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Pursuing Preservation of Pre-Bankruptcy Entitlements: Corporate Bankruptcy Law's Self Executing Mechanisms

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Pursuing Preservation of Pre-Bankruptcy Entitlements: Corporate Bankruptcy Law’s Self-Executing Mechanisms

Yaad Rotem†

Abstract: Much analogous to corporate law, the core problem of which could be described as the agency problem, corporate bankruptcy law’s nucleus problem is the Problem of Preservation: attempting to prevent inasmuch as possible unnecessary alteration of pre-bankruptcy entitlements. Pursuing preservation, however, is of course only a second order goal. Corporate bankruptcy law was not created as a means to accomplish preservation, but rather to deliberately alter pre-bankruptcy entitlements in order to pursue a first order goal—effectively help firms in financial distress. Thus, it becomes apparent that corporate bankruptcy law cannot rely on the decisions of a single regulator (i.e., the bankruptcy judge) to prevent excessive alteration of pre-bankruptcy entitlements, because attaining preservation inherently—and blatantly—conflicts with bankruptcy’s first order goals. Consequently, corporate bankruptcy law must also employ other mechanisms in order to truly support a policy of preservation. It is argued here that corporate bankruptcy law demonstrates its commitment to preservation by deploying specially crafted self-executing mechanisms. At least three types of such mechanisms can be identified in corporate bankruptcy settings: internal mechanisms that monitor against excessive redistribution; discretion-limiting mechanisms; and external monitoring and enforcement market mechanisms. The line of reasoning presented in this Article supplies a new point of view from which to explain certain corporate bankruptcy doctrines, and the structure of corporate bankruptcy law in general. Moreover, analyzing the bankruptcy phenomenon from the perspectives of the preservation problem and self-executing mechanisms leads to important normative conclusions. First, lawmakers ought to consider several additional preservation mechanisms, some of which are easily available. Second, future research ought to contemplate whether corporate bankruptcy law is indeed successful in preventing excessive alteration of pre-bankruptcy entitlements by deploying its specified self-executing mechanisms. More importantly, research should examine the relative efficacy of the various types of mechanisms.

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I. INTRODUCTION

In the competitive world of business—a world also influenced by macroeconomic fluctuations in the economy—the phenomenon of corporate debtors becoming insolvent is, sadly enough, quite common. Firms with a business model that failed to meet expectations for success, firms that could not endure the pressures of an aggressive market, or firms simply run by incompetent managers gradually deteriorate as their economic failure is translated into a state of financial distress; they may soon find themselves—and rightly so—on the verge of an insolvency catastrophe. The inevitable is sometimes attained, however, in a socially detrimental manner: creditors seeking individually to recover their claims from the firm race against each other, destroying in their fervor, asset values that could otherwise be saved.

1. An economically distressed firm—unlike a firm that is only financially distressed—is characterized as a firm whose operating expenses exceed its operating revenues, thus inefficiently draining the economy. Assets of such a firm are more valuable if redeployed and put to some other use in the economy. See Michelle J. White, Corporate Bankruptcy, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (Peter Newman ed., 1998), 483, 486. While it is easy enough to ascertain financial distress, economic distress is much harder to determine as it depends on such unobservables as the earnings of the firm’s assets in their best alternative use. Id. at 486-87. Further discussion and relevant literature can be found in Lemma W. Senbet & James K. Seward, Financial Distress, Bankruptcy and Reorganization, in 9 FINANCE - HANDBOOKS IN OPERATIONS RESEARCH AND MANAGEMENT 921-22 (R. A. Jarrow et al. eds., 1995).

2. In the long run, the process of eliminating inefficient firms benefits consumers as goods and services are produced and sold at the lowest possible prices. See Michelle J. White, The Corporate Bankruptcy Decision, 3 J. ECON. PERSP. 129 (1989) [hereinafter The Corporate Bankruptcy Decision].

3. This is the rationale offered by the famous “Creditors’ Bargain” theory to the existence of bankruptcy procedures. See, e.g., Douglas G. Baird & Thomas H. Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 51 U. CHI. L. REV. 97 (1984); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986). According to the Creditors’ Bargain theory, the unsecured creditors of the firm face a common pool problem on the eve of the firm’s financial distress. Where a common pool problem exists, individuals may each be driven by an incentive to overuse the pool to the detriment of everyone. In the bankruptcy context, when engaged in the process of individually collecting their debts from the firm, unsecured creditors face a multiparty “prisoner’s dilemma” situation—a setting where each of the rational players participating in a game and anticipating the other player’s move, chooses a strictly dominant strategy that eventually places all players in a worse state of affairs. By attempting to collect individually from the firm and hoping to collect sooner rather than later, while simultaneously fearing that each of the other creditors will beat them in the race to the firm’s limited pool of assets, the creditors end up in an inferior position as a group because the firm cannot repay all its debts. The creditors might each invest separately in expensive and duplicative monitoring of the firm’s financial affairs and individual collection procedures and efforts. The creditors’ individual actions to collect might also hasten the firm’s collapse. Assets might be sold at less than their maximum value by selfish creditors concerned with repaying their own claim.
Moreover, economically viable firms, with only a capital structure\textsuperscript{4} incompatible to the firm's unique characteristics and needs, sometimes find themselves victims of such a race, the results of which can be complete annihilation of an otherwise efficient business enterprise.\textsuperscript{5}

Many countries around the world have enacted legal arrangements purporting to make it possible for the government to intervene during critical sessions of financial distress that are ordinarily considered private and autonomous corporate events. The government's intervention intends to accomplish goals such as improved collection of debts for the sake of claimants of economically non-viable firms (in the legal framework called "liquidation"),\textsuperscript{6} or rehabilitation of efficient production units (in a legal framework called "reorganization"),\textsuperscript{7} which combines economic redeployment of the firm's assets and financial restructuring of the firm's capital structure\textsuperscript{8}).\textsuperscript{9} These first order corporate bankruptcy goals are accomplished by conducting a collective procedure under the auspices of a bankruptcy court.\textsuperscript{10} The main thrust of such a collective procedure is, of course, the stay imposed on all individual collection efforts exerted by claimants against the firm. The stay imposed on claimants derives the adoption of a collective-solution approach to

\textsuperscript{4} Firms finance projects with either equity or debt. When a firm is financed entirely by equity, the stream of cash flow produced by its assets belongs to the equityholders. When the firm is financed by debt as well, its cash flow is split between debtholders and equityholders. The former is a relatively safe stream, while the latter is riskier. Investors are therefore not indifferent to purchasing equity or debt securities from the firm and the firm needs to persuade investors to take either type of securities. The firm itself is also not insensitive to choosing a financing method as each method has both advantages and limitations. While financing operations with debt can be expensive—for example, during industry-wide downtums highly leveraged firms lose market share more easily—debt also carries tax benefits, since interest paid by the firm can be deducted from the firm's taxable income. Debt can also result in the firm going bankrupt. To the extent bankruptcy is a costly procedure for the firm, the firm's decision on the debt-equity mix is a result of the firm trading off current tax benefits with the risk of having to bear bankruptcy costs. Against this background the firm can issue equity and debt in order to finance projects. The mix of different securities issued by the firm becomes its capital structure. The question financial managers are troubled by is what constitutes an optimal mix of equity and debt that would maximize the firm's overall market value. See Mark J. Roe, Corporate Reorganizations and Bankruptcy—Legal and Financial Materials 501-05 (2000).

\textsuperscript{5} The creditors' race to seize assets of the firm subsequently dismantles the firm's production unit, and then the firm's going-concern value is lost.

\textsuperscript{6} See Bankruptcy Code, 11 U.S.C. §§ 701-784.

\textsuperscript{7} See Bankruptcy Code, 11 U.S.C. §§ 1101-1174.

\textsuperscript{8} A restructuring of the firm's capital can incur postponement of debt payments, cancellation of debt, conversion of debt into equity interests, or any combination thereof.

\textsuperscript{9} Notice, that the idea of a fresh start, which is perhaps the basis for the bankruptcy of flesh-and-blood human beings, is irrelevant in corporate bankruptcy since one can always replace one corporate charter with another. Even the preservation of some unique value embedded in a defined set of assets ("going concern value") need not be accomplished within a particular legal entity. See Douglas G. Baird, A World Without Bankruptcy, 50 Law & Contemp. Probs. 173, 182-83 (1987) (hereinafter A World Without Bankruptcy); see also Randal C. Picker, Contemporary Issues in Bankruptcy and Corporate Law: Voluntary Petitions and the Creditors' Bargain, 61 U. Cin. L. Rev. 519, 521 (1992).

\textsuperscript{10} The bankruptcy court is in fact a form of a governmental agency, the purpose of which is to accomplish the governmental task of conducting a bankruptcy procedure.
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solve the problems emanating from the firm's financial distress. The stay allows such problems to be solved by a single decision-making forum—the bankruptcy court. As a result, important decisions such as whether to dissolve or retain the firm's production unit, or how to deploy the assets owned by the firm are not made capriciously or erroneously as a result of one or another single creditor's self-interested move to collect his claim. Instead, decisions are made in a thoughtful and knowledgeable manner, synthesized by bankruptcy's specially designed decision-making mechanisms. 12

Intervening in the firm's ordinary course of business and in the process of its deterioration towards insolvency—whether the reason for intervening is achieving better debt collection rates (enjoyed by the firm's direct claimants alone) or promoting the possibility of a reorganization (enjoyed perhaps by other communities of the firm as well)—carries with it apparent redistributive

11. See supra note 3.

12. Existing models of bankruptcy decision-making mechanisms are subject to intense criticism in legal, economic, and financial literature. See, e.g., Douglas G. Baird, Revisiting Auctions in Chapter 11, 36 J. L. & ECON. 633 (1993), Michael Bradley & Michael Rosenzweig, The Intenable Case for Chapter 11, 101 YALE L.J. 1043 (1992); Karen H. Wruk, Financial Distress, Reorganization, and Organizational Efficiency, 27 J. FIN. ECON. 419 (1990); Lawrence A. Weiss & Karen H. Wruk, Information Problems, Conflicts of Interest, and Asset Stripping: Chapter 11's Failure in the Case of Eastern Airlines, 48 J. FIN. ECON. 55, 57 (1998); Todd C. Pulvino, Effects of Bankruptcy Court Protection on Asset Sales, 52 J. FIN. ECON. 151 (1999); Stuart C. Gilson, Edith S. Hotchkiss & Richard S. Ruback, Valuation of Bankrupt Firms, 13 REV. FIN. STUD. 43, 45 (2000); Ulrich Hege, Workouts, Court-Supervised Reorganization and the Choice Between Private and Public Debt, 9 J. CORP. FIN. 233, 254-55 (2003). Such criticism, however, is irrelevant for the purposes of this article because it is assumed that bankruptcy's decision-making mechanisms are nevertheless superior to a dispersed decision-making process, such as exists outside bankruptcy, where each creditor can in fact determine the future of the firm.

13. Economists would, of course, disagree with defining claimants as the sole beneficiaries of a system that takes only the claimants' interests into consideration: maximizing the value of the pool of assets reduces the costs of debt capital (the costs of credit) because creditors recover a higher percentage of their debt, which then becomes a social cost since society as a whole bears the loss when assets are not put to their highest valued use. See Robert K. Rasmussen, The Washington University Interdisciplinary Conference on Bankruptcy and Insolvency Theory: The Ex-Ante Effects of Bankruptcy Reform on Investment Incentives, 72 WASH. U. L.Q. 1159, 1161 (1994).

14. Shutting down the firm is considered to influence claimants, employees, tort victims, and the interests of the economy at large, whether local, regional or national. Sometimes the bankruptcy of one firm can send shock waves throughout the economy. Suppliers of the firm, for example, are also affected, or even competitor. As one scholar put it: "Business failure affects radically diverse interests—the interests of the creditor in being paid, the interest of the shareholder in maintaining her residual claim to the earnings of the business, the interest of the employee in retaining her source of income, and the interests of the surrounding community in maintaining an institution that provides numerous indirect benefits. The toll that business failure exacts on dependent constituencies goes beyond job loss and creditor recovery statistics. The closing of a failed business may produce shock waves that reverberate throughout the local, regional or national economy." See Christopher W. Frost, Bankruptcy Redistributive Policies and the Limits of the Judicial Process, 74 N.C. L. REV. 75, 76 (1995). Finally,
implications.\textsuperscript{15} Simply put, the collective procedure redistributes value from one agent to another, and more often than not it even redistributes wealth.\textsuperscript{16} Indeed, any decision made by the Bankruptcy Court during the collective procedure, in addition to the very initiation of the collective procedure, implicates pre-bankruptcy entitlements held by different agents.\textsuperscript{17} For example, staying a secured creditor from foreclosing on his collateral\textsuperscript{18} during time-consuming attempts to reorganize the firm, prevents the secured creditor from realizing a pre-bankruptcy entitlement of his, thus in fact altering that entitlement. It is perhaps necessary to burden the secured creditor by preventing him from taking the collateral away from the firm, in order to enable the reorganization effort to succeed; but it is nevertheless redistributive. It is thus agents other than the secured creditor who stand to gain from any attempt to reorganize the firm,\textsuperscript{19} and enjoy the decision to alter the secured creditor’s pre-bankruptcy entitlement.\textsuperscript{20}

Corporate bankruptcy law (hereinafter also: bankruptcy law) intends to accomplish certain tasks—such as improved debt collection or reorganization of financially distressed firms—and therefore allows redistribution among agents to occur. But redistribution per se is arguably not a goal of bankruptcy law. Indeed, bankruptcy scholarship is intensely divided over the question of whether bankruptcy law should aim solely at maximizing the value of the

one might argue that financially distressed firms represent more than just a pool of assets. Unlike property, the firm is an enterprise and has potential. \textit{See Vanessa Finch, Corporate Insolvency Law—Perspectives and Principles} 30 (2002).


\textsuperscript{16} Redistribution of wealth should be distinguished from redistribution of value. To the extent that claimants of the firm acknowledge, at the time of contracting with the firm, the existence of future redistributive impulses in bankruptcy, resulting redistribution of value in bankruptcy cannot end in a wealth transfer since claimants destined to be adversely affected will compensate themselves in advance. \textit{See} Barry E. Adler, \textit{Bankruptcy and Risk Allocation}, 77 CORNELL L. REV. 439, 464 (1992). Thus, consensual creditors might not be worried at all about redistribution as long as they adjust in advance the interest rates they charge on the loans extended by them to the firm. \textit{See} Robert K. Rasmussen, \textit{An Essay on Optimal Bankruptcy Rules and Social Justice}, 1994 U. ILL. L. REV. 1, 23. Nevertheless, even consensual creditors—and not only the firm—would very much like to avoid redistribution when possible. First, these creditors prefer the lower interest rates being set in loan contracts in order to raise the demand for loans. \textit{See} id. Second, even wealth-transfer-proofed creditors would like, ex-post, to maximize their profits. Hence, when faced with an opportunity to avoid any value being transferred from them to other agents, the creditors would seize such opportunity and behave accordingly.

\textsuperscript{17} Thomas H. Jackson & Robert E. Scott, \textit{On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors’ Bargain}, 75 VA. L. REV. 155, 162 (1989) (“Any collectivization procedure necessarily has both a redistributive and an allocative effect . . . There will obviously be an interference with prebankruptcy rights; there will also, however, almost inevitably be a change in the relative value of those prebankruptcy rights.”).

\textsuperscript{18} The security is an asset of the firm that earlier has been publicly recorded as a collateral for the loan extended by the secured creditor.

\textsuperscript{19} For example, junior creditors holding “underwater claims,” who are destined to be wiped out and receive nothing in case the firm is liquidated, gain a chance that some part of their claims will be saved. Employees of the firm, who are destined to lose their source of living if the firm is liquidated, represent another example for agents gaining from an attempt to reorganize the firm.

\textsuperscript{20} \textit{A World Without Bankruptcy}, supra note 9, at 185.
firm’s assets, or aspire to achieve broader goals, including reallocation of the losses caused by a disaster common to many. But even adherents of a pure redistributive bankruptcy approach cannot refute the contention that beyond a certain predefined set of such redistributive goals, bankruptcy law should abstain from redistribution. This well-known imperative will be referred to hereinafter as the Principle of Preservation.

