

Financial Distress as a Noncooperative Game: A Proposal for Overcoming Obstacles to Private Workouts

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I. INTRODUCTION

In the past several years, academics have increasingly expressed dissatisfaction with Chapter 11.¹ Among other complaints, critics point out that reorganizations of major public companies are expensive and usually take a number of years to complete.² In addition, from the scant empirical information available, failure rates appear high. One study shows that 38.3% of reorganized companies liquidate within four years.³ Accordingly, academic writers have cast about for alternatives to court-supervised reorganizations. Suggestions include proposals for an all-equity capital structure,⁴ market-based solutions like mandatory auctions,⁵ and measures designed to encourage private workout agreements which avoid the need for judicial supervision altogether.⁶

1. 11 U.S.C. §§ 1101-1174 (1988). See, e.g., Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992).

2. There is disagreement about the average length of reorganizations for large, public companies. One study shows they take 2½ years on average to complete. Lynn M. Lopucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11, 31-32 n.68 (calculated from information provided). Another indicates an average of almost four years. Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 748 (1989).

3. See Bradley & Rosenzweig, *supra* note 1, at 1075 (Table 11) (showing 61.7% of firms still in operation after four years).

4. See Barry E. Adler, *A Political Theory of American Corporate Bankruptcy*, TEX. L. REV. (forthcoming 1993) (manuscript at 18, on file with author) (proposing a firm structured entirely through issuance of a form of preferred stock called "chameleon equity"); Bradley & Rosenzweig, *supra* note 1, at 1053-54 (proposing an equity-based "perfect markets solution").

5. See Douglas G. Baird, *Revisiting Auctions in Chapter 11* (Chicago Law & Economics Working Paper No. 7 (2nd Series), 1992); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991).

6. Howard J. Kashner, *Majority Clauses and Non-Bankruptcy Corporate Reorganizations—Contractual and Statutory Alternatives*, 44 BUS. LAW. 123 (1988) (proposing modification of Trust Indenture Act to permit majority rule clauses in debt contracts); Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987) (same); Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, J.L. & ECON. (forthcoming 1993) (arguing that lifting ban on waiver of bankruptcy would facilitate private workouts).

From a theoretical perspective, private solutions are preferable to public ones. First, because of the great expense of formal judicial proceedings, private negotiations should produce substantial savings over litigation.⁷ Second, consensual resolution of disputes is more likely to maximize preferences than a solution forced on parties in the course of litigation.⁸ Third, public procedures, such as litigation and auctions, exploit public funds for the sake of private dispute resolution. Any benefits to the general public from these expenditures would be indirect, and presumably direct and more substantial benefits would result from alternative expenditures. For these reasons, scholars should look for ways of removing the obstacles to *private* settlements before searching for alternative *public* procedures.

This Note presents a contractual scheme to increase the likelihood of settling conflicts incident to financial distress out of court: the incorporation into debt contracts of a clause suspending creditors' state-law collection rights for a fixed period of time. Part II diagnoses the impediments to private workout agreements under current contractual provisions. It argues that the low settlement rate is caused by a collective action problem which prohibits negotiation in a multi-creditor situation. It then considers the effect of uncertainty on the above analysis. In particular, this Part rebuts the possible objection that the uncertainty of Chapter 11 litigation provides a better explanation for the low settlement rates. Part III shows why the parties must implement any consensual solution to the collective action problem in the original debt contracts. In theory, a direct, intercreditor contract drafted *ex ante*—prior to the onset of financial distress—could avoid collective action problems. Part III, however, explains why transaction costs bar such an agreement, and thus why creditors must make use of their common relation with the debtor to control the behavior of other creditors. Part IV presents the proposed suspension clause solution. It considers, among other things, the problem of preferential treatment of certain creditors prior to the public declaration of financial distress. This Note argues that appending a unanimous consent condition to the suspension clause would effectively solve the preference problem. Part V explains that the inclusion of unanimous consent clauses in debt contracts would eliminate another potential impediment to private workouts, the “holdout” problem.⁹ It also argues that scholars often

7. Bankruptcy proceedings are expensive and auctions may be as well. There is evidence suggesting not only that auctions are more expensive than private workouts, but that they are even more expensive than reorganizations. See Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 415 (1990); see also Adler, *supra* note 1, at 469-71.

8. This conclusion assumes that bargaining is fair, in other words, that there is no overreaching or coercion. See Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 210-11 (1989) (arguing for repeal of legal constraints on contracting to establish alternate priority schemes based on commitment to permit contracting parties to maximize preferences).

9. Strictly speaking the holdout problem is another species of collective action problem. It is referred to here as the holdout problem in order to distinguish it from the collective action problem considered in Part II.

exaggerate the importance of the holdout problem as an adequate explanation for the low success rates of private workouts. This emphasis on holdouts leads them to overlook the correct explanation, the collective action problem.

II. THE COLLECTIVE ACTION PROBLEM

Until relatively recently, the prevailing academic wisdom on corporate reorganization justified Chapter 11 on efficiency grounds: Chapter 11 prevents the dismantling under state collection laws of firms whose going-concern value exceeds their liquidation value.¹⁰ Without Chapter 11, creditors would pursue immediate satisfaction of their claims against a financially distressed debtor. This would forfeit the excess of the going-concern value over the liquidation value, and the creditors as a group would receive less than they would were they willing to wait.¹¹ Federal intervention is justified, the argument runs, because it solves a collective action problem.¹²

Thomas Jackson and Douglas Baird, the original proponents of this view of federal reorganization, present what they call the "creditors' bargain model" of federal bankruptcy law.¹³ Chapter 11, they claim, implements the agreement the creditors of a common debtor *would* reach if collective action problems did not preclude negotiations. *Mandating* collective proceedings, Jackson and Baird argue, thus helps to maximize the preferences of creditors, since the payoff structure otherwise precludes creditors from realizing the outcome they would regard as most advantageous.

The scant available empirical evidence supports Jackson and Baird's diagnosis of the problem. Settlement rates in bankruptcy are disproportionately

10. THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 17 (1986). For an example of a recent, opposing view, see Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987). See also Theodore Eisenberg, *Commentary on "On the Nature of Bankruptcy": Bankruptcy and Bargaining*, 75 VA. L. REV. 205 (1989).

11. "Common pool problems," as this type of collective action problem is called, can arise in any situation in which multiple claims are asserted against an undivided pool of assets. Extensive discussions on the subject appear in the literature on natural resources such as natural gas, oil, minerals, and ocean resources. See, e.g., Alan E. Friedman, *The Economics of the Common Pool: Property Rights in Exhaustible Resources*, 18 UCLA L. REV. 855 (1971); Gary D. Libecap & Steven N. Wiggins, *Contractual Responses to the Common Pool: Prorating of Crude Oil Production*, 74 AM. ECON. REV. 87 (1984); Richard J. Sweeney et al., *Market Failure, The Common-Pool Problem, and Ocean Resource Exploitation*, 17 J. LAW & ECON. 179 (1974).

12. JACKSON, *supra* note 10, at 10.

13. See, e.g., DOUGLAS G. BAIRD & THOMAS H. JACKSON, *CASES, PROBLEMS AND MATERIALS ON BANKRUPTCY* (2d ed. 1990); JACKSON, *supra* note 10; Baird, *supra* note 1, at 127-28; Douglas G. Baird & Thomas 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); Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311 (1991); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982) [hereinafter Jackson, *Creditors' Bargain*]; 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 (1989).

low as compared with other areas of the law.¹⁴ Studies indicate that workout offers from insolvent firms succeed in fewer than half the cases,¹⁵ whereas settlement rates in other kinds of private suits exceed 90%.¹⁶ Private suits in other domains, however, do not appear to differ in relevant ways from litigation in Chapter 11. Reorganizations of large, public companies may be exceedingly complex, but settlement rates in contexts other than financial distress are high even for complex disputes involving major corporate players.¹⁷ Moreover, once the relevant parties actually enter negotiations, the prospects of reaching agreement are high. Bankruptcy litigation under Chapter 11 almost always results in the confirmation of a plan of reorganization.¹⁸ In addition, the vast bulk of successful reorganizations occurs consensually. "Cramdowns"¹⁹ are quite rare.²⁰

Taken in combination, the above data suggest that there are no significant impediments to agreement. Therefore, settlement rates in the financial distress

14. This Note defines a "settlement" as any case whose *final* resolution took place out of court. This would include cases in which the parties entered litigation initially but were able to reach agreement privately at a later stage.

