CRYSTALS AND MUD IN BANKRUPTCY LAW: JUDICIAL COMPETENCE AND STATUTORY DESIGN

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[C]rystalline rules seem less the king of the efficiency mountain than we may normally assume. One can argue that elaborate ex post allocations of responsibilities might be efficient too, even if they make people's entitlements fuzzier ex ante. The very knowledge that one cannot gull someone else, and get away with it, makes it less likely that anyone will dissipate time and effort in trying to find the gullible.[1]

I. INTRODUCTION

Bankruptcy reform is on the horizon, and it is largely misguided. While reform bills in each of the last two legislative sessions may have stalled because of the inability of the two houses of Congress and the President to agree on the shape of the final legislation,[2] reform efforts will continue.[3] Legislators and lobbyists,

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1. Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 600 (1988).

2. In 1998, H.R. 3150, The Bankruptcy Reform Act of 1998, passed the House, and S. 1301, the bill's counterpart, passed the Senate, but both died when the two houses could not agree on a conference report. The Republicans then attempted to incorporate a version of the bill similar to H.R. 3150 into the 1999 appropriations bill, but these efforts failed. *See* Philip S. Corwin, *Bankruptcy Reform: Another Bill That Will Hold Until Next Year*, BANKING POLICY REPORT, at 1 (Nov. 16, 1998). In 1999 and 2000, a similar story unfolded. H.R. 833 passed the House by a vote of 313–108. *See Final Vote Results for Roll Call 115 available at* http://143.231.123.93/cgi-bin/vote.exe?year=1999&rollnumber=115 (visited Apr. 21, 2001).

distrustful of judges, are seeking to replace muddy, open-ended rules with crystalline, highly specific statutory provisions that, while difficult to penetrate, leave little to the imagination. This infatuation with "crystalline" statutory drafting turns on a misunderstanding of the roles that "muddy" rules, judicial discretion, and judicial competence play in the bankruptcy statutory scheme. To make matters worse, much current bankruptcy scholarship appears to share the same misconception.

Carol Rose, in her seminal article, *Crystals and Mud in Property Law*, describes how crystalline statutory drafting increases the likelihood that parties will be able to resolve disputes through bargaining while muddy statutory drafting increases the probability that disputes will be resolved by a judge.[4] The current battles royal in both the legislative and scholarly arenas are, each in their own way, contests over the institutional choice[5] between markets and judges, fought out over crystalline versus muddy rules. Legislators may choose crystalline rules

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S. 625 passed the Senate by a vote of 83–14. *See U.S. Senate Roll Call Votes 106th Congress—2d Session (2000) available at* http://www.senate.gov/legislative/vote1062/vote_00005.html (visited Apr. 21, 2001). A final bill, H.R. 2415, then passed the House of Representatives by a voice vote on October 12, 2000, and passed the Senate on December 7, 2000, by a vote of 70–28. *See Rollcall Vote No. 297 Leg. available at* http://www.abiworld.org/vote.html (visited Apr. 21, 2001). On December 19, 2000, the President announced his intention to "pocket veto" the bill, and did so. *See Legislation to Overhaul Laws on Bankruptcy Dies As President Fails to Sign It*, N.Y. TIMES, Dec. 20, 2000, at A32. A new bill, The Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, recently passed both the House and the Senate and is currently awaiting the naming of a conference committee. *See* American Bankruptcy Institute, *Today's Headlines April 11, 2001 available at* http://www.abiworld.org/headlines/todayshead.html (visited Apr. 21, 2001).

3. The fact that personal bankruptcies were hovering at a rate of just over 1,000,000 per year, while the economy appeared to be booming, created the perception in Washington that something was amiss. As the pace of the economy increased, so, until recently, did the number of personal bankruptcy filings, rising from 832,415 in 1995 to 1,389,839 in 1998, and then falling slightly in 1999 to 1,315,751. *See* ADMIN. OFFICE OF THE UNITED STATES COURTS, JUDICIAL BUSINESS OF THE UNITED STATES COURTS: 1999 ANNUAL REPORT OF THE DIRECTOR 34 (1999). While business bankruptcy filings declined from 51,042 in 1995 to 38,625 in 1999, see *id.*, the trend appears to have reversed, with business filings up twenty-six percent for the fiscal year ended March 31, 2000. *See* Gary Strauss, *Despite Booming Economy, Bankruptcy on Rise*, USA TODAY, July 12, 2000, at B1.

4. *See* Rose, *supra* note 1, at 577 ("We draw these ever-sharper lines around our entitlements so that we know who has what, and so that we can trade instead of getting into the confusions and disputes that would only escalate as the goods in question became scarcer and more highly valued."). Rose notes that this insight applies in the world of commercial law, as well as in the world of real property. *Id.* at 590 n.73 (*citing* Douglas Baird & Thomas Jackson, *Information, Uncertainty, and the Transfer of Property*, 13 J. LEGAL STUD. 299, 312–18 (1984)).

5. *See generally* NEIL KOMESAR, IMPERFECT ALTERNATIVES (1994).

to facilitate private resolution of disputes, but they may also choose crystals because they doubt the competence of judges.[6]

This distrust of judges is evident in the recent bankruptcy reform efforts[7] and in recent bankruptcy scholarship of the "Law and Economics" stripe.[8] These legislators and scholars use the supposed incompetence of bankruptcy judges as a principal basis for arguments in favor of limiting the goals of bankruptcy law and curbing the discretion of bankruptcy judges.[9] Indeed, some recent bankruptcy scholarship carries this disenchantment with bankruptcy judges even further,[10] seeking to make bankruptcy law irrelevant by reducing it to a set of contractual default rules.[11] This Article, without seeking to determine whether such skepticism

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6. *See* Susan Block-Lieb, *Congress' Temptation to Defect: A Political and Economic Theory of Legislative Resolutions to Financial Common Pool Problems*, 39 ARIZ. L. REV. 801, 864–65 (1997) (suggesting that narrowly drafted rules may be attempts by interest groups to lock in legislative gains).

7. S. 625 passed the Senate on February 2, 2000, by a vote of 83–14. H.R. 833 passed the house by a vote of 313–108 on May 5, 1999. *See supra* note 2. These proposed business bankruptcy reforms would limit the scope of the automatic stay with regard to certain specific types of property, such as rolling stock, ships, and aircraft (S. 625, 106th Congress §§ 401, 402 (1999)), *see infra* note 94 and accompanying text, limit the ability of judges to extend the debtor's exclusivity period (S. 625, 106th Congress § 413 (1999)), *see infra* note 92 and accompanying text, and limit the time to confirm a plan in small business cases (S. 625, 106th Congress § 427 (1999)). *See* Edward J. Janger, *The Locus of Law Making: Uniform State Law, Federal Law and Bankruptcy Reform*, 74 AM. BANK. L.J. 97, 105 n.45 (2000). Proposed consumer bankruptcy reforms would force certain debtors into Chapter 13 based on their median income level (S. 625, 106th Congress § 102 (1999)), see *infra* notes 204-219, and accompanying text, and render certain credit card debt non-dischargeable (S. 625, 106th Congress § 310 (1999)).

8. *See, e.g.*, Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 585–86 (1998).

9. *See, e.g.*, Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75, 99 (1995) (arguing that bankruptcy judges are not institutionally well situated to take community interests into account).

10. There has been a recent boom in articles proposing contractual alternatives to bankruptcy law that would eliminate the need for bankruptcy judges entirely. *See, e.g.*, Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1821–22 (1998). For a response to Schwartz, see Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999), and for a surreply, see Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343 (1999).

11. *See* Schwartz, *supra* note 10, at 1839 ("Congress should reject the [National Bankruptcy Review Commission's] recommendation to prohibit all bankruptcy waivers."); *see also* Barry E. Adler, *A World Without Debt*, 72 WASH U. L.Q. 811, 816–18 (1994) ("[I]n principle, a world without debt or bankruptcy, and with contractual solutions to the collective action problem, seems an efficient world."); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 313–14 (1993) ("Bankruptcy's solution to the common pool problem, however, rests on a faulty premise: that there is a common pool problem....In theory, each creditor could appoint management as its agent to enforce a mutual and irrevocable agreement among creditors to accept only a collective default remedy."); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1078–79 (1992) ("Chapter 11 should be repealed, abolishing court-supervised corporate reorganizations and, in effect, precluding

about judges is justified, argues that the legislative and scholarly push for more crystalline rules turns on a misunderstanding of the relevance of judicial competence to statutory drafting strategies.

Rose's distinction between "mud" and "crystals" mirrors a seemingly irreducible fault line among bankruptcy scholars.[12] So-called "proceduralists," mostly of the law and economics school, seek an "efficient" bankruptcy statute and crystalline statutory drafting, while traditional bankruptcy scholars, sometimes called "traditionalists,"[13] eschew economic methods in favor of broader conceptions of fairness and statutory mud.[14] In a recent article, Douglas Baird described the divide as turning not just on differing goals for bankruptcy law, but

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residual claimants from participating in any reorganization of the firm."); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 53–54 (1992) ("Contrary to the prevailing wisdom, this Article argues that bankruptcy law should be treated as a default rule.").

12. As Douglas Baird describes it:

> [T]here are two distinct camps. In the first are traditional bankruptcy lawyers and scholars whose views are largely reflected in the recent report of the National Bankruptcy Review Commission....The second group consists almost entirely of academics....The group's distinctive characteristic is its focus on procedure and its belief that a coherent bankruptcy law must recognize how it fits into both the rest of the legal system and a vibrant market economy.

Baird, *supra* note 8, at 576 (citations omitted); *see also* Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 2–3 (1994) ("The debate over Chapter 11 reflects a division over which policies bankruptcy should embrace.").

13. *See* Baird, *supra* note 8, at 576 n.9. Works by scholars that Baird deems "traditionalist" include: KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM (1997); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717 (1991); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987); Elizabeth Warren & Jay Lawrence Westbrook, *Searching for Reorganization Realities*, 72 WASH. U. L.Q. 1257 (1994).

14. *See* Baird, *supra* note 8, at 576 n.11. Works by scholars that Baird deems "proceduralist" include: THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107 (1994); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) [hereinafter Adler, *Theories of American Corporate Bankruptcy*]; James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097 (1990); Frank Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411 (1990); 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); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992); Randal C. Picker, *Voluntary Petitions and the Creditors' Bargain*, 61 U. CIN. L. REV. 519 (1992); Robert K. Rasmussen, *The* Ex ante *Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159 (1994); George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901 (1993); Michelle J. White, *Corporate Bankruptcy As a Filtering Device: Chapter 11 Reorganizations and Out-of-Court Debt Restructurings*, 10 J.L. ECON. & ORG. 268 (1994).

on fundamentally different visions of the bankruptcy judge.[15] According to this account, traditionalists seek equity among creditor constituencies. They live in, and glory in, a world of bankruptcy detail, a paradise where a complex statute and muddy facts merge to create a happy home for experts, a world of discretion for bankruptcy judges, and a black hole for everyone else.[16] The proceduralists, by contrast, favor crystalline statutory drafting to sharply reign in judicial discretion. They focus solely on maximizing the return to creditors and reducing the cost of credit. This focus leads some to suggest a radical reconceptualization of bankruptcy law, generally based on contract principles.[17] Baird describes the traditionalist world as a world of judicial discretion, and the proceduralist world as one of statutory precision.[18] The traditionalist vision is of a maximalist judge, imposing his will on the bankruptcy proceeding, while the proceduralist's ideal judge is a minimalist, adjudicating disputes, if at all,[19] in a manner, harkening back

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15. *See infra* notes 33–48 and accompanying text.

16. *See* Frost, *supra* note 9, at 75, 91 (offering a critique of the activist bankruptcy judge). To a large extent, the debate between traditionalists and proceduralists is a mirror of the broader political debates in the 1980s between the limited government agenda of the Reagan/Bush Republicans. These debates have shifted somewhat, with a newer so-called Chicago School emerging that looks at social institutions more broadly. *See* Lawrence Lessig, *The New Chicago School*, 27 J. LEGAL STUD. 661, 665 (1998); *see also* KOMESAR, *supra* note 5, at 5 ("Institutional choice is difficult as well as essential. The choice is always a choice among highly imperfect alternatives."). It may be time for a similar move in bankruptcy scholarship: time to move from a bipolar world dominated by one group of scholars who believe markets are perfect and another that view markets as either severely flawed in the bankruptcy context or as irrelevant. As such, this Article operates from the perspective that the market with all its imperfections will ultimately drive the results of a bankruptcy, but that government action, social norms, and personal idiosyncracies can shape the results of a case, and indeed, can shape the market.

17. *See, e.g.*, Adler, *Theories of American Corporate Bankruptcy*, *supra* note 14, at 323–41; Rasmussen, *supra* note 14, at 1190–1211; *see also* LoPucki, *supra* note 10; Schwartz, *supra* note 10.

18. Baird, *supra* note 8, at 579–80. Baird, a proceduralist himself, takes, as the centerpiece for his description of the bankruptcy academy, two competing visions of the goals of bankruptcy law and the role of the bankruptcy judge. As he describes it:

> [T]he traditional bankruptcy experts believe that:
> (1) the preservation of firms (and therefore jobs) is an important and independent goal of bankruptcy; (2) contemplation of the rights and needs of the parties before the court matters more than the effects on incentives before the fact; and (3) bankruptcy judges should enjoy broad discretion to implement bankruptcy's substantive policies.
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> By contrast, in the proceduralist world:
> (1) the preservation of firms is not an independent good in itself; (2) *ex ante* effects are important; and (3) the judge, after controlling for the biases and weaknesses of the parties and resolving the legal disputes, must allow the parties to make their own decisions and thereby choose their own destinies.

Id.

19. Contract bankruptcy proposals like those of Adler, Rasmussen, and Schwartz would keep most business cases out of bankruptcy court altogether, because the creditors would have agreed to their treatment in the event of insolvency in advance of giving credit.

to Lon Fuller, that pays close attention to the perceived limitations of the adjudicative process and to the perceived limitations of bankruptcy judges.[20]

These competing visions of the bankruptcy judge are driven by two competing visions of the paradigmatic bankruptcy case and by differing views of the ability of bankruptcy judges to distinguish between them. The proceduralists' bankruptcy case occurs in a world of efficient markets and low transaction costs, while the traditionalists' debtor exists in a world where prices are sticky, markets imperfect, and transaction costs are high. The proceduralists' judge is a dupe, unable to distinguish between cases that are candidates for reorganization and those which are hopeless. The traditionalists' judge, by contrast, is a hero, working with the parties to achieve a consensual, collective solution to a common problem. These competing views of the bankruptcy judge drive two radically different views of the appropriate goals of the statute and of the proper approach to statutory drafting.

In this Article, I seek to demonstrate that the proceduralists' reflexive prescription of crystalline rules, driven by their doubts about judicial competence, is misguided. In Part II, I identify the principal components of the proceduralist and traditionalist visions. The proceduralists' minimalist vision of the judge appears to be driven by two principles that I call, respectively, the proceduralist "should not" and the proceduralist "cannot." On the one hand, proceduralists take the normative view that any judicial interference in the market *"should not"* be redistributive. A court should only intervene if the effect is to make all creditors better off. On the other hand, proceduralists doubt that bankruptcy judges can accomplish this task. For institutional reasons, such as lack of information, they *"cannot"* distinguish firms with going concern value that can only be preserved through reorganization from firms that could be more efficiently liquidated piecemeal.

In Part III, I accept, for the purposes of argument, the proceduralist "should not,"[21] and develop a model of judicial role and statutory drafting based on the use of statutory mud and statutory crystals which satisfies that constraint. I argue that the role of the bankruptcy judge, in a world free of the proceduralist

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20. *See generally* Lon L. Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353 (1978); *see also* Frost, *supra* note 9, at 75, 91.

21. As would many bankruptcy scholars, who Baird deems "traditionalist," at least insofar as it applies to the role of judges. While the proceduralists and traditionalists may differ over whether the Bankruptcy Code should embody redistributive or consumer protective policies, *compare* WARREN, *supra* note 13, at 777 ("I see bankruptcy as an attempt to reckon with the debtor's multiple defaults and to distribute the consequences among a number of different actors."), *with* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 820–21 (1987) ("[I]n a world in which all assertions of ownership are stayed (as they are in bankruptcy), how much a particular owner gets should have nothing to do with how a firm's assets are used or whether it stays in business."), few, if any, traditionalist scholars suggest that bankruptcy judges should go beyond the mandates of the statute to benefit particular types of creditors at the expense of others.

presumptions about bankruptcy cases and judicial competence,[22] would be to identify abusive creditor and debtor behavior. I further argue that both the proceduralist and the traditionalist could agree on a least common denominator definition that characterizes abuse as unilateral behavior by either the creditor or the debtor that is likely to reduce the value of the firm.[23] The purpose of muddy rules is to allow such behavior to be brought before a judge, and as a second order effect, to alert the parties to the possibility that abusive behavior (either ex ante or ex post) will be presented to a judge and sanctioned. *In short, muddy rules can and should be used in the Bankruptcy Code to discourage inefficient non-cooperative behavior between and among transacting parties.*

This model of statutory drafting and judicial behavior, crafted within the confines of the proceduralist "should not," counsels a statute that looks a lot like the current bankruptcy statute and suggests a judge that looks a lot like the traditionalist judge that the proceduralists fear. I argue, therefore, that the proceduralist "should not" alone is insufficient to create the prescriptive divide that exists.[24] Instead, the divide appears to lie over the proceduralists' "cannot"—over whether judges *can* distinguish abusive from non-abusive behavior.

In Part IV, I explore the implications of the proceduralist "cannot" by relaxing the assumption of judicial competence and demonstrate that even the proceduralist "cannot" does not generate an argument for wholesale limitation of judicial discretion. Even if one assumes incompetent judges, a consistent proceduralist would allocate muddy and crystalline rules much the same way as under the assumption of competent judges. The rationale, however, would be slightly different. Instead of relying on the judge to spot abuse, the purpose of the muddy rule would be to increase the cost of non-cooperative behavior in contexts where such abuse is likely. The curious result, however, is that, *rationale notwithstanding, these two different sets of assumptions yield similar approaches to statutory drafting.*

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22. Constrained only by the principle that redistribution should only be in the name of increasing the size of the bankruptcy pie.

23. This is not to say that there are not some real differences buried in this definition. There are disagreements about how the "maximized" value of the firm should be divided among stakeholders and about whether the positive and negative externalities of a firm's existence should be considered when "valuing" the firm. By describing this definition as a least common denominator, I am arguing that this definition identifies a type of behavior that both proceduralists and traditionalists would view as abusive. Traditionalists might find additional forms of creditor behavior abusive, while proceduralists might find certain additional debtor behavior abusive. In adopting this definition, I seek to answer the proceduralists on their own terms.

24. A second proceduralist "should not" is beyond the scope of this Article. Proceduralists take the view that the Bankruptcy Code itself should not disturb non-bankruptcy entitlements, while traditionalists argue that the Bankruptcy Code may properly seek to redistribute the burden of personal and business failure among creditors. The Warren and Baird articles, *supra* note 21, reflect differing views regarding this second "should not."

In Part V, I give selected examples of "bad crystals," proposed by bankruptcy reformers and bankruptcy scholars, and show that they reflect both a misunderstanding of the role of mud in statutory drafting and, in some cases, a desire by interest groups to lock in legislative gains, rather than a desire for efficiency.

II. COMPETING WORLD VIEWS AND THE ROLE OF BANKRUPTCY JUDGES: "SHOULD NOT" VERSUS "CANNOT"

For a dozen years, the world of bankruptcy scholarship has been divided into two camps, the "proceduralists" and the "traditionalists."[25] Broadly speaking, the two camps split along two axes. The first division is normative, over whether Congress or bankruptcy judges should pursue redistributive goals in the name of "bankruptcy policy." The proceduralists view the sole goal of bankruptcy as generating the highest return for creditors, while traditionalists see a role in bankruptcy for protecting groups harmed by failure, such as employees, tort victims, retirees, and even the surrounding community.[26] The second division is empirical, over the institutional capacity of bankruptcy judges to achieve either the goal of social equity or even efficient disposition of assets.[27] In this section, I explore the scholarly divide and seek to show how these two axes, respectively the proceduralist "should not" and the proceduralist "cannot," appear, at first glance, to drive the proceduralist preference for limited judicial discretion and crystalline rules in bankruptcy.

A. The Proceduralist, the Traditionalist, and the Bankruptcy Judge—Thesis and Antithesis

According to Douglas Baird, three litmus test questions, or axioms, determine a scholar's affiliation. These questions are (1) whether the Bankruptcy Code should seek to rehabilitate firms; (2) whether bankruptcy judges should alter non-bankruptcy entitlements in order to rehabilitate firms; and (3) whether bankruptcy judges are capable of distinguishing likely candidates for reorganization from firms that are destined to fail. The paradigmatic proceduralist answers "no" to each question, while the paradigmatic traditionalist answers "yes" to all three. In this section, I will look briefly at each question, and show how, layer upon layer, each answer appears to reinforce the proceduralist's preference for crystals and the traditionalist's fondness for mud.

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25. *See* Baird, *supra* note 8.

26. *See* GROSS, *supra* note 13, at 19–24 ("Looked at as a society's mechanism for addressing these many failures, bankruptcy becomes a receptacle for some of society's most weighty problems. It cannot be dismissed as insignificant. Bankruptcy is like a three-legged stool, once the third leg—the interests of the community—becomes visible.")

27. *See infra* note 69.

