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Should the Secured Credit Carve Out Apply Only in Bankruptcy? A Systems/Strategic Analysis

Lynn M. LoPucki
University of Florida Levin College of Law, lopucki@law.ufl.edu

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Recommended Citation
Lynn M. LoPucki, *Should the Secured Credit Carve Out Apply Only in Bankruptcy? A Systems/Strategic Analysis*, 82 Cornell L. Rev. 1483 (1997)

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SHOULD THE SECURED CREDIT CARVE OUT APPLY ONLY IN BANKRUPTCY? A SYSTEMS/STRATEGIC ANALYSIS

Lynn M. LoPucki†

INTRODUCTION: THE CONTROVERSY 1483
I. THE BEBCHUK-FRIED STRATEGIC ANALYSIS 1489
A. Failed Businesses That Enter Bankruptcy 1489
B. Failed Businesses That Do Not Enter Bankruptcy ... 1490
II. THE STATE REMEDIES/BANKRUPTCY SYSTEM 1491
III. THE BEBCHUK-FRIED CARVE OUT PROPOSAL 1495
A. Proposed Changes in the System 1495
B. Strategic Analysis 1498
1. *The Secret Voluntary Liquidation Strategy* 1498
2. *System Response to the Voluntary Liquidation Strategy* 1503
a. *LoPucki: Bounty for Unsecured Creditors* 1504
b. *Jackson: Bounty for Debtors* 1504
c. *Bebchuk and Fried: Mandatory Bankruptcy Filing* 1505
3. *The Judgment-Proof Transferee Strategy* 1507
SUMMARY AND CONCLUSIONS 1509

INTRODUCTION: THE CONTROVERSY

The secured credit carve outs proposed by Professors Lucian Bebchuk and Jesse Fried in their *Yale Law Journal* article,[1] and by Professor Elizabeth Warren in her Memorandum to the Council of the American Law Institute,[2] are in most respects quite similar. Perhaps the principal difference is that Bebchuk and Fried proposed that their carve out apply only in bankruptcy,[3] while Warren proposed that her carve out be part of Article 9 and therefore effective both in and out

† Visiting Professor of Law, Harvard Law School, and A. Robert Noll Professor of Law, Cornell Law School. I thank Leon Foreman, Frances Foster, Kathryn Heidt, Ronald Mann, Elizabeth Warren, Jay Westbrook, and the participants in the Harvard Law School Symposium on the Priority of Secured Debt for their comments on earlier drafts.

1 Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996).

2 Letter from Elizabeth Warren, Leo Gottlieb Professor of Law, Harvard Law School, to the Council of the American Law Institute (Apr. 25, 1996) (on file with author).

3 Bebchuk & Fried, *supra* note 1, at 924.

of bankruptcy.[4] Participants in the Article 9 revision process raised a host of objections, the most strenuous being that even if the carve out were desirable, it should be effective only in bankruptcy.[5]

The objectors put forth three arguments. First, any carve out enacted should be part of bankruptcy law rather than the Uniform Commercial Code so that it would apply to both real and personal property.[6] Applying the carve out only to personal property would distort investment incentives.[7] Real estate lenders would have recourse to all of their collateral while personal property lenders would have recourse to only 75%[8] of theirs.[9] Second, if the carve out would apply to personal property but not real property, the law would have to distinguish the two, which would not be an easy task.[10] Professor Geoffrey Hazard, the Director of the American Law Institute, made the third objection in a foreword to a discussion draft of Article 9. It summarized the contention of "the proponents of the [d]raft:"

4 Letter from Elizabeth Warren to the Council of the American Law Institute, *supra* note 2.

5 *See, e.g.*, Letter from Michael J. Fleming, President of the Equipment Leasing Association, to Professor Geoffrey C. Hazard, Jr., Director of the American Law Institute 2 (Nov. 7, 1996) (on file with author) ("We agree with you that the Bankruptcy Code is a better place than the UCC for considering the Proposal."); Letter from Leon S. Forman, Esq., Counsel, Blank, Rome, Comisky & McCauley, to Elizabeth Warren, Leo Gottlieb Professor of Law, Harvard Law School, 1-2 (July 1, 1996) (on file with author) (expressing serious concerns with Warren's proposal and stating that "there is more merit in a bankruptcy solution where a deduction might automatically be made from the proceeds of collateral held by a secured creditor . . . on all the assets of an appropriate percentage for the benefit of the estate."); Letter from Jay L. Westbrook, Benno C. Schmidt Chair of Business Law, University of Texas at Austin School of Law, to Lynn M. LoPucki, A. Robert Noll Professor of Law, Cornell Law School 1 (Feb. 21, 1997) (on file with author) ("Article 9 itself should provide for a carve-out in case of an insolvency proceeding, which would normally be a bankruptcy.").

6 *See, e.g.*, Letter from Howard Ruda, Esq., Counsel, Hahn and Hessen LLP, to Geoffrey C. Hazard, Jr., University of Pennsylvania School of Law 4 (May 22, 1996) (on file with author) (concurring that "the Bankruptcy Code is the better place to limit secured lending if it is to be limited," and noting that "the universal applicability of the Bankruptcy Code would permit subjecting real property interests to the 20% rule. I see no economic reason for the Rule distinguishing between reality and personalty.").

7 *See id.*

8 The Warren Proposal calls for a 20% carve out, Letter from Elizabeth Warren to the Council of the American Law Institute, *supra* note 2, at 5, and the Bebchuk-Fried proposal, for a 25% carve out, Bebchuk & Fried, *supra* note 1, at 909. I have used the Bebchuk-Fried percentage because I address primarily the Bebchuk-Fried proposal.

9 *See, e.g.*, Letter from Howard Ruda to Geoffrey C. Hazard, *supra* note 6, at 4.

10 *See, e.g.*, *id.* ("Indeed, in the case of a plant mortgage I see substantial transactional difficulties in only applying the 20% Rule to the equipment (including fixtures?) component of the mortgage."). Thus far, the law has had little success in drawing the line between real and personal property. *See* 4 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 33-8 (4th ed. 1995) (describing the numerous tests for distinguishing fixtures from nonfixtures and concluding that "there is more than one line of authority, and . . . the lawyer must examine the cases with care to arrive at a reasonable guess about what is and what is not a fixture").

> [T]he proper legal regime through which to protect various rivals of secured creditors is elsewhere, in the law of bankruptcy. That is, it makes little sense to impose obstacles on creation of security arrangements, which have no adverse effect at all on unsecured creditors in the normal relationship with businesses that continue to be viable. Rather, the place for legal intervention to protect such creditors is where conflict has actually materialized between the competing interests of various classes of creditors. Hence, if additional protection needs to be provided to unsecured creditors—or any other class of claimants, for that matter—the matter should be addressed by amending the bankruptcy law.[11]

The first two objections are easily disposed of for the purposes of this Article. They do not in fact require that the carve out apply only in bankruptcy; they would be adequately met by expanding Warren's proposal to real property.[12] This Article addresses only the third objection.

The problems that result when a substantive rule of law—particularly a rule of priority—applies only in bankruptcy were the subject of a 1987 debate between Professor Elizabeth Warren and Professor Douglas Baird in a pair of essays in the *University of Chicago Law Review.*[13] Prior to that debate, Baird and Professor Thomas Jackson proposed the "creditor's bargain" theory of bankruptcy.[14] That theory posited that creditors' rights should be the same in and out of bankruptcy, except as necessary to solve the creditors' collective action

[11] UNIFORM COMMERCIAL CODE REVISED ARTICLE 9 at xv-xvi (Discussion Draft Apr. 16, 1996). Professor Jay Westbrook takes a slightly different approach. He advocates that the carve out apply only in bankruptcy, but that the changes be made in Article 9. Letter from Jay L. Westbrook to Lynn M. LoPucki, *supra* note 5, at 1 ("My proposal is that Article 9 itself should provide for a carve-out in case of an insolvency proceeding, which would normally be a bankruptcy.").

[12] Given the institutional structures by which changes in real and personal property security laws are made, coordination of a change in the two would be difficult if not impossible. Probably only Congress could implement a carve out applicable to both real and personal property.

[13] Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987).