Any redistributive impulse occurring in bankruptcy, which is not stringently dictated by the need to promote a predefined bankruptcy policy, is assumed to be inefficient, and therefore prohibited. The purpose of this article is to follow the latter proposition, and for the first time reveal how—as a matter of fact—bankruptcy law consistently attempts, albeit imperfectly, to minimize the efficiency costs of redundant bankruptcy redistribution, by preventing such redistribution from occurring.

Bankruptcy law is very much preoccupied with preservation of pre-bankruptcy entitlements. No one doubts that preventing excessive redistribution will minimize redistribution-related efficiency costs. The Supreme Court recognized and articulated the rationale for the principle of preservation, although in non-economic terms, in the famous case of Butner v. United States when the court stated:


22. It is therefore assumed that bankruptcy goals can clearly be defined or clearly described in advance as being legitimate. In reality, the questions “what are bankruptcy goals?” or “what should bankruptcy goals be?” are—as already mentioned—highly controversial. See id. Eventually, however, legislators should decide on a set of bankruptcy goals they deem legitimate and exclude other goals.

23. The Creditors’ Bargain theory is famous for having advanced a similar argument in the particular context of offering an economic goal as a predefined bankruptcy goal. See, e.g., Jackson & Scott, supra note 17, at 159. The Creditors’ Bargain theory, however, has focused on arguing that bankruptcy rules should be dedicated to shaping a neutral collection forum, which recognizes creditors’ rights under pre-bankruptcy law. This approach has exposed the Creditors’ Bargain to intense criticism. See, e.g., David Gray Carlson, Philosophy in Bankruptcy, 85 MICH. L. REV. 1341, 1377 (1987). This article acknowledges the possibility that bankruptcy law may in fact be used to redistribute value and wealth as well. Still, it is contended that such redistribution should not be without limitations. In other words, the rationale offered here to justify preservation of pre-bankruptcy entitlements is not neutrality, but the idea that once the predefined—or for that matter, any—rationale for bankruptcy redistribution ceases to apply, bankruptcy law should refrain from redistribution for efficiency reasons.

24. When a bankruptcy judge says: “A party to a contract with a firm, which later on enters bankruptcy, should not be dragged into the group of those damaged by the firm’s business failure, and his contractual rights should be honored by the trustee in bankruptcy,” she in fact means that bankruptcy law should enforce a preservation policy.

25. This article thus adopts an economic rationale to justify the problem of preservation. The problem of preservation, and the policy of preservation which derives thereof, can easily be explained using a constitutional rationale. Indeed, to the extent that bankruptcy redistribution alters pre-bankruptcy entitlements, it impinges upon property rights. Such a result is legal only to the extent the law explicitly permits its. See Thomas E. Plank, Bankruptcy and Federalism, 71 FORDHAM L. REV. 1063 (2002).
Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy."\textsuperscript{26}

But what the Court in \textit{Butner}—or the literature developed around the \textit{Butner} principle\textsuperscript{27}—failed to augment is the fact that preservation of pre-bankruptcy entitlements (i.e., preventing excessive redistribution) is by and large not bankruptcy's main premise.\textsuperscript{28} Rather, bankruptcy law maximizes preservation under a certain constraint, which is basically defined by a quite distinct goal from preservation.\textsuperscript{29} Bankruptcy law aims first and foremost at goals such as rescuing financially distressed firms or maximizing the value of the firm's assets. Bankruptcy law was certainly not enacted in order to prevent excessive redistribution. Thus, preservation, as far as it is the subject matter bankruptcy law, confronts a constrained maximization problem rather than a pure maximization problem. In other words, preservation is a second order goal.

To be sure, it is my contention that much analogous to corporate law, the core problem of which could be stated as the agency problem—emanating from the need to conduct economic activity within the hierarchical structure of a firm\textsuperscript{30} while separating ownership from control over the firm's assets\textsuperscript{31}—bankruptcy law's nucleus problem is the Problem of Preservation: attempting to prevent as much as possible unnecessary alteration of pre-bankruptcy entitlements. Redundant redistribution might be induced during the initiation of a collective procedure, which sets out to accomplish certain first order goals in an inherently redistributive manner. Yet while bankruptcy redistribution is inevitable, its scope nevertheless needs to be reduced to the minimum—i.e., excessive redistribution should be avoided. However, the task is not an easy

\textsuperscript{26} When a bankruptcy judge says: "A party to a contract with a firm, which later on enters bankruptcy, should not be dragged into the group of those damaged by the firm's business failure, and his contractual rights should be honored by the trustee in bankruptcy," she in fact means that bankruptcy law should enforce a preservation policy.

\textsuperscript{27} See, e.g., JACKSON, supra note 3; see also Douglas G. Baird, \textit{Elements of Bankruptcy} 5 (3rd ed., 2001) [hereinafter \textit{Elements of Bankruptcy}] ("When a litigant seeks an outcome different from the one that would hold outside of bankruptcy, the bankruptcy judge will likely ask the litigant to identify the part of the Bankruptcy Code that compels the departure."); id. at 79, 123-24.

\textsuperscript{28} For a recent example, see Charles W. Mooney, Jr., \textit{A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure}, \textit{61 Wash. & Lee L. Rev.} 931 (2004).

\textsuperscript{29} See supra note 6.

\textsuperscript{30} Rather than in the market via the price mechanism.

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one, as the very source of the problem—redistribution within a collective procedure, which impairs pre-bankruptcy entitlements—is overtly employed by the law as a solution to the problems created when firms become financially distressed.

Perhaps the most overwhelming example for the Problem of Preservation is the concern that bankruptcy judges tend to redistribute more than is necessary. To be sure, it is impossible to ascertain in any given case whether any judge-made redistribution is indeed essential and justified—whatever normative theory of bankruptcy is applied. Consider a classic example: a bankruptcy judge’s unascertainable decision that the firm is economically worth salvaging, which subsequently denies a secured creditor of his entitlement to foreclose on the security. If the judge is correct that the firm is salvageable, and if the reorganization process does not take longer than necessary, then the redistribution was not excessive. However, if the judge is incorrect and the firm isn’t salvageable, then the redistribution attributed to the reorganization process was neither essential nor justified. Unfortunately, except in those rare cases in which the firm’s economic viability, or lack thereof, is obvious; in most real world cases the extent to which the judge’s decision is correct cannot be verified ex ante. Moreover, even an ex post failure of the firm to survive does not necessarily mean that the firm lacked economic viability in the first place. Thus, even if bankruptcy judges do tend to redistribute more than necessary, a direct intervention approach would still be useless in preventing such excessive redistribution.

Acknowledging the Problem of Preservation as an attribute of the preservation endeavor in bankruptcy results in an understanding that bankruptcy law cannot settle on simply pursuing the preservation goal administratively. To be sure, bankruptcy law cannot rely on the decisions of a single regulator (such as the bankruptcy judge) to prevent excessive redistribution, as attaining preservation inherently, and blatantly, conflicts with any of bankruptcy’s redistribution-inducing goals. Indeed, the simplest of human limitations, for example, might curtail the judge’s sincerest efforts to balance the conflicting interests in order to avoid excessive redistribution. Perhaps it is also not unreasonable to assume that judges are inherently bound, whenever possible, to opt for redistribution. After all, the judges’ success is not going to be measured in terms of excessive redistribution. The problem further intensifies due to an ambiguity transpiring from the unsettled debate regarding bankruptcy goals. Those maintaining that bankruptcy law should intentionally

32. See, e.g., Bernard Trujillo, Patterns in a Complex System: An Empirical Study of Valuation in Business Bankruptcy Cases, 53 UCLA L. REV. 357, 358-59 (2005) (“the bankruptcy system leaves much of its most important work up to the discretion of actors 'on the ground'”).

33. For a painful demonstration, see Weiss & Wruck, supra note 12. Valuation of the firm made by bankruptcy judges is another example—out of many possible—for a context prone to redundant redistribution. See Trujillo, supra note 32, at 359.
redistribute wealth—but cannot accurately define in advance for what ends—will no doubt notice the importance of acknowledging the problem of preservation. 34

Consequently, other mechanisms must be employed by the law in order to truly back-up the needed policy of preservation. Moreover, these mechanisms should excel in promoting the preservation goal while interfering as little as possible with bankruptcy's pronounced first order goals. It is thus contended that bankruptcy law demonstrates its commitment to preservation by deploying specially crafted self-executing mechanisms. To be exact, at least three types of such mechanisms can be identified in corporate bankruptcy settings: internal mechanisms that monitor against excessive redistribution; discretion-limiting mechanisms; and external monitoring and enforcement market mechanisms.

The argument presented here posits a new point of view from which to explain certain corporate bankruptcy doctrines and the structure of bankruptcy law in general. This new perspective portrays bankruptcy law as having a hidden yet coherent formation. 35 Analyzing the bankruptcy phenomenon from the viewpoint of the preservation problem permits not only new positive conclusions regarding bankruptcy law, but normative conclusions as well. The article does not exhaust the latter line of research, but facilitates several preliminary insights. Indeed, the vigorous debate conducted in recent decades, regarding the exact goals corporate bankruptcy regimes should aim to accomplish, 36 has obscured the need to focus on the other side of the equation—the need to adopt policies for minimizing the harm caused by the government-driven bankruptcy intervention, specifically the alteration of pre-bankruptcy entitlements it generates. As a result, the understanding of the

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34. Advocates of a redistributive approach admit that they portray "a dirty, complex, elastic, interconnected view of bankruptcy from which...[one] can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision." See Warren, supra note 21, at 811.


36. One aspect of this debate was mentioned supra note 21, but even law and economics scholars are divided on this issue. See, e.g., James W. Bowers, Whither What Hits the Fan? Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution, 26 GA. L. REV. 27 (1991) (Distressed debtors are not indifferent to the question of redeployment of the firm's assets, and are actually the best liquidators and distributors of these assets, in a manner that reveals bankruptcy law—at best—as an unnecessary yet harmless mechanism, or—at worst—as an inefficient obstacle.); Robert K. Rasmussen, Debtor's Choice: A Menu Approach to Corporate Bankruptcy, 71 TEX. L. REV. 51 (1992) [hereinafter Debtor's Choice] (There exists no justification to describe corporate bankruptcy law as a set of mandatory rules. Since creditors willingly accept the terms of the contract offered to them by the firm, and since the costs of an inefficient bankruptcy rule are borne ultimately by the shareholders of the firm, who incur the costs of paying higher interest rates to unsatisfied creditors, one cannot claim that a common pool problem exists at all.); George G. Triantis, The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines, 16 INT'L REV. L. & ECON. 101 (1996) (The purpose of bankruptcy is to correct the inefficiencies that are being signaled by a firm's financial distress.); Nicholas Georgakopoulos, Bankruptcy Law for Productivity, 37 WAKE FOREST L. REV. 51 (2002) (Bankruptcy law, in addition to solving a common pool problem, serves the function of restoring productivity incentives and productive capacity, all of which the firm's financial failure has destroyed.)
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bankruptcy mechanism by legislators, judges, and scholars has been incomplete. Important normative recommendations regarding preservation are therefore still missing. To continue the previous comparison, while in corporate law the agency problem has been thoroughly excavated, the Problem of Preservation in bankruptcy law has not been discussed seriously. The reason, no doubt, rests in failing to recognize that bankruptcy redistribution should serve as a point of origin for analyzing bankruptcy law. Nevertheless, highlighting the Problem of Preservation (rather than the Principle of Preservation only) can—as this article shows—be translated into an immediate contribution to fill the gap.

First, it is argued that several additional self-executing preservation mechanisms ought to be considered by lawmakers. For example, lawmakers could consider creating a market for trustees, as a means of preventing excessive redistribution during reorganization efforts. Appointing a trustee (even in Chapter 11 cases alongside the debtor-in-possession) recommended by an agent vulnerable to redistribution in Chapter 11 proceedings, such as the secured creditor, would eventually create a market for trustees who would compete for the right to be nominated by secured creditors. To the extent that excessive redistribution in Chapter 11 cases impinges upon secured creditors, such competition would produce trustees who exert more effort to enforce preservation.

Second, it is argued that the new preservation agenda raises a number of questions to be tackled by future research. For example, one normative query presented here contemplates whether bankruptcy law is indeed successful in preventing excessive redistribution, particularly by way of deploying its specified self-executing mechanisms. Another normative question to be raised, undoubtedly, concerns the relative efficacy of the various types of preservation mechanisms. Indeed, when comparing the different types of preservation mechanisms to one another, one cannot but wonder whether a certain type of mechanism—the group of external market mechanisms, for example—is not distinctively more effective than the others.

The article proceeds as follows: Part I briefly describes the basic elements of bankruptcy. The stay and the manner in which bankruptcy regimes distribute the assets of the firm among claimants are presented. Then, the phenomenon of bankruptcy redistribution is discussed. Three contexts of bankruptcy redistribution are identified, while exposing bankruptcy’s various redistributive aspects. This part highlights what has been discussed so far only obliquely—the vastness of bankruptcy redistribution. Part II explains the problems induced when bankruptcy generates redistributive effects. An economic rationale is articulated to justify a bankruptcy policy focusing on preservation of pre-bankruptcy entitlements. Part III acknowledges the trade-off between the need to allow bankruptcy redistribution and the need to preserve pre-bankruptcy
entitlements. The Problem of Preservation is then used in Part IV as a general theory to explain the bankruptcy doctrines and institutions presented earlier. Normative recommendations are articulated according to the Problem of Preservation. A conclusion follows.

II. CORPORATE BANKRUPTCY REDISTRIBUTION

Redistribution in a bankruptcy setting—any bankruptcy setting—is ever-present and inexorable. Understanding this insight holds the key to understanding what bankruptcy is all about.

Redistribution can be broadly defined as any alteration of pre-bankruptcy entitlements held by agents—i.e., formation of a new bankruptcy entitlement or destruction of a pre-bankruptcy entitlement—that occurs once the firm enters a formal collective bankruptcy procedure. A provision of bankruptcy law is redistributive to the extent that it creates a bankruptcy entitlement or destroys a pre-bankruptcy entitlement.\(^{37}\)

Redistribution can be blatant. One form of such redistribution, for example, manifests in direct deviation from the absolute priority senior claimants are entitled to enjoy over junior claimants, as dictated by bankruptcy's main distributional rule—the absolute priority rule. Redistribution can nevertheless be more concealed.\(^{38}\) In order to understand how bankruptcy redistribution occurs, bankruptcy's fundamentals should first be exposed.

A. The Fundamental Elements of Bankruptcy

The most prominent feature of any western bankruptcy regime is its collective nature. In fact, one can argue that, by definition, a bankruptcy procedure is a collective procedure. Descent of the firm into insolvency is erupted by a collective effort—which in all legal systems is led by a bankruptcy court (meaning, the government)\(^ {39}\)—aimed at addressing problems emanating from the firm's financial distress. One such problem, for example, is the problem faced by claimants of the firm—creditors and shareholders—who wish to collect on account of debts owed to them by the firm. Bankruptcy's collective endeavor replaces any pre-bankruptcy individual debt collection procedures, attempts, and initiatives.\(^ {40}\)

\(^{37}\) This definition corresponds to prevailing definition in bankruptcy literature. See, e.g., JACKSON, supra note 3, at 22.

\(^{38}\) See infra part I.C.

\(^{39}\) IAN F. FLETCHER, INSOLVENCY IN PRIVATE INTERNATIONAL LAW — NATIONAL AND INTERNATIONAL APPROACHES 4-5 (1999).

\(^{40}\) One might depict a continuum of collection alternatives, ranging from sweet-talking the debtor through formal state-supported procedures, and ending at using violence to force debtors to pay. The stay in fact halts all methods employed by claimants to collect debts. See David G. Epstein, Steve H. Nickles, & James J. White, BANKRUPTCY 66 (1993).
Inherent to the title of collectivity are two elements: first, a stay imposed on individual claimants’ debt collection efforts with respect to their pre-bankruptcy claims; and second, the issuance of a coherent scheme, the purpose of which is the assimilation of the firm’s assets and its orderly distribution among the firm’s different pre-bankruptcy claimants. A distribution scheme is needed to substitute the “first come, first served” pre-bankruptcy distribution regime. The stay and the distribution scheme that follows it are coercive in all jurisdictions, and claimants usually cannot contract their way out of it.  