1. Redistribution and the Bankruptcy Code

The first litmus test focuses on whether the Bankruptcy Code incorporates (or should incorporate) redistributive goals. Baird asks: should bankruptcy law seek to rehabilitate firms?[28] The traditionalist says yes. To quote Elizabeth Warren:

> To the extent that it reallocates assets from a particular party to the group as a whole, thereby enabling the sale of an intact business or a reorganization effort, the Code carries out a deliberate distributional policy in favor of all those whom a business failure would have hurt. The choice to make bankruptcy "rehabilitative" represents a desire to protect these parties along with the debtor and creditors who are more directly affected.[29]

The traditionalists' Code seeks to protect jobs and communities.[30] Proceduralists, by contrast, see any such efforts as doomed at best and counterproductive at worst. "Firms must live or die in the market. All bankruptcy can do is ensure that fights among creditors and other investors...do not accelerate a firm's liquidation."[31] Baird's proceduralist nonetheless salvages a role for bankruptcy law. Proceduralists distinguish between two types of distress, financial and economic, one which bankruptcy can help resolve, and one which it cannot.[32] The distinction turns on whether the firm is worth more to the creditors dead than alive.

Economic distress is an incurable disease. A firm in economic distress produces a product or service that nobody wants. Baird evokes the image of a bad Chinese restaurant or a suburban pizza parlor that doesn't deliver.[33] In Baird's

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28. *Id.* at 577.

29. Elizabeth Warren, *Bankruptcy Policy Making in an Imperfect World*, 92 MICH. L. REV. 336, 355 (1993). According to Baird, "The traditionalists believe that bankruptcy law serves an important purpose in rehabilitating firms." Baird, *supra* note 8, at 577. Note, however, that even when Warren speaks of redistribution, it is against the background of 11 U.S.C. § 1123(a)(7), the best interests test of the Bankruptcy Code, which states that no plan of reorganization can be confirmed unless each creditor receives more under the Chapter 11 plan than they would have received from a liquidation under Chapter 7. *See generally* Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is it Anyway?*, 70 N.Y.U. L. REV. 993 (1995).

30. *See* GROSS, *supra* note 13, at 19–24 (providing the most recent exposition of this position).

31. Baird, *supra* note 8, at 578.

32. *See id.* at 580–81.

33. *See* Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173, 183 (1987). Baird has used the restaurant example before, though he locates it in a small town:

> Consider the following example. A restaurant in a small town serves heavy, overpriced food that few want. There is a rapid turnover of employees. Waiters come and go particularly quickly because the absence of business means that there is little in the way of tips. The owner of the restaurant is unhappy because he is losing money and all his friends always complain to him about the food and prices at his

view, "[O]ne cannot justify a bankruptcy law whose goal is to prolong the life of a bad restaurant."[34] By contrast, financial distress is the province of bankruptcy law. Financial distress arises when the underlying business is sound, but is not earning sufficient income to pay its debts. In the proceduralist world, "[T]he aim should be to ensure that a firm's assets are put to their best use."[35] As Baird sees it, "The mission of bankruptcy is to ensure that firms do not fail simply because they have creditors they cannot pay. A market economy works when firms that cannot compete effectively are allowed to fail."[36]

If the world were this simple and markets worked that well, there would be no reason for bankruptcy law at all.[37] At least in theory, the market, and hence the creditors, should realize that the business is worth more as a going concern than if divided piecemeal and should be able to restructure the debtor's finances consensually. Baird's principal contribution to the debate in his earlier work, alone[38] and in conjunction with Thomas Jackson,[39] has been recognizing that insolvency creates a "common pool" problem. The first-in-time principle of state debt collection law[40] creates a collective action problem among creditors that cannot be resolved without some form of government intervention.[41] Baird writes:

> restaurant. He was much happier in his old job as a bank loan officer. This restaurant is a firm that has failed.

Id.

34. Baird, *supra* note 8, at 582. Baird offers this example:

> [A] toy manufacturer borrowed a large amount of money to develop and market a toy tied to a movie that later flopped. The people responsible for this debacle have left the firm. The current managers are now the best in the business. Nevertheless, this huge loan and the firm's other obligations exceed the value of the firm itself. The firm is in fine shape with respect to everything it now does, but it cannot pay its debts. This firm is in *financial* distress.

Id. at 580–81 (emphasis added).

35. *Id.* at 582.

36. *Id.* One can accept Baird's distinction between financial distress and economic distress without accepting the entire proceduralist agenda. Along with this distinction, Baird's proceduralists also harbor a skepticism about the cognitive abilities of judges and specifically about their ability to distinguish between economic and financial distress. Conversely, the proceduralist holds no such skepticism about the ability of the market to make such distinctions accurately. *See id.* at 588.

37. Advocates of "contract" bankruptcy take this view, arguing that there is no need for bankruptcy law to solve the collective action problem described by Baird and Jackson, because creditors can solve this problem, at the time of lending, by entering into "bankruptcy contracts" *ex ante*. *See* Rasmussen, *supra* note 11, at 51; Schwartz, *supra* note 10, at 1820–21.

38. *See* Baird, *supra* note 33, at 183–84.

39. *See* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

40. Outside of bankruptcy, state law creates various mechanisms that allow creditors to enforce debt obligations by empowering them to seize assets of the debtor. These include enforcement of consensual security interests, foreclosure of judgment liens,

> Without a collective bankruptcy proceeding, each creditor will tend to rush towards the debtor's assets when the best course is patience. For example, all the creditors might agree, if they were able to meet and bind one another, that it was in their best interest to give the restaurant owner a second chance. The restaurant might work with a new chef and a new menu, and the value of a successful restaurant—even discounting for the chance of a second failure—is much greater than the value of a restaurant's equipment sold piecemeal. But only a collective proceeding, such as the one federal bankruptcy law provides, might give these diverse owners the chance to pursue such a goal.... In short, we may not desire a world without bankruptcy because the self-interest of creditors leads to a collective action problem, and a legal mechanism is needed to ensure that the self-interest of individuals does not run counter to the interests of the group.[42]

Under the proceduralist view, however, the role of bankruptcy law and of the bankruptcy judge is limited to conquering this collective action problem and preventing inefficient liquidations.[43]

The traditionalist, as described by Baird, does not envision a bad restaurant, but instead a factory in a small town.[44] Unlike the failure of a

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and garnishment. The common theme is that once one creditor has "perfected" its property interest in a particular piece of the debtor's property, that property is no longer available to the other creditors. *See* 11 U.S.C. § 544 (1994).

41. *See generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (rev. ed. 1971). As creditors realize that the debtor is in trouble, they become participants in the so-called "race of diligence," turning to state law debt collection remedies and grabbing up the property of the debtor in satisfaction of their debts. Forbearance is foolhardy in such a situation, because the forbearing creditor runs the risk that other creditors will seize property during the forbearance. *See* Baird, *supra* note 33, at 183–84.

42. Baird, *supra* note 33, at 183–84; *see also* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 749–50 (1988) ("Because bankruptcy is a collective proceeding, the bankruptcy judge has the power in some cases to bind nonconsenting parties. Without such a power, there would be no way to overcome the collective action problem that is the justification for bankruptcy in the first instance."); Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 50 (1997) (noting that the state law collective action problem creates a need for bankruptcy law).

43. Contract bankruptcy scholars, such as Barry Adler, Robert Rasmussen, and Alan Schwartz, have carried Baird's position even further, arguing that the collective solution required for efficient behavior upon insolvency can be reached through contracts or corporate charter terms negotiated before credit is extended. *See supra* note 11 and accompanying text. Indeed, such contracts are possible as a theoretical matter, but there are many situations where either the cost associated with negotiating such contracts *ex ante* or information problems that exist at the time of contracting may render it impossible or impractical to put such arrangements in place. *See* Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 ILL. L. REV. 503 (2001).

44. *See* Baird, *supra* note 8, at 582–83:

restaurant, the failure of the factory may have significant spillover effects (negative externalities, to use the economist's term). Employees may lose jobs, suppliers may lose customers, and the economy of the whole town could suffer. As Baird describes it, when looking at a lemon (the bad restaurant), the proceduralist says liquidate. Indeed, he points out, so, grudgingly, would the traditionalist.[45] Similarly, when looking at an apple or an orange (the factory), the traditionalist says reorganize, but even the proceduralist[46] grudgingly recognizes that some breathing space may be necessary to counteract the collective action problem that is inherent in state law debt collection devices.[47] The difference here lies not in what to do in a particular case, but "in the presumptions one brings."[48]

The proceduralist position on this first axiom thus turns on two presumptions: (1) that markets work efficiently; and (2) that the firm and its creditors are internalizing the costs of its operation and will internalize all of the costs of its failure.[49] These assumptions inhere in Baird's choice of the

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> The disputes a firm has with its creditors present a court with an opportunity to solve a number of different problems.... If the firm closes, workers lose their jobs, suppliers lose a crucial customer, and the economy of the entire town is thrown into jeopardy. These spillover effects justify a bankruptcy law that prevents creditors from [seeking to] destroy the firm in pursuit of their narrow self-interests. To be sure, one cannot ignore market forces forever, but bankruptcy law creates a breathing space that mitigates the harshness of these forces and gives firms, their workers and their communities a second chance.

Id.

45. *See id.* at 583 ("Both traditionalists and proceduralists recognize the difference between a bad restaurant in a large town and a large factory in a small one. Everyone would agree that the former is a less likely candidate for a successful reorganization than the latter.").

46. *See id.* It should be noted, however, that Baird would take a slightly different route than would Korobkin or Gross. Korobkin and Gross think that saving jobs is an end in itself. *See* GROSS, *supra* note 13, at 206–14; Korobkin, *supra* note 13, at 741. Baird would likely argue instead that the sunk costs and thin markets may give significant leverage to creditors with a security interest in the debtors' assets. These creditors will have a strong incentive to use this leverage to extort value from other creditors. The result of bargaining is likely to be inefficient, and bankruptcy law protection is therefore necessary. *See* Baird, *supra* note 8, at 583. Baird's rationale for this breathing space lies in a hypothetical "creditor's bargain." He suggests that if the creditors had bargained *ex ante* over the appropriate insolvency regime, they would have chosen one that includes breathing space for the debtor upon insolvency. Not all proceduralists agree with Baird on this point; they would go further and suggest that there is no reason to rely on a hypothetical bargain where actual bargaining is (they believe) possible. *See, e.g.*, Rasmussen, *supra* note 11, at 51; Schwartz, *supra* note 10, at 1820–21.

47. *See* Baird, *supra* note 33, at 184.

48. Baird, *supra* note 8, at 583.

49. This last assumption, in particular, pervades the proceduralist literature. *See, e.g.*, Schwartz, *supra* note 10, at 1815–17 ("[C]ommunity protection is important only when an insolvent firm would be difficult for a community to replace. Bankruptcy law should not attempt to protect communities even in this case, however, for efficiency and equity

proceduralist paradigm, the bad restaurant in a big city. The restaurant is surrounded by relatively robust real estate, capital and labor markets. Employees should be able to find other jobs in the restaurant industry. The fixtures can be sold at auction, and the space can likely be relet within a reasonable time. It is also realistic to think that all of the parties are at the table. While a good restaurant can do wonders for a neighborhood, and may have positive spillover effects, a bad one does not. Also, the number of parties involved is relatively small, so there should not be significant collective action problems.

The traditionalist paradigm—the large factory in the small town—reverses both of these presumptions. The assets owned by the factory are not liquid, and labor markets for trained employees do not always function smoothly. Creditors are diffuse. It may be difficult to negotiate with all creditor and investor constituencies simultaneously, and finally, both the positive and negative externalities associated with the factory's operations make it quite likely that a fair number of affected parties (many of whom will even be creditors) will not be at the table as the owners negotiate with investors and creditors outside of bankruptcy.[50]

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reasons."); Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 589 (1999). Schwarcz wrote:

> I assume that allowing prebankruptcy contracting under the limited circumstances contemplated in this article would not make a debtor's managers more likely to engage in risky ventures for the benefit of the shareholders. For example, managers might gamble the proceeds of a loan made possible by a prebankruptcy contract in order to maximize shareholder value even though such a gamble would prejudice involuntary creditors.

Id. But this assumption has been cast into question by the work of Lynn LoPucki and Lucian Bebchuk. *See* Lucian Ayre Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994). One notable exception here is Robert Rasmussen, who appears to acknowledge that the subordination of tort claimants and other voluntary claimants may create an opportunity for firms to externalize some of the risk of their operations. *See* Rasmussen, *supra* note 11, 64–66. To the extent that Rasmussen would accord priority to these claims, his work is exempt from this criticism.

50. *See* Lynn LoPucki, *The Unsecured Creditors Bargain*, 80 VA. L. REV. 1887, 1898–1901 (1994) ("The tort example illustrates the fundamental nature of security. It is not as Jackson and Kronman present it, a contract among debtor, secured creditor and unsecured creditor. Only the debtor need sign; the 'consent' of the unsecured creditor is implied in the best case and a blatant fiction in the worst."). Baird's opposition to rehabilitation in the name of reorganization appears at first to be based purely on utilitarian grounds. In other words, Baird's view is that in a world where markets generally work, it is unlikely that the externalities associated with failure will be so great that they will swamp the interest of the creditors who determine the debtor's fate. It is not, by any means, clear that this view is shared by other "proceduralists," many of whom appear to oppose redistribution on moral grounds. *See* Susan Block-Lieb, *supra* note 43. Thus, there appears to be a divide within the proceduralist camp between those who take a social welfare maximizing approach and use a Kaldor-Hicks definition of efficiency, and those who take

As such, when the two academic "schools" paint different pictures of bankruptcy law, they do so not because of a fundamental disagreement about what to do on a particular set of facts, but instead, like the proverbial blind men examining different parts of the same bankrupt elephant, they disagree over the dominant paradigm. Is the elephant a rope, a tree, or a wall? Is the debtor a bad restaurant that makes inedible egg rolls or undelivered pizza, or Chrysler with a cash-flow problem? The question is not "who is right?" but "who is right when?" and "who is more likely to be right more of the time?" The choice drives one's view of how decision-making authority ought to be allocated between the statute, judges, and the market. If one envisions a failing restaurant, a simple streamlined statute with limited judicial involvement will suffice. If one is trying to maximize the value of a factory, a more ambitious statute, and more judicial involvement, may be required.

2. Redistribution and the Bankruptcy Judge

The next fault line (the second "axiom") turns not on the paradigmatic bankruptcy case, but on the paradigmatic bankruptcy judge. To what extent should bankruptcy judges be permitted to interfere with pre-bankruptcy entitlements?[51] As Baird articulates it, proceduralists think that "ex ante effects matter," while traditionalists do not.[52] Bankruptcy judges should apply contracts and statutes as written and should not adjust pre-bankruptcy entitlements "ex post." If bankruptcy judges seek to make the best of a bad situation at the time of failure, rather than simply adjudicating rights based on pre-bankruptcy and non-bankruptcy entitlements, debtors will forum shop into bankruptcy.[53] Firms will file for bankruptcy to take advantage of special bankruptcy rules or sympathetic bankruptcy judges.[54] Therefore, the role of the proceduralist's bankruptcy judge should be limited to enforcement of non-bankruptcy entitlements, conquering the collective action problem and facilitating the sale of the debtor's assets. Judicial activism (in the form of ex post readjustment of pre-bankruptcy legal entitlements) should not, according to the proceduralist, be tolerated in bankruptcy judges.[55]

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creditor welfare maximizing approach and use Pareto optimality as the definition of efficiency. Again, the argument in this Article proceeds from the second and narrower of these two approaches, but that is not the only defensible position.

51. It is important to recognize here that the focus is on the judge, not on the statute. Baird does not appear to be focusing here on statutory protections for employees or tort claimants or victims of fraud. While such protections are, on some level redistributive, because they are written into the statute, they become, in effect, implied terms in the terms of credit *ex ante*.

52. Baird, *supra* note 8, at 589–90.

53. *See* Baird, *supra* note 21, at 824–27.

54. *See id.*

55. *See* Baird, *supra* note 8, at 589 ("Traditionalists support a type of judicial activism that legal scholars do not encounter elsewhere."). Note that even here, the paradigm seems to control the prescription. This is true, even if one does not, as Baird does not, think that community interests need to be considered along with those of the creditors and investors in the firm. Baird recognizes that the creditors of an insolvent business face a

Traditionalists, by contrast, would allow judges to modify some pre-bankruptcy entitlements, ex post, in the interest of rehabilitating debtors or in the interest of fairness as it appears after the fact. This worries the proceduralists because it alters the breach and performance incentives of the law of contracts[55] and the incentives to take reasonable care in the law of torts[57] that exist outside of bankruptcy. Proceduralists therefore fear that the traditionalists' favored bankruptcy regime will discourage contracting ex ante, because potential contracting parties will know that the debtor will be able to hide from the consequences of its behavior in bankruptcy, and may encourage unreasonably risky behavior for the same reason.

Note again, however, that the proceduralist objection to judicial reallocation of non-bankruptcy entitlements is apparently based on the utilitarian goal of maximizing wealth, rather than a libertarian opposition to redistribution. Indeed, it appears to be judicial discretion, as a product of muddy rules, and not redistribution per se that troubles the proceduralist here. After all, if bankruptcy entitlements are known by the contracting parties ex ante, they become in effect part of that bargain. Parties can adjust their contracts to account for the bankruptcy rule.[58] The evil here is mud. The bankruptcy-specific rule may not in fact be a rule at all. It may merely consist of a mandate to the judge to do justice. "Traditionalists," says the proceduralist, "support a type of judicial intervention and judicial activism that legal scholars do not encounter elsewhere."[59] But Baird's account of what is typical in the non-bankruptcy world may not be entirely accurate. While the type of judicial behavior advocated by traditionalists is not common in commercial cases outside of bankruptcy, it is not particularly unusual in public law litigation.[60] Operating from a private paradigm, however, Baird's

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collective action problem, and that negotiated solutions which preserve going concern value are therefore notoriously difficult to arrange outside of bankruptcy. The factory, with disbursed and numerous creditors, will face a significantly worse collective action problem than the pizza parlor. If the factory is worth more as a going concern, every creditor has an incentive to use what leverage it has to exact the largest possible share of that value. Without the procedural protections (hence "proceduralism"), there would be many inefficient liquidations. *See supra* notes 33–34. Thus, more involvement by the judge may be necessary in these larger, more complicated cases.

56. For a discussion of the theory of efficient breach, see generally E. ALLAN FARNSWORTH, CONTRACTS § 12.3, at 761–65 (3d ed. 1999); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 117–28 (4th ed. 1992). *See also* L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52 (1936); Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457 (1897).

57. *See* POSNER, *supra* note 56, at 163–67.

58. This does not answer the efficiency objection completely. Imagine that bankruptcy contains a rule intended to protect employees from the full force of business failure. This rule will influence every company that contracts in anticipation of bankruptcy. The rule will be efficient only if the benefit to employees outweighs the social cost of including this bankruptcy specific rule in every contract.

59. Baird, *supra* note 8, at 590.

60. *See infra* note 78 and accompanying text. While the proceduralists seek to assimilate bankruptcy into a purely private paradigm, the traditionalists (as described by Baird and exemplified by Korobkin and Gross) seem to follow a more purely public mode.

fear of ex post adjustment morphs into a fear of bankruptcy judges with a roving mandate to do equity, and the fear of judicial discretion turns further into a preference for crystalline over muddy rules.

3. Efficiency and Judicial Competence

This leads to the third proceduralist axiom. Traditionalists view bankruptcy judges as different from other judges, and the difference manifests itself, again, in a preference for mud over crystals. The traditionalist views the judge's role in the case as central, indeed heroic:

> Most of the action takes place in discussions and negotiations among the various players, mediated by the bankruptcy judge who decides discrete issues of law while steering the players in the right direction.... [T]he bankruptcy judge brings parties to the bargaining table. The judge forces them to negotiate and compromise, while simultaneously ensuring that rights are protected and that the substantive goals of bankruptcy are vindicated.[61]

See generally GROSS, *supra* note 13; Korobkin, *supra* note 13. This article takes the view that bankruptcy law can create value over and above that which would exist in its absence, and that no particular creditor has an *a priori* claim to that reorganization value. As such, there is room for the judge and/or Congress to reallocate that surplus in the interest both of correcting market failure and serving other legitimate governmental goals. *See generally* Mann, *supra* note 29. In this regard, bankruptcy law is public, and the bankruptcy judge, like a federal district judge, must be able to function in the public mode.

The approach advocated in this Article draws on both the economic and traditionalist accounts but follows neither precisely. Like the proceduralist, I assume that the goal of a business bankruptcy case is to achieve a socially efficient result. Unlike the proceduralist, I don't assume that such an efficient result can be achieved by parties bargaining *ex ante*, because I don't assume that all interested parties are at the table when an entity incorporates, or even when an entity borrows. Limited liability and the institution of secured credit render it axiomatic that there will be negative externalities associated with the operation of a business that fails. Collective action problems inherent in any complex business organization will also mean that important creditor interests will not be effectively represented in the bankruptcy bargaining process. Thus, bankruptcy law has a role in correcting inherent imperfections in the market. Employees and tort claimants, for example, may have an interest that needs to be protected in the bankruptcy case.

