application of the de-acceleration principle produces a compelling reason for interfering with negotiated non-bankruptcy entitlements.

It is not, however, just that the case for interference has not been made. Even though creditors can adjust for a bankruptcy de-acceleration rule, there may be reasons to think that this interference imposes an undesirable cost on the debtor and the creditors considered as a group. To examine this, we need to start more broadly with the question of the purposes served by the variety of clauses that allow one party to pull out of a contractual relationship with another party.

### 3. *The Role of "Ipso Facto" Clauses in Bankruptcy*

"Bankruptcy" or "ipso facto" clauses typically declare that a loan or contract is either terminated or accelerated automatically upon the filing of a petition in bankruptcy, or that bankruptcy constitutes an event of default, entitling the lender or contract-holder to terminate or accelerate the terms of the contract or lease.<sup>135</sup> These clauses are the direct target of de-acceleration. Yet, presumptively, such clauses are to the mutual benefit of the debtor and the contract-holder. Ipso facto clauses are candidates for override only if their presence is evidence either of a systematic breakdown in contractual bargaining between the debtor and the contract-holder, or of unaccounted-for third-party effects.

First consider an ipso facto clause from the perspective of the debtor and the contract-holder. One might imagine that an ipso facto clause is designed either to provide a creditor with some measure of protection against a debtor's non-systematic, non-misbehavior-induced risk,<sup>136</sup> or to provide a creditor with an opportunity to re-evaluate a contract to account for systematic market changes.<sup>137</sup> Neither of these reasons, however, seems

135. These clauses are effectively the ones discussed *infra* p. 888. Normally, these clauses will also cover collective proceedings *outside* of bankruptcy, for the reason that such expansion reduces negotiations over the level of entitlements owing to such a party in a non-bankruptcy collective proceeding. See Bankruptcy Code § 365(e)(1); see also *infra* pp. 901-06.

136. An ipso facto clause, in other words, might be perceived as designed to protect *C1* from a substantially increased chance of nonpayment, with the attendant inconveniences, delays, and uncertainties, upon certain unfortunate changes in *D*'s position, as measured externally, by the occurrence of an event such as bankruptcy. As such, it may provide the contracting party with the opportunity to reassess the credit-worthiness of the assignee or the risks of continuing with the original party after a clear signal has been given that the risk level has changed. See *infra* pp. 896-901.

137. Systematic changes in market conditions may have nothing at all to do with the likelihood of repayment by a particular debtor. An ipso facto clause could be perceived as serving this role by providing for the ability to accelerate upon the occurrence of a specified event such as bankruptcy.

convincing in light of other available means for achieving the same goal that will not cause the "bankruptcy incentive" disadvantages of an ipso facto clause.<sup>138</sup> Non-systematic risks (other than of the misbehavior sort) can be handled through diversification<sup>139</sup> and an *ex ante* cost adjustment while systematic risks can be dealt with equivalently by a shortening of the term of the contract.<sup>140</sup>

Although the presence of ipso facto clauses is not necessarily motivated solely by monitoring concerns,<sup>141</sup> it seems promising to view ipso facto clauses as serving a role akin to a range of other contractual covenants. The utility of such covenants (often called "financial covenant" or "restrictive covenant" clauses) in loan or other contracts is commonly perceived as one of policing.<sup>142</sup> After entering into a loan or a contract at a defined interest (or contract) rate, a debtor has an incentive to engage in activities that unilaterally increase the riskiness of the loan or contract—by, for example, changing investment decisions to include riskier choices.<sup>143</sup> Financial covenant clauses may be designed to allow a creditor to police this species of misbehavior by giving the lender the option of calling in the loan upon the occurrence of such opportunistic behavior.<sup>144</sup>

138. See *infra* pp. 891-892.

139. Considered *ex ante*, however, the non-systematic risk (described *supra* note 136) represents the overall chance that a debtor of a certain class will use bankruptcy. In the event of bankruptcy, acceleration will entitle the lender (or other contract-holder) to receive payment today (or to get the property back). This increased riskiness can presumably be contractually adjusted for *ex ante*. In that event, the presence of the clause is not required for reasons of efficiency. Langbein and Posner note that there is "no sound economic reason" for screening out of portfolios firms that are "in danger of going bankrupt." Langbein & Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 93 (1980).

140. Since the initiation of bankruptcy is a matter of statistical probability, the inclusion of an ipso facto clause has the same effect as shortening the term of the loan. A shortening of the term of the loan permits more frequent adjustments to systematic market changes, which, in turn, reduce the uncertainty associated with lengthier contract terms. Again, there is no particular reason to view a "bankruptcy termination" clause as serving any different function, in this respect, than a shorter term loan. Hence systematic risk provides no particular reason to believe the disappearance of such clauses would be missed.

141. Ipso facto clauses may serve other beneficial roles as well. A debtor may believe that it is very unlikely that he will go into bankruptcy yet have no effective way to convince a creditor of that so as to be placed in a lower risk class. Cf. A. KRONMAN & R. POSNER, *THE ECONOMICS OF CONTRACT LAW* 224 (1979) (discussing signalling function of penalty clauses). See also *infra* note 150 & p. 898 (discussing use of ipso facto clauses to provide contract-holder with ability to assess whether bankruptcy operates as delegation of debtor's duties).

142. See, e.g., R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 389-93 (1981); Smith & Warner, *supra* note 44. But cf. Van Horne, *Optimal Initiation of Bankruptcy Proceedings by Debt Holders*, 31 J. FIN. 897, 908 (1976) ("The obvious advantage to the lender of protective covenants is the additional ability it affords him to force bankruptcy . . .")

143. See, e.g., R. POSNER, *supra* note 35, at 293-94; Jensen & Meckling, *supra* note 44, at 334-37; Muris, *supra* note 61.

144. Miller, *The Wealth Transfers of Bankruptcy: Some Illustrative Examples*, 41 LAW & CONTEMP. PROBS. 39, 43 (Autumn 1977). This is not to say that such financial covenant clauses necessarily reduce the costs of policing. Rather, they have some *in terrorem* effect by saying that if a debtor is caught misbehaving there will be certain costly consequences. The possibility of such occurrence raises the costs of misbehavior and should, therefore, lower its incidence.



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The ability of a debtor, by resorting to bankruptcy, to defuse these clauses by means of "de-acceleration" would weaken the valuable misbehavior-monitoring function of financial covenant clauses.<sup>145</sup> In such cases, application of the de-acceleration principle would not simply be a "wash" (by virtue of *ex ante* adjustments for *ex post* events), but would result in a less efficient system, considered in the aggregate.

An ipso facto clause might be present in a given contract precisely because it serves such a policing role. To be sure, it does not allow a creditor to say "because you have misbehaved, I am terminating the loan," for it identifies no misbehavior. The contract or loan may be terminated only *after* the debtor has gone into bankruptcy (or a similar collective proceeding outside of bankruptcy). As such, it may serve as a broad-brush *in terrorem* clause designed to deter misbehavior in general<sup>146</sup> by imposing a cost on the debtor who resorts to bankruptcy, and hence imposing a cost on engaging in activities that increase the likelihood of bankruptcy.<sup>147</sup> Thus, an ipso facto clause may serve much the same function as a general legal rule ("one shall drive at a reasonable speed") or presumption ("anyone who drives off the roadway shall be presumed to be driving negligently") as opposed to the function of a specific legal rule ("speed limit 55 MPH").<sup>148</sup> Unlike most other financial covenant clauses, which identify defined quantum of increased riskiness, an ipso facto clause relies on a rough, but easily determined, surrogate for increased riskiness. As such, an ipso facto clause performs a general function that could not be done as

145. Miller, *supra* note 144, at 43. Financial covenant clauses may allow a lender to call in a loan when there have been systematic market shifts even where these shifts are unrelated to debtor misbehavior. To the extent this is true, however, it is a problem not related to bankruptcy and one that presumably has been effectively priced out. There seems to be little reason to have a bankruptcy rule here that attempts to "cure" this inefficiency.

146. Bernanke, *Bankruptcy, Liquidity, and Recession*, 71 AM. ECON. REV. 155, 155 (1981); Goetz & Scott, *supra* note 89.

