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Why Have a Federal Bankruptcy System

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"WHY HAVE A FEDERAL BANKRUPTCY SYSTEM?"

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I begin with an empirical observation: Businesses fail. Most businesses meet all their outstanding obligations and still turn a profit. But some do not. This talk is about the law of business failure.

I may be speaking to a room full of lawyers, I suspect that I am not speaking to a group of people trained to think about business failure. For most of you, the entire law school experience—with the exception of your course in bankruptcy—consisted of two questions: examination of the scope of a party's rights, and determination of how much another party owes if those rights have been infringed. In practice, however, I suspect that most of you have noticed that the problem with which attorneys frequently deal is not whether the rights exist or the scope of the outstanding obligation, but instead whether the debtor *can* or *will* pay what is owed. The law of failure deals with the central questions of how much we will force a debtor to repay and to whom those debts will be repaid.

There will always be business failures because we deal in a capitalist market that incorporates risk as a central feature. This means that we must have some way to deal with the failures that sometimes follow those risks. This means we must have a bankruptcy system. We may not want to call it a bankruptcy system; I don't really care what we call it. We could call it cucumber if that would make it more palatable. But the reality is that we must have a way to deal with business failures.

Markets change. Some risks result in success; some in failure. That is what risk assessment is all about. The question is: When businesses fail, what happens to all of those outstanding obligations? During the period of failure, businesses still have assets and

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they continue to engage in transactions. The law must determine what to do with all those obligations.

There are a wide range of options that might deal with failure. First, we could simply let the debtor decide who gets paid. The debtor could say, "I like you, so you'll get what I've got left. I'll pay you off and not the others." The favored creditors would be pleased, although the disfavored ones would be pretty unhappy. Second, the creditors could find their own extra-legal way to deal with loss distribution. Creditors could simply come to collect. And the bigger creditors—the powerful, the quick, the frightening—would likely collect more than the weak, slow, or cooperative creditors. This puts a real premium on size and speed, but it creates an effective distribution of the assets of a failing business.

Third, we could let the parties decide on a distribution pattern by contract. Parties could say in advance, "We will contract for failure. If anything goes wrong, you promise you will pay me first." And everyone says "Fine." Of course, there is a problem in that debtors will tend to promise everyone that they are going to be paid back first. But we could create some system to monitor that. Fourth, we might choose simply to have an imposed priority system—we could say that employees are going to get paid first, or that trade creditors are going to get paid first or that people who helped you purchase hard assets are going to get paid first. We could pick any number of people to benefit from an imposed priority system.

State law provides one way to deal with collapse. In effect, it picks the first three of the options set forth above. It lets the debtor pick who will be paid, and it lets the most powerful creditors—those who get in there first and get judgment liens—get paid first. State law also allows for some distribution by contract, permitting creditors to obtain security interests in certain assets.

The bankruptcy system chooses a number of ways to deal with failure. It uses the fourth alternative by imposing some repayment priorities. For example, bankruptcy law provides that taxing authorities will be paid ahead of most of the parties who did business with the debtor. It says that employees will be paid ahead of many other creditors. It also permits some contract ordering. Bankrnptcy acknowledges some prebankruptcy contracts in order to protect postbankruptcy positions. It also mandates a pro rata distribution.

The question is: Why have a federal bankruptcy system? Why not leave the problem to state law or to private, extra-legal collection? The justification for the existence of the federal bankruptcy system is based on two premises. One is that a federal uniform system, specifically designed to address collapse, is a rational way to deal with failure. Bankruptcy is provided for in the Constitution.

Consider how few aspects of commercial life were addressed in the Constitution. And yet it provides that there shall be a uniform law of bankruptcy.[1] Why? Because failure was seen as a big problem, and one that we do not want people escaping by moving from one state to another. The race to the bottom as states pass laws to encourage corporations to do business locally in the context of corporate law has produced serious problems. Consider the implication if the states determined what would happen to a multinational corporation once it decided to file for bankruptcy in Delaware, South Dakota, Oklahoma, or wherever. The ide is that the consequences of failure ought to be the same no matter where it happens. Moreover, a federal system can reduce total cost by providing nationwide service of process, as well as full coverage of all debtors, creditors and property in dispute. (I note parenthetically that we are now moving toward an international law dealing with business failure. The problems created because companies are free to move their assets either into the United States, where they will be better protected, or outside the United States, if they think they will be better protected somewhere else, cause havoc when multinational companies fail. But that is a separate problem for another day.)