15. See Robert Gertner & David Sharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1191 (1991) (showing initial settlement rates of 73 out of 156 for junk bond issues between 1977 and 1990); Stuart C. Gilson, *Bankruptcy, Boards, Banks and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355, 356 (1990) (showing private debt restructuring of 50 out of 111 publicly traded companies that experienced financial distress between 1979 and 1985); Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 326 (1990) (showing private restructurings for 80 public companies out of sample of 169 that experienced financial distress between 1978 and 1987).

16. Michael D. Green, Symposium, *The Inability of Offensive Collateral Estoppel to Fulfill its Promise: An Examination of Estoppel in Asbestos Litigation*, 70 IOWA L. REV. 141, 180 (1984); see ANNUAL REPORT OF THE DIRECTOR, ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, 1989 REPORT OF THE PROCEEDINGS OF THE JUDICIAL CONFERENCE OF THE UNITED STATES 21 (over a twelve-month period in 1988-89, only 5% of civil cases in federal court went to trial). *But see* Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 525 (1991) (estimating the rate of civil suit settlement as between 60% and 70%).

17. See Alexander, *supra* note 16, at 525 (settlement rates for securities class actions higher than for civil litigation generally, roughly 95%); Green, *supra* note 16, at 180 (settlement rate of approximately 95% for major asbestos cases); Richard L. Schmalbeck & Gary Myers, *A Policy Analysis of Fee-Shifting Rules Under the Internal Revenue Code*, 1986 DUKE L.J. 970, 979 (settlement rates in appellate level tax disputes same for large cases as for small). Even the massive legal dispute between Texaco and Pennzoil over the acquisition of Getty Oil ended in settlement (albeit after extensive litigation in a number of different courts). See Robert H. Mnookin & Robert B. Wilson, *Rational Bargaining and Market Efficiency: Understanding Pennzoil v. Texaco*, 75 VA. L. REV. 295, 296 (1989).

18. See Lopucki & Whitford, *supra* note 2, 18, at 41 n.105 (finding confirmation rates of 89% to 96% for largest Chapter 11's filed between 1979 and 1988); see also Gilson et al., *supra* note 15, at 316, 321 (showing a conversion rate from Chapter 11 to Chapter 7 of 5% for sample of publicly traded companies that filed for bankruptcy between 1978 and 1987).

19. The debtor's power, under 11 U.S.C. § 1129(b) (1988), to impose a plan over the objection of creditors if he can show the plan conforms to the absolute priority rule is known as the "cramdown" power.

20. See Gilson et al., *supra* note 15, at 318; Lynn M. Lopucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625, 627, 629 (1991) (study of reorganizations of 43 large, publicly held companies showed plan proponents sought cramdown in only three cases). As we shall see, however, the holdout problem may impair the prospects for reaching agreement even when the relevant parties are able to negotiate in the private context. Because Chapter 11 gives debtor and majority creditors the power to bind dissenters, the holdout problem does not stand in the way of agreement in Chapter 11 in the same way that it does outside it.

context could equal those in other types of disputes. A plausible explanation for the low settlement rates is that a collective action problem impedes otherwise feasible agreements. Proponents of the creditors' bargain model thus correctly assert that Chapter 11 allows the parties to achieve a solution comparable to one they would reach through negotiations were it possible to eliminate collective action problems.

The collective action problem is a species of n -person prisoner's dilemma ("P-D"). The problem is that each creditor's pursuit of a rational strategy maximizing her welfare in the short run produces an outcome which is suboptimal for all. Another possible outcome, the cooperative solution, improves the collective welfare, even from an individual maximizing perspective. By following individual maximizing strategies, however, the parties foreclose this solution.

To take a simple, two-party example, suppose a debtor has only two creditors, both unsecured. Each creditor has a claim against the debtor for \$100. Suppose also that the debtor has only one asset, a machine worth exactly \$100 if sold. The liquidation value of the debtor's business is thus \$100. But adding the debtor's expertise makes the business worth \$150 as a going concern. Each creditor faces a choice: either seek immediate satisfaction of her claim, or wait and hope to capture the going-concern value. Suppose Creditor₁ decides to demand immediate repayment. If Creditor₂ decides to wait, Creditor₁ will recover her claim in full. But Creditor₂ may also decide to seek immediate recovery. Since, *ex ante*, each creditor has a 50% chance of getting to the debtor first, the value of the claim diminishes in accordance with the probability of its satisfaction in full. The claims *ex ante* are thus worth \$50 to each creditor if both pursue collection immediately.²¹ Alternatively, Creditor₁ could decide to wait. If, however, Creditor₂ decides to seek payment, Creditor₁ will lose completely. If both decide to wait, each will eventually recover \$75.²² Each party's dominant strategy is to seek payment, but exercising these strategies simultaneously is inefficient. Unfortunately, however, only this solution is a Nash²³ equilibrium.

21. *Ex post*, of course, this is no longer the case. Either Creditor₁ or Creditor₂ will get to the debtor first, and one will receive \$100 while the other receives nothing. But from the *ex ante* perspective, the claim can be thought of as worth \$50 in the case in which both pursue simultaneously.

22. The chart below indicates the payoffs. (The left-hand number is Creditor₁'s payoff, the right-hand Creditor₂'s.)

		CREDITOR ₂	
		<i>Seek Payment</i>	<i>Wait</i>
CREDITOR ₁	<i>Seek Payment</i>	\$50, \$50	\$100, \$0
	<i>Wait</i>	\$0, \$100	\$75, \$75

23. Nash equilibrium is a game theoretic concept used to describe a strategy combination in which no player has incentive to deviate from his strategy given that the other players do not deviate. *See* ERIC

This case, however, differs from the usual P-D situation in one important respect. In the usual P-D, the parties cannot make binding agreements. Therefore, even if they agree in advance to cooperate, they cannot trust one another not to defect. In the present situation, the problem is *not* that an agreement would not be binding. On the contrary, an intercreditor agreement would be enforceable as is any other legally binding contract.²⁴ The problem lies instead in the fact that the parties cannot negotiate with one another at any point before or during the game.

The imposition of the automatic stay²⁵ in reorganization proceedings facilitates cooperation by eliminating the payoffs from noncooperative behavior. Proponents of the creditors' bargain model are right thus far. But this result does not constitute an adequate justification for Chapter 11.²⁶ For the following reasons, Chapter 11 is a suboptimal solution to the collective action problem. First, the return to the parties if they litigate is lower than it would be if they could cooperate without court supervision. Private settlement creates a cost savings which the parties could divide pro rata. Second, to the extent that Chapter 11 is the only way to prevent a run on assets, debtors are forced to take refuge in Chapter 11 even when they have no other reason for using a court-supervised procedure. The collective action problem and the lack of available alternatives to a Chapter 11 filing thus encourage use of federal bankruptcy law that would otherwise be unnecessary. A solution to the collective action problem that severed collective action from distributional questions would enable debtors to choose to enter Chapter 11 only when they required the full range of court powers to facilitate acceptance of a plan.

RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 33 (1989).

24. The financial distress game may occupy an intermediate status between fully cooperative and fully noncooperative games. See JOHN C. HARSANYI, RATIONAL BEHAVIOR AND BARGAINING EQUILIBRIUM IN GAMES AND SOCIAL SITUATIONS 110-11 (1977) (discussing one such intermediate category called the *almost-noncooperative* game).

25. 11 U.S.C. § 362 (1988 & Supp. II 1990).

26. Analogous arguments for mandatory schemes have greater force in an extralegal context. Some commentators, for example, interpret Hobbes' justification for the existence of government as a solution to a P-D problem. See JEAN HAMPTON, HOBBS AND THE SOCIAL CONTRACT TRADITION (1986). She argues that the inhabitants of the state of nature—described by Hobbes as a state of "Warre, where every man is Enemy to every man," and in which "men live without other security, than what their own strength, and their own invention shall furnish them withall," THOMAS HOBBS, LEVIATHAN 186 (C.B. Macpherson ed., 1968) (1651)—are in a noncooperative game that has the structure of a P-D. Although all would benefit from cooperation, they cannot cooperate because no agreement can be binding. As Hobbes says, "the question is not of promises mutuall, where there is no security of performance on either side; as when there is no Civill Power erected over the parties promising; for such promises are no Covenants . . ." *Id.* at 204 (emphasis added). The coercive power of a strong, central authority is justified as the only way to exit from the P-D.

This game theoretic justification for civil government depends on the assumption that the parties cannot make binding agreements. In the bankruptcy context, by contrast, because there is a legal system in effect, the parties *could* make binding contracts if only they could negotiate. See *supra* text accompanying note 24. If the creditors are in a semicooperative game, the justification for mandatory solutions may not apply.