The collective nature of the bankruptcy process dictates that bankruptcy tasks must be performed jointly. For a collective approach to be possible at all, individual debt collection actions must be halted. Thus, a stay is imposed on individual debt collection efforts. The bankruptcy court then becomes a collective forum, making in rem decisions that bind all, regarding the assets of the distressed firm. From an economic point of view, the firm—as a legal entity in charge of deploying its resources—is ignored and becomes de facto irrelevant, leaving behind only the collection of assets it previously owned.

In some legal systems a trustee is appointed by the court to take over the firm’s business and assets, for the good of the claimants. In other jurisdictions, the firm’s current management is left in charge of the business—as a “debtor-in-possession”—and fulfills a similar task to that of a trustee. Nevertheless, all appointed officials perform exclusively under the guidance of the bankruptcy court, and need to seek its approval for every significant action taken by them. Creditors’ committees are sometimes formed to assist in supervising the bankruptcy process and to protect the interests of creditors. Sometimes the Official State Trustee enters the bankruptcy case in order to increase the level of supervision. Disclosure by the firm to creditors is also made collectively, by way of submitting information to the bankruptcy court. Finally, the collective form of dealing with the firm’s financial distress influences yet another aspect of the bankruptcy regime: An ad hoc dispute


42. Some legal systems apply an automatic stay, which comes into effect whenever a bankruptcy procedure is initiated. U.S. bankruptcy law is an example. See Bankruptcy Code, 11 U.S.C. § 362 (LEXIS through 2007 legislation). In other jurisdictions the stay is a discretionary tool, which the bankruptcy judge can decide whether or not to use.

43. For example, this is the case in the United Kingdom. In the United States, a trustee is usually appointed to run only a liquidation procedure. See id. §§ 701-702. A trustee might be appointed in reorganization cases under extreme circumstances to protect creditors’ interests. See id. §§ 1104, 1107.

44. American bankruptcy law is an example. See id. § 1107.

45. See id. §§ 705, 1102.

46. See ELEMENTS OF BANKRUPTCY, supra note 27, at 5-6.

47. Id. at 210-11.
resolution mechanism, which is run by the bankruptcy court, and which often
demonstrates a clear preference for administrative efficiency over judicial
precision.48 Thus, for example, disputes between the firm and third parties, and
disputes among claimants, that would ordinarily (had a bankruptcy procedure
not been initiated) be resolved in the proper forum possessing jurisdiction over
the case, are now resolved almost exclusively by the bankruptcy court, in order
to save time.49

The second element inherent to the collectivity feature of bankruptcy
concerns the distribution scheme. The decisions made by the bankruptcy court
regarding the assets of the firm eventually yield a limited economic value to be
distributed among the firm's claimants. However, in most—if not all—
bankruptcy cases, the value (the bankruptcy estate) to be distributed among the
claimants is insufficient to satisfy all claims brought against the firm. As a
result, a rational and consistent loss distribution scheme must be implemented.

When speaking of distributing the proceeds generated by the bankruptcy
procedure,50 the principle of pro rata equality51 probably comes to mind. Many
courts actually still adhere to such a perception of bankruptcy law.52 Indeed,
even the first documented attempt in history to formulate a bankruptcy law—
the English parliament's act "Against Such Persons As Do Make Bankrupts" of
1543—ordered for the bankrupt's assets to be distributed to his creditors in "a
portion rate and rate like, according to the quantity of their debt."53 Further
down the line it was the slogan "equality is equity" that dominated judicial
opinions dealing with distribution.54

Still, when closely examined, bankruptcy's distribution scheme appears
only marginally based on equality.55 The many so-called exceptions to the
principle of equality in distribution reveal that it is in fact another rule of

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(1993).
49. The criterion for screening disputes to be resolved elsewhere from disputes to be resolved in the
bankruptcy court varies from one legal system to another. For example, sometimes the criterion is the
extent of factual litigation expected.
50. The following discussion is relevant whether a liquidation procedure or a reorganization
procedure is commenced.
51. Sometimes referred to as the "pari passu principle," "equality rule" or "equality principle."
52. See Beiger v. IRS, 496 U.S. 53, 58 (1990) (noting that equality of distribution among creditors
is the central concern of the Bankruptcy Code). See also the discussion in Jay Lawrence Westbrook, The
Control of Wealth in Bankruptcy, 82 Tex. L. Rev. 795, 822-23 (2004) [hereinafter The Control of
Wealth in Bankruptcy].
54. For example, in the United States, creditor equality has been a basic tenet of bankruptcy policy
since the very first U.S. bankruptcy statute of broad, general applicability, enacted in 1841, ch. 9, 5 Stat.
440, "whose aim [was] to divide the assets equally, and therefore equitably." See Shawhan v. Wheritt,
48 U.S. 627, 644 (1849).
55. Rizwaan Jameel Mokal, Priority as Pathology: The Pari Passu Myth, 60 Cambridge L.J. 581,
582-83, 585-87 (2001) [hereinafter Priority as Pathology].
distribution—the absolute priority rule—that dominates the distribution scheme.\textsuperscript{56} To be sure, bankruptcy’s distribution scheme could be summed by two basic rules of distribution. First, horizontal equality among claimants of the same class must be maintained. In many jurisdictions, applying the pro rata criterion attains such equality.\textsuperscript{57} Thus, claimants within each predefined class receive the same \textit{percentage} of their debt as other claimants in their class.\textsuperscript{58} Second, vertical \textit{inequality} among claimants of different classes must be maintained. Claimants of a higher class should enjoy absolute priority in distribution over claimants of a lower class.\textsuperscript{59} The claimants in the lower class are entitled to nothing unless the claimants in the higher class are paid in full. The latter scheme represents the absolute priority rule.

Focusing on the absolute priority rule, it is essential to notice that the hierarchy of classes among the claimants is actually forged outside the law of bankruptcy or the bankruptcy procedure.\textsuperscript{60} This hierarchy of classes derives from contracts made by the firm with its claimants,\textsuperscript{61} or from direct legislative instructions, or from the consequence of applying various rationales (including efficiency-based),\textsuperscript{62} all of which share one common feature: they are unrelated

\textsuperscript{56} One needs to distinguish between the absolute priority rule when referred to as a general principle relating to distribution in any bankruptcy setting, and between the exact same term mentioned to describe a rule devised in the United States to protect creditors against manipulations and abuses inflicted upon by secured creditors and shareholders. The latter use of the term “absolute priority rule” was the result of an era in American history, in the beginning of the nineteenth century, in which a receivership system was devised by lawyers to cope with a then-prevailing phenomenon of huge railway companies turning insolvent. See, e.g., Bruce A. Markell, \textit{Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations}, 44 STAN. L. REV. 69, 74-77 (1991).


\textsuperscript{58} For example, assume the trustee was able to gather $200 from selling all the firm’s assets. Creditors A, B, and C are owed $200, $50, and $250, respectively. A pro rata distribution would have creditor A receive $80, according to the following calculation: $200/(@200+50+250)\times200 = 80. Creditor B would receive $20; and creditor C would receive $100.

\textsuperscript{59} For example, assume creditor D is of a lower class to that of Creditors’ A, B, and C. Continuing the previous example, creditor D would receive nothing in a distribution. Creditor D would have received something had the trustee been able to gather more than $500 (the sum of A, B, and C’s debts) from the firm’s assets.

\textsuperscript{60} See, e.g., Thomas H. Jackson, \textit{Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain}, 91 YALE L.J. 857, 860 (1982) (“[E]quals are to be treated equally in bankruptcy: the important determination of who those ‘equals’ are is often not resolved under bankruptcy law.”). Although priorities among claimants are relevant only when the firm cannot pay all of them, it is still imperative to understand that not all insolvencies must end in a bankruptcy procedure.

\textsuperscript{61} Many jurisdictions have legislated a special priority status for certain debts such as tax debts, debts resulting from unpaid employees’ wages, unpaid rent, etc. These debts enjoy a priority status outside bankruptcy as well.

\textsuperscript{62} The hierarchy of classes is determined also as a result of “ex-ante deviations” from the absolute priority rule. These deviations can occur even if no collective procedure is conducted at all. They occur, for example, in an individual execution or foreclosure procedure as well. Note however, that the reasons for such redistributive effects, while unrelated to bankruptcy policy, might still be efficiency-based. Ex-ante deviations from the absolute priority rule take place, for example, when an unsecured creditor physically holds an asset of the firm in which the former has made improving alterations, and the debt owed by the firm to this creditor originates from the unpaid-for improvements. Certain jurisdictions have granted the unsecured creditor’s claim priority over all other claims against the firm. This is the

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whatsoever to bankruptcy policy. While these hierarchy-setting doctrines envision the default of the firm on its debt, and perhaps even the firm's default on many debts at once, they nevertheless assume no particular problem except that which emanates from the default itself.

Priorities held by claimants reflect, therefore, pre-bankruptcy entitlements. Inside bankruptcy, each claimant's pre-bankruptcy priority (or entitlement) is merely preserved. Consider the classic examples. A contract made by the firm with a creditor, granting the creditor an entitlement to levy on a specific asset in case the firm defaults on his claim—thus making him a secured creditor with respect to that particular claim—is undeniably respected within the bankruptcy forum. But secured debts get paid in full before unsecured debts, even if no collective bankruptcy procedure is initiated at all. The secured creditors' priority is unrelated to the initiation of a collective bankruptcy procedure.

Similarly, unsecured creditors get paid in full before equity holders can enjoy any dividend on their investment in the firm, inside any bankruptcy procedure as well as outside. Indeed, the justifications for each class of claimants' superiority over lower ranking classes are contextual and determined notwithstanding the initiation of a bankruptcy procedure.

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<table>
<thead>
<tr>
<th>Class #</th>
<th>Class of claims</th>
<th>Included in the Class of claims</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Secured claims</td>
<td>Claims secured by specific assets as collateral</td>
</tr>
<tr>
<td>2</td>
<td>Preferential claims set by the law</td>
<td>For example: Administrative expenses (expenses of running the bankruptcy estate after the commencement of a case); Specific tax debts; Rent debts; Unpaid employees fees; etc.</td>
</tr>
<tr>
<td>3</td>
<td>Claims secured by a crystallized floating charge (in certain countries)</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Unsecured claims</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Shareholders</td>
<td></td>
</tr>
</tbody>
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63. In several jurisdictions the absolute priority rule is applied—ignoring deviations that occur during an ongoing bankruptcy procedure—with reference to the following hierarchy of classes of claims (running from the most senior to the most junior):

64. To be more cautious and accurate, this proposition should perhaps be rephrased: The doctrines that set the hierarchy of priorities among claimants undertake to solve problems none of which requires a collective mechanism as part of the solution. On the other hand, a famous problem, for example, described in bankruptcy literature, which allegedly does require a collective problem-solving mechanism, concerns the common pool problem unsecured creditors of the firm face as the firm's finances begin to deteriorate and the firm approaches insolvency. This is the problem described by the "Creditor's Bargain" theory. See supra note 3.

65. As far as unsecured creditors' priority is concerned, this priority (over the firm's shareholders) is contract-based, except for nonconsensual creditors, whose priority is set by the legislator.

66. See, for example, the voluminous debate concerning the superiority of secured debt. For an updated review of literature, see Claire A. Hill, Is Secured Debt Efficient?, 90 TEX. L. REV. 1117 (2002).
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The vertical distribution rule—the absolute priority rule—thus dominates the distribution scheme. Only when there can be found no recognized justification for distinguishing a specific claimant from his fellow claimholders or for awarding him priority over lower ranking claimants, does a residual, or fall-back, rule of distribution—the rule of horizontal equality—kick in. This rule forces that claimant to share with others in his position the remaining value, on a pro rata basis. This scenario is why, for example, unsecured creditors of the firm share among themselves pro rata of the value left for them. The law does not accept as legitimate any difference between unsecured creditors that can justify awarding some of them priority over others.

One might wonder whether following the absolute priority rule, as a vertical distribution rule, in bankruptcy is desirable. Yet since the different ranks of classes of claimants under the absolute priority rule are set outside bankruptcy, the question becomes whether one should preserve the absolute priority rule within bankruptcy’s collective procedure. This question of preservation shall be addressed later.

B. Introducing Bankruptcy’s Redistributive Aspects

Consider the following basic development. Firm’s financial affairs are quickly deteriorating, and several creditors have been trying to salvage their claims by forcing Firm to pay them. Creditor A is an unsecured creditor of Firm, and is expected to be paid by Firm $10,000 on August 1, on account of a claim he holds against Firm. Firm is struggling, but will be able to pay Creditor A, and is indeed expected to do so in order to retain its vital business

67. Resorting to a residual rule of equality actually reflects an efficiency rationale of administrative nature. Within each class of seemingly “identical” claimants—for example, the class of unsecured creditors—there could have been further inquiry by the bankruptcy court as to who should be awarded priority, for instance, because of being extremely poor or desperately in need (or possessing blue-colored eyes, etc.). But assuming no efficiency goal can be achieved by conducting such a costly inquiry, and only justice in general might be promoted, bankruptcy laws refrain from such distribution, and adhere to the equality rule of distribution. Stated differently, a residual rule of equality is an indispensable and inherent result of conducting a collective regime, which applies a distribution scheme different than the “first come, first served” pre-bankruptcy regime. See also Priority as Pathology, supra note 55, at 613 (“The pari passu principle applies, then, whenever the costs of providing for different rankings for different claims would exceed the benefits”).

68. Pro rata equality, rather than other forms of equality, makes sense as a compromise between the need to avoid arbitrariness in distribution on the one hand, and a burdening inquiry into the claimants’ traits, on the other hand.

69. Although one can think of several reasons according to which to differentiate certain unsecured creditors and award them priority, being non-consensual creditors, as opposed to consensual creditors, has been argued to be a sufficient reason to justify granting non-consensual creditors special priority. See Note, Switching Priorities: Elevating the Status of Tort Claims in Bankruptcy in Pursuit of Optimal Deterrence, 116 HARV. L. REV. 2541 (2003). Another example one could think of relates to the possession of information. One could argue that creditors who have obtained superior information regarding the firm’s financial distress, and who have been using their information to better their position by collecting their debt sooner—should indeed be awarded superior priority, and the transfer of value to them, which in fact reflects their superior information, should not be overturned.

70. See Part III, infra.
relationship with Creditor A. Creditor B, an unsecured creditor whom Firm owes a similar amount, is in the midst of levying on Firm’s assets, following a court judgment, and on August 1, is expected to complete the legal procedures he has initiated and thereby retrieve his debt in full. Creditor C is a secured creditor, who in light of Firm’s failure to repay its loan, intends on August 1, to begin foreclosure on the collateral securing the payment of the loan. However, all those plans are interrupted at once on July 31, when Firm files for a Chapter 11 relief. A collective bankruptcy procedure is initiated. All individual collection efforts against Firm are stayed, and all forms of distribution to creditors are prevented. At the end of this collective procedure, which lasts several months and takes a turn for the worse once a liquidation path is chosen by the bankruptcy court, Creditor A and Creditor B share with other unsecured creditors pro rata, and therefore each receives only 30 percent of his nominal claim ($3,000), instead of the 100 percent each expected to collect. Creditor C is paid back his entire nominal claim, but receives no compensation for the lost time value of his money.

This simple scenario illustrates just how intrinsic redistribution is to any bankruptcy-related intervention in the ordinary course of events surrounding the firm’s deterioration, and how redistribution affects claimants and other parties as well. After all, it is possible, and in fact likely, that conducting the collective bankruptcy procedure in the example has increased the total value to be distributed among Firm’s various claimants, the result of which was perhaps also payment of dividends to certain claimants—such as Creditor D—who otherwise would have received nothing. Indeed, even those unsecured creditors who did not intend to make any collection effort whatsoever still share pro rata with unsecured creditors who did put an effort in preventing the debtor from destroying value. Thus, in the present example, the payment to D became possible at the expense of A, B, and C; who had not for the commencement of the bankruptcy proceeding, would have collected their entire debt.

It is important to note that bankruptcy redistribution can also occur in relation to non-pecuniary entitlements. For example, to the extent that a collective bankruptcy procedure halts, cancels altogether, or alters in any way any regulatory action taken by the government against the distressed firm, it actually brings about a redistributive impulse, even if such an impulse does not culminate in a straightforward monetary adjustment.