61. Baird, *supra* note 8, at 593; *see, e.g.*, Warren, *supra* note 13, at 351–52. As Elizabeth Warren puts it:

> Bankruptcy Courts also directly influence efforts to enhance the value of the bankruptcy estate. These courts enjoy enormous discretionary power that they can use to enhance the value of a failing business. Judges must make countless decisions—whether to permit the assumption of an executory contract, to appoint an examiner, or to approve the terms of a postpetition financing agrement—based on their assessment of what will yield the largest returns for the estate. In addition, a number of statutory provisions specifically require the court to exercise commercial judgement. For example, the judge must choose between competing valuations to decide whether a debtor may substitute collateral, or to evaluate business projections to determine if a reorganization plan is

For the traditionalist, muddy rules are a free ticket to court-guided discourse. To the proceduralist, by contrast, "giving discretion to the judge makes sense only when she is well-positioned to use it."[62]

The proceduralists *do not* view the bankruptcy judge as well positioned to intervene or to guide. To the proceduralist, the job of the judge, if she were up to it, would be to distinguish firms that are economically sound but financially distressed (the factory in a small town with a large outstanding tort claim) from firms that are not economically sound and are therefore financially distressed (the bad restaurant). Baird looks to the path-breaking work of cognitive psychologists Daniel Kahneman and Amos Tversky on endowment effects to support his view that bankruptcy judges are not up to that task. Baird states:

> As human beings, we tend to weigh more heavily the events immediately before us. As a result, we have a natural tendency to underestimate the effects of bankruptcy on those who are not in court and whose stories cannot be told with particularity. We can try to correct for this built-in bias when we use our intuitions, but there are few reliable benchmarks to help us.[63]

The proceduralist believes that judges will be biased in favor of reorganization because of their desire to help out the parties before them. It is this skeptical view of judges that makes crystalline statutory drafting and presumptions about the paradigmatic bankruptcy case so important. On the one hand, the proceduralist view that judges are incompetent leads to the view that discretion must be limited. On the other hand, the proceduralists must recognize that statutes are relatively inflexible, and necessarily over and underinclusive. Therefore, the governing presumption will determine the outcome in many cases. Because the proceduralist envisions a pizza parlor and an incompetent judge, the proceduralist prescribes a minimalist judge who rules only when she has to, and a

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> reasonably calculated to support its proposed payout. These fact-specific inquiries demand that judges make careful business decisions, as well as thoughtfully apply legal principles.

Id.

62. Baird, *supra* note 8, at 593. The view that bankruptcy judges are ill-equipped for this task is expressed most directly by Christopher Frost:

> The bankruptcy process is institutionally incapable of resolving the loss distribution issues among all who are interested in the outcome of the case. Even assuming that the social costs accompanying business failure should be spread over a broad base, the judicial system is particularly ill-equipped to make the types of judgments required to distribute losses in a way that bears any resemblance to rational policy.

Frost, *supra* note 9, at 77.

63. Baird, *supra* note 8, at 587 & n.40 (citing Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1342–46 (1990); Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCHOL. 207, 208 (1973); Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124, 1127–28 (1974)).

minimalist statute that gives the judge limited discretion so that rulings should rarely be necessary.[64]

B. The Proceduralist "Cannot" and the Proceduralist "Should Not"

Baird declares the debate indeterminate, unresolvable through empirical research, and ultimately resolvable only through a "study of aesthetics and morals."[65] The answer turns on whether one believes that it is moral to use bankruptcy to achieve redistributive goals. Baird's proceduralist pretty clearly thinks not. This conclusion does not appear, however, to be driven purely by the utilitarian reasoning that Baird uses throughout the article. The proceduralists' moral subtext is that Robin Hood was an outlaw, not a hero. However, neither the utilitarian's empirical instincts nor the libertarian's moral imperative are sufficient to yield the proceduralist prescription for the crystalline statute and minimalist bankruptcy judge.

The proceduralist vision of the judge and the proceduralist preference for crystals require two distinct moves. The first, described above, is based either on "morals" or on empirical instincts about bankruptcy cases. The second is based instead upon empirical instincts about the relative institutional capacities of judges and markets. Disentangling these two distinct moves demonstrates the extent to which the prescription for crystalline drafting turns on the proceduralist view of judicial competence.

1. The Proceduralist "Should Not"

Baird's first two axioms, that bankruptcy judges should not favor reorganization and that bankruptcy judges should not engage in post hoc reallocation of pre-bankruptcy entitlements, while justified on efficiency grounds, are both based on a moral judgment, supported by an empirical instinct, that I have labelled the proceduralist "should not." This proceduralist "should not" comes in both a strong version and a weak version. The strong version is based on what Susan Block-Lieb has described as a neo-libertarian moral view that disfavors redistribution of wealth, and thus exalts, and declares inviolate, non-bankruptcy entitlements.[66]

This is not, indeed cannot be, the vision that Baird advocates. In such a world, there is no room for bankruptcy law at all. Baird and Jackson, though not all proceduralists,[67] operate from a somewhat weaker perspective, recognizing that

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64. Curiously, Baird does not appear to feel that he needs to explain why cognitive imperfections of judges as decision-makers automatically render them inferior to markets (with their own peculiar and acknowledged imperfections) or, for that matter, legislatures (with their own susceptibility to interest group capture).

65. *See* Baird, *supra* note 8, at 599 & n.84 (quoting Ronald Coase and citing Frank H. Knight).

66. *See* Block-Leib, *supra* note 43.

67. Some advocates of contract bankruptcy would not even go this far. *See, e.g.*, *supra* note 11.

non-bankruptcy entitlements may need to be modified in order to, and only in order to, resolve the collective action problem that is created upon insolvency. What they oppose is redistribution for its own sake, not redistribution that increases the value of the bankruptcy estate.[68]

2. The Proceduralist "Cannot"

The difficulty faced by the proceduralist in advocating limited discretion for bankruptcy judges is that once one has moved to the weak version of the proceduralist "should not," where does one stop? One can justify a powerful judicial role, at least in some cases (the financially distressed, but economically sound, factory in a small town, with diffuse creditors who individually have an incentive to seize assets). The proceduralist must, therefore, make a second move. This is what I have labelled the proceduralist "cannot." Baird argues that even if we assume that cases exist where the exercise of judicial discretion in order to facilitate an efficient (pareto superior) reorganization would be justified, bankruptcy judges are not capable of identifying them. If the judge cannot distinguish likely candidates for reorganization from unlikely ones, the appropriate response is to advocate the minimalist judge.[69]

Baird develops his view of judicial capability more fully elsewhere,[70] while in another article, *Bankruptcy, Redistributive Policies and the Limits of the*

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68. This weak version of the proceduralist "should not" is embodied, as a matter of positive law, in the "best interests test" contained in §§ 1129(a)(7) and 1325(a)(4) and (5) of the Bankruptcy Code. A plan of business reorganization under Chapter 11 and a wage earner's plan under Chapter 13 cannot be confirmed unless every creditor receives more than she would have in liquidation. Reorganization must be Pareto superior. This is the hypothetical creditor's bargain advocated by Baird and Jackson—the bargain that the creditors would, presumably, have agreed to in advance of bankruptcy, had they had the opportunity to bargain. *See* JACKSON, LOGIC AND LIMITS OF BANKRUPTCY LAW, *supra* note 14, at 7–19.

69. The views of Christopher Frost are typical here. *See* Frost, *supra* note 9, at 75. Frost notes:

> While this institutional capability argument has been made by several economic theorists, including Baird and Jackson themselves, the concern has been inadequately developed in favor of the forum-shopping argument. But there is more to the institutional capability argument than has been heretofore made. Rather than being an adjunct to the forum-shopping concerns that dominate the economic analysis, the argument deserves elevation to an independent justification for an investor-focused bankruptcy regime.

Id. at 91 (citation omitted).

70. *See* 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, 102–03 (1984). Baird and Jackson's limited view of the bankruptcy process turns, at least, on the difficulty of the task facing bankruptcy judges:

> Fashioning remedies for all the harm a failing business may bring is difficult and beyond the competence of a bankruptcy court. The wider effects of the failure of a particular enterprise are not easy to assess. A

Judicial Process,[71] Christopher Frost uses the limits of judicial capacity to justify the proceduralist vision, arguing that even if one were to accept redistribution in favor of community interests as an appropriate goal of bankruptcy law, bankruptcy judges are not institutionally well suited to accomplish this goal.[72] Baird's use of the competence argument is even more aggressive than that of Frost, arguing that judicial competence, or lack thereof, renders bankruptcy judges unable to distinguish efficient reorganizations from inefficient ones.[73] Thus the proceduralist[74] preference for crystalline rules over muddy ones seems to be driven by a weak version of the proceduralist "should not," coupled with a strong version of the proceduralist "cannot."

C. Proceduralists, Traditionalists, and the Background Debates

Bankruptcy law does not exist in a vacuum, and neither does bankruptcy scholarship. The two key proceduralist moves have a deeper provenance that needs to be unpacked and situated. Each axiom is linked to older, non-bankruptcy, scholarly debates, each of which in turn rests on its own set of assumptions. Once these "background debates" are disaggregated, the relationship between the proceduralist "should not," the proceduralist "cannot," and the preference for crystalline rules becomes even clearer.

> principal characteristic of a market economy is, after all, that some firms fail, and postponing the inevitable or keeping marginal firms alive may do more harm than good.

Id. But they go further and register doubt regarding the capabilities of the judges themselves:

> Bankruptcy judges...seem to show either an inability or an unwillingness to comprehend the possibility that secured credit may be something more than a perverse and unfair creature of state law that should be thwarted at every turn. Even more remarkable is their wonderful capacity for hope, their unshakeable faith that, given time, the firm's ship will come in. Often, bankruptcy judges seem to think that markets systematically undervalue firms that have filed petitions in bankruptcy. A bankruptcy judge may insist that he, not the market, is the one best positioned to set a value on a firm in distress, even though year after year in case after case his valuations prove wildly inflated.

Id. at 126–27; *see also* James J. White, *Harvey's Silence*, 69 AM. BANK L.J. 467, 469 (1995) ("[C]ritics note that mostly Chapter 11 does not operate as a reorganization procedure but as a procedure for slow liquidation.").

71. Frost, *supra* note 9.

72. *See id.* at 134.

73. *See supra* note 70.

74. This is distinct from what Susan Block-Lieb describes as the neo-libertarian position taken by some advocates of "contract bankruptcy." *See* Block-Leib, *supra* note 43. These scholars, Block-Lieb argues, operate from a strong version of the proceduralist "should not." *See id*; *see, e.g.*, Schwartz, *Contract Theory*, *supra* note 10, at 1821–22 ("Firms could finance more projects if they had more freedom to contract, and they would have better incentives to maximize value.").

1. Efficient Capital Markets

The first background debate is over efficient capital markets.[75] The proceduralist assumption of efficient markets forms one of the bases for the proceduralist "should not" and underlies the proceduralist "cannot." The shadow of the debate can be found in Baird's dueling bankruptcy paradigms. The proceduralist envisions a restaurant in a big city; the traditionalist envisions a factory in a small town. A single restaurant does not gain much from bankruptcy law. It has relatively few creditors, and must earn their trust, inside or outside of bankruptcy, to reorganize. Once that trust is lost, no bankruptcy judge will be able to replace it. Similarly, society does not lose much if it fails. If the location can support a restaurant, then a new one will likely appear; if the location cannot, one will not. Assets can be shifted relatively easily. Restaurant fixture auctions are common. There is an after-market in the things restaurants use.

If markets are working well and the transaction costs associated with shifting assets are low, then limited goals for bankruptcy law and limited discretion for bankruptcy judges are appropriate. Where, however, the debtor is one with significant startup costs and substantial transaction costs associated with shifting assets in the wake of business failure—the factory—the calculus shifts. Even if one assumes that the sole goal of the bankruptcy system is efficiency, one should be willing to devote more social resources to preventing the failure of a viable factory than a bad restaurant.[76] In short, the proceduralist accuses traditionalists of ignoring the costs associated with bargaining in the shadow of failure, but the proceduralist minimizes the cost of failure itself. The proceduralist can do this because she's assuming a restaurant, not a factory. In short, a presumption that markets are functioning increases the likelihood that a market solution will be more efficient than any solution hammered out by a judge. If the market makes few errors, then judicial errors are placed in higher relief.

2. Judicial Role

The second background debate is the debate over the role of judges (not just bankruptcy judges). It is, after all, the bankruptcy judge who must decide whether, in a particular case, to lift the stay and allow the creditor to foreclose on its collateral, or to deny the motion and give the debtor a chance to attempt to reorganize. This discussion implicates the proceduralist "cannot." Lon Fuller, in his classic article, *The Forms and Limits of Adjudication*,[77] argued that the judicial system is at its best when it is deciding two party disputes over clear legal rules,

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75. *See, e.g.*, Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 910–17 (1989).

76. Who should contribute these resources is, of course, a separate question. To the extent that a business reorganization in bankruptcy succeeds, and all creditors are better off, the question is academic. Where, however, the bankruptcy fails, and some creditors are rendered worse off by the effort of the factory to reorganize, the question is who should bear the burden of failure.

77. Fuller, *supra* note 20, at 394–404. For an updated version of the Fuller argument in the bankruptcy context, see Frost, *supra* note 9, at 124–25.

but that the system is not well equipped to deal with multiparty, polycentric disputes. Such disputes are better left to the legislature. In the late 1970s, Abram Chayes launched an academic response with his article, *The Role of the Judge in Public Law Litigation*,[78] and was joined a year later by Owen Fiss with his article, *The Forms of Justice*.[79] Both conceded that the need to vindicate important public rights that were either constitutionally or statutorily created forced judges into unaccustomed roles in multiparty disputes. Fiss and Chayes, however, did not, like Fuller, shy away from this new role. Instead, they embraced it—Fiss from a moralistic perspective, and Chayes focusing on figuring out how best to judge in this unaccustomed mode.[80] Both Fiss and Chayes assumed that judges were competent to adjudicate these public rights (or at least more competent than legislatures and markets).

In the early eighties, a third vision of the judge emerged: the judge as mediator. The alternative dispute resolution movement advocated alternative forms of judging to resolve disputes.[81] The proceduralist favors Fuller's judge, while casting the traditionalist judge in the role of the public law mediator. Both the role of the judge that the proceduralist posits and the ex ante perspective that she champions presuppose a purely private pizza parlor, not Chrysler.[82] Indeed, when Baird describes the judge outside of bankruptcy, he describes a particular type of judge dealing with a particular type of case. The bankruptcy judge should function like a private law judge deciding a commercial dispute.

When the paradigm shifts to the factory, however, the legitimate goals of bankruptcy law (even if driven solely by the desire to maximize social (and perhaps even limited to creditor) welfare) may become broader and the picture of the judge may shift, because the factory, with its externalities, takes on some of the attributes of a public institution. In response, the proceduralist shifts to competence—the proceduralist "cannot." The proceduralist likens the traditionalists' judge to a mediator and suggests that such judging may do more harm than good. Indeed, judicial incompetence appears to have become the

78. Abram Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281 (1976); *see also* Abram Chayes, *The Supreme Court, 1981 Term—Foreword: Public Law Litigation and the Burger Court*, 96 HARV. L. REV. 4 (1982).

79. Owen M. Fiss, *The Supreme Court, 1978 Term—Foreword: The Forms of Justice*, 93 HARV. L. REV. 1 (1979).

80. *See* ROBERT M. COVER ET AL., PROCEDURE (1988); OWEN M. FISS & DOUGLAS RENDLEMAN, INJUNCTIONS (2d ed. 1984).

81. *Compare* STEPHEN B. GOLDBERG ET AL., DISPUTE RESOLUTION: NEGOTIATION, MEDIATION, AND OTHER PROCESSES (3d ed. 1999), *with* Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073 (1984).

82. Some skeptics of the bankruptcy system have argued that Chapter 11 instead provides a mechanism for old equity to bargain for deviations from absolute priority. While such deviations are not uncommon in consensual plans of large public companies, Lynn LoPucki has argued that the value of the equity retained does not significantly affect the recovery of other creditors. *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, 141–43 (1990) (showing mostly nominal recoveries for shareholders of insolvent companies in bankruptcy reorganization).

rallying cry for of a broader neo-formalist program. Recently Bob Scott has argued that limitations on judicial access to information counsel in favor of formalistic interpretation of contracts by judges,[83] while Adrian Vermeule has argued that limits on judicial competence suggest formalistic judicial interpretation of statutes.[84] Thus, while the proceduralist acknowledges that not all bankruptcy cases can be forced into Fuller's mold, she is distrustful of the bankruptcy judge as mediator and despairs of "efficient" public law judging. The proceduralist therefore appears willing to drive those cases out of the system that cannot be resolved by a bankruptcy judge operating in the classic adjudicative mode.

3. Crystals and Mud

The third and final background debate is the competition between crystalline and muddy rules (sometimes characterized as rules and standards).[85] This is where the action is. Crystalline rules minimize judicial discretion, clarify property boundaries, and shift resource allocation decisions out of court and into the market place.[86] The reason for this turns on one of the earliest "law and economics" insights.[87] When parties to a dispute are making the decision whether to litigate or settle the case, they will only litigate to and through trial if they have different assessments of the likely outcome of the trial. If they agree on what will happen in court, they will be able to arrange a market transaction outside of court "in the shadow of the law."[88]

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83. *See* Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847 (2000).

84. *See* Adrian Vermeule, *Interpretive Choice*, 75 N.Y.U. L. REV. 74 (2000).

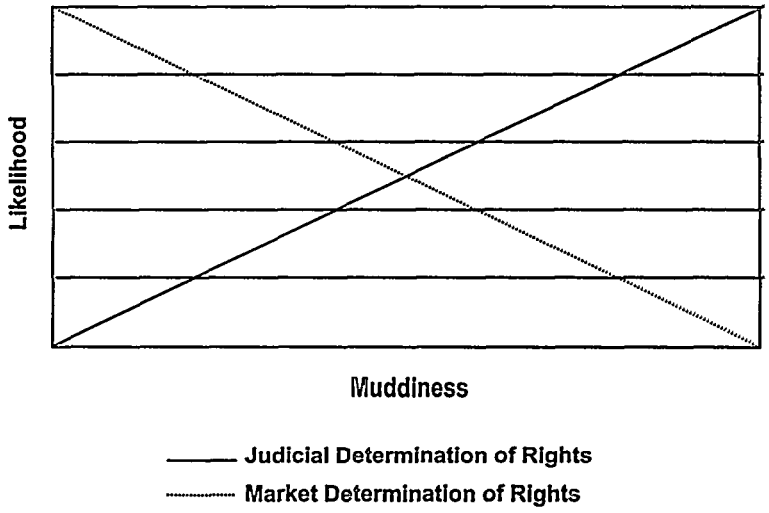
85. *Compare* Rose, *supra* note 1, *with* RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE 42–61 (1990); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976).

86. The mud and crystals distinction often gets confused with the distinction between property rules and liability rules, but they are not the same. *Compare* Rose, *supra* note 1, *with* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972); Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027 (1995); Carol M. Rose, *The Shadow of the Cathedral*, 106 YALE L. J. 2175 (1997). Where property rules and liability rules divide over remedy (whether a non-consensual taking can be purchased by paying damages or will instead be punished by criminal sanction), mud and crystals divide over the clarity of the substantive legal entitlement.

87. *See* RICHARD POSNER, ECONOMIC ANALYSIS OF LAW, 554–66 (4th ed. 1992).

88. *See* Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 951 (1979).

Fig. 1-Institutional Choice As a Function of Certainty of Legal Entitlement



This dynamic is presented graphically in Figure 1. As the muddiness of the legal rule increases (moving to the right on the x-axis), so does the likelihood (moving up the y-axis) of a judicial determination of rights (the solid line has an upward slope). As the rule becomes more crystalline (moving to the left on the x-axis), the likelihood of a market decision increases (the dotted line has a downward slope). As such, each of the three preceding background debates will manifest itself as a preference for either a clear or a muddy rule. If one thinks that the market will work well in a particular context, there is little reason for judicial intervention. A crystalline rule is best. If one thinks that the market is not functioning well, in a systematic way that can be judicially corrected, a muddy rule may be preferred. Similarly, if one thinks that judges are institutionally better suited, for whatever reason, to resolving the dispute (be it a traditional two-party dispute or a polycentric public dispute) than the legislature or the market, a muddy rule should be favored over a crystal.

When, then, should crystalline rules be used in bankruptcy law, and when is mud preferable? In the next two sections of this Article, I explore this question in two stages. The first stage is to ask what would happen if one were to accept the proceduralist "should not" but reject the proceduralist "cannot." How would the proceduralist define her ideal judge, and what statutory architecture would follow? I conclude that the ideal "competent" proceduralist judge would seek to identify and prevent "abuse" in the form of inefficient non-cooperative behavior. I then argue that crystalline and muddy rules should be allocated within the Bankruptcy Code to allow the judge to identify "abuse" when it is most likely. The second stage is to ask whether acceptance of the proceduralist "cannot" changes the preferred approach to statutory drafting. I conclude that the answer is no. Even if bankruptcy judges cannot distinguish abusive from non-abusive behavior, the effect of muddy rules is to increase the cost of non-cooperative behavior. Consequently, at least in bankruptcy, one may view muddy rules as a commitment device that encourages cooperative behavior. If one agrees with Baird and Jackson

about the existence of a collective action problem upon insolvency, the approach to statutory drafting with incompetent judges will be virtually the same as the approach to statutory drafting with competent ones.

III. BANKRUPTCY JUDGES AND STATUTORY DESIGN—ASSUMING JUDICIAL COMPETENCE

If the proceduralist could choose an ideal judge, what would that judge do, and how would one design the Bankruptcy Code around such a paragon? In this section, I seek to work within the proceduralist framework, accepting the (weak) proceduralist "should not," at least insofar as it applies to judges, but assuming judicial competence. I argue that the goal of that judge would be to identify and prevent abuse (defined as inefficient non-cooperative behavior).[89] I argue further that under this assumption, crystals and mud should be allocated throughout the Bankruptcy Code to expose abusive behavior to judicial scrutiny.

A. Crystals and Mud—Statutory Drafting and Institutional Choice

As noted in the introduction, the debate between the traditionalists and proceduralists is one of institutional choice fought out over clear versus muddy rules. Broadly speaking, the proceduralist favors crystalline rules articulated by Congress and interpreted by the market, while traditionalists favor muddy rules, or standards, implemented by judges and lawyers. Indeed, one way of characterizing the proceduralist objection to "reorganization" as a goal of the bankruptcy system is that it has the effect of muddying crystalline non-bankruptcy legal entitlements.