Another possible explanation for the low settlement rates, however, might be advanced. Parties will go to court only if the outcome of litigation is uncertain: it must either be the case that their expectations about the results of trial conflict, or that one or both parties lack clear expectations about the result.²⁷ One might, then, explain the low settlement rates by saying that Chapter 11 litigation is substantially more uncertain than other types of litigation. Higher levels of certainty in other areas of the law produce higher settlement rates. Settlement rates in the financial distress context may be low simply because the parties bargain in the shadow of bankruptcy law. Without firm expectations about their bankruptcy shares, the parties have may have insufficient information to negotiate.

A detailed consideration of the effects of uncertainty is beyond the scope of this Note. It will suffice to show that the above argument suffers from two flaws. First, it is not clear that the outcome of Chapter 11 litigation is more uncertain than outcomes in other types of litigation. Indeed, creditors may have greater certainty about the outcome of litigation in bankruptcy than litigants do in other contexts, since the parties know that the court will apply the absolute priority rule in bankruptcy, and will require the debtor to disclose all relevant financial information. A rebuttal would point out that reorganization plans systematically violate absolute priority. Equity regularly receives on the order of 5%²⁸ in Chapter 11. But because the return to equity is reliable and systematic, violations of absolute priority may not, in the long run, increase the parties' level of uncertainty.

Second, while it is true that certainty leads to settlement, the converse does not follow. Uncertainty may or may not lead to litigation. Even under uncertainty, the parties may prefer to settle in order to capture the savings from the avoided litigation costs. This is especially so if the parties' expectations, although uncertain, happen to coincide. Some authors have indeed argued that uncertainty fuels settlement.²⁹ Although the effects of uncertainty on settlement rates remains an open question, uncertainty appears to be a necessary but not a sufficient condition for litigation.

27. See, e.g., George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 17 (1984) ("In litigation, as in gambling, agreement over the outcome leads parties to drop out."); Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55, 63 (1982) ("[T]he only factor that could lead to a trial is that the plaintiff's expectations as to the likelihood of success or the judgment that could be obtained are more optimistic than the defendant's").

28. Studies show that reorganization plans routinely violate absolute priority. 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, 142 (1990) (Table III); see also Schwartz, *supra* note 6, at 10-11. This can probably be explained by the fact that it is difficult for management to remain in possession without the acquiescence of the shareholders.

29. See Peter H. Schuck, *The Role of Judges in Settling Complex Cases: The Agent Orange Example*, 53 U. CHI. L. REV. 337, 346 n.30 (noting "a strong positive relationship between uncertainty of outcome and settlement"); see also Eisenberg, *supra* note 10, at 210.

Finally, while uncertainty impairs the parties' ability to *reach* agreement, it need not have this same effect on their ability to *negotiate*. If uncertainty caused low settlement rates, one would expect to see many private workouts attempted and high rates of failed negotiations. The limited evidence there is, however, indicates the contrary. Corporations in serious distress tend to enter Chapter 11 immediately upon reaching the critical level of insolvency. In most cases, they do not even attempt a private workout before they resort to litigation.³⁰ If uncertainty affects the prospects of settlement, it is more likely when the parties can negotiate and yet cannot agree. Although there is virtually no empirical evidence on the question, such cases probably comprise only a small fraction of those that end up in Chapter 11.³¹

Before turning to the proposed suspension clause solution, this Note will consider whether the debtor's assets could be distributed prior to the onset of financial distress by a direct, intercreditor agreement.

III. EX ANTE INTERCREDITOR AGREEMENTS

The parties could cooperate if they could agree in advance to play their nondominant strategies. Part II argued that a collective action problem precludes the creditors from committing themselves to this result consensually, because it impedes the parties from negotiating with one another. This impediment to negotiation, however, emerges only after the onset of financial distress. If creditors could sit down at the bargaining table *before* they learned of their common debtor's financial distress—in other words, before they knew their relative priorities—they could presumably settle on a course of action for resolving common financial problems.³² Because an ex ante agreement of this sort would result from bargaining behind a "veil of ignorance,"³³ the creditors

30. See Lynn M. Lopucki, *The Debtor in Full Control: Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM BANKR. L.J. 99, 116 (1983) (characterizing as exaggerated view that negotiations are commonly attempted and presenting study of 48 bankrupt companies showing that none had attempted workouts). See also J. Bradley Johnston, *The Bankruptcy Bargain: National Conference of Bankruptcy Judges*, 65 AM. BANKR. L.J. 213, 232 n.97 (1991) (Pointing out that workouts are generally not attempted by firms that later file for bankruptcy, despite commonly held view that workouts are common).

31. The Lopucki study appears to be the only evidence that bears on the question, see *supra* note 30, at 116, and the sample of firms examined in that study is not sufficiently large to allow reliable inferences about the overall number of attempted workouts to be drawn. The hypothesis that few firms that enter Chapter 11 have actually attempted workouts is not, however, an unreasonable working hypothesis.

32. Thomas Jackson and Robert Scott present a justification of bankruptcy along these lines. They modify the original creditors' bargain model by arguing that an ex ante bargain among creditors would be motivated by a desire to provide for risk-sharing in the event of a common disaster. Jackson & Scott, *supra* note 13; but see Mark J. Roe, *Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics*, 75 VA. L. REV. 219, 221 (1989) (arguing that creditors may not want to share risks ex ante because "the costs of ascertaining the full range and probability of potential outcomes is too high.")

33. JOHN RAWLS, A THEORY OF JUSTICE (1971). For an attempt to apply Rawlsian analysis to the bankruptcy situation, see Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541 (1993).

would not know enough about their respective positions relative to the debtor to adopt individual maximizing strategies. Collective action problems would not arise. Moreover, if the parties are generally risk-averse, their rational strategy would be to maximize the common welfare. They would agree to share losses fairly—equally if they have no information about their future relations to the debtor, or pro rata if they have some knowledge about the size of their respective loans and anticipated priorities.³⁴

All potential creditors would have to contract to cover all contingencies created by their varying interests if risks are to be distributed in advance through an *ex ante* agreement. At this stage, however, it is impossible to know which individuals must be party to such an agreement. In firms of any substantial size, the identity of creditors and the amount of debt is likely to fluctuate constantly, and, especially where trade credit is concerned, the identity of creditors may not always be known. Debt contracts may be oral, and the debtor may not have a precise record of the status of its debt at any given moment in time. Thus, neither the identity of the creditors, nor the amount of insolvency, can be determined prior to the onset of financial distress.

While a collective action problem bars agreement *ex post*, transaction costs of a certain kind bar agreements *ex ante*.³⁵ Not surprisingly, proponents of the creditors' bargain model use the existence of transaction costs, along with the collective action problem, to justify Chapter 11. They argue that court-supervised reorganization implements the agreement the parties to a Chapter 11 proceeding would have reached if transaction costs did not preclude private agreement.³⁶

34. See Alan Schwartz, *Contracting for Priority Positions* (unpublished manuscript, at 4) (on file with author) (arguing that borrowers can expect to contract for at least two classes of debt). At the early *ex ante* stage under consideration, however, creditors will not necessarily know to which class they will belong, even if they can anticipate that there will be more than one class of debt. The identity of the lender will nevertheless provide an indication.

35. It may seem misleading to suggest that the task of identifying the relevant parties *ex ante* is prohibited merely by the *expense* of searching for them. The concept of transaction costs, however, is sometimes given a broad interpretation; it applies to virtually any feature of a situation that makes it more difficult to conduct consensual transactions. See Guido Calabresi & Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1094-95 (1972).

36. Thomas Jackson appears to be concerned with transaction costs, although he does not use the term explicitly:

Although we would expect to see a mandatory collective proceeding as a standard feature of the creditors' bargain, no *ex ante* meeting of the creditors will, realistically, take place. A debtor's pool of creditors changes over time and even the debtor is unlikely to know who the creditors of the business will be at any point in the future. As a result, the creditors themselves cannot be expected to negotiate this agreement, even though it would be in their joint interest to do so. A federal bankruptcy rule solves this problem by making available a mandatory collective system after insolvency has occurred.