The second premise of federal bankruptcy law is that these uniform laws should reduce the total loss imposed by the system. This is why, for example, secured creditors cannot just pull the plug on a faltering business. If a creditor has a security interest in a critical machine, the fact that there may be going-concern value in this business is irrelevant to the creditor, since it can sell the machine for more than the outstanding value of its loan. If the creditor can simply back the truck up to the business doors, take the machine and leave, then more loss is imposed on the creditor group as a whole. But if the creditor is required to leave that machine in place for a period of time and collect payments on it, other creditors will also continue to profit from the earnings of the business, and total losses will be reduced.

There is a third reason that we have the current bankruptcy system. We have made the decision, right or wrong, to maintain a voluntary bankruptcy system. There are no Chapter 11 or Chapter 7 police of any kind. There is no one who comes along and says "We investigated your reports and we think you're bankrupt. Shut this business down." Instead, we let the private parties themselves make that decision, including the decision to use Chapter 11. Because of that, there is a necessary trade off. Judge Jones is exactly right about what happens when a business decides to file for Chapter 11.

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[1] U.S. CONST. art. I, § 8, cl. 4.

Chances are good that it will be a death penalty for the business. The business is giving up an enormous amount: it must reveal an extensive amount of information about its operations. It is subjected to a number of controls over its business operations. Its managers may be subject to personal liability or criminal penalties for some of their actions. So what incentive is there to go into bankruptcy? It is the one shot the business has at survival when the alternative is that it will not survive at all. To encourage voluntary participations—and voluntary shutdowns—we develop a system that balances opportunities and risk for the debtor.

Is the bankruptcy system socialization of risk? No. My sense is that the reason bank failures and bankruptcy are stitched together in this panel is that the bankruptcy system is what happens when we do not socialize the risk, and bank failure is what happens when we do. There is no taxpayer back-up in bankruptcy; no FDIC or FSLIC to make up losses in bankruptcy. Loss distribution in Chapter 11 occurs among private parties. More to the point, in Chapter 11, there is strong protection of the public fisc. Bankruptcy provides repayment priority to the local, state and federal taxing authorities.[2] Moreover, Chapter 11 aims toward self-funding through the fees collected and privatized representation.

Bankruptcy involves risk distribution among private parties. But the risk that a debtor will fail, and that loan collection will be accomplished through bankruptcy, is something that private parties can certainly price. Anyone who determines the cost of a loan today must consider the risks associated with collection, including the possibility that one of the parties involved will file bankruptcy and will thereby establish certain rights. So long as the risks are clear in advance, private parties are able to adjust to them.

Is there abuse of the system? Undoubtedly. There is abuse in any big, bureaucratic system. But is the abuse so widespread that we would be better off moving to a different kind of bankruptcy system? Consider the data. Business bankruptcy filings are up. In 1980, there were 8,000 business bankruptcy filings; in 1983, there were 20,000; in 1986, 21,000; in 1988, down to 17,000; in 1990, back up to 20,000.[3] Erust & Whinney did a study suggesting that

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2 11 U.S.C. § 507 (1988).

3 ANNUAL REPORT OF THE DIRECTOR OF THE ADMIN. OFFICE OF THE U.S. COURTS 544 (1981) rounded; ANNUAL REPORT OF THE DIRECTOR OF THE ADMIN. OFFICE OF THE U.S. COURTS 328 (1986) rounded; ANNUAL REPORT OF THE DIRECTOR OF THE ADMIN. OFFICE OF THE U.S. COURTS 364 (1988) rounded; PRELIMINARY REPORT OF THE DIRECTOR OF THE ADMIN. OFFICE OF THE U.S. COURTS *reprinted in* Bankr. Ct. Dec. (CRR) No. 39, at A8 (Sept. 26, 1991) rounded.