The automatic stay—§ 362 of the Bankruptcy Code—provides a demonstration of the muddying effect of bankruptcy law. The automatic stay stops the pre-bankruptcy race to dismember a debtor by muddying the secured creditor's state law right to pick up her marbles and go home by liquidating her collateral.[90] Imagine that the Perfectly Private Pizza Parlor borrows money secured by its pizza ovens, or that Chrysler borrows money against its inventory of spare parts. Outside of bankruptcy, the secured creditor might simply foreclose (repossess and sell the pizza ovens or auto parts). If the debtor, or the other creditors of the debtor, want to stop repossession and foreclosure, they have to negotiate a deal with the secured creditor. Inside of bankruptcy, the secured creditor cannot foreclose unless a judge says so.

The judge's decision whether or not to lift the bankruptcy stay[91] will turn on a number of "muddy" considerations, such as (1) the value of the collateral (the pizza ovens or auto parts);[92] (2) whether the collateral is necessary to an effective reorganization which is reasonably in prospect (can a pizza parlor stay in business without ovens? can an automobile be made without parts?);[93] (3) whether that

89. *See* discussion *infra* notes 98, 101.
90. *See* 11 U.S.C. §§ 362(d)(1), (2) (1994, Supp. IV 1998 & Supp. V 1999).
91. *See* 11 U.S.C. § 362.
92. *See* 11 U.S.C. § 362(d)(2)(A).
93. *See* 11 U.S.C. § 362 (d)(2)(B).

reorganization is "reasonably in prospect" (is the debtor a goner, or can the business be saved?);[94] and (4) whether the secured creditor's interest is "adequately protected" (are the pizza ovens or auto parts declining in value?).[95] By introducing these muddy rules, bankruptcy law displaces the market and the state law entitlement to foreclose, and substitutes judicial decision-making.

B. Adjudication and Abuse: Statutory Design and Judicial Role

If the choice between mud and crystals is a choice between legislatively driven, market-based dispute resolution on the one hand, and open-ended judicial decision-making on the other, what is it that the judge should do when it comes time to decide a dispute against the background of a muddy rule? In order to determine when judicial intervention is desirable, it is necessary to determine what judges should be doing. What is their appropriate role? The proceduralists draw a picture, borrowed from Lon Fuller, of the judge who simply enforces non-bankruptcy entitlements.[96] But this cannot be the limit of the judicial role. After all, as we saw in the last section, when rules are clear, parties settle. Judges most often have to decide when either the legal entitlement or the factual context is muddy, rather than when it is clear.

In this section, I assume a competent judge and ask, what would the proceduralist want a competent judge to do?[97] I argue that the role of judges generally is to identify and lay bare "abusive" behavior, however that may be defined, and that the role of muddy rules is to deter such behavior. The first part of this section argues that the role of the judge is to identify and prevent abuse, and that this is best accomplished with a judge operating from an adjudicative rather than a mediative stance. In the second part of this section, I seek to define "abuse" in the context of the Bankruptcy Code and suggest that the principal form of abuse in bankruptcy, indeed, a definition shared by proceduralists and traditionalists (at least as a minimum), is inefficient non-cooperative behavior.

1. Muddy Rules and Abusive Behavior

At the outset it is worth noting that crystalline rules are appropriate when behavior is so obviously inefficient that it can simply be proscribed. No judicial sorting is required to determine that a trustee who uses debtor funds to paint his house has violated legal norms. However, even with seemingly crystalline rules, it is not entirely possible to avoid uncertainty. Even a rule against theft can become difficult to apply on the margin.

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94. *See* United Sav. Ass'n v. Timbers of Inwood Forest Assoc., 484 U.S. 365, 376 (1988) ("[T]here must be a reasonable possibility of a successful reorganization within a reasonable time.").

95. *See* 11 U.S.C. § 362(d)(1) (1994, Supp. IV 1998 & Supp. V 1999).

96. *See generally* Fuller, *supra* note 20.

97. Note that this is a somewhat artificial question, in that much recent proceduralist scholarship argues for a "new formalism," based precisely on the fact that judges have few, if any, informational advantages over the parties. *See* Scott, *supra* note 83; Vermeule, *supra* note 84.

In her seminal article, *Crystals and Mud in Property Law*, Carol Rose suggests a role for the judge, adjudicating in the face of muddy rules, and for muddy rules themselves, that is consistent with the goal of economic efficiency.[93] When examining the effects of muddy rules, it is necessary to weigh their effects ex ante in addition to their effects ex post. Rose points out that muddy legal rules can have a salutary effect on commercial conduct at the time of contracting.[99] An open-ended rule[100] indicates to the parties to a transaction that, no matter how carefully they draft their agreement, on the front end, their negotiating conduct may, if things fall apart, be presented to the judge:

> From this perspective, as indeed the more sophisticated economic analyses tell us, crystalline rules seem less the king of the efficiency mountain than we may normally assume. One can argue that elaborate ex post allocations of responsibilities might be efficient too, even if they make people's entitlements fuzzier ex ante. The very knowledge that one cannot gull someone else, and get away with it, makes it less likely that anyone will dissipate time and effort in trying to find the gullible. This knowledge will also reassure those of us who fear we may be made fools; we can go about our business and take part in the world of trade without cowering at home because we think we need to hire a lawyer and an accountant every time we leave the car at a commercial parking lot.[101]

Open-ended rules thus have a two-layered effect. First, they increase the likelihood of judicial resolution of the disputed entitlement, and second, they force the parties to a contract, at the time of negotiation, to avert to the possibility that a judge may have to examine the transaction in the event of a subsequent dispute. The tendency, when looking at muddy rules, is to focus on the costs they impose at the time a deal is coming undone. At that point, they make it more difficult to reach a consensual resolution. However, as Rose notes, this ignores the effect of a muddy rule, ex ante, when the deal is being struck.[102] A muddy rule forces the parties to avert, during negotiation, to the possibility that the bargained-for result may, at the end of the day, appear to be unfair either to the parties or, worse yet, to someone who was not a party to the transaction. The need to consider "how it will look later" may make contracting more difficult, but it may also deter overreaching during negotiations. [103]

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98. Rose, *supra* note 1, at 600.

99. *See id.*

100. For a rule to have this effect, it is not sufficient that it be an open-ended default rule or a rule of clear statement. To have the desired effect on behavior, the rule must be an open-ended mandatory rule. See discussion *infra* Part IV.C.

101. Rose, *supra* note 1, at 600.

102. *See id.*

103. Calibrating damages to achieve the optimal level of deterrence may be a tricky business, and is beyond the scope of this article. Most of the rules discussed in this Article are enforced by injunction rather than damages. *See* Edward J. Janger, *Muddy Property Rules and Information Forcing in Bankruptcy* (unpublished manuscript on file with author). Nonetheless, the uncertainty created by muddy rules may reduce the value of

An open-textured rule, therefore, means that a judge may get an opportunity to identify and undo abusive or opportunistic behavior, either at the time of dispute or at the time of contracting (if it is unmasked at trial). This insight has implications for legislators. If the legislature is concerned that a particular type of negotiation is likely to give one party or another an opportunity to act opportunistically,[104] an open-textured rule may serve to deter that behavior both at the time of contracting, and at the time of dispute. *In short, muddy rules can be used in bankruptcy (and elsewhere) to deter abusive behavior between and among transacting parties.*

2. Adjudication v. Case Management

If the purpose of muddy rules, from a legislative perspective, is to deter abusive behavior with the threat of judicial decision-making, what does this view of rules say about the role of the judge? Should bankruptcy judges be principally adjudicators or principally mediators? In relation to bankruptcy law, Congress has behaved in a somewhat schizophrenic fashion. The 1978 bankruptcy reform sought to reinforce an adjudicative stance, while the 1994 amendments undercut that resolve. Prior to the enactment of the Bankruptcy Code in 1978, the bankruptcy judge (or referee) was responsible for the administration of the case.[105] One goal of the 1978 Code was to shift the bankruptcy judges into a more adjudicative mode in order to eliminate the perception of cronyism and bias inherent in practice under the Act.[106] The 1994 amendments appear to shift the

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entitlements that are protected by such rules. This reduction in value may cause muddy rules to underdeter in some cases. At the same time, muddy rules also create the possibility that non-culpable behavior may be found to be culpable. This may lead to overdeterrence in other cases. *See* John E. Calfee and Richard Craswell, *Some Effects of Uncertainty on Compliance With Legal Standards*, 70 VA. L. REV. 965, 996-97 (1984). If you assume, as I do in this section, (1) that the judge will be able to identify abuse accurately, and (2) that enforcement is by injunction, the level of deterrence should be, on average, optimal. This conclusion breaks down if one recognizes that litigation is costly, and legal fees may exceed the value of any recovery. *See* Keith N. Hylton, *Litigation Costs and the Economic Theory of Tort Law*, 46 U. MIAMI L. REV. 111 (1991). Hylton points out that to deal with this it may be necessary to shift attorney's fees to account for litigation cost.

104. *See* Edward L. Rubin, *Types of Contracts, Interventions of Law*, 45 WAYNE L. REV. 1903, 1910 (2000). Rubin states:

> The existence of a market failure such as information asymmetry does not mean that any contractual clause that is implicated by the failure should be automatically voided by public authorities. It simply means that the efficiency of the clause cannot be assumed from the fact that it was agreed to by a willing buyer and a willing seller. Thus, the public interventions of the criminal and contract law will not be sufficient, by themselves, to ensure an efficient result.

Id. at 1911.

105. *See* Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. L.J. 431 (1995).

106. *See generally* Thomas E. Plank, *Why Bankruptcy Judges Need Not and Should Not Be Article III Judges*, 72 AM. BANKR. L.J. 567 (1998).

balance back towards the pre-Code model. Rule 7016 now allows bankruptcy judges to encourage settlement during pretrial conferences,[107] and these amendments have led some judges to perceive their role as more mediative than adjudicative.[108]

Since the Bankruptcy Code appears to contemplate bankruptcy judges operating in both an adjudicative and a mediative mode, which is preferable? Jennifer Gerarda Brown and Ian Ayres, in their article, *Economic Rationales for Mediation*,[109] provide a framework for analyzing this question. They explore the benefits of mediators in resolving disputes. The principal benefit that they identify arises from the fact that mediators talk, separately, with the parties to the dispute. As a result, they are able to elicit and manipulate information that the parties would otherwise hold private. This ability to elicit information derives from the mediator's ability to talk to the parties one at a time and in the process to make certain commitments about how and when certain private information will be shared.[110]

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107. *See* Miller, *supra* note 105, at 435 ("Since 1978, the pressing need for efficiency in the prosecution of Chapter 11 cases has resulted in a continuing erosion of the principle of separation of judicial and administrative functions.").

108. *See id.*; *cf.* Korobkin, *supra* note 13, at 721 ("Because the participants' varied grievances typically reflect conflicting and fundamentally incommensurable values, bankruptcy law provides a forum for an ongoing debate in which diverse values can be expressed and sometimes recognized."). As Korobkin puts it:

> [B]ankruptcy rules structure the ensuing discourse, not only specifying particular occasions for debate, but providing a larger context in which participants in financial distress may contribute toward defining the aims of the estate as enterprise. In essence, bankruptcy rules create the discursive space in which the enterprise may realize its nature.

Id. at 775. Korobkin sees the judge as central to this discourse: "In arguing its case for or against special treatment, the creditor and other parties in interest offer for the court's consideration competing versions of what should be of value to the estate as enterprise....[T]he court must decide between incommensurable visions of what the estate shall exist to do." *Id.* at 778–79; *see also* GROSS, *supra* note 13, at 237–39 ("The contextual model does not require that the Bankruptcy Code be revamped from start to finish. It does free up judges to use their equitable powers.").

109. Jennifer Gerarda Brown & Ian Ayres, *Economic Rationales for Mediation*, 80 VA. L. REV. 323 (1994).

110. *See id.* at 326:

> Sequential caucusing is uniquely mediative: arbitrators generally do not conduct ex parte meetings with parties and negotiation necessarily requires the parties to meet together. By shuttling back and forth between meetings with individual disputants, mediators can collect and distribute private information. An economic rationale for mediation centers on caucusing because it is here that the mediator most clearly controls the flow of information between the disputants. Although our title refers to "economic rationales for mediation," probably a more illuminating description would be "economic rationales for mediative caucusing."

Id.

If, however, the benefit of mediation is the ability to hold sequential meetings with the parties, then a judge is uniquely ill-suited to perform this function. Ethical constraints on judges prohibit ex parte contacts between judges and litigants.[111] Judges must meet with the parties as a group, and are not, therefore, in a position to break down the information barriers inherent in private negotiation. Instead, the bankruptcy judge is limited to a role that is one-half judge and one-half facilitator. The judge has a limited number of tools to encourage settlements, and chief among these is the use of strategic hand-tipping to get the parties to settle. This facilitation is not worthless. The facilitator might help the parties get past hurt feelings and conduct discussions among the parties so that all players have an opportunity to speak. The facilitator may probe the parties' positions and establish an agenda.[112]

Adopting such a facilitative role may have costs, however. If mediation fails, the bankruptcy judge will be called upon to decide the dispute that she is facilitating. Thus any hand-tipping by the judge during negotiation (in the absence of a full record and without the procedural protections associated with a trial on the merits) will likely constrain the judge when the time comes to render a decision. As a result, such pretrial facilitation may impair the judge's role as an adjudicator.[113]

3. Adjudicating in the Shadow of Muddy Rules

To summarize, Carol Rose's abuse-based approach to muddy rules focuses not on what the judge does with his or her discretion, but on the effect that such discretion is likely to have on the parties to transactions that are negotiated in the shadow of the open-textured rule. However, this view of the role of muddy rules has implications for judges as well. The role of the judge that should be envisioned by judges themselves is not one that is purely minimalist, administering clear statutory mandates and exercising minimal discretion. Neither is it the maximalist mediative role envisioned by Korobkin.[114] Instead, the efforts of the judge should be focused on spotting and deterring abuse. The next question, then, is how should bankruptcy "abuse" be defined?

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111. *See* MODEL CODE OF JUDICIAL CONDUCT Canon 3 (1990).

112. *See* NANCY H. ROGERS & CRAIG A. MCEWEN, MEDIATION: LAW, POLICY, AND PRACTICE 9 (1989); *see also* Brown & Ayres, *supra* note 109, at 324 n.5 (citing numerous authorities, including STEPHEN P. DOYLE & ROGER S. HAYDOCK, WITHOUT THE PUNCHES: RESOLVING DISPUTES WITHOUT LITIGATION, 88–92 (1991); HOWARD RAIFFA, THE ART AND SCIENCE OF NEGOTIATION 108–09 (1982); LINDA R. SINGER, SETTLING DISPUTES: CONFLICT RESOLUTION IN BUSINESS, FAMILIES, AND THE LEGAL SYSTEM 20 (1990)).

113. *See* Judith Resnick, *Managerial Judges,* 96 HARV. L. REV. 374, 428 (1982) ("Having supervised case preparation and pressed for settlement, judges can hardly be considered untainted if they are ultimately asked to find the facts and adjudicate the merits of a dispute.") (citation omitted). Many of the benefits of mediation can be obtained by utilizing court annexed mediation, without impairing the role of the judge as an adjudicator.

114. *See* Korobkin, *supra* note 13, at 775, 778–79.

C. Judicious Deployment of Mud—The Role of the Judge in Business and Consumer Bankruptcy Cases

If muddy rules create an opportunity for judicial decision-making, and judges are tasked with preventing abusive or opportunistic behavior (either through judicial decision or bargaining in the shadow of a judicial decision), then the next question is what constitutes abuse in bankruptcy cases. In this section, I seek to define the judicial role in terms of the various bankruptcy abuses that might arise. This inquiry proceeds in three stages. First, I will look to the structure of the statute and the legislative history to describe the broad purposes of the Bankruptcy Code. In this regard, I seek to identify the least common statutory denominator—a purpose of the statute upon which both proceduralists and traditionalists can agree.[115] Traditionalists might wish the statute to do more, but proceduralists, at least those who work from the weak version of the proceduralist "should not," should be comfortable with this minimal statutory goal. Second, I will define abuse in light of this broad purpose, and third, I will look at the existing deployment of open-textured rules in the Bankruptcy Code to see if it is consistent with this definition of abuse.

1. The Purpose of the Statute—Business Bankruptcy

The precise legislative purpose behind the Bankruptcy Code's business bankruptcy provisions has been hotly debated, but there are certain areas of broad agreement that can be identified in the legislative history and in the statute as enacted.

a. Legislative History

At the very least, the Bankruptcy Code seeks to facilitate reorganizations that preserve the going concern value of businesses.[116] In so doing, it was thought, jobs and asset values would be preserved. As the House Report to the Bankruptcy Reform Act of 1978 states:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they are designed are more valuable than those same assets sold for scrap. Often, the return on assets that a business can produce is inadequate to compensate those who have invested in

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115. It is important not to overstate the amount of agreement. While both will agree that if the size of the pie can be increased, it should be, the agreement breaks down when it becomes necessary to balance distributional choices against the size of the pie.

116. Going concern value is generally defined as the value of the business in excess of the value of its constituent parts if sold of piece by piece. *See* MICHAEL GERBER, MARCIA GOLDSTEIN, LARRY GOTTESMAN & EDWARD JANGER, BUSINESS REORGANIZATIONS 76–77 (2d ed. 2000).

> the business. Cash flow problems may develop, and require creditors of the business, both trade creditors and long-term lenders, to wait for payment of their claims. If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.[117]

For the proceduralist, Congress saw reorganization as wealth maximizing because it allows assets to be used in the most efficient manner. For the traditionalist, by preserving jobs, reorganization allows people to continue to work in the positions for which they were trained (saving the cost of retraining), and by continuing production, it allows assets to continue to be used in the manner for which they were designed. But the traditionalist goals are reached by way of a proceduralist justification. Reorganizations are desirable because they save jobs and preserve business entities, but jobs are to be saved and entities preserved because to do so would be efficient.

b. The Bankruptcy Code

The Code, like the legislative history, has elements which support both the proceduralist and traditionalist visions. On the one hand, a number of elements of the Code seem clearly addressed to alleviating financial distress:

- First, the automatic stay[118] enjoins all efforts by individual creditors to collect on pre-petition debt. This has the effect of stopping the race of diligence, under which individual creditors proceed by exercising their state law remedies to dismember the debtor. By stopping individual debt collection, the various creditors are given an opportunity to determine, collectively, whether the debtor is worth more as a going concern or sold off piece by piece.
- Second, the sections of the Code which permit the debtor to use or sell property of the estate in the ordinary course of business[119] and borrow money post-petition[120] facilitate the continuation of the business while the creditors determine whether or not there is going-concern value to be protected.
- Third, class voting,[121] which allows majorities of creditor classes to bind dissenting class members, and the cram-down provisions,[122] which allow the bankruptcy court to confirm a plan of reorganization over the objection of a dissenting class, limit the power of holdouts.

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117. H.R. REP. NO. 95-595, at 220 (1977) (citations omitted).
118. *See* 11 U.S.C. § 362 (1994, Supp. IV 1998 & Supp. V 1999).
119. *See* 11 U.S.C. § 363 (1994).
120. *See* 11 U.S.C. § 364 (1994).
121. *See* 11 U.S.C. §§ 1126(c), (d) (1994).
122. *See* 11 U.S.C. § 1129(b) (1994).

- Fourth, the absolute priority rule ensures that non-bankruptcy entitlements are respected in bankruptcy.
- Finally, the best interest of the creditor test operates as a protection to the pre-petition creditors by ensuring that they can block a plan of reorganization if it offers them a less favorable return than they could obtain if the debtor were to liquidate.[123]

By contrast, a number of aspects of current bankruptcy law favor the traditionalist view without retaining the close tie to the goal of efficiency. A number of them are judge-made, and can be summed up in the concept that the debtor should be given some breathing room to rearrange its affairs.

- One aspect of this breathing space, which is clearly redistributive, was affirmed by the Supreme Court's decision in *Timbers*.[124] In that case, the court applied a plain language reading to the statute, and held that a debtor need not pay interest during the pendency of the case to undersecured creditors.[125]
- Second, the debtor's exclusive period to propose a plan of reorganization allows the debtor to maintain control of the debt-restructuring process for a brief period.[126] In the hands of a number of judges, it has become common to extend the exclusive period routinely until a plan can be proposed and confirmed.[127] This may limit the ability of the creditors to

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123. *See* 11 U.S.C. § 1129(a)(7). The Supreme Court's recent decision in *Bank of Am. Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999), also suggests that the Court may be thinking in proceduralist terms. Courts have been divided over the last five years over the continued vitality of the so-called "new value" exception to the "absolute priority rule" contained in 11 U.S.C. § 1129(b). *See 203 N. LaSalle*, 526 U.S. at 441–43. The issue was whether a court could confirm a plan of reorganization over the objection of an impaired class of unsecured claims, where the old equity owners obtained an interest in the reorganized debtor in return for a post-petition contribution of capital. *See id.* at 443. The Supreme Court held that a new value plan could not be confirmed where the only parties given an opportunity to bid on the new equity were the old owners. *See id.* at 454–55. The case suggests that the Supreme Court shares the proceduralist desire to use market mechanisms to ensure that the creditors obtain the highest possible return on their claims.

124. United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assoc., 484 U.S. 365 (1988); *see supra* note 91 and accompanying text.