Jackson, *Creditors' Bargain*, *supra* note 13, at 866-67 (citations omitted). Jackson concludes that because creditors cannot contract *ex ante* on their own, a *mandatory* sharing rule, such as that provided by Chapter 11, is justified, since it effectuates the solution the parties would have reached had agreement been possible. As discussed above, however, the inefficacy of consensual solutions cannot provide a justification for a mandatory scheme unless it can be shown that no alternative means of overcoming the impediments to

An analogous argument justifies protecting interests in person and property with a liability rule in the context of automobile accidents.³⁷ A liability rule permits individuals to impose risks as long as they “buy” the privilege *ex post*. The argument holds this is desirable, because parties to an accident are barred by high transaction costs from distributing the losses from an accident by contract in advance.³⁸ No wealth has been transferred before the accident. *Ex ante*, the potential victim still has something to “sell” to the potential injurer, namely his willingness to be exposed to danger at some time in the future. Thus the parties can bargain *ex ante*. *Ex post*, however, no bargain can take place, since the loss has fallen entirely on the victim, and the injurer has no incentive to agree to share that loss. Thus, bargaining must take place *ex ante*, but because transaction costs prohibit *ex ante* bargaining, a mandatory distributional rule is indispensable.

Although in the accident case transaction costs preclude negotiation at the only conceivable bargaining point, namely *ex ante*, financial distress is different. The debtor’s declaration of financial distress identifies the relevant parties. Unlike in the accident situation, the creditors still have an incentive to bargain *ex post*. There are two reasons for this. First, immediately after the announcement of financial distress, the gains and losses have not yet been distributed. The event that separates *ex ante* from *ex post* is not a wealth-transferring event, as it is in the accident case. Second, the parties have an incentive to bargain over the division of the bankruptcy cost savings. Thus, even if financial distress inexorably implied a certain fixed pattern of distribution *in bankruptcy*, parties attempting to settle out of court would have something over which to bargain. Theoretically, bargaining in the financial distress situation can take place at a time when the identities of those affected are already fixed, that is, at a time when transaction costs would not prohibit negotiation. Although the parties have incentive to bargain, however, they are precluded at this point from bargaining by collective action problems. If the collective action problems could be solved by suspending alternative methods of debt collection, the parties could bargain with one another *ex post*.

agreement exist. See *supra* note 26 and accompanying text.

37. See GUIDO CALABRESI, *THE COST OF ACCIDENTS* 90-92 (1970); Calabresi & Melamed, *supra* note 34, at 1108-09. The theory is that, in the absence of transaction costs, drivers would enter into *ex ante* agreements with one another in order to allocate the risk of accidents in advance. Some drivers who valued driving dangerously would purchase the right to do so from those they endangered. In order to ensure that the costs of every possible accident were allocated in advance, every driver would have to contract with every other driver (not to mention pedestrians) with whom he might come into contact. Moreover, *ex ante* contracts would have to specify every possible type of injury at the various possible levels of severity, in addition to the types of property damage, etc. Transaction costs clearly would be prohibitive, since both the number of dangerous drivers and the variety of risks to which they expose others is enormous. Alternatively, the parties could sign a single, vast contract, but in this case the agreement would have to specify every possible type of interaction, establish a price for each one, and make provisions prescribing the mode of wealth-transfer with respect to all such interactions.

38. Calabresi & Melamed, *supra* note 34, at 1108-09.

IV. TEMPORARY SUSPENSION CLAUSES

The collective action problem disappears if creditors' state-law collection rights are unavailable when the debtor announces that he is in financial distress. The parties should therefore incorporate a temporary waiver of creditors' collection rights under state law into the original debt instrument. The contract should specify a fixed suspension period of relatively short duration, perhaps one month. The theory behind the suspension clause solution is that it enables the parties to negotiate as well as provides maximal incentive for cooperation by retaining the threat advantage the creditors and the debtor have over one another. It accomplishes this by returning these rights at the end of the suspension period: the creditors are restored their right to collect under state law and the debtor is restored his right to file for bankruptcy. Coordination is facilitated because all parties know that the other parties can resort to their legal rights if the negotiations do not succeed. Creditors know that they will have to compete with other creditors for the debtor's assets on a first-come-first-served basis if they cannot reach agreement. The creditors as a group know that the debtor may file for bankruptcy if he is not permitted to retain a certain amount of the value of the firm for equity. And although the creditors' right to pursue collection under state law does not amount to much if debtor retains his power to enter Chapter 11, debtor may wish to avoid bankruptcy himself, and since the only answer he has to a rush on his assets is to file for Chapter 11, he has reason to fear the creditors' invocation of their state-law rights. The suspension clause solution is thus a way of exploiting the incentives created by existing legal regimes to help maximize the parties' chances of avoiding using these regimes.

Insolvency, as defined in the debt contract, triggers the suspension provision. At the relevant level of insolvency, the terms of a contract containing a suspension clause would require the debtor to notify its creditors of its financial position and to provide a reasonable account of its assets and liabilities. The debtor should propose a workout plan shortly after notification. The debtor could facilitate coordination by calling a general meeting of the creditors to explain the offer. Because creditors might require more time to evaluate the debtor's offer, the parties might wish to include a provision in the suspension clause allowing the creditors to vote to extend the negotiation period, either unanimously or upon a certain number of votes.

Although the suspension clause restrains both the debtor and the creditors from legal action during the suspension period, the parties do not in fact commit themselves to negotiate by including the clause in the debt instrument. They merely create a window of time during which they can safely explore extra-legal avenues. Conceivably, neither party will initiate negotiations. The parties' incentives to settle depends on their assessment of the likelihood of bankruptcy and of their probable returns in Chapter 11. For example, if a

creditor does not think the debtor likely to enter Chapter 11 at the end of the suspension period, she might prefer to wait out the month and try to collect under state law. If, however, she fully expects the debtor to enter bankruptcy at the end of the waiting period, she has incentive to settle. Thus a debtor can increase the likelihood of successful negotiations if he can credibly threaten to enter bankruptcy at the end of the suspension period.

A debtor, too, will weigh the likelihood of Chapter 11 in considering whether to attempt settlement. A debtor might be particularly interested in settling if he thinks he stands a reasonable chance of recovery. In that case, he might worry he would have to pay off the creditors' claims in full if he fails to settle. The debtor's optimal bargaining position is one in which he knows he has a reasonable chance of success but is able to convince creditors to the contrary. In order to avoid coercion of this sort, the parties should include significant disclosure requirements in their debt contracts to operate in conjunction with the suspension clause.

One objection to this scheme might be that the parties will not want to include the suspension clause in their debt contracts, even if they would want to settle once the suspension of state-law rights had removed the impediments to consensual solutions. But the suspension clause should be attractive to anyone who had strong reasons to avoid litigation. The debtor and the various classes of creditors all share such reasons.

Secured creditors will appreciate the advantages of a high-pressured negotiation, since they suffer most from the length of bankruptcy proceedings under the present system. Despite the requirement under the Bankruptcy Code that secured creditors receive "adequate protection,"³⁹ the Supreme Court has held that secured creditors are not entitled to compensation for the time value of their claims while bankruptcy proceedings are under way.⁴⁰ Banks and other lenders who lend on a secured basis are in effect required to make interest-free loans to debtors who enter Chapter 11. Normally, the return to secured creditors is not in doubt, since secured creditors can usually receive full value. Consequently, secured creditors are above all concerned with the speed of the proceedings. Although they will not receive a larger nominal sum in the workout than they would receive in bankruptcy, their interest in early payment will make them more than willing to facilitate negotiations. Moreover, because loss of interest over a several-year period can be significant, secured creditors might even be willing, at the negotiation stage, to give up some value in order to facilitate a workout. The excess could be used to coax recalcitrant general creditors into accepting the debtor's offer.

39. 11 U.S.C. § 362(d)(1) (1988). Acceptable methods for providing "adequate protection" are defined in 11 U.S.C. § 361 (1988), but neither that section nor § 362(d)(1) explain what constitutes "adequate protection" in the context of secured creditors.

40. *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365 (1988).

Although the time savings also provides unsecured creditors with an incentive to incorporate the suspension clause into their debt contracts, the cost savings advantages unsecured creditors most. The unsecured creditors usually benefit directly from an increase in the pool of assets. In addition, since no single unsecured creditor can force the debtor into an involuntary reorganization, an unsecured creditor may worry that the debtor will not enter Chapter 11 and will be dismantled under state "grab" laws instead. Unsecured creditors will welcome the opportunity to reduce the likelihood of both these unfavorable outcomes.

