BANKRUPTCY LAW AND INEFFICIENT ENTITLEMENTS

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ABSTRACT

The question as to the justification of bankruptcy law remains unanswered. The literature tends to emphasize the conflict and inability to compromise between the different normative outlooks of the insolvency law system. A deeper reflection on the existing theories of bankruptcy law reveals, however, that all theories share the same starting point: All theories share the understanding that efficiency considerations justify the enforcement of contractual bankruptcy arrangements. When the social theories call for increased levels of coercion and redistribution, these theories rely on normative considerations of distributive justice and rehabilitation values. They by no means rely on efficiency grounds. This article presents a new theory of bankruptcy law that challenges this shared starting point. The article joins the economic analysis' focus on efficiency considerations. It calls for bankruptcy law rules that would maximize the aggregate value of the debtor's assets to his or her creditors and equity holders. Yet, the analysis shows that under particular circumstances, efficiency-based considerations can support the coercive avoidance of existing entitlements. Accordingly, I will argue that the role of bankruptcy law is to provide the procedural and substantive framework for severing the debtor's economic resources from his or her inefficient liabilities. Finally, the analysis shows how the new theoretical framework explains many of the positive legal arrangements of bankruptcy law. First, it explains why ***courts prefer reorganization*** plans over liquidation proceedings. Second, it explains the special priority that is afforded by the law to post-petition creditors. Finally, it explains the arrangements regarding ***executory contracts***.

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INTRODUCTION

The question as to the justification of bankruptcy law remains unanswered. The literature tends to emphasize the conflict and inability to compromise between the different normative outlooks of the insolvency law system.[1] In particular, the literature emphasizes the conflict between the economic perspectives that focus on the efforts to maximize the value paid to the creditors in the event of insolvency, and the social perspectives, which emphasize the social and rehabilitation value of the law. Naturally, the specific laws that derive from each of these perspectives differ greatly, while it appears that the compound that developed in the positive law over the years is a quasi-amalgam, lacking any clear preference towards any of the different approaches.

In particular, contemporary theories of bankruptcy law conflict on two main issues: First, the accurate ***level of justified coercion*** that should be involved in the bankruptcy proceedings; and second, the accurate level of ***justified intervention*** with prior entitlements. While contemporary economic analysis of bankruptcy law calls for contractual bankruptcy arrangements,[2] the social theories support a more interventionist regulation to protect the "weak" parties against the losses of

[1] For this ongoing debate, see O. Tene, Revisiting the Creditors Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations, 19 *Bank. Dev. J*. 287 (2003), and the references therein; C.W.Mooney, A Normative Theory of Bankruptcy Law: Bankruptcy as (is) Civil Procedure, *U of Penn, Inst for Law & Econ Research Paper* 03-27, (June, 2003), and the references therein; L. M. Lopucki**,** The Myth of the Residual Owner: An Empirical Study, *UCLA School of Law, Law & Econ Research Paper No*. 3-11 (April, 2003); M.E. Tracht, Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law, 82 *Cornell L. Rev*. 301 (1997); C. W. Frost, Bankruptcy Redistributive Policies and the Limits of the Judicial Process, 74 *N.C.L. Rev*. 75 (1995); J.L. Westbrook, The Control of Wealth in Bankruptcy, 82 *Tex. L. Rev*. 795 (2004).

[2] *See* A. Schwartz, A Contract Theory Approach to Business Bankruptcy, 107 *Yale L.J.* 1807, 1851 (1998) ("This Essay's central claim is captured in a variation on a trendy slogan: Privatize bankruptcy."); A. Schwartz, Bankruptcy Contracting Reviewed, 109 *Yale L.J.* 343, 343 (1999) ("If the rule against contracting for a preferred bankruptcy system were relaxed, parties would write bankruptcy contracts that would induce a borrowing firm to choose the system that would be optimal for it and its creditors were it to become insolvent."); B. Adler, B. Polak, and A. Schwartz, Regulating Consumer Bankruptcy: A Theoretical Inquiry, 29 *J. Legal Stud*. 585 (2000); R.K. Rasmussen, Resolving Transnational Insolvencies through Private Ordering, 98 *Mich. L. Rev*. 2252 (2002); D.G. Baird & R.K. Rasmussen, The End of Bankruptcy, 55 *Stan. L. Rev*. 751 (2002).

insolvency.[3] Thus, while economic analysis challenges the coercive interference of the bankruptcy courts with contractual arrangements made prior to the insolvency event, social theories support a legally enforced redistribution scheme in bankruptcy proceedings.

A deeper reflection on the existing theories of bankruptcy law reveals, however, that all theories share the same starting point: All theories share the understanding that efficiency considerations justify the enforcement of contractual bankruptcy arrangements. All theories presume that the protection of entitlements that were formed *ex ante* would maximize the aggregate efficiency. The enforcement of prior entitlements secures the efficient planning of credit transactions by solvent corporations. When the social theories call for increased levels of coercion and redistribution, these theories rely on normative considerations of distributive justice and rehabilitation values. They by no means rely on efficiency grounds.

The present article presents a new theory of bankruptcy law that challenges this shared starting point. The article joins the economic analysis' focus on efficiency considerations. It calls for bankruptcy law rules that would maximize the aggregate value of the debtor's assets to his or her creditors and equity holders. Yet, the analysis shows that under particular circumstances, efficiency-based considerations can support the coercive avoidance of existing entitlements. Under these particular circumstances, the existing entitlements drive the business into an inefficient use of its economic resources, which in turn leads to financial distress. Apparently, rational parties should then renegotiate their contracts, and reconstruct the company liabilities. However, I will point out several factors that may obstruct the renegotiation process

[3] *See* S. Block-Lieb, The Logic and Limits of Contract Bankruptcy, 2001 *U. Ill. L. Rev*. 503; S. Block-Lieb, The Politics of Privatizing Business Bankruptcy Law, 74 *Am. Bankr. L.J*. 77 (2000); C.J. Tabb, Of Contractarians and Bankruptcy Reform: A Skeptical View, 12 *Am. Bankr. Inst. L. Rev*. 259 (2004); R.B. Chapman, Missing Persons: Social Science and Accounting for Race, Gender, Class, and Marriage in Bankruptcy, 76 *Am. Bankr. L.J*. 347 (2002); E. Warren, *Bankruptcy Policy*, 54 *U.Chi.L.Rev.* 775 (1987); E. Warren & J. L. Westbrook, Financial Characteristics of Businesses in Bankruptcy, 73 *Am. Bankr. L.J*. 499 (1998); D. Korobkin, Bankruptcy Law, Ritual, and Performance, 103 *Colum.L.Rev.* 2124 (2003); D. Korobkin, Rehabilitating Values: A Jurisprudence of Bankruptcy, 91 *Colum.L.Rev.* 717 (1991); D. Korobkin, The Role of Normative Theory in Bankruptcy Debates, 82 *Iowa L. Rev*. 75 (1996).

and preclude the possibility of contractual settlement. When these cumulative conditions are satisfied, the coercive interference of the bankruptcy proceedings may become essential for shifting the company resources back to efficient business activity.

This argument will provide the framework for defining both the circumstances that should trigger the commencement of bankruptcy proceedings, and the role of bankruptcy law. In particular, the law must regulate the commencement of bankruptcy proceedings when the following three cumulative conditions are satisfied: First, the debtor's existing entitlements produce an inefficient use of economic resources; second, the debtor has failed in his or her attempt to reconstruct the existing liabilities; and third, the inefficient entitlements lead the debtor into financial distress. Then, in the absence of any legal intervention, the inefficient use of economic resources would have been perpetuated, whereas, the costs of inefficient activities would have been augmented over time. Some form of coercive interference is essential for shifting the economic resources back to efficient activity. Accordingly, I will argue that the role of bankruptcy law is to provide the procedural and substantive framework for severing the debtor's economic resources from his or her inefficient liabilities. Thus, bankruptcy proceedings inherently involve some level of coercion and redistribution.

Finally, I will show that the new theory can explain many of the positive legal arrangements of bankruptcy law. First, it explains why ***courts prefer reorganization*** plans over liquidation proceedings. Second, it explains the special priority that is afforded by the law to ***new investors***, who provide new financial resources to the bankrupt company. Finally, it provides the normative framework for the legal arrangement of ***executory contracts***.

PART I of the article presents the main conflicting views concerning the role and content of bankruptcy law. PART II of the article presents the efficiency-based justification for coercive avoidance of existing entitlements. PART III of the article explains how bankruptcy law leads to the severance of the debtor's assets from his or her contemporary liabilities. Finally, PART IV of the article discusses the concrete legal arrangements, and shows how positive arrangements reconcile with the above theory.

PART I: THE EXISTING LITERATURE

1. *Economic Goals vs. Social Goals*

The main conflict between the different approaches of bankruptcy law is the familiar one between the economic and social approaches to the law. The economic approach emphasizes the efficiency aims of the law, i.e., aims relating to ways to enlarge the "aggregate pie which is to be divided," whereas social approaches emphasize the policy considerationsappropriate to guide the law in deciding the distribution rules of "the aggregate pie" between the different individuals. In the context of bankruptcy law, the economic approaches emphasize the goal of enlarging the value of the bankrupt estate, while the social perspectives focus on the worthy distribution rules, which should govern the situation amongst the creditors.

In the context of the economic approach, it is correct to distinguish between the early economic approach of liquidation law and the later one. In 1986, Professor Jackson published his book *The Logic and Limits of Bankruptcy Law*, in which he presents the aims and limitations of bankruptcy law.[4] According to his thesis, the source of bankruptcy law is in the "common pool" problem and the prisoner's dilemma that it causes: In the case of insolvency, the company's assets are too few to sufficiently cover payment of the company's debts in their entirety. The law grants the creditors the right to confiscate the assets in order to pay back the debts; however, it is clear at the outset that there are not sufficient mutual reserves of company assets in order to pay back the debts in full. The consequence is that collection laws create an arbitrary method according to which, "the early bird catches the worm": The creditors who will reach the end of the collection process before the other creditors will succeed in getting their debts repaid in full, while the rest of them will be left empty-handed. The arbitrary method of "the early bird catches the worm" creates a quasi "race" of creditors towards the communal fund. However, this race diminishes from the comprehensive value of all the assets and minimizes the value of all the debts that will be paid from the communal reserves. In other words, in the case of insolvency, the ordinary collection laws create a situation in which every single one of the creditors acts in a fashion that is not beneficial for the common, collective interests of the

[4] R. Jackson, *The Logic and Limits of Bankruptcy Law* (1986); *See* also Baird & Jackson, *Cases, Problems and Materials on Bankruptcy*, (1985), at 31.

aggregate of creditors. Bankruptcy law attempts to solve this dilemma by pooling all creditors together, and by submitting them to collective proceedings. Later in the book, Professor Jackson delves into an in depth discussion on the contents of bankruptcy law, while trying to show that the existing set of laws does indeed match the idea of “the communal reserves.” Furthermore, the author claims that the aims of bankruptcy law must be limited to that of solving the prisoner’s dilemma, which is created as a result of the communal reserves phenomenon. This set of laws must not deviate from this goal, because were that to occur, the bankruptcy laws would produce inefficient outcomes.

Professor Jackson’s theory greatly influenced the development of the later literature. In particular, authors that support social insights of bankruptcy law emphasized the limited spectrum that the idea of “the communal reserves” places on this field of law, while stressing that bankruptcy law provides answers for a wide variety of problems.[5] Gradually, also those supporting the economic analysis joined in and began to voice criticism towards Professor Jackson’s theory. From these authors’ point of view, the idea of communal reserves is problematic, since it appears to provide justification for the massive interference of the law in the relationship amongst the creditors themselves, and between them and the shareholders. The modern economic approach states that when individuals are given sufficient freedom, they will design their own solutions in the event of possible insolvency, already at the early stage of entering the original contract.[6] Therefore, for example, creditors who are interested in securing their payment in a case of insolvency will make certain to get a security interest in the company’s assets. The security interest mechanism is a contractual, desired mechanism through which the creditors and the company bring to fruition their own desired solution, in the case of insolvency. Likewise, when the parties fail in their attempt to design this possible solution at the outset, then in retrospect, they will reach an agreement and settlement also without the law’s interference. When the creditors are faced once again with a company undergoing hardships, they have incentives to try to rehabilitate the company, and an effort to rehabilitate, which is based on the

5 *See* E. Warren, *Bankruptcy Policy, supra* note 3.

6 The most radical manifestation of this approach is found in D.G.Baird & R. Rasmussen, *The End of Bankruptcy*, *supra* note 2.

creditors' agreement to do so, is preferred over an effort to rehabilitate, which is forced upon the party by the legal system.