[14] 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).

problem.[15] In particular, there should be only one set of priorities among creditors, applicable in and out of bankruptcy.[16]

Warren began by distinguishing two prototypes of default: "first, the single default where only one creditor complains about repayment and the remaining creditors are evidently (even if only temporarily) content with their repayment prospects; and second, the debtor's widespread default and collapse in which every creditor's prospects for repayment are sharply diminished."[17] She argued that the state collection system was designed with only the first type of default in mind; the bankruptcy system, with only the second type of default in mind.[18] The bankruptcy system had its own set of priorities, some of which addressed problems unique to widespread default and collapse. State collection rules and priorities should not be "accepted [in bankruptcy] simply because some of the rules make sense in a different, state law scheme."[19]

Baird countered that the state collection system resolved many situations involving widespread default and collapse.[20] The priority rules of the state collection system were designed with such situations in mind.[21] He challenged Warren to explain why the rules she advocated to govern widespread default and collapse in bankruptcy should not also govern widespread default and collapse outside bankruptcy.[22]

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15 Baird and Jackson initially argued that rules of nonbankruptcy law should apply in bankruptcy unless a bankruptcy policy required a different rule. *Id.* at 100 ("Bankruptcy law should change a substantive nonbankruptcy rule only when doing so preserves the value of assets for the group of investors holding rights in them."). In the Warren-Baird debate, Baird modified his position to state merely that rules should be the same in and out of bankruptcy unless policy requires otherwise. Under Baird's modified position, the better rule should govern, whether it originates in the bankruptcy system or under nonbankruptcy law. Baird, *supra* note 13, at 822 ("Whenever we must have a legal rule to distribute losses in bankruptcy, we must also have a legal rule that distributes the same loss outside of bankruptcy. All Jackson and I advocate is that these two rules be the same.") (footnote omitted).

16 *See* Baird, *supra* note 13, at 832 ("The idea is . . . to approximate the same deal that they had outside of bankruptcy so that no one has an incentive to begin a bankruptcy proceeding simply because its distributional rule is different.").

17 Warren, *supra* note 13, at 781.

18 *Id.* at 782 ("[S]tate collections laws cope with a wide spectrum of limited defaults, while the bankruptcy scheme concentrates on default in the context of the debtor's imminent collapse. The state collection scheme . . . is rationalized in order to serve a wide variety of collection needs.").

19 *Id.* at 785.

20 Baird, *supra* note 13, at 822.

21 *See id.* ("For better or worse, the drafters of Article 9 knew that their main business was creating priorities among creditors.").

22 Specifically, Baird challenged:

> If Warren thinks nonbankruptcy law's ordering of creditors is inappropriate when a bankruptcy filing has signaled that there is not enough money to pay all their due, she must explain why she would permit this ordering to operate in nonbankruptcy disputes even when there is likewise not enough money to cover all claims.

In response, Warren acknowledged that "[i]n some cases . . . state collection laws will resolve the relative collection rights of parties when a debtor collapses."[23] But, she then repeated her assertion—unchallenged by Baird—that "the state law system is *not* well-suited to . . . [widespread default and collapse] precisely because it necessarily must consider too broad a range of possible debtor-creditor relationships and follow collection principles inconsistent with those raised in the circumstances of complete collapse."[24]

Both Baird and Warren seemed to recognize the central importance of the legions of debtors collapsing outside bankruptcy. Baird, sensing the strength of his point that the affairs of many collapsing debtors never reach bankruptcy and thus are resolved pursuant to nonbankruptcy law, raises it early,[25] and repeats it often.[26] Warren seems to regard the problem of widespread default and collapse outside bankruptcy as merely a glitch in the system—even if an intractable one. To operate effectively, she acknowledges, the system must distinguish "the context of a single troublesome debt and complete debtor collapse."[27]

Warren did not suggest that the system could, or even should, force all collapsing debtors into bankruptcy. From a systems standpoint, it would be sufficient if workouts and nonbankruptcy liquidations were negotiated in the shadow of bankruptcy, and therefore on

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Id. at 824-25; *see also id.* at 830-31 (posing hypothetical in which a legislator asks Warren what priorities retirees should have in bankruptcy, noting that firms with retirees have closed without a bankruptcy petition being filed, and asking whether Warren would "nevertheless tell the legislator that legislation is needed only for firms that are in bankruptcy").

23 Warren, *supra* note 13, at 783; *see id.* at 794 ("Some businesses collapse outside bankruptcy because information or transaction costs preclude any interested party from filing.").

24 *Id.* at 783.

25 Baird, *supra* note 13, at 816-17 ("As long as many firms close or fail outside of bankruptcy, treating the question of how to distribute the losses that flow from a business failure as a bankruptcy question ignores much of the problem and creates perverse incentives.").

26 *E.g.*, *id.* at 819 ("Even if bankruptcy's gatekeeping rules were much better than they are, those who want a special legal regime governing loss distribution when a firm fails or closes at the same time it defaults to creditors must expect to see in bankruptcy many cases that do not belong there, and many cases outside bankruptcy that belong in bankruptcy."); *id.* at 822 ("A coherent approach to the question of how losses from failed firms should be distributed cannot ignore the distributional effects many legal rules have on firms that are not in bankruptcy."); *id.* at 823 ("In rejecting these nonbankruptcy priorities in bankruptcy, Warren does not follow through and explain why they are appropriate outside bankruptcy."); *id.* at 824-25 ("If Warren thinks nonbankruptcy law's ordering of creditors is inappropriate when a bankruptcy filing has signaled that there is not enough money to pay all their due, she must explain why she would permit this ordering to operate in nonbankruptcy disputes even when there is likewise not enough money to cover all claims."); *id.* at 827 ("Workers should not have a different place in line simply because someone has been able to start a bankruptcy proceeding."); *id.* at 829-30 ("When Warren focuses on *default*, she does not tell us why default policies should exist only in bankruptcy.").

27 Warren, *supra* note 13, at 795.

the terms specified in bankruptcy law. But in the absence of bankruptcy, a party can compel settlement on bankruptcy terms only if it has a cheap, easy, and quick means of forcing the case into bankruptcy should its opponent not agree to settle. The system Warren envisions still requires an effective bankruptcy triggering mechanism.

Bebchuk and Fried's proposal—echoed by a Greek chorus of Article 9 drafters—that the carve out be effective only in bankruptcy resurrects the issue Baird and Warren debated. Ironically, it is Warren who now proposes that the new unsecured creditor priority be the same in and out of bankruptcy and Bebchuk and Fried, employing a law and economics approach, who would have the existence of the priority depend on whether there has been a bankruptcy filing. But, the controlling, and as yet unresolved, issue remains the same. Can the system effectively separate cases of single troublesome debt and cases of widespread default and collapse, with the latter, and only the latter, settled on bankruptcy terms (including the carve out)?

In their article, Bebchuk and Fried were concerned principally with the economic implications of the existence of substantial numbers of nonadjusting creditors.[28] Their carve out proposal comes near the end of the article, and they address only briefly their reasons for concluding that it should apply only in bankruptcy.[29] Regarding the bankruptcy-only aspect of their proposal, Bebchuk and Fried's principal concern was the same one I present here—whether secured creditors and debtors might be able to evade the bankruptcy-only carve out by liquidating the collateral outside bankruptcy.[30]

Bebchuk and Fried's method was to hypothesize that a bankruptcy-only carve out proposal had been enacted, and then explore the strategies that borrowers and their secured creditors would likely employ in response.[31] This Article builds on their strategic analysis to assess their implicit conclusion that the strategic effects of a bankruptcy-only carve out are acceptable or controllable.[32]

Systems/strategic analysis employs a dialectic in which the analyst begins by describing the operation of the law-related system, with emphasis on how it will process various kinds of cases.[33] Then the analyst—or someone else[34]—assumes the roles of the various system

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28 Bebchuk & Fried, *supra* note 1, at 864-67.

29 *Id.* at 904-13, 924-26.

30 *Id.* at 924.

31 *Id.* at 923-29.

32 *Id.* at 934.

33 *See* Lynn M. LoPucki, *The Systems Approach to Law*, 82 CORNELL L. REV. 479 (1997) (describing the method for systems/strategic analysis).

34 For example, the *Debtor Creditor Game* is a computer program that manages a simulation of debtor-creditor interaction. Participants in the simulation, usually law students enrolled in an advanced bankruptcy course, assume the roles of participants in the system and try to resolve the financial problems of a hypothetical debtor. *See* Louis M. Brown,

participants and attempts to formulate the strategies by which the individual participants can best advance their respective interests.[35] If the result of the strategic interaction is inconsistent with the goals of the system, the analyst proposes modifications to the system to alter the strategies of participants. The analyst then reassumes the roles of various participants to test the modified system. Ultimately, a successful analysis will either discover the system form or forms that will achieve the system's goals, or demonstrate that no such form exists.

Part I of this Article summarizes Bebchuk and Fried's strategic analysis of their bankruptcy-only carve out proposal. To elaborate on and test that analysis, Part II describes the state remedies/bankruptcy system as it currently operates. Part III describes the operational changes that would occur if the Bebchuk-Fried proposal were adopted and then analyzes the new system. Part III concludes that either of two strategies would enable secured creditors to defeat the bankruptcy-only carve out under consideration. The first is a secret liquidation followed by strategic settlements with objecting unsecured creditors. The second is liquidation by consensual foreclosure, with the proceeds widely disbursed before the unsecured creditors could react. Finally, after summarizing the analysis, the Article concludes that a bankruptcy-only carve out would not change significantly the asset distributions of collapsing debtors or lending practices.

