The Butner Fallacy and Bankruptcy’s Procedural Bargain

This paper seeks to clarify the fundamental question of bankruptcy’s proper purpose. Bankruptcy law is commonly assumed to have a finite reach. In the view of most bankruptcy lawyers and scholars, there is a line that separate bankruptcy matters from nonbankruptcy matters. Bankruptcy law does not reach beyond that line. That idea of a limited reach is referred to as the Butner Principle. It is foundational to most law and economics views of bankruptcy law and it is also one of the most misunderstood ideas in all of bankruptcy law. The conventional understanding of the Butner Principle obscures the fundamental purposes of bankruptcy law.

It is true that the line between bankruptcy and nonbankruptcy--once located--can guide us through many of the thorniest and fundamental issues that arise when a firm enters bankruptcy. But that idea is only helpful if we know where to draw the line. The starting point for most law and economics scholars is the idea of the creditors’ bargain: bankruptcy law should mimic the ex ante hypothetical bargain that creditors would reach if they had the chance to sit down and negotiate. Thus, we want to know what things the creditors would have put within the reach of bankruptcy law. For four decades, many scholars have interpreted this as a question of ex ante substantive rights: the creditors would have bargained for the set of rules that vindicates their substantive ex ante entitlements. Thus, ex post bankruptcy laws can only reach matters that do not interfere with those ex ante entitlements.

This is an unworkable theory of bankruptcy that misunderstands the creditors’ bargain. Bankruptcy law operates entirely by interfering with rights and entitlements that exist outside of bankruptcy. To be sure, a good rule of thumb is that bankruptcy law should interfere with private ordering as little as possible. But that just suggests that bankruptcy law should have a limited reach and raises the question of what purpose ever justifies intervention. This paper presents the case that bankruptcy’s core purpose is to create a procedural system that enhances firm value by reducing opportunistic behavior among creditors. There is nothing radical in this idea, but the recurring focus on preserving substantive rights in the name of the Butner Principle has diverted attention from this core purpose. Reducing opportunistic behavior and facilitating coordination does not suggest that any particular substantive or procedural rights are beyond the reach of bankruptcy, but rather suggests that every line-drawing question turns on an inquiry about whether bankruptcy law can provide procedural rules that reduce opportunistic behavior and facilitate coordination in dealing with financial distress.