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0521457173 - Corporate Bankruptcy: Economic and Legal Perspectives
Edited by Jagdeep S. Bhandari and Lawrence A. Weiss
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This collection is the first comprehensive selection of readings focusing on corporate bankruptcy. Its main purpose is to explore the nature and efficiency of corporate reorganization using interdisciplinary approaches drawn from law, economics, business, and finance. Substantive areas covered include the role of credit, creditors' implicit bargains, nonbargaining features of bankruptcy, work-outs of agreements, alternatives to bankruptcy, and proceedings in countries other than the United States, including the United Kingdom, Europe, and Japan. The editors' introductions guide readers through each of the six parts, comprised of edited versions of papers combined with editorial notes to reduce the time required to absorb key ideas.

The Honorable Richard A. Posner, Chief Judge of the U.S. Court of Appeals for the Seventh Circuit, offers a foreword to the collection.

Corporate bankruptcy

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Economic and legal perspectives

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Foreword

Professors Bhandari and Weiss have put together a splendid anthology on the economics of corporate bankruptcy. A subject that lies at the intersections of price theory and game theory and of economic theory and finance theory – a subject moreover of great practical importance because of the large number of bankruptcies of major business firms in recent years – it has attracted some of the keenest minds in law, economics, and their interface have generated a literature of great power and variety well illustrated by the selections in this volume.

The literature has a twofold focus. The first is the puzzle of corporate debt. Without debt, and indeed without multiple creditors, a corporation would not face a substantial risk of bankruptcy (there would be some risk, because of the possibility of multiple involuntary creditors, such as asbestos tort claimants). Since bankruptcy is usually a personal disaster for the managers of the bankrupt firm, and since according to the Modigliani–Miller thesis the value of a firm is invariant to its capital structure, one is surprised that American corporations typically have so much debt and so many creditors. The answer is that the thesis abstracts from what may be important aspects of the economics of corporate structure, not only the obvious one – the more favorable tax treatment of debt than of equity – but also agency costs. Among other things, corporate debt may offset excessive risk aversion by managers that is due to the fact that their wealth is concentrated in firm-specific human capital.

The second focus of the economic literature on corporate bankruptcy is on the costs, benefits, and consequences of, and possible alternatives to, reorganization in bankruptcy (chapter 11). Reorganization is the most interesting feature of corporate bankruptcy, and it poses formidable theoretical and empirical challenges. There are doubtless situations in which the immediate liquidation of an insolvent firm is an inefficient response to insolvency, but one that may occur in the absence of judicial intervention because the costs of transactions among the firm's creditors and between the creditors and the firm's management are greater than the incremental value of a reorganized over a liquidated firm. This problem can be solved by giving management a temporary right to continue the operation of the firm free from efforts of creditors to enforce their claims (for that would force the firm into liquidation). The reason for giving this right to management is that only management, and not a committee of creditors or a trustee, auctioneer, or venture capitalist or other acquirer has the know-how to *continue* the firm in operation, as distinct from reviving it (maybe) after an interruption for a change in control.

By solving the problem of premature liquidation due to high transaction costs, reorganization could reduce the cost of debt by enabling more value to be squeezed from some insolvent firms. Cheaper debt could in turn reduce the risk of bankruptcy by reducing a firm's fixed costs – or it could increase that risk by encouraging firms to take on more debt. So the overall effect of reorganization on the number of bankruptcies is uncertain even if reorganization solves the problem of premature liquidation. A further complication is that hope of being able to salvage something in a reorganization may reduce the perverse incentive of managers of a firm headed for insolvency and liquidation to undertake excessively risky projects, knowing that if the projects fail the creditors will bear all the costs. By inducing greater caution in the pre-bankruptcy period, the prospect of reorganization may actually reduce the number of bankruptcies. In any event, so long as all the costs of bankruptcy are borne by the shareholders ex ante – so that an increased risk of bankruptcy will be reflected in higher interest rates, thus compensating creditors at the expense of shareholders for bearing that risk – it is not clear that society should care whether bankruptcy is more or less common. But there are some external costs of bankruptcy, if only to involuntary creditors and to the bankruptcy court system, so probably society should care.

A further complication comes from the fact that most reorganizations in bankruptcy fail, and liquidation results. This is consistent with the proposition that reorganization avoids some *premature* liquidations, but it suggests that reorganization may also postpone some, perhaps a great many, *timely* liquidations. Once the firm is liquidated, the managers and shareholders are out on the street. If they can delay liquidation, they may be able – by imposing delay and, therefore, cost on the creditors – to drive a bargain with the creditors that will give the shareholders and the managers something. The risk to creditors that such tactics will be employed is another upward influence on interest rates – with the same indefinite effect on the number of bankruptcies noted previously.

Because the economic problems presented by reorganization are difficult ones, the literature that is sampled in this volume has not converged on a confident conclusion, in the way that the economic literature on antitrust in the 1970s and 1980s converged on a confident conclusion that antitrust policy was overextended, or that the economic literature on rent control has converged on a confident conclusion that rent control is inefficient. And because of the lack of convergence, the question arises whether this literature can be of value to bankruptcy judges and other officials involved in the bankruptcy process and for the bankruptcy bar. I think it can be. It is helpful to the practical world simply to be shown that economic efficiency is an appropriate guide to the interpretation of the bankruptcy laws and the administration of bankruptcy proceedings, a guide that can be used at a minimum to refute many bad arguments made in these proceedings. Beyond that, the economic literature has shown that chapter 11 has a nonnegligible if highly imperfect economic logic. That logic can provide a lodestone for judges. It can help them identify reorganizations that are not in good faith, or plans of reorganization that represent merely stalling tactics; and on the other hand to identify those reorganizations and plans that seem responsive to a genuine transaction-cost problem which may cause premature liquidation unless reorganization is permitted.