147. This explanation for the presence of ipso facto clauses presupposes that they are an effective deterrent. If the debtor (the equity owners) would receive nothing in bankruptcy anyway, ipso facto clauses would not seem to deter misbehavior. See also *infra* note 158. Yet ipso facto clauses may inspire deterrence from other quarters. For one thing, *ex ante*, a debtor will not know whether the institution of bankruptcy will leave him with nothing. Furthermore, misbehavior of the sort we are concerned with involves the debtor engaging in risk-increasing activities that effectively lower the interest rate he is paying on previously-incurred contracts. See Jackson & Kronman, *supra* note 53, at 1149; *supra* note 143. Ipso facto clauses effectively allow the contract-holder to adjust the interest rate in response to such opportunistic behavior. Even if the debtor is indifferent to such adjustments *ex post*, as long as the debtor needs the participation of subsequent creditors in his opportunistic behavior schemes, the result may well be the same because of *ex ante* adjustments. Subsequent creditors will view potential de-acceleration by earlier contract-holders as a cost to them, which may deter acquiring subsequent credit because it will limit the debtor's ability to "get something for nothing." Ipso facto clauses, finally, may also increase the monitoring incentives of short-term trade creditors, who may be the most efficient monitors. See Jackson & Kronman, *supra* note 53, at 1160-61.

148. For a discussion of the utility of both sets of rules from an economic standpoint, see Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974); see also Easterbrook & Fischel, *supra* note 89 (discussing fiduciary duty rules in corporate context as alternative to direct monitoring by replacing prior supervision with deterrence).

well by another, more specific, contract term.<sup>149</sup> Viewed this way, application of the de-acceleration principle to ipso facto clauses appears unwise. Such application would eliminate the deterrence function of such clauses, which would in turn increase aggregate credit costs.<sup>150</sup>

Even if justified as between debtor and contract-holder, there may be externalities associated with the use of ipso-facto clauses.<sup>151</sup> Whatever the justification for the existence of ipso facto clauses, their presence introduces an inevitable problem.<sup>152</sup> If ipso facto clauses are enforceable in bankruptcy, *C1* may, under certain circumstances, have an incentive to see *D* file for bankruptcy.<sup>153</sup> Under the facts of our hypothetical, for example, *C1*, by possessing the rights an "ipso facto" clause would give her, is \$100,000 better off the moment *D* goes into bankruptcy. *C1*, therefore, will have an incentive to have *D* put into bankruptcy whenever the market rate exceeds the contract price, even if this is not to the creditors' collective advantage. In those circumstances, *D*'s other creditors are at least \$100,000 better off if *D* does not go into bankruptcy.<sup>154</sup> *C1* could, of course, bargain with the other creditors (directly or through a re-negotiation of the contract with *D*) for some of the advantages they would realize (over and above \$100,000—which would be *C1*'s minimum demand) for

149. Use of an ipso facto clause in this manner is most striking when dealing with unsecured loans. Secured lenders, as well as many holders of contracts and leases, may be better insulated against the effects of misbehavior, and therefore have less need for a general rule policing against such misbehavior. See Jackson & Kronman, *supra* note 53, at 1149-58. If this were entirely true, ipso facto clauses would not be needed for misbehavior-deterrence. One might then construct a bankruptcy process that would recognize ipso facto clauses in the case of unsecured loans but would not recognize such clauses in the case of secured loans, temporal contracts or leases. Justifying the establishment of this hypothetical system would depend on establishing that ipso facto clauses were inefficient in cases of secured loans and temporal contracts and leases. See *infra* note 158 (discussing some of the fallacies inherent in such a position). Interestingly, even if the net inefficiency of ipso facto clauses in the case of secured loans and temporal contracts and leases were established, de-acceleration would be inappropriate in liquidation cases, because of the independent justifications for general non-delegation rules. See *infra* pp. 896-901.

150. Ipso facto clauses may exist because of their unique ability to serve as a form of non-delegation clause. Non-bankruptcy law generally prohibits delegation of contractual duties when the delegating party is divested of continuing responsibilities for performance under the contract. See *infra* pp. 897-901. Determining when the composition of the "owners" of the debtor has changed sufficiently so as to prohibit delegation under those general rules may be difficult in bankruptcy. See *infra* notes 182 & 186. An ipso facto clause may permit the contract-holder to make those determinations alone.

151. If accounted for, a cost could not technically be an "externality." See J. DUKEMINIER & J. KRIER, *PROPERTY* 56 (1981); see also Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 347 (1967).

152. See Hirschleifer & Riley, *The Analytics of Uncertainty and Information—An Expository Survey*, 17 J. ECON. LIT. 1375, 1390-91 (1979); Pauly, *The Economics of Moral Hazard: Comment*, 58 AM. ECON. REV. 531 (1968).

153. See Van Horne, *supra* note 142, at 908. Thus, use of an ipso facto clause effectively introduces an element of moral hazard. Even if the ipso facto clause covered non-bankruptcy collective proceedings, the discussion in text would still apply because *C1* would have an incentive to force *D* to undergo one of these non-bankruptcy proceedings.

154. The debtor often has the power to "avoid" unfavorable loans or contracts by invoking the bankruptcy process. Cf. White, *supra* note 44, at 552-56 (noting other incentives debtors have to go into bankruptcy).

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not having *D* put into bankruptcy. This result would, however, be predictably costly to negotiate, as there may be multiple parties in *C1*'s position, as well as a number of other creditors.

But to say that there exists an inevitable moral hazard problem arising from the presence of an ipso facto clause does not itself say that an unaccounted-for externality has been demonstrated that would justify a rule barring the effectiveness of such clauses in bankruptcy.<sup>155</sup> For, if the costs of an ipso facto clause outweighed its benefits, we would expect to see the clause excluded *ab initio*.<sup>156</sup> The costs introduced by the presence of the clause presumptively have been "priced out" because a debtor will be affected directly by the costs the clause imposes on his other creditors in the form of higher credit charges by them.<sup>157</sup> In that event, the externality problem effectively disappears, because its costs, having been accounted for by third parties, are internalized.<sup>158</sup>

The presence of an ipso facto clause, therefore, suggests its net utility.<sup>159</sup>

155. See Goetz & Scott, *supra* note 89, at 584-85.

156. Historically, ipso facto clauses served a useful role in allowing a creditor with an otherwise non-provable claim to participate in the bankruptcy distribution. Use of ipso facto clauses for such purposes is traced in *Kuehner v. Irving Trust Co.*, 299 U.S. 445 (1937), and *Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2d Cir. 1944). Discarding the concept of provability in the Bankruptcy Code removes this function of ipso facto clauses. See Bankruptcy Code §§ 101(4), 502(a)-(c).

157. See Jackson & Kronman, *supra* note 53, at 1147-43; *supra* p. 871. These conclusions would be upset if one believed that the debtor and a contract-holder could impose these costs on the other creditors because of ignorance, unsophistication, or other reasons. See Schwartz, *supra* note 53, at 30-31. But establishing such advantage-taking may depend on showing widespread ignorance. See generally Schwartz & Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979). To effect nonrecognition of ipso facto clauses in bankruptcy, while other clauses are presumptively legitimated, would also require showing that such ignorance particularly affected this type of clause.

158. See *supra* note 151. Because of the difficulties of policing a debtor, it is possible that the presence of an ipso facto clause may not indicate its net efficiency. See *supra* note 44. Creditors may have difficulty ensuring that *D* does not enter into contracts and leases that grant the bankruptcy-inducing ipso facto clauses to future creditors. It might be the case that creditors will charge *D* on the assumption that such clauses will in fact be granted in the future. The individual "wasteful" costs of such a clause in a given contract may be too small to warrant the necessary monitoring expenses by any one creditor. Under those circumstances, the efficient solution may be for the creditor to charge for that risk, since it is too difficult to police. *D*, accordingly, might not appear to have the proper incentives to resist inclusion of such clauses. This, however, does not satisfactorily explain the presence of most ipso facto clauses. Equity-holders will have a strong incentive to have the clause excluded because it reduces the value of their residual. The interests of equity-holders are congruent with those of management with regard to senior classes of creditors such as debt-holders. See Jensen & Meckling, *supra* note 44. There are ample incentives to ensure that ipso facto clauses will be included only if their presence is advantageous to the debtor and the creditors, considered as a group.

159. See also *supra* note 141. The advantage-taking opportunities afforded lenders or creditors by virtue of an ipso facto clause may be no greater than those provided by the acceleration right given debtors upon the occurrence of bankruptcy. "Financial covenant" clauses, since they are unrelated to the occurrence of bankruptcy, do not suffer from the "bankruptcy incentive" problem of pure ipso facto clauses. Even if ipso facto clauses were suspect, financial covenant clauses should not be. The distinction between these two types of clauses mirrors the de-acceleration principle itself. If the loan could be accelerated outside of the bankruptcy context, there is no particular *bankruptcy-related* reason to refuse to recognize the existing right of acceleration. See also *infra* pp. 901-907 (discussing another application of de-acceleration principle).