Professor Alan Schwartz calls this solution "Contractual Bankruptcy Law."[7] If this concept is indeed correct, then the dominant approach in bankruptcy law should be that of refraining from letting the law interfere in agreements, which had been established at the outset between the parties. The law must respect, as much as possible, the contracts which the parties have signed in regard to the provisions in case of insolvency.

It is worth noting that this approach does not especially oppose the alternative of reorganization. However, it does oppose the element of coercion that is involved in every legal solution forced upon the parties by the court. In other words, a redistribution of the claims which is reached as a result of an agreement amongst the creditors is preferred over a redistribution which is forced by the legal system.

The End of Bankruptcy[8] presents a contemporary variation of this approach that challenges the justification of reorganization proceedings. In this article, the authors Baird & Rasmussen claim that today these proceedings are barely used for the original purpose of "reviving failed businesses," and they actually serve the interests of the companies' owners, who wish to sell their businesses for more than they would have received had they sold the assets directly via the free market. Baird & Rasmussen claim that most reorganization proceedings end up in a sale of the "going concern" to a third party. The companies no longer undergo the regular reorganization process, where the going concern remains in the hands of the creditors and the original shareholders. Rather, the assets are sold to a willing buyer, and the original investors are rewarded financially for their holdings in the failed company. Additionally, in many cases, the bankruptcy court settles for enforcing the parties' pre-determined distribution of risks, as agreed by the parties *ex ante*, in preparation for the possibility of insolvency. Then, these proceedings lose their original character and become traditional proceedings of enforcing contracts. The element of coercion, which portrays the original bankruptcy proceedings, is gradually disappearing, in

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7 *See* Schwartz, *supra* note 2.

8 *See* Baird & Rasmussen, *supra* note 2.

favor of proceedings in which the court implements the conditions that the parties agreed upon at the outset in the event of insolvency.

The authors base the explanation of this phenomenon on the inconsistent character of the market at the beginning of the third millennium. In the past, the value of traditional reorganization proceedings was based on the existence of special sources of value which were owned by the insolvent company and which could not be transferred to a different body without creating losses (These sources of value are known as “Firm- Specific Assets”).[9] Given that the company does indeed have special sources of value, reorganization of the company is the preferable solution: In liquidation proceedings, the liquidator must sell the company’s assets, hence losing its special sources of value. When selling the company’s assets part by part, it is impossible to realize the special sources of value, since these cannot be transferred to any other body aside from the original company. Similarly, in the case of selling a company’s business as a “going concern,” the company will have to hand over the entirety of the company’s assets to the buyer, who in turn, will not be able to enjoy the company’s special sources of value. Only in the case of reorganization can the company continue to exploit its firm-specific sources of value, for the benefit of its creditors and shareholders.[10]

The traditional example of reorganization of bankrupt companies with firm-specific assets concerns the American railroad companies, which collapsed at the beginning of the previous century. These companies could not repay their outstanding debts, even though they had valuable assets, like train cars, railroad tracks, etc. Had the companies been forced to realize these assets, in any way, the value they would have received would have been substantially lower than the value of these assets within the framework of the railroad companies themselves. In this reality, the alternative of reorganization was the one most worthwhile for the creditors and the shareholders of those companies. Thus, their creditors supported an “equity receivership,” at which

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[9] For the notion of asset specific assets as the basis for incorporation, see R H. Coase, The Nature of the Firm, *ECONOMICA* 4 (1937).

[10] The theory of Coase relies on the existence of transaction costs. As the efficiency of the market improves, these costs lessen. Therefore, according to Baird & Rasmussen, as the market becomes more efficient, with lower transaction costs, there is no longer an economic justification for reorganization.

the railroad companies had been reorganized, already before the reorganization alternative was incorporated into the Bankruptcy Act.[11]

The main claim of *The End of Bankruptcy* is that this economic reality has changed, and today, the economic reality that is analogous to that of the railroad companies exists in only a very small number of companies. In the vast majority of cases, the failed companies do not hold any special sources of value which cannot be realized when sold to a third party. Baird & Rasmussen point out a number of metamorphoses that the economy has undergone over the past few decades, which led to the gradual nullification of the companies' firm-specific assets. They claim that especially in the current economic situation, the market is divided into "winning players" and "losing players," where the former succeed in taking control of the relevant market in its entirety, while the others gradually cease to exist. In a "winner takes it all" reality, the losing players no longer hold any special sources of value which cannot be realized by selling the company's business to the winning players.

Therefore, the need and justification for the existence of complex judicial proceedings in which the judge and the trustee seek a reorganization plan, which will enable the continued existence of the company and which will satisfy a large number of the creditors, is gradually dissipating. In the current reality, the legal system can make due with enforcing the contracts that were agreed upon between the parties at the outset, regarding the provisions in the event of insolvency.

The article, *The End of Bankruptcy,* aroused much criticism among those who specialize in economic analysis of the law. In particularly, the critics claim that Baird & Rasmussen develop their theoretical analysis on the basis of a factual description that is completely unrealistic.[12] Competing empirical research show that in most cases

[11] *See* D. Baird & R. Rasmussen, Control Rights, Priority Rights, and the Conceptual Foundation of Corporate Reorganizations, 87 *Va. L. Rev.* 921 (2001).

[12] The criticism about this radical article focuses on undermining the factual claim that today there is loss in realizing the company's assets by selling them to a third party. *See* L. LoPucky, The Nature of the Bankrupt Firm, A Response to Baird and Rasmussen's The End of Bankruptcy, 56 *Stan. L. Rev*. 645 (2003). The criticism points to a consistent rise in bankruptcy and reorganization proceedings. Likewise, it shows that many substantial proceedings are customized to coincide with the traditional procedure, which chapter 11 brought about. Finally, the criticism points to

of insolvency, the legal system continues to enforce arrangements that coincide with the classic model of reorganization, in such a way that the existing shareholders and creditors are the ones that receive possession of the company after it has been rehabilitated. Selling businesses to a third party remains the "exception," which exists only in the minority of the cases. Likewise, empirical research emphasize that Baird & Rasmussen's analysis is based on the assumption that "the company's assets" establish the main justification for its existence. Therefore, from the moment the assets can be realized by selling them to a third party without losses, Baird & Rasmussen claim that this is the preferable alternative both for the parties and for the court. However, in reality, "the company's assets" are not its main resource. In modern reality, "relationships" between the company and its clients, between the company and its suppliers, between the company and its human resources, are what constitute the main source of value, which justifies the existence of the legal entity. In every procedure involving selling assets to a third party, whether the sale is as a whole "going concern" or in parts, the relationships that the legal entity represented are lost, and hence the justification for preferring reorganization over selling the assets during liquidation. As such, the critics emphasize the large number of procedures in which the court is not satisfied with simply enforcing the contracts that were agreed upon between the parties.

Until now, I have focused on the criticisms voiced by those who specialize in economic analysis of the law. However, the social approaches regarding bankruptcy law oppose merely focusing on the economic aspect of the collective proceedings. Professor Korobkin's[13] opinion is that bankruptcy law aims to provide answers in regard to all aspects of the financial distress phenomenon, including its emotional, political-social, moral and economic aspects. Insolvency enhances the conflict of interests between the parties involved. Therefore, the law attempts to provide a forum where interests and values can be expressed, without having to choose one of them

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the companies' special sources of value today, and in doing so, singles out the special relationships that the company has cultivated with its clients, etc.

[13] *See* D. R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, *supra* note 3. For a later presentation of this approach, in the broader context of the place of theoretical analysis in bankruptcy literature, see D. R. Korobkin, *The Role of Normative Theory in Bankruptcy Debates*, *supra* note 3.

exclusively.[14] As Professor Warren[15] emphasizes, in contrast to the advocates of the economic approach, whose sole aim is to enlarge the value paid to the creditors in the event of insolvency, the advocates of the social approaches stress the numerous aims and values that form the basis of bankruptcy law.

Warren claims that the main aim of bankruptcy law is the distributive consideration: As the losses of the failed business have to be distributed anyway, the main question of the law is, how to distribute those losses? She claims that there are different kinds of values that must be taken into account when deciding the distribution scheme, and none of the values outweigh each other.

The criticism of the economic approach[16] emphasizes that it is wrong to expect that contractual solutions will reach better and more efficient results than the arrangements which are forced upon the parties by law. In this regard, the literature stresses three central considerations:

1. *Confusion between form and content:* From the point of view of the parties to the dispute, the main question is: What is the content of the applied arrangement, as opposed to its source, whether contract or law.
2. *Effect on third parties*: In the case of insolvency, every agreement between the debtor and one of his creditors affects the other creditors. The advocates of

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[14] Recently, Korobkin has broadened the approach that views bankruptcy proceedings as a "stage" for expressing the different conflicts of interest, which in light of the insolvency, cannot be bridged. In this analysis, Korobkin draws a comparison between the legal system and the performing arts and points out the importance of the judicial process as one which gives rise to the expression of different basic insights, which determine the society we live in. In this sense, bankruptcy law is an essential mechanism for dealing with loss and failure. *See* D. R. Korobkin, *Bankruptcy Law, Ritual and Performance*, *supra* note 3.

[15] *See* Warren, *supra* note 3. For Baird's response to Warren, see Baird, Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Warren, 54 *U.Chi.L.Rev*. 815 (1987). In a later work, Warren presents an empirical analysis which portrays the complexity of insolvency procedures and the impossibility of reaching a clear, one-dimensional conclusion as to the aims of the proceedings, *see* E. Warren & J. L. Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, *supra* note 3. Elsewhere, the author discusses her approach in the context of the reform that has recently taken place in the 9th article of the U.C.C. *See* E.Warren, Making Policy with Imperfect Information: The Article 9 Full Priority Debate, 82 *Cornell L. Rev*. 1373 (1997).

[16] S. Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, *supra* note 3.

bankruptcy law, who rely on settlement and contracts, disregard the effect of such contracts on the other creditors who were not parties to the contracts.

3. *Costs of the agreement*: The assumption that it is cheaper to agree upon a settlement and a solution rather than to utilize the legal mechanism is wrong, since also the contractual arrangement and its execution involve extremely substantial costs, which are higher than the cost of implementing the law.

2. Procedural Aims vs. Substantive Aims

An additional conflict that arises from the different approaches revolves around the issue of classifying these laws. According to one of the approaches, bankruptcy laws supply, first and foremost, a mechanism for collecting debts, and therefore, they belong in the field of procedural law.[17] According to the other view, bankruptcy laws seek to supply effective mechanisms for restoring the company's economic resources to lucrative business activity.[18] Among other things, reorganization law attempts to give a failed business another opportunity. In order to achieve such rehabilitative goals,[19] bankruptcy laws must completely reorganize all of the company's legal liabilities. In other words, bankruptcy laws are part of the fields of substantive law, which define and formulate individuals' rights, and do not solely provide the mechanism used to enforce these rights.

This dilemma between the procedural categorization and the substantive one of bankruptcy laws directly affects the contents of the law: Scholars who uphold the procedural classification will emphasize that the liquidation laws must avoid "redistributing" the layout of the essential rights. As any procedural mechanism, the liquidation laws must remain loyal to the rights that existed before the event of

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[17] For a radical expression of this approach, see C.W. Mooney, A Normative Theory of Bankruptcy Law: Bankruptcy as (is) Civil Procedure, (Research Paper 03-27, Institute for Law and Economics, University of Pennsylvania, August 2003).

[18] For an expression of this approach, see Korobkin, *supra* note 13.

[19] The judicial decisions recurrently emphasize the rehabilitation goals of bankruptcy proceedings. *See Miller v. United States*, 363 F.3d 999 (March, 2004);*In re Dicey*, 2004 BNH 15 (May, 2004); *Estate of Harris v. Dawley*, 312 B.R. 765 (April, 2004); *Mt. McKinley Ins. Co. v. Corning Inc.*, 2003 U.S. Dist. LEXIS 4295; *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston*, 299 B.R. 732 August, 2003).

insolvency, and limit themselves to enforcing these existing rights.[20] In contrast, scholars who advocate the substantive classification will emphasize the vital necessity in reorganizing the rights to the company's assets, in order to enable the realization of the substantive goals of the procedure. In particular, in order to enable the reorganization of the company, there must be no immediate enforcement of some of the original rights which existed before the event of insolvency.[21]

It is interesting to note that in the past, this dichotomy in regard to the classification of bankruptcy law was closely bound with the conflict between the economic and social approaches. The supporters of the economic view identified with the procedural classification, while the supporters of the social view were inclined towards the substantive classification of these laws. Therefore, it was the advocates of the economic analysis who so vehemently opposed the reorganization arrangement of the company, since every reorganization plan involves a certain degree of violation of prior entitlements, and of the priority rules that govern the distribution of the company's assets in liquidation proceedings.[22]

As such, for example, an essential pre-condition for the company to return to its lucrative activity is the minimization of its outstanding debt; however, the lessening of the burden of outstanding debt is only possible after a process in which some of the creditors waive their debts, in exchange for other rights in the rehabilitated company. In other words, reorganization plans involve the reconstruction of the company's capital structure, such that some of the creditors will have no choice but to exchange their loans or bonds for stock or options in the reorganized company, while the exchange alters the arrangement of the original, substantive rights the creditors had prior to the event of insolvency.[23] In a similar manner, the

[20] This is Jackson's view in his book. *See* Jackson, *supra* note 4.