filings are likely to stabilize somewhere in this range.[4] The percentage of filings that are in Chapter 11, however, has taken a curious drop. From 1983 to 1988, 5% of all bankruptcy filings were in Chapter 11. In 1990, only 2.2% of bankruptcy filings were in Chapter 11.[5] The system has grown enormously (and has certainly grown in its press coverage), but the proportion of bankruptcy filings that are in Chapter 11 has become much smaller. Unfortunately, that is not going to help Judge Jones or Judge Easterbrook much. Filings per judge are up 66% in the last decade, and that means lots of business for sitting judges, since the court system has not expanded accordingly.[6]

Judge Jones is exactly right about the success of businesses in Chapter 11. Nine out of ten fail; of those that are nominal successes, probably a third are also liquidations. The true survival rate is probably less than 5%. That means, in effect, that the people who file Chapter 11 are not rich and wealthy companies that say, "Hah, I found a way not to pay my debts." No one goes cheerfully to have major surgery. No, the data suggest that these are businesses that took a chance on the last thing that might help them survive, and most found that in fact it did not because they were already dead. There is very little that the bankruptcy system can do for certain problems. It is a limited remedy. It can help a business that is able to stay in place and refinance. It can help a business that needs to sever a bad business part from a good business part. But Chapter 11 cannot turn around a depressed real estate market. It cannot make a business productive. It cannot give a business a product that everybody wants to buy. It can administer the business's liquidation, which, in fact, is what it does most of the time.

The most difficult social problems get dumped into bankruptcy—mass torts, environmental disasters, the dashed expectations of retired employees. (I should note here that is going to be the next big problem. We bought labor peace in the 1970s and 80s by promising those employees that they were going to have retirements like you would not believe. Well, you know what? They should not have believed because there is not enough money to pay off on many of those promises. The LTV bankruptcy raises a frightening specter of future pension cases.)

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4 ERNST & WHINNEY, REPORT TO THE ADMINISTRATION OFFICE OF THE U.S. COURTS ON BANKRUPTCY FINANCIAL INFORMATION 5 (May 1989).

5 *ABI Briefs Press on Bankruptcy Statistics and Fees Survey*, ABI NEWSLETTER No. 4, at 8 (June 1991); and calculation from sources in note 3 *supra*.

6 ADMINISTRATIVE OFFICE OF THE U.S. COURTS, BANKRUPTCY STATISTICAL INFORMATION 5 (April 1990).

It hurts not to be paid. I do not like it any more than anyone else does. It makes me very angry. There are losses in bankruptcy to be distributed; that is what bankruptcy is about. And we blame the bankruptcy system for distributing those losses. But failure caused the loss; bankruptcy is only the means of distributing it. If we are really talking about responsibility and socialization here, the bankruptcy system is something for which we should be grateful. Bankruptcy is what keeps private losses private and helps prevent the shifting of those losses in a genuinely socialized way.

One case provides a good illustration of the consequences of a weak bankruptcy system. In the late 1970s, Chrysler announced that it was tottering on the brink of financial collaspe. At the time of this announcement, the Bankruptcy Code was in transition between the 1898 Act and the 1978 Code. There was a lot of dissatisfaction with the old bankruptcy system, and no one believed the system was strong enough to handle a big bankruptcy. Everyone turned to Congress. The banks, the insurance companies, the pension funds, and the unions all pressured their congressmen to help Chrysler out. And the government said, "Okay, we'll provide loan guarantees." It helped Chrysler because of the fear that if it didn't, the consequences might be economically untenable. More to the point, Congress was sure that the consequences of letting Chrysler fail would be *politically* untenable.

Eventually we became more experienced with Chapter 11. When Johns-Manville got into trouble a few years later, the company went to Congress and said, "Help us out." The victims went to Congress and said, "Help us out." Then Eastern got into trouble and said, "Help us out." Continental Airlines and Braniff Airlines said, "Help us out." Even Wickes Lumber wanted help. But by then the answer was "No." That is what Chapter 11 is there for. The creditors and the debtors must work out their problems privately. A viable bankruptcy system sends a message to disputing debtors and creditors: "Work it out. You got into this arrangement without the government's help. You will deal with the losses, distribute the assets through Chapter 11, and survive collapse without its help."

Chapter 11 does not work perfectly. But given the job it has to do, it is critical to keep the system very much intact.