The more appropriate inquiry would be to see if a more finely-tuned approach could be pursued that would recognize ipso facto clauses in bankruptcy, and attempt to control misbehavior by a lender or contract-holder in other ways. Rules regulating creditor-initiated implementation of the bankruptcy process may provide a set of rules that promote efficient asset-disbursement decisions. Such rules will, therefore, protect against pure "advantage-taking" action by creditors without detracting unduly from the utility of bankruptcy laws. The Bankruptcy Code has such rules. For example, the Bankruptcy Code limits the ability of creditors to initiate bankruptcy proceedings by requiring a minimum of three or more creditors with unsecured claims.<sup>160</sup> The Bankruptcy Code also limits creditor-initiated bankruptcies to situations in which the debtor is generally not paying debts as they become due.<sup>161</sup> These particular bankruptcy initiation rules may not be optimal,<sup>162</sup> but a system that incorporates these sorts of rules as a means of deterring individualistic advantage-taking may be preferable to a system that contains a blanket prohibition on the effectiveness of ipso facto clauses, because such a blanket prohibition would completely eliminate the general- or presumption-type rule deterrence function of such clauses.

### B. *Liquidation and Reorganization: Is There a Difference?*

The general recognition of ipso facto clauses in bankruptcy, such as existed under the Bankruptcy Act of 1898,<sup>163</sup> is preferable to a general bar

160. An involuntary bankruptcy requires:

three or more entities, each of which is . . . a holder of a claim against [the debtor] that is not contingent as to liability . . . if such claims aggregate at least \$5,000 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims. . . .

Bankruptcy Code § 303(b)(1). Only one claim-holder is required if there are fewer than 12 claim-holders (not counting employees, insiders, and holders of certain voidable transfers). Bankruptcy Code § 303(b)(2). These rules may involve complicated factual determinations. See *In re Covey*, 650 F.2d 877 (7th Cir. 1981).

161. Bankruptcy Code § 303(h)(1). This limitation is ignored if other creditors have initiated a non-bankruptcy collective process. Bankruptcy Code § 303(h)(2). In that event all creditors presumably need the threat of a resort to the bankruptcy process in order to protect their minimum entitlements. See *supra* p. 867. It is not certain that this modified "cash-flow" insolvency test is preferable to other tests such as the "balance sheet" insolvency test in Bankruptcy Code § 101(26) and used elsewhere in the bankruptcy process. See Bankruptcy Code §§ 547(b)(3), 548(a)(1), (a)(2)(b). The Bankruptcy Act of 1898 relied on a form of balance sheet insolvency to define when involuntary petitions in bankruptcy could be filed. See 11 U.S.C. § 21 (1975) (repealed prospectively effective Oct. 1, 1979); see generally Rostow & Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334, 1374 (1939). See also Bankruptcy Code § 305(a)(1) (permitting dismissal of case when interests of parties would be better served by such dismissal).

162. A rule specifying a minimum number of creditors can be circumvented by paying other creditors to file. See *In re Win-Sum Sports*, 14 Bankr. 389 (Bankr. D. Conn. 1981) (filed on behalf of three creditors who had received a written indemnity from manager against costs in connection with the petition).

163. 11 U.S.C. § 110(d) (1975) (repealed prospectively effective Oct. 1, 1979); see *supra* notes 108 & 156.

on the effectiveness of such clauses. We have not, however, focused on how the Bankruptcy Code should treat contracts that do not contain ipso facto clauses. Bankruptcy law does not distinguish between contractual acceleration rights and acceleration rights in the absence of a contractual provision. Yet, it does distinguish between lenders and executory contract-holders: lenders are subject to a general de-acceleration right in the debtor's control only in a Chapter 11 reorganization proceeding.<sup>164</sup>

### 1. *A Theory of Reorganization and Liquidation*

Before this inconsistent treatment accorded general rights of acceleration can be satisfactorily explored,<sup>165</sup> we must have a conceptual understanding of what a "reorganization" is. A reorganization, at least as a start, may be viewed as a *form* of liquidation. The business entity, however, is sold to the creditors themselves rather than to third parties.<sup>166</sup> The drafters of the Bankruptcy Code and almost all commentators have ignored the fact that the Bankruptcy Code's separate system of reorganization is not the only alternative to a piecemeal liquidation of assets. A business may be disposed of ("liquidated") as a *unit*<sup>167</sup> and, if its highest and best use is as a "going concern," it would seem that a properly conceived-of Chapter 7 proceeding would require the entity to be sold (*i.e.*, liquidated) as a unit rather than piecemeal whenever its going concern value exceeds its piecemeal liquidation value.<sup>168</sup>

164. See *supra* pp. 882-883. Although the examination was only in the context of *secured* creditors, the discussion should not be limited to them. See *supra* note 129.

165. De-acceleration is available generally in the case of executory contracts. See *supra* p. 880. Furthermore, de-acceleration seems to be available, regardless of the reasons for the acceleration. But see *In re La Paglia*, 8 Bankr. 937 (Bankr. E.D.N.Y. 1981) (discussed *supra* note 119). Having already concluded that there does not seem to be a reason for disparate treatment of lenders and executory contract-holders, one ought not reject the Bankruptcy Code's treatment of lenders without exploring the concepts of liquidation and reorganization.

166. See Clark, *supra* note 18, at 1252-54.

167. This could be done, for example, by hiring an investment company to find a private buyer or by imposing a new capital structure and selling the entity to the public as is done in a public offering. That the Bankruptcy Code ignores this alternative is yet another example of the under-utilization of available market mechanisms.

168. See *supra* pp. 864-865. Cf. Bulow & Shoven, *supra* note 18 (discussion of merger as alternative to bankruptcy); Weston, *supra* note 21, at 65. This view exposes two likely fallacies in the distinct treatment of the best interest of creditors test in Bankruptcy Code § 1129(a)(7) and the "absolute priority rule" in Bankruptcy Code § 1129(b). First of all, the best interest of creditors test, which provides a "not less than liquidation" protection for impaired individual creditors, should not be as distinct from the absolute priority rule protection afforded *classes* of creditors as the drafters apparently believed. The difference between the two is perceived by the drafters of the Bankruptcy Code as a question of class-wide allocation of the "going concern surplus." See J. TROST, G. TREISTER, L. FORMAN, K. KLEE, & R. LEVIN, RESOURCE MATERIALS: THE NEW FEDERAL BANKRUPTCY CODE 335-39 (1979) [hereinafter cited as J. TROST, RESOURCE MATERIALS]. This perception ignores the fact that an enterprise can be liquidated as a going concern. There is no reason why Chapter 7 would not be an appropriate mechanism for a "going concern" cash sale to third parties—or, indeed, why such a sale should not be *mandatory* if it would maximize distributions to creditors. But then, the "not less than liquidation" test of Bankruptcy Code § 1129(a)(7)(A) would compare a going concern sale

Reorganization proceedings provide nothing more than a method by which the sale of an enterprise as a going concern may be made to the creditors themselves. This process, like any liquidation procedure, involves two steps. First, the assets of the enterprise are sold. Second, the claims against the debtor are paid out of the proceeds of this sale.<sup>169</sup>

What differs in the situation in which the enterprise is sold to its own claimants is that the valuation of the proceeds out of which the claims against the debtor are to be paid is more difficult. In a straight piecemeal liquidation, either the assets are distributed in kind to secured claimants (thus mimicking their non-bankruptcy rights) or the assets are sold (usually for cash) and the cash is distributed to the parties, principally in the order of their non-bankruptcy entitlements. In a going concern liquidation, the business is sold to a third party, usually for cash and/or marketable securities. In many instances, therefore, the liquidation process will involve simply paying off the claims, in the order of their non-bankruptcy entitlements. The value of the payment for these claims will be easily determinable.<sup>170</sup> In a reorganization, however, the proceeds from the "sale" out of which claims against the debtor will be paid will consist principally of new claims against the same enterprise. This makes the valuation of the payment to the claimants substantially more difficult. It is principally these valuation issues that provide the core of the reorganiza-

to third parties in Chapter 7 to a Chapter 11 reorganization. To the extent there is an "extra" going concern surplus in Chapter 11, it consists of the surplus that results where the going concern value of a sale to the *creditors themselves* exceeds the going concern sale value of a sale to some third party. See Clark, *supra* note 18, at 1252. But this is almost certain to be a smaller differential than would exist in comparing a going concern reorganization to a piecemeal liquidation. Further, there is a general assumption that the cumbersome absolute priority rule procedures of Bankruptcy Code § 1129(b) can often be avoided, because classes of creditors will want to avoid the incremental procedural costs of a full valuation hearing. See J. TROST, *RESOURCE MATERIALS*, *supra*, at 337 (Bankruptcy Code § 1129(b) valuation will be sufficiently time-consuming so as "to stimulate senior classes to permit juniors to receive a portion of the going concern bonus in return for elimination of the full valuation hearing"); cf. H.R. REP. NO. 595, *supra* note 11, at 414 ("While section 1129(a) does not contemplate a valuation of the debtor's business, such valuation will almost always be required under section 1129(b) to determine the value of the consideration to be distributed.") This assumption ignores that determining whether a dissenter has received as much as he would have received in Chapter 7 requires a determination of what the value of the business would have been if liquidated. See Bankruptcy Code § 1129(a)(7). If the concept of a Chapter 7 liquidation includes, as it should, going concern sales to third parties, the valuation of the debtor's business for purposes of Bankruptcy Code § 1129(a)(7) will be as difficult as is § 1129(b)'s absolute priority rule valuation. Moreover, it will be impossible to determine how well a dissenter has done in Chapter 11 without valuing the consideration to be received by that creditor. When the consideration consists of claims against the debtor, valuing this consideration necessarily involves valuing this debtor's enterprise. See Blum, *Corporate Reorganization Doctrine as Recently Applied by the Securities and Exchange Commission*, 40 U. CHI. L. REV. 96, 110 (1972).

