Contracting Out of Bankruptcy: An Empirical Intervention

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Introduction

Academic debates often seem to circle the same issues again and again for years, until the combatants grow bored with the clash of shop-worn abstractions and move on. Bankruptcy law presents no exception. For nearly a decade one idea has dominated the academic stage. It centers on privatization of bankruptcy, permitting a business and its creditors to select not only their interest rates and loan collateral, but also to choose the legal regime that will be in place if the debtor-business fails.[3] After some years of sharp clashes in fields of generalization, this debate threatens to grow stale. In this article we freshen it with a dose of fact.

Bankruptcy law, as currently formulated, is a mandatory system. A debtor in trouble may file for bankruptcy according to a pre-determined set of federal rules; most courts will not enforce pre-bankruptcy contractual agreements not to file, nor will they permit the parties to vary the applicable rules once the debtor files.[4] A number of scholars have recently suggested various schemes by which businesses[5] might agree *ex*

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[3] We describe this as an entirely theoretical debate because there is currently no apparent interest in Congress to consider such a move. Of course, not so long ago a debate over means testing would also have been described as entirely theoretical by such criteria. Now both the House and the Senate have passed bills featuring complex means-testing devices. It seems that even the most academic debates may be the forerunners of legislative action.

[4] *E.g.*, In re Pease, 195 B.R. 431, 433 (Bankr. D. Neb. 1996); Farm Credit, ACA v. Polk, 160 B.R. 870, 873-74 (M.D. Fla. 1993); In re Sky Group Int'l, Inc., 108 B.R. 86, 88 (Bankr. W.D. Pa. 1989); In re Madison, 184 B.R. 686, 690 (Bankr. E. D. Pa. 1995). *Contra, e.g.,* In re Atrium High Point Ltd. Partnership, 189 B.R. 599, 607 (Bankr. M.D.N.C. 1995); In re Cheeks, 167 B.R. 817, 818-19 (Bankr. D.S.C. 1994).

[5] These proposals are generally limited to the defaults of legal entities like corporations. Our discussion includes both corporations and individual entrepreneurs, but we too exclude consumer bankruptcy. To

ante to a bankruptcy scheme other than the current federal system.[6] An answering chorus has vigorously responded that any such scheme is completely unworkable.[7] Those scholars who promote schemes of bargained bankruptcy, a group that may be called "contractualists," have filled the law reviews with claims and objections, most of them fact-free.[8]

Although contractualists have various approaches, the common thread is that parties should be free to bargain in advance for a set of rules that will govern their rights in the event of bankruptcy and that their bargain should be permitted to override the rules of bankruptcy, presumably rendering the bankruptcy system applicable only as a default arrangement for those who make no private bargain. It has been suggested that the contractualist approach be extended to govern international insolvencies as well.[9]

The principle of party choice has ample precedent in commercial law. Indeed, party autonomy is at the core of contract law and the central rationale for government enforcement of contracts. But mandatory rules are equally part of the norm in commercial law. Parties cannot, for example, decide privately on the core rules governing foreclosure of a loan.[10] Those governing rules are imposed by law, mandatory and unwaivable. The question is not whether party autonomy or mandatory rules are better. Our commercial law system employs both quite successfully. The question is *when* one approach is preferable to the other.

The stakes in private versus public bankruptcy schemes are substantial. Bankruptcy is the final arbiter of who gets what when a company fails. Nearly all businesses that file for bankruptcy have some value, either in liquidation or as going concerns. The contest for those assets may be the final game played out among the parties. Those who do not recover in the bankruptcy distribution are forced to absorb losses, which can be quite substantial. The bankruptcy system also has powerful non-bankruptcy effects, setting the framework for negotiations with a troubled debtor as each

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date, as far as we know, no one has suggested that VISA or Wal-Mart be allowed to include a bankruptcy system on the back of that credit card application it gives to Suzy or Jimmy.

[6] *See, e.g.,* Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 776 (1988) [hereafter "Bebchuk, New Approach"]; Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy- Priority Puzzle*, 22 J. Legal Stud. 73 (1993) (hereafter "Adler, Solution"]; Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 118 (1992) [hereinafter, Rasmussen, Menu]; Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 Yale L.J. 1807, 1821-22 (1998) [hereafter "Schwartz, Contract Theory"];

[7] *See, e.g.,* Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz* 109 Yale 317 (1999) [hereafter "LoPucki, Contract"]; Lynn LoPucki, T*he Case for Cooperative Territoriality in International Bankruptcy*, 98 Mich. L. Rev. 2216, 2246-47 (2000) [hereafter "LoPucki, Cooperative"]; Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 Ill. L. Rev. 503, 504 (2001).

[8] We may be guilty of coining "contractualist" as a generic description of these authors. For a summary of the contractualist proposals, *see* Elizabeth Warren and Jay Lawrence Westbrook, THE LAW OF DEBTORS AND CREDITORS 1003-43 (4th ed. 2001).

[9] Robert K. Rasmussen, *A New Approach to Transnational Insolvencies*, 19 Mich. J. Int'l L. 1 (1997).

[10] *See, e.g.,* UCC 9-602 (nonwaivable rules in enforcement of secured debts). For real estate, *see, e.g.,* Lynn LoPucki and Elizabeth Warren, SECURED CREDIT: A SYSTEMS APPROACH at 59 (4th ed. 2003) ("the requirement that collateral be exposed to public sale as part of the foreclosure process generally cannot be varied by contract."); *Restatement of Mortgages*, 3.1-3.3.

party parlays with a sharp eye on what would be the party's rights if the debtor filed for bankruptcy. Even the initial lending decision or the structure of the deal may be shaped in part by the rules that will apply if one party should find itself in bankruptcy.[11]

The details of the current bankruptcy system are labyrinthine, but they could generally be described as constraining the collection rights of each creditor individually in order to promote a somewhat more efficient liquidation or reorganization. This is accomplished by shrinking the collection rights of the most powerful creditors in order to promote somewhat greater distribution among *all* those who have a stake in the debtor. Parties who are best able to negotiate for protection outside bankruptcy in the form of security interests and greater default rights often resist seeing their contractual rights diminished in bankruptcy to produce a benefit to other creditors who did not achieve such pre-bankruptcy protection. The academic debate over a contract-based system of bankruptcy is a debate to determine whether the current balance between private bargains and public rules will govern creditor priority in the end game.

Thus far, the debate over whether parties should be able to contract out of bankruptcy has been entirely theoretical. Using a first-principles approach that rests upon the efficiencies presumed from permitting party autonomy, supporters of a new regime argue that multiple approaches to dealing with debtor collapse would permit parties to tailor a default system to their specific needs.[12] Critics respond from a different perspective, arguing that efficiencies must be demonstrated, not merely presumed,[13] and that the multiparty nature of bankruptcy, affecting many creditors who have different bundles of legal rights created over different time periods, requires a non-opt out rule to assure protection for all parties.[14]

The contractualists present several variations on their theme. One may be called "automated bankruptcy," in which a system of priorities and options is built into a series of financial instruments so that upon default the ownership and control of a business passes to the owners with the priority appropriate to the business' financial condition, with no bankruptcy proceeding needed or no more than a minimal judicial role.[15] Another is a "menu" system, in which a debtor chooses from a menu of perhaps five bankruptcy regimes with varying provisions and embeds them in its articles of incorporation, unchangeable without the approval of all of its creditors.[16] A third may be designated the "ever-green" regime, in which the debtor negotiates bankruptcy-regime

[11] Ethan S. Bernstein, *All's Fair in Love, War & Bankruptcy: Corporate Governance Implications of CEO Turnover in Financial Distress* 5 (copies on file with authors) [hereafter "*Bernstein, Governance*"]
[12] *See, e.g.*, Rasmussen, Menu, *supra* note xx, at 53-55 ; Schwartz, Contract Theory, *supra* note xx, at 1850-1.
[13] *See* Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 Am. Bankr. L. J. 509, 543-50 (2000) (hereafter "Direct Costs"] (comparison of costs of large business bankruptcies with costs of acquisitions and other, similar transactions, based on data from the Business Bankruptcy Project).
[14] *See* LoPucki, *Cooperative, supra note xx, at* 2243-51; LoPucki, *Contract*, *supra* note xx, at 339-42; Block-Lieb, Limits, *supra* note xx, at 507-8.
[15] *See* Bebchuk, *supra* note xx; Adler, *supra* note xx.
[16] *See* Rasmussen, *supra* note xx.

contracts with a succession of creditors, the last such contract before default being the one that is controlling.[17]

Despite the different nuances in their views, the contractualists share certain basic premises. Each assumes that a bankruptcy regime negotiated in the marketplace will be far more efficient than the standardized "contract" provided by Congress in the Bankruptcy Code. This point is apparently self-evident, not requiring further evidence. Second, the contractualists are, to varying extents, rather vague about how their schemes will be implemented and how they will work, leaving two central questions unanswered. Would the proposed schemes be redistributional and therefore likely to create inefficiencies of their own? Would these schemes create transaction costs that would exceed any claimed efficiencies resulting from marketplace bargaining?

We propose to address these two questions with our data, but in some respects must postulate the contractualists answers to these questions in order to test their theories. We have repeatedly prodded those in our field who consider themselves theorists to put forward testable hypotheses, assuring them we would be glad to gather data to test them.[18] Our suggestions have been ignored, so we have to push the proposed theories into testable hypotheses ourselves, by identifying the factual premises on which the theories necessarily rest. We do that here.

On that basis, we introduce some factual reality into the ongoing discussion. We draw on data we have collected from thousands of failed business that initially filed for bankruptcy in twenty-three federal districts around the country in a single year,[19] harnessing those data in an effort to inform the current debate.

We begin with the theoretical arguments that have been at the center of the debate. Critiques of proposals to permit parties to contract out of the bankruptcy scheme center on two allegations related to the questions identified above:

- A private bankruptcy system would have redistributive consequences by permitting strongly adjusting creditors to shift risks to weakly adjusting or non-adjusting creditors;[20]

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[17] *See* Schwartz, Contracting Theory, *supra* note xx. Another group of contractualist proposals can be grouped under the heading "waiver." *See, e.g.,* Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEXAS L. REV. 515 (1999) (proposing the enforcement of certain waivers in bankruptcy). Unlike the other proposals, this approach focuses on creditors contracting with debtors after they have already fallen into financial distress. The proposal is to enforce waivers of the automatic stay and other bankruptcy provisions in exchange for new credits that might enable the business to survive without bankruptcy. The waiver approach involves some substantially different issues than the others and we do not address it in this article.

[18] Elizabeth Warren & Jay Lawrence Westbrook, *Searching for Reorganization Realities*, 72 Wash. U. L. Q. 1257, 1287 (1994). The analogue, of course, is physical science, where the theorists generate testable hypotheses and the experimentalists test them. *Id*.

[19] For a detailed discussion of the procedures employed to gather and report the data, see Warren & Westbrook, *Financial Characteristics*, *supra* note xx, at 504-05, n. 4.

[20] The terms "weakly adjusting" and "non-adjusting" are explained CR.