I
The Bebchuk-Fried Strategic Analysis

For the purpose of their analysis, Bebchuk and Fried divide the population of failed businesses into two groups: those that eventually enter bankruptcy and those that do not.[36]

A. Failed Businesses That Enter Bankruptcy

Bebchuk and Fried begin by acknowledging that their bankruptcy-only carve out would give secured creditors an incentive to liquidate before bankruptcy.[37] But they also note that their carve out will give the debtors and unsecured creditors in the same cases an equally strong incentive to liquidate in bankruptcy.[38] The strategic resolution of those incentives, Bebchuk and Fried conclude, will be

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Strategies for Legal Education: Creative Presentations in Bankruptcy, 21 L. & Soc'y Rev. 913, 916-17 (1988) (book review) (describing the *Debtor Creditor Game*).

[35] *See, e.g.*, Lisa M. Bossetti & Mette H. Kurth, *Professor Elizabeth Warren's U.C.C. Article 9 Carve-Out Proposal: A Strategic Analysis*, 30 UCC L.J. 1 (1997) (using strategic analysis to analyze Professor Warren's proposal).

[36] Bebchuk & Fried, *supra* note 1, at 924-25.

[37] *Id.* at 924.

[38] *Id.* at 925.

liquidation in bankruptcy.[39] That will occur because secured creditors can neither seize their collateral nor liquidate their debtors without their debtors knowing of their attempt "with ample time to file a bankruptcy petition."[40] If the debtor does not file a voluntary bankruptcy petition before the secured creditor forces a nonbankruptcy liquidation, the unsecured creditors will file an involuntary bankruptcy petition within 90 days after the nonbankruptcy liquidation. The unsecured creditors will then have the trustee avoid the nonbankruptcy liquidation as a preference and apply the carve out in the ensuing redistribution.[41]

B. Failed Businesses That Do Not Enter Bankruptcy

Bebchuk and Fried acknowledge that some debtors nevertheless will manage to liquidate without entering bankruptcy.[42] For the cases of those debtors, Bebchuk and Fried offer three alternative solutions. First, they propose "mandatory bankruptcy filing[s]"[43] for which the enforcement mechanism presumably would be criminal. Second, they assert that under a carve out regime the distributions in nonbankruptcy liquidations will mimic the distribution in bankruptcy liquidations because "unsecured creditors with large enough claims will be able to threaten credibly to push a liquidating borrower into bankruptcy if they do not receive an amount reflecting what they would have received" under the carve out.[44] Third, the existence of a bankruptcy carve out that might be applied against lenders later will cause them to lower their loan-to-collateral ratios at the time loans are made, thereby exerting the desirable influence of the carve out.[45]

Of course, lenders will have an incentive to respond to the carve out only to the extent the system can enforce it. Thus Bebchuk and Fried's last two arguments fail if, in contested cases, the secured creditors can defeat the carve out by irreversibly liquidating their collateral before bankruptcy. Part III will address whether they can do so. But before developing those strategies, it is first necessary to describe the system in which those strategies must operate.

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39 *Id.* at 926.
40 *Id.* at 925.
41 *See id.*
42 *Id.* at 925-26.
43 *Id.* at 926.
44 *Id.*
45 *See id.*

II
THE STATE REMEDIES/BANKRUPTCY SYSTEM

The coercive collection system is widely acknowledged to consist of two distinct subsystems—the state remedies system and the bankruptcy system.[46] The state remedies system has as its primary purposes the resolution of disputes regarding the existence and amounts of debts and forcible debt collection.[47] While the bankruptcy system serves the same purposes (among others),[48] it is specifically designed to do so in the cases of widespread default and collapse.[49] Because the claims are likely to exceed the value of the assets, and realization of the maximum value from the assets may require cooperation among the claimants, the creditors' interests are interdependent. In recognition of this, bankruptcy procedure—unlike state remedies procedure—requires notice to all creditors and an opportunity for all to participate.[50]

Despite general efforts to preserve nonbankruptcy entitlements in bankruptcy,[51] the two subsystems will generate different distributions for a given case.[52] To illustrate, assume that a debtor with $10 in assets has unsecured liabilities of $10 to each of 10 different creditors. If this case is assigned to the bankruptcy system, the creditors will share pro rata; each will recover $1, which is 10% of the debt owing to them. If this case is assigned to the state remedies system, the shares will be determined by a "race of diligence." That is, the debtor can distribute its own estate through payments or transfers of security until unpaid creditors seize the property.[53] The creditor who acts first may receive the entire estate.

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46 *See* Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 312.

47 *See id.*

48 *See id.* at 314-52 (describing the similarity of purpose).

49 *See id.* at 312.

50 *See id.* at 343-48.

51 *See, e.g.*, Butner v. United States, 440 U.S. 48, 55 (1979) ("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.").

52 Law-and-economics scholars seem to accept this point only grudgingly. *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 195-97 (1986) (noting that the existence of different procedures in and out of bankruptcy invariably changes the relative values of creditors' claims in and out of bankruptcy); Thomas H. Jackson & Robert E. Scott, *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.").

53 Preference avoidance is possible under the law of a few states, but, absent bankruptcy, such avoidance is rare. A transfer is not avoidable as fraudulent merely because its effect is to "prefer" one creditor over another with equal rights. *See, e.g.*, 2 DAVID G. EP-

The existence of two subsystems, each specialized to a particular kind of case, necessitates a mechanism for assigning cases to the appropriate subsystem. The mechanism employed gives each interested party—management, shareholder, unsecured creditor, and secured creditor—the ability to move a case into bankruptcy. Management can do so by filing a voluntary petition;[54] if they do not, their shareholders can replace them with managers who will.[55] Historically, the principal restraints on voluntary petitions were informal. For nearly all debtors, the social and economic repercussions of a filing were sufficiently severe that only those in financial distress chose to file.[56] Today, the repercussions remain sufficiently severe that filings by debtors not in financial distress are rare.[57] In an abundance of caution, some courts infer a requirement that bankruptcy filings be "in good faith,"[58] thus enabling them to reject filings they consider inappropriate.

Unsecured creditors can move the debtor to bankruptcy by filing an involuntary petition.[59] The control on involuntary petitions is for-

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STEIN ET AL., BANKRUPTCY § 6-59, at 99 (1992) (stating that preferences are rarely constructively fraudulent and that the intention to prefer a creditor is not, in itself, actually fraudulent).

54 In most corporations, the board of directors has the authority to file a bankruptcy petition. *See* MARK S. SCARBERRY ET AL., BUSINESS REORGANIZATION IN BANKRUPTCY 74-75 (1996) (discussing authorization of corporate filings).

55 In some close corporations, this will require only a written agreement among shareholders. *See id.* at 75 n.4. In others, it may be necessary to hold a shareholder meeting to remove the directors. *See* ROBERT CHARLES CLARK, CORPORATE LAW § 3.2, at 105 (1986) ("Directors may be removed by shareholders 'for cause' and, if the statute allows, without cause."). Because of the difficulty of convening a meeting, the shareholders of a large, publicly held corporation may have no practical way, until annual elections, to override the board's decision not to file.

56 The repercussions typically included the loss of customers and suppliers, inability to get credit, damage to reputation, and other kinds of problems. *See, e.g.*, Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 88 (1992) (lost business opportunities and customers); Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 273 (1987) (speculating on loss of suppliers, customers, and managers).

57 For several years, commentators used the Manville case as an example of a debtor filing bankruptcy strategically, even though it was not in financial distress. *See In re* Johns-Manville Corp., 36 B.R. 727, 732 (Bankr. S.D.N.Y. 1984) (holding that a debtor need not be insolvent to file under Chapter 11). The characterization of Manville as solvent was wrong from the start, and was proven so as the volume of asbestos litigation increased and Manville's financial condition deteriorated. The magnitude of the error is captured in the incongruous facts that Manville's commercial creditors were paid in full with interest, and Manville's equity holders recovered $132.9 million in the bankruptcy, *see* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 166-67 tbl.IV(A) (1990), yet Manville's asbestos claims—whose priority rights were equal to the commercial creditors and superior to the equity holders—are now being paid at a rate of only 10 cents on the dollar, *see* Louis Sahagun, *Dow Corning's Bankruptcy Filing: Asbestos Firm Took the Same Path*, L.A. TIMES, May 16, 1995, at D13 (noting that "the best the [asbestos] victims can now expect is 10 cents on the dollar").

58 *See, e.g.*, *Johns-Manville*, 36 B.R. at 737.