169. See Note, *Giving Substance to the Bonus Rule in Corporate Reorganizations: The Investment Value Doctrine Analogy*, 84 YALE L.J. 932, 943-46 (1975).

170. Clark, *supra* note 18, at 1252 (payment-type valuation problems do not exist when liquidation or receivership results in sale to outsiders for cash). The more difficult it is to value the consideration, the more this third-party sale will involve the problems inherent in a "pure" reorganization.

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tion chapter's provisions.<sup>171</sup>

The point, however, is that the difficulties associated with a reorganization proceeding are in the valuation of the proceeds received upon the sale of the enterprise. Whether the process be a piecemeal liquidation, a going concern liquidation (*i.e.*, a sale of the entity to a third party), or a reorganization liquidation (*i.e.*, a sale of the entity to the creditors), nothing in the form of the process seems to call for a different standard of *allocation among claims* (the second step) in one type of proceeding than in another.<sup>172</sup>

This suggests that the relevant inquiry in choosing a Chapter 7 liquidation (piecemeal or going concern) or a Chapter 11 reorganization should be at the first step when the decision is made as to which of the three conceptual processes to use. As the creditors' bargain model would suggest, this decision should be made on the basis of which form provides the greatest aggregate dollar-equivalent return from the assets<sup>173</sup>—a determination that should be made without considering the claims outstanding against those assets (this consideration becomes relevant at the payout, but not at the sale, stage).<sup>174</sup>

### 2. *Of Bankruptcy Incentives and Property Rules (Herein of the Law of Assignments)*

In one respect, this account of the similarities between liquidation and

171. Bankruptcy Code §§ 1111(b), 1121-29. These provisions state the basis for determining who formulates a "plan" and what sorts of constraints exist on the terms of a plan, and they provide a set of procedures for approving the plan. These provisions also demonstrate that the universe of potential arrangements (*e.g.*, whether bondholders get debentures or common stock) is expanded greatly when the consideration used to "pay off" claims is other than cash or market-tested equivalents. Their absence in Chapter 7 reflects the substantially easier valuation and payment questions that confront a sale of assets for cash or market-equivalents.

172. Brudney, *supra* note 91, at 677; *see also* Note, *supra* note 169, at 944-46 (discussion of the two stages of a reorganization); *cf.* Public Utilities Holding Company Act of 1935, 15 U.S.C. § 79k (1976) (mandating capitalization of public utilities to simplify their extremely complex capital structures). (While liquidation values were *not* used in the Public Utility Holding Company Act (on the ground that this statutory recapitalization should not mature rights that were created "without regard to the possibility of simplification" of this sort, *Otis & Co. v. SEC*, 323 U.S. 624, 638 (1945)), courts insisted that *shifting* of going concern values from one class to another not occur. The question of whether this standard was appropriate in bankruptcy reorganization has been argued in detail. *See supra* note 98.)

173. This is not only the socially efficient way to decide on how to use the debtor's resources, it is also a result wholly consistent with the creditors' bargain model. By using the optimal form of "liquidation" or "reorganization" under such a selection standard, each creditor can be left at least as well off as under the selection of some other form, and some creditors can be made better off. *See White, supra* note 44; *see also supra* notes 61 & 62.

174. The choice of the type of bankruptcy proceeding is *already* a selection that works in the favor of the "lower entitlement classes" by maximizing aggregate returns and by providing that no class should be paid more than in full. *See supra* p. 870 & note 62. There is no normative reason that suggests further redistribution, depending on the type of bankruptcy proceeding, of non-bankruptcy entitlements from one class to some other class.

reorganization obscures an important difference between them. Normally, in a liquidation under Chapter 7, the assets are sold off and the "debtor" is, effectively, removed from the picture. Third parties are almost certainly involved, as "owners" if not as managers. The essence of a reorganization, however, is that third parties are *not* involved: the debtor is "continued," albeit the "owners" of the debtor may be replaced to some extent. Although it is possible to overstate this distinction, it is plausible to view a reorganized enterprise as a "continuation" of the web of relationships between the debtor and its former owners and creditors<sup>175</sup> while a liquidation, almost by necessity, involves a disruption of those relationships. Liquidations, therefore, may differ from reorganizations in this respect. Is there, however, any analytical relevance to this difference?

At this point, we need to examine non-bankruptcy law and the possible substantive distinction, in that law, between contracting parties and third parties. The law of assignments places two general obstacles in the way of an attempted delegation of duties without prior consent: it prohibits the delegation of certain duties entirely, and it does not allow the divesting of responsibility by a party. Consider, first, the general question of delegation. Contract law generally distinguishes the delegation of "fungible" duties from the delegation of "non-fungible" duties.<sup>176</sup> Certain kinds of contracts, often called "personal service contracts," are deemed by the common law to be non-delegable because they are based on particular skills or other unique features of the contracting party.<sup>177</sup> In essence, holders of these contracts are protected by a property rule: they do not have to deal with any assignees of their contracting counterpart unless permission for such assignment is obtained. This protects the expectations of a party that has contracted with a particular entity in much the same way the specific performance rule does in other circumstances.<sup>178</sup>

175. A reorganization procedure "made economic sense whenever there were no or few potential outside buyers with accurate and timely information about the true state of affairs and the future prospects of the business." Clark, *supra* note 18, at 1252. The end result of the process is a system "that would primarily involve a reshuffling of the paper claims against the business assets." *Id.* at 1253.

176. 4 A. CORBIN, CORBIN ON CONTRACTS 865 (1951); see Taylor v. Palmer, 31 Cal. 240 (1866).

177. "Delegation of performance is a normal and permissible incident of many types of contract. . . . The principal exceptions relate to contracts for personal services and to contracts for the exercise of personal skill or discretion." RESTATEMENT (SECOND) OF CONTRACTS § 318 comment c (1981); see also Munchak Corp. v. Cunningham, 457 F.2d 721 (4th Cir. 1972); Evening News Ass'n v. Peterson, 477 F. Supp. 77 (D.D.C. 1979); U.C.C. § 9-318(c) (1972); J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS 662-65 (2d ed. 1977). With regard to executory contracts and unexpired leases, these rules are generally respected by Bankruptcy Code § 365(c).

178. The analogy of the concept of non-delegable duties to contract law's concept of specific performance should be obvious. For a discussion of the rule of specific performance in terms of property rules, see Kronman, *supra* note 80; see also Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979). Even in cases in which the general rules of contract law would not call a duty non-delegable, however, the parties are free to draft their own anti-delegation clause. In this respect, parties are free to contract into their own creation of a property rule. See, e.g., Eastern Advertising



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Even when duties may be delegated without prior consent, the original contracting party remains ultimately responsible for the performance of his contractual obligations.<sup>179</sup> That is to say, even in the case of delegable duties, a person subject to a contractually-created obligation does not ordinarily have the right or power to divest himself of liability by substituting another in his place without the consent of the person to whom the duty is owed. While the delegatee may be entitled to perform for the original obligor if the duty is of the delegable sort, nonetheless, the original obligor remains ultimately liable until discharged by performance (or otherwise).<sup>180</sup>

This learning may be applied to our discussion of bankruptcy liquidation and reorganization proceedings. From the perspective of contract law, an attempt to continue a contractual obligation of a debtor past a piecemeal liquidation proceeding involving that debtor would almost certainly be viewed as a "delegation" of that obligation to a new entity, coupled with a divesting of duties by the debtor.<sup>181</sup> At the opposite end, many bankruptcy reorganizations would not be viewed as involving a delegation at all, much less a divesting of duties, under applicable non-bankruptcy law, especially where management remained in place and the old owners retained some substantial ownership position. It may be more difficult to make a general rule about "going concern" liquidations, which exhibit some of the features of a piecemeal liquidation and some of the features of a "pure" reorganization.<sup>182</sup> If we are trying to locate general presumptions for the purpose of fashioning off the rack rules, however, it seems plausi-

Co. v. McGaw, 89 Md. 72, 42 A. 923 (1899); RESTATEMENT (SECOND) OF CONTRACTS § 318(2) (1981). This could be done either directly as a matter of assignment ("A cannot assign his obligation to deliver wheat to me"), or indirectly, as a term of the contract ("A must deliver to me wheat grown on A's farm, located at Blackacre, Kansas"). Games such as this may be played under the Bankruptcy Code, which, while striking down anti-assignment clauses, requires the assignee to give adequate assurances of performing the terms of the contract. Bankruptcy Code § 365(f)(2).