125. *See id.* at 375. The effect of the *Timbers* ruling is to significantly reduce the cash outlay required to keep the debtor operating during the course of the bankruptcy case. It increases the burden of bankruptcy on secured creditors, both by reducing the payments to them during the pendency of the case, and by increasing the likelihood that foreclosure will be further delayed.

126. *See* 11 U.S.C. § 1121(b) (1994) (120-day exclusive period).

127. *See* Lynn M. LoPucki & William C. Whitford, *Corporate Government in the Bankruptcy Reorganization of Large Publicly Held Companies*, 141 U. PA. L. REV. 669, 693, 717 n.177 (1993) (finding, in a 1993 study of reorganizations of public companies, that in 34 of 43 cases studied, exclusivity was extended for the duration of the case). For

expose the company to the market,[128] but it may also help the judge to limit the effect of unreasonable creditor behavior.

- Third is the case law under § 365, which allows a debtor to compel a non-debtor to perform its obligations under a contract with the debtor, even though the debtor is not performing its own pre-petition obligations under the contract.[129]
- Fourth, the presumption against appointing a trustee in Chapter 11 cases gives the debtor significant leverage over creditors during the early stages of a case.[130]

On the one hand, this quick review of the broad structure of the Bankruptcy Code and of its legislative history might appear inconclusive regarding the "purpose" of the statute. However, neither the proceduralist nor the traditionalist would dispute that one goal of the statute is to encourage cooperation among creditors, at least for the purpose of determining the highest and best use of the debtor's assets.[131] As Baird has noted, the principal obstacle to such an outcome is unilateral action by creditors to enhance their recovery at the expense

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examples of cases where exclusivity was extended, see *In re* AMKO Plastics, Inc., 197 B.R. 74, 77 (Bankr. S.D. Ohio 1996) (finding adequate cause for extending exclusivity where debtor instituted "an extensive turn-around program" (to which creditors did not object) because debtor would not be in a "position to propose a plan to its creditors...until the results of the turn-around manifest[ed] themselves"); *In re* Gibson & Cushman Dredging Corp., 101 B.R. 405, 410 (E.D.N.Y. 1989) (finding adequate cause for extending exclusivity where creditors were "recalcitrant" and unwilling to negotiate with debtor about plan of reorganization and there was no "danger of dissipation of assets to the creditor's detriment").

128. *See, e.g.*, 11 U.S.C. § 1121(b). The Supreme Court's recent decision in the *203 N. LaSalle* case may go a long way toward limiting the benefits of an extension of exclusivity, as a new value plan may not be confirmable under 11 U.S.C. § 1129(b) (1994) unless the exclusive period has been terminated. *See generally 203 N. LaSalle St. P'ship*, 526 U.S. 434.

129. *See* Data-Link Sys., Inc. v. Whitcomb & Keller Mortg. Co. (*In re* Whitcomb & Keller Mortgage Co.), 715 F.2d 375 (7th Cir. 1983); *In re* Gunter Hotel Assoc., 96 B.R. 696, 700 (Bankr. W.D. Tex. 1988). Under these cases, the debtor may be able to stay in business by compelling non-debtors to perform their contract obligations, even though the debtor may not, pre-petition, have complied with all of the conditions precedent to that performance.

130. *Compare In re* Sharon Steel Corp., 871 F.2d 1217, 1218 (3d Cir. 1989) (appointing a trustee where incumbent management had been shown to have wasted assets of the debtor), *with In re* Crescent Beach Inn, Inc., 22 B.R. 155, 159 (Bankr. D. Me. 1982) ("[S]ome degree of mismanagement exists in virtually every insolvency case."). The fact that trustees are only infrequently appointed gives incumbent management significant power in the early stages of a bankruptcy case. Note, however, that in most large bankruptcy cases, incumbent management is replaced at some point in the case, whether or not a trustee is appointed. *See* LoPucki & Whitford, *supra* note 127, at 727.

131. The disagreement arises over whether encouraging cooperation should be limited to conquering the so-called collective action problem or should go further.

of the creditor body.[132] All of the Code sections described above, which are described as supporting the proceduralist view, serve this end.

2. The Role of the Judge—Business Bankruptcy

a. Abuse Defined

Even if one accepts the divided view of the bankruptcy world, it is striking to note that neither a proceduralist nor a traditionalist would contest that the essential role of the bankruptcy judge in a business case is, at the very least, to identify and control inefficient unilateral debt collection by creditors and inefficient use of the bankruptcy process to continue a doomed business by debtors. Inefficient unilateral debt collection is not "abusive" in any moral or ethical sense; it is not abusive for a secured creditor to seek to enforce her collection rights by asking the bankruptcy court to lift the stay. It may, however, be abusive in the context of a collective bankruptcy proceeding. For example, an oversecured creditor may choose to foreclose on its collateral and shut the debtor down, even though the debtor is worth more as a going concern. Such unilateral behavior may lead to deadweight loss.[133]

The proceduralist would argue that the bankruptcy judge's role should be limited to the prevention of such abuse, and the proceduralist paradigm of the bad restaurant would suggest that the presence of thick markets and market discipline would make creditor abuses rare; as such, they would focus on debtor abuse. By contrast, the traditionalist would assume thin markets and a greater role for the judges in preventing creditor abuse and would find debtor abuse of the system unlikely. If one assumes, however, that judges are able to determine what type of case and what type of behavior are before them, both proceduralists and traditionalists should be able to agree on the following basic principles:

1. The role of judges is to detect abusive (i.e., inefficient, non-cooperative) behavior, such as:
   a. debtors using bankruptcy strategically to capture value from creditors;
   b. creditors using leverage to extort preferential treatment during the bankruptcy;

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132. *See* Baird, *supra* note 33, at 183–84.

133. As one early reader of this Article asked:

> Why is it abusive for the secured creditor to say: "I am entitled to be paid full value today. If you pay me today, I will go away. If you don't pay me, I will not cooperate in anything that defers me because it necessarily exposes me to risk of nonpayment later through devaluation of my collateral.

E-mail from Ronald Mann, Professor of Law, University of Michigan, to Ted Janger (September 17, 2000) (on file with Author).

c. creditors using leverage to endanger an efficient reorganization in order to extort a larger share of the debtor's reorganized value.

2. Creditor abuse is more likely in cases where:

a. markets are thin;[134]

b. creditors are numerous and diffuse;[135]

c. important claimants, such as diffuse tort or trade claimants, are not active in the bankruptcy.

3. Debtor abuse is more likely in cases where:

a. markets are thick;[136]

b. creditors are few;[137]

c. all claimants are present and active in the case.

Thus, if one is applying the weak version of the proceduralist "should not," bankruptcy judges should gauge their involvement in bankruptcy cases on whether markets are likely to be functioning well or poorly with regard to a particular debtor. Where markets are functioning well, there is little need for the bankruptcy judge to force a cooperative solution. After all, valuation questions should be straightforward for the parties to resolve and the deadweight loss associated with failure is likely to be small. By contrast, however, where markets are not functioning well, either because of information problems, illiquid assets, assets that are difficult to value, or widely disbursed creditors, the judge should be prepared to become more involved.

The Bankruptcy Code, as presently written, can easily accommodate judging focused on inefficient, non-cooperative behavior. If one looks at the rules intended to enforce cooperation, discussed above, they are all muddy rules which turn on the same two questions: (1) whether the debtor has going concern value that needs to be protected (i.e., is the debtor using bankruptcy to extort value from creditors); and (2) whether the creditor is seeking to use the suit to enhance its recovery at the expense of a reorganization that is reasonably in prospect. The questions of lifting the stay, extending exclusivity, compelling assumption or rejection of an executory contract, and confirming a plan over the objection of creditor class all require the judge to determine whether unilateral creditor action (foreclosing, proposing a competing plan, or breaching a contract, for example) by an individual creditor will harm the estate and whether, on the other hand, pursuing the reorganization will work harm on the creditors.

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134. This gives important creditors extra leverage.

135. On the one hand, this may give certain imporant creditors the ability to extract value from more diffuse unrepresented creditors, but it may also give rise to the possibility of an alliance between the debtor and an important creditor at the expense of the other creditor.

136. There is less need for reorganization procedures.

137. There are few obstacles to negotiation outside of bankruptcy.

On the debtor side, the Code will not allow a debtor to stay in bankruptcy unless there is reorganization value to be preserved. If there is no value to be protected, the judge may, for example, lift the stay and allow the creditor to foreclose, or even dismiss the case.[138] On the creditor side, creditors cannot use their leverage to extort a better distribution by threatening the reorganization effort. Lift-stay motions,[139] motions to dismiss,[140] motions to extend exclusivity,[141] and plan confirmation[142] all require the judge to address these two fundamental questions at various stages in the case, and in so doing, allow the judge to focus on these potential abuses. If there is value to be protected, the judge should leave the stay in effect, continue exclusivity, give the debtor time to decide whether to assume or reject contracts, and so on. In short, the judge should encourage cooperation among the creditors where cooperation will preserve asset value. By contrast, if there is no value to be protected, the court should allow the piecemeal liquidation of the debtor. In each case, the abuse is inefficient, non-cooperative (or opportunistic) behavior, In each of these cases, an open-ended rule is used to allow the judge to identify it.[143]

b. Revisiting the Proceduralist "Cannot"

Viewed in this light, the Bankruptcy Code, as currently drafted, contains a fairly sophisticated deployment of open-textured rules predicated on the idea of competent judges who are able to detect abuse. To the extent that the proceduralists who follow the weak version of the proceduralist "should not" object to this use of muddy rules to allow the judge to enforce cooperation, their objection cannot be based solely on the desire to avoid redistribution. If competent judges follow the principles stated above in an even-handed manner, the bankruptcy system will operate solely to correct the market imperfection created by the collective action problem inherent in state debtor/creditor law.

The proceduralist objection appears instead to be based on the proceduralist "cannot"—the belief that judges will not be able to fulfill their assigned role. They will be unable to value assets or gauge the prospects for

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138. *See* 11 U.S.C. § 362(d) (1994, Supp. IV 1998 & Supp. V 1999); 11 U.S.C. §1112(b) (1994).

139. *See* 11 U.S.C. § 362(d).

140. *See* 11 U.S.C. § 1112.

141. *See* 11 U.S.C. § 1121(d).

142. *See* 11 U.S.C. § 1129.

143. In this context, "inefficient" must be judged against the background of what the statute requires. For example, some judges might conclude that a debtor who is unable to pay interest on undersecured claims is engaging in "debtor" abuse. Here, however, it would be inappropriate to lift the stay because the *Timbers* rule prohibits it. *See* United Sav. Ass'n. v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 372, 382 (1988). As noted above, this Article seeks to bracket redistribution contained in the statute, and focus, to the extent possible, not on what the rule should be, but upon whether it should be muddy or crystalline. To put it another way, whether or not one thinks that the *Timbers* rule is wrong does not alter the analysis of whether the rules for lifting the automatic stay should be clear or muddy.

reorganization. Markets may be imperfect, but judges will always be worse. Judges, the proceduralists would argue, will virtually always be a second-best alternative to markets. By contrast, the traditionalist fondness for the current scheme is based on the view that judges are capable of the task assigned to them.

3. The Role of the Judge—Consumer Bankruptcy

a. Statutory Goals

The debate between traditionalists and proceduralists (and this Article so far) has focused on business cases. This is due, at least in part, to the fact that relatively little judicial time is spent on most consumer cases. As Karen Gross has noted:

> At a 95% level of statistical reliability, business Chapter 7 cases occupied 40 minutes per case of judicial time, whereas nonbusiness Chapter 7 cases occupied 10 minutes of time per case. On average, judges spent 38 minutes on each Chapter 13 case. Judges spent on average 456 minutes [seven and one-half hours] on each Chapter 11 case, with the amount of time increasing with the size of the case.[144]

Moreover, the goals of consumer bankruptcy are different. In business cases, the goal is to preserve going concern value that inheres in a business enterprise. When individuals file for bankruptcy, except those rare individuals whose personal affairs are inextricably intertwined with their business, going concern value is not an issue. Instead, the goals are to give the honest but unfortunate debtor a fresh start and to ensure equality of distribution among similarly situated creditors.[145] The questions that must be posed are (1) what must

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144. GROSS, *supra* note 13, at 132; *see also* Peter Alces, *Book Review: Failure and Forgiveness: Rebalancing the Bankruptcy System*, 15 BANKR. DEV. J. 383, 386 (1999) (reviewing GROSS, supra, note 13).

145. A number of citations to the legislative history of the Bankruptcy Reform Act support the conclusion that the purpose of the Act is to give honest but unfortunate debtors a fresh start:

> The result of the increase in consumer debt has been a corresponding increase in the number of consumers who have overburdened themselves with debt. Often, these consumers are able to keep up with their obligations in normal times, but have saved very little for emergencies or unexpected events. When a family member takes seriously ill or when the breadwinner is laid off from his job, a financial crisis ensues. In many cases, a young family of two, both working, incur a large amount of debt. If the wife stops working because of pregnancy, the family loses nearly half of its income, and has an extra member to feed and shelter. The family will go deeper and deeper into debt to support themselves, until finally the roof falls in.
>
> The vast majority of consumer financial crises are of these kinds. Aggressive advertising and sales techniques by the consumer credit industry, many of whose members rely more on quantity of loans than on quality to make a profit, add to the problems young families

a debtor do in order to earn a fresh start; and (2) how should the debtor's possessions be allocated as among the various creditors and between the creditors and the debtor's fresh start? The consumer bankruptcy system offers two options to the debtor. The debtor may choose Chapter 7, where the debtor commits all of his or her non-exempt assets to payment of creditors in return for a discharge and the right to keep all post-petition wages, or the debtor may choose Chapter 13 and commit all disposable income for three to five years to the payment of creditors in return for a fresh start and the right to retain non-exempt assets.

b. Defining Abuse

Abuse on the creditor side is concerned with attempts to violate the principal of equality of distribution and attempts to interfere with the debtor's fresh start.[146] Abuse on the debtor side is focused on attempts to secret assets or to avoid paying creditors where the debtor has the ability to do so.[147] However, if Karen Gross's numbers are correct about how much time judges spend on Chapter 7 cases, the judge will have virtually no interaction with the case other than to sign the discharge order. Similarly, thirty-eight minutes per Chapter 13 case will allow time for the judge to hold a confirmation hearing and handle one or two lift-stay motions or plan-modification hearings. In the vast majority of consumer cases, the bankruptcy judge will have little or no substantive interaction with the case. What

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> encounter. When the crises finally erupt, the experience of the industry in collecting from overburdened debtors allows it an enormous advantage against the inexperienced and generally distraught consumer. Harsh collection practices heaped on top of already serious financial problems often result in ill health, family strain and divorce. Bankruptcy often provides the only remedy. Thus, the number of bankruptcies has risen over 2000 percent in the past 30 years. The rise has paralleled the rise in the amount of consumer credit outstanding.

H.R. REP. NO. 95-595, at 116 (1977) (citations omitted).

> Some consumer debtors are unable to avail themselves of the relief provided under Chapter 13. For these debtors, straight bankruptcy is the only remedy that will enable them to get out from under the debilitating effects of too much debt. The purpose of straight bankruptcy for them is to obtain a fresh start, free from creditor harassment and free from the worries and pressures of too much debt. Unfortunately, the current Bankruptcy Act, last revised at a time when the consumer credit industry was in its infancy, does not provide consumer debtors with adequate relief.
>
> The two most important aspects of the fresh start available under the bankruptcy laws are the provisions of adequate property for a return to normal life, and the discharge, with the release from creditor collection attempts. Current law is deficient in both of these areas. H.R. 8200 offers consumer debtors significant protections in and after straight bankruptcy that are not now available, and remedies the inadequacies of current law.

H.R. REP. NO. 95-595, at 125 (1977).

146. *See, e.g.*, 11 U.S.C. §524(c) (1994).

147. *See supra* note 145.

this indicates, more than anything else, is that relatively few creditors find it worth their while to raise objections in bankruptcy cases. Most of the time, the stakes are simply not high enough.[148]

c. Practical Limits on Judicial Involvement

Judges simply don't spend much time on consumer cases. Debtors cannot afford to pay their lawyers to appear at contested hearings, and generally, even if a creditor wins, there is not likely to be much in the way of recovery. If there is no money to pay the creditor, and no prospect, then there is no reason for the creditor to object to discharge even if the debtor's behavior was culpable. Thus, under the law as currently constituted, honest but unfortunate debtors get a discharge but so do some dishonest debtors. It is simply too costly to identify the dishonest ones, and little is to be gained by creditors from doing so. Second, most consumer cases simply are not that complicated. Most debtors have only a few important creditors, a few important assets—the house, the car, and a job. To the extent that creditors have reliable information about the extent of the debtor's holdings and the extent of other claims against the debtor, there are not significant obstacles to bargaining.

d. Crystals and Mud in Consumer Bankruptcy

For the most part, crystalline rules would therefore appear to be appropriate. Judicial involvement is only really necessary in one of three situations: (1) where the debtor is lying about the non-existence of assets or

148. *See* Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079, 1087–88 (1998). As Professor Warren has noted:

> The microdata suggest that the people who file for bankruptcy generally are those who need it.... In the early 1990s, for example, the typical family filed for bankruptcy with an annual combined income of about $21,200 (in 1997 dollars), compared with a median family income of about $42,400 (in 1997 dollars) for those not in bankruptcy. For many, their incomes represented a sharp drop over the preceding year as they coped with unemployment, downsizing, and self-employment as independent contractors. At the same time, their debts were staggering, far outstripping debt loads for most Americans. The ratio of consumer debt-to-income (which omits home mortgage debt), shows that at the median these debtors owed more than their annual income to doctors, hospitals, credit card issuers, finance companies, and other consumer lenders. On average, they owed so much in short-term, high-interest debt that every fifth paycheck would have to be used exclusively for interest payments on their debts just to stay even. If they could not afford to give up one paycheck every five weeks, then they would simply fall deeper into debt even if they never incurred another doctor's bill or another credit card charge or picked up any new rocks.

Id.; see also TERESA A. SULLIVAN, ETAL., AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 111 (1989) [hereinafter SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS]; Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981–1991*, 68 AM. BANKR. L.J. 121, 128 tbl.1 (1994).

income; (2) where the debtor has secreted assets pre-petition or is secreting them post-petition; and (3) where the creditor is endangering the debtor's fresh start. The deployment of muddy-open ended rules should be, and is, therefore, somewhat different in consumer cases.

In Chapter 7 cases, debtors get their discharge. The principal occasion for bargaining is between the debtor and his principal secured creditors over whether or not he can keep the car or the house[149] and with unsecured creditors over reaffirmations.[150] Thus, one would hope to see muddy rules where the goal is to govern the behavior of debtors and creditors, and that, more or less, is what we find. Rules regarding denial of discharge require a finding of debtor culpability by the judge. Either the judge must conclude that the debtor lied to creditors or to the court or that somehow the discharge would constitute a substantial abuse.[151] Otherwise, the debtor receives a global discharge. Similarly, with the exception of alimony and support, particular debts will be discharged unless the debtor has engaged in criminal or fraudulent behavior of some sort.[152] Pre-petition conduct is governed by state and federal fraudulent conveyance law[153] and perhaps the muddiest of all provisions in the Bankruptcy Code, the preference provisions.[154] With regard to creditor behavior, there is a great deal of confusion (as well there should be) over appropriate reaffirmation practices.[155]

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149. *See* SULLIVAN, WARREN & WESTBROOK, AS WE FORGIVE OUR DEBTORS, *supra* note 148, at 310 tbl.124 (finding that cars were the most frequently listed collateral for debtors' secured loans, with home mortgages coming in second). In many cases these assets are subject to liens that either exceed the value of the asset or leave no value left over for the estate after exemptions are applied. *See* Kenneth N. Klee, *Reforming Consumer Bankruptcy Law: Four Proposals Restructuring Individual Debts*, 71 AM. BANKR. L.J. 431, 446 (1997). Klee describes the typical consumer bankruptcy case as follows:

> If past is prologue, of the one million-plus individual bankruptcy cases that will be filed in 1997, about seventy percent will be individual Chapter 7 cases and about thirty percent will be Chapter 13 cases. These cases will average about eighteen creditors that are owed approximately $51,000 in debt, more than twice the average income of the debtors....In about ninety-six percent of the cases the debtors will have no nonexempt property.

Id. at 445–46.

150. Which are rarely a good deal for the debtor, and must be supported by an attorney affidavit. If entered into pro se, they are subject to judicial scrutiny under 11 U.S.C. § 524(c)(6)(A) (1994).

151. *See* 11 U.S.C. § 707(b) (1994, Supp. IV 1998 & Supp. V 1999).

152. *See* 11 U.S.C. § 523 (1994, Supp. III 1997 & Supp. IV 1998).

153. *See* 11 U.S.C. §§ 548(a), 547 (1994, Supp. IV 1998 & Supp. V 1999).

154. *See* 11 U.S.C. § 547.

155. *See* 11 U.S.C. §§ 524(c) (1994). There are two areas of uncertainty with regard to reaffirmation practice. The first area concerns whether a creditor can seek a reaffirmation, and the second concerns whether a debtor can "reinstate" a secured loan without reaffirming, post-discharge. These two issues illustrate nicely the distinction between muddy and crystalline rules. The rules governing reaffirmation practices are very muddy. The Code permits only "voluntary" reaffirmations. *See* 11 U.S.C. § 362 (1994, Supp. IV 1998 & Supp. V 1999). This muddy rule is aimed at creditor abuse.