Finally, the debtor also has adequate incentive to avoid having to choose between a possible dismantling under state law or a long, drawn-out reorganization. Despite the rise in the number of reorganizations in the last thirty years,⁴¹ significant stigma still accompanies bankruptcy. This stigma often translates into loss of goodwill and other impediments to financial rehabilitation. Michael Bradley and Michael Rosenzweig have recently cast doubt on the traditional wisdom that managers will attempt to avoid bankruptcy at all costs, claiming that Chapter 11 "serves mainly to protect managers' jobs."⁴² They claim that managers who have mismanaged a company and fear replacement will throw the company into bankruptcy in order to remain in control.⁴³ But this claim is not supported by the evidence.⁴⁴ Stuart Gilson, in a study of 409 of the most troubled public companies in Chapter 11 between 1979 and 1984, showed that managers lost their jobs within two years after filing in 71% of the cases.⁴⁵ When taken in conjunction with studies showing extremely low turnover rates for nonbankrupt companies, as well as lower rates for distressed, but nonbankrupt companies, the Gilson study demonstrates that bankruptcy proceedings impair managerial security.⁴⁶

A second objection might be that an attempt to conduct a private reorganization would encounter a preference problem. While the trustee in

41. The total number of corporate bankruptcy filings rose from 12,284 in 1960 to 62,534 in 1989. ANNUAL REPORT OF THE DIRECTOR, ADMINISTRATIVE OFFICE OF THE U.S. COURTS 163 (1960) and ANNUAL REPORT OF THE DIRECTOR, ADMINISTRATIVE OFFICE OF THE U.S. COURTS 362 (1989).

42. Michael Bradley & Michael Rosenzweig, *Time to Scuttle Chapter 11*, N.Y. TIMES, Mar. 8, 1992, at F13.

43. See Bradley & Rosenzweig, *supra* note 1, at 1050-51. They also claim that managers will be more inclined to make risky investment decisions because they know that Chapter 11 is available in the event of failure. *Id.*

44. See Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437, 448-55 (1992).

45. Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241, 247 (1989). Gilson also shows that managers of financially distressed companies who avoided Chapter 11 and restructured privately instead lost their jobs at a rate of 60% within two years of restructuring. *Id.*

46. See Sheila M. Puffer & Joseph B. Weintrop, *Corporate Performance and CEO Turnover: The Role of Performance Expectations*, 36 ADMIN. SCI. Q. 1, 6-7 (1991) (reporting mean annualized turnover rate of 5.3% for CEO's of 480 large publicly traded companies); Michael Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 438-41 (1988) (reporting mean annualized turnover rate of 3-5% for 367 nondistressed firms between 1974 and 1983).

Chapter 11 has the power to avoid transfers that have conveyed assets out of the debtor's estate ninety days prior to the date of filing,⁴⁷ no one in the workout situation is similarly empowered. A firm that anticipates insolvency can convey all its assets to a preferred creditor, only then declaring itself insolvent and open to negotiations. The creditors are apparently powerless to force the return of the assets.

There is, however, an implicit bargaining solution to the preference problem under the suspension clause regime. Because the suspension clause merely defers the threat of bankruptcy, all parties know that the dispute would stand a significant chance of winding up in court if the parties fail to settle by the time the suspension period runs out. They also know that once this happens, assuming the ninety-day preference period has not expired, the preferred creditor's interest will be avoided. Other creditors now enjoy significant leverage against the preferred creditor, that is, assuming it is in their interests to expend the resources to bargain with him. If the preferred creditor has received a substantial enough portion of the assets, it will not be worth the creditors' while to settle with the debtor without the return of these assets to the debtor's estate. In that case, the creditors will prefer bankruptcy to the workout offer, and this allows them to threaten credibly to block any settlement offer from the debtor. This leaves the debtor with no alternative but to file for bankruptcy at the end of the suspension period. If the debtor is recalcitrant, the creditors can also bring an action under § 303 of the Bankruptcy Code to force the debtor into an involuntary Chapter 11 or Chapter 7 proceeding.⁴⁸

The preferred creditor will thus wish to accept a settlement offer which accords her some amount between what she would receive in bankruptcy and the face value of her claim (assuming she received the latter in the preferred transfer). To induce her to give up value, other parties can offer some additional amount, representing the probability that the debtor might not actually enter bankruptcy in the event that the suspension period expires without settlement. She might, then, be able to hold out for slightly more than she would have received had she not already been paid. But if the debtor's or the creditors' threat to file for Chapter 11 is credible, this additional amount will be small.

The above solution to the preference problem depends on a relatively short suspension period. What would happen if the parties wished to provide for a longer suspension period, for example, a three—instead of a one—month period? Under current law, creditors would run the risk that the debtor would convey assets out of the estate just prior to the suspension period and then be

47. 11 U.S.C. § 547(b) (1988).

48. In order to bring an involuntary Chapter 11 or Chapter 7 petition, there must be three or more creditors whose claims are noncontingent, and, if there are fewer than 12 creditors, one or more of the creditors must have claims worth at least \$5,000 in the aggregate. 11 U.S.C. § 303(b) (1988).

unable to draw these assets back in in an eventual Chapter 11 proceeding. In order to allow the parties maximum flexibility in the time for suspension, § 547 of the Bankruptcy Code could be amended to provide that the ninety-day preference period would be tolled while the suspension clause was in effect. The parties would then be free to adopt whatever suspension period they regarded as advantageous, without running the risk of losing the threat advantage provided by the trustee's avoiding powers in an eventual bankruptcy. The parties must add a clause forbidding the debtor from conveying assets out of the estate during the suspension period, however, if the Bankruptcy Code were amended in this way.

A third, and perhaps more serious, objection is that private negotiations involve serious valuation problems. There are two aspects to this objection. First, one might suppose that a neutral third party is needed to resolve disputes about the value of the debtor firm's assets. The parties' conflicting interests can lead them to reach extremely divergent conclusions about the size of the pool of assets. In general, secured creditors have incentive to make low valuations of the firm, since equity's share is determined on a percentage basis. For the same reason, the debtor has incentive to inflate the value of the firm. But, except in the event of a cramdown, the court in a Chapter 11 proceeding does not normally undertake an independent evaluation of the debtor's assets.⁴⁹ Judges rarely resolve disputes over valuation. If parties can routinely resolve disputes through bargaining in bankruptcy without the help of an outside appraiser, they must be able to resolve these same disputes through bargaining outside of bankruptcy as well.

The second aspect is that the extremely short time frame in which negotiations take place under a suspension clause might exacerbate valuation problems. Creditors will wish to inquire into the debtor's financial position and to assess the veracity of his representations. The time pressure restricts creditors' ability to do this and obligates them to take the debtor's representations almost entirely at face value. But this feature of the suspension clause solution is not particularly objectionable. Commentators have noted that creditors usually consider themselves unable to conduct their own evaluations of the debtor's net worth in bankruptcy.⁵⁰ In the usual case, the debtor presents a valuation of the firm in the context of a proposed reorganization plan. Creditors have difficulty objecting to the debtor's valuation, because their access to information about a debtor's financial status is limited. In addition, disclosure requirements will mitigate the asymmetry of information. Although some asymmetries will remain, asymmetries exist in bankruptcy as well. There is no reason to suppose that the parties are worse off under a suspension clause

49. See LoPucki & Whitford, *supra* note 28, at 141 (attributing low incidence of contested plans to fear of overly complex cram-down hearings).

50. *Id.* at 129-30.

than they would be in bankruptcy on this question. Indeed, they might fare slightly better under the suspension clause solution, since the time and cost savings help to compensate for any losses due to inaccuracies of valuation.

A final possible objection to the suspension clause solution warrants particular attention. Suppose a workout situation in which it seems clear that the creditors would fall into roughly five classes if the parties ended up in Chapter 11 litigation, class one ranking the highest. And suppose there is a preferred creditor who is a member of class four, and that she has received payment in full. The remaining asset pool is sufficiently large to pay classes one through three, even after the preferred creditor has been paid in full. Suppose, therefore, that creditors from the first three classes are willing to accept the workout offer. The remaining members of class four object to the offer, because under it they will receive \$.50 on the dollar, whereas otherwise they receive \$.75. The members of class five object to the offer, because under it they receive nothing and are deprived of their rightful share of the bankruptcy cost savings.

Although, strictly speaking, there are no "classes" in a workout situation, since the division of creditors into classes is proposed in the reorganization plan,⁵¹ the example serves to illustrate a potential problem. Because the bargaining takes place "in the shadow" of bankruptcy law,⁵² the various interests of the creditors will depend on the priority each can expect to have in bankruptcy. To the extent that an eventual bankruptcy would impose a hierarchy of priorities, parties to a workout agreement have different levels of priority in the workout context and hence sharply divergent interests. Creditors may thus be unable to mobilize effectively against a preferred creditor, because this will often require unanimity of purpose.