71. As one scholar put it: “Business failure affects radically diverse interests - the interests of the creditor in being paid, the interest of the shareholder in maintaining her residual claim to the earnings of the business, the interest of the employee in retaining her source of income, and the interests of the surrounding community in maintaining an institution that provides numerous indirect benefits. The toll that business failure exacts on dependent constituencies goes beyond job loss and creditor recovery statistics. The closing of a failed business may produce shock waves that reverberate throughout the local, regional or national economy.” See Frost, supra note 14, at 76.
C. Contexts of Bankruptcy-Related Redistribution

Any attempt to formulate a theory that ensues in a single justification for all redistributive aspects of bankruptcy is doomed to fail.\(^7\) The reason is simple: bankruptcy redistribution can emanate from several sources\(^7\) and can serve a number of goals. For example, it certainly can serve a pure distributive purpose, justifying redistribution of wealth from "rich" and well-diversified creditors to "poor" employees, whose entire human capital is invested in the firm. Bankruptcy laws in other jurisdictions seem to straightforwardly adopt such a policy of redistribution.\(^7\) On the other hand, bankruptcy redistribution also intends to target creditor misbehavior.

It is more useful then to describe bankruptcy redistribution in its different contexts. At least three such contexts can be identified.

1. Commencement of the Collective Procedure

As already mentioned, the mere commencement of bankruptcy's collective procedure is by itself highly redistributive. The collective procedure interrupts the ordinary course of events surrounding the firm's day-to-day existence, including its claimants' efforts to retrieve their claim,\(^7\) and therefore inevitably alters pre-bankruptcy entitlements. The economic effect of producing redistribution from one agent to another emerges from the materialization of each agent's understanding (which in fact is a prediction he makes) of "what could have happened" had a collective bankruptcy procedure not been launched. In bankruptcy, Creditor A received only 30 percent of his claim, but Creditor A knows that had a collective procedure not been initiated, he would have retrieved his claim in its entirety. Similarly, Creditor D received 30 percent of his claim, but Creditor D knows that had a collective procedure not been launched, he would have retrieved nothing further down the line.

The commencement of the collective procedure hosts a variety of redistributive impulses. For example, once a collective procedure begins, no transaction in the firm's assets is allowed, and all post-bankruptcy transactions are—by default—rendered void.\(^7\) Special privileges are often awarded to

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72. Although several such attempts have been made. See Jackson & Scott, supra note 17; Richard V. Butler & Scott M. Gilpatrick, A Re-Examination of the Purposes and Goals of Bankruptcy, 2 AM. BANKR. INST. L. REV. 269 (1994); Paul B. Lewis, Bankruptcy Thermodynamics, 50 FLA. L. REV. 329 (1998).

73. See, e.g., Jackson & Scott, supra note 17, at 163 (the typology specified).

74. For example, in France employees are accorded a special status, and their interests are sometimes preferred over those of creditors. See Kevin M. J. Kaiser, European Bankruptcy Laws: Implications for Corporations Facing Financial Distress, 25 FIN. MANAGEMENT 67, 72 (1996).

75. For example, the stay prevents claimants from filing a lawsuit against the firm. Moreover, individual debt collection procedures undertaken by claimants prior to the initiation of bankruptcy are annulled, to the extent that the relevant procedure did not reach a formal completion.

76. See Bankruptcy Code, 11 U.S.C. § 541(a) (LEXIS through 2007 legislation); Epstein, Nickles
certain agents, including the firm, only because a collective procedure has commenced or is being conducted.\textsuperscript{77}

A redistributive effect is also created when the trustee in bankruptcy decides whether to assume or reject certain contracts, which are referred to as "executory contracts"—contracts that simultaneously supply the firm with a liability as well as with an asset.\textsuperscript{78} The act of assuming an executory contract is possible despite the fact that the firm might have breached the contract, thus entitling the other party either to withdraw away from it or demand damages. If the contract is assumed in bankruptcy, the other party is denied his right of withdrawal and—as far as damages are the subject matter—is relegated to the status of a pre-petition unsecured creditor (although contractual obligations incurred once the contract is assumed are treated as post-petition administration expenses and are usually paid in full). If rejected in bankruptcy, the other party to the contract can demand damages on account of the breach, but is nevertheless relegated to the status of a pre-petition unsecured creditor.

Perhaps another significant redistributive effect emanating from the commencement of the collective procedure is the change in priority granted to liabilities incurred by the firm once a bankruptcy procedure has been formally initiated, and during the period of time in which the procedure is being conducted. Called "administrative expenses," new liabilities incurred during this period of time are granted priority and are paid from any value gathered before all other pre-bankruptcy unsecured claims.\textsuperscript{79} Pre-bankruptcy non-claimants, for example, with whom the firm in bankruptcy contracts during the time a collective procedure is being conducted, are awarded this super-priority; if a collective procedure had not been initiated, however, non-claimants like that would not have enjoyed any such benefit. Moreover, since the bankrupt firm sometimes needs to contract in bankruptcy with a pre-bankruptcy creditor—say, a supplier whose services are indispensable—and since this critical vendor can take advantage of the fact he is being needed, he can effectuate a redistributive change in his favor: his pre-bankruptcy claim would be paid ahead of other pre-bankruptcy claims.\textsuperscript{80} Finally, the process of running any bankruptcy proceeding takes time. When a secured creditor is prevented from taking possession of or enforcing a lien on a property of the debtor-firm during bankruptcy, and is awarded, in exchange, by the court, "adequate protection" that later proves to be inadequate, this creditor has a claim that is

\& White, supra note 40, at 32-33, 406.

\textsuperscript{77} See, e.g., 11 U.S.C. § 525, which prevents any governmental agency, under certain conditions, from revoking a license the debtor holds.

\textsuperscript{78} See id. §§ 365(b), 1124(2).

\textsuperscript{79} See id. § 364(b).

\textsuperscript{80} See Joshua A. Ehrenfeld, Quieting the Rebellion: Eliminating Payment of Prepetition Debts Prior to Chapter 11 Reorganizations, 70 U. CHI. L. REV. 621 (2003).
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given super-priority over every other administrative expense. This change in priorities is also a redistributive effect.

2. Regulating Eve-of-Bankruptcy Behavior

Regulating eve-of-bankruptcy behavior constitutes a second context of redistribution that is not as systematic as the first one, but is nevertheless evident in many bankruptcy cases. The initiation of a bankruptcy procedure may trigger several redistributive doctrines dictated by bankruptcy law, all of which target specific pre-bankruptcy acts and omissions associated with specific agents. For example, the doctrine of equitable subordination marks as its objective the prevention of misbehavior by shareholders. Another example is the doctrine of directors' liability: certain jurisdictions have enacted laws that enable the bankruptcy court to hold directors and managers of bankrupt firms liable for not placing an insolvent firm in a collective bankruptcy procedure, or for fraudulently managing the firm prior to its bankruptcy.

Moreover, certain powers granted to the bankruptcy trustee target various actions of agents on the eve-of-bankruptcy, and result in redistribution. For example, the trustee appointed to collect a firm's assets ignores a security interest in that firm's assets that have not been properly perfected or publicly recorded by the proclaiming-to-be secured creditor prior to the bankruptcy filing. The assets claimed to be subjected to the security interest are nevertheless included in the bankruptcy estate. Another well-known example for regulating eve-of-bankruptcy behavior is the doctrine of preferences, which targets unlawful opt-out attempts made by claimants at the eve-of-bankruptcy. Opt-out attempts are sometimes assisted by the firm or by its insiders, the purpose being to release a claimant from the grim future of having to share with other claimants a limited pool of value in case the firm enters a formal bankruptcy procedure. Powers awarded to the

82. Note that similar doctrines exist to regulate misbehavior of agents in case the firm turns insolvent, but do not relate to bankruptcy policy per se, such as "piercing the corporate veil" or issuing civil suits against third parties.
84. In Britain, section 214 of the Insolvency Act 1986, called the "wrongful trading provisions", avails a liquidator with an option to file an action against directors of liquidating firms, who knew or ought to have known that there was no "reasonable prospect" of avoiding liquidation, unless from then on the director took every step to prevent creditors from loosing money. See Rizwaan Jameel Mokal, An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain, 59 CAMBRIDGE L.J. 335 (2000) [hereinafter Wrongful Trading Provisions].
87. See id. § 547.
trustee allow him to both redistribute value and recover the bankruptcy estate’s value that was transferred by the firm to a claimant prior to the initiation of the bankruptcy proceeding. Put differently, the trustee’s avoiding powers actually enable him to fix and freeze the absolute priority rule with regard to a defined and specific ranking of claimants’ classes, at a certain moment in time that precedes the initiation of a formal bankruptcy procedure. From that moment forward, the ranking of classes remains constant.

Yet another redistributive impulse in this context is represented in the doctrine of fraudulent conveyances, which targets unlawful opt-out behavior of the debtor-firm itself. The classic case is of an insolvent firm giving its assets for less than fair consideration, thus making the recipient of the value better off, while its claimants are made worse off. Such transfers are annulled in bankruptcy.

3. Reorganization and Ex-Post Deviations From Absolute Priority

The third and final context to host redistributive impulses is the process of reorganization. Corporate bankruptcy reorganization proceedings display several redistributive occurrences. For the most part, these impulses reflect deviations from the absolute priority rule. In fact, three redistributive changes are repeatedly observed in reorganizations.

The first concerns the freezing-out of unsecured creditors. According to the absolute priority rule, shareholders of an insolvent firm, which owes more than its assets are worth, are due to receive nothing within any distribution scheme in bankruptcy unless one of two things happens: either the unsecured creditors themselves consent to having their claims be subordinated to those of the shareholders or the bankruptcy procedure unexpectedly yields a large enough value, from the bankruptcy estate, that makes it possible to pay all of the firm’s debts. Nevertheless, a phenomenon frequently observed in reorganization scenarios is of shareholders of the firm—contrary to the absolute priority rule—exiting the collective procedure with value, while the higher-ranking class of unsecured creditors receives nothing or a payoff equal to only a

88. See id. § 544(b).
89. See, e.g., Senbet & Seward, supra note 1, at 947-48. Any investigation into redistributive effects occurring during the reorganization of firms must account for several questions. First, is the redistributive effect a formal one—that is, currently dictated by bankruptcy law—or only an informal phenomenon to be observed? Second, is the redistributive effect a systematic one that occurs in each and every case reorganization is undertaken? Third, what is the rationale justifying any one of the redistributive effects? Is there a common denominator for all of them? Fourth, what are the ex-ante implications of each redistributive effect? In what way does it influence the behavior of agents when the firm operating is operating in a pre-bankruptcy environment? Fifth, does the redistributive effect induce a wealth transfer? This inquiry, however, is beyond the scope of the current article.

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fraction of its claims. Since most reorganization regimes are founded upon a process of negotiation among the different classes of claimants, this maneuver of "freezing-out" unsecured creditors results from such multi-party negotiations. The reorganization plan often awards old shareholders of the firm ownership interests in the reorganized firm, while unsecured creditors are left with nothing or with interests in the firm reflecting the value of only a fraction of their claims. This economic outcome, where unsecured creditors are frozen-out by the reorganization plan conceived by the claimants—is then tested by the law. For example, in most bankruptcy regimes, the bankruptcy court supervises the negotiations and the court’s approval is required; otherwise, there can be no reorganization of the firm’s capital structure. If all claimants approve a proposed plan, the court will confirm it. Yet even an objection of claimants to the plan can be imposed upon, or in bankruptcy terminology, be "crammed down" on. Thus, even if a class of claimants—including that of the unsecured creditors—does not consent to a proposed reorganization plan the old shareholders can still retain ownership in the firm if the plan is to guarantee the dissenting class full repayment of its allowed claims. Otherwise, the plan is perceived to be violating the absolute priority rule, since a lower-ranking class (shareholders) receives value before a higher-ranking class (unsecured creditors), and the plan will be disqualified. Still


92. It is important to notice, that another redistributive effect can occur in negotiation-based reorganizations, but that effect is concealed and unintentional, rather than exposed and deliberate as the freeze-out effect: when a re-capitalization of the firm is being debated by the claimants and by the supervising court, an inaccurate estimate of the firm’s true value would end in a redistribution towards lower-ranking claimants. For example, if the firm is indebted to its senior claimants in the amount of $10 million, and to junior claimants in an amount of $15 million, an estimation of the firm’s value as being $15 million, would result in junior claimants receiving shares in the reorganized firm as well, even if the absolute priority rule is strictly upheld. But if it turns out that the true value of the firm was in fact only $12 million, the senior claimants end up holding an asset (shares in the reorganized firm) worth only $8 million, instead of owning shares in an amount equal to $12 million. The junior claimants have been awarded the missing $4 million, and thus enjoy this redistributive effect. See Jerold B. Warner, Bankruptcy, Absolute Priority, and the Pricing of Risky Debt Claims, 4 J. FIN. ECON. 239, 244 (1977). Replacing the decision-making mechanism can solve the problem.

93. Usually, a class of claimants is considered to have accepted a plan if a majority of the class and those holding a defined fraction—for example, two-thirds—of the total dollar amount of the claims within that class, vote to approve the plan. See 11 U.S.C. § 1129(c).

94. See id. § 1129(a). Theoretically, a plan may be confirmed by the court despite objections to it, if the plan reinstates all pre-bankruptcy entitlements in full. This is a rare scenario, however, since it means that the firm is in fact not insolvent.

95. See 11 U.S.C. § 1129(b)(1), which permits confirmation of a reorganization plan despite a dissenting class of claimants’ objection, if "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." § 1129(b)(2) describes the required features of a “fair and equitable” plan.

96. See id. § 1129(b)(2)(B)(i).

97. See 11 U.S.C. § 1129(b)(2)(B)(ii), which states that in order to be crammed down on a
(and taking a more realistic approach to plans violating the absolute priority rule), bankruptcy laws approve of a reorganization plan, the effect of which is to freeze-out unsecured creditors while violating the absolute priority rule—and the approval being made despite the unsecured creditors’ objection—as long as the plan meets the terms of a doctrine called the “New Value Exception Doctrine.” According to this doctrine, old shareholders of the firm can be awarded an entitlement of some sort against the reorganized firm—usually an equity interest—even if unsecured creditors are not paid in full and the absolute priority rule is breached. This is possible to the extent that the old shareholders make a new contribution of value—in money or money’s worth—to the reorganized firm.

Consider a second redistributive change to occur in corporate reorganizations. Often enough, the success of reorganization attempts (especially those that take time to complete) depends on the bankrupt firm’s ability to obtain new capital. New financing is needed first of all, in order to allow the firm entering a bankruptcy procedure to maintain its ongoing production unit. While the stay imposed in bankruptcy on any debt collection efforts made by creditors relieves the firm from the burden of having to repay debts as they come due, or pay interest on loans, the firm nevertheless has no source of free cash to turn to in order to buy raw materials or pay employees. If the firm is making use of an asset owned by another—for example, renting a building, using another firm’s vehicle, etc.—it needs to raise money in order to pay the owner for any further use of his asset. Sometimes new financing is needed even to merely alleviate the pressure exerted on the distressed firm by dissenting class, the plan must meet the following condition: "the holder of any claim or interest that is junior to the claims of . . . [the impaired dissenting] class will not receive or retain under the plan on account of such junior claim or interest any property."

98. In the United States, the doctrine, which is sometimes referred to as “the new value corollary,” is judicially-crafted and was stated for the first time in *Case v. Los Angeles Lumber Products Co.* 308 U.S. 106, 118, 121-22 (1939) ("[T]here are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor . . . Where th[e] necessity [for new capital] exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made . . . [W]e believe that to accord 'the creditor his full right of priority against the corporate assets' where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder."). The very existence of the doctrine has been subject to controversy in American law, since the language of the statute (§ 1129(b)(2)(B)(ii)) virtually does not speak of such an exception to the absolute priority rule. Finally, in 1999, the U.S. Supreme Court acknowledged a narrow version of the doctrine. See *Bank of Am. Nat'l Trust and Savings Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 449 (1999). This version conditions the confirmation of a new value plan upon receiving an assurance that the price that old shareholders offer, in order to retain ownership in the reorganized firm, is "the best obtainable"; and upon receiving such assurance by way of resorting to a “market valuation.” See *id.*, at 456, 458. In other words, a cramdown of a new value plan will be possible only if other investors get a reasonable chance to buy the equity interest offered to the old shareholders.