- A private bankruptcy system would be inefficient because transaction costs would be high as multiple negotiations took place over time, while any attempt to reduce those costs by standardization of bankruptcy contracts would largely forfeit the claimed benefits[21]

With our data, we test the factual assumptions implicit in each of these arguments. We examine the types of claims creditors assert in business bankruptcy cases, the number of such claims, and the individual and collective dollar values of those claims. These data stand as a stark reminder that in virtually every bankruptcy case the rights of a broad range of parties are resolved in a single court proceeding. Whether through a confirmed plan of reorganization or a liquidation of the debtor's assets, the parties claiming from the now-bankrupt estate have a wide variety of both pre-bankruptcy experiences and opportunities in their dealings with the debtor—from novice to sophisticate, from one-time players to industry specialists, from mega-corporations to the hapless driver who was waiting at the stoplight behind the company's truck when it discharged four tons of wet cement.

The data show that a substantial proportion of the creditors listed in business bankruptcies are likely to be weakly adjusting or non-adjusting, tending to confirm the hypothesis that there would be substantial redistributive implications from a private bankruptcy system that gave strongly adjusting creditors additional opportunities to shift losses to weakly adjusting or non-adjusting creditors. The data further suggest that business bankruptcies of every size are characterized both by a large number of claims and by many small claims. The large numbers and small size of the claims suggest it is likely that a system dependent upon private bargaining would generate substantial transaction costs, making it difficult for any supposed efficiencies to produce a net reduction in costs.

In commercial law, the practical often informs the theoretical. This paper represents an effort to test two intertwined factual assumptions that underlie the proposals for contracting out of bankruptcy, but the findings ultimately take us back to the theoretical debate about the essential nature of bankruptcy. The data presented here are consistent with a vision of bankruptcy that emphasizes its multi-party aspects, rather than a vision of bankruptcy as governed by a series of two-party agreements.

In this article, our focus is efficiency, not fairness. To the extent that bankruptcy laws have distributional objectives—such as the protection of employees or the subordination of misbehaving creditors—only non-opt-out rules can achieve those ends.[22] Those are concerns we take very seriously, but we set them aside here to concentrate on efficiency. Because our data show that a large number and variety of claims are presented in most business bankruptcy cases, it becomes apparent that a mandatory rule that

[21] Block-Lieb, Limits, *supra* note xx, at 548-9; LoPucki, *Cooperative, supra note xx, at* 2243; Lubben, *Direct Costs supra* note xx, at 544-50 (2000).
[22] 11 U.S.C. §507(a), 1126 (2000). For a discussion of the distributional objectives embodied in protections for general unsecured creditors, see Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 Mich. L. Rev. 336 (1992).

governs in all cases—and for which parties spend no time or money negotiating—produces substantial efficiencies of its own. In the mix of mandatory and opt-out schemes that characterize commercial law, the data presented in this paper suggest that the collective nature of bankruptcy makes it a particularly unsuitable candidate for an opt-out approach.

Business Bankruptcy Study

The Business Bankruptcy Project began with the collection of court records for a random sample of business debtors in twenty-three judicial districts around the country. The sample was designed to draw 150 business cases from each district, evenly divided among Chapter 11, Chapter 7, and Chapter 13 cases that were designated as business filings.[23] The cases were all filed during 1994 and followed longitudinally for six years, with data collection concluding in 2001. Because some districts did not produce even 50 Chapter 11 or business Chapter 13 cases and some courts were unable to locate files for cases in our sample, the final number of business cases was 3,201 rather than the projected 3,450. Those 3,201 cases form the core sample of the study.[24]

The data were collected data from court records and supplemented with telephone interviews for those debtors we could reach. The court record data included the information on the initial schedules as well as the subsequent events in the case. The database now has more than 200 variables describing each case.

The twenty-three districts we studied comprised about 40 percent of all the business cases filed in the United States in 1994. Our sample cases alone equaled about 6 percent of all business filings in the country. [25]

In order to understand more about the claimants in business bankruptcy cases, we examined a sub-sample of the cases in greater detail. We had already collected summary data on secured claims, priority unsecured claims and general unsecured claims for all the cases in the sample. For the analysis for this report, however, we re-examined a subset of cases to categorize each individual unsecured claimant and the dollar amount listed for each separate unsecured claim. The subset was limited to cases originally filed in Chapter 7 or Chapter 11, about 2100 cases in all. We re-examined every fifth Chapter 11 and Chapter 7 business case, recording the type and amount of each unsecured claim

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[23] The designations came from the face sheet of the petition. Cases were deemed "business cases" if any of the following indicia was present: "(1) the lawyer checked 'business' in the business/nonbusiness box on the face sheet of the petition; (2) the petitioner's name had a business style (e.g., 'Corp.,' 'Inc.,' 'Co.'); or (3) the petitioner had a designation of 'doing business as,' 'formerly doing business as,' or 'also known as,' if the latter designation was a business style." Warren & Westbrook, *Financial Characteristics*, *supra* note xx, at 512.

[24] The protocols for the Business Bankruptcy Project are set out in greater detail in Warren and Westbrook, *Financial Characteristics*, supra note xx, at 503-18. The preliminary report shows a useable sample size of 3,121 cases. When those data were drawn, some courts had been unable to locate the court records for some of the debtors that were in the initial sample, so that we had no useful data about those cases. After publication of that article, however, we were able to recover data from additional cases in the initial sample, increasing the useable sample size to 3,201.

[25] *See Financial Characteristics*, *supra* note xx, at 512-13.

listed in the files. This created a sub-sample of 386 business cases from around the country; this sub-sample forms the basis for this paper.[26]

We identified twenty-two categories of claimants for which we collected additional, detailed data:

Secured creditors[27]
Judgment lien creditors
Attorney priority creditors
Attorney non-priority creditors
Other priority creditors
Bank/institutional lenders
Bonds
Credit card issuers
Employee priority creditors
Employee non-priority creditors
Insurance companies
Individuals, specify loans
Landlords
Medical care providers
Plaintiffs, personal injury
Plaintiffs, unspecified lawsuits
Taxing authorities (priority claims)
Taxing authorities (non-priority claims)
Trade creditors (whether an individual or business is named as creditor)
Utilities
Business entities, unspecified
Individuals, unspecified

The categorization of the claims involved some judgment calls, and debtors were not always consistent in providing all the information required by statute—or the information necessary to categorize their claimants. To promote consistency, we did not use a large team of coders. Instead, the work was undertaken by only two trained researchers who completed all coding themselves.[28] The two worked in close contact with each other and

[26] Because of some missing data, our sub-sample started at 405 cases. After excluding consumer Chapter 11 cases which were not part of the core business sample, we were left with 386 business cases in those two chapters. Of those, 40 had no unsecured claims of a specified amount listed, other than priority tax claims. See discussion at note __ *infra*. That is, they either failed to list any unsecured claims or they listed such claims without specifying the amount of any single claim. All but one of these cases had only secured claims and/or tax claims and therefore appear as "zero-unsecured" cases in the sub-sample. One case listed no claims at all.

[27] Our coders did not sample more detailed information from the secured claims in the sub-sample, and we do not have detailed information about those claims. We have only summary data about the nature and amount of the secured claims.

[28] Scott Kirwin, Harvard Law School Class of 2001, was the lead coder. He worked closely with Catherine Ellis, Columbia Law School Class of 2004, who also coded the sample. Determination of the initial categories and coding protocols were made in conjunction with Elizabeth Warren and Jay Westbrook, and any questions that arose during the coding were resolved in consultation with both professors.

in direct consultation with us. Ultimately they coded detailed data for 7,959 general unsecured claims for the sub-sample to supplement the data that had already been coded for the secured and priority claims for the entire sample.[29]

Because we had limited resources to spend to enrich this aspect of the database, we developed the additional data for the Chapter 11 and Chapter 7 business cases only, despite our realization that the smaller business cases filed in Chapter 13 are also important. This means that the enhanced claims database is not representative of the whole sample; it represents only those business cases initially filed in Chapter 11 or Chapter 7. The sample therefore eliminates a significant proportion of the individual business people who comprise the Chapter 13 business cases. The effect is to shift the sample to over-represent corporate cases because even small corporations are ineligible for Chapter 13.[30] Elimination of Chapter 13 business cases also tilts the sub-sample toward larger cases, because of the debt limits imposed on Chapter 13 filers.[31] Exclusion of Chapter 13 cases may be appropriate for this analysis, because larger corporate cases seem to be the chief interest of those debating the issue of contract bankruptcy.[32]

Notwithstanding the omission of Chapter 13 cases, the sub-sample, like the larger sample of Chapter 11 and Chapter 7 cases, includes both natural persons and legal entities filing business bankruptcies. In the Chapter 11 cases, about one-quarter of the cases are filed by human debtors and about three-quarters by legal entities. In the Chapter 7 cases, the proportions are reversed, with about three-quarters of the business liquidations filed by individuals.[33]

Although the sub-sample comprises only about 18.3% of the Chapter 7 and 11 cases in the overall sample, [34] by itself it represents a very large total amount of debt. The total debt, secured and unsecured, in the sub-sample is about $374 million, an average of about $970,000 per case.[35] The total unsecured debt in the sub-sample is more than $133 million, an average of about $372,000 per case.[36] Thus the unsecured claims represent about a third of the total debt in the sub-sample cases.

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[29] The figure 7,959 includes the claims of lien creditors, because they began as unsecured creditors. *See* note 55 *infra*. Excluding lien creditors, the total of unsecured claims is 7,898.

[30] 11 U.S.C. §109(e) (2000).

[31] 11 U.S. C. §109(e) (2000).

[32] Indeed, some scholars have indicated a certain disdain for cases that are less than mega. *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751, 752, 788-789 (2002).

[33] Warren & Westbrook, *Financial Characteristics*, supra note xx, at 532. Note that the chapter designations in our data apply to the chapter of initial filing, ignoring any later conversions to other chapters.

[34] We often round as an act of kindness to our readers and ourselves. We round up from .05.

[35] As usual, the median is considerably lower, at about $162,000.

[36] The median unsecured debt per case is about $75,000. These figures do not include priority tax debt for reasons explained below in the second section. CR discussion under many claims. They do include the 40 zero-unsecured cases. *See* CR [defining zero-unsecured]. Of course, tax claimants are included in the first section, describing types of claimants.

Hypotheses—What We Can Test

The most directly useful thing empirical research can do is to establish whether specific factual hypotheses or premises are inconsistent with the known data. We set out to test the two factual propositions that are implicit in the proposals of those who advocate a bankruptcy contract-out scheme, creating the testable hypotheses they have failed to generate:

> Hypothesis #1: The great majority of creditors in business bankruptcy cases will be able to contract for appropriate outcomes or able to adjust their prices to reflect any changes in risk that may be imposed on them by the contracts of others, so a contracting out scheme will have little or no redistributive effect.
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> Hypothesis #2: A contracting out scheme is unlikely to impose transaction costs that are substantial enough to offset any gains in efficiency that may be derived from party autonomy, because business bankruptcy cases will generally involve a relatively small number of claims and most of the claims will be large ones.

Redistribution Hypothesis: Can Most Creditors Protect Themselves?