179. The general rule governing delegation of duties absent express agreement is that "delegation of performance . . . [does not] discharge any duty or liability of the delegating obligor." RESTATEMENT (SECOND) OF CONTRACTS § 318(3) (1981). See also J. CALAMARI & J. PERILLO, *supra* note 177, at 644 (assignor cannot divest himself of his duties; may sometimes delegate them, but remains liable for their due performance); U.C.C. § 2-210(1) (1972); *Wetherall Bros. Co. v. United States Steel Co.*, 200 F.2d 761 (1st Cir. 1952); *Smith v. Wrehe*, 199 Neb. 753, 261 N.W.2d 620 (1978); *Western Oil Sales Corp. v. Bliss & Wetherbee*, 299 S.W. 637 (Tex. Comm. App. 1927); *New York Bond Note Co. v. Hamilton Bank Note Engraving & Printing Co.*, 180 N.Y. 280, 293, 73 N.E. 48, 52 (1905).

180. See RESTATEMENT (SECOND) OF CONTRACTS § 316 comment c (1981).

181. See, e.g., *Western Oil Sales Corp. v. Bliss & Wetherbee*, 299 S.W. 637 (Tex. Comm. App. 1927); *Boston Ice Co. v. Potter*, 123 Mass. 28 (1877); cf. *The British Waggon Co. v. Lea & Co.*, 5 Q.B.D. 149 (1880) (assignment of duties by company in process of winding up permissible "so long as [that company] continues to exist"). But cf. *Macke Co. v. Pizza of Gaithersburg*, 259 Md. 479, 370 A.2d 645 (1970) (allowing purchaser of obligor to assume contract); *Evening News Ass'n v. Peterson*, 477 F. Supp. 77 (D.D.C. 1979) (assignment permitted upon merger because assuming corporation substantially similar to original corporation).

182. For example, management may remain the same while the owners are changed.

ble to treat bankruptcy liquidations (whether piecemeal or going concern) under Chapter 7 as the equivalent of cases involving both delegation and divesting of duties under applicable non-bankruptcy law, and to treat bankruptcy reorganizations under Chapter 11 as involving neither such delegation nor divesting.<sup>183</sup> Parties that felt uncomfortable with these off the rack rules could, of course, contract around them. Indeed, it seems likely that ipso facto clauses may on occasion serve as contractual clauses allowing the contract-holder to make his own determination about whether a particular bankruptcy proceeding implicated the concerns underlying non-bankruptcy law's delegation rules.<sup>184</sup> But whether or not such contractual clauses are allowed,<sup>185</sup> a general de-acceleration rule, such as exists in the case of executory contracts and unexpired leases under the Bankruptcy Code, sweeps too broadly. The distinction between reorganization and liquidation proceedings that applies to lenders appears normatively preferable.

For a reorganization proceeding, then, a general de-acceleration rule that is applicable in the absence of a contrary clause may be viewed as reflecting, in rough fashion, the non-bankruptcy rules underlying its treatment of non-delegable duties.<sup>186</sup> A liquidation proceeding, however—which centers around the sale of assets and (if permitted by bankruptcy law) the delegation of duties to third parties—does run up against, in a direct way, the justifications underlying both the general rule allowing contractual non-delegation clauses and the non-bankruptcy prohibition against non-consensual divesting of duties by a contracting party.<sup>187</sup> For the ability to de-accelerate in a liquidation proceeding would be meaningless without the concomitant right of assignment to a third-party and, almost inherent in the concept of a liquidation, release of the debtor from further obligation.<sup>188</sup> A bankruptcy rule that provided gener-

183. In this examination, I am not dealing with a situation in which a trustee (as distinguished from the debtor, the debtor-in-possession, or possibly even the debtor with new trustee management) will be performing the duty. These cases (which would largely be *individual* debtor cases) obviously raise distinct issues. For example, nothing I am saying here attempts to justify the trustee of a famous opera singer assuming his obligation to sing the lead tenor role in *Aida*. See *In re Taylor Mfg.*, 6 Bankr. 370 (Bankr. N.D. Ga. 1980).

184. See *supra* note 150.

185. See *supra* p. 890 & note 158. There are substantial reasons for allowing such clauses. See *supra* pp. 888-892.

186. This is so because the entity is emerging with essentially the same owners, and hence would not generally be considered to be a "delegation." *In re Milton L. Ehrlich, Inc.*, 5 N.Y.2d 275, 157 N.E.2d 495 (1959). See RESTATEMENT (SECOND) OF CONTRACTS § 318 illustration 8 (1981). This, of course, assumes that there is no assignment to an entity other than the reorganized debtor, under Bankruptcy Code § 365(f), which would involve not only a de-acceleration but also an assignment.

187. See *Arkansas Valley Smelting Co. v. Belden Mining Co.*, 127 U.S. 379 (1888); *Crane Ice Cream Co. v. Terminal Freezing & Heating Co.*, 147 Md. 588, 128 A. 280 (1925).

188. While a corporation does not receive a discharge in a bankruptcy liquidation, Bankruptcy Code § 727(a)(1), the corporation almost certainly will thereupon dissolve under applicable state corporation law.

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ally—even in the absence of a specific clause—for the acceleration of rights in a liquidation proceeding would, therefore, respect the non-bankruptcy rules on delegation in that it would protect not only the property rule established to deal with the special category of non-delegable duties<sup>189</sup> but also the “secondary” property rule that, in all cases, disallows discharge of the delegating party without express consent of the other party to the contract.<sup>190</sup>

The reasons for respecting this property rule in the bankruptcy context seem sensible.<sup>191</sup> Consider, first, the situation of unsecured lenders. The general common-law rule is that loan contracts are non-delegable.<sup>192</sup> Why is this so? Consider the long-term unsecured creditor—the creditor “disembodied” from any particular asset. For such a creditor, the question of who the debtor is may be of paramount importance. The decision whether or not to loan is based on such factors as knowledge of and confidence in the debtor, the ability to monitor the debtor, and so forth.<sup>193</sup> A liquidating debtor’s assignment of an existing obligation to repay a loan would raise the same issues as underlie the common law’s treatment of the assignment of a contract to make a loan.<sup>194</sup> In both cases, allowing the transaction has the effect of “discharging” the original debtor from any obligation and substituting a new party without the lender’s consent.

Secured creditors and “property-specific” contract-holders (such as lessors) may seem to be in a different situation since they have identified property to look to in the event of non-performance. While this attachment to specific items of property may reduce the need to monitor, it is not likely to weaken substantially the interest in who the particular debtor

189. These represent *both* cases in which duties are generally non-delegable under applicable law and cases in which a contractual provision has made them non-delegable. See *supra* notes 177 & 179.

190. See *Smith v. Wrehe*, 199 Neb. 753, 261 N.W.2d 620 (1978); *Western Oil Sales Corp. v. Bliss & Weitherbee*, 299 S.W. 637 (Tex. Comm. App. 1927); *RESTATEMENT (SECOND) OF CONTRACTS* § 318(3) (1981).

191. All contracts with the federal government may be non-assignable for purposes of Bankruptcy Code § 365(c)(1), (e), & (f). See 41 U.S.C. § 15 (Supp. IV 1980); *In re Adana Mortgage Bankers*, 12 Bankr. 977 (Bankr. N.D. Ga. 1980). The justification for this rule is that the prohibition on assignment is designed “to secure to the United States the personal attention and services of the contractor, . . . and to assure that the government ‘might also know with whom it was dealing until the contract was completed and settlement made.’” *Id.* at 984 (citation omitted).