59 *See* 11 U.S.C. § 303(b) (1994).

mal. Unless the petitioners can show that the debtor "is generally not paying such debtor's debts as such debts become due," the bankruptcy court will dismiss the petition and assess costs and attorneys' fees against the petitioners.[60]

Although secured creditors have no direct means of moving their debtor into bankruptcy, they do have adequate indirect means. Their contracts generally give them the right to declare a default on the basis of virtually any symptom of financial distress.[61] Personal property secured creditors usually can obtain a writ of replevin within days of the default, giving them the immediate right to have a sheriff seize the collateral.[62] The threat of a levy generally leaves the debtor with no practical alternative but to file for bankruptcy. Real property secured creditors often can obtain the appointment of a receiver within a short time after filing a complaint for foreclosure, giving many of them a similar, but somewhat less effective, method of forcing a bankruptcy.[63]

Though nearly any interested party can force bankruptcy in an appropriate case, that alone does not assure a bankruptcy distribution. The debtor might be able to liquidate its assets under nonbankruptcy law before the petition is filed, or some creditor might be able to force such an eve-of-bankruptcy liquidation. The system's solution to this threat is to authorize the post-filing avoidance of preferential transfers to creditors that occurred within the ninety-day period before filing.[64] By recovering assets transferred to creditors in the ninety days before bankruptcy and redistributing them according to bankruptcy rnles, the system extends the distributional scheme of bankruptcy ninety days into the prebankruptcy past. But, in order to grasp the full importance of the preference rule to the system's intentions, one must consider the strategic implication. Preference law is not designed merely to extend the bankruptcy distribution rules into the past; it is designed to prevent nonbankruptcy distribution by any debtor in financial distress. The concept is that if a debtor made or suffered such a distribution, any party disadvantaged by it would force a bankruptcy filing within ninety days and reverse it. Thus, effective

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60 *Id.* § 303(h)(1). If the case is filed in bad faith, the award can include damages (including punitive damages). *See id.* § 303(i)(2).

61 *See* LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 255-57 (1995) (describing typical default provisions).

62 *See, e.g.*, Del's Big Saver Foods, Inc. v. Carpenter Cook, Inc., 603 F. Supp. 1071 (W.D. Wis. 1985), *aff'd*, 795 F.2d 1344 (7th Cir. 1986) (upholding issuance of a writ of replevin without notice to the debtor on the day the case was filed, resulting in the same day seizure of the debtor's business).

63 *See* 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 4.34 (3d ed. 1993) (discussing the basis for appointing a receiver).

64 *See* 11 U.S.C. § 547(b) (1994). If the transfer is to an insider, the period is one year. *See id.*

procedures for petitioning debtors into bankruptcy, together with a functioning preference scheme, could separate cases of a single troublesome debt from cases of widespread default and collapse.[65]

However, the current preference scheme is a failure. Involuntary bankruptcy petitions are filed in cases where exceptionally large amounts of money are at stake,[66] but are rarely filed in ordinary cases.[67] Debtors liquidate their own estates or grant security interests to favored creditors, without the filing of bankruptcy cases within the applicable preference periods. Even when Chapter 11 cases are filed within the preference periods, preferential transfers typically are not avoided.[68] By and large, debtors in widespread default and collapse still manage to control distributions of their estates.[69] The words I wrote in 1982 remain true today:[70]

> The bankruptcy court deals not with businesses in financial difficulty, but with their skeletons, already picked clean by workouts,

65 I assume here that a debtor in a state of widespread default and collapse will fail to pay its debts as they become due. Where such debtors do generally pay their debts as they become due, unsecured creditors may have no means of forcing them into bankruptcy.

66 *See* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 756 n.277 (1993) (noting that out of 43 Chapter 11 cases of large, publicly held companies, 6 (14%) were involuntary).

67 The percentage of involuntary petitions declines with the size of the case, demonstrating its sensitivity to the deterrent effects of transaction costs. *See* LoPucki, *supra* note 46, at 363 n.257 (rates for 1977, 1979, and 1980 were about one-half of one percent of bankruptcy filings); Lynn M. LoPucki & George G. Triantis, *A Systems Approach to Comparing US and Canadian Reorganization of Financially Distressed Companies*, *in* CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW 109, 121 n.34 (Jacob S. Ziegel ed., 1994) [hereinafter CURRENT DEVELOPMENTS] (noting that for the twelve month period ending June 30, 1988, 260 out of 18,629 Chapter 11 cases (1.4%) were involuntary filings).

68 *See* Jerome R. Kerkman, *The Debtor in Full Control: A Case for Adoption of the Trustee System*, 70 MARQ. L. REV. 159, 196-97 (1987) (presenting empirical data on Chapter 11 cases in the Eastern District of Wisconsin demonstrating that preference avoidance is rare).

69 *See, e.g.*, Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. & ECON. 223, 226 (1991) ("In most [Chapter 7 liquidation] cases, the firm has no unencumbered assets. The purpose is not so much to give creditors assets as it is to assure them that no assets are there."); 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, 57 (1991) ("The empirical evidence is that few distributions occur in bankruptcies. Thus, if bankruptcy is intended as a device for redistributing wealth from rich to poor creditors, it has been stunningly unsuccessful.").

70 In 1977, the percentage of bankruptcy liquidations in which there was a distribution to general creditors was only 13.3%. *See* ADMINISTRATIVE OFFICE OF THE U.S. COURTS, TABLES OF BANKRUPTCY STATISTICS 8-9 (1978) (discussing "asset cases" in a manner showing that they include distributions to unsecured creditors and indicating that 30,850 of the 231,509 cases closed in 1977 (13.3%) were asset cases). By 1991-92 it had sunk to five percent. U.S. GEN. ACCOUNTING OFFICE, BANKRUPTCY ADMINISTRATION: CASE RECEIPTS PAID TO CREDITORS AND PROFESSIONALS 1-2 (1994); Michael J. Herbert & Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed During* 1984-1987, 22 U. RICH. L. REV. 303, 311 (1988) (finding that 4.25% of Chapter 7 cases during the study period resulted in distributions to unsecured creditors).

> state court proceedings, informal liquidations, or merely the ravages of time and poor management. "Bankruptcy," as that term is used in economic theory, does not take place in the bankruptcy courts.[71]

Even without the additional stress of a bankruptcy-only carve out, the system has been "stunningly unsuccessful" in invoking the bankruptcy rules for the liquidation of collapsing debtors.[72]

III
The Bebchuk-Fried Carve Out Proposal

A. Proposed Changes in the System

Bebchuk and Fried directed their attention principally to matters of economic theory. As a result, the specifics of their carve out proposal are not developed fully. To describe their proposal in systems terms requires that I make assumptions as to how they would have resolved various implementation issues. I do so because specifics are necessary to render the proposed system sufficiently concrete for systems/strategic analysis. The reader should keep in mind that Bebchuk and Fried might resolve some of these issues differently, ultimately leading to different conclusions.

As one of two alternatives, Bebchuk and Fried propose that in bankruptcy cases,[73] secured creditors should recover only the amount of their secured debt or 75% of the value of the collateral, whichever is less.[74] They contemplate that the proposal would apply in Chapter 7 and Chapter 11,[75] but only with regard to "commercial borrowers."[76] The proposal will increase the incentives for secured creditors to liquidate their debtors outside bankruptcy, but it also will increase the incentives for unsecured creditors to liquidate their debtors in bankruptcy. Thus, it is not obvious that the carve out will make the system more or less effective in triggering bankruptcy.

Though Bebchuk and Fried never say so directly, they apparently contemplate that the carve out will be applied as of the date of the bankruptcy filing, and that after filing, the carved out creditors will be

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71 LoPucki, *supra* note 46, at 312.

72 Bowers, *supra* note 69, at 57.

73 Bebchuk & Fried, *supra* note 1, at 904 ("[T]he operation of security interests outside bankruptcy would be completely unaffected by [the carve out].").

74 *Id.* at 909-11 (discussing the "fixed-fraction priority rule" and using 75% as an example).

75 *Id.* at 911-13 (arguing that the carve out will not be a sharp break from current practice because the existing regime erodes priority in cases under Chapter 11); *see also id.* at 928 (arguing that the incentive to substitute leases for security interests in a carve out regime will be moderate because leases are eroded under Chapter 11 as it currently operates).

76 *Id.* at 934; *see, e.g., id.* at 904 n.158 (stating that the carve out proposals are not "intended for use in consumer bankruptcy cases where the individual was not engaged in a business before going bankrupt").

able to accrue interest and attorneys' fees on the secured portions of their claims.[77] Thus, if a debtor filed under Chapter 11 owing its secured creditor $100 secured by an asset worth $100, the creditor initially would have a secured claim in the amount of $75 and an unsecured claim in the amount of $25.[78] The creditor then would be entitled to accrue interest and attorneys' fees on the secured portion of its claim, because after applying the carve out, the claim would be "secured by property the value of which. . . is greater than the amount of such [secured] claim."[79] If, for example, interest accrued at 12% per year for the duration of a two-and-one-half year Chapter 11 case, the secured creditor would have a secured claim of $97.50[80] and an unsecured claim of $25. Such a creditor might be *better off* in the carve out regime than under current law where the creditor would have only a secured claim of $100.[81] Permitting the accrual of interest and attorneys' fees after application of the carve out would moderate the overall effect of the carve out, but probably not to any great degree in cases under Chapter 7, which conclude more quickly than those under Chapter 11.