The central feature of any proposal that calls for parties to contract for a set of applicable bankruptcy rules is that the scheme chosen will affect the rights of creditors who were not part of the negotiation. Because businesses engage in transactions over time and with a variety of different kinds of creditors, there is no single moment in advance of default when a contract can be negotiated with all the affected parties present. Creditors will come and go; some will increase their stakes, reduce their stakes, or initiate various collection actions. Some parties whose relationships may be founded on a contract are nonetheless extremely unlikely to engage in pre-default negotiations that reflect differences in pricing based on the bankruptcy scheme selected. Moreover, some parties can never be present because their claims are not based in contract. For example, some creditors begin with an involuntary relationship that sounds in personal injury or fraud. Because bankruptcy constitutes a final liquidation of the debtor's assets or a complete financial reorganization of the business, the point of any bankruptcy scheme is to deal with *all* the parties to whom the debtor owes obligations—not just the parties who negotiated for special treatment if the debtor later defaulted. In this first section, we identify and quantify the creditors who are unlikely to be able to contract for a privileged position or an individually bargained bankruptcy system.

Contracting creditors can be expected to negotiate for a system that benefits themselves—not the parties who are absent from the negotiating table. For that reason, all contract-bankruptcy schemes depend upon some form of "deemed" acceptance by non-parties. If the absent parties can learn about the rules that would apply on default and adjust their behavior to reflect the changes in risk associated with the new default regime, then any such proposal for party autonomy would have no redistributive effect.[37] But if some of the affected creditors are unable to adjust, then the proposal has a redistributive effect, permitting some creditors to push the risk of loss off on to other creditors, with a corresponding loss in efficiency.

To make the example more vivid, it is useful to consider a contracting creditor and debtor who agree that upon default the debtor will have no access to bankruptcy and will immediately turn all of its assets over to the contracting creditor. Upon default, the immediate removal of property from the business to benefit the contracting creditor may result in the collapse of the business. The benefit gained by the contracting creditor would come at the expense of the parties who might have benefited from both the wealth enhancing and the distributional aspects of the otherwise-applicable bankruptcy proceeding. For example, absent the contract, the non-contracting party might have profited from continuation of the business and preservation of its going-concern value because the non-contracting party would have been paid in full if the business survives, but would be paid nothing if it is immediately liquidated. If non-contracting parties cannot fully adjust their behavior to reflect the increased risk that they would take nothing in the event of the debtor's default, then there has been an involuntary wealth transfer from those parties to the contracting party and a resulting inefficiency in the system.

The contractualists implictly assert that their proposals are not redistributional because they do not offer a normative or efficiency ground that would justify any redistributional effect. Instead, their necessary—if unspoken—assumption is that all parties would be able to adjust their bargaining terms (price or other terms) to reflect the effects of the contract approaches they propose. In that respect, their proposals are congruent with the many articles arguing that secured credit is efficient and not redistributional.[38] Thus the critiques of the efficiency arguments for secured credit are

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[37] Such a scheme might have other adverse social effects, such as a reduction in the availability of credit from the absent group, an increase in its cost, or injury to some group important to social welfare, such as small entrepreneurs. We put those questions aside for present purposes.

[38] *See generally* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982) [hereinafter Levmore, *Monitors*]; James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985); F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986); Scott, *Relational*, *supra* note. Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989); James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27 (1991); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992); Richard L. Barnes, *The Efficiency Justification for Secured Transactions: Foxes with Soxes and Other Fanciful Stuff*, 42 KAN. L. REV. 13 (1993); Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993) [hereinafter Adler, *Puzzle*]; David Gray Carlson, *On The Efficiency of Secured Lending*, 80 VA. L. REV. 2179, 2179–80 (1994) [hereinafter Carlson, *Efficiency*]; Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J 1 (1997) [hereinafter Mann, *Small-Business*].

equally relevant here.[39] Many of the most cogent criticisms of secured credit law are based on the assertion that the effect of secured credit is to capture gains for the secured creditor and the debtor at the expense of non-adjusting or weakly adjusting unsecured creditors. The same critique applies to contractualism generally.

The idea of an involuntary or reluctant (quasi-involuntary) creditor was the subject in a chapter of our book, *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America*[40] in 1989. We had drawn a sample of individual (not corporate) debtors in Chapter 7 and Chapter 13 (not Chapter 11). We discovered that 72.5 percent of the cases in the sample listed debts to entities we classified as "involuntary or reluctant creditors,"[41] such as tort victims, utilities, and medical creditors. We defined such creditors as those who had no contract relationship with the debtor (for example, a tort victim or tax authority) and those who attempted to stay on a cash or near-cash basis, but were sometimes forced by circumstances to extend credit (for example, many utilities and health care providers).

Professor Lynn LoPucki brought the notion of involuntary or reluctant creditors to bear in the debate over the efficiency (or inefficiency) of secured credit.[42] He observed that many "unsecured creditors do not consent to their status in any meaningful sense."[43] He concluded that secured creditors could lend for less than unsecured creditors because they had the power to "victimize involuntary creditors."[44] He explains that the secured creditors "expropriate for themselves value that, absent the agreement, would go to involuntary creditors."[45]

In 1996, Professors Bebchuk and Fried made a similar distinction among business creditors, focusing on three categories of creditors: non-adjusting, weakly adjusting, and perfectly adjusting.[46] They argued that the case for declaring secured credit efficient was "at best problematic" and that systems for preferring secured creditors who obtain certain preferences by contract at the expense of all non-adjusting and weakly adjusting claimants "generate a number of inefficiencies."[47] Collectively, these non-adjusting and weakly adjusting creditors might be deemed "maladjusting" creditors.

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[39] One of us has gone farther to argue that contractualism necessarily requires a system of dominant security interests in favor of the contract party to provide the necessary control over the debtor's assets. *See* Jay L. Westbrook, *The Control of Wealth in Bankruptcy*, 82 Texas L. Rev. 795 (2004) [hereafter "Westbrook, Control"].

[40] *See* Teresa A. Sullivan, Elizabeth Warren, & Jay L. Westbrook, *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America 293 (1989)* [hereafter "*Forgive*"].

[41] Forgive at 295, Table 16.1.

[42] Lynn LoPucki, *The Unsecured Creditor's Bargain*, 80 Va. L. Rev. 1887 (1994) [hereafter "Bargain"].

[43] *Id.* at 1896.

[44] *Id.* at 1987.

[45] *Id.* at 1897-98.

[46] Lucian Arye Bebchuk and Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 Yale L. J. 857, 864, 881 (1996) [hereafter "Uneasy Case"]; Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279, 1286–88 (1997).

[47] *Id.* at 859. An empirically based criticism of the Bebchuk-Fried position is stated by Professor Hill. Claire A. Hill, *Is Secured Debt Efficient?* 80 TEXAS L. REV. 1117, 1160-62 (2002). She does not deny the

There are various ways to infer whether a party who ultimately became a creditor would have been able to protect itself either by a pre-bankruptcy contract or by a pre-bankruptcy price adjustment that reflected changing risks from a different distribution scheme. None is perfect. We offered a list in our 1986 work.[48] Professor LoPucki identified a similar list in his work,[49] and Professors Bebchuk and Fried offered several examples.[50] All approaches include some of the same claimants. Personal injury claimants are at the top of everyone's list as the prototype of a creditor unable to negotiate risks, and taxing authorities appear on all three lists. Professor LoPucki notes that his list is not exclusive: "Regardless of where one draws the line among these creditors, involuntary unsecured credit clearly exists in substantial amounts."[51] Bebchuk and Fried take a position befitting less empirically oriented scholars. They state that their conclusions about transferring risks to maladjusting creditors do not depend on documenting the existence of tort or government creditors, instead asserting simply "there invariably exist non-adjusting creditors."[52]

Alas, we are involved in the factual business of trying to identify these maladjusting creditors, which requires us to develop some criteria for selection. We focus on the pre-bankruptcy circumstances of different creditors listed in bankruptcy, using as our test whether the parties had a meaningful opportunity pre-bankruptcy to negotiate with the debtor business. Those who did, we assume were able to assess the risks and adjust their prices accordingly—or walk away from an unattractive arrangement. Those who did not have an opportunity to negotiate represent the class who would simply be required to absorb the costs imposed upon them when the other creditors negotiated for their preferred bankruptcy arrangement. We divide and sub-divide the creditors, ultimately settling on five categories of debt that are most likely to include maladjusting creditors.

We recognize that by using general categories, our assessment of the sophistication or negotiating opportunities facing any particular creditor within a category

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existence of creditors who find it difficult or impossible to adjust, but argues on the basis of interviews that secured lenders are so sensitive to the additional financial risk such creditors represent that the secured parties see to it that few such creditors are likely to suffer. Her only concrete explanation of how this might happen is that creditors require high-risk debtors to purchase adequate amounts of insurance, presumably to cover personal injury claims. Figure 1 shows that 21% of the cases in our sample had insurance debts, many of which were presumably unpaid premiums, which suggests to us that the insurance coverage in those cases may not have been all one would like. But that is all the light we can shed on this point for now.

[48] The list was aimed at consumer cases and included tort victims, former spouses and children with unpaid support orders, government agencies, educational lending agencies, health care providers, tax authorities, landlords and utilities. Forgive, *supra* note xx, at 294-98.

[49] *Bargain*, *supra* note xx (around 33), at 1896. Professor LoPucki concentrated on business cases, identifying personal injury claims, claims for business torts and other business activities that subject companies to civil or criminal liabilities, environmental claims, taxes, other government claims, and utilities. *Id.* at 1897.

[50] They identified tort claimants, government agency claims, taxes, trade claims, and claims too small to be worth negotiating. *Uneasy Case*, *supra* note xx, at 882-888.

[51] *Bargain*, *supra* note xx, at 1897.

[52] *Uneasy Case*, *supra* note xx, at 865.

may be wrong. Nonetheless, we think the generic descriptions are sufficiently accurate to advance our understanding of the balance between strongly adjusting and weakly adjusting creditors. Any questionable inferences should be obvious in the discussion. We realize, of course, that others may wish to draw different conclusions from these data, so we make every effort in this report to explain enough about the data and its derivations to permit alternative analyses.

The Initial Presumptions

We begin this analysis with a factual presumption: secured creditors are strongly adjusting creditors. We assume that any creditor sophisticated enough to get a security interest or mortgage has both the opportunity to negotiate in advance with the debtor and the savvy to understand something about repayment risk. We realize that secured creditors may differ in their individual capacities and that banks, family members, car dealers and inventory suppliers may not have identical opportunities to assess and deal with risk. Nonetheless, as a group, they signal that they are best situated to cope with risk. Not surprisingly, in the business bankruptcy cases, these creditors have the most debt. By dollar value, about 61.2 percent of all the debt listed in business Chapter 11s and Chapter 7s is secured.[53] This means that those who negotiated for collateral to secure the amounts they were owed claimed well over half of all the dollars demanded in business bankruptcy cases. We assume these are the creditors who are likely to negotiate for bankruptcy rules that most favor their interests.

Our focus in this paper is what happens to the remaining 40 percent or so of the debt listed in bankruptcy, debt that is not backed up by a pre-negotiated security interest. Among the unsecured creditors may be some very sophisticated lenders. Banks and other institutional lenders, credit card lenders, landlords, and creditors holding unsecured bonds all end up with unsecured debt in bankruptcy, presumably for a price that reflects the risks they took. But not all the unsecured creditors are so sophisticated or well positioned. We make an effort to disaggregate the unsecured creditors to test for the presence of sizeable subgroups of creditors who are unable to make appropriate risk adjustments.