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its creditors. Indeed, empirical studies show that a positive correlation exists between resorting to new financing during reorganization and the probability of succeeding to reorganize the firm and minimizing bankruptcy costs. Firms in bankruptcy, therefore, contract with non-claimants to obtain new capital from them. But the high risk involved in lending money to an already insolvent firm, the uncertainties accompanying any prediction regarding the future of the firm in bankruptcy, and perhaps also the negative stigma attached to lending money to a bankrupt firm, often result in the firm being compelled to offer the new financier higher priority over other pre-bankruptcy claimants in repayment of the claim created when the new money is lent.

Many bankruptcy regimes acknowledge the necessity of obtaining new credit during attempts to reorganize the firm, and thus equip bankruptcy courts with the power to approve of such upgrading of the entitlements held by the non-claimant offering an injection of new capital to the reorganizing firm. Non-claimants offering new financing can be rewarded in several ways. First, the claim resulting from lending the new money can be treated as an “administrative expense,” which—as recalled from earlier comments—puts the new financier’s claim ahead of all other unsecured claims. Second, the new financier’s claim can be given priority over all other “administrative expenses.” Third, if the firm still owns unencumbered assets, the court can give the new financier a security interest in those assets, consequently putting his claim ahead of all other unsecured creditors’ claims in the order of priorities. Fourth, the new financier’s claim can be awarded super-priority, that is, priority not only over unsecured claims but also over secured pre-bankruptcy claims.

Another agent who often enjoys a redistributive impulse (similar to the new supplier of finance) during attempts to reorganize is one of the firm’s suppliers, whose services are needed by the firm to such an extent that the supplier can extract a payment of a pre-bankruptcy debt owed to him, before other debts are paid by the firm. The critical vendor can be either a much-needed trade

100. See id. at 910. The authors give an example of a firm that borrowed $250 million to use only as a credit cushion, in order to provide other creditors with confidence in the firm’s viability.


102. In the United States, the financing of firms in Chapter 11 is called “debtor-in-possession financing.”


105. See id. § 364(c)(1).

106. See id. § 364(c)(2).

107. See id. § 364(d)(1). The new financier is awarded a “priming lien.”

supplier of the firm, or even a key employee threatening to leave if demands are not met. While the law is not always clear as to what to do with such demands by critical vendors, certain jurisdictions have demonstrated a willingness to approve of such payments.\textsuperscript{109}

Finally, consider a third redistributive change to occur during reorganization. When a stay is imposed on claimants’ attempts and efforts to withdraw the investment made by them in the firm, pre-bankruptcy entitlements requires bankruptcy law to supply secured creditors of the firm with special protections.\textsuperscript{110} Indeed, secured creditors have contracted with the firm to provide it with capital in exchange for a superior entitlement compared to other claimants, in case the firm defaults on their debt, and were promised to enjoy the benefit of foreclosing and taking away a particular asset of the firm—the collateral—in case such default occurs. The commencement of bankruptcy procedure expropriates from the secured creditor the right to determine the exact format upon which to withdraw his claim from the firm, leaving him with a diluted entitlement. This already-diluted entitlement, however, needs to be preserved during reorganization attempts. Secured creditors can be awarded two kinds of protections during the time a reorganization procedure is being conducted in order to preserve their entitlement: first, a protection against \textit{temporal} depreciation of the collateral; second, a protection against \textit{physical} depreciation of the collateral. Both protections are intended to guarantee that secured creditors are able to contract with the firm—at the time secured creditors extend a loan to the firm—to enjoy in reorganization the two-components-based entitlement. Protecting against \textit{temporal} depreciation means that secured claims should be paid the accumulated interest on the value of their collateral at the end of the reorganization process—"post-petition interest"—as such interest should accrue for the time period the reorganization takes place and the collateral is withheld from the secured creditors. Withholding the collateral away from any foreclosure, for the period in which reorganization is attempted, denies that creditor of the possibility to sell the collateral and collect its market price, which subsequently could be invested by the secured creditor elsewhere. The lost time value of money is to be compensated by paying the secured creditor interest on an amount equal to the market price of the collateral.

Protecting against \textit{physical} depreciation means that secured claims should be given "adequate protection" during reorganization efforts in order to prevent mishaps from decreasing the value of the collateral, and hence the size of the

\textsuperscript{1} \textsc{Depaul Bus. \\ & Comm. L.J.} \textbf{361}, 390 (2003).

\textsuperscript{109} See Tabb, \textit{supra} note 108, at 92-103.

\textsuperscript{110} See 11 U.S.C. \textsection 362(a), which imposes an automatic stay, and \textsection 362(d)(1) which orders that secured creditors be relieved from the stay to the extent they are denied "adequate protection." The Bankruptcy Code \textsection 361, illustrates the meaning of "adequate protection." 11 U.S.C. \textsection 361.
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claim secured. While it is impossible to prevent any such mishaps from occurring, it is possible to guarantee that each secured creditor would have a sufficient pool of value to be paid from at the end of the reorganization endeavor. Since giving the secured creditor adequate protection is a precondition for moving on with a reorganization, the specific format of the protection—whether by cash payments, by granting the secured creditor an additional or replacement lien in another asset, or otherwise—is determined either at the time reorganization is initially undertaken or when the secured creditor raises such a request. Nevertheless, several bankruptcy regimes award secured creditors with a protection only against physical depreciation of the collateral, and not against temporal depreciation. According to American bankruptcy law, for example, under-secured creditors are to be denied post-petition interest, despite the fact that the stay prevents these creditors from foreclosing on the collateral and reinvesting the proceeds elsewhere. Moreover, although most bankruptcy regimes formally acknowledge the secured creditors' right to have their secured claim adequately protected, secured creditors are often de facto withheld even their legally-acknowledged protection against physical depreciation of the collateral. Bankruptcy courts sometimes do not adhere to petitions by secured creditors to be awarded adequate protection. Since awarding adequate protection relies on estimates made by the bankruptcy court—for example, regarding the probability that a particular asset serving as collateral will depreciate in value over time, or even regarding the value of the security interest to begin with—the court can produce biased or manipulative estimates, the result of which is abstention from any kind of ruling that conditions the progress of the reorganization process upon the secured claim being adequately protected.

111. See id. § 361.

112. See also 11 U.S.C. § 507(b), which gives the secured creditor an administrative expense priority with regard to the part of the secured claim that ex-post turned out to be inadequately protected.

113. See United Savings Ass'n of Texas v. Timbers of Inwood Forest, Ltd., 484 U.S. 365, 371 (1988). The United States Supreme Court held in that case that an undersecured creditor is not entitled to compensation for the delay, imposed upon him by the stay, which prohibits him from foreclosing on the collateral as soon as a reorganization procedure commences. The reasoning for the Court's conclusion was not economic: The Court held that the undersecured creditor owns an "interest in property", but that interest does not include the right to immediate foreclosure on the collateral. This ruling was subject to immense criticism, because of the perverse incentives created when only nominal—rather than real—values of secured claims are protected. Basically, it not only encourages agents to push for a collective procedure in order to attain the benefit of an interest-free use of assets, it also distorts future-facing investment decisions, or, in other words, the decision on how to redeploy the assets of the firm. See, e.g., Baird & Jackson, supra note 3; Omer Tene, Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations, 19 Bankr. Dev. J. 287, 347-49 (2003). In contrast to the undersecured creditor, an oversecured creditor is entitled to post-petition interest on his secured claim, as provided by the loan contract between that creditor and the firm; and up to a limit—the value of the collateral. See 11 U.S.C. § 506(b).

III. THE IMPORTANCE OF PRESERVATION

Now that various contexts of corporate bankruptcy redistribution have been exposed, the expected questions to be asked are: What is wrong with redistribution occurring within a bankruptcy procedure? Why is it inefficient to alter in bankruptcy pre-bankruptcy entitlements?\(^{115}\)

Clearly, redistribution in bankruptcy possesses the potential to minimize the costs incurred when the firm becomes insolvent. Otherwise, the entire concept of a collective procedure would not have been adopted as a basis for bankruptcy law. The government's interference in the course of the firm's financial deterioration—an intervention which has already been acknowledged to be causing redistributive effects—obviously also carries with it some form of compensating value, notwithstanding the exact nature of the compensating mechanism. Moreover, a simple comparative glimpse at prevailing bankruptcy regimes in different jurisdictions reveals that this compensating mechanism relies heavily on the collectivity feature.\(^{116}\) It is therefore safe enough to conclude that bankruptcy redistribution can minimize the ex-post costs of financial distress.\(^{117}\)

Redistribution can also have ex-ante beneficial effects. Commentators have focused in this context on one form of redistribution: violation of the absolute priority rule in favor of shareholders during the reorganization process.\(^{118}\) Violating the absolute priority rule in favor of shareholders, thus freezing out higher-ranking unsecured creditors, has been argued to have a positive influence (prior to the firm's period of insolvency) on shareholders and managers' incentives to invest in good projects, and to properly serve creditors' interests.\(^ {119}\)

Nevertheless, despite any beneficial effects to be attributed to redistribution, redistribution in bankruptcy is generally considered to be significantly harmful.

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115. The Principle of Preservation is presented here as an economic-driven principle. The principle could, however, be articulated in constitutional terms as well, which emphasize a constitutional rationale for the policy of preservation: Implementing a bankruptcy regime reflects a governmental intervention with private actions and liberties as bankruptcy law brings about redistribution. Thus, bankruptcy redistribution should be precluded and can be accepted only when Congress has specifically permitted it, subject to the constitutional constraints on Congress' power to enact bankruptcy laws. See Plank, supra note 25.

116. See Fletcher, supra note 39, at 8.

117. In Frank H. Easterbrook, Is Corporate Bankruptcy Efficient?, 27 J. Fin. Econ. 411, 413-14 (1990), Easterbrook argues that "enduring legal institutions endure either because they are efficient or because they redistribute wealth to concentrated, politically effective interest groups." Transfers of wealth—Easterbrook continues—are an implausible explanation for current bankruptcy regime, so efficiency is the only possible explanation. See also Tenc, supra note 113, at 291-92.

118. For a list of references, see Ex Ante Costs, supra note 91, at 446.

119. Id.
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A. Ex-Post Misdeployment

Commentators have described the problem as one of strategic behavior.\textsuperscript{120} The reasoning is simple enough:

Insolvency may be an occasion to 'collectivize' what hitherto had been an individual remedies system. It does not, however, justify the implementation of a different set of relative entitlements, unless doing so is necessary as a part of the move from the individual remedies system. It is not just that the need for a collective proceeding does not go hand in hand with new entitlements. It is that the establishment of new entitlements in bankruptcy conflicts with the collectivization goal. Such changes create incentives for particular holders of rights in assets to resort to bankruptcy in order to gain for themselves the advantages of those changes, even when a bankruptcy proceeding would not be in the collective interest of the investor group.\textsuperscript{121}

Different agents (claimants or non-claimants\textsuperscript{122}) might attempt to take advantage of any redistributive effect generated by the bankruptcy procedure, and in order to enjoy, or avoid, such redistribution, will push the firm into bankruptcy—or respectively stall the firm from entering bankruptcy—according to their own selfish needs.\textsuperscript{123} American bankruptcy history is packed with such cases.\textsuperscript{124} Such a strategic behavior counteracts any attempt made by bankruptcy law—mainly through the allocation of control rights\textsuperscript{125—to promote the optimal redeployment of the assets of the firm.\textsuperscript{126}} For example, firms with a potential to successfully endure hard times without needing a costly bankruptcy procedure might be erroneously pushed into one, waste resources in an attempt to survive the procedure, and subsequently perhaps even be liquidated; in contrast firms in desperate need of a bankruptcy procedure—be it liquidation or reorganization—might shy away from it. Similarly, a bankruptcy procedure might be initiated at a bad time. Thus, at any given moment, agents interested in bringing about—or respectively preventing—bankruptcy redistribution, would act to further their own self

\textsuperscript{120} Jackson & Scott, supra note 17, at 161; Wrongful Trading Provisions, supra note 84, at 337-38.

\textsuperscript{121} See Jackson, supra note 3, at 21; Baird & Jackson, supra note 3, at 100; see also Loss Distribution, supra note 21, at 825-26.

\textsuperscript{122} For example, employees of the firm, or managers.


\textsuperscript{124} See, e.g., Jay Lawrence Westbrook, A Functional Analysis of Executory Contracts, 74 MINN. L. REV. 227, 229 (1989) [hereinafter A Functional Analysis of Executory Contracts] (describing famous bankruptcy cases in which attempts were made to attain a rejection of executory contracts in bankruptcy).


\textsuperscript{126} Bankruptcy law creates mechanisms to trigger a bankruptcy procedure when there is a justification for such a procedure. Strategic behavior impairs the efficiency of such mechanisms.
interests despite any attempt (made by the law) to accomplish the more important social goal of achieving an optimal deployment of the firm’s assets.

Note that such strategic behavior can be expected—depending on the circumstances—from almost every agent. Indeed, even non-claimants are players in this game since they can also anticipate a certain redistributive impulse in their favor and even attempt to induce it. Once bankruptcy redistribution is allowed, the firm is exposed to misbehavior by all.

To better understand the inefficiencies created because of bankruptcy redistribution, consider first the incentives created for agents. For example, a secured creditor, who knows that bankruptcy redistribution will deny him of his full package of rights with regard to the collateral, will have a strong incentive to avoid bankruptcy by foreclosing on the security as soon as any likelihood for bankruptcy appears on the horizon, thus withdrawing—perhaps too early, and with no real economic justification—an asset essential to the firm’s continuing existence. Similarly, a secured creditor with leverage over the firm may avoid bankruptcy by threatening the firm and its managers not to consider bankruptcy as an option, even if a collective procedure can either better the firm’s financial situation by relieving it from part of its debt load, or if necessary liquidate the firm and its assets to be redeployed elsewhere in the economy.

Perhaps no less severe is the danger of junior claimants, such as shareholders or unsecured creditors, all holding “underwater claims,” or even non-claimants, such as employees of the firm—forcing bankruptcy on the firm in order to increase their share and enjoy a redistributive impulse. To the extent bankruptcy redistribution benefits such agents—usually by increasing the chances that reorganization will at least be attempted—these agents have an incentive to put the firm in a collective procedure. Indeed, the more a particular bankruptcy system is willing to allow reorganizations (that benefit junior claimants and employees on account of secured creditors), the more bankruptcy filings are to be expected.

Even managers might push the firm into bankruptcy if initiating a bankruptcy serves their purpose. For example, if the firm is allowed to repudiate a collective bargaining agreement only in bankruptcy but not elsewhere, managers of financially distressed firms are more likely to opt for

127. The structure of existing bankruptcy decision-making mechanisms increases significantly, first, if the chance is that a reorganization will be attempted. See Jeremy I. Bulow & John B. Shoven, *The Bankruptcy Decision*, 9 BELL J. ECON. 437, 438 (1978); *The Corporate Bankruptcy Decision*, supra note 2, at 143-44, 147-48; Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1213-14 (1991); Robert M. Mooradian, *The Effect of Bankruptcy Protection on Investment: Chapter II as a Screening Device*, 49 J. FIN. 1403 (1994). Second, the structure of existing bankruptcy regimes increases the chances that in a reorganization even claimants holding “underwater claims” will survive the bankruptcy procedure and receive something. The main reason for such a result is considerable bargaining power allocated to junior claimants. See Lucian Arye Bebchuk, *Using Options to Divide Value in Corporate Bankruptcy*, 44 EUR. ECON. REV. 829, 833 (2000).
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bankruptcy, even if a bankruptcy procedure is unwarranted.128

As a result of agents' strategic behavior, the chances that firms will either be put in a collective bankruptcy procedure only when such bankruptcy filing is truly justified on its merits, or at least be put in a collective procedure at the correct timing, diminish considerably. Indeed, bankruptcy is a costly procedure129 and should therefore be evoked only when no cheaper alternative exists for solving problems of financial distress. Yet surviving periods of financial distress without having to resort to a formal bankruptcy is still very possible. For example, firms in financial distress can initiate a private workout to solve financial problems. The firm can privately renegotiate with creditors and obtain each creditor's consent to forgive a part of his claim. Sufficient evidence exists to support the proposition that in well-functioning markets, workouts should be a perfect substitute for formal bankruptcy procedures, especially when firms are financed by private debt.130 Alternatively, a special form of workout called "prepackaged bankruptcy" can be undertaken. Prepackaged bankruptcy involves mixing elements of a private workout with those of a formal bankruptcy procedure. In a typical prepackaged bankruptcy scenario, the firm (prior to any initiation of a collective procedure) solicits creditor approval of a proposed reorganization plan, and only then enters a collective bankruptcy procedure in order to obtain approval of the plan, which—when confirmed by a supermajority vote and later on by the bankruptcy court—binds non-consenting creditors as well.131

128. See A World Without Bankruptcy, supra note 9, at 185.

129. The costs of running a bankruptcy procedure are usually divided into two categories: first, direct costs. See Stephen P. Ferris & Robert M. Lawless, The Expenses of Financial Distress: The Direct Costs of Chapter 11, 61 U. PITtk. L. Rev. 629 (2000). Direct costs are the legal and administrative fees that are paid from the firm's pool of assets while a formal bankruptcy procedure is being conducted. Direct costs thus include attorneys' fees, court expenses, and all payments to officials being hired to manage the firm or assess the extent of the firm's economic crisis and prospects—professionals such as accountants, investment bankers, appraisers, auctioneers, etc—that would not have been hired had the firm continued to operate outside bankruptcy. Fees paid to professionals directly reduce the value generated from the firm's assets for the benefit of the firm's claimants. In addition, increased fees paid to these hired professionals and deducted from the firm's resources, sometimes inadvertently accelerate the firm's shut-down. Second, running a bankruptcy generates indirect costs. See Ben Branch, The Costs of Bankruptcy — A Review, 11 Int'l Rev. Fin. Anal. 39 (2002). The indirect costs of running a bankruptcy procedure are more substantial than the direct costs, although much harder to measure. These costs are in fact opportunity and uncertainty costs, generated by sub-optimal actions taken by different insiders of the firm. For example, these costs originate from the mere fact that the firm's assets are not employed to extract their full—though modest perhaps—potential during bankruptcy. The firm does not perform well during any distress, and during times when distress-handling procedures take place especially. See also infra, note 137.