Bebchuk and Fried are correct in their choice of rules regarding the accrual of interest and attorneys' fees on a carved secured claim. To understand why, assume that the opposite rule has been adopted: during a bankruptcy case, secured creditors may accrue interest and attorneys' fees only to the extent of 75% of the value of the collateral. The pattern of lending that would best exploit such a rule is the pattern that I call "segmented" lending.[82] As applied here, the strategy would direct that instead of borrowing under a single mortgage, the

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77 *Id.* at 911-13 (discussing the erosion of secured claims that currently occurs in cases under Chapter 11, in part because undersecured creditors are not permitted to accrue interest and attorneys's fees on their claims). If secured creditors were not permitted to accrue interest and attorneys' fees on their claims after application of the carve out, the erosion of the carve out would be added to the existing erosion. That is, the secured creditor would lose the 25% carve out and the time value of the remaining 75% of its claim. Bebchuk and Fried seem to contemplate that the carve out will be a substitute erosion, rather than an added erosion. *Id.* at 911 ("[The carve out] rule would certainly be preferable to the currently prevailing de facto rule of partial priority."); *see also id.* at 871-72 (asserting that the carve out would not effect a radical change because the system is already one of partial-priority).

78 *See id.* at 910 (giving a similar example).

79 11 U.S.C. § 506(b) (1994).

80 The interest would be: $75 × .12 × 2.5 = $22.50, making the principal and interest: $75 + $22.50 = $97.50.

81 Thus interpreted, the carve out would have the positive effect of reducing the debtor's incentive to delay in Chapter 11 in order to enjoy the benefits of an interest-free loan from its undersecured creditors. Because of the carve out, the debtor would have no undersecured creditors for several years into the bankruptcy case. Obviously, in a long case, interest accruing to the secured creditors could consume the carve out, leaving nothing for unsecured creditors.

82 LYNN M. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS § 3.05(J) (3d ed. 1997).

debtor should borrow from two creditors on first and second mortgages.[83] The first mortgage would be for approximately 60% of the liquidation value of the collateral; the second mortgage, for the remaining 40%.[84] Through this strategy, the debtor, along with the secured creditors as a group, would gain two advantages. First, in any ensuing bankruptcy, the first mortgage would be oversecured, so that interest and attorneys' fees would accrue on it after application of the carve out.[85] By contrast, if the secured lending had been from a single mortgagee for 100% of the liquidation value of the collateral, no interest or attorneys' fees would have accrued.[86] Thus, lenders using the system-unintended, segmented lending strategy would largely defeat the carve out, while those not using the strategy would suffer the carve out. The carve out would cause strategic activity without affecting outcomes substantially.[87]

The second advantage gained by the alliance of debtor and secured lenders through loan segmentation would be that second secured lenders could specialize in liquidating debtors outside bankruptcy to defeat the carve out. The second secured lenders would be motivated by the fact that, outside bankruptcy, they would have priority over the unsecured creditors, although, in bankruptcy, they would share pro rata with the unsecured creditors. The segmented lending this pattern of incentives generates would push debtors in the direction of nonbankruptcy liquidation, thus rendering the carve out less effective.

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83 Regardless of the effect of the carve out on lending practices, one should not expect the last 25% of collateral value to arrive at bankruptcy unencumbered. Having a security interest against the last 25% of any item of collateral will carry with it *some* rights and therefore will have *some* value; certainly, *some* creditors will bid for it, thus encumbering it.

84 The secured creditor need not estimate the liquidation value of the collateral to gain the benefit, or even the full benefit, of this strategy. Any loan segment that is less than the value that the bankruptcy court assigns to the collateral will accrue interest during bankruptcy. By dividing the loan into a near infinite number of segments, the secured creditors could assure that interest will accrue on the entire secured portion, regardless of the value the court assigns. For example, assume that a $100,000 loan were divided into 100,000 segments, each in the amount of $1. If the court determined that the value of the collateral was $67,000, the first 66,999 loans would be *oversecured* and the holders of each would be entitled to accrue interest. Only the 67,000th loan would be affected by the Supreme Court's decision in *United Savings Ass'n v. Timbers Forest Associates*, 484 U.S. 365 (1988). Had the loan instead been a single segment of $100,000, under *Timbers*, no portion of the loan would accrue interest.

85 That is, the secured claim would be 60% of the value of the collateral, so it would accrue interest until it reached 75%.

86 This assumes that the single secured loan would have been in an amount in excess of 75% of the collateral's value. Were it not, a second mortgage loan would be necessary to capture the collateral's full value in quick liquidations under Chapter 7.

87 The argument presented here favors the accrual of interest on secured claims not only after carve out, but also under current law. *See* LoPucki, *supra* note 82, § 3.05(J).

Bebchuk and Fried make clear their intention that the carve out be enforced retroactively for ninety days through preference law.[88] Because the carve out will create a new class of avoidable preference—liquidation of collateral within the preference period—and the transactions often will be in substantial amounts, one effect probably will be to increase the dollar amounts that trustees and debtors-in-possession must recover as preferences. In turn, the increase in dollar amounts will make it somewhat more difficult for the trustees or debtors-in-possession to collect their judgments of avoidance.[89]

In their initial article, Bebchuk and Fried did not consider whether purchasers at foreclosure sales should be liable for the preferences that the sales effect. Part III.B.3 considers that issue.

B. Strategic Analysis

The system, as modified in Part III.A, would be vulnerable to two strategies that the system could not counter. The first is a secret voluntary liquidation of collateral outside bankruptcy for the benefit of secured creditors, shielded by strategic settlements with unsecured creditors who discover the liquidation in time to challenge it. The second is the use of judgment-proof entities to receive and disburse widely the proceeds of liquidations that occur on the eve of bankruptcy.

1. *The Secret Voluntary Liquidation Strategy*

In their strategic analysis, Bebchuk and Fried assume that debtors would oppose secured creditors' efforts to liquidate collateral outside bankruptcy.[90] Their assumption ignores the possibility that in a carve out regime, the interests of collapsing debtors may coincide with the interests of their secured creditors in achieving a nonbankruptcy liquidation. The coincidence would result from contractual obligations incurred at the time of making the secured loans. At that time, the interests of debtors and their secured creditors regarding possible liquidation would coincide. The debtor would prefer to bind itself to a nonbankruptcy liquidation because that would increase the value of the collateral to the secured creditor and thus enable the debtor to obtain better terms. There might be some tendency for the debtor to suffer correspondingly worse terms in obtaining unsecured credit, but

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88 Bebchuk & Fried, *supra* note 1, at 925 (arguing that unsecured creditors would make the carve out effective by filing involuntary petitions).

89 A trustee or debtor-in-possession attempting to recover a preference usually sues as an unsecured creditor. Yet many of the creditors from whom they must recover the payments are judgment proof. *See* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 14-38 (1996) (describing the techniques for defeating recovery by unsecured creditors).

90 *See supra* text accompanying notes 38-39.

this tendency will not offset the advantage gained with secured creditors.[91]

Means for debtors to bind themselves to nonbankruptcy liquidations are readily available. For example, a debtor's shareholders might personally guarantee the debt to a secured creditor without guaranteeing the debts to nonadjusting unsecured creditors. Whether or not the creditor actually could collect from the shareholders on the guarantee, the guarantee would tend to cause the interests of the shareholders and the secured creditor to coincide at liquidation. Both would want the secured creditor paid in preference to the unsecured creditors.[92] In recent years, innovative strategists have been experimenting with other ways of "bankruptcy-proofing" companies.[93] The primary limitation on bankruptcy-proofing has not been the inability to do it, but the lack of demand for it. One could expect that to change if 25% of the secured creditor's collateral were at stake.

If a business is worth more in operation, the debtor and its secured creditor will share an interest in keeping it that way. But liquidation *of the collateral* is not inconsistent with the continued operation of the business. Liquidation of the collateral can be merely a paper transaction. The secured creditor might sell the assets in place, buy them at the sale,[94] and lease them to the debtor—or employ some transactional equivalent.

The nonadjusting unsecured creditors, as a group, would have precisely the opposite interests; they would gain most by forcing the debtor to liquidate in bankruptcy. The most direct means for accomplishing that would be for three or more unsecured creditors to file

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91 *See* Bebchuk & Fried, *supra* note 1, at 882-91 (noting the existence of many unsecured creditors who will not adjust the terms on which they will lend); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1896-98, 1916-20 (1994) (noting the existence of substantial numbers of unsecured creditors who have neither the opportunity nor the information necessary to adjust to the terms on which their debtors obtain secured credit).

92 Although the secured creditor could not collect on the guarantee, it could use the guarantee to force the shareholders into bankruptcy. *See* 11 U.S.C. § 303(a) (1994) (stating that an involuntary case may be commenced only under Chapters 7 or 11).