We focus on the unsecured creditors for another reason as well. The traditional theme of bankruptcy—equity is equality—is based on the principle of a *pro rata* sharing of the assets or future income of the bankrupt estate. Secured creditors are those who, by contract, have already managed to lock up some portion of the assets for their exclusive use if the debtor defaults, thus exempting themselves from the pro rata treatment imposed on others and shrinking the pie that is left over for the general creditors. The non-opt-out bankruptcy scheme is designed to bind even those secured creditors into a collective resolution of the debtor's problems for the benefit of all the creditors, even if that means the secured creditors will be giving up some of the benefits for which they had contracted in advance. If the data demonstrate that a sizeable portion of the unsecured creditors are

[53] According to the debtors' schedules, about 50.8 percent of all debt is backed up by collateral and about 10.4 percent of all debt is the unsecured portion of an otherwise secured loan.

maladjusting creditors, then much of the effort to select a private default scheme is overtly redistributional, with the primary benefits going to the secured creditors.[54]

The Claimants

We begin by sorting out the unsecured creditors by type. Figure 1 lists groups of unsecured creditors by the proportion of Chapter 11 and Chapter 7 business bankruptcy cases in which they appear.[55] Trade creditors are the most ubiquitous in bankruptcy, showing up in three-quarters of all business cases. At the other end of the continuum, bond creditors are least frequent, listed as creditors in less than one percent of the business bankruptcy cases.

[54] For an argument that the contractualist idea necessarily requires that the bargaining creditors obtain a dominant security interest, see Westbrook, Control, *supra* note xx.

[55] For the purposes of Figure 1, we omitted details on four creditor groups and combined two other groups to shrink the initial list of 22 types of creditors about whom we collected detailed data from 22 to 16 categories. We omitted secured creditors on the assumption that they, by definition, could contract in advance for priority of repayment, a point we develop in more detail below. We omitted attorney claims, priority and non-priority, on the assumption that they are highly adjusting creditors who know they are dealing with a troubled debtor (priority attorneys fees which are incurred in connection with the case) or who usually have an extensive opportunity to negotiate with their clients. We consolidated priority and non-priority employee claims, in part because the number of non-priority employee claims was miniscule and in part because priority status does not matter greatly to the discussion. Priority and non-priority tax claims are included with separate reports. We omitted the remaining priority claims because there are too few to lump together and say anything meaningful. We have retained reports on "judgment lien creditors" even though they were presumably secured at the time of the bankruptcy filing, because they were originally unsecured creditors. They may have been more aggressive at the enforcement stage than other unsecured creditors, but we assume they were in similar positions at the start.

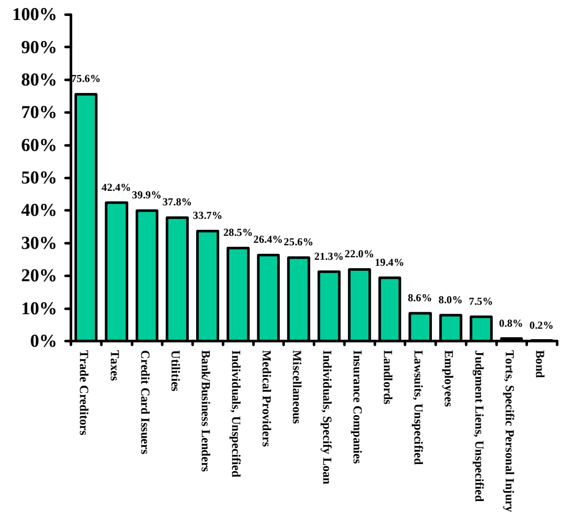

Figure 1: Proportion of Business Bankruptcy Cases Listing Unsecured Creditors, by Category
Source: Business Bankruptcy Project, Claims Sub-Sample

About one in four businesses listed at least one claim that fits into no discernible category either because the category was too rare (e.g., one computer business listed "veterinarian bill") or too little information was provided (e.g., some companies listed the generic "unsecured debt"). But for three-quarters of the business, every single debt could be categorized. While some of the businesses had at least one debt we could not classify in the list in Figure 1, overall the number of unclassifiable debts was modest, about 5.3 percent of all claims.

As we develop our analysis in this paper we examine some of these categories in greater detail, but Figure 1 remains available to put this analysis in context.

For this analysis, we focus on the claimants who can make the strongest argument that, as a group, they are least likely to have a meaningful opportunity to adjust their behavior (or their prices) to reflect increased risks imposed on them by the contractual arrangements of others. We focus specifically on five groups: personal injury claimants, utility companies, taxing authorities, employees, and individual (rather than corporate) creditors.[56] We also include a discussion of creditors who show up merely as plaintiffs or

[56] For this analysis, we omit the health-care providers. They are nearly always involuntary or reluctant creditors, and they were prominently included in our analysis of consumer bankruptcies. We were astonished to see that they appear in more than one in four business bankruptcies. We omitted them nonetheless because they appear almost exclusively in the entrepreneur bankruptcies instead of the corporate bankruptcies. For people focused on business decisions, this debt seemed deeply personal. That

judgment lien creditors, making some calculated guesses about their circumstances. We collect those creditors in Figure 2, in the order in which we discuss them in the upcoming section.

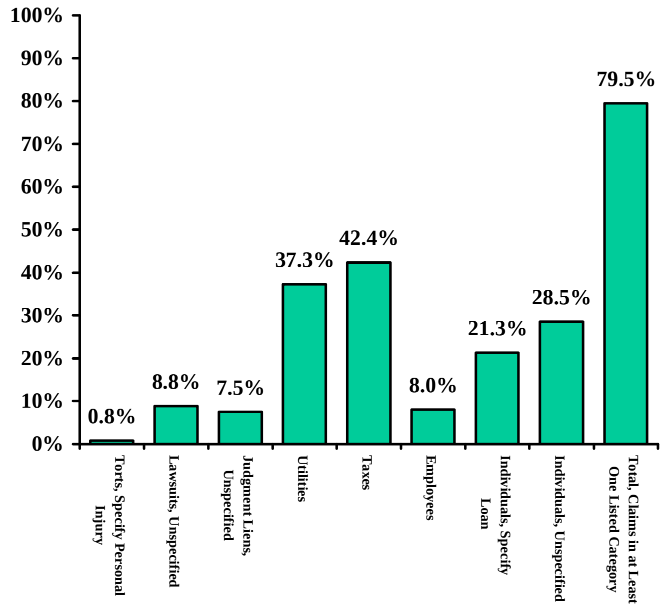

Figure 2: Proportion of Business Bankruptcy Cases Listing Non-Adjusting or Weakly Adjusting Creditors
Source: Business Bankruptcy Project, Claims Sub-Sample
N = 386

It is important to note that we have not included on this list trade creditors or landlords. We have not done so, because these categories include such a mix of creditors and circumstances, some weakly adjusting and some fully adjusting. Including a category so large and yet so mixed would dilute the probative value of the data. But there is every reason to believe that a substantial portion of the trade creditors would have a difficult time adjusting their prices to reflect differential bankruptcy systems for currently-paying customers. Many trade creditors are eager to make sales; they often fear that harsh credit terms or delivery delays while credit investigations take place will send some customers elsewhere. Many transactions are relatively small, and the expected duration of credit extended is often relatively short. Many sellers have standardized credit terms offered to all customers with no history of default. To assume, as the contractualists must, that these trade creditors could negotiate for different bankruptcy arrangements or adjust their prices to reflect the impact of negotiations that other creditors has undertaken to advantage themselves to the disadvantage of the trade debt requires a leap of faith about business practices that we believe is unsupported.

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said, these data should make clear that any decision affecting small businesses will have substantial fallout in unexpected places.

For the purposes of pinning down a more clearly maladjusting group of creditors, we eliminated the trade debt and landlords from the analysis, but we remain conscious that we have thereby seriously skewed our findings by their omission. Trade creditors are especially important, because they have a substantial majority of the claims in business bankruptcies—listed as unpaid creditors in 75.6 percent of all the business bankruptcy filings.[57] Any shift of legal presumptions that favors those creditors who can negotiate for advantage or adjust their prices to reflect changing risks will powerfully affect a group of creditors that appears in three out of four business cases.

Many, if not most, of the trade creditors who dominate the claims registries lack the business machinery and expertise to create sophisticated and particularized financial terms for varying types of customers and circumstances.[58] For these reasons, we can be sure that by excluding trade creditors from our list of maladjusting creditors we are reducing that category well below its true size and omitting a substantial number of weakly adjusting creditors far more typical of bankruptcy claimants than are lenders.

For our analysis of non-adjusting or weakly adjusting creditors, we combine the cases in which at least one of these identified creditors appears. The overall picture is startling: nearly four out of every five business cases in our sub-sample—79.5 percent—lists at least one of these non-adjusting or weakly adjusting creditors. Of course, many of the claimants overlap; that is, one case may have employee, utility and tax creditors. The plaintiffs in unspecified lawsuits and the judgment lien creditors overlap the most categories; in every single case in which they appear except one, another creditor from the list—personal injury claimant, employee, etc.—also appears. This means the total number of cases involving maladjusting creditors would remain essentially unchanged, even if we did not count judgment lien creditors or unspecified lawsuits.

Below we discuss each of the five groups of claimants, discussing their collective circumstances and the frequency of their appearance in business bankruptcy cases.

Tort Claims

In the academic debates, as in life, the paradigmatic non-adjusting creditor is the tort victim. This is the creditor who has no option to negotiate with the debtor before the injury occurs. It is on behalf of tort victims that much of the resistance to contract based bankruptcy has been argued.

In our sub-sample of 386 cases, we could clearly identify only three debtors as having personal injury claims filed against them. As Figure 2 illustrates, this is a small fraction of the debtors, a little less than 1 percent. These are the cases for which we can

[57] Not only are trade claims found in the vast majority of the cases (see Figure 1), but we find that they constitute more than half of all the general unsecured claims, a total of 4,474.
[58] *See* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case For The Priority Of Secured Claims In Bankruptcy: Further Thoughts And A Reply To Critics*, 82 Cornell L. Rev. 1279, 1299-1300, at n. 73 (1997).

say with the greatest certainty that the creditors were unable to negotiate in advance for a risk adjusted premium or for a liquidation scheme that would protect their interests.

Those are the minimum number of tort claims in our sample, but they are not the maximum. Tort claims are difficult to identify in the bankruptcy files. There is no box on the bankruptcy forms that asks a creditor to identify whenever a claim is grounded in tort. We used whatever information was available in the files, such as a debtor's voluntary identification of a claim as based on a personal injury. We recognized that such statements were not systematic—that is, the absence of such statements did not mean in other cases that the debts were not also personal injury claims; merely that the debtor did not identify any claims as such. To try to locate some of these claims, we looked for other markers of an involuntary relationship between the debtor and the claimants. We recognize that such markers are imperfect, because they either undercount tort claims or contain a mix of tort and non-tort claims. Our only other option, however, was to curse the darkness. With that caveat, we offer a few data runs that may hint at the presence of more cases with involuntary creditors.

We began expanding the list of possible involuntary creditors by examining all claims identified as lawsuits. Claims other than personal injury lawsuits may also involve involuntary relationships. Property damage claims, slander, libel, unfair competition, and fraud are among the many grounds on which someone may sue a business. These claims would also involve an injury to maladjusting creditors. Like personal injury lawsuits, victims of these claims would have no pre-injury opportunity to negotiate. The problem, of course, is that some lawsuits against a business debtor may be grounded on breach of contract, such as failure to pay a debt or some other court action taken after a contract relationship went sour. As a result, the generic heading "lawsuit" may include relationships that were initiated both by adjusting and by maladjusting creditors.