For this reason, the parties must append an additional provision to the suspension clause in the original debt contract: they must condition a workout offer on unanimous acceptance by creditors. Any creditor who is disadvantaged by a preferred transfer prior to the declaration of insolvency, but within the preference period, should have the power to block a workout agreement. The dissenting creditor(s) could thus effectively strong-arm the preferred creditor into joining the negotiations, since if the former were sufficiently aggrieved, the threat of bankruptcy would be credible.

The combined operation of a suspension clause and a unanimous consent provision would result in an extremely high-pressured negotiation. While the obstacles to agreement may seem significant under such conditions, in theory the parties stand to reap considerable savings of both money and time by accepting the offer. All have strong incentives to avoid bankruptcy, and they

51. 11 U.S.C. 1123 (1988); DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 235 (1992).

52. See, e.g., Robert Cooter et al., *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225 (1982); Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950 (1979).

will therefore work hard to reach agreement. The parties have reduced incentives for posturing and game playing in a short time frame, since these impair the prospects of settlement by expending valuable time and resources. In addition, each individual experiences pressure to cooperate, since a successful workout requires the consent of all parties. As noted above, the advantages of reaching agreement quickly and informally may be high enough to induce the parties to overlook the central disadvantage of speedy negotiations—the inability to conduct an extensive investigation of the debtor's assets. They may thus be willing to risk a certain amount of inaccuracy in valuation in order to wind up their affairs as quickly as possible.⁵³

V. UNANIMOUS CONSENT CLAUSES AND THE HOLDOUT PROBLEM

An individual creditor has incentive to withhold her consent from a workout offer, since if enough other creditors accept, the workout will succeed, and the dissenting creditors will be paid in full. This is known as the “holdout problem.”⁵⁴ As Douglas Baird explains, “[e]ven though it is in the rational interest of the group to renegotiate the loan . . . , it is in the self-interest of each individual creditor to hold out and hope that others compromise their claims.”⁵⁵

Scholars often blame the holdout problem for the low settlement rates in this area of the law.⁵⁶ While the holdout problem is a serious one, it does not provide an adequate explanation for the observed settlement rates. The holdout problem can only impede workouts once the parties are able to negotiate with one another. But, as argued above,⁵⁷ collective action problems render ex post intercreditor negotiations extremely difficult. The holdout problem, in other words, can only provide an explanation for the failure of workouts that are in fact attempted. But as discussed above in the context of uncertainty, there is reason to think that most cases of serious corporate financial distress pass directly into Chapter 11, without even attempting a private workout before resorting to litigation.⁵⁸ The holdout problem arguably provides an explanation for failed workouts where the parties undertook negotiations but could not reach agreement. Nevertheless, the small number of attempted negotiations supports the contention that the collective action problem is principally responsible for the low settlement rates. Thus, although a solution

53. See *supra* text accompanying notes 48-49. In addition, as already noted, the risk of inaccurate valuation may be no greater in a workout than in bankruptcy.

54. See BAIRD, *supra* note 50, at 73; Schwartz, *supra* note 6, at 2. Mark Roe is responsible for first characterizing the problem in these terms. Roe, *supra* note 6, at 236.

55. BAIRD, *supra* note 50, at 73.

56. See, e.g., Roe, *supra* note 6, at 235-37.

57. See *supra* Part II.

58. See *supra* text accompanying note 30 and sources cited therein.

to the holdout problem is called for, it is called for only insofar as the prior impediments to negotiation have been eliminated.

The holdout problem disappears in bankruptcy, because it is possible for acquiescing creditors to bind dissenters.⁵⁹ It is generally not possible to bind dissenters outside of bankruptcy.⁶⁰ If bankruptcy is to be effectively avoided, the suspension clause solution must be supplemented with a solution to the holdout problem. Several such solutions have been proposed in the literature to date.

A. *Majority Rule Clauses*

A number of scholars have argued that the holdout problem can be solved by the inclusion of a majority rule clause in the debt contract.⁶¹ Majority rule clauses allow a specified percentage of debt holders to amend the conditions of the debt agreements of the other creditors.⁶² Under such a regime, a majority of creditors who accept an offer could bind the remaining creditors to the workout share. Majority rule clauses, however, at least those that impair the debtholders' right to payment, are barred in the case of public debt by § 316(b) of the Trust Indenture Act of 1939 (hereinafter the "TIA").⁶³

Some scholars accordingly call for the repeal of the TIA's prohibition of majority rule clauses.⁶⁴ They point out that if two-thirds of the creditors are allowed to cram down a plan of reorganization on dissenting creditors *in* bankruptcy, it is odd to disallow the same outside bankruptcy.⁶⁵ But it is not difficult to understand the rationale for the asymmetry between bankruptcy and nonbankruptcy on this point. The situations in which creditors are allowed to alter the contractual terms of their fellow bondholders over the dissent of the

59. 11 U.S.C. § 1126 (1988) (binding dissenting minority of class); 11 U.S.C. § 1129 (1988) (binding dissenting classes).

60. As Douglas Baird writes, "Outside of bankruptcy, the trade creditors have no way to overcome the holdout problem. Firm may end up in Chapter 11 because the trade creditors need a legal mechanism that allows the majority to bind the minority." BAIRD, *supra* note 50, at 73; *see also* Kashner, *supra* note 6, at 123.

61. *See* Robert A. Haugen & Lemma W. Senbet, *Bankruptcy and Agency Costs: Their Significance to the Theory of Optimal Capital Structure*, 23 J. FIN. & QUANTITATIVE ANALYSIS 27, 30 (1988); Kashner, *supra* note 6, at 123-24; Roe, *supra* note 6, at 249.

62. Kashner, *supra* note 6, at 124.

63. 53 Stat. 1173 (1939) (codified at 15 U.S.C. § 77ppp(b) (1988)).

64. *See, e.g.*, Roe, *supra* note 6, at 235. Schwartz points out, however, that lifting restrictions against such clauses may not help, since creditors may prefer not to use them. He argues that such clauses create incentives for debtors to make workout offers that are less favorable to creditors than the "successful" offer, i.e. the offer that retains for debtor only enough to give him the return he would get in bankruptcy, plus the share of the cost savings avoiding bankruptcy entails. Schwartz, *supra* note 6, at 7; *see also infra* Part V(B). He also points out that majority rule clauses are not commonly used where they are not forbidden, namely in nonpublic debt issues. Schwartz, *supra* note 6, at 5.

65. *See generally* Roe, *supra* note 6, at 255. Roe explains that this asymmetry was not always present. Prior to 1978, it was the case that bondholders could only be bound in bankruptcy against their consent pursuant to a showing that junior interests were impaired only to the extent necessary to assure bondholder compensation. *Id.*

latter should be carefully circumscribed. If a majority of creditors could bind the minority at will, the majority would have every reason to offer the minority bondholders nothing on their claims and to split the remaining pool of assets among members of the majority.⁶⁶ This is a danger no matter how large a majority the clause requires for the offer to succeed, since the creditors in the majority would always prefer to have the minority's share to divide among themselves. Moreover, absent restraints, creditors offered a return on their claims would have every reason to reject any offer that *failed* to sell out the allowed minority percentage of creditors, since the consent of the latter would not be required for the workout to succeed. Anything the minority received would be superfluous from the majority's perspective.

Advocates of majority rule solutions to the holdout problem may suppose that the majority could only bind the minority to the same share that the majority creditors receive themselves.⁶⁷ But in light of the fact that creditors can expect to receive different treatment in bankruptcy depending on their level of priority, this solution will not work. The minority creditors might enjoy a higher priority than the majority creditors. Debt contracts would have to specify priority levels and to bar the majority from binding dissenters to workout shares that did not reflect their bankruptcy priority share. Apart from the other complications this would add to the negotiation of debt contracts, it would exacerbate valuation problems. For example, high priority creditors would attempt to place a low valuation on the claims of lower priority, minority creditors. There would be no neutral judge to oversee the valuation efforts of the parties. Nor could the debtor be expected to offer a disinterested valuation of the minority's claims, since senior creditors could collude with the debtor to agree on valuations that would allow them to appropriate a portion of the minority's share.