93 Examples include: (1) security interests in the owners' shareholdings that will enable the secured creditor to seize control of the company if the company suffers financial distress; (2) loan covenants by which creditors can assume voting control of the company directly if it suffers financial distress; and (3) covenants enabling the creditors to assume seats on the board of directors if the company suffers financial distress. *See generally* LOPUCKI, *supra* note 82, § 3.08 (elaborating on examples).

94 Alternatively, the secured creditor might arrange for a third party to buy them, depending on whether buyers at foreclosure sales are vulnerable to preference avoidance. *See infra* text accompanying notes 26-29. Under UCC § 9-504, the sale must be commercially reasonable, but that does not mean the sale cannot be "private." U.C.C. § 9-504(3) (1995).

an involuntary bankruptcy petition against the debtor.[95] However, unsecured creditors file relatively few involuntary bankruptcy petitions.[96] In part, the low filing rate results from procedures that are deliberately hostile to involuntary filers.[97] For example, petitioning creditors typically have no reliable means of obtaining the information they need to determine the appropriateness of their petition in advance. In most cases, they must take a shot in the dark.[98] Yet Bankruptcy Rule 9011 requires that either the petitioners or their attorney certify that "to the best of the attorney's or party's knowledge, information, and belief formed after reasonable inquiry [the petition] is well grounded in fact."[99] If their petition fails, petitioning creditors may be liable for the debtor's attorneys' fees and costs, and may even be liable for the debtor's actual damages from the filing or punitive damages.[100] If their petition succeeds, the petitioning creditors reap no reward for joining the petition; they share pro rata with those unsecured creditors who did not join the petition. They have a claim against the debtor's estate for their own attorneys' fees, but that claim is subordinate to the claims of secured creditors and must share pro rata with other expenses of administration.[101]

Bebchuk and Fried correctly point out that a bankruptcy-only carve out will, in some respects, enhance the incentives of unsecured creditors to file involuntary petitions.[102] In the event of a successful

95 Alternatively, the unsecured creditor might force the debtor into bankruptcy by obtaining a writ of execution and threatening to seize critical assets. Strategists, however, have developed techniques that have reduced the effectiveness of this alternative. *See* Lynn M. LoPucki, *Legal Culture, Legal Strategy, and the Law in Lawyer's Heads*, 90 Nw. U. L. Rev. 1498, 1537-41 (1996) (describing strategy by which a cooperating secured creditor can block execution).

96 *See supra* notes 66-67.

97 For a brief description of the historical roots of the hostility, see Judge Friendly's dissent to *In re Gibraltor Amusements, Ltd.*, 291 F.2d 22, 26 (2d Cir. 1961). Among other things, Friendly cites the statement of Martin Van Buren, denouncing an attempt to provide for voluntary and involuntary bankruptcy in a single statute: "'It is an erroneous idea . . . that this bill can be made to serve God and mammon by combining two things totally at variance.'" *Id.* at 27 n.2 (Friendly, J., dissenting) (alteration in original) (quoting 3 Cong. Deb. 279 (1829)).

98 *See* Elizabeth Warren & Jay Lawrence Westbrook, The Law of Debtors and Creditors 464-65 (3d ed. 1996) (raising, in problem 27.1, the issue of how creditors can obtain the information necessary to file an involuntary case); Elizabeth Warren & Jay Lawrence Westbrook, The Law of Debtors and Creditors: Teacher's Manual 158 (3d ed. 1996) (commenting that "[W]e want the students to see how very difficult it can be for a creditor to learn enough information about the debtor to permit a prudent decision about an involuntary filing even when the debtor hasn't paid our creditor and the debtor is rumored to be in serious trouble").

99 Fed. R. Bankr. P. 9011(a).

100 *See* 11 U.S.C. § 303(i) (1994).

101 *See id.* § 503(b)(3)-(4) (providing for allowance of the attorneys' fees and costs of involuntary petitioners).

102 Bebchuk & Fried, *supra* note 1, at 925.

petition, at least 25% of the value of the secured creditors' collateral would be available for the payment of expenses of administration, other priority debts, and unsecured creditors. Thus, for example, the attorneys' fees and other out-of-pocket expenses of successful petitioning creditors almost certainly would be paid.[103] It might appear that the most profitable course of action open to an unsecured creditor who discovers that its debtor has surrendered collateral to a secured creditor would be to enlist two other unsecured creditors, file an involuntary petition, and secure the appointment or election of a trustee who will avoid the transfer.

However, in most cases, that preference avoidance strategy will be less appealing than a strategy that defeats the carve out and enables the would-be petitioning creditors to share in the nonbankruptcy liquidation. First, it is not clear that the preference avoidance strategy will result in significant distributions to unsecured creditors. Freed from the hold of its secured creditor by the involuntary petition, the debtor is likely to attempt a reorganization. The carve out would assure that the funding for a reorganization would be available in every case—that is one of the justifications for adopting the carve out in the first place. A debtor has the right to attempt a reorganization[104] and little to lose by trying; typically, neither the debtor nor its owners will recover anything in a liquidation.[105] The distribution that the secured creditor would get in liquidation might be at risk in reorganization, but if the secured creditor still has leverage with the debtor, it can use that leverage to obtain favoritism under the reorganization plan.[106] If the debtor fails in an attempt at reorganization, the failure is likely to consume the bulk of the funds that the carve out made available to

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103 *See* 11 U.S.C. § 503(b)(3)-(4) (making the attorneys' fees and costs of successful petitioning creditors expenses of administration).

104 *See id.* § 706(a) ("The debtor may convert a case under [Chapter 7] to a case under chapter 11, 12, or 13 of this title at any time, if the case has not been converted [to Chapter 7] under section 1112, 1208, or 1307 of this title.").

105 *See supra* note 70.

106 In practice, debtors seldom sue to avoid preferences in cases under Chapter 11. *See* Kerkman, *supra* note 68, at 196-97. Instead, they use the threat of such avoidance to secure support for their plans. *See* LoPucki, *supra* note 82, §§ 10.03[F], 11.03[H]. That strategy generally is acceptable to the bankruptcy courts, so long as the courts perceive that the debtor is using the leverage to benefit the estate rather than the insiders. *See, e.g.*, Harstad v. First Am. Bank, 39 F.3d 898, 905 (8th Cir. 1994) (stating in dicta that the debtor would not have been able to avoid a preference because the power of avoidance was for the benefit of only the estate and the debtor did not show how its recovery would have benefitted anyone other than the debtor). When a debtor uses the leverage to benefit the insiders, many bankruptcy courts permit the unsecured creditors' committee to prosecute the preference actions on the estate's behalf. *See, e.g.*, *In re* V. Savino Oil & Heating Co., 91 B.R. 655, 656-57 (Bankr. E.D.N.Y. 1988) ("If . . . a trustee/debtor-in-possession unjustifiably fails to employ its statutory arsenal of avoiding powers or otherwise abuses its discretion in not suing, a creditors' committee has implied authority to bring an action on behalf of the estate in bankruptcy with the approval of the bankruptcy court.") (footnote omitted).

the estate.[107] Even if the debtor does not attempt reorganization, the expenses of administration, together with tax and other priority claims, are likely to consume the bulk of the carve out funds,[108] leaving relatively little for distribution to unsecured creditors, including petitioning unsecured creditors.

The better strategy for the unsecured creditor that discovers an avoidable surrender of collateral would be to bargain with the debtor and the secured creditor to join their alliance. Elsewhere, I have explored in detail the forms such a settlement might take.[109] The most efficient form is for the preferred creditor to assign to the complaining creditor the same percentage of the preferential transfer that the complaining creditor holds of the unsecured claims against the debtor.[110] To continue with the previous example, assume that in a carve out regime the holder of a $25,000 unsecured claim discovers that Debtor surrendered $1 million in collateral to Secured Creditor, effecting a preference to Secured Creditor in the amount of $250,000. Assume further that potential unsecured claims total $500,000, so that avoidance of the preference would result in a dividend to unsecured creditors of fifty cents on the dollar, less the expenses of administration, priority claims, and reorganization losses.[111] That is, in bankruptcy the complaining creditor would get $12,500, less its pro rata share of the expenses of administration, priority claims, and reorganization losses. Both Secured Creditor and the complaining creditor will fare better in a settlement in which Secured Creditor assigns to the complaining creditor a 5% interest in the $250,000 transfer Secured Creditor received. The assignment might be made pursuant to an agreement not to disclose the assignment or encourage the filing of a bankruptcy case while the surrender of collateral remains avoidable as a preference, but no agreement on the part of the complaining creditor is needed. Once the assignment is made, the recipient of the surrender and the complaining creditor share a common interest in

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107 *See, e.g.*, Robert M. Lawless et al., *A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies*, 1994 U. ILL. L. REV. 847, 868 (finding that "total chapter 11 direct costs averaged 21.55% of all unencumbered and encumbered assets reported in the petition and 14.49% of disbursements to all creditors").