131. See 11 U.S.C. § 1126(b), which permits the debtor to solicit approval of a reorganization plan
bankruptcies result in shorter periods of time spent by firms in a formal bankruptcy procedure, thus saving on formal procedure costs.\textsuperscript{132} However, being pushed into a bankruptcy procedure before reaching the conclusion of the informal part of the prepackaged bankruptcy process turns everything upside down and threatens even the success of the prepackaged solution.

Indeed, it is also essential to understand that an unnecessary bankruptcy filing is not only costly, but can trigger a chain of events the end of which is hard to predict. To the extent that bankruptcy is a procedure prone to deployment mistakes, pushing the firm into bankruptcy unnecessarily exposes society to the possibility of such a mistake being made. For example, an inherent danger in bankruptcy is of economically viable firms, with going concern value, being liquidated.\textsuperscript{133} Another danger of formal bankruptcy proceedings is of economically inefficient firms being reorganized.\textsuperscript{134}

To be sure, upon entering the collective procedure, the power to make decisions regarding the firm's fate is expropriated from the firm and its shareholders, and in many jurisdictions that power is conferred upon the bankruptcy judge. Being detached from the influence of markets,\textsuperscript{135} and sometimes having a personal agenda of his own to promote, the bankruptcy

\textsuperscript{132} For example, one research study found that the length of time being spent in bankruptcy fell from an average of eighteen months to only three months. \textit{See Troubled Debt Restructurings, supra note 131, at 325. Bankruptcy costs are of course directly dependent on the length of the collective procedure.}

\textsuperscript{133} Any bankruptcy procedure is prone to make two kinds of mistakes in terms of the errors of the system any bankruptcy system tries to minimize the number of type-I errors, which occur when inefficient firms are saved, and the number of type-II errors, which occur when efficient firms are shut down. \textit{See Michelle J. White, Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganizations and Out-Of-Court Debt Restructurings, 10 J. L. ECON. & ORG. 268, 269 (1994); Michelle J. White, Does Chapter 11 Save Economically Inefficient Firms?, 72 WASH. U. L.Q. 1319 (1994); The Corporate Bankruptcy Decision, supra note 2, at 129-30.}

\textsuperscript{134} \textit{See id.}

judge can practically navigate the firm to whatever direction he sees fit. Thus, the result of entering a collective procedure is increased uncertainties for the outcome of such a procedure, and increased chances that a capricious or erroneous deployment decision will be made.

The timing for initiating a bankruptcy procedure is also important and can be inefficiently manipulated by agents driven by perverse incentives. Pushing the firm too late into bankruptcy is inefficient, because the result could be an increased rate of economically viable firms being destroyed. Pushing the firm into bankruptcy too early is also inefficient. Bankruptcy carries with it, for example, serious reputational implications for the firm that hinder the ability of the firm to exhaust its full productive potential, and can even terminate it altogether.

It is important to notice, in this regard, that manipulating the timing of the firm's entrance into a bankruptcy procedure is relatively easy. Every agent—whether a creditor, a shareholder, a manager, or even the firm itself—can file for bankruptcy at any moment. Of course, bankruptcy law sets certain screening devices to protect against unjustified bankruptcy filings. But to the

136. See, e.g., Jocelyn Evans, The Effect of Discretionary Actions on Small Firm's Ability to Survive Chapter 11 Bankruptcy, 9 J. CORP. FIN. 115 (2003) (Describing how some pro-creditor decisions (especially a decision to reduce the exclusivity period, in which the debtor-in-possession can suggest a reorganization plan) in the reorganization of closely-held firms tend to decide the outcomes of an administrative modeled bankruptcy. Judges' pro-creditor inclinations were found to reduce the chances of firms to survive.).

137. See, e.g., Pulvino, supra note 12, An interesting indication of the poor performance of bankrupt firms spending time in a court-supervised procedure was found in a survey conducted in the airline industry. Reviewing a sample of used commercial aircraft transactions conducted from 1978 to 1991 by twenty-seven major U.S. airlines, eight of which went bankrupt, it was concluded that bankrupt airlines sold assets at greater discounts (averaging between 14 percent and 46 percent) than did distressed but non-bankrupt carriers! Furthermore, in this context, no significant differences were found in discounts offered within reorganization proceedings compared to discounts offered within liquidation proceedings, which could support the contention that reorganization is preferable to liquidation. One might argue then, that the firm's formal in-bankruptcy status by itself not only attracts opportunistic buyers (with "seductive" low offers), but might also influence the business judgment of decision-makers.

138. See Lynn M. LoPucki, The Trouble With Chapter 11, 1993 Wis. L. REV. 729, 738-39. During bankruptcy, sales and profits decrease since customers are reluctant to buy from the firm, and suppliers are hesitant to sell to the firm. See EDWARD I. ALTMAN, CORPORATE FINANCIAL DISTRESS – A COMPLETE GUIDE TO PREDICTING, AVOIDING, AND DEALING WITH BANKRUPTCY 5 (1983). Alternatively, the firm's costs of capital may rise as suppliers, for example, might insist on better terms of payments (for the suppliers) made by the firm. See Lawrence A. Weiss, Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims, 27 J. FIN. ECON. 285, 289 (1990). The firm's insiders—board of directors and senior officers especially—and the firm's resources generally, are diverted away from everyday business operations, which are already being handled in a strained environment. See Robert H. Mnookin & Robert B. Wilson, Rational Bargaining and Market Efficiency: Understanding Pennzoil v. Texaco, 75 VA. L. REV. 295, 313 (1989). Resources are diverted away from the firm's business to bankruptcy matters, including communications with outsiders involved in the collective procedure. See Branch, supra note 129, at 43. During financial distress, even correct business decisions are sometimes avoided, especially if bold and innovative. See Mark J. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 COLUM. L. REV. 527, 528-29 (1983).

extent such devices are fallible, misdeployment of the firm's assets is bound to occur. Withholding a firm from entering a collective procedure is harder, but nevertheless possible, especially when, for example, a secured creditor such as a bank is interested in avoiding bankruptcy. Often enough, only a few insiders know the true situation of the firm, and the firm can stay buoyant, at least for a certain period of time. Indeed, an unfortunate and too common phenomenon is that firms enter bankruptcy when it is too late for resolution.\footnote{140 See id. at 1493-95; Lynn M. LoPucki, A General Theory of the Dynamics of the State Remedies/Bankruptcy System, 1982 Wis. L. Rev. 311, 312.}

To conclude, any deviation created from the state of optimal deployment of the firm's assets as a result of selfish behavior by agents is costly; it carries with it a deadweight loss for society.

B. Ex-Ante Contracting

Strategic behavior by selfish agents attempting to enjoy or avoid bankruptcy's redistributive effects endangers not only ex-post efforts to optimally redeploy assets of distressed firms, but also the amount of the dividend certain claimants expect to receive in case of bankruptcy. The result is an ex-ante efficiency cost.

To be sure, from the perspective of consensual claimants alone, the event of bankruptcy is not at all unexpected. In fact, consensual claimants are assumed to calculate two kinds of risk, which jointly reflect the probability of not being paid back because the firm has become insolvent, into the price they charge for credit extended to the firm. The first charge is for an exogenous risk of insolvency. This risk depends on "external" factors such as downturns occurring in the worldwide economy or in the national economy; changes of consumer tastes that send a shockwave across the entire industry within which the firm operates; unexpected disasters; etc. Consensual claimants also take into consideration an endogenous risk of insolvency. This sort of risk depends on the quality of the firm, the quality of product it manufactures, and the quality of its managers.

The possibility of redistribution occurring in bankruptcy introduces yet a third kind of risk to be calculated by consensual claimants of the firm: the risk of intentional human behavior causing marginally-distressed firms to deteriorate further into insolvency or decreasing claimants' dividends in case of insolvency. Indeed, claimants worried about this third risk consider themselves incapable of monitoring the firm or other agents in a manner that would enable the claimants to foresee and protect themselves from strategic behavior by others.

This third risk not only increases the uncertainties faced by consensual
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claimants—regarding the possibility of being repaid if extending the loan— but it also mandates that the claimants charge higher prices from firms for loans. The result is decreased social welfare, as all firms in the economy can borrow less money and can finance fewer good projects.

IV. ENFORCING PRESERVATION

Describing a problem of strategic behavior by agents that generates efficiency costs raises the question of how the law should cope with such misbehavior. Bankruptcy law could, of course, attempt to implement an ex-post solution for punishment in order to create a deterrence. But the problem with such a solution concerns the fact that the same behavior to be condemned is also sometimes to be condoned. Bankruptcy law relies heavily on agents initiating a collective procedure when the time for such a proceeding is right. Trying to detect cases in which the initiation of a collective procedure was wrong would be almost impossible, and would no doubt create a chilling effect and discourage agents from filing for bankruptcy even when necessary. Moreover, the costs of detection would be high because of the need to inquire into agents’ true motives.

A different solution to the problem of strategic behavior is to eliminate the perverse incentives that cause agents to misbehave in the first place. Thus, bankruptcy law should remove the incentives that drive agents to initiate a collective procedure when such a procedure is unnecessary or ill timed. In other words, bankruptcy law should attempt to prevent redundant bankruptcy redistribution.

There is obviously a trade-off between the positive effects (both ex-ante and ex-post) resulting from bankruptcy redistribution and between the parallel harmful effects (both ex-ante and ex-post). The trade-off manifests into a legal doctrine—the Principle of Preservation, which, as a matter of fact, is employed by all bankruptcy systems. The Principle of Preservation applies to any redistribution effect occurring once the firm enters a collective procedure. The principle states that preservation of pre-bankruptcy entitlements should be vigorously upheld in bankruptcy, and that breaking away from the preservation policy is permitted only when such a move is aimed at accomplishing a predefined—and thus legitimate—bankruptcy goal (notwithstanding the exact nature of such a goal and its justification, which in reality are subject to

141. To the extent that the strict rationality assumption adopted here is relaxed, and consensual claimants are assumed to be unable to calculate in much precision the probability of bankruptcy and the relevant dividend in case of bankruptcy—it is obvious that the mere fact that a risk of human behavior alters the returns to claimants (rather than the other two risks mentioned), creates additional costs as the invariance in resource allocation increases. In other words, it is harder for claimants to correctly estimate the return in case of bankruptcy, and as a result any process of resource allocation becomes more error-prone.

142. Lewis, supra note 72, at 356-57.
For example, creating a collective working environment for debt collection—to replace the "first come, first served" pre-bankruptcy environment in which creditors operate outside bankruptcy—can surely be considered a predefined bankruptcy goal. The redistributive effect caused by the stay imposed on claimants' efforts to collect their claims from the firm is therefore justified to the extent that the stay is indeed essential for a collective debt-collection environment to be formed. This illustrates why, in certain jurisdictions, during a liquidation procedure, the stay imposed on creditors does not apply to secured creditors who from the outset do not submit to the "first come, first served" pre-bankruptcy regime, and are therefore irrelevant for accomplishing this predefined bankruptcy goal.

Preservation is in fact a unifying theoretical principle for bankruptcy law. Indeed, while redistribution is an integral component of bankruptcy—redistribution in bankruptcy being a powerful tool to accomplish bankruptcy goals—the efficiency costs emanating from bankruptcy redistribution should nevertheless be minimized. Bankruptcy law and different bankruptcy institutions actually attempt just that. To be sure, bankruptcy law could be coherently explained through a reference to the Problem of Preservation: how to prevent the unnecessary alteration of pre-bankruptcy entitlements induced during the initiation of a collective procedure, which itself accomplishes predefined bankruptcy goals in an inherently redistributive manner. Since redistribution is an inherent feature of bankruptcy, applying a policy of preservation cannot abolish such efficiency costs altogether, but rather only minimize them. A residual cost will always be incurred.

How does bankruptcy law promote preservation of pre-bankruptcy entitlements? Bankruptcy law applies a direct regulation policy of attempts to

143. See supra note 21.

144. Recall that the problem of preservation can be articulated as a constitutional problem. See supra note 115. Modern bankruptcy regimes should aspire to display a strict correlation between the scope of redistribution allowed by the formal directive made by the bankruptcy legislator and the scope of redistribution emanating from the need to accomplish any acknowledged bankruptcy goal. In other words, where the law refrains from allowing bankruptcy redistribution to occur, one need not be able to speak of a legitimate predefined bankruptcy goal that should be accomplished (through bankruptcy redistribution). Thus, to the extent that redistribution in bankruptcy occurs without any formal directive from the legislator, redistribution should be considered unlawful. Unfortunately, in certain countries—such as Israel—a correlation between the legal directive and between the scope of bankruptcy redistribution allowed by courts does not always exist. Courts accept redistributive impulses although no bankruptcy statute can be traced to authorize it, sometimes perhaps because the redistributive effect, from an economic point of view, is indeed warranted and justified. In the United States, a different problem exists, as courts display a clear tendency to interpret statutes too broadly, as permitting redistribution. See, e.g., Federal Commc'ns Comm'n v. Nextwave Personal Commc'ns, Inc., 537 U.S. 293 (2003) (interpreting the silent section 525 of the Bankruptcy Code as forbidding a Governmental agency, that had granted a license to a subsequently insolvent debtor, from revoking the license once the debtor files for Chapter 11, even if the agency's decision is inspired by a legitimate regulatory motive).

145. This is the case, for example, in United Kingdom law. See Rizwaan Jameel Mokal, The Search for Someone to Save: A Defensive Case for the Priority of Secured Credit, 22 OXFORD J. LEGAL STUD. 687, 688 n.3 (2002).
induce excessive redistributive impulses, and constantly works to prevent them. The regulator is the bankruptcy judge. For example, it is well known that opt-out behavior is being rebutted in bankruptcy by counter-opt-out redistribution. In this context, the court’s approval is necessary in order to retrieve value already transferred to an opting-out claimant. Indeed, neither other claimants nor the trustee alone can effectuate redistribution from the opting-out claimant towards the bankruptcy estate. Consider another example: the court oversees agents to detect frivolous attempts to reorganize the firm, which in fact are intended only to effectuate redistribution and also to manage the length of time reorganization is attempted. If secured creditors, for example, are withheld post-petition interest for the duration of a reorganization endeavor, or simply denied their full entitlement to foreclose on the collateral, then reducing the length of time reorganization takes minimizes the extent to which redistribution occurs. The court can watch over agents to detect time-wasting maneuvers.