In addition to the identified personal injury claims, as Figure 2 illustrates, 8.8 percent of the business cases listed lawsuits outstanding at the time of filing. The grounds for these suits were unspecified. The claims listed only the name of the lawyer handling the case or the name of the plaintiff. In addition, 7.5 percent of businesses listed judgment liens against their property, presumably from lawsuits that had been completed before the business filed for bankruptcy. Again, the basis for the suits was not specified in the filing documents. We infer that a pending lawsuit may signal an involuntary creditor, but it is impossible to know for certain.

In addition to the lawsuits, claims may be listed in bankruptcy that would form the basis for a lawsuit but no suit had been filed at the time the bankruptcy was initiated. It is also possible that not all pending lawsuits were clearly identified as such; debtor's counsel might simply list the name of the filing party or the name of the party's attorney without specifying that a lawsuit had been filed. For collection suits against the debtor, the amount of the claim is likely to be known; that is, the creditor is likely to sue for a very specific amount, even if the creditor hopes to add on attorneys' fees or court costs. But a debtor facing injury-based lawsuits-in-progress, whether filed or not, would typically list the amount of the claim as "unknown" or "unliquidated." Such listings can include contract debts, of course, but such designations would be most likely for tort claims or utility claims, where the amounts due are not yet known to the debtor. In our sub-sample, we found 5.4 percent of debtors listed one or more debts to individuals for an amount that was "unknown" or "unliquidated." Another 3.4 percent listed one or more debts to other businesses for amounts that were "unknown" or "unliquidated." These cases suggest a possible expansion of the category injury-based claims.[59]

It is not possible to go further with the analysis of completely involuntary creditors. We cannot ascertain with precision the number of cases that involve an action against the debtor that is based on an involuntary relationship. We can, however, use these data to create a range. At one extreme, if none of the unidentifiable lawsuit claims, judgment liens, or unknown debts involved any sort of injury, then only about 1 percent of the cases listed in bankruptcy had any such involuntary claimants. At the other extreme, if at least one of the unidentified lawsuits and unspecified claims for each debtor was based on an involuntary relationship—admittedly unlikely—then about 25.5 percent of all cases would involve such a claim.[60] Reality lies between these boundaries.[61]

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[59] More than one in five—21 percent—of the businesses list one or more debts to insurance companies. Some of these debts may be for insurance premiums. Because many businesses must pay premiums in advance, another possible reason a business would owe money to an insurer would be because the victim's own insurance company paid out claims and now sought reimbursement from the debtor company or the debtor's company paid by mistake and now sought reimbursement from the debtor. Other, more complex, arrangements having to do with loss recoveries may also explain some of the filings. The average debt is about $6,100, and 19.8 percent of the debts listed are either greater than $10,000 or listed as "unknown" in amount. The presence of a high proportion of debtor businesses that owe money to insurers suggests yet another place where tort debt may be represented, although not identified as such. Because of the highly speculative nature of this part of the analysis, we omit these data from the compilation of possible non-adjusting and weakly adjusting debt, but we recognize that in doing so we are once again understating the role such debt plays in business bankruptcies.

[60] To arrive at this aggregated number, we included all cases in which any claim was in the following categories:

Schedule D Lien Creditor Debt
Lawsuit Debt (P.I.)
Lawsuit Debt (Non- P.I.)
Lawsuit Debt (uncertain)

and all cases for which there was an unknown claim in the following categories

Debts to Individuals (uncertain)
Misc. Debt

The list does not include claims owed to insurance companies because the inference about the nature of the debt seemed too ambiguous. Using just the listed categories, 25.5 percent of all cases included at least one debt that might be classified as "involuntary."

[61] It is possible to look at the number of claims, rather than the number of cases with at least one claim of this type, to develop another perspective on the data. The high proportion of certain kinds of claims (e.g., trade debt) produces some distortions in the data. From among the 7,959 claims we categorized, only seven claims in three cases were clearly identifiable as personal injury claims. Another 68 pending lawsuits, 61 judgment liens, and 64 claims owed for unspecified reasons in unspecified amounts were listed (34 to individuals and 30 claims owed to businesses), for a total of 193 claims. If all the obligations in those categories were in fact involuntary, then an additional 193 claims—about 2.5% of all claims--were involuntary. We have included judgment liens although their holders have become secured by enforcing their judgments, because those creditors began unsecured and acquired a lien only after suing the debtor and getting a judgment in court.

For a few bankruptcy cases, such as companies with substantial asbestos or other product liability exposure, the personal injury claimants may number in the tens of thousands.[62] For routine cases, such as those that show up in this sample, however, we could not identify a substantial number of such claims. Whether other involuntary creditors such as victims of employment discrimination or unfair trade practices are listed in the bankruptcy cases in substantial numbers is also hard to pin down, but the data suggest a possible range of about 1 to 25.5 percent of all cases.

Debts Owed to Utilities

Tort victims are not the only creditors who might have a difficult time adjusting. A utility is another example of a maladjusting creditor who shares some of the same limitations on its ability to negotiate in advance for different treatment based on the customer's selected bankruptcy regime.

Most public utilities make some effort to protect themselves against customer default by requiring deposits prior to initiating service and by threatening to shut off service if the debtor becomes delinquent. But utilities are sharply constrained by statute or by regulatory rules in their ability to deny service or to charge differential rates for their services based on the credit risk of the customer. As Figure 2 illustrates, about 37.3 percent of the business debtors were delinquent on one or more utility bills[63] at the time of the bankruptcy filing.[64]

Tax Obligations

Taxing authorities are another example of maladjusting creditors. Neither the Internal Revenue Service nor the local municipality can adjust *ex ante* the tax rate imposed on a business based on its assessment of the business' creditworthiness.[65] Taxing authorities are typically paid at the end of the assessment period or after the transaction that triggers the tax obligation, thus forcing the taxing authorities into an involuntary debtor-creditor relationship.

A third analysis would involve evaluating the claims by dollar amount. But in the category of pending lawsuits, the high proportion of cases in which the amount claimed against the debtor is listed as "unknown" or "unliquidated" makes meaningful comparisons impossible.

[62] The RAND Corporation estimated that every manufacturer of asbestos and asbestos-related products would be in bankruptcy by the year 2003. The list includes both those companies that have confirmed a plan of reorganization, such as Johns Manville, companies that have liquidated in bankruptcy, such as Fuller Austin, and companies with pending bankruptcies, such as W.R. Grace, Owens Corning, Federal Mogul and a number of others. Other product liability cases, such as Dow Corning (breast implants) and A.H. Robins (Dalkon Shield) have also been taken to the bankruptcy courts in order to resolve pending tort issues. In all of these cases, personal injury claims numbering into the tens of thousands of claimants have been the principal reason for filing. The sub-sample does not include any such mass-tort cases.

[63] The mean amounts outstanding were modest, but not insignificant—about $5,123 per debtor.

[64] The proportion of claims is smaller. There were 398 claims filed by utility companies, about 7.3 percent of all the claims filed.

[65] These authorities generally can impose penalties for non-payment, but only after default.

While taxing authorities can be quite vigorous in their collection efforts, the bankruptcy data show that there are nonetheless substantial numbers of debtors who file for bankruptcy with an outstanding tax obligation. By the time the debtor files for bankruptcy, the taxing authorities may have already secured a lien against some of the debtor's property, making the legal protection of the taxing authority similar to that of a secured creditor. For purposes of this analysis, we omit such tax debts from our calculation. Even if the taxing authority had no ability to protect itself in advance, fixing a lien on the debtor's property is a good sign, albeit not a guarantee, that the taxing authority will be repaid in full. By omitting tax liens, however, we once again understate our findings about the number of involuntary creditors. Even in cases in which the taxing authority claims a lien against specific property, the taxes owed may exceed the value of the property. In those cases, the taxing authority will have only a general unsecured claim for the remainder. By eliminating all the tax cases in which a lien is listed, we cut out some portion of unsecured tax debt.

Taxing authorities enjoy an advantage over most other unsecured creditors. If the taxing authority has not secured a lien by the time the debtor files for bankruptcy, the bankruptcy priority system provides that most tax debt will receive a repayment priority.[66] This means that most tax debts must be paid in full before any general unsecured creditor receives a penny of distribution. A small amount of tax debt is neither secured nor priority debt and stands in line with the other general unsecured creditors.

For this analysis we focus only on the tax debts that are not supported by a lien. As Figure 2 illustrates, nearly half of the businesses filing for bankruptcy—42.2 percent—listed a general obligation to one or more taxing authorities. These cases are ones in which the taxing authority had a claim for which it did not already have a lien against the debtor's property. In the overwhelming majority of these cases, the debtor listed the tax claim as a priority claim, meaning that it was eligible to be paid as a priority ahead of other general unsecured claims. Altogether, 39.1 percent of the cases were filed by debtors who owed a priority tax debt, while 6.7 percent of the cases were filed by debtors who owed non-priority tax debts. About 3.6 percent of the debtors owed both priority and non-priority tax claims.

Voluntary But Weakly Adjusting Creditors

Employee Debt

Although few employees might describe themselves as such, they are nearly always creditors of their employers. Employees are typically owed money for work completed before payday. Some companies have made commitments to provide severance pay, post-retirement insurance or long-term disability payments, putting the employee in the position of a long-term creditor. In addition, the practice of funding

[66] 11 U.S.C. §507(a)(8) (2000). In general terms, unpaid tax claims that are more than three years old (one year for property taxes) and on which the government has not yet secured a lien, lose their priority status.

pension plans with future promises rather than current cash also can turn employees into long-term creditors. Federal law imposes some constraints on the ability of employers to delay their current pension obligations, but as a number of recent large bankruptcies have demonstrated, a significant number of employees will nonetheless find that the bankruptcy of their employer means there will be nothing left for the employee's retirement.[67]

Because employees deal voluntarily with their employers, they are not maladjusting creditors. They may be, however, weakly adjusting creditors. Employees can protect themselves from the risk of their employer's insolvency by making an investigation of the company's financial condition and either working elsewhere or demanding higher wages to reflect those risks, but that possibility is more theoretical than real for most rank-and-file employees. The sophistication required and the transaction costs imposed to obtain the necessary information present substantial barriers. Moreover, the costs of moving from one employer to another can be quite substantial for those employees who are building seniority or who have uniquely matched job skills or who are geographically pinned down by a working spouse, homeownership, or children in local schools. Employees in these circumstances might fairly be described as very weakly adjusting creditors.

The number of debtors listing outstanding obligations to employees was quite modest. As Figure 2 illustrates, 8.0 percent of the businesses in bankruptcy listed employee obligations on their schedules.[68] Bankruptcy law provides a limited priority for employees, covering recent wages and benefit contributions.[69] The majority of debtors listed employees as priority debt claimants, suggesting that the employees were seeking wages and pension payments.[70] Another six debtors listed non-priority employee claims. These may have been for wage or retirement fund payments that exceeded the statutory maximum or for something else, such as a promised repayment to settle a grievance between employer and employee.