The TIA could be modified to permit good faith majority rule clauses—majority rule clauses that do not circumvent the rights of dissenting minority creditors. The TIA, in other words, could contain provisions similar to sections of Chapter 11 that establish a baseline for the protection of minority interests: the plan must either be in the best interests of the creditors,⁶⁸ meaning that a dissenting class of creditors must receive at least as much as it would receive under a Chapter 7 liquidation,⁶⁹ or, failing that, the plan

66. This is precisely what happened under the old equity receiverships. *See* Northern Pac. Ry. v. Boyd, 228 U.S. 482 (1913) (holding that a freezeout of trade creditors is not permissible). The drafters of the 1978 Code adopted what is known as the "best interest of the creditors" test, 11 U.S.C. § 1129(a)(7) (1988), and the "fair and equitable" requirement, 11 U.S.C. § 1129(b) (1988), specifically in order to eliminate freezing out of middle-level creditors.

67. Alan Schwartz has suggested that there is an unstated assumption to this effect in the writing on majority rule clauses. Interview with Alan Schwartz, William K. Townsend Professor of Law, Yale Law School, in New Haven, Conn. (Nov. 19, 1992).

68. 11 U.S.C. § 1129(a)(7) (1988).

69. *Id.*

must be "fair and equitable," meaning that it must respect absolute priority.⁷⁰ But these standards are admittedly nebulous, since whether a plan is fair and equitable must be determined in light of the specifics of each case. Judicial supervision is thus needed to determine whether minority interests have been properly respected. If left to interpret the import of similar phrases themselves, creditors would surely attempt to collude with the debtor to push through abusive offers. To avoid this kind of abuse, a majority of creditors should be allowed to bind a minority only where the interests of the dissenting bondholders can receive some protection from an independent third party.

Chapter 11, however, is not the only safeguard against majority tyranny. There must, at least in theory, be other, less costly ways to prevent creditors from freezing one another out. If we accept the premise of the creditors' bargain model that reorganization is in the interests of the creditors as a group, a successful workout should not require giving some creditors the power to bind dissenting creditors. Theoretically, there should be a workout offer that would be in the interest of all to accept. Rather than permit a majority of creditors to bind a minority, and then require an expensive judicial proceeding to ensure that minority interests are respected, it would make more sense to retain the ban on majority rule clauses and to attempt to facilitate private agreements that *all* parties would prefer to bankruptcy. It is this last insight that motivates a second proposed solution to the holdout problem.

B. *Successful Offer Clauses*

In a recent paper, Alan Schwartz offers the following diagnosis of the holdout problem.⁷¹ There is an offer, Schwartz argues, that all would accept: an offer that gives each creditor the amount she would receive in bankruptcy, plus a pro rata share of the cost savings. Call this offer the "successful offer."⁷² In general, as discussed above,⁷³ equityholders can count on receiving a certain amount of the value of the firm in a reorganization. The successful offer thus gives a creditor her appropriate share of the pre-bankruptcy value of the firm (i.e. the value of the firm before bankruptcy costs are taken into account), minus the payment to equity and the workout costs. The return to a single creditor under the successful offer is presented as

$$w_i = n\% (v - s - e_s),$$

where w_i is the workout share of the creditor in question, v the pre-bankruptcy value of the firm, s the cost of the workout arrangement, e_s the share allotted

70. 11 U.S.C. § 1129(b)(1), (2) (1988).

71. Schwartz, *supra* note 6.

72. *Id.* at 5.

73. See *supra* text accompanying note 28 and sources cited therein.

to equity, and $n\%$ the creditor's appropriate share of the assets.⁷⁴ Assuming that the value of the debtor's assets less the workout costs is greater than the value of those assets less the bankruptcy costs (in other words $(v - s) > (v - c)$, where c is the costs of bankruptcy proceedings), the creditor receives more under the successful offer than she does in bankruptcy ($w_i > b_i$, where b_i represents the bankruptcy share). The creditor thus has no incentive to refuse the offer, if she thinks bankruptcy is the only alternative.

Schwartz argues for this reason that "the holdout problem does not arise 'naturally' from the payoff structure."⁷⁵ Debtor firms, in effect, choose to create the holdout problem, by making offers which are not the successful offer. Instead of successful offers, firms routinely make "greedy offers"—offers that retain a larger share for equity than the portion it would receive in bankruptcy. Creditors have incentive to reject greedy offers because they know there is another offer the firm can make—the successful offer—which would be more to their advantage and yet still be worth the debtor's while to make. Creditors have strong incentives to reject a greedy offer, then, because they know the debtor has retained more for himself than is strictly necessary.

Why would a creditor think that bankruptcy is the only alternative to the successful offer if she does not think this in the case of the greedy offer? One might suppose that in the face of a successful offer she still has incentive to hold out, in the hope that others will compromise their claims and she can reject and be paid in full. The answer follows from the structure of the successful offer. An implication of Schwartz's analysis is that the successful offer leaves the debtor with no excess funds, and thus with nothing to pay rejecters. Since the successful offer awards equity the minimum 5%, the debtor has no excess funds to pay rejecters. The debtor spends everything save 5%. Greedy offers, by contrast, leave out funds which the debtor can use to pay rejecters because equity can give up some value and still be better off than it would be in bankruptcy.⁷⁶ Successful offers therefore contain an implicit unanimity condition, since anything less than unanimous acceptance dooms the offer to failure.

Having analyzed the problem in this way, Schwartz presents the following solution: debt contracts should incorporate a successful offer clause, that is, a clause requiring the debtor to make the successful offer. Firms will thus be unable to make greedy offers, and the offer they make will be accepted.

74. Schwartz, *supra* note 6, at 12. Schwartz calculates the appropriate share on a percentage basis, which is accurate in the case in which there is only one class of debt. The percentage represents the single creditor's share of the class. Thus if a certain creditor holds 10% of the debt of the class, and there is only one class, his workout offer will be $w_i = .10 (v - s - e)$.

75. Schwartz, *supra* note 6, at 5.

76. It would not be worth debtor's while to make an offer that required it to dip into its own share to pay dissenters, since debtor would prefer bankruptcy to that state of affairs. The firm's threat to enter bankruptcy if the successful offer is rejected is thus credible.

The problem with Schwartz's solution, as he himself points out,⁷⁷ is that successful offer clauses are unenforceable, since they involve a waiver of the debtor's right to use the legal bankruptcy process. Bankruptcy waivers are banned.⁷⁸ Schwartz therefore argues that the ban on bankruptcy waivers should be lifted.⁷⁹ He argues that the ban on waivers serves no purpose where the debtor is a corporation, since the paternalistic concerns about consumer coercion are inappropriate in the corporate context. Among other things, individuals have the right to have their debts discharged in bankruptcy, but corporations have no such right.⁸⁰ Furthermore, asymmetries in the parties' access to information justify protecting the individual more than the corporate debtor.

There are, however, a number of objections to lifting the ban on waivers. First, it will be recalled that the solution to the preference problem in the workout context depends on the ability of the debtor and/or the remaining creditors to threaten the preferred creditor with bankruptcy if the latter does not agree to join the negotiations.⁸¹ Under the suspension solution they can do this, because the parties retain the right to avail themselves of the bankruptcy process after the suspension period has expired. Under Schwartz's solution, by contrast, the parties have committed themselves to an extra-judicial solution in advance. Because they have mutually agreed to forego their right to use Chapter 11, they lose the threat advantage they might have had over preferred creditors. It is true that preferring a creditor would constitute a breach of the successful offer term in the debt instrument. The creditors would thus have the right to sue the debtor collectively for breach of contract, and they could presumably sue the preferred creditor for tortious interference with contract. But from a strategic perspective, it may be impossible to mobilize a creditor suit, since many creditors will be unaffected by the preference and would not care whether their share is paid from the preferred creditor's fund or from the lower priority creditors' share. The debtor must have leverage over the preferred creditor for the return of the assets to be assured, and the only possible source of leverage the debtor has is his power to enter bankruptcy.

Second, there may be good reasons for retaining the ban on waivers for corporate debtors. Large lenders are often more powerful and enjoy a superior bargaining position in negotiation than even average-sized public companies. One would expect to see systematic use of bankruptcy waivers, if permitted. There may be some complex cases, however, where the coordination advantages of court supervision are indispensable. Under Schwartz's solution, debtors legitimately in need of Chapter 11 may not avail themselves of it.

77. Schwartz, *supra* note 6, at 59.

78. See *United States v. Royal Business Funds Corp.*, 724 F.2d 12, 15 (2d Cir. 1983).

79. Schwartz, *supra* note 6, at 7.

80. *Id.* at 7-8.

81. See *supra* text accompanying notes 45-48.

Debtors would thus lose a significant body of rights—the bargaining power conferred by the ability to enter Chapter 11 and the ability to use Chapter 11 when it is indispensable—and would have gained little for it. Although the ban on waivers *may* be unnecessary in the corporate context, a solution to the holdout problem which relies on this still tendentious claim is subject to doubt.