[21] The most radical expression of stalling the enforcement of original rights is found in denying the secured creditors their right to immediately enforce their security interests. For the effect of reorganization on the rights of secured creditors to immediate foreclosure see infra para. 4.2.

[22] *See* L. Bebchuk, A New Approach to Corporate Reorganizations, 101 *Harv.L.Rev.* 775 (1988); L. Bebchuk & H.Chang, Bargaining and the Division of Value in Corporate Reorganization, 8 *J.L. Econ. & Org*. 253 (1992).

[23] This is the feasibility requirement. *See* 11 U.S.C.S. section 1129(a)(11). For application of the feasibility requirement, *see In re Wood*, 1991 U.S. Dist. LEXIS

reorganization proceeding affects the distribution of claims between the different creditors in the company, and between them and the shareholders. Even when the law requires that the reorganization plan satisfy the Absolute Priority Rule, reality shows that the reorganization proceeding involves a certain amount of "cramdown" of the senior debts, to the benefit of the junior creditors and to the benefit of the shareholders[24].

Today, the advocates of the economic approach distance themselves from the procedural classification of bankruptcy law. In particularly, in another article, Baird & Rasmussen[25] show how the Absolute Priority Rule, which dominates the priority orders in liquidation, is expected to produce inefficient results in the case of reorganization.[26] Since the managers of the company before the reorganization procedures are the shareholders' representatives or the shareholders themselves, the shareholders must receive a promise to get a "piece" in the rehabilitated company. Allocating a piece in the new company to the old shareholders is essential, in order to ensure that they will be motivated to act towards effectively rehabilitating the company. Furthermore, a necessary condition for reorganization is injecting new credit into a failed business. Baird & Rasmussen show that the shareholders of the

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20083; *In re Cheatham*, 91 B.R. 377 (1988); *In re Stapleton*, 55 B.R. 716 (1985); *Danny Thomas Props. II Ltd. Pshp. v. Beal Bank*, S.B.B., 241 F.3d 959 (2001); *Kane v. Johns-Manville Corp*., 843 F.2d 636 (1988); *In re Pikes Peak Water Co*., 779 F.2d 1456 (1985); *Berkeley Fed. Bank & Trust v. Sea Garden Motel & Apts. (In re Sea Garden Motel & Apts.),* 195 B.R. 294 (1996).

24 *See* Bebchuk & Chang, *supra* note 22, and the references therein.

25 Baird & Rasmussen, *supra* note 11.

26 It is interesting to note that these developments reflect the intellectual development of Professor Baird himself. At the beginning, Baird joined Jackson and developed the argument that there is no economic justification to reorganize companies since it is possible to realize the going concern value by selling the business to a third party in liquidation. In light of the redistributive effect involved in reorganization, Baird claimed that this proceeding must be avoided. *See* D. G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. Legal Stud. 127 (1986). At a later point in time, Baird joined Rasmussen in an article that advocated reorganizations and the avoidance of the absolute priority rule. *See* Baird & Jackson, *supra* note 4. Finally, the two embarked on an additional article that ostensibly seems to contradict the previous one, and argue that there is no longer any justification for the existent bankruptcy law. In this article, the authors emphasize that the railroads can no longer be used as the guiding example, since the circumstances of that case are substantially different from the circumstances that revolve around most of the cases of insolvency today. *See* Baird & Rasmussen, *supra* note 2.

company are the best candidates for investing more money in a failed business. In contrast to other investors, who fear the past failures of the company, the existing shareholders are aware of the company's potential value and therefore willing to provide the financial sources needed to rehabilitate the company. In order to motivate the shareholders to continue investing in the company, they must be partners to the increase of the company's value, which results from the reorganization, i.e., there must be a deviation from the absolute preference of the creditors over the shareholders.

3. Micro-Economic Aims vs. Macro-Economic Aims

Until now, we assumed that an event of insolvency is a specific event for the individual company, which affects only the creditors and shareholders of that company. In the past, events of insolvency were perceived as merely micro-economic phenomena, and the bankruptcy laws were perceived as part of the private law. However, over the passage of time, reality overturned this underlying assumption. The economic crisis of the 1920's showed that at times, a company can reach the point of insolvency due to macro-economic factors which affect the entire market, leaving the individual company without control over the situation. In a comprehensive situation of crisis, many companies will become insolvent, without any control over the situation.[27]

From the macro-economic point of view, there should be an attempt to reorganize failed businesses. According to the modern macro-economic approaches, the government and legal systems should interfere in times of depression. The authorities must take steps that will ultimately lead to the awakening of the economy and the

[27] Indeed, the Bankruptcy Act was enacted in 1939, after the economic crisis of 1929, and as a part of the New Deal. Thus, an example of this justification can be found in Congress's explanatory notes to the American Bankruptcy Act, where the aims of bankruptcy are presented as follows: "…protect the investing public, protect jobs, and help save troubled businesses." 124 Congress Rec. 33990 (October 5, 1978). These words teach us that the framers of the law took into consideration not only the interests of the immediate parties connected to the company, but also the interests of the general public, i.e., the comprehensive effect of the power that one of the creditors is expected to have in order to bring about the closure of the business. For the history of the Bankruptcy Act, see H.R. Miller & S.Y. Waisman, Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century? 78 *Am. Bankr. L.J*. 153 (2004).

solution to the crisis. Otherwise, the economic crisis could deepen, in a manner similar to a "snowball" effect, hence causing the downfall of the one company to lead to the downfall of many other businesses, and so forth.

The reorganization of failed companies is desirable, because it contributes to limiting the crisis, while liquidation is undesirable, since it encourages the "snowball."[28] When a company is liquidated, its assets are put on a quasi "public auction" on the market, and its employees are ejected outside of the workforce. As long as the insolvency phenomenon is specific, these occurrences have no macro-economic effect. However, when the market is in a crisis, many companies reach insolvency and liquidation simultaneously. Great numbers of assets are put up for sale and many employees are discharged from the workforce. The liquidation proceedings intensify the economic crisis: Realizing the assets contributes to the drop in the market prices of the economic resources, and the discharge of the employees from the workforce contributes to further minimizing the aggregate demand.

In contrast, reorganization contributes to moderating the economic crisis: The actual postponement in realizing the companies' assets and discharging the employees into the market in fact supplies the time necessary to recover from the crisis. Likewise, in the event that the reorganization attempt succeeds, and the company returns to lucrative business activity, the realization of the companies' assets is avoided and the employees remain in the workforce. Finally, when dealing with relatively large companies which have relatively large liabilities, settlements made with banks to delay due dates and to perfect terms of credit are multi-partied arrangements, in which not only the failing company's direct creditors take part, but also the creditors of the banks themselves. Thus, the chain effect in which the one company's insolvency leads many other companies into insolvency, and so forth, is avoided.

[28] This argument was first introduced by Miller & Waisman, *id*.. One may find some variations of this argument in R.B. Chapman, Missing Persons: Social Science and Accounting for Race, Gender, Class, and Marriage in Bankruptcy, supra note 3; *see also* M. Kelman, Could Lawyers Stop Recessions? Speculations on Law and Macroeconomics, 45 *Stan. L. Rev*. 1215 (1993); Macro-Economic Changes from Centralized to Market Economies: Big Bang v. Gradual Change: Big Bang and Decision Making: What Went Wrong, 13 *B.U. Int'l L.J.* 435 (1995).

PART II: INEFFICIENT ENTITLEMENTS AND LEGAL COERCION

1. General

The above discussion of conflicting views of bankruptcy law demonstrates how all of these views share the premise that efficiency considerations reconcile with the preservation and the enforcement of prior entitlements. Jackson's *Logic and Limits of Bankruptcy Law*[29] limits the interventionist effect of bankruptcy law to the resolution of the "common pool" problem. Schwartz's *Contractual Bankruptcy Law*[30] emphasizes the efficiency value of enforcing the pre-determined contracts regarding the allocation of insolvency risks. Baird & Rasmussen's *End of Bankruptcy*[31] highlights the decline of firm-specific assets as a justification for avoiding the redistributive effect of reorganization. While the social theories call for alternative solutions, they all rely on policy considerations that are not related to efficiency. Warren emphasizes the rehabilitating and distributive values of bankruptcy law.[32] Korobkin emphasizes the need to provide the parties who suffer the losses of insolvency the right to express their frustration in order to reach collective solutions.[33] Accordingly, the debate remains loyal to the traditional conflict between efficiency oriented laws and legal arrangements that aim at optimizing distributive justice.

This accepted starting point relies on two major normative considerations: First, the enforcement of contractual arrangements is necessary in order to enable efficient planning of credit transactions by solvent companies. When creditors *ex ante* expect that in case of insolvency, they will remain unpaid, they should increase their interest rate and/or subordinate the company to more restrictive covenants. Furthermore, any form of uncertainty that is involved in the expected results of bankruptcy proceedings is reflected in higher risks and higher costs of finance. Thus, *ex post* intervention of the bankruptcy courts with prior entitlements increases the cost of capital *ex ante*, to the detriment of solvent companies and their shareholders. To avoid this effect, the bankruptcy courts should refrain from coercive interference with existing entitlements, and settle for enforcing the pre-planned allocation of insolvency risks.

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29 Jackson, *supra* note 4.
30 Schwartz, *supra* note 2.
31 Baird & Rasmussen, *supra* note 2.
32 Warren, *supra* note 3.
33 Korobkin, *supra* note 3.

Second, when none of the parties can expect the court to alter the existing entitlements in his or her favor, they will be encouraged to manage an efficient process of renegotiation. Inefficient contracts and liabilities would be transformed upon the parties' better understanding of the relevant needs.

Nevertheless, any acquaintance with the practical reality of insolvency cases teaches that while the above policy considerations are powerful, they cannot fully exhaust the relevant efficiency-oriented considerations. In many cases, corporations reach financial distress because they had engaged in contracts and liabilities that drove the business into inefficient activities. These corporations file for reorganization after they already failed in their efforts to renegotiate their contracts with the company's creditors, e.g., lenders, employees, vendors and customers. In real world cases, companies do not go bankrupt when they reach insolvency, but rather, when they cannot acquire new financial resources to meet their current liabilities. They fail in their efforts to raise the new capital because of the existing inefficient entitlements: Every potential new investor expects that after the company would fulfill its current liabilities, no resources will remain to cover his or her new debt, or to provide him or her with positive returns on equity investment.[34] Under these conditions, bankruptcy law can never fully enforce the existing entitlements, and the above policy considerations cannot be fully upheld. Furthermore, even if some of the company's creditors have contracted *ex ante* for the allocation of insolvency risks, the full enforcement of these contracts in bankruptcy proceedings will usually decrease, rather than increase, the aggregate value to all other creditors.[35] In other words, some of the agreements between the company and its creditors for the allocation of insolvency risks may involve inefficient entitlements. Then, in order to shift the company assets back to lucrative activity, some contractual provisions must be avoided.

[34] In many cases, bankruptcy proceedings are essential for obtaining the necessary credit for maintaining the business activity. See infra para. 4.2.

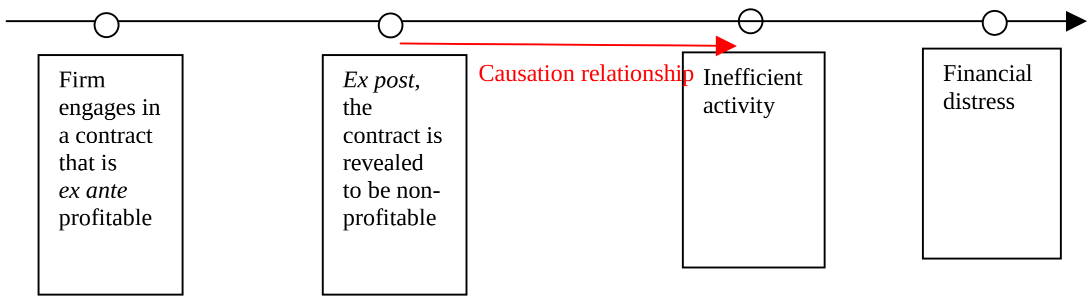
[35] For example, secured creditors *ex ante* contract for immediate foreclosure upon the commencement of bankruptcy proceedings. Nevertheless, an immediate sale of assets may obstruct the survival of the going concern. If the going concern value is higher than the assets' value, then the full enforcement of the rights of secured creditors would decrease the aggregate value of the bankrupt estate. Accordingly, Section 362 of the Bankruptcy Act subordinates the secured creditors to the automatic stay. See 11 USC Section 362.