192. See *Arkansas Valley Smelting Co. v. Belden Mining Co.*, 127 U.S. 379 (1888); *Texas & N.O.R. Co. v. Phillips*, 196 F.2d 692 (5th Cir. 1952); *In re Adana Mortgage Bankers*, 12 Bankr. 977 (Bankr. N.D. Ga. 1980); *Frissell v. Nichols*, 94 Fla. 403, 114 So. 431 (1927); *Menger v. Ward*, 87 Tex. 622, 30 S.W. 853 (1895); *Rice v. Gibbs*, 40 Neb. 264, 58 N.W. 724 (1894). The actual rule is a bit more limited: the non-delegation rule applies where “one of the duties sought to be delegated is the execution of a promissory note or other instrument of credit . . .” J. CALAMARI & J. PERILLO, *supra* note 177, at 664; see, e.g., *E.M. Loew’s v. Deutschmann*, 344 Mass. 765, 184 N.E.2d 55 (1962); *Lojo Realty Co. v. Estate of Isaac G. Johnson*, 253 N.Y. 579, 171 N.E. 791 (1930). See also Bankruptcy Code § 365(c)(2).

193. *Crane Ice Cream Co. v. Terminal Freezing & Heating Co.*, 147 Md. 588, 128 A. 280 (1925); see *infra* note 196.

194. See *supra* note 192.

is. For example, a secured party with inventory as collateral may care very much who the debtor is, because of concerns over property maintenance, levels of misbehavior, and so forth, even though the secured party may not monitor the debtor carefully (for precisely the reason that the decision as to the level of monitoring required is based, in the first instance, on an evaluation of the characteristics of the debtor).<sup>195</sup> Thus, it seems entirely correct that non-bankruptcy law also protects these people with a property rule by prohibiting non-consensual discharge of the original contracting party from underlying liability.<sup>196</sup>

This suggests that, even if one were suspicious of contractually created ipso facto clauses in general, a rule providing for the override of ipso facto clauses by an ability to de-accelerate in a reorganization proceeding,<sup>197</sup> but generally allowing acceleration in a liquidation proceeding, when coupled with a general rule prohibiting the non-consensual delegation of contractual duties, would be the preferred solution. Such a rule would respect the well-settled property rights that support the non-delegation rules of contract law.<sup>198</sup> General hostility to contractually created ipso facto clauses (which in itself seems unjustified)<sup>199</sup> should not obscure the fact that contract law's usual refusal to allow a delegation of duties without the consent of the other party to the contract, unless the delegator remains contractually responsible for performance, is not such an ipso facto clause, and should not be condemned along with them.

195. The pervasive inclusion of anti-assignment clauses in leases may suggest the desire to protect, through use of a "property rule," the intangibles that underlie the general non-delegation rule. Moreover, a number of executory contracts (such as for the delivery of "requirements" in the future) leave a seller in essentially the position of an unsecured creditor following each delivery. *Arkansas Valley Smelting Co. v. Belden Mining Co.*, 127 U.S. 379 (1888). The Uniform Commercial Code gives a seller a limited right to reclaim goods delivered while the buyer was insolvent, although this right may be subject to competing claimants. U.C.C. § 2-702 (1972). See *In re Samuels & Co.*, 526 F.2d 1238 (5th Cir.) (en banc), cert. denied, 429 U.S. 834 (1976). (This right has been given substantial recognition in bankruptcy. See Bankruptcy Code § 546(c); *In re A.G.S. Food Systems*, 14 Bankr. 27 (Bankr. D.S.C. 1980). Apart from this limited right, a seller who has a long-term contractual commitment but no security interest will find himself, after each delivery, to be an unsecured creditor.

196. See *supra* note 179; U.C.C. § 2-210 comment 6 (1972) (noting that non-assigning party has stake in reliability of person with whom he has contracted); *Funk v. Baird*, 70 N.D. 396, 295 N.W. 87 (1940) ("The personal covenants of the heirs may be better than those of the vendor, but the defendants are not bound to accept them . . .")

197. Such an override would be accomplished by giving the debtor the ability to de-accelerate in a reorganization. Presumably this ability would apply to both lenders and other contract-holders, as the reasons underlying the rule for executory lenders of Bankruptcy Code § 365(c)(2) would be reflected in the more general rule. Again, there seems to be no persuasive reason to treat lenders of money separately from other extenders of credit (or supplies). See *supra* note 132.

198. It is likely that most "forced" bankruptcies will result in a reorganization rather than a liquidation or, alternatively, in dismissal of the petition. See Bankruptcy Code §§ 305, 706, 707; *In re Luftek, Inc.*, 6 Bankr. 539 (Bankr. E.D.N.Y. 1980). As a consequence, protecting the property rights underlying general contract law's non-delegation rules, by generally allowing acceleration in liquidation proceedings, would not seem to trench unduly on a solution to any perceived "bankruptcy incentive" problem.

199. See *supra* pp. 888-892.

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This suggests a fundamental flaw in the reasoning underlying the general ability to assign executory contracts and unexpired leases in Bankruptcy Code section 365. While Bankruptcy Code section 365(c) mirrors the "personal service" rules of non-delegation, it ignores the second property rule underlying the treatment of delegable duties under non-bankruptcy law. For that second rule only permits delegation of duties if the original obligor remains liable.<sup>200</sup> The override of that non-bankruptcy rule seems to be without normative justification.<sup>201</sup>

### IV. The De-acceleration Principle, State-Created Priorities, and Bankruptcy Statutory Liens

We have explored the uncertain justifications underlying the application of bankruptcy's de-acceleration principle<sup>202</sup> to consensually-created arrangements. The de-acceleration principle, however, has another, quite separate, role to play in the bankruptcy process. Beginning in the late 1930's, changes made to the Bankruptcy Act of 1898<sup>203</sup> have consistently moved in the direction of refusing to recognize attempts by a state to elevate the claims of any one type of claimant in bankruptcy through the device of either a state-created priority<sup>204</sup> or a statutory lien effective only in bankruptcy (or a similar non-bankruptcy occurrence).<sup>205</sup> These at-

200. See *supra* notes 179 & 196.

201. The Bankruptcy Code is quite insistent on overriding this property rule. See Bankruptcy Code §§ 365(k), 727(b), 1141(c), (d). While Bankruptcy Code § 365(f)(2)(B) does require that adequate assurance of future performance by the assignee be provided prior to any assignment, this is not a substitute for the property rule. Rather, it reflects a general rule of contract law regarding delegation. Under this general rule, such assurances must be provided even where the original obligor remains ultimately liable. See U.C.C. § 2-210(1), (5) (1972); *Funk v. Baird*, 70 N.D. 396, 295 N.W. 87 (1940).

202. See *supra* pp. 879-881.

203. Chandler Act, ch. 575, 52 Stat. 840-940 (1938). See S. REP. NO. 1159, 89th Cong., 2d Sess. (1966); *In re Federal's*, 553 F.2d 509 (6th Cir. 1977); *In re Telemart Enterprises*, 524 F.2d 761 (9th Cir. 1975).

204. "Priorities are to be distinguished from property rights. . . . The priority creditor . . . has no property right, merely a statutory advantage to be given effect on distribution." J. MACLACHLAN, *supra* note 1, at 145. A brief history of the demise of state-created priorities is contained in *Analysis of H.R. 12889*, 74th Cong., 2d Sess. 201 (1936); 3A W. COLLIER, *supra* note 12, at 2053-54.

205. The 1938 legislation, which dropped the bankruptcy priority for state-created priorities, also expressly validated state-created statutory liens, but declared that they would be paid after administration and wage priorities. Chandler Act, ch. 575, § 67c, 52 Stat. 877 (1938). In 1952, an amendment struck down all statutory liens that attached to personal property and were not accompanied by "possession, levy, sequestration or distraint." Act of July 7, 1952, ch. 579, 66 Stat. 420. When this test proved unsatisfactory, Congress amended § 67c of the Bankruptcy Act of 1898 to strike down statutory liens that became "effective upon the insolvency of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor" or were not "perfected or enforceable at the date of bankruptcy against one acquiring the rights of a bona fide purchaser from the debtor on that date . . . ." 11 U.S.C. § 107c(1)(B) (1975) (repealed prospectively, effective October 1, 1979); see Kennedy, *Statutory Liens in Bankruptcy*, 39 MINN. L. REV. 697, 703-22 (1955). See generally Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 713-27 (1967).

tempts by a state were felt to contradict, in a fundamental way, the notion that "equality is equity." Initiation of a bankruptcy proceeding is not, under this view, a reason for calling forth a different set of allocative entitlements by any creditor or class of creditors than existed outside of bankruptcy. The refusal to recognize a state's attempt to influence directly bankruptcy's allocation rules has raised few, if any, eyebrows. Indeed, the opposite has occurred: the purported application of the de-acceleration principle has sometimes struck down state-created entitlements that, instead of suffering from the "bankruptcy only" problems of state-created priorities or bankruptcy statutory liens,<sup>206</sup> appeared to be all but indistinguishable from ordinary non-bankruptcy entitlements.<sup>207</sup>

What, if anything, is wrong with state-created priorities and bankruptcy statutory liens?<sup>208</sup> Surprisingly little critical attention has been directed to this inquiry.<sup>209</sup> Two questions, however, seem to be raised. First, is there any justification at all for a state's attempt to prefer a given type of creditor in bankruptcy? Second, if there is a justification for such an attempt, is there any reason to believe that the use of state-created priorities and bankruptcy statutory liens is not a proper way to implement those desired preferences?