108 *See* 11 U.S.C. §§ 507(a), 726(a) (1994) (specifying the classes of unsecured claims that have priority over general unsecured creditors).

109 LoPUCKI, *supra* note 82, § 2.16[D].

110 *See id.*

111 Reorganization gains would be possible, but given the high rate of business failure during Chapter 11 and the strategies available to debtors for assuring that unsecured creditors do not capture the lion's share of the gains, losses are probably considerably more likely. *See* Samuel L. Bufford, *Chapter 11 Case Management and Delay Reduction: An Empirical Study*, 4 AM. BANKR. INST. L. REV. 85, 87-89 (1996) (collecting studies showing the confirmation rates in ordinary Chapter 11 cases to be between 17% and 44%); *id.* at 112-13 (reporting confirmation rates of 16.1% and 16.8% under a "fast track" case management system adopted by Judge Geraldine Mund in Los Angeles).

having the preference period expire without further incident. The filing of a bankruptcy, followed by avoidance of the surrender as a preference, will render the assignment worthless as well. Thus, if no bankruptcy is filed and the transfer is not avoided, the complaining creditor will recover $12,500. If the transfer is avoided, the complaining creditor will recover only $12,500, less the expenses of administration, priority claims, and reorganization losses. If other unsecured creditors complain of the preference, Secured Creditor can settle with them in the same manner. Secured Creditor's benefit from the preference will be reduced, but Secured Creditor will remain better off than if Debtor went into bankruptcy and the preference were avoided. The only exception would occur in the unlikely event that *every* unsecured creditor complains. I have successfully employed this settlement technique in practice.

This settlement technique works because, in the absence of bankruptcy, unsecured creditors usually have a severe collective action problem. That is, it ordinarily would be in the interests of unsecured creditors as a group to monitor Debtor, discover the grant of the preference, and force Secured Creditor to disgorge it. But it rarely would be in the interests of each unsecured creditor to do so. Preserving the preference enables the monitoring creditors, Debtor, and Secured Creditor to capture and divide among themselves the share that the nonmonitoring unsecured creditors would get in bankruptcy. To generalize further, whenever the system permits contracting parties to capture and divide between them value that, absent the contract, would have gone to someone else, the parties will tend to make the contract.[112] The effect here is to permit only complaining unsecured creditors to benefit from a bankruptcy-only carve out.[113]

2. *System Response to the Voluntary Liquidation Strategy*

Under the current rules for triggering bankruptcy, debtors and their secured creditors could easily defeat a bankruptcy-only carve out through prebankruptcy liquidation. But the issue identified in the Warren-Baird debate remains—whether better triggering rules might yield better results. Three such rules have been proposed.

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[112] Secured credit is another example of such a deal. *See* LoPucki, *supra* note 91, at 1899 ("Security is an agreement between A and B that C take nothing.").

[113] Some of the means suggested here could avoid a carve out applicable inside and outside bankruptcy. That is, insiders could settle on non-carve out terms and share their advantage only with unsecured creditors who complain. But a universal carve out would be less vulnerable to these strategies because it is so much easier for general creditors to initiate a lawsuit than an involuntary bankruptcy.

a. *LoPucki: Bounty for Unsecured Creditors*

In 1982, I proposed that the claims of successful petitioning creditors whose debts were not consumer debts should receive priority over the claims of general creditors in the distribution of the bankruptcy estate.[114] The grounds for such a petition—that the debtor was generally not paying its debts as they became due—would remain unchanged. I continue to believe that the proposal would have a positive effect on the operation of the state remedies/bankruptcy system by channeling the cases of financially distressed debtors into bankruptcy at earlier stages.

That proposal, however, might not be adequate to solve the even greater challenge a bankruptcy-only carve out poses. To bring debtors who were generally not paying into bankruptcy earlier would not be sufficient; it would be necessary to bring them into bankruptcy before they could effect an irreversible nonbankruptcy liquidation. Such a liquidation might occur before the petitioning creditors were even eligible to file—while the debtor was still generally paying. Moreover, the proposal would do nothing to solve the petitioning creditors' greatest problem—obtaining the information necessary to determine when an involuntary petition is necessary and appropriate.

b. *Jackson: Bounty for Debtors*

In 1986, Professor Thomas H. Jackson noted the incentives for shareholders of a firm "to delay too long in filing a bankruptcy petition."[115] He explored briefly the possibility of offering "a bounty based on the extra value gained by resorting to the bankruptcy" to shareholders—as "the group that is most likely to learn first about debtor's insolvency"—to commence a bankruptcy case instead of to delay.[116] In a later article, Baird suggested that "[t]he weakness of giving a cash bounty to the managers . . . may lie in the inability of the court to determine after the fact when the bankruptcy petition should have been brought and how much difference bringing the proceeding at the right time makes."[117]

Baird may have overstated his case. The court's determination will be only an approximation, but knowledge that the court will make such a good faith approximation may be sufficient to establish appropriate incentives for debtors to file.

The real problem with the proposal of a bounty for debtors is that this proposal seeks to solve a problem by rewarding the persons who

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114 LoPucki, *supra* note 46, at 365-68.

115 JACKSON, *supra* note 52, at 205.

116 *Id.* at 206-08.

117 Baird, *supra* note 69, at 231.

cause the problem in the first place. The bankruptcy bounty would be somewhat analogous to payments to criminally minded people not to commit theft. If the payments were large enough, theft might slow, but the cost would be substantial, and it would continue to grow as more people found it profitable to become criminally minded and thereby eligible to share in the bounty.

To illustrate the problem with respect to the carve out, assume that Debtor has assets of $100 that are collateral for a debt in the same amount. Further assume that Debtor and Secured Creditor plan a nonbankruptcy liquidation in which the owner-managers will be released from $12.50 in guarantee liability that they would otherwise have to pay. The bankruptcy system might be able to capture the case by paying a bounty of $13 to the owner-managers, but that would be an expensive route to take. Unsure of which debtors were capable of strategic combination with their secured creditors, the system would have to pay the bounty to all debtors. The secured creditors, who would benefit at any price less than the $25 carve out they would face in bankruptcy (plus appropriate allowance for transaction costs and risk premium), might even be able to outbid the court that offered $13.

c. *Bebchuk and Fried: Mandatory Bankruptcy Filing*

In 1996, Bebchuk and Fried raised the possibility of requiring that every liquidating firm with unpaid debt file a statement with the bankruptcy court listing its assets, transfers made during the preceding year, and the identities of all of its unpaid creditors.[118] A court-appointed representative of the unsecured creditors or some other party could then supervise the allocation of the debtor's assets so that it conformed with the carve out.[119] Such a rule would eliminate completely any problem that out-of-bankruptcy liquidations would pose.[120]

The proceeding they proposed would not be markedly different from a case under Chapter 7 of the Bankruptcy Code. That is, for a corporate debtor, Chapter 7 involves no issues of discharge or retention of property. The focus of a corporate Chapter 7 case under current law is the same as the focus of the proposed proceeding—liquidating and distributing the estate. What Bebchuk and Fried proposed, in essence, is that all debtors in complete collapse face a requirement to liquidate in bankruptcy. Bebchuk and Fried did not explain how they would enforce their filing requirement. Presumably, however, they would attach some penalty to failure to file when the case is appropriate for bankruptcy.

118 Bebchuk & Fried, *supra* note 1, at 926.

119 *Id.*

120 *Id.*

To implement their proposal, the system would have to identify, with specificity adequate for criminal enforcement, the circumstances triggering the duty to file. But, that may be possible. The system might require that any debtor that seeks to liquidate an asset of a specified value file a bankruptcy case when the debtor's remaining assets would be insufficient to satisfy its debts.[121] Given the draconian consequences that a bankruptcy filing would have for the debtor-secured creditor alliance, violations of the law would be common unless enforcement were vigorous. The British system makes directors and officers personally liable for continuing the operations of an insolvent company outside bankruptcy,[122] but the law does not appear to be very effective.[123]

The greatest obstacle to each of these three proposals is the abiding American prejudice in favor of negotiated, out-of-court solutions.[124] Any scheme that made it possible to bring financially-distressed debtors into bankruptcy cheaply, easily, and quickly would reduce the number of out-of-court workouts drastically. More financially distressed debtors would be subject to the "stigma" of bankruptcy.[125]

I do not share the prejudice in favor of out-of-court workouts. Negotiations are more, rather than less successful when they occur on a conveyor belt moving toward adjudication, and it is particularly so in complex, multiparty litigation such as bankruptcy.[126] If information about debtors were readily available in manageable forms, the "stigma" of bankruptcy would be neither more nor less than it should

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121 This standard is similar to the standard for the payment of dividends by a corporation. *See, e.g.*, OHIO REV. CODE ANN. § 1701.33(C) (Anderson Supp. 1996) ("No dividend . . . shall be paid to the holders of shares of any class . . . when the corporation is insolvent or there is reasonable ground to believe that by such payment it would be rendered insolvent."). Another alternative would be the British standard for imposing personal liability on directors for wrongful trading "[when] there was no reasonable prospect that the company would avoid going into insolvent liquidation." Insolvency Act, 1986, ch. 45, § 214(1) (Eng.).