The relatively modest proportion of businesses in bankruptcy listing outstanding employee obligations might seem surprising. After all, more than half of the Chapter 7s and more than three-quarters of the Chapter 11 businesses in the overall sample had one or more employees at the time of filing, suggesting ongoing operations and outstanding paychecks.[71] Among businesses filing for Chapter 7, the mean number of employees was 15. For the Chapter 11 businesses, the number of employees was even larger: the mean

[67] *See, e.g.*, *Market Watch: Lopsided 401(k)'s, All Too Common*, NYT 10/5/03, §3, p. 1 (re lawsuits re Enron employees' pension losses); *A Plan to Postpone Pension Financing At United Airlines*, NYT 11/20/03, §A, p. 1.

[68] The number of employee claims was 124 claiming priority repayment and 9 claiming repayment as general, unsecured creditors.

[69] 11 U.S.C. §507(a)(3), (4) (2000).

[70] These claims were similarly modest. If we total the employee claims for each debtor, the mean of the claims by case total was $7,186 and the median was $4,242.

[71] The likelihood of employees was not distributed evenly between the two chapters. About 54 percent of the Chapter 7 cases and about 77 percent of the Chapter 11 cases had one or more employees other than the owner. Warren & Westbrook, *Financial Characteristics*, *supra* note xx, at 544.

number was 216 in Chapter 11.[72] Failure to list any employees as creditors in more than 90 percent of these cases suggests that generally, employers are meeting their payrolls as they come due. Employees may be weakly adjusting, but they do have another form of leverage: if their paychecks are not ready on time, they can quit showing up.

On the other hand—and there is always another hand in bankruptcy—while the proportion of bankruptcy cases listing employee claimants is not large, the impact in those cases is likely to be great. For the employees counting on wages or pension contributions for work already done, ending up as an unsecured creditor, even a priority unsecured creditor, in bankruptcy cannot be good news. Employees may have built claims over years—promises for sick pay and health insurance, or retirement checks that are based on seniority. The discovery that they need to learn about allowed claims in bankruptcy likely means a sharp cutback in their own lives. These data indicate that about one in twelve businesses that file for bankruptcy has outstanding obligations to their employees.

Natural Persons as Creditors

In a sample of business bankruptcy cases, we had expected that, with the exception of employee obligations and debts owed to trade creditors, there would be few voluntary debts owed to individuals as opposed to legal entities. We were wrong.

After we had separately classified involuntary debts, lawsuits and unexplained debts, employee debts, trade debts, debts owed to attorneys, and medical debts, we were left with a residual category of debts owed to individuals who are listed as general unsecured creditors. The first category is loans from individuals to the debtors. As Figure 2 illustrates, about one in five of the bankrupt businesses—21.3%—owed money to an individual based on what the debtor characterized as "loans." We confess to being somewhat surprised by the proportion of businesses borrowing from individuals. We were also surprised to discover that corporate debtors were *more* likely to have borrowed from individuals than did their individual debtor counterparts, although the differences were not significant. Among the corporate debtors, one in four—25%—listed one or more outstanding unsecured loans from individuals, while only 17% of entrepreneurs had unsecured loans from natural-person lenders. While we assume that owners do lend to businesses, our coders found no substantial evidence that the individual creditors listed were equity owners, so it appears that many or most of these creditors were third parties. We found that the corporate businesses had borrowed money from individuals in a substantially higher proportion than they had tapped banks on an unsecured basis. Presumably these are all voluntary relationships; the debtor's description of "loan" suggests a willingness to transact, even on an unsecured basis

In addition, a surprising number of debtors owed money to individuals in transactions that were not characterized as "loans." More than one in four business debtors—28.5 percent—owed money to an individual who was not identified other than

[72] *Id.* at 548, Table 12.

by name. It is possible, of course, that some of these individuals were tort claimants, employee, trade creditors, lenders or health care providers. The debtors provided no clues, except by negative inference—they listed no business name, no professional association, no title such as "Dr." These claims list a human being and what appears to be a home address, with little else. Whether these were based on negotiated or involuntary relationships, it is not possible to tell from the records. If we could cross-examine the debtors, we might discover that some of the debts owed to individuals rightly belong in one of the preceding categories, such as trade debt or tort debt, while others may be outright loans from individuals.

When we bring together these various categories, it turns out that nearly half—46.5 percent—of businesses in bankruptcy list one or more unsecured debts to individuals whose relationship to the debtor is either an employee, lender, or unspecified.[73] There are some overlaps, with some debtors owing individuals in more than one of these categories. The largest group is comprised of the undifferentiated obligations to individuals (28.5 percent), followed by the loans by individuals (21.3 percent), followed by obligations to employees (8.1 percent), followed by lawsuits filed by individual claimants (6.3 percent). With the limited amount of data available, it is not possible to assess either the sophistication or the circumstances that would permit these individuals to adjust rates or price as a function of differences in creditworthiness or varying schemes of distribution on dissolution. It is nonetheless intriguing to discover the high proportion of individuals who are listed as general unsecured creditors in bankruptcy, and it suggests a line of inquiry about another possible category of maladjusting creditors.

Summary

We have identified five categories of unsecured creditors that are candidates for being deemed maladjusting: tort claimants, utilities, taxing authorities, employees, and individuals. The number or kind of involuntary or reluctant creditors identified in these categories varies from case to case. Collectively, the number of cases in which creditors in at least one of the five categories are present in a Chapter 7 or Chapter 11 bankruptcy is about 79.5 percent of the business cases in the sample.[74] The final bar on Figure 2 brings those cases together.

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[73] Perhaps the most surprising finding is that when all the categories are combined, the data hint that corporations may be more likely to owe money to individuals than are human being debtors. We found that more than half of the corporate debtors (52.5 percent) and less than half of the individual debtors (42.7 percent) listed one or more claimed to individuals, but the difference is not statistically significant ($p = 0.055$). The difference approaches statistical significance; perhaps with a larger sample it would have reached the level of significance. We recognize that some of these loans in corporate cases may have been made by owners investing additional capital in the form of loans to their companies. In any case, the data strongly suggest that both corporations and human debtors are likely to owe money to human-being creditors when they file for bankruptcy.

[74] For this combined calculation, we use the most restrictive definition of tort claimant—only those three cases in which the debtor clearly identified the claim as one for a personal injury. If we used the least restrictive definition, including all possible lawsuits, the number of debtors with one of these claims would increase by only one debtor—a statistically insignificant change. The reason, of course, is that many of these debtors identify claims within more than one of the weakly-adjusting or non-adjusting categories. See discussion at CR *supra*.

We recognize that some of the creditors identified in these categories are only *candidates* for classification as maladjusting creditors; the information about them is too sketchy to permit a confident evaluation of their pre-bankruptcy readjustment capacities. Conversely, we have omitted whole categories of creditors who, on closer examination, might properly belong among the weakly adjusting creditors. Trade creditors are the single largest group of unsecured creditors listed in bankruptcy, and undoubtedly include substantial numbers of maladjusting creditors.

More generally, we recognize that we can demonstrate only that the role non-adjusting debt plays in the current bankruptcy system is substantial. Our data on this point are non-specific; we cannot quantify the number of non-adjusting or weakly adjusting creditors. But the data demonstrate the existence of a large set of creditors that is highly likely to contain a substantial subset of non-adjusting or weakly adjusting creditors. The effect is like using data to show that there are many trees in the forest that have no fruit. One might admit that some of them are just young trees that will grow fruit ultimately, but note that there are highly persuasive reasons to believe that many of the trees will remain fruitless. Therefore, while one might not be able to quantify precisely the number of non-fruit trees in the forest, one will have demonstrated that there are many of them. In the same way, the presence of so many creditors in the categories we have identified strongly suggests that any effort to move to a contract-determined bankruptcy system has a strong potential to redistribute wealth away from weakly adjusting or non-adjusting creditors and toward the creditors who can negotiate for better distributions.

We can further document the importance of maladjusting creditors in resolving outstanding claims against bankrupt businesses by reversing foreground and background. Financial creditors—that is, banks and other institutional lenders who offer everything from lines of credit to business credit cards—play a surprisingly modest role in the *unsecured* debt extended to troubled businesses. Our data show that half all business bankruptcy cases have *no* unsecured financial creditors at all.[75] Instead, trade creditors and other non-financial creditors absorb most of the unsecured losses listed in bankruptcy. Many of them are maladjusting.

Finally, the data in the second section of this article will demonstrate that there are a very large number of small claims in bankruptcy and those small claims are found in the great majority of cases. Necessarily, it is more difficult and costly to adjust price and other terms for small claims;[76] even if the claimants are themselves large companies (and often they will not be), the size of the claims will preclude efficient adjustment because of information and transaction costs. Therefore claimants with small claims will often be maladjusting as well.

[75] If we group unsecured bank debt, business loans, and credit card debt, the median case (that is, at least half the cases) has none of them. By a separate calculation, we found the average case has .6 bank and business-loan debts and less than 2 credit card debts.
[76] *See* Uneasy Case, *supra* note xx.

The presence of maladjusting creditors in so many bankruptcies strongly suggests that any efforts to move to a contract-determined bankruptcy system has the potential to redistribute wealth away from these creditors and toward the creditors who can negotiate for better distributions. The potential redistributive effects of a contracting-out system, and the resulting inefficiencies, disprove the first hypothesis we set out to test.

Transaction Cost Hypothesis: Number and Size of Claims

If a bankruptcy contract system is to be justified on efficiency grounds, the contracting process itself must not impose significant new costs on the parties. Thus we propose to test a second proposition:

> Hypothesis #2: A contracting out scheme is unlikely to impose transaction costs that are substantial enough to offset any gains in efficiency that may be derived from party autonomy because business bankruptcy cases will generally involve a relatively small number of claims and most of the claims will be large ones.

As noted earlier, the contractualist proposals are vague about how they would operate in the marketplace, but some points can be fairly inferred. Each of the proposals bows to the collective nature of the bankruptcy process by proposing a method by which one particular bankruptcy contract will be the operative one—binding all the creditors—following the debtor's default. One is through a scheme embedded in the debtor's financial structure through provisions in its debt instruments.[77] A second puts the bankruptcy contract in the debtor's articles, selected from a "menu"of permitted bankruptcy regimes.[78] A third makes the last bankruptcy contract negotiated before default binding on all.[79]

The first and third of these proposals seem open-ended: the controlling regime is subject to change whenever a new financing is arranged or a new bankruptcy contract negotiated.[80] The second is more stable, because it is more rigid and difficult to change.[81] These differences reflect a fundamental tension in contractualism. The open-ended approaches provide flexibility and a specifically negotiated solution among debtors and over time, while they also increase transaction costs and exacerbate the problem of notice. The more rigid approaches reduce costs and notice problems, but lose much of the claimed advantages of marketplace bargaining as compared to a fixed Congressional bankruptcy regime. Even within the menu system, concerns about change over time create difficult choices. Limiting the number of permitted choices represents a choice

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[77] *See* Bebchuk, New Approach, *supra* note xx; Adler, Solution, *supra* note xx.
[78] *See* Rasmussen, Menu, *supra* note xx.
[79] *See* Schwartz, Contract Theory, *supra* note xx.
[80] The first proposal might be either open-ended or rigid. If the financial structure of the company is subject to constant change by the issuance of new financial instruments, then it would be open-ended. If the structure were embedded in the articles of incorporation or enforceable covenants, then it might function much like the menu approach.
[81] Professor Rasmussen would permit a change in menu choice only with the consent of all creditors. *See* Rasmussen, Menu, *supra* note xx.

between reduced costs and reduced benefits: two choices are much less costly than ten in terms of negotiation and notice, but ten choices will capture much more of the claimed transactional benefits.