Several reasons, other than simply political expedience or special interest group pressure, may explain a state's desire to provide a level of protection to certain types of claimants, instead of leaving the issue to the area of consensual security interests. First, non-consensual claimants, such

206. Hereinafter, statutory liens effective only in bankruptcy will be referred to as "bankruptcy statutory liens," to distinguish them from statutory liens of a normal sort, which have a recognized existence and validity in and out of bankruptcy.

207. See *infra* note 228; see also MacLachlan, *Improving the Law of Federal Liens and Priorities*, 1 B.C. IND. & COM. L. REV. 73 (1959). Since the date of these enactments, few statutes involving true state-created priorities or bankruptcy statutory liens have been tested. A possible example of such a statute was MASS. GEN. LAWS ANN. ch. 254, § 31 (West 1961). The statute "causes a lien to arise in favor of materialmen upon the adjudication in bankruptcy of certain contractors." *N.W. Day Supply Co. v. Valenti*, 343 F.2d 756 (1st Cir. 1965) (declaring the statute invalid in bankruptcy); see also *Strom v. Peikes*, 123 F.2d 1003 (2d Cir. 1941).

There has also been a lengthy debate over the validity of U.C.C. § 9-306(4) (1972) under these provisions. See Countryman, *Code Security Interests in Bankruptcy*, 4 U.C.C. L.J. 35, 45-49 (1971); Henson, "Proceeds" *Under the Uniform Commercial Code*, 65 COLUM. L. REV. 232 (1965).

208. With respect to ipso facto clauses, which are also directed specifically at the bankruptcy process, we were able to rely on a contractual model to tentatively justify their existence. See *supra* pp. 887-892. Such an explanation is obviously not available with respect to state-created liens and priorities.

209. Most commentators note, approvingly, that the refusal to recognize state-created priorities or bankruptcy statutory liens promotes national uniformity and furthers the goal of creditor equality by striking down state interference directed at the bankruptcy process. See, e.g., *Analysis of H.R. 12889*, *supra* note 204, at 201; 3A W. COLLIER, *supra* note 12, at 2053-54; Kennedy, *supra* note 205, at 699-70; Comment, *Statutory Liens Under Section 67c of the Bankruptcy Act: Some Problems of Definition*, 43 TUL. L. REV. 305 (1969); Note, *Statutory Liens Under Section 67c of the Bankruptcy Act*, 62 YALE L.J. 1131 (1953). These reasons are unsatisfying in light of the numerous instances of deference to non-bankruptcy entitlements. See *In re Telemart Enterprises*, 524 F.2d 761 (9th Cir. 1975).

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as tort creditors, pose special problems to which application of a consensual model seems largely inapplicable. Should a state believe that a certain level of deterrence is desirable to protect against certain behavior, a system of priority entitlements to "victims" of that behavior may help the state achieve that goal, at least with respect to some types of torts.<sup>210</sup> By giving non-consensual tort claimants priority over general unsecured creditors, those general creditors (whose chance of repayment has been made more risky than under a proportional payment scheme) will have an increased incentive to monitor the debtor to reduce the likelihood of such torts occurring in the first place.<sup>211</sup> Second, a state may have reason to believe that, with respect to a particular class of claimants, there is systematic advantage-taking of them by other creditors, because of an informational disparity or other reasons.<sup>212</sup> Intervention by a state, in giving this class of claimants priority entitlements, may be a way of addressing a form of market inefficiency.<sup>213</sup> Finally, the state is itself likely to be a claimant (oftentimes, as in its taxing capacity, a non-consensual one), in which case the level of priority it provides is a part of the cost calculus it has decided on in setting its rates (whether tax rates or otherwise).

There may be inefficient interferences by a state as well, due to politically-motivated causes.<sup>214</sup> But the relevant point is that state interventions may sometimes be efficient or otherwise justified and, in any event, are generally recognized in bankruptcy. The bankruptcy law upholds state-created entitlements unless the entitlement is directed specifically at the bankruptcy process.<sup>215</sup> Unless there is some reason to believe that inefficiently motivated instances of state interference are more common with

210. Cf. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 506 (1976) (discussing involuntary extensions of credit in negotiation-based model). To be sure, insurance may also serve some of these goals. But it is unlikely that insurance will be able to curb that behavior as well as a priority rule. Therefore, even if one were to have an insurance scheme, one might nonetheless want to have a priority scheme as well.

211. The issue of priority among creditors that is raised by a state-created priority or bankruptcy statutory lien does not deal directly with incentives to have the debtor behave in a socially desirable fashion. Equity-holders come after creditors, whether or not a state-created priority is created or recognized. (Indirectly, of course, there are incentives arising from monitoring and the cost of credit.) Direct incentives are created by such things as removing the discharge right with respect to certain debts. See Bankruptcy Code § 523(a)(6) (non-discharge of debts resulting from intentional torts); *In re Shawsheen Dairy*, 47 F. Supp. 494, 498 (D. Mass. 1942); Note, *Tort Claims and the Bankrupt Corporation*, 78 YALE L.J. 475, 479-80 (1969).

212. See Schwartz, *supra* note 53, at 30-33.

213. The case for this form of intervention may be difficult to make. But once a state has made such a determination, the justifications for second-guessing by a federal bankruptcy rule may likewise be slender. See Eisenberg, *supra* note 16, at 957-58; Schwartz, *supra* note 53, at 36.

214. See, e.g., R. POSNER, *supra* note 35, at 404-07; Peltzman, *Towards a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. 335 (1974).

215. See Bankruptcy Code § 545 (distinguishing between valid and invalid statutory liens); 124 CONG. REC. H11,114 (Sept. 28, 1978).

respect to state-created priorities or bankruptcy statutory liens than with respect to other forms of state-created entitlements, inquiry into the validity of an entitlement should first be directed at the *form* of the intervention. The relevant inquiry is whether there is anything particularly undesirable about state-created priorities or bankruptcy statutory liens that justifies the blanket prohibition against them in the bankruptcy process and that distinguishes them from other forms of non-bankruptcy entitlements.

State-created priorities and bankruptcy statutory liens attempt to direct allocative entitlements in bankruptcy, but in this respect they are indistinguishable from other types of non-bankruptcy entitlements routinely recognized in bankruptcy.<sup>216</sup> The difficulty with state-created priorities and bankruptcy statutory liens is that they suffer from the same "bankruptcy incentive" problems previously discussed in connection with ipso facto clauses.<sup>217</sup> Since the rules of the bankruptcy process set the minimum level of entitlements against which non-bankruptcy "workouts" must be evaluated,<sup>218</sup> a creditor enjoying a state-created priority effective only in bankruptcy will demand to be treated similarly outside of bankruptcy as well.<sup>219</sup> A creditor with such a priority might push for initiation of the bankruptcy process when it is not in the aggregate interests of the creditors to do so.<sup>220</sup> But because a creditor with a state-created priority does not necessarily have that priority right outside of the bankruptcy process, he must negotiate with the other creditors in order to receive that preferential treatment. These negotiations, because they are likely to involve a number of unsecured creditors, may involve free-rider problems that will not only make negotiations costly but also may lead ultimately to an inefficient use of the bankruptcy process.<sup>221</sup> Moreover, unlike the case of consensually negotiated agreements, there is no persuasive reason to believe that this state of affairs involves policing or other sorts of efficiencies that may justify retention of the system.<sup>222</sup> Therefore, at our creditors' bargain

216. Occasionally, a state-created priority will be distinguished from a lien on the ground that its holder is paid only after all "true" lienholders have been paid, and therefore is somewhat suspicious. See Comment, *supra* note 209. From the perspective of general creditors, however, the effect is the same: the person with the entitlement must be paid in full first. See *Strom v. Peikes*, 123 F.2d 1003, 1006 (2d Cir. 1941).

217. See *supra* pp. 890-892.

218. See *supra* p. 867.

219. Pre-bankruptcy payments to the holder of a state-created priority would have added protection against attack by the trustee. Bankruptcy Code § 547(b)(5) provides that a trustee may not avoid such a transfer unless it "enables such creditor to receive more than such creditor would receive if (A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title." *Id.*

220. See *supra* p. 876.

221. An inefficient use of the bankruptcy process will occur if the negotiations break down. See *supra* pp. 890-891.

222. See *supra* pp. 887-892. Since the priority rights of these people are not fixed until bank-



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meeting, if it were clear that a particular creditor was going to receive a state-created priority or bankruptcy statutory lien, we would expect the creditors as a group to view it as in their interest to give that creditor a lien that is valid both in and out of bankruptcy. Refusing to recognize state-created priorities and bankruptcy statutory liens simply requires a state that wishes to give someone a "priority" to do so by means of an entitlement that is good in and out of bankruptcy.