Portraying the bankruptcy court, and particularly the bankruptcy judge, as being a regulator against excessive redistribution, and thus (directly) promoting a policy of preservation can help explain why many firms deliberately refuse to entrust the administration of the collective bankruptcy procedure to a non-judicial agency, and consistently prefer a court of law for that task. Although, the goals of promoting better debt collection or reorganization could be equally accomplished in the former as well as the latter. Moreover, for an economic task to be accomplished, perhaps a specialized administrative agency would be more suitable. It is the task of preservation, however, that courts of law arguably perform better than administrative agencies; consequently many systems insist that bankruptcy be a judicial rather than an administrative process. The judiciary—founded upon an adversarial process of litigation—can be described as more apt to execute a balance of interests, rather than zealously focus on one side or the other (i.e., promoting better debt-collection or reorganization).

146. See Epstein, Nickles & White, supra note 40, at 275.
147. Consider yet another example: The first move initiated in any bankruptcy proceeding by the trustee is to collect the firm's assets into a single estate. See Bankruptcy Code, 11 U.S.C. § 541(a) (LEXIS through 2007 legislation); Epstein, Nickles & White, supra note 40, at 32. The act of gathering the assets into a single estate, in fact, enables the trustee to monitor against excessive redistribution. Indeed, defining the scope and contents of the bankruptcy estate is a process that requires a careful screening of potential assets. Difficult questions are confronted by the trustee, such as whether an insurance policy owned by the firm but which provides for a third party to enjoy the proceeds in case of an accident, is an asset of the estate? Answering this question negatively See 11 U.S.C. § 541(a)(1), (which gives the creditors only those rights that the debtor itself enjoyed outside of bankruptcy and reveals that such an insurance policy is not, in fact, property of the bankruptcy estate). Note, however, that the very need to compile the estate prompts the asking of the right questions, and prevents bankruptcy from excessively bringing about a redistributive change. Having an outside citizen to answer these questions is a factor that alone promotes preservation. In addition, arranging for a bankruptcy estate prevents assets of the firm from being the subject of a redistributive move. For example, the firm is sometimes also a creditor itself, and debtors owing money to the firm know that although the firm has turned insolvent, they will still have to pay their debts to the estate.
Bankruptcy law resorts then to direct regulation of redistribution in order to promote preservation. But is direct regulation sufficient? Does bankruptcy law employ other means as well?

Acknowledging the Problem of Preservation augments the conclusion that the entire structure of bankruptcy law has been carved to promote preservation, and consequently, to minimize the efficiency costs emanating from excessive bankruptcy redistribution. To be sure, note that bankruptcy law maximizes preservation under a stern constraint. Bankruptcy law has not been introduced into the world in order to promote preservation, but rather to achieve a set of quite distinct goals, all of which rely on redistribution. Indeed, these goals have been a subject of intense debate, but are more or less clear. As far as preservation is concerned, bankruptcy law, in fact, pursues a constrained maximization problem, rather than a pure maximization problem. Preservation is sought by the law, but only as a secondary goal. Thus, a policy of preservation cannot be accomplished by depending on bankruptcy judges to avoid excessive redistribution, as they deliberately employ redistribution to accomplish all other bankruptcy goals.

Bankruptcy law has therefore made a strategic choice of its own: to overcome the Problem of Preservation—and thus accomplish the task of minimizing the costs generated by excessive redistribution—using means other than the bankruptcy judge’s discretion as a regulator; in fact, some of these mechanisms rely on the power of markets. In this context, at least three different types of self-executing mechanisms are employed. The effect of using these mechanisms to promote preservation can be identified by measuring them against possible alternative mechanisms and by examining them from a comparative perspective, which takes notice of other legal systems. As the following discussion will show, American bankruptcy law does not seem to go far enough to promote preservation.

Before proceeding, note that the preservation mechanisms described here can be classified as working either internally, to preserve relative entitlements among claimants of the firm and along the class structure of claimants; or externally, to prevent redistribution towards non-claimants. Both internal preservation and external preservation are necessary components of a complete preservation scheme. The distinction between internal and external preservation, however, can help clarify the nature of each preservation tool.

148. See supra notes 21 & 36.
149. Note, however, that the following analysis does not address the question of whether the mechanisms employed by bankruptcy regimes are successful at accomplishing the goal of minimizing bankruptcy redistribution. Further note that the list of mechanisms may be incomplete, and other mechanisms may also be identified.
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V. SELF-EXECUTING PRESERVATION MECHANISMS

A. Monitoring Mechanisms

Bankruptcy law creates a number of mechanisms, the functions of which are to monitor against excessive redistribution. These mechanisms are put to work once the collective procedure is initiated; they monitor all three contexts of bankruptcy-related redistribution: commencement of the collective procedure, regulation of pre-bankruptcy behavior, and the process of reorganization.

1. The Collective Forum

Bankruptcy proceedings take place in a collective forum, which is—as will immediately be explained—specifically designed to monitor against excessive redistribution. In particular, two qualities make the collective forum an efficient monitoring mechanism: first, the collective forum supports a constant flow of relevant information; and second, it is—quite distinctively—highly accessible to any interested party.

Once a bankruptcy procedure is formally initiated, the court comes to possess the power to invest resources in discovering attempts by various agents—including claimants, non-claimants, and even bankruptcy officers such as the trustee—to excessively induce redistributive effects. But the court also helps to monitor against such redistribution indirectly, by enhancing the supply of relevant information to all parties involved. A flow of information is created. Submission of relevant information to the collective forum, as is often ordered by the law—and enforced by the court—thus induces different agents to monitor, individually, against excessive redistribution.

A bankruptcy procedure is an in rem procedure. When a motion is filed, all relevant parties assemble together before the court, and get an opportunity to share information, as well as to shed light, on any redistributive effect. For example, reorganization attempts can be interrupted if they are conducted for redistributive purposes only. A prerequisite for commencing a bankruptcy procedure and granting a stay of proceedings to protect the firm is that sufficient information about the firm and its business be submitted to the court.151 The court then reviews the need for a bankruptcy procedure to be initiated, and can be either strict or lenient on redistribution. But as information becomes public, other agents can also alert against potentially redistributive moves, and the absence of justification thereof. As a result, unnecessary

151. See supra note 47.
bankruptcy procedures are screened away.

The collective forum is easily and promptly accessed. The trustee, and other interested parties—e.g., claimants and non-claimants—communicate directly with the court. Sometimes such communications become available through a special procedure. Any procedure allowing easy and informal access to the bankruptcy court assists in monitoring against excessive redistribution by letting claimants whose entitlements are altered in bankruptcy—for example, creditors threatened by decisions to annul pre-bankruptcy transfers of value to them—to apply to the court for help. Unlike ordinary civil procedures that do not recognize third parties’ standing before the court, a bankruptcy case is managed as a dynamically changing multi-party case, during which any interested party can approach the court, even if for only a brief moment. More importantly, parties can do so rather easily. Emphasis is put on the content of parties’ motions rather than on formalities. Such emphasis is highlighted as bankruptcy law encourages an atmosphere of crisis, requiring the court to focus on that which is truly important. Agents can thus easily turn the court’s attention to unnecessary redistribution.

2. The Trustee

Bankruptcy law offers interplay between two figures, each of whom can be awarded control over the firm once it enters a bankruptcy procedure—the debtor-in-possession and the trustee. Both are private agents, but the trustee is a representative of the creditors, while the debtor-in-possession is the debtor-firm’s incumbent management. While in Chapter 7 cases the default option is for the court to appoint a trustee, in Chapter 11 cases the debtor-in-possession is usually left in charge of running the firm, although interested parties may seek the appointment of a trustee in his stead. In many European countries a trustee is always appointed, even when a reorganization procedure is commenced. Sometimes the trustee is a representative of the government called the United States Trustee.

The trustee, appointed by either the court or the United States Trustee to serve as the court’s “long arm,” is a second monitoring mechanism found in bankruptcy. Enjoying powers and resources to run the firm’s assets and to

152. See generally David Hahn, Concentrated Ownership and Control of Corporate Reorganizations, 4 J. CORP. L. STUD. 117 (2004).
154. Id.
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investigate, the trustee serves a monitoring function against over-zealous applications of bankruptcy's redistributive powers. For example, a trustee is often appointed in order to further examine and sharpen the factual basis claimed to be justifying the initiation of a collective procedure. 158

3. Creditors' Communications

Bankruptcy regimes dictate that creditors communicate with one another. The nature and intensity of communication differs across jurisdictions and across bankruptcy procedures (liquidation versus reorganization), but it is nevertheless required. Thus, the law almost always prescribes an initial meeting of creditors, 159 and sometimes creditors are allowed to be elected to a formal creditors' committee, 160 which also has the power to hire professionals to examine the firm's affairs. 161

Establishing such a channel of communications among creditors enhances the flow of information and the degree of monitoring by creditors over the case.

4. The Bankruptcy Language

Acknowledging the Problem of Preservation can help identify missing monitoring mechanisms as well. One monitoring mechanism, which is clearly absent in bankruptcy law—despite scholarly attempts to bring a change—concerns the language employed to analyze redistribution and problems that emanate thereof. The commencement of a collective bankruptcy procedure introduces a whole new world of rules and entitlements, which overwrites the old, familiar world of private law. Indeed, standing before the bankruptcy forum, the meaning of the terms "property" and "contract" no longer helps to fully clarify and analyze the problems faced, or more importantly, to understand the redistributive impulses generated. For example, should a debtor-firm's announced privacy policy with regard to information it comes to possess be enforced once it enters bankruptcy? In considering the answer, one is reminded that pre-bankruptcy law treats privacy policies as promissory rather than as conferred property rights, and that pre-bankruptcy law gives no indication as to whether these promises should be enforced in bankruptcy. Classifying rights to privacy as relying on contractual obligations made by the

158. See Eisenberg & Sundgren, supra note 156, at 1534, 1541.
160. See id. §§ 705(a), 1102(a)(1).
162. See, e.g., A Functional Analysis of Executory Contracts, supra note 124.
debtor-firm can forward the result of the contracts being discharged, but classifying these rights as being property can similarly result in these rights not being honored.

Using the general private law terminology in bankruptcy thus blurs the true trade-off to be confronted, and more often than not also results in an increased tendency to redistribute, sometimes without grasping the full meaning of actions taken against pre-bankruptcy entitlements. Introducing a new bankruptcy language, which emphasizes redistributive effects when they occur, could actually prevent excessive redistribution.

Consider an attempt to develop such a new bankruptcy language. The redistributive effect emanating from the mere commencement of the collective procedure can in fact be attributed to the imposition of a stay on individual collection efforts against the firm. Thus, the mere imposition of the stay can generally be described—from bankruptcy’s point of view of the Cathedral—as having the effect of removing a certain element from each claimant’s pecuniary entitlement against the firm. To be sure, from the perspective of bankruptcy, each person occupying our world can be said to enter the bankruptcy world owning a pre-bankruptcy entitlement, which consists of one or more of the following components: first, a right to demand merely a withdrawal of that person’s investment in the firm; second, a right to set the exact timing of such investment’s withdrawal; third, a right to set the exact format of the withdrawal. For example, an unsecured creditor’s pre-bankruptcy entitlement consists of the first and second components, but not the third. This arrangement is why unsecured creditors, individually levying on the firm’s assets outside bankruptcy, cannot insist that a particular asset of the firm be used to satisfy their claim. Unsecured creditors can insist however—again, when acting individually to collect the debt—on interest accruing on any debt not being paid by the debtor at a certain date. Still, the entitlement described above is only the initial entitlement. Once a collective bankruptcy procedure commences, the unsecured creditor is being deprived of another factor—the second component. Thus, while unsecured creditors in bankruptcy are entitled to participate in any distribution of proceeds (as dictated by the second component), they are

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165. Janger, supra note 164, at 1836.
166. See Janger, supra note 164, at 1840 (“Under current contract law, treating privacy promises as liability-based obligations subject to discharge serves the bankruptcy goals of encouraging reorganization and preserving the value of assets for creditors. On the other hand, it has the disadvantage of defeating . . . expectations of privacy, which are generated by the [debtor’s] privacy policy . . . By contrast, treating personal information as property has the unfortunate effect of destroying the value of an important asset of the debtor, when it might be possible to realize the value of that asset while still safeguarding reasonable [privacy] expectations.”).
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nevertheless not entitled to post-petition interest on their claim (considering that interest is being paid to compensate for the time value of money withheld from the creditor).

Secured creditors, on the other hand, enjoy an initial pre-bankruptcy entitlement, which consists of all three components. This entitlement is why a secured creditor can decide when to withdraw his investment in the firm (when the loan contract stipulates so) and also in what format to withdraw his investment (foreclosure on particular collateral). But once a bankruptcy procedure commences, the secured creditor is being expropriated of the third component. Thus, while secured creditors in bankruptcy can insist on being paid post-petition interest, and the value of their collateral must be adequately protected from the date the collective procedure commences and afterwards—all in order to protect the second component—they are still deprived of the third component (the right to set the exact format of the withdrawal), since they are prohibited by the stay from foreclosing on their collateral away from the firm.

Finally, shareholders hold a pre-bankruptcy entitlement, which consists of the first component alone. This is why shareholders can never decide when to withdraw their investment in the firm, and can rely only upon their basic entitlement to the firm’s residual value. Once a collective procedure commences, however, shareholders can be deprived of the first component as well, and be prevented from participating in any distribution of the firm’s assets if the proceeds are insufficient to satisfy all the creditors’ claims. In fact, if a collective bankruptcy procedure is to be commenced only upon the firm’s insolvency, then wiping out the shareholders when the procedure commences is precisely the meaning of the firm being insolvent.\footnote{169}

It is clear, therefore, that the bankruptcy stay takes away from each claimant one component upon which that claimant’s entitlement is founded. Such taking culminates in a redistributive effect, because someone is bound to enjoy the fulfillment of bankruptcy goals accomplished by the collective procedure. Thus, any redistributive effect generated by the mere initiation of the bankruptcy procedure and the imposition of the stay, continues to last for as long as the stay remains intact. Once the stay prevents the secured creditor from foreclosing on his collateral, any decision by the bankruptcy court—even a seemingly esoteric decision to delay a hearing and schedule it to a later date—enhances the redistributive impulse.

\footnote{169. The description of the set of rights that comprise any kind of entitlement in bankruptcy for any given claimant can be further elaborated. Indeed, there exists a fourth component, which might be referred to as the “right of participation.” The right of participation is the most basic component that exists, and is enjoyed by all human beings, claimants as well as non-claimants. Although it is perhaps not a right recognized by law, it describes the right of each and every person to enjoy the benefits indirectly deriving to the community from the firm’s actions and projects. For example, if a firm is contributing to the competition in a certain products market, all consumers enjoy the result.}
B. Discretion-Limiting Mechanisms

Bankruptcy law creates another type of mechanism, the purpose of which is to reduce the chances of excessive redistributive effects occurring in bankruptcy. Discretion-limiting mechanisms limit in advance agents’ discretion to induce or accept bankruptcy redistribution.

1. The Absolute Priority Rule

The bankruptcy rule requiring strict application of an absolute priority rule in any form of bankruptcy distribution—be it distribution of proceeds gathered in a liquidation procedure or distribution within a reorganization plan—is in fact a mechanism intended to limit any discretion, such as the discretion possessed by the court, the debtor-in-possession, or the trustee to induce a redistributive change. By mandating strict adherence to the absolute priority rule, the law encourages claimants in reorganization to not attempt to formulate a reorganization plan that includes deviations from the absolute priority rule. Moreover, since the default distribution is according to the absolute priority rule, for any deviating redistribution to occur, sufficient reasons and proper evidence must be presented by whoever supports such a deviation, in order to persuade that such redistribution is justifiable. Of course, to the extent reorganization law allows reorganization plans that deviate from absolute priority to be approved, the law undercuts the discretion-limiting effect.

2. Classification of Claimants and Equality

Obtaining claimants’ consent to a proposed reorganization plan, or distributing the proceeds gathered in a liquidation procedure, requires that claimants be divided into classes and be treated equally within each class. Treating classes of claimants as a single unit means that among each class redistribution is impossible.

Indeed, when considering the residual distribution rule in bankruptcy, one could argue that among each class—for example, the class of unsecured claims—priority should still be awarded to certain creditors who have invested in monitoring the firm, or in obtaining information about the firm, in a manner that improved the situation of everyone else. Nevertheless, bankruptcy law resents such a position, and refuses to award investment by creditors, prior to the firm’s collapse, in socially desirable activities. Other than the priorities

170. Epstein, Nickles & White, supra note 40, at 461.
172. See Epstein, Nickles & White, supra note 40, at 839 (“this simple rule is a powerful brake on the debtor’s behavior and a strong influence on the negotiation that is likely to occur over a reorganization plan”).
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specifically set by statute, bankruptcy law always resorts to equality.