The more challenging task is to translate this sad reality into a theoretical framework of bankruptcy law. For this purpose, one must inquire into the sources of inefficient entitlements and into the reasons for the failure of the renegotiation process.

2. The Meaning and Sources of Inefficient Entitlements

Inefficient entitlements are ones that drive the company into sub-optimal actions, i.e., actions that reduce the aggregate value of the corporation below its optimal value, and which the company would not have undertaken unless it previously provided one or more of its shareholders or creditors with the prior entitlement. This means that inefficient entitlements are characterized by two elements: First, their yielding ***future sub-optimal activity***; and second, a ***causation relationship*** between the entitlement and the future activity (**FIGURE No. 1** presents this chain of events on the time-axis).

FIGURE No. 1: The Chain of Events on the Time-Axis



How can a contract at some earlier time-point, t_0, yield a sub-optimal activity at some later time-point, t_n? The answer to this question stems from the gap between the expected profitability of the contract, *ex ante*, and its actual profitability, *ex post*, and from the impact of the non-profitable contract on the future activities of the company. When the company enters into the initial contract, it expects this contract to be profitable. The company measures the expected profitability of the contract by its expected returns, i.e., it relies on a probability analysis of all possible factors, which may affect profitability. For example, when the company employs a new employee, it expects that his or her contribution to the company's value will exceed the costs of employment. When the expected contribution is unknown, the company estimates the contract's value by using the expectation function. The company estimates the probability distribution over all possible scenarios, and then sums up the products of the probability values multiplied by the expected cash flow under each of the probable events.

Then, *ex post*, only one of the expected scenarios turns into reality. By definition, the real contribution of the contract would usually be different from the expected value.[36] If the real contribution of the contract is substantially lower than the expected value – the contract may be revealed to be non-profitable. For example, if the employee's contribution is significantly lower than the expected one, then the employment of this particular employee is non-profitable.[37] A contract may also be revealed to be non-profitable due to macro-economic events. For example, in the context of employment, the boom of the hi-tech industry towards the end of the last century led to a dramatic increase in the average salary of software developers. Then, alongside the collapse of this industry during 2002, the average salary dropped dramatically. As a result, companies that hired developers in 1999 and in 2000, found themselves bound by sub-optimal contracts in 2002.[38]

Apparently, the non-profitable contract only involves distributive effects. For example, in the context of employment, it appears that the negative returns of the company stand against the abnormal positive returns of the employees, such that the aggregate efficiency remains unchanged. Deeper reflection reveals, however, that

36 The following simplistic example clarifies this point: Assume that a company employs a sales agent to market new products. The employment contract is made under uncertainty, both as to the actual demand for the new product, and as to the capability of the sales agent. For simplicity assume that the expectation value is calculated according to the following possible scenarios: 1. under the first scenario, both the demand for the product and the agent are favorable. Then, the firm would earn from this agent's sales a value of 10; 2. Under the second scenario, either the agent or the demand are less favorable, and therefore, the firm would earn only 5; 3. Finally, under the last scenario, the actual demand is much lower than expected, and therefore, the firm's value from the sales is reduced to zero. If all scenarios are equally probable, then, the expected value is 5. The firm would be willing to pay the agent a salary of 2. Now, if the third scenario is the one that materializes, then, the contract is revealed to be non-profitable.

37 Indeed, the parties may contract against the pessimistic events, but as will become apparent in the following discussion, any form of defense measure against the risks of sub-optimal contracts is inherently incomplete and involves costs.

38 While these firms could theoretically dismiss these employees, the termination of employment contracts involves tremendous costs.

non-profitable contracts may drive the company into inefficient activities. For example, the excessive employment costs may drive the company to reduce its investment in new technologies or in new products. Because this company continually competes against other similar companies over potential investors, it must retain a competitive level of net returns. Thus, if the company engages in too high costs of human capital, it must reduce its other costs.[39] In the long run, the sub-optimal investment may result in sub-optimal returns.

In sum, non-profitable contracts lead to sub-optimal activities because they influence the subsequent decisions of the company and because they may distort the incentives of the company incumbents to maximize the aggregate returns.[40] The following examples demonstrate concrete cases of inefficient entitlements:

a. ***Unreasonable burden of debt***: At times the company is led, either by choice or otherwise, into a situation in which its burden of debt is incredibly high. The high leverage ratio is likely to lead to inefficient activity, since the company is acting under immediate pressures to pay its outstanding debt.

b. ***Substantial alterations in interest rates***: The economy-wide factor of interest rates affects the company. Interest rates change from time to time, while affecting the advantageousness of the company's existing loans. In the event that the interest rate drops substantially below the interest rates of the company's loans, the cost of the company's credit becomes "excessively expensive." The company is forced to pay higher interest rates than it could have attained through a current credit

[39] Otherwise, the company will not be able to compete with other players over new investments.

[40] Indeed, the law does not support the possibility of adapting a contract to new events and realities. Contract law states that a mistake as to the profitability of a contract will not justify the nullification of the contract. *See Louisiana Power & Light Co. v. Allegheny Ludlum Industries,* 517 F. Supp. 1319 (1981); *Wooldridge v. Exxon Corp*., 473 A.2d 1254 (1984); *L-J, Inc. v. South Carolina State Highway Dep't*, 270 S.C. 413 (1978); *Hill v. A.O. Smith Corp.,* 801 F.2d 217 (1986). All of these cases rely on the doctrine requiring that the mistake refer to past or present facts, which already exist at the time the contract is made. A mistake cannot refer to erroneous predictions of the parties concerning future facts.

transaction. High credit costs are likely to lessen the company's competitive power in the market. The company will be forced to sell its products at higher prices than its competitors, or be satisfied with smaller profits. In any event, minimizing the profitability is expected to lessen the shareholders' incentives to continue investing in the company.

c. ***Gradual growth over time, beyond expected, in the total value of required investments:*** Despite the attempts of the company's captains to foresee and correctly estimate the costs of development, production and operation at the outset, reality can sometimes surprise them. In many cases, these costs will be higher than expected. Then, the company will be bound to enlarge its fixed liabilities beyond the pre-planned value. Higher costs are likely to cause inefficient utilization of the company's assets: The company's management is likely to be swayed by its interest to minimize those costs, even at the price of deviating from the original operation plan. In other cases, the heightened costs could lead to the company needing to raise additional capital, under less comfortable conditions than the original ones, etc.

d. ***Development of inefficient control:*** Corporate control is determined according to the holdings of its share-capital. The guiding principle places the control in the hands of the shareholder who holds more than 50% of the company's shares. In many cases this principle can lead the company into an inefficient control. Thus, for example, the controlling group may be comprised of a number of shareholders who suffer from major disagreements and coordination problems. Another example is the struggle for power among the founders of a start-up company and its investors, which is likely to lead to inefficient decisions. In general, the collective action problems may thwart the efficient management of the assets.

e. ***Substantial alterations in the supply and demand for the business's workers:*** An additional factor related to the efficient operation of the company is that of employment contracts. The employment conditions are decided upon with each employee according to the conditions of the relevant job market at the beginning of the employment. As a result, substantial changes in the relevant job market are expected to affect profitability and efficiency. Thus, for example, should the customary employment conditions of the market deteriorate, after the employment of some of the workers, and assuming that the company is bound to the original salary agreements, the company will be in a position in which the costs of its workforce are substantially higher than the same costs of competitor companies. Naturally, the company will seek to be released from its current employment contracts, however it will not always succeed in doing so. Crucial workers in the company will tend to insist on the continuance of their original employment conditions. Likewise, in the event that the workers are organized, the task of altering the employment conditions will be made more difficult.

f. ***Substantial negative deviation from the expected income of the company and its income in actual fact:*** An additional source of inefficiency in operating the company's assets is related to the demand for the company's products. Long-term changes may lower the demand for the company products: Novel technologies annul the demand for old technologies. Changes in the course of business activity revoke the need for certain products and services, and create demand for new products and services. The passing of generations and changes in consumption habits cancel certain products and create demand for new products.

In some cases, the company will succeed in adapting its production channels to the dynamic reality, and will succeed in retaining efficient activity. In other cases, the company will not be successful. In these cases, efficiency dictates the release of the assets from the existing arrangement of liabilities, whether by selling the assets piecemeal, so that every buyer makes different use of them; or by selling the assets as a "going concern" to a buyer who will be able to make the necessary adjustments in the company's products. Nevertheless, incumbents may object this sale for personal reasons that are not associated with efficiency considerations.

g. ***Macro-economic changes in the economy's situation***: Finally, macro-economic changes are expected to affect the advantageousness of the existing activity in the company. The salient example of this in the Israeli economy is that of tourism, which was severely harmed as a result of the outbreak of the second Intifada, and has not yet recovered. Most probably, many investors would never have invested in this field had they been able to foresee these developments.

On a higher level of abstraction, inefficient entitlements may emerge from one or more of the following three potential sources:

a. ***Non-profitable Contracts***: The major source of financial distress concerns the sub-optimal conditions of the company's liabilities. A too high leverage ratio, or, sub-optimal employment contract, or, sub-optimal interest rates are examples of this possibility. Under these conditions, the sub-optimal contracts deter potential investors, because these investors expect that after the company would comply with its current liabilities, there would be no value left for the new investors (hereinafter, ***the First Source of inefficiency***).

b. ***Inefficient control***: The second possibility is that problems in the company's management or its control are preventing it from lucrative activity (hereinafter, ***the Second Source of inefficiency***).

c. ***The lack of potential cash-flow***: Finally, it is also possible that changes in the times and customs are what led to the decrease in the demand for the company's products, or that the price of manufacturing these items rose drastically, hence diminishing the stream of income (hereinafter, ***the Third Source of inefficiency***).

Fixed liabilities, by their nature, endanger the efficient activity of the company, since they limit its ability to adjust to dynamic business reality. The contents of the fixed liabilities are designed on the basis of information that is in the hands of the parties at the time of their creation; however, a reality different from what the parties originally expected may be revealed when actually executing the commitment. The gap between the parties' expectations at the time of the creation of the fixed liabilities and the business reality that is exposed at the point of their execution, may turn the existing arrangement of liabilities into non-profitable ones. The lack of profitability may lead the company to new decisions and actions, which reduce the long-run aggregate value of the company.

Therefore, if it were possible, companies would completely avoid entering into fixed liabilities, and they would offer all of its parties some share in the aggregate proceeds. In actual fact, avoiding fixed liabilities is impossible, and is not necessarily the most efficient choice for the company. Firstly, there are contracting parties who would not agree to residual consideration. Amongst these are banks, the company's employees,[41] its suppliers,[42] and consumers.[43] Even if these investors would agree to stipulations that would make the company's liabilities towards them more flexible, these stipulations would remain marginal without changing the comprehensive character of the contract. The company is therefore forced to bind itself in a fixed commitment upfront, whether it likes it or not. Secondly, a residual claim against the company's assets is usually related to the investor's power to influence decision making in the company.[44] Thus, for example, it is the shareholders who appoint the company's directors and managers, and control the decision-making. Other investors as well will tend to condition the flexibility of the contract with them on their power to affect the

[41] The vast majority of the employees would like to receive a fixed salary that is independent of the business' returns.

[42] Suppliers would usually require fixed prices that are independent of the company's returns.

[43] Consumers would expect the company to demand some fixed price for its product. While the prices may change over time, they by no means depend on the corporation's returns.

[44] For the connection between residual claims and corporate control, see H. Hansmann, **The Ownership of Enterprise**, (1996); H. Hansmann & R. Kraakman, The Essential Role of Organizational Law, 110 *Yale L.J.* 387 (2000).

decision making in the company. Broadening the number of residual claims entails broadening the number of individuals who take part in the decision-making process of the company. This broadening is likely to lead the company into stagnation and the inability to operate.

In other words, every form of contracting with the company may lead to an arrangement of claims that will thwart the efficient operation of the company's assets: Fixed claims threaten to limit the company's flexibility and ability to adjust itself to dynamic business reality; residual claims, like stock, threaten to create an inefficient arrangement of decision-making in the company. Throughout its activity, the company attempts to balance between its possible types of inefficiency and vary the kinds of claims made against the company. The company balances between collecting capital through loans and collecting capital through issuing shares; likewise, the company can include stipulations in its contracts with the different claimants, thus making the contracts more flexible to change in the dynamic reality. However, this attempt to balance between the different types of inefficiency does not always succeed in leading to the efficient management of the company's assets. Whether due to the lack of choice, a case of misjudgment, or as a result of unforeseeable events, the company may be led into a situation in which it will be bound by inefficient contracts. In such a case, releasing the assets from the existing arrangement of liabilities is vital in order to bring the assets back to lucrative activity.