The puzzle with respect to state-created priorities and bankruptcy statutory liens is why a state would ever enact an entitlement that is good only in bankruptcy.<sup>223</sup> Part of the answer is that, at least based on reported cases from the last twenty-five years or so, few such statutes have been passed.<sup>224</sup> Ironically, bankruptcy law's failure to recognize entitlements only good in bankruptcy may be viewed as justified, not on the ground that it is protective of something fundamental to the bankruptcy process itself, or even of general unsecured creditors, but rather on the ground that it protects claimants in the aggregate (and ultimately the debtor) against presumptively illogical actions by state governments, which accrue to no one's advantage.<sup>225</sup>

From another perspective, however, the greater irony may be that bankruptcy law's obsession with formulating a rule on the subject may have done more harm than good. For while the prohibition on state-created entitlements good only in bankruptcy may occasionally strike down an aberrant state statute designed to create an irrational form of entitlement, the presence of the federal rule has, meanwhile, led to substantial confusion in its application.<sup>226</sup> For if an entitlement is enforceable both in

ruptcy (or similar event) they do not enjoy the protections of a first-in-time rule such as exists in Article 9 of the U.C.C. and which is a necessary part of the efficiencies (if any) of that system. See Jackson & Kronman, *supra* note 53, at 1161-64.

223. Even assuming that the legislative process results in inefficient decisions some of the time, it is not clear what group would lobby for a state-created priority instead of, say, a full status lien or what group would oppose full status lien treatment (if the choice were solely between that and a state-created priority). Prior to 1938, when the bankruptcy laws contained an open invitation to create state-created priorities, it is conceivable that this was viewed as a safe way to proceed.

224. See *supra* note 207. While there have been several cases striking down state-created priorities and bankruptcy statutory liens, these cases have normally not involved "bankruptcy incentive"-type statutes, see *infra* note 228. Even a statute such as U.C.C. § 9-306(4) (1972) would not create a "bankruptcy incentive" on the part of a secured creditor, as that section usually gives such a secured creditor less than he would get outside of bankruptcy. 2 G. GILMORE, *supra* note 4, at 1337-38 ("§ 9-306(4) is the reverse of . . . [a state-created priority or bankruptcy statutory lien], since it sharply cuts back the secured party's rights when insolvency proceedings are instituted"). Ironically, U.C.C. § 9-306(4) may be a statute that gives a "bankruptcy incentive" to unsecured creditors in the event of insolvency. This result might seem to be equally undesirable.

225. The creditors as a whole are not benefited because the costs of such a system are greater than the costs associated with a full-status lien system, nor does any discernable group appear to be benefited. See *supra* note 223.

226. Indeed, the pre-1938 explicit recognition of state-created priorities by the Bankruptcy Act of 1898 may itself be the root of the evil. See *supra* note 223.

and out of bankruptcy, there is no reason, stemming from the justifications underlying condemnation of state-created priorities or bankruptcy statutory liens, to refuse recognition of the entitlement.<sup>227</sup> The failure to recognize this simple point has led to a variety of confusing and ill-considered decisions by appellate courts.<sup>228</sup> The rule against state-created priorities and bankruptcy statutory liens, if correctly understood, may be harmless and even occasionally beneficial. But since the reasons for the rule are misperceived, the resulting misapplications may engender more uncertainty than continuation of the rule is worth.<sup>229</sup>

227. There would be an independent reason to refuse recognition of the entitlement if it was decided that the state intervention was otherwise inefficient. See Schwartz, *supra* note 53, at 33-37. Few, if any, judicial decisions even reach this question, much less have adequate data on which to base a reasoned decision to strike down the state entitlement.

228.

The Ninth Circuit, for example, has had an extremely difficult time distinguishing between legitimate state preferences and invalid state-created priorities and bankruptcy statutory liens. This difficulty is likely to increase credit costs because it creates uncertainty. A California statute provided that all the assets of an agent selling checks and money orders would be impressed with a trust in favor of the principal and the trust would remain until the amount due to the principal was paid. The Ninth Circuit, after noting that this would "relieve check and money order principals from the burden of tracing commingled funds," concluded that:

Giving effect to the provisions of [the California statute] . . . would open the door to state creation of priorities in favor of various classes of creditors by labeling such priorities as "trusts." This would tend to thwart or obstruct the scheme of federal bankruptcy.

*Elliott v. Bumb*, 356 F.2d 749, 759-55 (9th Cir.), *cert. denied*, 385 U.S. 829 (1966). The holding misperceives the nature of the inquiry. All state-created entitlements act in favor of some group of creditors, but bankruptcy law generally recongizes them nonetheless. The inquiry, which *Elliott v. Bumb* ignored, is whether the statute applied only in bankruptcy. Without further inquiry into the efficiencies of a particular application of statutory trust doctrine there is nothing to suggest that these impressed trusts should be considered contrary to bankruptcy policy. The legislative history of the Bankruptcy Code recognizes, in discussing "tax trusts," that there is little difference between a "trust" and a "lien." 124 CONG. REC. H11,114 (Sept. 28, 1978). Similarly, in *In re Leslie*, 520 F.2d 761 (9th Cir. 1975), the Ninth Circuit stopped at an examination of a label, although the state statute in question is of doubtful utility given that it used a priority scheme that seems flawed. See *supra* pp. 904-05. The efficient solution—although not one open to the Ninth Circuit—would have been to strike the statute down *in toto*. See Eisenberg, *supra* note 16. In *Leslie*, California law had established a system of priorities for payment of creditors of a liquor dealer upon transfer of a liquor license. Citing *Grover Escrow Corp. v. Gole*, 71 Cal. 2d 61, 65, 453 P.2d 461, 463, 77 Cal. Rptr. 21, 23 (1969), the Ninth Circuit stated that the statute established "statutory priorities, not statutory liens," and struck the scheme down as inconsistent with the Bankruptcy Act of 1898. It is true that *Grover Escrow Corp.* invoked the word "priority," but it is also clear that it meant "lien":

The precise issue is whether that section precludes a creditor from establishing priority over the escrowed proceeds of such a transaction by attachment or garnishment. We conclude that section 24074 represents a mandatory and exclusive scheme for payment of creditors of liquor license transferors, giving creditors who comply with that section priority over those who employ any form of levy on the proceeds.

71 Cal. 2d at 62, 453 P.2d at 461, 77 Cal. Rptr. at 21. Again, why is *this* state-created entitlement bad, when others are upheld? Since this statute was applicable both in and out of bankruptcy, nothing in the Bankruptcy Act of 1898 condemned its use.

229. See 2 G. GILMORE, *supra* note 4, at 1287 ("As appellate judicial review becomes more sporadic, it also becomes more unpredictable. . . . If [a federal judge] exercises his own judgment in a bankruptcy case, the result may well be aberrational.") (footnote omitted).

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### Conclusion

The bankruptcy rules governing state-created priorities and bankruptcy statutory liens reflect a normative view of the world that is consistent with the creditors' bargain model presented in this Article. But the application of those rules to particular facts seems haphazard, as the application is usually uninformed by any consistent normative model. At other places the Bankruptcy Code itself seems to deviate, without explanation, from a model that seems to illuminate and justify much of the bankruptcy process.

Bankruptcy law has, for too long, been molded and interpreted without any systematic questioning or understanding of its normative role in a larger legal, economic, and social world. This Article asserts that not only is there a coherent normative theory justifying a bankruptcy system that deals with inter-creditor questions, but also that we would be better able to formulate and apply principled bankruptcy rules if we would give systematic and critical attention to the impact of those rules on non-bankruptcy entitlements. That the answers to creditor-allocation questions posed by the bankruptcy process will often be difficult does not excuse the failure of the statutory drafters, bankruptcy judges, and the bankruptcy bar from even identifying the questions they purport to be answering.<sup>230</sup> Greater attention to the relevance of the creditors' bargain model in formulating the non-discharge related rules of the bankruptcy process appears to be a promising, and necessary, beginning to a principled development of our bankruptcy laws.

230. See Eisenberg, *supra* note 16, at 998:

Although a Congress fully cognizant of the issues addressed here might nevertheless adhere to its existing reform decisions, it ought to do so knowing the costs of poor coordination with nonbankruptcy law. Unfortunately, the new act not only reflects these costs, but to some degree reinforces bankruptcy law's isolation, a development that can be expected to generate future discontinuities between bankruptcy and nonbankruptcy law.

*Id.*