3. The Judicial Balancing Technique

As decisions in bankruptcy are highly redistributive, and often made under an emergency atmosphere that tends to push towards over-zealousness in achieving bankruptcy goals, a question arises as to what is the appropriate balancing technique to be adopted by the bankruptcy judge. For example, how is the judge to decide which is more important, promoting the possibility of reorganization of a financially distressed firm, or protecting the secured creditor’s entitlements? Or, to consider another example, how is the former goal to be balanced against the need to protect the privacy of agents, should these two goals collide?174

An implicit assumption is that bankruptcy’s goals are clear and well defined. Unfortunately, in reality, this assumption is rarely true, as lawmakers cannot always agree on a clearly defined set of legitimate goals.175 The classic example is the deadlocked debate concerning social goals: When and on what terms are such goals legitimate?

But even when bankruptcy goals are defined by statute, certain goals are phrased too broadly on terms such as “reorganization” or “rehabilitation.” Such an open definition only invites bankruptcy judges to ignore pre-bankruptcy entitlements in a quest to accomplish these goals.176

Nevertheless, bankruptcy law can limit the judge’s discretion as far as allowing excessive redistribution to occur, to the extent that the law insists that the judge follow a three-tiered paradigm. First, bankruptcy judges are required to refrain from directly balancing the need to promote any of bankruptcy’s goals with any other conflicting goal. Second, the judge is simply required to carefully verify that the legislator has indeed authorized the promotion of a particular bankruptcy goal. In other words, the judge is required to examine whether the statute’s words and purpose encompass the promotion of the specific bankruptcy goal. Of course, the more detailed the bankruptcy goal is defined the better, but one needs to consider the possibility of facing a rather-

174. See the example mentioned earlier in note 163.
175. See supra note 21.
176. One might also argue that the mission of preserving pre-bankruptcy entitlements, which obviously relies on balancing certain conflicting interests, has been trusted with professional judges rather than with administrators because the former—whose comparative advantage lies in balancing conflicting interests—are better at accomplishing preservation than the latter. See, e.g., Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 92-93 (2004) (describing the unique ability devised by bankruptcy judges to screen out businesses that should not be in a bankruptcy procedure). Indeed, bankruptcy could otherwise be conducted as a pure administrative procedure rather than as a judicial procedure. For example, consider bankruptcy law in Colombia, which gives a special superintendency of companies the sole authority to conduct a bankruptcy proceeding. See Izak Atiyas, *Bankruptcy Reform – Breaking the Court Logjam in Colombia*, 51 PUBLIC POLICY FOR THE PRIVATE SECTOR 1 (1995).
loosely defined bankruptcy goal. Third, and most important, once the judge has verified she is authorized by statute to promote a certain bankruptcy goal, the judge is required to conduct an *evidentiary* inquiry, to ascertain whether a certain decision of hers will indeed promote the bankruptcy goal in question. The more specific the evidentiary inquiry becomes, the more restrained the judge will be with regard to redistribution.

This working paradigm thus transforms an overwhelming mission of balancing conflicting values and policies into a basically simple evidentiary inquiry. In order to understand the manner in which this specific balancing technique curtails discretion to redistribute, one need only compare this technique to a simple balance made (again, by the bankruptcy judge) between any two conflicting goals under the auspices of the emergency atmosphere controlling the bankruptcy process. The latter balancing technique actually invites the judge to overemphasize the importance of bankruptcy goals, and hence initiate more of bankruptcy’s redistributive moves.

Sometimes, lawmakers seem to have already struck a balance between conflicting interests. In such cases, the judge’s most important role is still gauged on conducting an evidentiary inquiry. Consider as example the case of adequately protecting secured creditors.\(^\text{177}\) Having to protect secured creditors’ claims against (temporal and physical) depreciation of the collateral as a condition for a reorganization to commence at all, seems to narrow down the court’s discretion as to how much redistribution can be allowed within a given reorganization procedure. Indeed, according to the doctrine of adequate protection, even the court cannot allow a (redistributive) bankruptcy procedure to commence without guaranteeing, at least partially, that secured creditors are not taken on a wild ride by junior creditors at the expense of the former. Any limiting power over discretion to redistribute, however, which emanates from the doctrine of adequate protection, is conditioned upon the judge deroga
ting his inquiry to an evidentiary examination of the relevant economic parameters, so that manipulation by interested parties is minimal. Thus, the more focused the judge is upon examining the relevant economic parameters—rather than on making value judgments regarding the proper balance between the need to adequately protect secured creditors and the need to promote reorganization efforts—the less chances are that secured creditors will be subjected to a redistributive maneuver.

4. The Element of Arbitrariness

Arbitrariness plays an important role in limiting discretion to allow redistribution. The initiation of a collective bankruptcy procedure is accompanied by several strict and somewhat arbitrary rules either banning the

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\(^{177}\) *See supra* note 110.
involvement of certain agents that otherwise could naturally be seen as participants in the bankruptcy process, or limiting the period of time allocated to the bankruptcy effort. An emphasis is put in this context on formalities rather than on the true nature of transactions. But shifting the focus to formalities serves as a mechanism that limits discretionary decisions, and thus possesses an enormous potential for redistribution.

Consider the example of avoiding preferences. Section 547(b) of the Bankruptcy Code targets any eve-of-bankruptcy transfers made by the debtor-firm to preferred creditors, and subjects such transfers to possible annulment by the trustee's avoiding powers. A § 547(b) transfer is defined only as one which was made within ninety days of filing a bankruptcy petition. The ninety days time frame is set arbitrarily. Could bankruptcy law rely on other parameters to preclude the trustee's avoiding legitimate transfers made by the debtor to its creditors? The answer is yes. Bankruptcy law could dictate that creditors' or the debtor's state of mind with regard to the transfer be the ultimate criterion for whether a particular eve-of-bankruptcy transfer should be avoided in bankruptcy. Instead, the law resorts to a formality, such as how many days have passed since the transfer was made. Moreover, this formal criterion is absolute and cannot be overcome.

There is, however, a strong rationale for this seemingly odd choice made by the legislator: an automatic limitation on the bankruptcy court's redistributive powers is needed. Arbitrarily banning agents from the game is in fact a way to prevent unwarranted redistributive effects, as it is assumed that the chances for excessive redistribution to occur if these agents are not protected are higher than the chances that justified redistribution only would take place.178

Consider another example to demonstrate arbitrariness in corporate bankruptcy law. The redistributive impulses occurring during reorganization attempts have already been exposed in length. Bankruptcy law, in an effort to avoid excessive bankruptcy redistribution, may sometimes limit discretionary decisions that can culminate in excessive redistribution by setting a rigid cap on the time frame to be extended for any reorganization attempts. For example, Section 1121(d)(2) of the Bankruptcy Code limits the debtor's exclusive right to propose a reorganization plan to a period of eighteen or twenty months. Such a time restriction may be found in other jurisdictions as well.179

Thus, redistributive reorganization attempts can take only so much time.

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178. One could criticize this approach as it is well known, for example, that senior lenders take a preference and then try to keep the firm alive for ninety days to escape the trustee's powers. See Elements of Bankruptcy, supra note 27, at 148. Still, my purpose is simply to demonstrate the logic behind this approach. It is the Code's implementation of self-executing preservation mechanisms.

179. Sometimes the time cap is more lenient: according to Finnish bankruptcy law, for example, the trustee in bankruptcy cases (the administrator) must submit a reorganization plan within a court-specified time period, normally not more than four months. See Eisenberg & Sundgren, supra note 156, at 1539.
Could bankruptcy law refrain from setting these time caps? The answer is of course, yes. Will any time cap set (be it shorter or longer) demonstrate itself—sooner or later—to be arbitrary? Again, the answer is yes. No one can predict in advance, for each and every prospective distressed firm, the exact amount of time a reorganization proceeding would require in order to succeed. So why do certain jurisdictions insist on setting rigid time caps on reorganization efforts? Because these systems implicitly acknowledge the need to limit the bankruptcy court’s discretion to allow redistribution.

5. Requiring Claimants’ Consent to a Reorganization Plan

While the reorganization process can display several redistributive impulses, in many bankruptcy systems it is nevertheless controlled by the need to obtain claimants’ consent to the reorganization plan.\textsuperscript{180} Facing the need to approach claimants and asking for their approval to a plan requires the formulator of the plan to avoid redistribution in the first place, to the best of his ability. Otherwise, any refusal by claimants to his proposed plan would not be considered unreasonable. Comparing the requirement to obtain claimants’ consent, to the absence of any parallel requirement in other jurisdictions, reveals the restraining effect of such a prerequisite. Indeed, in France for example, the bankruptcy court alone can approve of a plan, without needing the claimants’ consent.\textsuperscript{181}

C. External Monitoring and Enforcement Mechanisms

Another type of mechanism prevents excessive redistribution using markets.

1. The Market for Trustees

Trustees are appointed by either the court or the United States Trustee—usually only in Chapter 7 cases—and are chosen from among a wide selection of candidates known for having the proper expertise in fulfilling this position. It is common knowledge that once appointed, the trustee becomes an officer of the court, and needs to represent the interests of all claimants.\textsuperscript{182} Sometimes the trustee is initially chosen by the party filing for bankruptcy, but eventually


\textsuperscript{181} However, a different prerequisite limits the scope of redistribution there. In France, no creditor can be compelled to accept less than full payment of its claim, although payment can be extended and postpetition interest stops accruing. See Richard L. Koral & Marie-Christine Sordino, The New Bankruptcy Reorganization Law in France: Ten Years Later, 70 AM. BANKR. L.J. 437, 444, 451-53 (1996).

\textsuperscript{182} See, e.g., Epstein, Nickles & White, supra note 40, at 7 (generally), 746-48 (applying the principle in reorganization).
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approved by the firm's creditors.\textsuperscript{183}

Priority in appointments could be given to a candidate suggested for this purpose by an interested party—for example, a secured creditor, with a large stake in the firm. Indeed, in certain jurisdictions, instead of appointing to the position of a trustee a neutral candidate, who has no connections whatsoever with any of the parties interested in the particular collective procedure at hand, the appointing authority strangely—but consistently—adheres to the wishes of interested parties regarding the identity of the trustee. To the extent this is a rule, it can create a market for preservation-fanatic trustees. Lawyers and accountants interested in being appointed to serve as trustees in bankruptcy need to attain in advance the approval of the relevant nominating agent. The trustee, if indeed the secured creditor recommends him, is likely to serve that creditor's interests. If preservation is important for the secured creditor, the trustee's loyalty to preservation will become a competitive characteristic among candidates.

The creation of a market for trustees should therefore be considered. For example, if a Chapter 11 bankruptcy procedure subjects secured creditors more than any other agent to redistribution, perhaps bankruptcy courts should appoint trustees in Chapter 11 cases, rather than leave the stage solely for the debtor-in-possession. Moreover, priority in appointment should be to a candidate suggested by the secured creditor. On the other hand, when a Chapter 7 bankruptcy procedure is initiated, if non-creditors are the first victims of the redistribution phenomenon, as the trustee makes efforts to retrieve value transferred to them earlier, it would be reasonable to prefer as trustees candidates who can demonstrate willingness and capability to minimize the extent to which bankruptcy redistribution occurs; and perhaps in these cases, a neutral candidate should be appointed.

Other mechanisms that result in an effective market for trustees exist as well. For example, in Sweden, the trustee is required by statute to take special care of promoting employment, to accomplish this task while minimizing the loss to the claimants, and all the while being constantly supervised by a special governmental agency. Thus, misbehaving trustees risk losing future appointments, and the trustee's reputation in the creditors' eyes becomes important.\textsuperscript{184}

2. The Market for Credit

When extending credit to firms, secured creditors can estimate, at least roughly, the extent to which bankruptcy redistribution is bound to occur. Firms

\textsuperscript{183} This is the situation in Sweden. See the Swedish Bankruptcy Code, Chapter 7 section 8.

taking measures to either prevent bankruptcy from occurring in the first place, or to minimize the extent of bankruptcy redistribution would be able to borrow money on better terms. Thus, the credit market encourages firms to adopt strategies that would prevent redistribution. For example, firms have devised their own informal bankruptcy proceedings—often called "workouts"—which attempt to overcome the problem of financial distress without having to subject secured creditors to a redistributive bankruptcy procedure (or at least minimize the extent to which such a formal procedure is necessary). Note, of course, that firms adopt such strategies without knowing whether the law would approve of such initiatives.

3. The Market for Formal Bankruptcy Procedures

Another market, the absence of which adversely affects preservation, is the market for formal bankruptcy procedures. Legal systems usually employ one kind of bankruptcy procedure, which in turn defines a certain scope of redistribution. Yet even here market forces could be initiated to assist in promoting preservation. Indeed, each legal system can create an effective market for bankruptcy procedures by offering investors several options for bankruptcy procedures. Offering a variety of bankruptcy procedures would induce competition among different procedures with regard to the issue of excessive redistribution.

Recall that the idea of maintaining several bankruptcy procedures is not new. Yet the discussion of preservation here offers a new rationale to justify this idea and the policy recommendations that flow from it. While existing literature has focused on improving redeployment as a justification for maintaining a menu of several bankruptcy procedures, it is suggested here that competition over reducing the scope of redistribution could serve as a second justification.

4. The Market for Out-Of-Court Restructurings

A bankruptcy system that advocates preservation and shrinks costs of redistribution, could promote the reduction of formal bankruptcy procedures for restructuring and reorganizing financially-distressed firms. Indeed, not all financially distressed firms need enter a formal bankruptcy procedure. Many firms are liquidated or reorganized outside the bankruptcy court. Of course, out-of-court restructurings do not induce redistributive impulses. Thus, perhaps a "good" bankruptcy system is one that decreases the use of formal bankruptcy procedures and increases the use of informal out-of-court restructuring processes.

185. See, e.g., Debtor's Choice, supra note 36.
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VI. CONCLUSION

Bankruptcy and redistribution go hand in hand. While the many aspects of corporate bankruptcy redistribution cannot be summed up in one theory, preventing excessive redistribution can certainly be articulated as a unifying theory for corporate bankruptcy law.

Similar to the way a shareholder who wants to conduct business within the framework of a public company willingly incurs the costs of having to employ self-interested agents to manage his firm, so should society be ready to incur the efficiency costs generated when a bankruptcy procedure—initiated for certain purposes, all of which revolve around the financial distress of a firm—alters pre-bankruptcy entitlements and effectuates redistribution among agents. Nevertheless, society—like the shareholder facing the agency problem—should also forcefully attempt to minimize the relevant efficiency costs.

The argument put forward in this article has focused on the manner in which bankruptcy law coherently and consistently attempts to minimize the costs of bankruptcy redistribution. Bankruptcy law does not settle on simply having bankruptcy judges apply the Principle of Preservation. Directly regulating against excessive redistribution is just not enough. Other means must also be employed to seriously support a policy of preservation. Bankruptcy law deploys self-executing mechanisms for that end. Thus, the Problem of Preservation is a unifying theoretical keystone for bankruptcy law: many different bankruptcy mechanisms and doctrines correspond to this problem, and can be understood from the viewpoint of implementing a preservation policy.

This paper has modestly undertaken to articulate the problem of preservation, and reveal some of its solutions. Future research on the subject should focus on a normative direction; indeed, to the extent bankruptcy law does not adhere to the Problem of Preservation, legal rules should be amended. Thus, for example, thought should be dedicated to improving some of the preservation mechanisms mentioned.

Moreover, since bankruptcy redistribution generates efficiency costs, and since bankruptcy is inherently redistributive, it becomes clear that bankruptcy goals—the accomplishment of which consequently triggers the redistributive process—should be meticulously and clearly defined in advance in order to prevent excessive redistribution. In legal systems applying a modern bankruptcy regime, within which bankruptcy goals are indeed so defined and agreed upon in advance, and accordingly dictated by a specific legislated directive, such a directive needs to be construed as prohibiting per se redistribution.186 Where lacking explicit statutory guidance, bankruptcy judges should—when contemplating day-to-day decisions—industriously implement

186. See Butner, 440 U.S. at 55.
a strict policy of preservation. Indeed, the doctrine of preservation can supply normative guidance to bankruptcy judges, and to the extent that legislated instructions are absent, such guidance is critical.