Third, parties might resist using a clause that contains a waiver of bankruptcy. Since the debtor's only bargaining power comes from his ability to threaten bankruptcy, waiving the right to file in Chapter 11 would impair the power to force negotiations and inhibit his ability to demand the customary 5% return to equity. Creditors could conceivably extort greater returns than the successful offer provides, and the debtor would be unable to object. Of course debtor could resist the creditors' demands if he could prove they violated the successful offer clause, but this would involve the debtor in difficult and costly litigation on the highly speculative question of what the successful offer clause requires.

C. *Unanimous Consent Clauses*

The pure unanimous consent clause discussed in the context of the preference problem solves the holdout problem without the difficulties the majority rule and the successful offer clauses encounter. Unlike the majority rule clause, a unanimous consent clause does not run afoul of the Trust Indenture Act, because it does not allow some creditors to bind others. Unlike the successful offer clause, it does not entail a waiver of bankruptcy. It is both legal and it preserves the debtor's only source of bargaining strength. Because offers that are in the interests of all parties are stable from a bargaining perspective, a mandatory settlement clause should be unnecessary. The parties have adequate incentive to settle once we eliminate the collective action and the holdout problems.⁸²

A unanimity condition may seem a counterintuitive means of facilitating agreement among large numbers of individuals with divergent interests. People are irrational, and one might think that someone would always insist on holding out, even though it is in everyone's interest to accept. If this were true, unanimous consent would *reduce*, rather than *enhance*, the prospects for agreement. But consider the reasoning of an individual creditor. She would find nothing to lose by accepting the workout offer. If she accepts the

82. Instead of incorporating unanimous consent clauses into the debt contracts, debtors could make their offers conditional on unanimous consent. Creditors would in effect be presented with a take-it-or-leave-it offer. But incorporating the unanimity requirement into the debt contract would be preferable, since firms might be put under pressure by creditors who wished to attempt to hold out to make the offer conditioned on the acceptance of less than 100% of the creditors. Such pressure could unravel the workout, and, given the time limitations under the suspension period solution, precious time would be lost in reaching agreement.

agreement and it succeeds, she will receive what she would have received in bankruptcy, plus a share of the cost savings. If it fails, she will end up in bankruptcy. If, on the other hand, she rejects, she will end up in bankruptcy anyway. She might consider rejecting in order to induce other creditors to bribe her to accept. But, like the successful offer, there will be no excess funds to use to pay dissenters. If other creditors give up value, they will prefer bankruptcy, and the workout will fail. Since the creditor knows this, and the limited time frame creates incentives to move immediately to the cooperative position, she will accept the offer. The only possible reason she might refuse, then, is if she thought she would receive more in bankruptcy. But by hypothesis she will not.

A problem with greedy offers, however, may remain. Under a pure unanimity condition, what would prevent a debtor from making a greedy offer to creditors, thereby resurrecting the holdout problem in a different form? Presumably under the time pressure created by the suspension clause, the debtor has an incentive to make offers likely to succeed. The possible range of abuse is thus restricted. But some greedy offers will nevertheless pass. In general, a greedy offer in which either (1) the debtor's threat to enter bankruptcy if the offer fails is not credible, or (2) creditors are offered less than they would receive through litigation (factoring in the costs of delay) will fail. The fact that other greedy offers will pass is not objectionable.

First, consider offers in which the debtor is willing to settle for less than he retains for himself under the present workout offer, in other words, in which there exists a lower offer at which the debtor would still be willing to forego bankruptcy. In this case, the debtor's threat to enter bankruptcy will not be credible, and the offer will fail. When this happens, the debtor will presumably make another offer. If the threat to enter bankruptcy upon the failure of this new offer is not credible, the offer will fail again, and the debtor can make a third offer. The debtor will make offers repeatedly until the parties settle. The point of agreement will fall within a certain range: a debtor's workout share, e_w (return to equity), must be greater than or equal to the debtor's bankruptcy return, e_b , and similarly the creditors' workout share, c_w must be greater than or equal to her bankruptcy return, c_b . If C represents the bankruptcy cost savings, then there is some value, x , between 0 and C , representing the share of the cost savings that the creditors collectively receive, where the parties will settle. Thus we can express the debtor's share as

$$e_w = e_b + C - x,$$

and the creditors' share as

$$c_w = c_b + x.$$

On one end of the spectrum, $x = C$, where the debtor will receive no more than he would have received in bankruptcy. On the other end, $x = 0$, meaning that the parties settle where the debtor receives the full amount of the cost savings.

If we suppose that motivations are transparent, creditors can only hope to receive the full cost savings if they prefer bankruptcy to any settlement where $c_w < c_b + C$. Similarly, the debtor can only hope to receive the full cost savings if he prefers bankruptcy to any settlement where $e_w < e_b + C$. Realistically, creditors will prefer a workout to bankruptcy, even where $c_w = c_b$, since workouts involve a considerable time savings. The same is probably true of the debtor, if not for the time savings, then because of the stigma bankruptcy litigation involves. If these forces are evenly balanced, the debtor and creditors will split the cost savings. If they are not evenly balanced, then the party who most wishes to avoid bankruptcy will be forced to give up some portion of the savings to the other, provided his motivations can be accurately assessed. Because creditors, especially secured creditors, are eager to avoid the delays bankruptcy litigation involves, one can expect corporate debtors to fare significantly better in workouts than they would in bankruptcy.

If, on the other hand, the parties can bluff, then a greedy offer which did not reflect a Nash equilibrium might succeed, because the misled party would not have had an opportunity to assess the payoffs correctly. We saw this in the context of negotiations during the suspension period: if a debtor can falsely convince creditors of an intention to file for bankruptcy, he may win a settlement he could not win if he were honest about his intentions. But presumably no one will have been made worse off by the workout, since any one who would have preferred bankruptcy to the workout share can simply refuse to enter into the settlement. It may not, at any rate, be as easy for the parties to bluff as one might think. The debtor's motivations are rational and arise out of states of affairs that are as observable to creditors as to the debtor. Creditors can make reasonable guesses about what a debtor is likely to regard as advantageous.

Offers under which creditors are offered less than they would receive in bankruptcy present an even more obvious example of the kind of greedy offer that should fail. It would be impossible for such an offer to pass, except in the unlikely event that one party would be willing to accept less than her bankruptcy share in the hope that the time savings would make up for the loss in value.

VI. CONCLUSION

To the extent that the bankruptcy literature has taken the collective action problem seriously, it presents it as a justification for Chapter 11. Scholars who argue in this way, however, fail to notice that the collective action problem cannot justify the existence of Chapter 11 as a whole. It provides at best a justification for the automatic stay, and it does that only if there is not a more cost-effective method for preventing a run on the debtor's assets. This Note

has presented one alternative to Chapter 11 which in all likelihood would involve considerable cost savings.

On the other hand, those who press for private alternatives to Chapter 11 litigation tend to minimize the importance of the collective action problem. They blame the low settlement rates on the holdout problem instead, and they consequently focus their attention on solutions designed to bring about agreement at the negotiation stage. This Note has argued, despite the importance of ensuring that the holdout problem does not defeat potentially successful workouts, that the collective action problem is responsible for the observed settlement rates. It has argued accordingly that solving the holdout problem will not substantially increase settlement rates unless accompanied by a method for facilitating negotiations. It has suggested that the number of private workout agreements would increase significantly under a contractual regime that suspended creditors' state-law collection rights for a limited period of time, if implemented in conjunction with a unanimous consent clause.

The efficacy of the proposed solution may seem dubious in light of the fact that parties to debt contracts do not now, nor have they ever, included suspension clauses in their debt instruments. One might suppose that experienced lenders, for example, would have discovered that suspending their own and other creditors' state law rights would facilitate negotiations, and would have attempted it in some form. It is often difficult, however, for individuals to conceive of the necessity of self-limiting provisions, solutions which require a willingness to restrict one's own freedom in order to increase one's welfare. This may be especially true in the context of competitive and somewhat adversarial business negotiations, in which parties are extremely wary of weakening their bargaining positions. Suspension clauses and unanimity provisions may not be used because it is highly counterintuitive to restrict one's legal remedies as a method for facilitating bargaining. But parties to debt contracts must attempt to think systemically, and attempt to fashion a new legal regime based on voluntary, rather than mandatory, rule-making if they hope to avoid expensive and cumbersome centralized proceedings. The more parties to financial agreements act as their own policy makers, the more efficient they can make their interactions.