The editors have made a wise decision to exclude highly technical papers. By this decision they have created a volume that while highly sophisticated is accessible to the nonspecialist. I commend the volume highly to every bankruptcy judge and to every lawyer whose practice includes corporate bankruptcy.

The Honorable Richard A. Posner
Chief Judge, U.S. Court of Appeals for the Seventh Circuit

Preface

This book has been a long time in process. It was apparent to most observers some years ago that economic analysis of law had matured. Law and economics scholars produced a multitude of papers that found their way into existing and newly begun journals. Readers or edited volumes appeared in various areas of the law such as torts, contracts, antitrust administrative law, and corporate law.[1] For various reasons, economic analysis of bankruptcy law was somewhat slower in developing.[2] This may appear puzzling, at first, in view of the fact that many issues in bankruptcy intimately implicate financial or economic considerations. Perhaps, the slower application of economic methods or analyses to bankruptcy law partly can be ascribed to the fact that most scholars of bankruptcy law in the late 1970s and early 1980s were not yet tutored in economic thinking.[3] And, in any case,the bankruptcy law underwent a major revision in 1978. Consequently, some time elapsed before experience accumulated with the new law and before scholars of bankruptcy law mastered the tools of both theoretical and quantitative economics.

The last decade has witnessed a very rapid growth in scholarship employing economic reasoning and methods to various issues in bankruptcy law and a large body of such literature now exists in the form of articles and even casebooks.[4,5] However, to our knowledge, there is, as of yet, no existing reader or

[1] See, for example, *Economic Foundation of Property Law,* Bruce A. Ackerman (ed.), Little Brown (1975); *Economics of Contract Law,* Anthony T. Kronman and Richard A. Posner (eds.), Little Brown (1979); *Economics of Corporation Law and Securities Regulations,* Richard A. Posner and Kenneth E. Scott (eds.), Little Brown (1980); *Economic Analysis and Antitrust Law,* Terry Calvani and John Siegfried (eds.), Little Brown (1988); *Readings in the Economics of Contract Law*, Victor P. Goldberg, Cambridge University Press (1989); *Perspectives on Tort Law,* Robert L. Rabin (ed.), Little Brown (1990).

For more recent books, see for example: *Foundation of Tort Law,* Saul Levmore (ed.), Oxford University Press (1994); *Foundations of Corporate Law,* Roberta Romano (ed.), Oxford University Press (1993); *Foundations of Administrative Law,* Peter H. Schuck (ed.), Oxford University Press (1994).

[2] Perhaps the first comprehensive effort at an economic approach to bankruptcy is represented by Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law,* Harvard University Press (1986).

[3] By contrast, scholars in financial economics had long been interested in insolvency issues. See, for example, *Corporate Financial Distress,* Edward I. Altman, John Wiley and Sons (1983).

[4] A parallel development also occurred in the recent literature in financial economics. For example, *The Journal of Financial Economics* devoted a special issue to insolvency in 1990. (See vol. 27, no. 2 of that journal). See also, *Bankruptcy and Distress Restructuring,* Edward I.Altman (ed.), Business One Irwin (1993).

convenient collection of articles in this area, analogous to the many edited volumes in other areas of the law.[6]

This book is directed at an unusually wide audience. First, it is intended as a companion volume to case materials used by law students and professors in basic and advanced courses in bankruptcy. As the title suggests, the primary focus of the book is on business or corporate bankruptcy although the concepts discussed in many articles included in the book have obvious application to individual or personal bankruptcy as well. It is also my hope that most, if not all of the papers, offer theoretical or practical insights that may be useful to various bankruptcy professionals such as attorneys, judges, trustees, examiners, and others.

Our second aim is to reflect the interdisciplinary nature and possibilities of bankruptcy law and policy. To this end, several representative articles from the financial literature on insolvency have been included. This should make the volume attractive to students and faculty in business schools where courses dealing with financial distress are typically taught.

Finally, the study of bankruptcy or financial distress in other countries than the United States is just beginning. Accordingly, the final section of the book includes recent materials which should be of interest to scholars of both bankruptcy and comparative law.

The selections included in this book are necessarily extensively edited versions of larger works. Many, if not most, of the footnotes and citations have been deleted and those that remain have been numbered consecutively. In many instances the text was also heavily edited both in the interests of brevity and in view of the focus of the book on corporate insolvency.

It is impossible to complete a large undertaking of this type without substantial assistance from others. Our principal intellectual debt is owed to Barry Adler for his suggestions on the structure of this book and for his invaluable assistance in drafting editorial material. We alone are responsible for any errors, omissions, or inconsistencies that remain.

We are also grateful to all of the authors of the original articles both for permission to include their work and, in many cases, for suggesting editorial changes. A special word of thanks is due Judge Posner who made time from an extremely busy schedule to write the Foreword to this volume.

Except for one article, longer versions of all the selections included in this volume have appeared elsewhere. Permission to reprint edited versions of the papers is gratefully acknowledged and is also duly noted in the credit line at the beginning of every selection.

[5] One casebook which emphasizes economic considerations in bankruptcy is Douglas G. Baird and Thomas H. Jackson, *Cases, Problems and Material on Bankruptcy*, Little Brown (1990).
[6] See note 1 *supra*.

Preface

Financial support for the production of this volume was received from the Sarah Scaife Foundation and from Duquesne University. Portions of the manuscript were reviewed by Marilyn Ringiewicz. The manuscript was typed with speed and accuracy by Lynn Miller with the assistance of Susan Fortran and Lori Godshall. Finally, we are grateful to Cambridge University Press, in particular to Scott Parris, for cheerfully accommodating my various requests and for countless useful suggestions.

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and
Lawrence A. Weiss