3. The Failure of the Renegotiation Process

When an inefficient arrangement of liabilities against the company is formed, the problem can be solved in one of two ways: The first option is that the parties reach new contracts that nullify the original ones. Then, with a degree of commercial flexibility ("give and take"), the parties will succeed in returning the assets to sound activity without involving the courts. The second option is that changing the existing arrangement of liabilities will be done either by the reorganization or by the liquidation proceedings. Then, the court will enjoin the parties to make the changes necessary to bring the assets back to sound activity.

The discussion in the following paragraphs shows how agreed solutions to inefficiency are preferred over solutions that are forced upon the parties by the court.

Therefore, the discussion will show that reorganization or liquidation should become relevant alternatives only after the parties failed to solve the inefficiency independently, through redesigning their mutual contracts.[45]

There are many reasons why the efficient solution cannot always be reached through agreement: In some cases, coordination and cooperation difficulties arise. All of the claimants in the company are expected to enjoy an improvement in the existing arrangement of liabilities against the company; however, naturally, every investor prefers that the other investors will be those affected by the changes. Thus, for example, a lender of the company will prefer to continue to receive the interest that was agreed upon in the loan contract, also when the contractual rate is higher than the market's, by way of expecting that the company's other creditors will agree to minimize their claims upon the company. Thus, also when the company is in need of new sources of funding, every shareholder will prefer that the other shareholders will continue to invest further resources in the company, in order to enable it to continue to operate. Finally, if new employment contracts are necessary for the change, every worker will prefer that the company's other workers will be those that will be subjected to the alteration in their employment conditions, while he remains employed in the company according to the original employment conditions.

When the company's assets are led into inefficient activity, the conflicts of interest between the creditors and the shareholders intensify. Inefficiency causes losses, and these are passed on to either the shareholders or the creditors. The party that is harmed from the inefficiency will ask to alter the existing arrangement of liabilities, while the unharmed party will insist on retaining the status quo. Indeed, it will usually be the shareholders who will ask to change the existing arrangement of liabilities, in order to encourage the return of the assets to sound activity. Thus, for example, when the inefficiency is caused by excessively high salaries, the controlling shareholders will

[45] Under particular circumstances, the debtor's effort to renegotiate his liabilities is considered to be a pre-requirement for establishing good faith. See *East v. Educ. Credit Mgmt. Corp. (In re East),* 270 B.R. 485 (October, 2001) (Discussing the duty of former students to make an effort to renegotiate their student loans, before they file for bankruptcy); *Tenn. Student Assistance Corp. v. Mort (In re Mort),* 272 B.R. 181 (January, 2002); *In re Conner*, 89 B.R. 744 (august, 1988); *Stern v. Educ. Res. Inst. Inc. (In re Stern),* 288 B.R. 36 (December, 2002); *East v. Educ. Credit Mgmt. Corp. (In re East),* 270 B.R. 485 (October, 2001).

try to hold an additional round of bargaining in an attempt to lessen the value of the comprehensive liabilities towards the workers. Naturally, the workers will try to reject the controlling shareholders' claim, and they will succeed in doing so according to the degree of dependency that the company has on the workers' identities and according to the degree of the workers organization. As long as the company's workers succeed in preventing alterations to the employment conditions, they are likely to drag the company's assets into inefficient activity, dictated by the workers' interests and not according to the aggregated efficiency test.

In exceptional cases, it will be the company's creditors who will ask to change the existing arrangement of liabilities, and the shareholders who will refuse to cooperate with them. This situation may occur when the company takes out an additional loan from a later creditor, thus diluting the rights of the earlier creditors.[46] When the comprehensive burden of loans creates substantial dangers of insolvency, the earlier creditors will ask that the company direct its efforts to minimizing the credit burden. In these cases, the shareholders may refuse to cooperate with the earlier creditors, since they benefit from the later credit, despite its inefficiency.

4. Financial Distress

Inefficient liabilities threaten to lead the company to financial distress: on the one hand, they reduce the company's returns, and thereby, increase the company's needs for new funding; and on the other hand, they reduce the incentives of new investors to provide the company with new financial resources. As a result, after a while, the inefficient liabilities may lead to a situation where the company lacks the necessary finance to meet its current debts.

[46] For the problem of creditors' dilution, *see* Clifford W. Smith, Jr., & Jerold B. Warner, On Financial Contracting: An Analysis of Bond Covenants, 7. *J. Fin. Econ*. 117 (1979). *See also* G.G. Triantis & R.J. Daniels, The Role of Debt in Interactive Corporate Governance, 83 *Calif. L. Rev*. 1073 (1995); R.C. Picker, Security Interests, Misbehavior, and Common Pools, 59 *U. Chi. L. Rev*. 645 (1992); R.E.Scott, A Relational Theory of Secured Financing, 86 Colum. L. Rev. 901 (1986); A Schwarts, Priority Contracts and Priority in Bankruptcy, 82 Cornell L. Rev. 1396 (1997); H.B. Shadab, Interpreting Indentures: How Disequilibrium Economics and Financial Asset Specifically Support Narrow Interpretation, 75 S. *Cal. L. Rev*763 (2002).

This means that the renegotiation process with prior creditors takes place, when the company is under a time pressure. If the company fails to renegotiate its contracts before it reaches financial distress, it would be in default towards some of its creditors. The time pressure reduces the negotiating power of the company: Usually, the parties who are more pressured to complete the negotiation would agree to less favorable terms. In other words, the threat of financial distress reduces the practical capability of the company to complete the necessary renegotiation processes in order to shift the company's assets back to lucrative activity.

5. The Justification of Coercive Interference with Existing Entitlements

When the company engages in inefficient entitlements, these entitlements burden the lucrative business activity. Efficiency requires that the assets be severed from these entitlements, in order to shift the assets back to efficient activity.[47] If this solution cannot be maintained by negotiation and contract, there must exist some procedure for enforcing this solution on the parties. Otherwise, the perpetuated inefficiencies would increase the losses incurred by the inefficient entitlements.

PART III. THE ROLE AND CONTENT OF BANKRUPTCY LAW

1.General

We can now present the conditions for the commencement of bankruptcy, and the role of bankruptcy law: Our main claim is that ***when the following three accumulative conditions are fulfilled, there is a justification for severing the company's assets from the existing arrangement of liabilities. The aim of collective collection proceedings is to bring about this essential severance, whether by way of reorganization or by way of liquidation, in order to reinstate the company's lucrative business activity.***

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[47] The reader may wonder how do we distinguish between "assets" and "entitlements"? In the legal context, the two concepts seem to overlap, because the one party's contractual entitlement against some other contractual party may be a part of his or her assets, and vice versa. In the economic context, the two concepts are separate: Assets exist in the world, in disregard of their distribution to human beings. Thus, one may identify these "assets" by exploring into their existence, in a world where all human rights and possessions had disappeared. If the asset in question would have continued to survive, in the absence of human rights and possessions, then, it is an asset, and not merely an entitlement. If, on the other hand, the asset in question would have disappeared, together with all human rights and possessions, then, it merely reflects an entitlement.

The three accumulative conditions are:

a. The existing arrangement of liabilities leads to inefficient exploitation of the company's resources.
b. The inefficiency cannot be solved through agreement.
c. Financial distress.

Before I discuss this claim, a preliminary question must be addressed: The question is, why is a collective collection proceeding necessary in order to change the existing arrangement of liabilities, when the parties fail to reach the necessary change through agreement? In other words, why are we not able to change the existing arrangement of liabilities without new contracts and without liquidation or reorganization proceedings? The answer to this question is found in the guiding principle of contract law which states that "a mistake as to the profitability of the transaction cannot be regarded as a mutual mistake that justifies non-performance."[48]

In regard to the substance of our main claim, it is sufficient that one of the three conditions mentioned above is not fulfilled in order for there not to be a justification for entering into collective collection proceedings:[49] Firstly, as long as the arrangement of liabilities is efficient, there is no justification to change it. Both considerations regarding efficiency and those regarding autonomy of the individuals justify the continuance of the existence of the arrangement of liabilities. Secondly, as long as the parties can solve the inefficiency through an agreement, there is no reason to enter into the collective proceeding: The agreed solution is better since it is expected to be more efficient and it also manifests the parties' desire. The agreed solution is more efficient since it encompasses lower costs than the collective proceeding. In addition, the parties will be able to design the new arrangement of liabilities better than any other external body would have been able to do so. The agreed solution goes hand in hand with the parties' autonomy, since it does not involve the element of coercion that characterizes the collective proceeding.

48 *See supra* text accompanying note 40.
49 In other words, the three conditions are essential.

Finally, the condition of financial distress is vital, since it correctly outlines the amount of time allocated to the company's captains, in order for them to attempt to find a solution to the inefficiency problem by themselves. According to the agreements drawn up by the parties at the outset, the control of the company is given to the shareholders and their representatives. Among other things, their powers consist of the ability to change the existing arrangement of liabilities, if such a change is deemed necessary; they have the power to conduct negotiations with each and every one of the company's investors to change the conditions of the existing contracts. As long as the company is successful in paying its debts on time, there is no need for the court or any of the creditors to intervene. The financial distress, however, indicates the company's captains' failure to reach an agreed solution, thus constituting the point from which the company's creditors will be the ones that will have to bear the costs of the failure to reach an agreed solution. Therefore, it is the suitable milestone from which the responsibility for changing the existing arrangement of rights is transferred from the controlling shareholders to the court and the trustee.

The existence of the three conditions is sufficient in order to justify the opening of collective collection proceedings: Firstly, the combination of the inefficiency with the financial distress justifies the change of the existing arrangement of liabilities, in order to return the assets to lucrative business activity. The financial distress leads the company into a state in which it cannot implement its arrangement of liabilities, as it was agreed upon at the outset. Any attempt to continue the company's activity without change will involve violating some of the original liabilities. The existing arrangement of liabilities will change anyway, since the company will breach some of its liabilities. At this point, redesigning the existing arrangement of liabilities through a collective normative system is preferable over doing so through the coincidental factual progression, which will develop as a result of the creditors' desperate attempts to collect their debts. Secondly, in light of the failed attempt to reach an agreed solution without a collective proceeding, the element of coercion becomes inevitable: The first possibility is that the trustee would force the parties to release the assets from the existing arrangement of liabilities; or, that the circumstances of the factual progression that will develop will bring about a forced change on part of the creditors' rights, since the company will not be able to pay all of its liabilities on time. Most probably, the arranged and guided solution of the court involves more appropriate coercion and less arbitration than the coercion that will develop as a result of the absence of a collective proceeding. Finally, in order to reinstate efficient use of the company assets, it is essential that the changes in existing entitlements will be managed by a third party, e.g., the trustee, and not by the company controlling shareholders or by some of the creditors. Otherwise, the transformation of existing entitlements would be tuned to the interests of particular investors and not to the aggregate efficiency.[50]

2. The Essence of Collective Collection Proceedings

The collective collection proceedings release the company's assets from the existing arrangement of liabilities, in order to return the assets to lucrative business activity. The liquidation or reorganization proceedings are expected to include one or more of the following ways to transform the existing arrangement of rights:[51]

a. *Changing the structure of the commitments:* The one option is that the discharge from prior entitlements will focus on the left side of the company's balance sheet. The company's business will continue operating normally, so that the company will continue to be a going concern, however the collective proceedings will lead to a reorganization of the claims against the company. Therefore, for example, in the event that the company reaches insolvency due to its leverage ratio, the capital structure will have to be reorganized in such a way that some of the fixed liabilities will be replaced by share equity. For this purpose, through the collective proceedings, some of the debts will be erased, and some of the creditors will receive preferred or

[50] Indeed, Baird & Rasmussen have shown that a critical phase of the collective proceedings concerns the shift of control from the shareholders' representatives to the trustee. See Baird & Rasmussen, *supra* note 11. See also *Henderson v. Casciato-Northrup*, 2001 U.S. Dist. LEXIS 23637; *Correll v. Equifax Check Servs.*, 234 B.R. 8, 1997 (September, 1997); *In re Harris*, 200 B.R. 745, (September, 1996); *In re Gray*, 28 B.R. 348 (March, 1983); *McRoberts v. Associates Commer. Corp. (In re Derickson)*, 226 B.R. 879, (October, 1998); *First Bank & Trust v. Gross (In re Reid)*, 179 B.R. 504 (February, 1995).