In Chapter 13 cases, the debtor pays creditors out of disposable income rather than assets. In order to keep his or her assets, the payout in the Chapter 13 must exceed the payout that would have gone to the creditors if the assets had been liquidated in a Chapter 7 case. Muddy rules come into play first with regard to the valuation of assets that a debtor wishes to retain and second with regard to the calculation of the debtor's budget, which determines the lifestyle that the debtor will enjoy during the plan period. The most controversial "muddy" rule in the consumer bankruptcy system, however, involves the Chapter 7 versus Chapter 13 choice. Under § 707(b), the judge may deny a debtor discharge where discharge would constitute a substantial abuse. The principal form of "abuse" that has been litigated concerns whether a debtor who seeks to discharge debts in Chapter 7 has sufficient income to complete a Chapter 13 plan that would result in substantial repayment to creditors.[156] Courts are divided over what constitutes

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Reaffirmations of unsecured debt are generally not in the debtor's best interest and endanger the debtor's fresh start. Because of the interaction between 11 U.S.C. §§ 524 and 362, the creditor must always face the possibility that overzealous efforts to seek a reaffirmation will constitute a violation of the automatic stay. By contrast, while courts are divided over whether a debtor can reinstate a secured loan post-discharge (i.e., prevent foreclosure by keeping the loan current), *compare In re* Bell, 700 F.2d 1053 (6th. Cir. 1983) (no "installment redemptions"), *with In re* Boodrow, 126 F.3d 43 (2d Cir. 1997) (allowing reinstatement); *In re* Bellanger, 962 F.2d 345 (4th Cir. 1992) (prohibiting reinstatement), the choice is between competing crystalline rules. Either reinstatement is allowed, or it is not.

156. Section 707(b) of the Bankruptcy Code provides:

> After notice and a hearing, the court, on its own motion or on a motion by the United States trustee, but not at the request or suggestion of any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts if it finds that the granting of relief would be a *substantial abuse* of the provisions of this chapter. There shall be a presumption in favor of granting the relief requested by the debtor.

11 U.S.C. § 707(b) (emphasis added). Circuit courts have set up various standards for determining when ability to pay gives rise to substantial abuse of Chapter 7. *See, e.g.*, First U.S.A. v. Lamanna (*In re* Lamanna), 153 F.3d 1, 4 (1st Cir. 1998) ("Among the factors to be considered in deciding whether a debtor is needy is his ability to repay his debts out of future earnings....[A] court would not be justified in concluding that a debtor is needy and worthy of discharge, where his disposable income permits liquidation of his consumer debts with relative ease."); Kornfield v. Schwartz (*In re* Kornfield), 164 F.3d 778, 784 (2d Cir. 1999) ("The record depicts debtors with substantial...income....Most of the present debt could have been avoided, and all of it can be repaid over time....This is a paradigm of the case that Section 707(b) was designed for...."); Green v. Staples (*In re* Green), 934 F.2d 568, 572 (4th Cir. 1991) ("The debtor's relative solvency may raise an inference [of substantial abuse]"); *In re* Krohn, 886 F.2d 123, 126 (6th Cir. 1989) ("In determining whether to apply § 707(b) to an individual debtor, then, a court should ascertain from the totality of the circumstances whether he is...'honest'...and whether he is 'needy'.... Among the factors to be considered in deciding whether a debtor is needy is his ability to repay his debts out of future earnings."). Both the House and Senate versions of the Bankruptcy Reform Act of 1999 create a presumption of abuse when an individual debtor's monthly income exceeds IRS medians. *See* H.R. 833, 106th Cong. § 102(a)(2)(A)(i) (1999); S. 625, 106th Cong. § 102(a)(2)(A)(i) (1999).

abuse,[157] but one of the major factors considered is whether the debtor would have been able to confirm a Chapter 13 plan that would have resulted in a substantial repayment to creditors.[158] In any event, each muddy area appears to concern one of the key abuses—secreting of assets and ability to pay. These statutory provisions create an opportunity for a judge to examine behavior that could affect the distribution to creditors, but in all cases, reexamination is likely only if a creditor finds it worthwhile to object, and the assumption of the statute appears to be that the judge will be capable of identifying abuse when it is presented.

e. Abuse and the Burden of Litigation in Consumer Cases

While abuse of the bankruptcy system will exist in consumer cases, any theory of the role of the bankruptcy judge in consumer cases must recognize that the number of actual judicial interventions into consumer cases is going to be, of necessity, very small. As a result, statutory draftsmen must take care when allocating the burden of litigation. Since most cases will not be litigated, evidentiary presumptions will, in most cases, be dispositive. If abuse is presumed, most debtors will not receive a discharge, and if the presumption is in favor of discharge, then some abusive behavior will slip through the cracks.

Thus, the prescription for statutory drafting in consumer cases is one that uses muddy rules in areas where abuse is expected, but which takes great care in allocating the burden of litigation, because of the great risk of over-and underinclusiveness which results from the small number of dollars at stake in proportion to litigation expense.

D. Conclusion—Assuming Judicial Competence

In the Bankruptcy Code, muddy rules are used to allow a judge to determine whether abusive behavior has occurred. If one views the judge as competent, this use of muddy rules should be applauded both by the traditionalist and by the proceduralist. Even in consumer cases, muddy rules will allow the judge to examine abuse where the abuse is of sufficient financial importance to make it worth a lawyer's time.[159] In the next section, I examine whether altering the assumption of judicial competence alters the manner in which muddy rules should be used in the Bankruptcy Code.

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157. *See* cases cited *supra* note 156.

158. *See id.*

159. As noted in footnote 103 *supra*, the extent to which a muddy rule will encourage judicial determination of a dispute turns not just on the amount of money at stake. It may also be influenced by whether the rule is a property rule or a liability rule. Because the entitlement holder can veto any behavior by the non-holder, the dispute can only be resolved by consent of the right holder or judicial order. By contrast, liability rules have the effect of reducing the amount at stake, and muddy liability rules further reduce the amount at stake. For the most part, the rules discussed above, such as the automatic stay and the discharge injunction, are in the form of property rules.

IV. RELAXING THE ASSUMPTION OF JUDICIAL COMPETENCE—THE NON-IMPLICATIONS OF THE PROCEDURALIST "CANNOT"

Up to this point, this Article has proceeded from a perspective that assumes judicial competence. The model bankruptcy statute described in the previous section (1) identifies categories of abusive or opportunistic behavior; (2) uses muddy rules as a mechanism for allowing the judge to identify and prevent such behavior where it occurs; and (3) forces parties to bargain in the shadow of a muddy rule and a "competent" judge capable of identifying inefficient opportunistic behavior. Such opportunistic behavior may take a number of forms. A creditor may be seeking to exploit its leverage over the debtor's business to obtain a disproportionate recovery at the expense of other creditors. A debtor in a business case might use the bankruptcy process to keep a non-viable business alive. A creditor might use sharp practices to obtain a reaffirmation in a consumer case, or a consumer debtor might secret assets or obtain a bankruptcy discharge notwithstanding his ability to repay debts. We assumed, however, that the reason for using muddy rules in areas of perceived abuse was that the bankruptcy judge was capable of identifying such abuses when brought to her attention.

Proceduralists are deeply suspicious of this assumption. Baird expressly casts doubt on the ability of a bankruptcy judge to distinguish debtors that are likely candidates for reorganization from those that are not. He says:

> While it is easy to observe those who lose jobs when a firm fails, it is virtually impossible to identify with any specificity those who indirectly gain from a new job when the failed firm's assets are redeployed. Moreover, even if such information were at hand, striking this balance would require overcoming one of the most persistent and intractable problems of cognitive bias.[160]

His skepticism is not, however, absolute. He notes that bankruptcy judges "are less likely to let a debtor play for time and more likely to grant lift-stay motions when an effective reorganization is not in prospect. Moreover, they have become increasingly adventurous in invoking market mechanisms when those markets exist."[161]

Other proceduralist scholars have not shown Baird's moderation.[162] Judicial competence would seem at first to be crucial to any system that relies on judges to make decisions. The obvious response to judicial incompetence would be to shift responsibility to the legislature, using crystalline rules to prohibit

160. Baird, *supra* note 8, at 587; *see* sources cited *supra* note 63.

161. *See* Baird, *supra* note 8, at 588.

162. *See, e.g.*, Alan Schwartz, *Incomplete Contracts*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 277 (Peter Newman ed., 1998); Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL. STUD. 271 (1992). As Eric Posner has noted, "Schwartz is most explicit about the assumptions one must make about judicial competence. He points out that identifying the value maximizing action in any contract is likely to require information that is not available to the court." Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749, 753 (2000).

certain well defined behaviors, while tolerating a significant amount of over- and underinclusiveness.

However, if one considers the implications of Carol Rose's description of the effect of muddy rules, this facile prescription of crystalline drafting as a remedy for judicial incompetence loses much of its appeal. If one accepts, as Rose suggests, that open-ended rules both allow judges to identify abuse *and* discourage abusive behavior in bargaining situations, then judicial competence is not as crucial.[163] In this section, I argue that relaxing the assumption of judicial competence does not significantly alter the desired approach to statutory design. Statutory draftsmen should continue to use open-textured rules in roughly the same manner as they do when judicial competence is assumed. First, muddy rules may enhance efficiency even if judges are not perfectly competent. Second, muddy rules in the Bankruptcy Code, if placed at points where "abuse" is likely, increase the cost of non-cooperative behavior, even when the decision-maker is not competent at all.

A. Crystals, Mud and Limited Judicial Competence

In a different context, Gillian Hadfield has argued that even where judges are not perfectly competent, muddy standards may nonetheless be preferable to bright line rules.[164] Hadfield explores the effect of judicial competence on the ability of judges to enforce contractual "good faith" clauses. She points out that contracting parties, performing under contracts with gaps (i.e. not "fully specified" to use her term) face a problem. Compliance with contracts is costly. In any joint venture, the benefits of any efforts are shared, while the cost of such efforts are borne by the party who makes the effort.[165] As a result, the joint efforts of the parties, in the absence of an enforceable contract term, are likely to be suboptimal. The purpose of a "good faith" clause, Hadfield points out, is to encourage such "optimal" effort. Courts interpreting good faith clauses, however, may not be capable of determining the optimal level of effort for a given type of contract.[166]

Hadfield asks whether courts, unable to determine with confidence the optimal level of effort, should adopt bright line crystalline rules or muddy standards. To do this, she models the effect of legal enforcement of good faith clauses on behavior. Without a good faith clause, contracting parties determine their level of effort based upon the expected benefit from each unit of effort, discounted by the cost of such effort. When a good faith clause is present, the parties must additionally consider the expected liability under the good faith clause. Additional effort reduces the likelihood of liability.[167] Thus, so long as the cost of increased effort is less than the reduced likelihood of contractual liability, enforcing good

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163. Though, as the discussion below will show, judicial even-handedness is essential.

164. Gillian K. Hadfield, *Judicial Competence and the Interpretation of Incomplete Contracts*, 23 J. LEGAL STUD. 159 (1994).

165. *Id.* at 167.

166. *Id.* at 169-70.

167. *Id.*at 168-69.

faith clauses will increase the contracting party's effort above the suboptimal level.

Under this model, if a court of limited competence adopts a bright line rule that misses the mark (i.e. misidentifies the optimal level of effort for that particular type of contract), the rule will either fail to encourage compliance or encourage inefficiently high levels of compliance. For example, if the court sets the bright line rule at a level below the level of effort the parties would expend in the absence of the rule, then the rule will have no effect on behavior. If, by contrast, the rule demands a level of effort so high that even assuming liability, the cost to comply exceeds the expected liability, then the rule will lead to overcompliance, or no contracting. If, instead, a standard is adopted, the effect will be to encourage compliance in a broader range of contractual types and reduce the costs associated with overcompliance when it occurs.[168]

Hadfield's conclusion has obvious implications for bankruptcy judges and Congress. Inefficient unilateral behavior is likely when a debtor is insolvent, both because a collective action problem gives creditors an incentive to dismember the debtor, and diffuse small creditors are not in a position to monitor the debtor. Hadfield's insight shows that the inability of judges to perfectly identify efficient or inefficient reorganizations does not necessarily counsel a bright line rule. To the contrary, the threat of judicial enforcement will help remedy the collective action problem, and will work best if the legal norm is articulated as a muddy standard.

Hadfield notes further that while some of the benefit of a muddy rule might be overshadowed by the costs of litigation, the muddy rule will also affect behavior in the vast majority of cases that are not litigated. In those cases, efficiency will be gained without incurring the associated litigation cost.[169]

B. Judicial Incompetence—A Cost-Based Theory of Judicial Role

Hadfield assumes limited, if not perfect, judicial competence. In a recent article, entitled *A Theory of Contract Law Under Conditions of Radical Judicial Error*,[170] Eric Posner goes further and articulates a role for judicial enforcement of contracts based on litigation costs that completely deemphasizes the need for accurate decision-making. Posner argues that even if one assumes that judges cannot identify and punish opportunistic behavior in contractual relationships,[171] judicial decision-making can play a crucial role in encouraging cooperation among contracting parties.

Posner suggests a paradox. On the one hand, "The traditional neo-classical paradigm of contractual behavior...assumes that people make contracts because only legal sanctions will deter a party from cheating on a contract when it

168. *Id.*at 178-179.
169. *Id.* at 174.
170. Posner, *supra* note 162.
171. *See id.* at 754 ("I argue...that even if courts are radically incompetent, people would still voluntarily enter legally enforceable contracts.").

is profitable to do so,"[172] and parties routinely insist on legally enforceable agreements. However, business people do not appear to believe that legal enforceability is sufficient to guarantee compliance with the contract. If parties actually relied on judicial enforcement, much observed contracting behavior would not occur. Merchants invest large amounts of time and effort augmenting their commercial relationships with personal ones. "Business is almost always conducted in a highly social manner."[173] Posner blames judges:

> Courts have trouble understanding the simplest of business relationships.... Judges must be generalists, but usually they have narrow backgrounds in a particular field of law, and they often owe their positions to political connections rather than merit. Their frequent failure to understand transactions is well documented. One survey of cases involving consumer credit for example showed that the judges did not even understand the concept of present value.[174]

This explains, according to Posner, why parties invest time in developing reputation and networks of social relations.[175] If they cannot rely on judges to enforce agreements accurately, they must instead turn to social networks and social norms to encourage cooperation. However, while this explains corporate golf outings, it does not explain why "[i]f they cannot rely on courts to enforce contracts properly, people so frequently take pains to ensure that their contracts are enforceable."[176]

1. Cost-Based Judging

As an answer to this riddle, Posner suggests that the parties who enter into legally enforceable contracts recognize that even an uncomprehending court can deter opportunistic behavior in contracting situations. According to Posner, parties use contracts as a commitment device:

> Parties can protect themselves ex ante by entering a legally enforceable contract. But the protection does not result from the ability of courts to punish the party that breaches.... It is assumed that courts are not able to acquire the information that they would need in order to determine liability and harm. The protection results because the victim of the breach, if he cares about his reputation,

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172. *Id.* at 756.

173. *Id.* at 757.

174. *Id.* at 758 (citing Jeffrey E. Allen & Robert J. Staaf, *The Nexus Between Usury, "Time Price" and Unconscionability in Installment Sales*, 14 U.C.C. L.J. 219 (1982)).

175. While this is "an" explanation, it may not be "the" explanation. It is also possible that, even with competent judges and a perfectly reliable legal system, the cost of judicial enforcement of a contract might exceed the marginal cost of investments in social and reputational networks. Nonetheless, Posner's thought exercise does help to identify a social function for an imperfect judicial system.

176. *Id.* at 758.

> can credibly threaten to inflict a mutual harm by bringing a negative sum lawsuit.[177]

In short, parties enter into legally binding contracts because legal enforceability increases the cost of non-cooperative behavior. This increased cost is not dependent on the court getting the right answer. It is driven instead by litigation costs. According to Posner, parties will choose to make contracts legally enforceable even when they believe judges to be incompetent so long as two conditions hold: (1) the parties will be willing to bring a negative sum (reputational) lawsuit in order to deter future breaches; and (2) each party can increase its chance of winning by spending more on the lawsuit.[178] When these two conditions are satisfied, the victim of a breach can punish the breaching party by bringing suit and can impose additional costs on the defendant by vigorously prosecuting the lawsuit.[179]

2. Competence, Bias, and Muddy Rules in Bankruptcy

This cost-based view of judicial enforcement has implications for statutory drafting and the optimal use of crystals and mud in bankruptcy. While Posner focuses on relational contracts, to the extent his assumptions carry over, his insight will apply equally where the Bankruptcy Code and bankruptcy judges are involved. Increased expenditure by litigating parties will increase the likelihood of success in bankruptcy court. Good lawyering is good lawyering wherever it occurs.

It is less clear, however, that parties will be willing to bring reputational lawsuits in bankruptcy cases. Many debt contracts are not "relational." They instead involve one-shot lending arrangements and no further relationship between the creditor and the debtor, other than extracting payment.[180] While there is a well developed literature on how secured credit, guarantees, and letters of credit may have the effect of cementing the relationship between the debtor and the creditor,[181] once the debtor is in bankruptcy, the relationship has generally broken down, and the enhanced remedies accorded to secured creditors or others that originally may have served to bind the debtor to the creditor will often increase the leverage of the creditor in the context of insolvency. Moreover, the first-in-time nature of state law debt collection devices forces the debtor/creditor relationship into a contractual end-game-mode.

Bankruptcy law seeks to alter this characteristic of collection law. Bankruptcy law generally and Chapter 11 in particular seek to replace the end-

177. *Id.* at 759. A negative sum lawsuit is a lawsuit where the expected costs of litigation exceed the case's expected value.

178. *See id.* at 759–62.

179. *See id.*

180. Car loans are a good example.

181. *See, e.g.*, Ronald J. Mann, *Verification Institutions in Financing Transactions*, 87 GEO. L. J. 2225, 2249–52 (1999); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 904 (1986); *see also* Ronald J. Mann, *The Role of Letters of Credit in Payment Transactions*, 98 MICH. L. REV. 2494 (2000).

game of state law debt collection with a collective proceeding, where the creditors and the debtor must continue to deal with each other. So long as the debtor remains in bankruptcy, the automatic stay prevents unilateral action and links the creditor's recovery to the recovery of the creditors as a group. Thus creditors will have an incentive, on the one hand, to appear willing to bring a reputational lawsuit (seeking, perhaps, to lift the automatic stay) to enhance their bargaining position in the bankruptcy, while on the other hand, they must recognize that the costs will come out of their recovery.[182] Similarly, the debtor's management outside of bankruptcy has no incentive to cooperate with creditors, to protect the value of assets, or to do anything other than leave and look for another job. Thus, the effect of Chapter 11 is, again, to tie the future of key personnel to the reorganization itself.[183] Finally, while in many contexts, litigants with small claims who are not repeat players may find that litigation costs swamp the value of their claims, the committee structure of bankruptcy goes a long way toward remedying this problem by aggregating the value of these claims.

Another aspect of bankruptcy practice that has frequently been remarked upon is that the nature of bankruptcy cases has an unusual effect on the conduct of bankruptcy lawyers. While bankruptcy lawyers seek a reputation as tough and hard-nosed, bankruptcy lawyers also recognize that during the course of a bankruptcy case, opponents in one dispute may be allies in a matter that comes up later in the case. The lawyers are often repeat players with each other within the case, and, more controversially, across cases.[184] As a result, the lawyers also need to develop reputations as straight shooters. Thus Chapter 11 both turns the parties into repeat players and creates the need to be viewed as "tough" in a repeat game. Both the parties and the attorneys do have an incentive to bring a reputational lawsuit to establish this "toughness."

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182. Doug Baird points out that in bankruptcy many of the parties do not bear their own litigation costs. Letter from Douglas G. Baird to Ted Janger (on file with author). Oversecured creditors will be paid their attorney's fees as part of their secured claim, creditors' committees expenses (including professional fees) are paid out of the estate, and the debtor's counsel are paid out of the estate. This is not fatal. Litigation expenses of oversecured creditors eat into their equity cushion. Litigation expenses of unsecured creditors' committees come directly out of the recovery for unsecureds. By contrast, except in the rare case where the debtor proves to be solvent at the end of the day, the debtor-in-possession (whether incumbent management or old equity or both) is litigating with other people's money. This may suggest that, in the typical case, where the unsecured creditors are the residual claimants, the litigating decision should rest with the unsecured creditors' committee rather than the debtor.

183. LoPucki and Whitford have found that in large company bankruptcies, current management almost always loses control, but in small company bankruptcies (which succeed less often), the owner-managers who are able to reorganize successfully virtually never lose control. *Compare* LoPucki & Whitford, *supra* note 127, at 727, *with* Lynn LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 247, 263–66 (1983).

184. Nancy B. Rapoport, *Our House, Our Rules: The Need for a Uniform Code of Bankruptcy Ethics*, 6 AM. BANKR. INST. L. REV. 45 (1998).

As such, muddy rules in bankruptcy appear to increase the cost of unilateral action and encourage cooperation. This should be true regardless of whether the judge is competent. The muddy bankruptcy rules identified above all represent attempts to correct the end-game of state law debt collection. The automatic stay, the exclusive period, and the limitation of the power of holdouts in the plan confirmation process all govern whether a creditor will be able to opt-out of the collective bankruptcy proceeding. If a judge *is* competent, he or she will be charged with identifying inefficient unilateral behavior, and muddy rules will be deployed in order to allow the judge to do so. If the judge is incompetent, but the chance of winning is positively correlated with litigation expenditures,[185] then the effect of a muddy rule will be to increase the cost of unilateral behavior.