122 *See* L. S. Sealy, *Personal Liability of Directors and Officers for Debts of Insolvent Corporations: A Jurisdictional Perspective (England)*, *in* CURRENT DEVELOPMENTS, *supra* note 67, at 485, 491-94.

123 *See id.* at 494-95.

124 *See* Walter O. Weyrauch, *American Law as a Bargaining System*, FLA. LAW., Fall 1989, at 14, 14-15 (describing the overwhelming preference for bargained solutions in the American system and contrasting it with continental systems).

125 The bankruptcy literature is replete with schemes to achieve the benefits of bankruptcy without its stigma. *See, e.g.*, LoPucki, *supra* note 95, at 1539-41 (describing strategy attorney Lincoln Brooks invented to achieve the effect of a bankruptcy stay against dissenting unsecured creditors without filing a bankruptcy case); Richard E. Mendales, *We Can Work It Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 RUTGERS L. REV. 1211, 1301-04 (1994) (proposing a new, nonbankruptcy procedure called a "securities restructuring" that would substitute for prepackaged Chapter 11 cases).

126 *See* LoPucki & Whitford, *supra* note 57, at 143-49 (showing prejudice of reorganization lawyers against adjudicated solutions to be empirically unwarranted).

be. Rather than tout the cost savings of avoiding bankruptcy, we should reduce the costs of bankruptcy. But these are not ideas that are going to be adopted any time soon—and certainly not merely to limit the carve out to bankruptcy.

3. *The Judgment-Proof Transferee Strategy*

Assume that after enactment of the carve out, Secured Creditor forecloses on property of Debtor, which is sold to Buyer at a sheriff's sale for $1 million. The sheriff pays the sale proceeds to Secured Creditor. Unsecured creditors petition Debtor into bankruptcy less than ninety days after the sale, and Trustee sues Buyer, not Secured Creditor, to recover the $250,000 preference.

Should the preference law be drafted to permit the action?[127] The courts recently faced a closely analogous issue with regard to actions by trustees to set aside prebankruptcy foreclosure sales as fraudulent transfers. In resolving a long-standing split among the circuits, the Supreme Court in *BFP v. Resolution Trust Corp.*[128] held that trustees should not be able to avoid prefiling foreclosure sales.[129] In doing so, the Court explained,

> It is beyond question that an essential state interest is at issue here: We have said that "the general welfare of society is involved in the security of the titles to real estate" and the power to ensure that security "inheres in the very nature of [state] government." Nor is there any doubt that the interpretation urged by petitioner would have a profound effect upon that interest: The title of every piece of realty purchased at foreclosure would be under a federally created cloud. (Already, title insurers have reacted to the *Durrett* rule by including specially crafted exceptions from coverage in many policies issued for properties purchased at foreclosure sales[)].[130]

BFP was a policy-driven stretch of the Bankruptcy Code language; undoubtedly, the Court's fear was that permitting bankruptcy courts to upset later state foreclosure sales would, in the long run, depress foreclosure sale prices.

If the preference power associated with the bankruptcy-only carve out could be used to avoid the sale to Buyer, the federally created cloud again would be on every piece of property sold at a foreclosure

127 The Ninth Circuit has held that current law does not permit this action. *In re* Ehring, 900 F.2d 184, 189 (9th Cir. 1990) (refusing to set aside as a preference a foreclosure sale in which the secured creditor was the bargain purchaser).

128 511 U.S. 531 (1994).

129 *Id.* at 545 (holding that a reasonably equivalent price is one received at the foreclosure sale, so long as there has been no violation of state requirements).

130 *Id.* at 544 (citation omitted) (quoting American Land Co. v. Zeiss, 219 U.S. 47, 60 (1911)).

sale.[131] The only differences would be that it would be a preference cloud rather than a fraudulent transfer cloud and that, in many instances, the cloud would extend for ninety days rather than for a full year. However, in most cases, the shorter time period would be of little comfort to Buyer because sophisticated debtors or unsecured creditors who wished to avoid the sale would, as a matter of strategy, file the bankruptcy earlier so that the transfer could be recovered.

If, as seems more reasonable, preference law bars recovery from the purchaser at sale and permits recovery only from the creditors receiving the proceeds of sale, strategies available to secured creditors liquidating collateral in the shadow of bankruptcy would be capable of defeating recovery altogether. To illustrate, Debtor seeking financing equal to the $1 million liquidation value of a project might obtain a mortgage in the amount of $1 million from Secured Creditor. Secured Creditor might raise the $1 million by borrowing the bulk of it from a bank, secured by an interest in the mortgage. If Secured Creditor later forced a foreclosure sale of the project and recovered its $1 million, Secured Creditor would immediately distribute those proceeds to the bank and to its investors, leaving Secured Creditor an empty shell. If Debtor filed for bankruptcy while the liquidation was still within the preference period, Trustee's action to recover the preference would be futile. Trustee could not recover against Secured Creditor because Secured Creditor would have no assets. Trustee could recover against neither the bank nor the investors because they are subsequent transferees who have taken "for value, including satisfaction . . . [of an] antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided."[132]

Even if the courts held such transfers avoidable as preferences, that would not insure recovery. Today, large amounts of capital are raised in capital markets through securitization at competitive costs.[133] If the funds loaned in the preceding transaction were raised from thousands of investors in the securities markets, and repaid to them immediately upon liquidation of the collateral, preference re-

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131 That is, if the debtor whose property was sold went into bankruptcy within 90 days after the sale, a carve out preference action would lie against the buyer at the sale. If the debtor did not, the buyer would not be subject to the carve out.

132 11 U.S.C. § 550(b)(1) (1994). Neither the bank nor the investors could have had knowledge of the voidability of the transfer, because the transfer was not voidable at the time they received their interest. *See, e.g.*, Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890 (7th Cir. 1988) (holding that where debtor paid third party who directed bank as subsequent transferee to apply the funds to satisfaction of third party's debt to bank, trustee could not recover from bank).

133 *See, e.g.*, Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 146-51 (1994) (arguing that securitization reduces net financing costs).

covery would be impractical. The cost of recovering small amounts from thousands of investors would exceed the amounts recovered.[134]

This illustration suggests that adoption of a preference rule that prohibits recovery from Buyer at a foreclosure sale might result in lenders routinely employing such techniques. The effect would be to make the carve out ineffective against transactions by sophisticated parties. Ultimately, the problem is that preference actions are actions to recover on unsecured debts; such recovery is highly problematic.

Summary and Conclusions

In their 1987 debate, Warren and Baird demonstrated the crucial link between legal rules that operate only in bankruptcy and the bankruptcy triggering process. Ideally, the system would have two sets of collection rules: one for the single troublesome debt, the other for debtors in widespread default and collapse. But that requires some means of separating the two kinds of cases. It is far from clear that the means thus far proposed would be effective. In any event, neither bankruptcy scholars nor the larger bankruptcy community seem disposed to make the radical changes that would be necessary to force collapsing debtors into bankruptcy.

As matters now stand, most debtors liquidate portions of their estates before bankruptcy and irrevocably fix the distributions of the remainder by granting security interests. The bankruptcy system lacks an effective mechanism for triggering its operation in time to avoid the debtor's transactions as preferences. The result is a system malfunction in two respects. First, there are insufficient unencumbered assets with which to administer the bankruptcy estate or reorganize the debtor in an appropriate case. Second, the bankruptcy policy in favor of pro rata distribution is given little effect.

Adoption of a bankruptcy-only carve out is likely to make the situation worse. Particularly in liquidation cases, the carve out will increase the incentives for the debtor-secured creditor alliance to accomplish the liquidation outside bankruptcy more than it will increase the incentives of unsecured creditors to accomplish liquidation in bankruptcy. Because the debtor-secured creditor alliance generally will succeed in liquidating the collateral under nonbankruptcy law,

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134 *See* David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 Colum. L. Rev. 1565, 1612 (1991) ("[T]he transaction costs of collecting from small shareholders would significantly blunt its effect."); LoPucki, *supra* note 89, at 56-57 (arguing the impracticality of bringing such actions); Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 Vand. L. Rev. 1, 20 (1994) ([T]he costs would consume the benefit of collecting from many small shareholdings so that enforcement is [un]likely . . . to be feasible . . . . "). *But see* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale L.J. 1879, 1900-01 (1991) (argning that substantial collection could be effected).

the carve out will have little effect on bankruptcy distributions. For that reason, it will have little effect on lending or prebankruptcy settlement practices.

Perhaps the principal effect of a bankruptcy-only carve out will be to generate system-unintended strategic activity. While the bottom line will be much the same, the debtor-secured creditor alliance will incur substantial transaction costs in getting there. Familiar simplicity will give way to unfamiliar complexity.