[51] These changes are depicted in Warren's article, *see* Warren, *supra* note 3, at 785-86. Although the author presents bankruptcy law as a procedural proceeding for collecting debts that constitutes an alternative to the State's individual collection proceeding, she points out that bankruptcy law changes the existing arrangement of rights. The court emphasized in particularly the change that the existing arrangement of rights undergoes with the entrance into collective collection proceedings.

common stock, instead of the original claims of debt. The creditors can be compensated for the increased risk involved in the shares, as opposed to the loans, by a number of shares that reflects the higher comprehensive nominal value.[52]

Additional changes in the structure of the capital are likely to be manifested through altering the interest rates, so that the existing creditors will agree to receive lower returns on their investments; or, in collecting new credit during the collective proceedings, so that old loans will be paid and exchanged with new loans. Finally, changes in the employment contracts with the company's workers will also be classified as a part of this category.

b. *Changing the structure of control:* Upon the company's entrance into liquidation or reorganization proceedings, the control of the company's assets is transferred from the shareholders' representatives to the creditors. After the beginning of the collective proceedings, the structure of control of the assets will never return to what it was while the company was a going concern: If the company reaches liquidation, then its assets will be transferred to the ownership and control of other businesses; and if the company reaches reorganization proceedings, the original shareholders will be left with a lower value, so that they will not be able to activate the original control they possessed in the company's assets.[53]

c. *Realizing the assets:* The most drastic form of severance of the company's assets from its prior liabilities will occur when the company's assets will be realized and sold to third parties. Selling the assets causes a change in the existing arrangement of liabilities against

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52 Apparently, this is the essence of reorganization, as opposed to liquidation. A deeper reflection reveals, however, that the transformation of current commitments may be accomplished by liquidation as well. Therefore, at this stage, the analysis remains general, and does not refer to reorganization or to liquidation. Para. 4.1. below discusses the distinction between liquidation and reorganization.

53 *See supra* note 11.

> those assets, since it severs the link that existed before the liquidation, between the assets and the company's shareholders and creditors; in the place of this original link, a new ownership relationship between the buyer and the company's assets will emerge. When the company's assets are sold as a "going concern," all of the assets are transferred to the ownership of a single buyer. When the sale is done "piecemeal," each one of the company's assets is distributed to a different buyer. In any event, the original ownership link is severed.

The collective proceedings are expected to include one or more of these categories: In reorganization, the claims against the company, as well as the structure of control in the company, are altered in order to enable the return of the assets to lucrative activity. In liquidation, the assets are transferred from the company to the buyer, so the company's original investors no longer own them. Obviously, any severance from the original arrangement includes a change in substantive rights.

The type and level of severance of the company's assets from its initial entitlements should be adapted to the sources of inefficiencies. The basic guideline is that we want to minimize the impediment of existing entitlements, and therefore, no unnecessary type of severance should occur. For example, if the company reaches financial distress only because of its leverage ratio, it should undergo reorganization proceedings, at which a feasible capital structure would be restored. However, there is no justification for selling the assets to third parties.[54] Similarly, if the source of failure is rooted in the company's control, incumbents must be replaced. However, this shift of control should not lead to any alteration of the debt liabilities nor should the company be sold to third parties.

PART IV: CONCRETE ARRANGMENTS OF BANKRUPTCY LAW

1. The Choice between Reorganization and Liquidation

Until now, I have discussed the conditions under which there is a normative justification to sever the company's assets from the arrangement of liabilities that was created in relation to those assets. The following question is related to choosing the correct way to

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54 *See* infra para. 4.1.

release the assets from the existing rights. First, should the default procedure be the one of reorganization or rather the one of liquidation? Second, what should be the guiding policy considerations for selecting one of the two options, liquidation or reorganization?

Positive law does not mandate an explicit examination of the choice between reorganization and liquidation by the bankruptcy court. Initially, the person who files the petition for commencement also determines the choice between the two proceedings.[55] In particular, the debtor may file a petition for commencement, together with a reorganization plan. Then, the Bankruptcy Act provides the debtor with a period of 100-180 days[56] to lead the plan to confirmation. Once the proceedings begin, the collection procedures are stayed, and the debtor has a chance to reorganize the business. This statutory arrangement implicitly inclines towards reorganization: Because the debtor or the shareholders of the bankrupt firm would usually prefer reorganization, they would usually precede their creditors, and file the petition for commencement. Once they succeed to stay the collection proceedings for 100-180 days, they also gain a strong negotiation position that facilitates the enforcement of reorganization on all of the other creditors.[57] Indeed, the sources of inefficiency that have led the firm into financial distress are addressed by the trustee and by the bankruptcy court when dealing with particular bankruptcy law issues, like the feasibility of capital structure, or, the adequate protection of secured creditors.[58] Nevertheless, the bankruptcy court is not required to condition the choice of procedure, i.e., the choice between reorganization and liquidation, on an inquiry into the sources of inefficiencies. As a result, many firms undergo reorganization proceedings, even though, they suffer from the third type of inefficient entitlements, and their assets should have been sold to third parties.[59]

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[55] Although, a short while after commencement, the fate of the reorganization effort would be determined by the capability of the trustee to obtain new credit in order to cover the ongoing expenses of the going concern. See, infra para. 4.2.

[56] This period may be extended. See 11 USC Section 1101. Additionally, section 362 of the Bankruptcy Acts stays the foreclosure of security interests for nine months.

[57] Bebchuk & Chang, *supra* note 22.

[58] *See* infra para. 4.2.

[59] *See* Lynn M. LoPucki, The Debtor in Full Control -- Systems Failure Under Chapter 11 of the Bankruptcy Code?, 57 *Am. Bankr. L.J.* 99 (1983).

Traditional law and economics, on the other hand, supports liquidation, and recurrently claims against reorganization:[60] In 1981, Professor Baird presented the *Uneasy Case of Corporate Reorganizations*.[61] In this essay, Baird presented the possibility of selling the bankrupt going-concern to a third party in liquidation proceedings as a justification for reformulating the choice between the two options. Traditionally, corporate liquidations were associated with selling the corporate assets piecemeal, whereas, corporate reorganizations were associated with maintaining the going concern. Accordingly, reorganizations were considered the accurate choice, when the value of the going concern was higher than the value of the assets, when sold in parts. Nevertheless, as Baird indicated, if the going concern can be sold in liquidation proceedings, then, its excess value cannot be deemed sufficient to support reorganization. On the contrary, because reorganizations involve the allocation of new claims against the unknown value of the reorganized firm, they inherently involve some form of redistribution and avoidance of existing entitlements. Thus, liquidations always remain more efficient than reorganizations: They succeed in providing the same aggregate value, but without violating prior entitlements. Baird suggested to perceive reorganizations as hypothetical sales of the company's assets to their initial investors. Only when the initial investors are willing to invest the highest value in the corporate business, should the company undergo reorganization proceedings.

Bebchuk & Chang[62] pointed at the bargaining power of the shareholders in reorganization proceedings, as a result of their power to stay the collection proceedings for at least nine months. Facing the nine months delay, senior creditors would be forced to surrender portions of their initial entitlements. Accordingly, Bebchuk & Chang suggested a legal arrangement that would allow the parties to opt-out, *ex ante*, of the reorganization option.

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[60] Reorganizations involve tremendous costs. *See* S.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 (2000); Stephen J. Lubben, Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory, 106 *Dick. L. Rev*. 267 (2001); K.A. Kordana & E.A. Posner, A Positive Theory of Chapter 11, 74 *N.Y.U.L. Rev* 161 (1999).

[61] Baird, *supra* note 26.

[62] Bebchuk & Chang, *supra* note 22.

Finally, the recent *End of Bankruptcy Law*[63] points to the practical transformation of reorganization proceedings. In this essay, Baird & Rasmussen claim that contemporary reorganizations no longer involve the rehabilitation of failed businesses, but rather they become a source of opportunity for the shareholders to sell their business to a third party for a better price. Baird & Rasmussen suggest that because the initial justification of reorganizations no longer holds, bankruptcy law should settle for enforcing the pre-formed contracts.

The present theory does not support the positive law's implicit inclination towards reorganization, nor does it follow the law and economics' preference of liquidation. The new theory calls for a legal arrangement that would mandate a preliminary hearing, at which the bankruptcy court would be assigned the discretion to select the accurate proceedings for the particular case. This judicial hearing would save the costs involved in futile reorganization efforts, and would secure the correspondence between the judicial proceedings and the sources of inefficient entitlements.

For example, while the legal system may help in solving the first and second sources of inefficiency, it cannot solve the third one. Reconstruction of current liabilities, avoidance of burdensome contracts, and change of control may be inflicted by the court. However, the legal system cannot affect in any way the demand for the corporation's products, or, the costs of production. Accordingly, the third source of inefficiency can be resolved only by liquidation.

The remaining question concerns the legal choice between reorganization and liquidation in bankruptcy cases that emerge from the first and second sources of inefficiency. In these cases, the traditional law and economics calls for liquidation proceedings in order to avoid the redistribution effects of reorganization: As Baird indicated, the efficient business activity can be restored by liquidation proceedings at which the going concern would be sold to a third party.

The present theory challenges this argument, and calls for a more refined choice between the two types of procedures. The following discussion establishes this

63 Baird & Rasmussen, *supra* note 2.

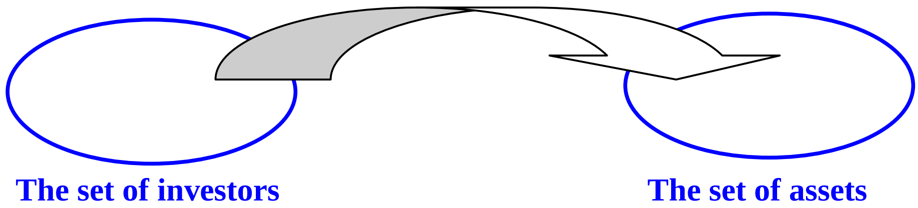
argument in two stages: First, I will show that it is incorrect to assume that reorganizations involve a more far-reaching avoidance of existing entitlements. The analysis will show that both types of procedures yield the severance of the bankrupt estate from pre-petition entitlements. Second, I will show that the degree of coercive interference with existing entitlements changes from one case to another. Indeed, in some of the cases, reorganizations would yield a more severe impact on existing entitlements. Nevertheless, in other cases, reorganizations would better preserve the initial scheme of distribution.

To understand this point, one must note that the pre-petition arrangement of liabilities involves two types of relationships:

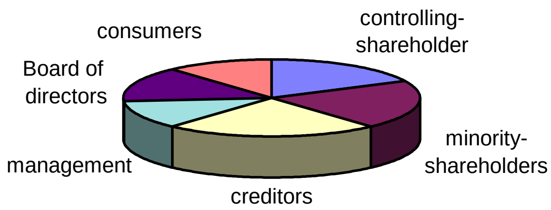
a. *The relationships between the assets and the contracting parties:* Pre-petition entitlements entail legal relationships between the company's sub-set of assets and its shareholders and creditors. For example, existing entitlements provide the shareholder who holds over 50% of the company shares the right to control its assets. Similarly, existing entitlements entail the identity and authority of each of the company's employees, thereby, entailing the actions that each employee would perform on behalf of the company. These actions affect the assets and their value. Finally, the company's property interest in its assets excludes other potential holders from having any proprietary rights in those resources.
b. *The relationships between the contracting parties themselves:* The existing entitlements also entail a distributive scheme between the company's investors themselves. For example, traditional priority orders entail that the shareholders hold the residual claim against the company's assets. This implies that the creditors are entitled to be paid in full before the shareholders gain any positive value. Similarly, the law states that secured creditors are entitled to be paid in full before the unsecured creditors recover any positive value, etc (see: FIGURE No. 2).

FIGURE No. 2: Two Types of Relationships

2.a. The First Type of Relationships: Existing entitlements yield a function from the set of the company investors to its set of assets:



2.b. The Second Type of Relationships: Existing entitlements yield a distribution scheme among the company investors:



Liquidations involve a more far-reaching avoidance of the first type of relationships: In reorganizations, at least some of the initial investors would continue to hold claims against the company assets. The corporation's shareholders and bondholders would hold new securities against the reorganized company; portions of the company employees would continue to work for the reorganized firm; and suppliers and dealers would continue to work with the company. In liquidations, on the other hand, these relationships are totally terminated, as the assets are sold to a third party.[64]

Reorganizations involve a more far-reaching intervention with the second type of relationships, i.e., the relationships between the company investors themselves. Because reorganizations violate the absolute priority rule, they yield a redistribution of the initial claims against the company's assets.