Since muddy rules increase the cost of unilateral behavior whether or not the judge is competent, the important question becomes not, "Can the judge identify abuse," but instead, "Has the legislature identified contexts in which abuse is likely?" If the answer is yes, then a muddy rule will increase the cost of abuse, regardless of whether the judge is competent.[186] Again, the logic of the automatic stay is that it allows judges to sort inefficient unilateral debt collection (i.e., where a more efficient collective solution is in prospect), and efficient unilateral debt collection (i.e., where nothing is lost by allowing the creditor to foreclose). In other words, the judge needs to determine whether the harm caused to the creditor by delaying the foreclosure on the pizza parlor's ovens or Chrysler's auto parts is outweighed by the benefit of giving the reorganization a chance. By contrast, if the judge is thought to be incompetent, the rationale for an open-ended rule shifts. Instead of using the judge as a filter, litigation costs are used as a deterrent. Therefore, the question becomes whether the conduct governed by the muddy rules is of the type where non-cooperative behavior needs to be deterred.

If we return to our example of the encumbered pizza ovens and auto parts, the question one must ask is whether the secured creditor is likely to use its ability to shut down the business (by foreclosing on the pizza ovens or auto parts) to the detriment of the creditor body as a whole. Under the litigation cost approach, the rationale behind muddy rules for lifting the stay lies in the collective action problem identified by Baird and Jackson, which arises out of the insolvency common pool. If the race of diligence is inefficient, then the automatic stay makes unilateral behavior more costly and thereby enhances efficiency.

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185. Which, by all accounts, it is. *See* Lynn M. LoPucki & Walter O. Weyrauch, *A Theory of Legal Strategies*, 49 DUKE L.J. 1405 (2000); Marc Galanter, *Why the "Haves" Come Out Ahead: Speculation on Limits of Legal Change*, 9 LAW & SOC'Y REV. 95, 96 (1974).

186. The crucial caveat here is that the judge's limitations as a decision-maker must be evenhanded. If judges err on the side of the debtor as often as they err on the side of the creditor, then the effect of the muddy rule will be to deter abuse, so long as the form of abuse is correctly identified in the statute. By contrast, if judges are systematically biased, then the result may be to encourage abuse by the favored party.

The question is an empirical one. Does the race of diligence lead to deadweight loss? If the answer is yes, then a muddy rule that deters inefficient unilateral debt collection is a good thing even where the judge is incompetent.[187] The proceduralist "cannot" does not mandate a wholesale limitation of judicial discretion. Open-ended rules have a role even in a bankruptcy judicial system where the decision-maker is viewed as flawed.

C. Justifying Mandatory Muddy Rules

Parties to a contract choose to make their promises legally enforceable. Bankruptcy law, by contrast, is not "chosen" by the parties. The Bankruptcy Code imposes mandatory terms on contracting parties that they probably didn't agree to and may expressly have attempted to contract around.[188] Indeed Posner notes:

> The value of a legally enforceable promise as a commitment device depends on the freedom of parties to opt into or out of legal liability. The ability to impose legal liability on a stranger without ex ante consent would give people the ability to use courts strategically to extract wealth from each other.[189]

While some courts have enforced contractual waivers of the automatic stay, courts are divided on this point, and do not lightly permit contracting parties to waive the benefits of the Bankruptcy Code, if they do so at all.[190] One might,

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187. Of course, one could simply prohibit unilateral creditor behavior entirely, and do away with motions to lift stay under § 362(d). However, as noted above, just as unilateral creditor behavior is not always inefficient, debtor behavior is not always efficient. While perfect judicial sorting may not be possible, the threat of litigation costs raises the threshold at which unilateral behavior becomes profitable, and therefore increases the likelihood that it will be efficient.

188. *See* Schwartz, *supra* note 10, at 1821–22; *see also* LoPucki, *supra* note 10.

189. Posner, *supra* note 162, at 769.

190. *See* Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 516 n.4 (1999), and authorities cited therein. To wit, *compare In re* Atrium High Point Ltd. Partnership, 189 B.R. 599, 607 (Bankr. M.D.N.C. 1995) (recognizing that a prepetition debtor may waive the automatic stay); *In re* Jenkins Court Assocs. Ltd. Partnership, 181 B.R. 33, 36 (Bankr. E.D. Pa. 1995) (same); *In re* Powers, 170 B.R. 480, 482–83 (Bankr. D. Mass. 1994) (same); *In re* Cheeks, 167 B.R. 817, 818–19 (Bankr. D.S.C. 1994) (same); *In re* Club Tower L.P., 138 B.R. 307, 311 (Bankr. N.D. Ga. 1991) (same); *In re* Citadel Properties, Inc., 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988), *with In re Pease*, 195 B.R. 431, 433 (Bankr. D. Neb. 1996) (refusing to enforce the waiver of the automatic stay); Farm Credit, ACA v. Polk, 160 B.R. 870, 873–74 (M.D. Fla. 1993) (same); In re Sky Group Int'l, Inc., 108 B.R. 86, 88 (Bankr. W.D. Pa. 1989) (same). The academic literature on this point is extensive. *See, e.g.*, Edward S. Adams & James L. Baillie, *A Privatization Solution to the Legitimacy of Prepetition Waivers of the Automatic Stay*, 38 ARIZ. L. REV. 1 (1996); Daniel B. Bogart, *Games Lawyers Play: Waivers of the Automatic Stay in Bankruptcy and the Single Asset Loan Workout*, 43 UCLA L. REV. 1117 (1996); Rafael Efrat, *The Case for Limited Enforceability of a Pre-Petition Waiver of the Automatic Stay*, 32 SAN DIEGO L. REV. 1133 (1995); Robert K. Rasmussen, *Free Contracting in Bankruptcy at Home and Abroad*, *in* THE FALL AND RISE OF FREEDOM OF CONTRACT (Francis Buckley ed., 1999); Marshall E. Tracht, *Contractual Bankruptcy*

therefore, ask whether the benefits of muddy rules aren't swallowed by the costs of making them mandatory. In other words, having worked from the weak version of the proceduralist "should not," we must still respond to the strong version.

There are a number of responses to this question. First, one might argue that a mandatory bankruptcy rule is only mandatory in the sense that it is a mandatory incident of the debtor/creditor relationship. Posner suggests that the function of legal enforceability of contracts is to encourage cooperation.[191] Mandatory bankruptcy rules could be viewed as a mere incident of enforceability. This is only a partial response, however. Why not simply permit contracting parties to freely elect between crystalline and muddy rules?

A second partial response is to look to Baird and Jackson's "creditor's bargain" heuristic itself. One starts with a version of Rawls' original position, by hypothesizing that all of the stakeholders in the debtor are locked in a room together, but are denied knowledge of who they are.[192] They are then instructed to craft a set of insolvency rules that will govern in the outside world. One can justify many of the attributes of bankruptcy law using this device.[193] The question here is when, under the assumption of judicial incompetence, will the parties choose to create open-textured rules and thereby choose judicial resolution of disputes?

In this thought exercise, the hypothetical blindfolded stakeholder would still choose to use open-textured rules in areas where there was a high probability for opportunistic behavior by creditors. Under Hadfield's approach, a muddy rule would be preferred with judges of limited competence. According to Posner, even with an incompetent judge, muddy rules would be desirable. As far as the creditors are concerned, the purpose of legal rules is to discourage abusive or non-cooperative behavior—to affect the interaction among the creditors themselves. From this perspective, even without "accurate" decision-making by a judge, a statute which properly allocates open-textured and closed textured rules can still operate to counteract the collective action problem faced in bankruptcy.

However, simply saying that some stakeholders would choose open-ended rules does not provide a justification for making those open-ended rules mandatory. In order to justify mandatory open-ended rules, one must show that there is something wrong with bargaining outside the Rawlsian veil of ignorance that makes it impossible for parties to arrange the same contract in the real world that they would negotiate in the idealized original position. Indeed, this is the view articulated by Schwartz, Adler, and Rassmussen. They argue that rational

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Waivers: Reconciling Theory, Practice, and Law, 82 CORNELL L. REV. 301 (1997); *see also* Michael St. Patrick Baxter, *Prepetition Waivers of the Automatic Stay: A Secured Lender's Guide*, 52 BUS. LAW. 577 (1997) (offering guidance to secured lenders in the use of prepetition waivers of the automatic stay); Bruce H. White, *The Enforceability of Pre-Petition Waivers of the Automatic Stay*, AM. BANKR. INST. J., Jan. 1997, at 26 (summarizing the arguments for not enforcing prepetition waivers of the automatic stay).

191. *See supra* notes 178–180 and accompanying text.

192. *See* JOHN RAWLS, A THEORY OF JUSTICE 130–50 (1971).

193. The automatic stay and the best interests test are perhaps the best examples.

stakeholders are perfectly capable of negotiating their own bankruptcy contracts, and that bankruptcy law should merely function as a default rule.[194]

The advocates of contract bankruptcy, however, ignore the collective action problem. Just as creditors in the current world price debt and negotiate in the face of existing bankruptcy law, creditors in a world without bankruptcy law would lend in the shadow of the race of diligence. Just as creditors have an incentive at the time of insolvency to carve up the debtor's property, so creditors, at the time they lend, have an incentive to fix their place in any such race. Granted, the debtor has more leverage with creditors pre-bankruptcy, and may be able to negotiate ex ante for the right to attempt reorganization. There is reason, however, to believe that pre-bankruptcy contracting will simply yield the race of diligence, without the race.

Whether or not this will be the case is an empirical question, but one about which it is possible to have intuitions. For example, imagine that a principal creditor negotiated not only for security, but for a waiver of the automatic stay. Just to keep things simple, assume further that this was the first creditor of the debtor, and all other lenders came later in time. If the various subsequent creditors would incorporate the stay waiver into their credit risk decision and price their own loan accordingly, then the provision is non-problematic. However, even with this simple example, one can easily imagine creditors who will not accurately respond to the increased risk. Employees do not generally run credit checks on their employers. Prospective tort claimants do not even choose to enter into a debtor/creditor relation. The taxing authority taxes based on income, not riskiness. So even with this simple example, it is possible to imagine a subsidy to the debtor and the advantaged creditor arising out of the enforceable stay waiver.[195] As such, outside the "original position," it might not be possible for the debtor and creditors to engineer the automatic stay, even though it might be the optimal rule.

If the advantaged lender (i.e., the one who negotiates for a stay waiver) lends after the debtor has already borrowed from others, the problems become greater. Many creditors will not be able to exit the credit relationship or adjust their interest rate in response to the stay waiver. It gets complicated quickly,[196] but, again, there is reason to believe (1) that creditors, ex ante, would choose at least this one mandatory open-ended bankruptcy rule, even if they significantly distrusted bankruptcy judges, and (2) that it would be difficult or impossible to obtain this rule through negotiation. Making the automatic stay mandatory, on this theory, improves on the market.

The argument from social policy bypasses the original position and simply recognizes that the goal of the bankruptcy statute, at least in business cases,

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194. *See generally* Schwartz, *supra* note 10; Adler, *supra* note 11; Rasmussen, *supra* note 11; Bradley & Rosenzweig, *supra* note 11.

195. As noted previously, Rasmussen suggests that tort claimants might be accorded priority to remedy this concern, and this is a partial response to this critique, but tort claimants are not the only creditors who might be affected. Rasmussen, *supra* note 11, at 64–66.

196. *See generally* LoPucki, *supra* note 10; Block-Leib, *supra* note 43.

is to counteract the collective action problem inherent in state law debt collection. Here it is not necessary to explain why certain parties would choose judicial resolution of certain questions. Instead, it is merely necessary to explain why society requires it. Under Posner's model, an open-ended rule gives the debtor the ability to impose costs on a creditor who is not cooperating with the effort to reorganize. The open-ended rule also gives that creditor the power to impose costs on the debtor. Both parties' litigating behavior is constrained by cost. A creditor stands to gain from seeking a lift stay because that will give it the ability to foreclose on its collateral. However, the creditor must pay its own legal fees (not to mention its pro rata share of the legal fees of the debtor if the creditor loses). Similarly, the debtor, as a repeat player with multiple creditors, has a powerful incentive to be viewed as a tough customer. Even where the judge is a wild card, open-ended bankruptcy rules will help counteract the common pool problem inherent in insolvency situations. Finally, when considering litigation expenses in the social welfare balance, it is important to remember Carol Rose's point, that mud has an effect both during litigation ex post and during negotiation ex ante. Litigation expenses are incurred, however, only in those cases where a dispute actually arises ex post. In the vast majority of cases that are not litigated, society benefits from the disciplining effect of the muddy rule without suffering deadweight litigation costs. Thus, the argument from social policy also explains why open-ended rules aimed at non-cooperative behavior may be efficient.[197]

a. Crystals and Mud in Consumer Bankruptcy

Does the same rationale work in consumer cases? In business bankruptcy cases, the statute seeks to preserve going concern value by encouraging collective decision-making by creditors. In most individual cases, this goal is irrelevant. Nonetheless, there is a "Rawlsian" rationale for the consumer bankruptcy system as well. First, the creditors (if placed in the original position, behind the veil of ignorance) might choose equality of treatment over the first-in-time treatment of state law. Not knowing in advance whether they are creditors who will be in a position to monitor the debtor or not, they would choose instead the pro-rata treatment accorded by the Bankruptcy Code. Second, these same creditors might choose to be bound by the automatic stay in Chapter 13 in order to facilitate a wage earner plan that will yield more than liquidation, in or out of bankruptcy.

Even the bankruptcy discharge can be justified this way. The parties behind the veil of ignorance in the original position would include the debtor. Therefore, a person behind the veil of ignorance would be uncertain as to whether he or she would be a creditor or a debtor. As such, they might agree to a bankruptcy discharge on the theory that the bankruptcy deal, under which the debtor commits all non-exempt assets or all disposable income for three to five years to the payment of creditors would yield virtually as much for creditors as a world without the discharge, while alleviating the anxiety about the fact that he or she might be the debtor, once the veil of ignorance is lifted.

197. It does not, however, respond to the proceduralist "should not."

Thus, Posner's cost-based view of the judicial system suggests a view of bankruptcy law that can satisfy the proceduralist "should not" while offering a response to the proceduralist "cannot." Even if judges cannot be relied on to identify abusive or non-cooperative behavior, open-textured rules can still be used as a mechanism to encourage cooperative behavior of creditors in an insolvency situation.

D. Implications for Legislators and Judges

1. Legislators

If muddy rules deter abuse whether or not the judge is competent, legislators should allocate open-ended rules without regard to whether they view the bankruptcy judge as competent or incompetent. If the goal of a statute is to regulate behavior, muddy rules will accomplish this goal regardless of whether judges can be relied on to decide cases correctly. This does not mean that the cost-based approach does not have implications for legislators, however. Posner's insight suggests that instead of focusing on a question of institutional empiricism (are judges competent?), legislators should focus on a substantive empirical question. To wit, does the open-ended rule identify an abuse that needs to be deterred, and has the burden of litigation been allocated properly? In bankruptcy, the legislator should ask, does increasing the cost of non-cooperative behavior improve on the market operating without such a mandatory rule?

2. Judges

Posner does not assert that judges are incompetent,[198] nor does he argue that incompetent judges are desirable. He acknowledges that competent judges are better than incompetent ones.[199] He is merely controlling for judicial competence in the institutional analysis. This, however, does not mean that Posner's analysis does not have important implications for judges.

First, Posner assumes that judicial incompetence is even-handed, or as he puts it, "normally distributed around" the mean.[200] He assumes that errors are truly random.[201] This assumption is crucial. If a judge is perceived as being systematically favorable to creditors or debtors, this will give rise to strategic behavior. Thus judges must take care not to appear to favor one side or the other systemically. On one level, this injunction to impartiality seems obvious. On another, it speaks to the debate over whether judges should adopt a mediative or adjudicative stance. One of the risks of mediation by bankruptcy judges is that the judge will drop hints about the likely disposition of the case. As such, a mediative stance conveys information to the parties about the judge's possible biases. This is problematic even if judges are competent because these judicial hints are based on

198. *See* Posner, *supra* note 162, at 774.
199. *See id.*
200. *See id.* at 762.
201. *See id.*

predispositions which are formed without the benefit of a full factual presentation. If there are doubts about the ability of judges, the hints dropped during mediation may skew the results of the parties' bargaining.

Second, judges themselves do not assume their own incompetence. Does the discussion above tell us anything about what judges should do when they seek to adjudicate cases? Should they roll the dice (to ensure impartiality), or should they try to belie Posner's lack of faith? Posner answers that the judges should give it their best shot, "as long as judges are not perfectly incompetent but occasionally right. Even if they are right only rarely, they can deter bad behavior by exerting effort to discover whether the promisor breached or not."[202]

To put the answer another way, so long as increased judicial effort to "get it right" is positively correlated with "getting it right," and does not instead merely introduce bias, then the additional information provided by good judicial decision-making and good judicial reasoning will improve the efficiency of the system.

Third, and finally, in addition to concerning themselves with an adjudicative posture and trying hard to "get it right," judges must avoid being biased. A perceived pro-debtor or pro-creditor bias will skew the effect of a muddy rule, not just in the cases that the judge actually decides, but also in the cases that are negotiated in the shadow of a judicial decision. In this regard, Baird's point about endowment effects and the lessons of cognitive psychology are instructive. Bankruptcy judges need to recognize that rooting for one side or another may impair the working of the system, that viewing success as a confirmed plan of reorganization may actually undercut the salutary effect of muddy rules on both creditor and debtors.

Thus, to the extent that the debate between proceduralists and traditionalists turns on differing assessments of the ability of judges to identify opportunistic or abusive behavior, or to identify businesses that are worth saving, it would appear to be a red herring. To the extent that Congress identifies an abuse that it wishes to control, then it makes sense to use muddy rules to confer that task on judges, either because judges are good decision-makers or because of the salutary effect that possible decision making, even by an incompetent judge, has on the behavior of the parties. By contrast, to the extent that there are concerns about judicial competence, this seems to reinforce the need to combat any actual or perceived bias as well as the importance of an adjudicative rather than mediative stance for bankruptcy judges.

V. PERILOUS CRYSTALS

At the beginning of this Article, I argued that bankruptcy reform and modern bankruptcy scholarship were heading down a blind alley because of their wrongheaded infatuation with crystalline statutory drafting driven by a misunderstanding of the importance of empirical assessments of judicial competence and statutory design. In this section, I offer a few examples of

202. *Id.* at 774.

wrongheaded crystals proposed in recent bankruptcy reform bills and by scholars. One example will be drawn from proposed consumer bankruptcy reforms, two will be drawn from the proposed business bankruptcy reform, and the final example will be drawn from the literature on contract bankruptcy. One caveat is important here. Notwithstanding their fascination with crystals, proceduralist scholars do not necessarily approve of the statutory crystals discussed in this section, and have been open in their criticism of means-testing in particular.[203]

A. Means Testing

Most of the discussion relating to the proposed bankruptcy amendments has circled around the consumer bankruptcy reforms. The discussions have been fueled by the politically powerful fact that in the year 2000, with the economy in its eighth year of recovery, personal bankruptcy filings are above one million and have been at that level for the last few years, notwithstanding the booming economy.[204] Two explanations have been offered, and the proponents of each explanation have proposed widely divergent approaches to bankruptcy reform. One explanation is a decline in personal responsibility, the disappearance of the stigma associated with bankruptcy, and a rise in the use of the Bankruptcy Code by people who could in fact afford to repay their debts.[205] This explanation was challenged by the National Bankruptcy Review Commission ("NBRC") and others[206] who offered instead a competing image of Americans deeply in debt

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203. In particular, Doug Baird has written an op-ed opposing means-testing, and has testified against it in Congress. Alan Schwartz and Barry Adler have written a recent law review article criticizing the means test. Barry Adler, Ben Polak & Alan Schwartz, *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL STUD. 585, 609 (2000) ("Reform proposals to make Chapter 13 mandatory seem ill advised because they would eliminate much of bankruptcy's insurance function.").

204. NAT'L BANKR. REVIEW COMM'N, FINAL REPORT, 1 BANKRUPTCY: THE NEXT TWENTY YEARS 77 (1997) [hereinafter NBRC REPORT] ("For nearly 1.3 million American families, the most important event of 1997 will be the public declaration that they are bankrupt.").

205. *See* Edith H. Jones & James I. Shepard, *Recommendations for Reform of Consumer Bankruptcy Law by Four Dissenting Commissioners*, *in* NBRC REPORT, *supra* note 204, at 2. This is the position taken by Judge Edith Jones and other members of the National Bankruptcy Review Commission who dissented from the Commission's report. *See id.*

206. The NBRC REPORT states:

> In 1981, two years after the 1978 Bankruptcy Code went into effect, Americans who filed for bankruptcy listed in their schedules short-term, non-mortgage debts that were, on average, slightly more than twice their annual income....
>
> The statistics suggest that the picture has not changed appreciably since the early 1980s. Families filing for bankruptcy in 1997 apparently have incomes, assets, and debts little different from those of their counterparts nearly two decades earlier when bankruptcy filing rates were far less alarming.

NBRC REPORT, *supra* note 204, at 83. Studies cited by the NBRC for this proposition are SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS, *supra* note 148, at 75; Marianne B.

because of increasing household debt loads, which in turn are a product of the lending and marketing strategies of the consumer credit industry.[207] Notwithstanding the rising default rate, consumer lending has remained quite profitable.[208] However, the NBRC Report was not unanimous, and a vocal minority filed a dissenting report.[209]

The consumer bankruptcy reforms contained in the recent bankruptcy bills have followed the approach of the dissenting report rather than that of the majority of the NBRC. By far the most controversial of these proposed reforms is the proposal to "means test" Chapter 7. Under this proposal, individual debtors would be deprived of a discharge in Chapter 7 if they were deemed able to repay a substantial portion of their debt. This proposal turns on the perception that abuse of Chapter 7 is widespread.