The key point for present purposes is that the tradeoffs become more painful the more creditors are involved. That is, transaction costs and notice difficulties increase dramatically if a large number of creditors must be the subject of negotiation or notice, while rigidity and one-size-fits-all become less efficient to the extent that a large number of creditors are being fitted to a procrustean bed. Thus any contractualist approach must rest upon the premise that only a relatively small number of creditors need be considered in weighing the efficiency of a bankruptcy-contract regime.

Here we examine the number of claims and the size of claims. We follow the intuition that transaction costs can overwhelm efficiency gains either if many negotiations are necessary or if many transactions are too small to support any individual negotiations. If the reality of credit extension and default consists of many parties and if many of the creditors have claims too small to justify *ex ante* negotiation, then the individual negotiations required by contractualism may be prohibitively expensive. They may consume all the claimed efficiency gains of privatization and then some. Further, any such scheme must have a method of picking one contract that will control if bankruptcy comes, which creates substantial information costs. If the solution to that problem is to adopt standard contracts, that solution greatly reduces the gains alleged to result from customized negotiations and imposes serious information costs on each transacting party. Thus the number and size of claims bears directly on the claims of efficiency gains made by the proponents of contractualism, regardless of the implementation approach suggested by the proponent.

In our data from over three thousand business bankruptcy cases, we found that in business bankruptcies there are many claims and a great many of those are small claims. Furthermore, although the number of claims per case varies widely across the sample, a substantial number of cases have a large number of claims, many of which are small in amount. Of course, many of these small claims are held by creditors who are unlikely to possess either the knowledge or power to negotiate individually in any meaningful sense--that is, held by maladjusting claimants, the point already discussed. Beyond that point, this second batch of data demonstrates that even where the holders of claims were in a position to negotiate, these claims are so numerous and so often small that it would be difficult or impossible to devise a scheme that would permit bargaining without also generating transaction costs far in excess of any likely benefit. The existence of many cases with many claims, many of which are small claims, makes the contractualist case highly problematic, both as to capacity and cost.

Many Claims

In our sub-sample of 386 cases, the total number of unsecured claims in the claims sub-sample, after excluding priority tax claims, was 7,959, of which 513 were listed for an unknown amount, leaving 7,446 that could be investigated as to size of claim.[82] That yields a mean of about 19 claims per case, close to what we found for the whole sample.[83] We have excluded tax priority claims for the purposes of this section,[84] because no contractualist has yet suggested that the IRS or the local tax district wants to negotiate a bankruptcy system with each taxpayer, so we ignore those claims for the purpose of determining the efficiency of private contracting for bankruptcy.

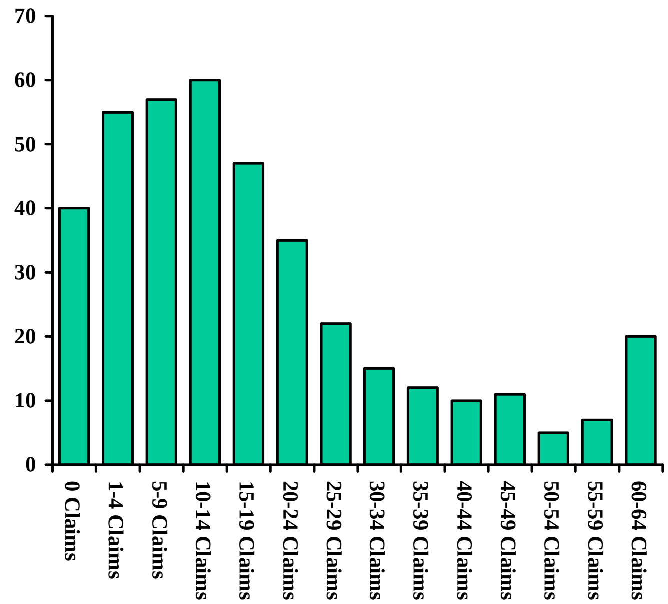

Figure 3: Number of Unsecured Claims Per Business Case
Source: Business Bankruptcy Project, Sub-Sample
N = 386

Figure 3 shows that many of the business cases have many claims. About 130 cases, roughly a third of the total, have 20 or more unsecured claims.[85] If we exclude the cases with no general unsecured claims, [86] the cases with 20 or more such claims are almost 40 percent of the total number of cases. One case, involving a ski equipment

[82] These claims are unsecured, except for judgment lien creditors, who are included because they began as unsecured creditors. *See supra* note 55. There were almost 9,000 secured claims in the sample.
[83] *See* Warren & Westbrook, *Financial Characteristics*, *supra* note xx, at 515. If we exclude the cases with no unsecured claims, we get an average number of unsecured claims of 21.5 per case. If we include claims of unknown amount, 7,959 in all, we get about 21 claims per case. If we include claims of unknown amount and exclude the 40 cases with no unsecured claims, the number of claims per case rises to 23. In our overall sample, we found an average of about 22 claims per case. *Id.*
[84] We did not exclude claims of reluctant creditors or non-tax priority creditors, identified in the first section of this article, because some may want to argue that utilities or employees, for example, are potentially negotiating creditors. We should note there are only 42 non-tax priority claims.
[85] If the reader should perceive an apparent anomaly between an average of 20 claims and only a third of the cases with 20 or more claims, it is explained by the difference between means and medians. The mean is pulled up by cases with substantially more claims.
[86] Forty of the sub-sample cases—10.3 percent—have no general unsecured claims at all. Except for one anomaly, they are cases with only secured and priority tax claims. CR to fn re them supra [now fn 12].

manufacturer, topped the sample at 255 unsecured claims. The distribution is captured in Figure 3.

These numbers identify *new* negotiations imposed on the parties in a contractualist regime. They would be added to the 9,000 secured claims, which would continue to be negotiated, but which would now have an additional new term to consider—the selection of a bankruptcy system to deal with a possible default, a problem far more complex than any normally addressed in a secured financing agreement.

We have trouble envisioning a debtor negotiating twenty or more contracts concerning the conduct of its possible future bankruptcy, or, as some proponents suggest,[87] negotiating and re-negotiating the bankruptcy regime twenty times as each new creditor signs on. The problem is compounded by the acknowledgment that this is merely the minimum number—the number of unsecured creditors who were still around at the time of the filing of the bankruptcy. There would presumably be a number of instances in which the debtor and creditor negotiated over the bankruptcy system to be implemented, only to conclude their relationship before the debtor filed.

Even with these high numbers, the costs might be kept under control if certain kinds of debtors were found consistently to have fewer claims. That is, the contractualist approach might be adopted for certain kinds of businesses even if it were inapplicable to all businesses. Including the zero-unsecured cases,[88] there are about 95 cases, about 25% of the sample, in which there are fewer than five unsecured claims. We speculated that these cases might fit into identifiable categories, such as certain industries or businesses in the corporate form, but so far we have not discovered a common thread among businesses that would permit *ex ante* identification of a business unlikely to have many unsecured claims.[89]

Small Claims

Small Claims Common Throughout

Understanding the size of the unsecured claims in business cases is an exercise in the differences between means (averages) and medians (middle numbers). The mean

[87] Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 Yale L. J. 343, 346-48, 359-60 (1999).
[88] There are about 40 zero-unsecured cases which list no unsecured claims at all. *See supra* note 26. In 45 cases there is at least one unsecured claim, but less than five.
[89] For example, we ascertained that these cases had greater secured debt, but the statistical analysis showed the differences in secured debt between these cases and those with more claims were not statistically significant. Using the face-sheet data about business type we find that real estate cases are more likely to have fewer claims and the relationship is statistically significant. This finding is suggestive, but the quality of the face sheet data raise doubt about whether it is substantively meaningful. Unfortunately, the face-sheet data are simply too unreliable to support a meaningful finding, so we will have to leave this interesting point for another paper. *See* Warren & Westbrook, *Financial Characteristics*, *supra* note xx, at 529. We probed to find a relationship between these cases and a number of other variables, but without success.

claim in the sub-sample was about $19,000, but that number reflects some truly enormous claims at the top. The median claim in the sub-sample was a far more modest $905. This means that half of all the unsecured claims listed in Chapter 7 and Chapter 11 business bankruptcy cases were for $905 or less.

Nearly four out of five of all the unsecured claims (79 percent) were for less than $5,000. Figure 4shows the total number of claims in the sub-sample divided into categories, under $500, $500 - $999, $1000-$499, $5,000 - $9,999 and $10,000 and over.[90] The average total number of unsecured claims per case is about 20; the average number of claims under $5,000 was about 15.[91]

[90] Although we excluded detailed coding of secured debt from this database, we note that the average secured debt in the sample as a whole was quite substantial, at $137,088. However, that number is inflated by huge claims. More than 2200 of the 8,954 of secured claims (about 27%) amounted to $5,000 or less and over six hundred (7%) were $1,000 or less. (We have excluded claims of unspecified amount.) Therefore, many secured debts may also present uneconomic subjects for negotiation of a bankruptcy system by contract, but we have not included them in our calculations.

[91] The median for the total number of unsecured claims per case was 13. We have 20 as the mean number of claims here, versus 19 earlier, because this computation includes the unknown claims that we excluded in computing the earlier number.

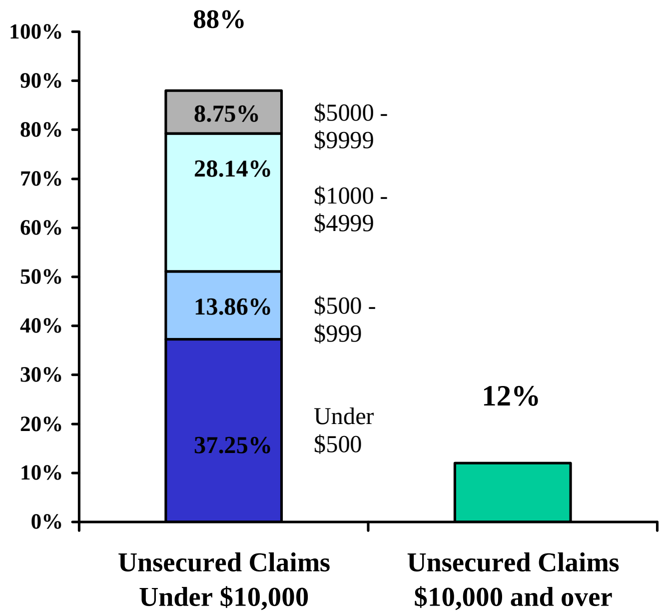

Figure 4: Distribution of Unsecured Claims by Dollar Amount
Source: Business Bankruptcy Project, Claims Sub-Sample
N = 386

At least as measured at the time of the bankruptcy, many of the claims are quite small. We recognize that the initial loan may have been larger, and that the amount listed in bankruptcy may simply be what is left after the debtor has made many payments. Of course, the facts may go the opposite way as well: A claim for $5,000 in bankruptcy may have involved a transaction for less money initially, but it is now pumped up with compounded interest, late fees and processing charges.