64 For the emphasis on firm specific relationships as a justification for reorganization, *see* Lynn M. LoPucki, The Nature of the Bankrupt Firm, *supra* note 12. From this viewpoint, the perception of reorganization as a "hypothetical sale" of the corporation's assets to their initial owners is flawed: This perception assumes that the assets were already fully detached from their owners, and then, turns to explore the adequate way to sell the detached assets to the highest bidder. It is dubious, however, why should the assets be detached from their initial investors and owners in the first place.

The level of interference with existing entitlements changes from one case to another. In some cases, liquidations would be more interventionist than reorganizations, and vice versa. Therefore, in selecting between the two options, the court must employ its discretion, and adapt the decision to the particular circumstances of the case. In particular, the following policy considerations must be taken into account:

a. ***The source of inefficient entitlements:*** The judicial examination must begin by an inquiry into the sources of inefficient entitlements. When dealing with the third source of inefficiency, the court must order liquidation. Otherwise, the court must turn to apply the following policy considerations.

b. ***The feasibility of acquisition by a third party:*** The abstract law and economics presumes that the trustee would always be able to find a third party buyer for the corporation's assets or for the going concern. Nevertheless, this presumption does not always hold. In many concrete cases, there is no potential buyer who is willing to pay a reasonable price for the bankrupt business. Then, the only option for maintaining the going concern value would be reorganization. Therefore, when considering the choice between liquidation and reorganization, the trustee must seek potential buyers. To the extent that if the trustee finds a third party buyer, the court should order liquidation. Otherwise, the two possible solutions (reorganization and a sale to a third party) must be advanced simultaneously. The option that can be realized in the shortest period of time should be selected.

c. ***The uncertainty involved in the reorganization plan:*** While all reorganizations involve some level of deviation from the absolute priority rule, the degree of avoidance of existing entitlements changes from one case to another. Accordingly, in considering a reorganization plan, the court must take into account the level of uncertainty that is involved with the estimated value of the going concern after reorganization. The more uncertain the outcomes of the reorganization plan are, the less favorable this option becomes. High risks should be deemed sufficient for dismissing a reorganization plan.

d. ***The level of cooperation by the shareholders and management:*** Because reorganizations can succeed only upon the full cooperation of existing management and shareholders, their willingness to invest further human and financial resources in the reorganization plan should be taken into account.

e. ***The feasibility of new credit in reorganization:*** The discussion below demonstrates that the realistic chances of the reorganization plan are best measured by the willingness of new investors to provide the company with new finance during the reorganization proceedings. Accordingly, the feasibility of new financial resources should also guide the court in selecting between reorganization and liquidation.

f. ***The proportionality test:*** Finally, if none of the above tests fully determines the judicial choice of procedure, the court must turn to apply some flexible balancing test. The court must balance the costs of inefficiencies that would result from terminating the relationships between the company investors and its assets in liquidation, against the costs of inefficiencies that would result from the violation of the absolute priority rule. The results of this balancing test would change from one case to another.

2. Obtaining New Credit in Reorganizations[65]

The company commences the bankruptcy proceedings due to financial distress: Its shareholders and management can no longer attract new investment, and therefore, the company fails in its effort to obtain the necessary funding for its current activity. When the bankruptcy proceedings begin, the trustee must find ways to acquire new credit for the bankrupt business. On many occasions, the capability of the trustee to obtain new credit determines the practical feasibility of reorganization. Bankruptcy law facilitates the acquisition of new credit by enabling the trustee to provide the new investor with a senior position: The trustee can provide the new creditor with the preferential position of "administrative costs," or provide the creditor a lien on the property of the estate.[66] As long as the new credit is obtained in the ordinary course of

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65 N.L. Georgakopoulos, **New Value, Fresh Start,** *Stanford Journal of Law, Business, and Finance*, Vol. 3, No. 1, Winter 1996.

66 11 USC Section 364.

business, the trustee is authorized to act without judicial approval. When the acquisition of the new credit is beyond the ordinary course of business, the trustee must precede the transaction by turning to the bankruptcy court for approval.[67]

The judicial interpretation of section 364 developed two tests to determine whether the credit is obtained in the "ordinary course of business":[68]

> … the first test is the creditor's expectation, or the ***vertical test***. It asks whether a reasonable creditor would view the transaction as deviating from the debtor's normal day-to-day operations… The counterpart is the ***horizontal test***, which compares the debtor's business with other like businesses to determine whether the disputed transaction is ordinary for the particular type of business concerned...

The bankruptcy courts decline to approve the preferential position of the new creditor retroactively, when the new credit exceeds the ordinary course of business,[69] unless the court finds that the retroactive order will further the purposes of the Bankruptcy Code without unfairly prejudicing parties-in-interest.[70]

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[67] *See* 11 USC 364(b).

[68] *In re Blessing Indus*., 263 B.R. 268 (Bankr. D. Iowa, April 5, 2001). See also, *Rajala v. Langer* 259 B.R. 728 (D. Kan., February 27, 2001); *In re Ockerlund Constr. Co*., 308 B.R. 325 (Bankr. D. Ill., April 7, 2004); *In re Atlanta Retail*, 287 B.R. 849 (Bankr. D. Ga., December 17, 2002); *Moore v. Brewer*, 259 B.R. 440 (Bankr. D. Ga., September 18, 2000); *Albany Port Dist. Comm'n v. Cibro Petroleum Prods*., 2004 U.S. Dist. LEXIS 17260 (D.N.Y., August 27, 2004); *In re Dornier Aviation*, 2002 Bankr. LEXIS 1653 (Bankr. D. Va., December 18, 2002); *Dobin v. Presidential Fin. Corp*., 304 B.R. 681 (Bankr. D.N.J., February 18, 2004); *In re Husting Land & Dev., Inc*., 274 B.R. 906, 2002 U.S. Dist. LEXIS 4092 (D. Utah, January 30, 2002).

[69] *Rajala v. Langer* 259 B.R. 728 (D. Kan., February 27, 2001).

[70] For the doctrine of the nunc pro tunc relief see *In re Hillard Dev. Corp*., 2004 Bankr. LEXIS 931 (Bankr. D. Fla., April 16, 2004); *In re Lehigh Valley Prof'l Sports Clubs, Inc*., 260 B.R. 745, 2001 Bankr. LEXIS 300 (Bankr. D. Pa., March 28, 2001); *In re Ockerlund Constr. Co*., 308 B.R. 325, (Bankr. D. Ill., April 7, 2004); *Schwartz v. Aquatic Dev. Group, Inc*., 352 F.3d 671, (2d Cir., December 17, 2003); *Farinash v. Vergos*, 264 B.R. 485, (D. Tenn., July 20, 2001); *In re Searcy*, 313 B.R. 439 (Bankr. D. Ark., August 23, 2004); *In re Fleming Cos.*, 305 B.R. 389 (Bankr. D. Del., January 29, 2004); *United States v. AAPC, Inc*., 277 B.R. 785 (Bankr. D. Utah, March 15, 2002).

The preferential position of post-petition creditors manifests the role of bankruptcy law: As long as the company is active, it is required to fulfill its liabilities in their entirety. Every new creditor who agrees to transfer new credit to the company does so as an aggregate to the existing debts. The new creditor knows that the company will be required to pay both its new debt and its other debts to preceding creditors. At a certain point, new potential creditors will fear the possibility that the company's income will not suffice to pay the liabilities towards them and towards the creditors who preceded them; potential investors in the company's shares will fear that the existent burden of debts will drain the company's income, thus leaving no remaining source of value for the shareholders.

The commencement of bankruptcy severs the debtor's assets from his or her pre-petition liabilities, and thereby, enables the trustee to use the bankrupt's assets in order to secure the repayment of post-petition credit. Once the business can obtain the necessary financial resources, it can return to lucrative activity. Indeed, the trustee's powers to obtain new credit and to provide the new creditor with priority over pre-petition ones are not unlimited. The trustee may obtain the new credit only when the new financial resources are essential for increasing the value of the estate, i.e., when the attainment of new financial resources is supported by efficiency considerations.

The power of the trustee to provide the post-petition creditors with a preferential position highlights the conflict between pre-petition and post-petition creditors: While the post-petition creditor would insist on acquiring some form of seniority, pre-petition creditors may oppose the new credit transaction because it diminishes the value left for the repayment of their debts. Section 364 of the Bankruptcy Act resolves this conflict by subordinating the trustee's power to the ***adequate protection*** of pre-petition holders of security interests.[71] The following examples demonstrate how the actual legal arrangement depends on the judicial interpretation of the concept of ***adequate protection***:[72]

a. ***Assume, for example, that the trustee aims at providing the new creditor with superior security interest, and that the prior secured***

[71] 11 USC 364(d)(1)(B).

[72] Adequate protection is defined in 11 USC Section 361.

creditors are over-secured: Let the value of the collateral that serves to secure both the pre-petition and post-petition creditors be $1M; let the pre-petition secured debt be $500,000 at the date of commencement; and let the new loan be at a value of $500,000. The trustee desires to provide the new creditor with a superior lien. The pre-petition creditor opposes the transaction, claiming that it would diminish the value of his security interest, in contradiction with the adequate protection requirement.

In the case of *Shaw Indus. v. First Nat'l Bank (In re Shaw Indus.),*[73] the Bankruptcy Court dealt with similar circumstances, and ruled for the pre-petition secured creditor. The Bankruptcy Court found that even though, the pre-petition creditors were over-secured, the new superior security interest would increase the risk that the pre-petition creditor would not be paid in full. In that case, the pre-petition creditor expected that the collateral's value would decrease over time, and therefore, the junior security holders would not be fully paid.[74]

b. ***Assume for example, that the trustee desires to substitute collaterals, and shift the initial security interest from one collateral to another, in order to provide the new creditor with a superior security interest in the initial collateral:***[75] Let the value of the initial collateral be $1M, whereas, the initial security interest secures a debt of $500,000. The trustee obtains a new loan in the value of $500,000, and is willing to provide the new creditor with a superior security interest. For this purpose, the trustee substitutes collaterals, and shifts the initial security

73 300 B.R. 861 (November, 2003).

74 For example, following the above numerical example, if the collateral's value decreases below $1M, then, it can no longer cover both debts. Thus, if the new security interest is superior to the pre-petition one, then, the initial creditor would no longer be repaid in full. Similarly, when the two debts continue to accumulate post-petition interest, then, the value of the new debt is expected to increase to above $500,000. Thus, if the new creditor enjoys an absolute priority over the initial one, the remaining value that would be left after the new creditor is paid in full would not be sufficient to cover the initial debt.

75 The possibility of providing adequate protection via "replacement lien" is fixed in subsection 361(2) of the Bankruptcy Act.

interest to an alternate collateral of the estate, that is worth only $600,000. The pre-petition creditor claims that the shift of security interest from one collateral to another violates the adequate protection requirement, because it increases the risk that the value of the collateral would not be sufficient to cover the debt in its entirety.

In both of these examples, there are three possible interpretations for the adequate protection requirement: The first possible interpretation follows the judicial decision in *In re Shaw Indus*, and prefers the interest of pre-petition creditors over the trustee's interest in obtaining new credit. This interpretation would limit the powers of the trustee to avoid existing entitlements, even though, such limits may obstruct the reorganization process. Accordingly, in the first example, the court would bar the capability of the trustee to provide the post-petition creditor with a superior lien, even when the pre-petition creditors are over-secured. In the second example, the court would prevent the shift of security interest from one collateral to another, unless the value of the new collateral is equal or higher than the value of the initial collateral.[76] The advantage of this interpretation is that it succeeds in protecting pre-petition entitlements, and thereby, encourages *ex ante* planning of efficient credit transactions before the business goes bankrupt. The trouble with this interpretation is that it diminishes the capability of the trustee to employ all existing sources of value for the purpose of obtaining new credit. In both examples, the trustee would not be able to use the difference between the value of the collateral and the value of the pre-petition debt, in order to secure the repayment of post-petition credit. Thus, the trustee may unnecessarily fail in his efforts to reorganize the bankrupt business.

The second possible interpretation would limit the adequate protection requirement to the value of the pre-petition debt at the date of commencement. In the above examples, it would suffice that the trustee would maintain some security interest on behalf of the pre-petition creditor, in some collateral that is worth at least $500,000,

[76] Similarly, in *In re Waste Conversion Techs.*, 205 B.R. 1004 (1997), the Bankruptcy Court ruled that the replacement lien must provide full compensation. Thus, when the initial lien is fully perfected, the creditor is entitled to automatic perfection in the replacement lien as well. *See also In re Martin*, 761 F.2d 472 (1985).

in order to satisfy the adequate protection requirement.[77] Then, in the first example, the trustee would be able to provide the new creditor with a superior lien on the collateral, because the collateral's value would still cover the pre-petition debt of $500,000. In the second example, the trustee would be able to shift the initial creditor from the initial collateral to an alternate one, as long as the substitute collateral's value exceeds $500,000. This interpretation facilitates the capability of the trustee to rearrange the pre-petition security interests, and thereby, maximize the remaining value for securing the repayment of new credit. However, this interpretation involves a far-reaching interference with prior entitlements, and thereby, threatens the capability of pre-petition creditors and solvent businesses to pre-plan their credit transactions.