Abuse of Chapter 7 arises in two related situations. In Chapter 7, a debtor can obtain an immediate discharge of debts in return for selling all of his or her non-exempt assets. By contrast, a debtor who wishes to protect assets must file a Chapter 13 plan and commit substantially all of his or her income over three to five years to the payment of creditors. When a high income/low asset debtor files a Chapter 7 case, all future earnings are excluded from the estate. Creditors will receive nothing out of the sale of assets, but the debtor will be able to continue to live an extravagant lifestyle post-discharge. The paradigmatic case here is a high-flying stockbroker who rents a $3000/month apartment in Manhattan (with leased furniture and art), earns $200,000/year, and manages to live well beyond these substantial means by eating in fancy restaurants, skiing in the Alps, drinking expensive wine, and gambling in Monaco. Chapter 7 would allow this debtor to discharge her debt and resume her extravagant lifestyle while paying creditors virtually nothing. The second and even more extreme form of this abuse arises if our stockbroker lives in Texas, Florida, or some other state with an unlimited homestead exemption. In this case, our stockbroker doesn't even need to gamble

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Culhane & Michaela M. White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors*, 7 AM. BANKR. INST. L. REV. 27 (1999); Sullivan et al., *Consumer Debtors Ten Years Later, supra* note 148, at 142; and a study compiled by Hon. Barbara Sellers, examining 1997 bankruptcy filings in the Southern District of Ohio, which has not been published. A study, funded by the consumer credit industry, was also conducted in 1998 by Ernst & Young. That study is criticized in the *Creighton Study. See generally* TERESA A. SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT (2000) [hereinafter SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS].

207. *See* Warren, *supra* note 148, at 1099. Warren notes, "The macrodata are unambiguous about the best predictor for consumer bankruptcy. Consumer bankruptcy filings rise and fall with the levels of consumer debt." *Id.* at 1081 (citation omitted). As she sees it, "The profit margins of credit card issuers substantially increased beginning in 1982, as a result of the functional deregulation of credit card interest rates coupled with prevalent consumer behavior. This has created incentives for card issuers to relax their credit standards, in turn leading to a secular increase in the rate of credit card defaults." *Id.* at 1083 (citation omitted); *see generally* SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS, *supra* note 206.

208. *See* Warren, *supra* note 148, at 1099.

209. *See* note 216 *infra.*

away her earnings; she can invest them in a well-appointed mansion on South Padre Island.

The underlying insight is uncontroversial. No rational bankruptcy scheme should encourage such behavior.[210] The question here is whether it should be controlled through use of mud or crystals. Current law uses mud. Current bankruptcy reform proposals would use an elaborate crystal.

Means testing has a long history as a strategy for curbing debtor abuse. In 1978, when Congress enacted the Code, "ability to pay" was considered as a basis for dismissing a Chapter 7 case. The proposal was rejected. Instead, the Code contains § 707(b) which states:

> After notice and a hearing, the court, on its own motion or on a motion by the United States Trustee, but not at the request or suggestion of any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts if it finds that the granting of relief would be a *substantial abuse* of the provisions of this chapter. There shall be a presumption in favor of granting the relief requested by the debtor.[211]

The report of the Senate Judiciary Committee states explicitly:

> This section authorizes the court to dismiss a liquidation case only for cause, such as unreasonable delay by the debtor that is prejudicial to creditors or nonpayment of any [trustee's fees]. These causes are not exhaustive, but merely illustrative. The section does not contemplate, however, that the ability of the debtor to repay his debts in whole or in part constitutes adequate cause for dismissal. To permit dismissal on that ground would be to enact a non-uniform mandatory chapter 13, in lieu of the remedy of bankruptcy.[212]

Despite this legislative comment, most courts consider ability to pay as one of a number of factors which may give rise to substantial abuse.[213] Some courts have gone further and used it as a sole criterion.[214] The NBRC Report struck an agnostic pose, saying:

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210. *See, e.g.*, Michelle J. White, *Why It Pays to File Bankruptcy: A Critical Look at the Incentives Under U.S. Bankruptcy Law and a Proposal for Change*, 65 U. CHI. L. REV. 685 (1998) (advocating limitation of exemptions and merging Chapters 7 and 13).

211. 11 U.S.C. § 707(b) (1994, Supp. IV 1998 & Supp. V 1999) (emphasis added).

212. S. REP. NO. 95-989 (1977).

213. *See supra* note 156.

214. As the National Bankruptcy Review Commission noted:

> Courts have divided over whether ability to pay some portion of one's debts is substantial abuse of the Chapter 7 discharge. Some courts, including the Eighth and Ninth Circuit Courts of Appeals, have held that ability to pay a substantial percentage of debt out of future income is grounds for dismissal of a Chapter 7 case. Under this type of approach, some courts will find a Chapter 7 case to be substantial abuse only if the

> The Commission's Consumer Bankruptcy Working Group discussed § 707(b) but did not make a recommendation on the appropriate interpretation or changes to that provision. The Commission's endorsement of guidelines to replace the problematic disposable income requirement was not intended to be applied to Chapter 7 debtors to be a proxy for substantial abuse, for this would stretch the term "substantial abuse" beyond recognition.[215]

This absence of a position on means testing prompted an angry dissenting report from Judge Edith Jones and Commissioner James Shepard, which focused on the abuse and also on the courts' non-uniform approach to the problem.[216]

> debtor could have paid 100% of debts in a reasonable period of time. The Court of Appeals for the Sixth Circuit took a slightly broader approach, but ultimately determined that the debtor's ability to repay may be sufficient to support a finding of substantial abuse. The debtor's ability to pay would be a mandatory consideration, but other factors could rebut whatever presumption of substantial abuse was created by the debtor's apparent repayment ability. Taking a different course, the Court of Appeals for the Fourth Circuit has held that a Chapter 7 debtor's ability to repay a substantial percentage of debt, in itself, could not support a finding of substantial abuse. Rather, substantial abuse must be assessed on a case-by-case basis in view of the "totality of circumstances" to see if the case is abusive overall. Under any of these approaches, courts that review cases for repayment ability closely scrutinize the details of the life and expenses of the debtor and related parties, similar to the disposable income analysis. The inquiry is heavily fact intensive and consumes substantial judicial resources when it arises.

NBRC REPORT, *supra* note 204, at 270–71 (citations omitted).

215. *Id.* at 271–72.

216. The dissenters state:

> Chapter 7 is also not immune from a lack of uniformity. A review of various judicial opinions concerning the application of the substantial abuse dismissal power, 11 U.S.C. § 707(b), leads to no general principles. Although the credit industry in 1974 had hoped that Congress would pass legislation which would have required a debtor to file Chapter 13 if he had sufficient income projected to fund a plan, Congress rejected this proposal. Instead, Congress enacted § 707(b), which permits a court to dismiss a Chapter 7 petitioner upon a finding of substantial abuse. In spite of Congressional rejection of the "income test", several courts have adopted such a test. *See, e.g., In re* Harris, 960 F.2d 74, 77 (8th Cir.) (rejecting an inquiry of "egregious behavior" on the part of the debtor as a necessary condition for dismissal under 707(b)); *In re* Kelly, 841 F.2d 908, 914–15 (9th Cir. 1988) (noting a finding that a debtor can fund a Chapter 13 plan, alone will justify granting a motion to dismiss under section 707(b)). Other courts have taken a more equitable approach and investigated the "totality of circumstances," not just the ability to fund a Chapter 13 plan. *See, e.g., In re* Green, 934 F.2d 568, 572 (4th Cir. 1991). The equitable approach is arguably more consistent with the language of the statute. 11 U.S.C. § 707(b) ("There shall be a presumption in favor of granting the relief required by the debtor.").

Despite the non-position of the Commission, means testing Chapter 7 became a centerpiece of the bankruptcy reform legislation. In their 1999/2000 incarnation, the reform bills proposed in both the House and Senate contained a means test. In both cases, there was a presumption that the debtor would be denied a discharge in Chapter 7 if the family's disposable income, calculated based on the IRS median income for the region, would allow the debtor to repay a substantial portion of their outstanding debt. In the Senate Bill, a substantial portion was defined as thirty percent, or $15,000. In the House Bill, the debtor would be required to file a Chapter 13 if he or she would be able to repay $6000 over five years.[217]

What is striking about the reforms contained in both bills is not that they propose means testing, but instead that they go to great lengths to define precisely the concept of ability to pay. The approach of S. 625 is remarkable in its bizarre use of crystals to quantify a distinctly muddy form of abuse. The result is to create a rule that is likely to accomplish virtually none of the stated goals of its drafters.

In most consumer cases, the burden of litigation will be dispositive. The model of the judge in consumer bankruptcy suggests that consumer bankruptcy rules that are intended to regulate behavior ought to state broad (if mud-like) principles, but then take great care in determining how to allocate presumptions. If the debtor has the burden of litigation, the debtor's own constrained resources will preclude litigation. Similarly, if the creditor has the burden of litigation, the small dollar amounts at stake will often mean that the game is not worth the candle. In most cases, a debtor who must litigate his or her way into Chapter 7 will be denied a Chapter 7 discharge altogether. Means testing increases the cost of going bankrupt, and as a result, more troubled debtors simply won't have the money to seek relief.

Thus, as in business bankruptcy, empirical instincts about the paradigmatic case become crucial in allocating the litigation burden. If most debtors are abusing the system, then the presumption should be against Chapter 7 relief. If most debtors are in trouble because of illness, loss of job, or other unforeseen circumstances, then the presumption should be in favor of relief. The approach followed in the current bill is to presume abuse whenever the debtor's income exceeds IRS income and expense guidelines. Thus, if the debtor has significant income, the burden shifts to the debtor to demonstrate that it cannot repay its debts.[218] This approach is a significant change from current law, which

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Jones & Shepard, *supra* note 205, at 67–68 n.117, *in* NBRC REPORT *supra* note 204, at ch. 5.

217. A competing bill, S. 945, sponsored by Senator Durbin, would have adopted an approach closer to current case law. Under § 102 of the Durbin Bill, the court would have been allowed to deny a discharge if the debtor has an ability to pay, but leaves it up to the judge to define ability to pay. Moreover, only the U.S. Trustee would have standing to raise the issue if the debtor's income fell below the IRS medians. *See* S. 945, 106th Cong. § 102 (1999).

218. In addition, if the U.S. Trustee brings a motion to convert to Chapter 13 or a motion to dismiss and either is granted, and the debtor's position is found not to be

presumes no abuse and grants a discharge unless a creditor objects, or unless the judge or the U.S. Trustee argues that a discharge would be a substantial abuse.[219] Moreover, it appears that the presumption is being placed on the wrong side. To the extent that there is empirical evidence, it suggests that very few debtors have significant ability to repay their debts.[220] In addition, the provision, as currently drafted, is not backward looking. The debtor cannot rebut the presumption of abuse by showing that the debts were the result of medical bills, job loss or other non-culpable behavior. More importantly, this provision will require a substantial reallocation of judicial time to determining eligibility for Chapter 7. In this regard, the provision has all of the disadvantages of mud and none of its advantages, as well as all of the disadvantages of a crystal and none of its advantages.

B. Limiting Extensions of Exclusivity

On the business bankruptcy side, a misguided crystal can be found in S. 625's prohibition on extensions of the debtor's exclusive period to file a plan beyond eighteen months and its outside limit on exclusivity (whether or not a plan has been confirmed) of twenty months.[221] This provision is a response to the perception that some bankruptcy judges were using serial extensions of the debtor's exclusive period as a way of stacking the deck in favor of reorganization, sometimes for as long as four years. In 1993, Lynn LoPucki and William Whitford examined forty-three bankruptcy cases of public companies and found that in thirty-four of those cases, the judge left the exclusive period in place for the entire case.[222] This may be evidence of a pro-debtor bias on the part of bankruptcy judges, but it could also be evidence of creditor consent in most cases. To the extent that this bias exists, it is problematic. However, the solution may not be to enact a crystalline rule. To the extent that the purpose of the exclusive period is to eliminate the incentive for creditors to hold out, this policy is furthered by the current "muddy" nature of the judge's decision whether to extend the debtor's exclusive right to propose a plan.

"substantially justified," the debtor's attorney will be liable for the trustee's attorneys' fees. Section 102 of S. 625 provides in pertinent part:

> The court shall order the counsel for the debtor to reimburse the panel trustee for all reasonable costs in prosecuting a motion brought under section 707(b), including reasonable attorneys' fees, if—
> (I) a panel trustee appointed under section 586(a)(1) of title 28 brings a motion for dismissal or conversion under this subsection; and
> (II) the court—
> (i) grants that motion; and
> (ii) finds that the action of the counsel for the debtor in filing under this chapter was not substantially justified.

S. 625, 106th Cong. § 102 (1999).

219. 11 U.S.C. § 707(b) (1994, Supp. IV 1998 & Supp. V 1999).

220. *See supra* note 207 and accompanying text.

221. *See* S. 625, 106th Cong. § 413 (1999).

222. LoPucki & Whitford, *supra* note 127, at 693, 717 n.177.

In any event, *this* particular crystalline rule is highly problematic in that it creates strong incentives for strategic behavior by creditors. Where the judge cannot extend the exclusive period beyond a certain point, regardless of the reason for the debtor's failure to confirm a plan (which might just as well be a product of creditor recalcitrance as debtor delay), creditors who oppose the plan are given a strong incentive to hold out until the twenty month period has expired. As such, this provision may have unintended adverse consequences, precisely because of its crystalline nature. A preferable strategy would be to require the judge to premise any extension of exclusivity on a finding of creditor recalcitrance and a finding that there is a likelihood of successful reorganization. This would leave the muddy nature of the rule intact while guiding the judge in her exercise of discretion.

C. Special Treatment of Security Interests in Aircraft and Rolling Stock

A second type of "crystal" originally proposed in the bankruptcy reform bill, but separately enacted as section 744 of H.R. 2000, is a provision that limits the extent of the automatic stay for certain types of assets. The provision would add §§ 110 and 1168 to the Bankruptcy Code, which would grant special treatment to creditors whose collateral is airplanes, trucks, or trains.[223] For these lenders, the automatic stay will last sixty days unless the debtor agrees to make timely payments under the security agreement and cure any defaults. If the debtor does not cure and perform its obligations, or if the creditor does not extend the sixty day period, the creditor can repossess and sell the collateral pursuant to its state law rights. This ability to insist on full performance of pre-petition obligations, which has also been granted to non-residential real estate lessors, among others,[224] is generally justified by arguing that a certain type of creditor is particularly harmed by bankruptcy. The effect of the statute is to remove the muddy lift-stay rules of the automatic stay and replace them with an automatic lifting of the stay. This provision does not shift the burden of litigation around a muddy rule (on the assumption that abuse is more likely on the debtor side than on the creditor side). Instead, the provision lifts the automatic stay without giving the judge the opportunity to determine which party is engaging in opportunistic behavior.

One might come to the conclusion that this is a product of a legislative determination that creditor overreaching is not a concern. However, there is also reason to believe that many of these creditor-specific provisions are more a product of effective lobbying than public-interested legislation. As Susan Block-Lieb has pointed out, these provisions reflect a reappearance of the bankruptcy common pool problem reasserting itself in the legislative arena. If every group could organize in the legislature, the end result would be the piecemeal evisceration of the automatic stay.[225] Indeed, it is possible to reconcile these two views. The preferred position for airline lenders may work to the advantage of the airline and the secured lender while harming non-adjusting and involuntary

223. *See* S. 625, 106th Cong. § 401 (1999).
224. *See* 11 U.S.C. § 365(d) (1994).
225. *See* Block-Lieb, *Congress' Temptation to Defect*, *supra* note 6, at 850–51.

creditors of the airline. If this is the case, then the crystalline nature of the rule would appear to be a reflection of an interest group's attempt to lock in a legislative gain and would have the effect of ratifying, indeed encouraging, inefficient non-cooperative behavior.[226]

D. Enforcing Waivers of the Automatic Stay

One crystal that is the darling of certain proceduralist scholars, but which has not yet been incorporated into any proposed statute, is the recognition of waivers of the automatic stay, discussed briefly above.[227] Remember, it is the automatic stay that converts the crystalline rights of secured creditors to foreclose under state law into the muddier entitlements to adequate protection and relief from the automatic stay. Enforcement of pre-bankruptcy stay waivers would allow creditors to opt for the crystalline state law remedies instead of the now mandatory collective remedy of bankruptcy.

As noted above, the desire to enforce so called "bankruptcy contracts," turns in part on a deep suspicion of judicial ability to determine whether a business reorganization effort is efficient or merely protective of incumbent management. But it also turns on the view that if the secured creditor's loan terms up front depend on its liquidation rights, the borrower should have the right to make enforcement of that contract credible. It could be that only stupid borrowers would make that contract, but it also could be an efficient contract. The question is an empirical one, but the discussion above demonstrates that it is not sufficient for the advocates of contract bankruptcy to state that judges are less able to value a business than the market. Instead, the focus must be on whether pre-bankruptcy stay waiver contracts are subject to "abuse" in the form of inefficient unilateral behavior.

The analysis proceeds in two stages. First, as noted above, there are two competing empirical instincts. On the one hand, in certain cases, stay waivers might be efficient because they will make credit available to the debtor that would not otherwise be available.[228] On the other hand, stay waivers may create an opportunity for subsidy from non-adjusting and involuntary creditors, and impair the effectiveness of the automatic stay in stopping the race of diligence. If we "knew" which effect dominated, it would be appropriate to adopt a crystalline rule stating either that all such stay waivers are prohibited or all such stay waivers are

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226. Whether or not this is the case turns on whether the negative externalities of secured credit (harm to involuntary and non-adjusting creditors) outweigh the positive externalities associated with additional credit availability. *See* Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989).

227. *See supra* text accompanying note 188. Note, however, that section 912 of S. 420 raises many of the same issues. That section allows certain debtors to exclude assets from the bankruptcy estate by conveying them to a so-called "Special Purpose Vehicle."

228. *Compare* Schwarcz, *supra* note 49, at 565-71, *with* Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373 (1997). *See also* Lynn M. LoPucki, *The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz*, 52 STAN. L. REV. 55 (1999).

permitted. However, we don't have any such knowledge.[229] The first step, therefore, is to ask whether a muddy rule would be appropriate, i.e., if judges could answer this question on a case by case basis. A judge could take both ex post and ex ante effects into account, and therefore lift the automatic stay where efficient, and enforce stay-waiver contracts where efficient. Muddy rules would encourage efficient behavior, because parties would anticipate the results of competent judging.

If, instead, we assume even-handed judges who do not have adequate information or ability to make this decision, then a muddy rule may nonetheless be desirable. A muddy rule will operate to increase the cost of non-cooperative behavior, whether or not it is inefficient. Thus, muddy rules should be used where there is a legislative judgment (hopefully based on an empirically correct instinct) that unilateral behavior will tend, more often than not, to be inefficient. Thus, muddy rules for stay waivers are appropriate if we believe (1) that the race of diligence is more likely than not to be inefficient; and (2) that stay waivers, if generally enforced, have the potential to simply begin the race of diligence at an earlier point in time.

VI. CONCLUSION

In this Article, I have argued that the combined effect of the proceduralist "should not" and the proceduralist "cannot" do not mandate an unreflective shift to crystalline rules in bankruptcy. Muddy rules that confer discretion on judges in contexts where abusive or inefficient non-cooperative behavior raise the cost of opting out of the bankruptcy case. This dynamic operates even where we have no confidence that bankruptcy judges are capable of identifying abuse. Even where judges have limited capacity, the costs of litigation associated with the open-textured rule will operate as an incentive to cooperate.

Moreover, this is not just true in the cases where the parties actually litigate. It will also be true any time a party considers unilateral action. Thus, when legislators and law reformers speak of eliminating statutory ambiguity or of limiting judicial discretion, they should recognize that increased statutory specificity may reduce the extent to which broad statutory policies are incorporated into the behavior and thinking of the parties subject to statutory regulation.

How then do we explain the proceduralist fascination with crystals if it is not driven by the weak "should not" of Baird and Jackson, or even the "cannot" of the new formalists?[230] One answer may be that the weak version of the "should not," justified in utilitarian terms, coupled with the "cannot," justified in the neutral terms of cognitive psychology, are really sugar coating for, on the one hand, a strongly normative libertarian view (as opposed to a welfare maximizing view) on the part of some proceduralists, and, on the other hand, a harsher, less politically palatable indictment of the bankruptcy judiciary which alleges bias

229. *But see* Schwarcz, *supra* note 49, at 574-75.
230. *See supra* note 97.

rather than informational shortcomings. If this is the case, the proceduralists need to recognize that the preference for crystals may not have a sound basis in theory or in fact. Indeed, if they are alleging bias as a factual matter, this allegation needs to be backed up by systematic factual inquiry.[231]

The lessons of this Article thus appear to be threefold. First, legislators who are seeking to maximize social welfare should not assume that limitations of the adversary process and of judges themselves suggest a wholesale limitation of judicial discretion. Second, judges should recognize that in a world of uncertainty and imperfect information, judicial even-handedness (and the perception of even-handedness) is crucial and may be the quid pro quo for discretion.[232] Third, and finally, proceduralists need to think more systematically, and perhaps empirically, about comparative institutional competence.

231. Douglas Baird is currently engaged in an empirical study of the bankruptcy judges in the Northern District of Illinois. It is important to note that Baird and Jackson's comments about bankruptcy judges date back to the early 1980s, and rely on impressions of bankruptcy referees formed under the Bankruptcy Act. It is possible that examination of bankruptcy judges 20 years later may yield a different picture.

232. This article has bracketed out, for the purposes of analysis, all norms other than efficiency. As noted in footnote 143, there may be some redistributive provisions and redistributive norms embodied in the statute itself. For example, the *Timbers* rule, discussed *supra*, deprives the undersecured creditor of pendency interest. Where this is the case, "even-handedness" or "impartiality" would require the judge to implement the statutory norm rather than the norm of efficiency.