The profit margin in a $5,000 loan or sale varies from one transaction to another, but it seems hard to believe that any benefit from bargaining about bankruptcy, discounted by the improbability of bankruptcy measured at the time of contracting, would make it worthwhile to negotiate a different bankruptcy system where the amount at stake is less than $5,000. Using that as a breakpoint, about eighty percent of the claims in our sample would be too small to sustain a bankruptcy bargain. That seems even more certainly true for the 51 percent of the claims valued at less than $1,000. As to claims under $500, which constitute more than a third of all business bankruptcy claims (37%), negotiation seems almost a silly suggestion.[92]

Many Cases Have Many Small Claims

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[92] If we were to increase our denominator of total number of claims by including claims of undetermined amount, the percentages would change slightly, to 74%, 48%, and 35%, respectively. It seems to us more likely that the claims listed in an unknown amount would be small claims, thus increasing the percentage of small claims if the amounts were known, but we cannot know for sure. Because of that uncertainty, we have excluded claims of unknown amount unless indicated otherwise. There are 513 such claims, approximately 7% of the total number of claims.

Of course, in any statistical universe distribution can be as important as overall numbers. Are small claims found only in a small number of cases or are they typical of most of the cases? The answer we found is that small claims are found in most cases. More than two-thirds of the cases have one or more claims under $500. If anything under $5,000 is a small claim, 87 percent of the cases had one or more small claims. Furthermore, these are not cases with the odd small claim nestled among many large ones. Most of them are cases with a substantial number of small claims. Figure 5 illustrates the distribution.

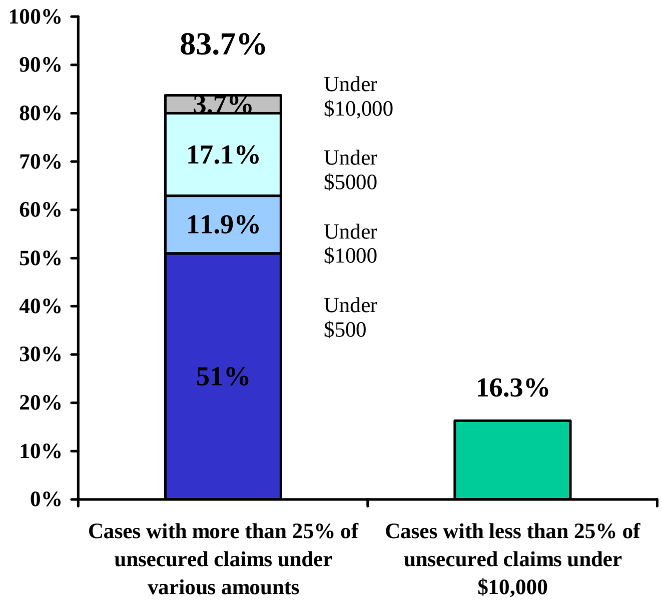

Figure 5: Proportion of Business Cases with Small Claims Constituting 25 or more of Unsecured Debt
Source: Business Bankruptcy Project, Claims Sub-Sample
N = 386

Figure 5 shows the distribution of claims at four levels, $500, $1,000, $5,000 and $10,000. This detailed analysis shows that claims ranging from tiny to small are found in substantial numbers in most cases; collectively, these claims make up a significant portion of all the claims in most of the cases. It shows the number of cases for which at least one-quarter of the claims are small claims, defining a small claim at each of those levels. For example, although a claim under $500 is tiny, such claims made up more than a quarter of the claims in a majority of the cases in the sub-sample.[93] That is, in most of the business cases in the sample, at least one out of four claims was for less than $500. The notion that each of those creditors should have negotiated a bankruptcy system as part of its contract may seem a bit farfetched.

If the definition of a small claim—a claim that is too small to be worth negotiating for a bankruptcy system—is raised to $5,000 level, the great majority of cases include a large proportion of small claims. In 80% of the sub-sample cases, claims under $5,000 constitute at least 25% of the claims.

Although it seemed fairly clear to us that a claim under $5,000 would not be worth the parties' time to negotiate a contract clause to determine the applicable bankruptcy system, there are no behavioral or cost data available to identify the point at which more detailed negotiation of low-probability events such as bankruptcy might begin to be plausible under at least some circumstances. We speculated that $10,000 might be such a point, so we performed some of the same tests at the $10,000 level. If $10,000 is defined as the ceiling for small claims, 85% of the cases had small claims and in those cases the small claims almost always make up more than 25% of all claims.[94] Using either $5,000 or $10,000 to define a small claim, overall the picture is clear: a minority of cases (15-17 percent) have no small unsecured claims at all, while the great majority of cases have a high percentage of small claims.

As to the businesses in bankruptcy that have no very small claims, we found that 67 cases, about 17 percent of the total, have no claims under $5,000 ("high-claim companies").[95] If $5,000 is a proxy for a point at which parties might begin to think about negotiating for a bankruptcy regime, this suggests that about one in every six companies who end up in bankruptcy might have been dealing exclusively with transactions that would support a negotiation for bankruptcy alternatives. Of course, that still leaves five out of six companies that had many claimants who were too small to support that expectation.

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[93] In about two-thirds of the cases, claims under $500 constituted more than 10% of the total number of claims in the case.

[94] Only 63 cases of 386 (15%) had no claims under $10,000. Almost all of the cases that did have a claim under $10,000 had a substantial proportion of such claims. In 98% of those cases with claims under $10,000, those claims constituted a quarter or more of the total number of such claims. (This figure comes from a separate calculation.)

[95] About 26% of the cases had no claims under $1,000 and less than a third (30%) had no claims under $500. Thus small claims were found throughout most of the sample.

Parallel to a point we made in the last section, it is not very helpful for transactional or policy purposes to know that there is a group of cases with fewer small claimants unless some characteristic of such cases can be identified *ex ante* that could be used to designate which case should receive special treatment or be subject to special rules. Once again, we attempted to discover if we could predict which companies would be "high-claim" companies. So far, we have been unsuccessful in finding any such characteristic. For example, it is plausible that "high-claim" companies might be disproportionately corporations rather than individual entrepreneurs.[96] The data, however, reveal no statistically significant difference regarding the presence of claims under $500 or $1,000 between business bankruptcies filed by humans and by corporations. At the $5,000 level, such claims remain widespread and important in the bankruptcies of both individual and corporate businesses, but a statistically significant difference emerges: claims under $5,000 constitute 64 percent of the number of claims made in corporate bankruptcies versus more than 75 percent of the unsecured claims listed in the bankruptcies of individuals. Although it might be intuitive that corporate debtors would have fewer small claimants than individual debtors, we were surprised to find that almost two-thirds of the claims in corporate bankruptcies are also quite small.

It is often the case that the simplest explanation is the right one. The "high-claim" debtors may just be businesses that paid most of their smaller bills before filing.[97]

Aside from the interesting high-claim puzzle, the central fact is the existence of many small claims widely distributed throughout the bankruptcy cases. That fact creates serious difficulties for the contractualist approach. As noted earlier, contractualism creates a tension between an open-ended approach that permits constant re-negotiation of the bankruptcy regime that will apply in case of debtor default and a more rigid approach that offers only a limited number of hard-to-change alternatives. In light of the reality of many claims, many of them small, the open-ended approach would impose extraordinary negotiation costs that would necessarily swamp any efficiencies it could generate. If this problem is solved by restricting access to only a limited number of permissible contracts, much of the benefit of private negotiation is lost. The menu approach begins by presupposing a small number of standard contracts, but faces the same difficult tradeoff: each additional contract increases information costs, but too few choices limit or eliminate the benefits of private bargaining.

In addition to negotiation costs, both approaches are also caught between the information costs generated by flexibility and the lost benefits of bargaining arising from a standard form. If a contractualist proposal offers many alternative bankruptcy regimes, it will be complicated and expensive for each new counterparty to determine which is the applicable regime and what its application would mean to that counterparty. If the

[96] We call legal entities "corporations" most of the time. They usually are corporations and "legal entity" is a semantic toad.

[97] We tried alternate hypotheses, to no avail. For example, one might imagine that small claims would be more common in cases with much unsecured debt, but perhaps more rarely found associated with debtors who have substantial secured debt. That is not true of our sample. We compared the percentage of small claims in a case at each level (percentage under $500, under $1,000, under $5,000) with the percentage of that case's total debt that was unsecured. There was no relationship even close to statistical significance.

scheme narrows to one standard-form bankruptcy regime, the result would be identical to the present system in imposing a standard set of rules for everyone, except the result would be adopted by some private "power" rather than Congress. It is hard to see an efficiency benefit there. Two forms would provide more flexibility, but information costs and negotiation costs would begin immediately to rise. Where there are many claims in bankruptcy, and many of them are small claims, it is hard to see how these problems could be easily resolved in a way that would produce a net gain in efficiency.

In the end, the two problems discussed in this article converge. If the only efficient way to deal with the many small claims in bankruptcy is to use a standard form or a limited range of forms, then many small claimants will be rendered non-adjusting even if they would not otherwise have been, because there will be no negotiations with them and higher information costs will often preclude their making an effective adjustment to the effects on them of the chosen bankruptcy regime. Most claimants will then be subject to whatever bankruptcy regime produces the largest payoff for negotiating creditors, payoffs that will often come at the expense of the rest of the creditors because of non-adjustment. For the reasons that the critics have presented, that result is likely to be inefficient. Our data demonstrates that the effect of the inefficiency will be widespread and substantial.

Conclusion: Why a Mandatory System of Bankruptcy is More Efficient and More Fair

Our data show that private bankruptcy systems would have the effect of shifting risks and costs to involuntary and weakly adjusting creditors in a substantial number of cases. Some creditors would never have any meaningful opportunity to negotiate for their place in line if the debtor defaulted, and others would be pressed by economic necessity into signing contracts containing boilerplate bankruptcy provisions that waived the rights otherwise afforded them in law. Even among parties of equal bargaining power, the need for standard forms will create substantial litigation and transaction costs, along with informational costs, and these added costs may swamp any supposed gains from bargained bankruptcy regimes. All this follows from the fact that the claimed efficiencies of contractualism pre-suppose negotiations among a relative handful of creditors.

These costs vividly contrast with the efficiencies of a mandatory system. Such a system is universal and highly predictable. Most commercial lawyers can give a good account of the likely fate of various transactional structures in case of bankruptcy and their clients can price their risks accordingly. Claims of great expense and delay in the current, mandated system as compared to other, similar business transitions have been subject to cogent empirical critique,[98] and recent evidence suggests that, at least in the big cases, costs are declining as parties become more effective users of the bankruptcy

[98] *See* Lubben, *Direct Costs*, *supra* note xx.. *See also*, Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 Journal of Finance 161 (March 1997). (transactions costs are smaller and there is less recurrence of financial distress when firms restructure in Chapter 11 rather than through out-of-court financial restructuring).

system. While many useful reforms might be proposed, it seems to us a bad idea to abandon the field to a contractual system likely to be closer to Rube Goldberg than Ronald Coase.

The proponents of contractualism have never explained how their systems would produce efficiencies, other than with reference to a general expectation that privately negotiated arrangements are always better than those imposed by law. Such a simplistic view ignores basic economic theory, including the problems of redistribution and high transaction costs. Because the efficiencies that would be gained by contractualism remain unspecified, it is difficult to net the substantial costs we have identified against those claimed efficiencies. It is not clear that anyone should take seriously the proposals for a private bankruptcy system until its proponents can show how their approach can overcome the costs identified through our empirical work and can demonstrate a likelihood that the claimed savings from their approach would produce superior results.