The above theory of bankruptcy law supports a third interpretation of the adequate protection requirement: Under the third interpretation, adequate protection entitles the pre-petition secured creditor to a value equal to the value that he would have received, if the collateral were foreclosed immediately upon the commencement of bankruptcy proceedings. In the above examples, the security interest should continue to cover both the value of $500,000, and the market cost of delay, i.e., post-petition interest that is calculated according to the market interest rate. Assume, for example, that following reorganization, the post-petition creditor would recover his debt only five years after commencement. Also, assume that the market interest rate is 8%. Then, adequate protection requires that the collateral continue to secure the value of $586,660 for the pre-petition creditor. In example No. 1, the new secured credit cannot exceed the value of $413,340. In example No. 2, the alternate collateral must preserve the value of $586,660.[78]

[77] This is the accepted judicial interpretation of adequate protection in the context of under-secured creditors, and creditors whose collateral only covers the value of the debt at the date of commencement. In the case of *United Sav. Asso. v. Timbers of Inwood Forest Associates, Ltd*., 484 U.S. 365 (1988), the Supreme Court decided that adequate protection does not mandate the preservation of a cushion for covering the post petition interest, when the initial collateral covers the debt value at the date of commencement. This decision was distinguished by several later decisions. *See, for example, LNC Invs., Inc. v. First Fid. Bank, N.A.*, 247 B.R. 38 (2000). However, the decision was not overruled.

[78] This interpretation is supported by many judicial decisions. *See, for example, In re Park West Hotel Corp.*, 64 B.R. 1013 (October, 1986) (The debtor's burden is to show not only that the market value of the property, less costs of sale and tax

The third interpretation accomplishes the purpose of severing the bankrupt's assets from their prior inefficient entitlements, and the purpose of protecting the pre-planning of credit transactions. In fact, following the third interpretation, the acquisition of new credit in reorganizations would become a quasi-monitoring mechanism, which enables only the companies worthy of it to go through the reorganization proceeding: The reorganization is appropriate only when the value of the company's assets in reorganization is higher than their value in liquidation. In order for the reorganization plan to be efficient, it must ensure its investors a higher value than the alternative yield that it could have received in the market, in exchange for investing money that would have been received by immediately selling the company's assets in liquidation. Thus, for example, if the company's assets in immediate sale reach the value of 100; and the value of the market interest is 8%; then, reorganization will be advantageous only if the future income of the company is expected to exceed 8%. Otherwise, it is advisable to dissolve the company, sell its assets in exchange for 100, and enable its creditors to enter alternative investments with the money that will be received by selling the assets.

Assume, for example, that all of the company's existing assets are subordinated to pre-petition security interests. According to the third interpretation of the adequate protection principle, the trustee will be forced to supply the secured creditors with a value of 100 + an annual interest of 8%; while in relation to these values, he will not be able to grant any sort of preference to the new creditor. Finally, assume that the company requires new credit at the value of 20; the new credit will raise the current value of the company's assets to 120; however, the new creditor will not be prepared to settle for a security which will be given to him in the new assets which were added to the company through the money from his loan. He will fear that this security will cover only the value of his debt's capital, and not the interest as well. Therefore, he

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encumbrances, is greater than the steadily increasing amount of the secured party's debt; but also that it is greater by a margin sufficient to ensure that the secured party's interest is not at risk. In contrast, other courts have held that the mere existence of an equity cushion cannot be held to constitute adequate protection.); *In re R & H Inv. Co.*, 46 B.R. 114 (January, 1985*); In re Kertennis*, 40 B.R. 895 (July, 1984); *In re Heath*, 79 B.R. 616 (November, 1987); *Anchor Sav. Bank FSB v. Sky Valley, Inc.*, 99 B.R. 117 (January, 1989); *In re Mellor*, 734 F.2d 1396 (June, 1984).

will agree to transfer the new credit only if the company's income will have an annual yield, which exceeds 8; in this way, the trustee will be able to meet the adequate protection conditions towards the previous creditors, as well as ensure the new creditor's sources of payment. In other words, the new creditor will not be prepared to invest in the company, unless he expects the company's business to produce higher values than the market's yield on the credit.

The monitoring mechanism on the company's ability to raise new credit during reorganization is extremely important: At the stage of examining the reorganization plan, there is no certainty as to the advantageousness of the reorganization. The court's decision is a result of valuation formulae, which rely on the future hypothetical values of the reorganized company. Valuation techniques enable much flexibility and may lead to substantial imparities in the possible results. This difficulty is magnified in light of the frequency of the possibility that different interested parties in the company will try to distort the results of the assessment, in order to drive the court to decide on the liquidation or the reorganization in accordance with their personal interests, which do not always conform with the general aims presented above.

Thus, when reorganization is the action taken, it is expected that in nearly every company in distress, a group of claimants (i.e., controlling shareholders, managers of the company or regular creditors) will appear asking for a piece of the reorganization yield. This group will suggest reorganization plans, which are based on an optimistic assessment of the expected revenue of the company, only because they may personally profit more from this than from liquidation. When the reorganization proceeding is possible, although the value of the company in reorganization is not higher or lower than the value that would have been paid in immediate sale, it harms the company's creditors in their entirety, instead of being beneficial to them. The reorganization also involves considerable costs, which are necessary in order to activate the company in the framework of the collective proceedings, postponing the payment of the debts and leading new creditors to invest in the failing company. Therefore, it is important that also the trustee will not be able to raise new credit for the reorganization without any limits. The adequate protection for the previous secured creditors will ensure that the raising of credit will be done only when there are investors who believe that the company's revenue will outweigh the value of the market interest.

3. Executory Contracts

The role of bankruptcy law is most clearly manifested by the legal arrangement of executory contracts:[79] As long as the company is active, it cannot be released from commitments it took upon itself, also when these turn out to be non-profitable investments. After the commencement of bankruptcy proceedings, the trustee is entitled the choice between performance and avoidance of pre-petition contractual obligations. If the trustee would select to perform the contract, then, both parties (the bankrupt estate and the other contractual party) would have to abide by the pre-petition liabilities; otherwise, the estate would not perform its duties under the contract, and the other parties would be forced to share the value of the estate with the other non-secured creditors.

In order to clarify the practical meaning of this arrangement, it is important to note the different stages that the company's contracts can be found in at the beginning of the collective proceedings:

a. *Either early stages of performance, or, continuous contracts*: It is possible that the company entered into the contract, however both parties have not yet implemented the majority if the contractual obligations involved in it. A similar possibility arises when both parties have already partially performed the contract, however it is a continuous one, where both parties are committed to implementing different commitments over a period of time. Thus, at any point of time that the collective collection proceedings will begin, there will still remain many obligations that the parties will have not yet performed.

[79] *See* 11 U.S.C.S. 365. Section 365 grants the authority to the liquidator or the trustee to choose whether to assume, assign or to reject an executory contract. Executory contracts are contracts in which both parties, i.e., the company and the second party to the contract, have not yet performed all of their commitments. Every contract which has a mutual commitment can be considered an executory contract. Thus, for example, shareholder agreements, which commit one of the shareholders who reaches liquidation, will be considered executory contracts from the point of view of the shareholders. *See In re Riodizio, Inc.*, 204 B.R. 417, 424 (Bankr. S.D.N.Y. 1997); *In re Parkwood Realty Corp.*, 157 B.R. 687, 689 (Bankr. W.D. Wash. 1993);*Vecchitto v. Vecchitto*, 2000 U.S. App. LEXIS 25439.

b. *Intermediate stages of performance*: It is possible that the creditor has already implemented his obligations towards the company, however the company has not yet implemented its obligations towards him.

c. *Intermediate stages of performance*: It is also possible that the company implemented its obligations towards a third party, however he has not yet implemented his contractual obligations.

d. *Advanced stages of performance*: Finally, it is possible that both parties fulfilled the majority of their mutual contractual commitments.

The arrangement of executory contracts refers only to contracts of the first type: In the second stage of performance, the trustee will avoid fulfilling the company's obligation towards the creditor, when the latter can claim his debt in collective proceedings.[80] At the third stage of performance, the trustee will be able to file for performance on behalf of the estate. At the fourth stage of performance, both parties will have performed their obligations, therefore the collective proceeding does not affect the parties' rights. The Bankruptcy Court defined the relevant contracts to this arrangement as follows:[81] "…a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."

Then, the law grants the trustee or liquidator the right to reexamine the profitability of the transaction, from the point of view of the company. Only in the event that the foreseen return that is to be received as a result of performing the contract is higher than the value that the company has not yet paid according to the contract, the trustee must implement it. Otherwise, the contract should be perceived as an "unprofitable contract" that should be "avoided." For example, if we are discussing a contract to purchase an apartment from a real-estate company, and the company reached

[80] There is an internal conflict on this issue, as to how to classify option contracts. The leading approach is that options will not be considered executory contracts, unless the owner of the option decides to realize the option before submitting the request for bankruptcy. *See*, for example, *In re Robert L. Helms Construction and Development Co.*, 139 F.3d 702 (1998).

[81] *Northwest Airlines, Inc. v. Klinger (In re Knutson)*, 563 F.2d 916, 917 (8th Cir., 1977); *In re James M. Craig*, 144 F.3d 593 (1998).

insolvency during the building process, the trustee will have to estimate the expected return which is expected to be received from the buyer and compare it both to the costs of finishing the building, and to the cost of losing the alternative contract (in which the apartment will be sold to a different buyer). The trustee will choose to perform the contract only when the value of the return balance that he will receive from the buyer is higher than these costs.

The following numerical example clarifies this situation (see **Table No. 1** below):

Table No. 1: Examining the Existence of a Burdensome Asset

	Numerical example	**Denoted:**
The costs of completing the building.	100	C_b
Balance due	150	EP_c
Current market price of the apartment	400	V_m
Value of implementing the contract	(150 – 100)	$(EP_c - C_b)$
Transaction costs of alternative contracts	50	TC
Value of alternative transaction	(400 – 100 – 50)	$(V_m - C_b - TC)$
The trustee's necessary decision	Since the value of implementing the contract is lower than the value of the alternative transaction, the trustee must refrain from executing the contract.	$\mathrm{Max}\{(EP_c - C_b), (V_m - C_b - TC)\}$ The trustee must choose the most profitable alternative for the estate; therefore, he must prefer an alternative transaction if it is expected to yield a higher value, and vice versa.

In the numerical example, if the trustee would choose to execute the contract, he would receive from the buyer the return balance, and transfer the apartment to him, after finishing the building. The liquidation fund will bear the costs of completing the building. In contrast, if the trustee would avoid the contract, he would be able to sell the apartment to a new potential buyer. Indeed then, the trustee would have to bear the costs of completing the building and finding a new buyer as well as performing the contract with him, however in many cases, the yield that this alternative will provide will be higher than the yield the trustee would receive from performing the contract.

The example clarifies also that when examining the performance of executory contracts, the trustee will not be able to be satisfied with positioning the value of the balance due against the costs of completing the construction; rather, he must also take into account the price that he will be able to receive from selling the apartment to a third party. Only when performing the contract will lead to a higher profit than the alternative transaction, he should prefer to perform the contract. Thus, for example, in a situation where prices of apartments are gradually dropping, the trustee may find that performing the original contracts will be more beneficial. In contrast, in a situation where prices of apartments are rising, the more efficient alternative will usually be to cancel the existing contracts in favor of new transactions at higher prices. Of course, the buyer can try to entice the trustee into choosing the alternative of performing the contract, by showing willingness to enlarge the balance due. The buyer's willingness to relinquish part of his contractual rights, and transfer larger amounts of money to the estate, will enable the completion of the construction of the apartment on his behalf. Finally, the trustee must consider the fact that the alternative transaction will bind him to the costs which are entailed in the transaction. Therefore, the trustee or the liquidator's willingness to continue performing the original contracts will be dependent also on the fluidity of the company's assets.

This legal arrangement implies that the commencement of bankruptcy proceedings entitles the trustee to the right to avoid onerous and non-profitable contracts. The law enables the trustee to free the estate from non-profitable liabilities in ways that are not available outside the bankruptcy proceedings. The purpose of this legal arrangement is to facilitate the severance of economic resources from inefficient entitlements, in order to enable their return to lucrative business activity.