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Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren

Douglas G. Baird[†]

Elizabeth Warren has presented a view of bankruptcy that, while rarely as well articulated, is widely shared. The virtues of Warren's paper, like those of the rest of her work, are easy to identify. Her style is sharp and penetrating. She writes with insight and wit, and she demands that all analysis be held against the light of empirical data—the brighter the better. Warren has put forward a critique of the work I have done with Thomas Jackson that merits a response both because of its own strengths and because it captures misgivings other traditional bankruptcy scholars have shared about our work.

There is much in Warren's view of bankruptcy policy that I admire and agree with. Indeed, to understand our disagreement, it is necessary first to recognize the extent of our common ground. Warren and I agree that, in the main, existing bankruptcy law is consistent with sound bankruptcy policy. The trustee should have the powers of a hypothetical lien creditor; the trustee should be able to set aside voidable preferences and reject executory contracts; creditors (including secured creditors) should be stayed from asserting their substantive claims after the filing of a bankruptcy petition. Warren and I also agree that victims of nonmanifested torts should have their rights against the firm recognized in bankruptcy.

On what in my view is a different front, Warren and I also think existing laws do not adequately protect many, such as workers, who are affected when a firm fails. Warren and I both have doubts about whether secured credit brings benefits that outweigh its rather obvious costs. I am more inclined than Warren to think that the institution is one worth having, but we agree that the issue is not clear.

Warren's attack on the theory of bankruptcy that I have developed with Thomas Jackson goes to methodology. Jackson and I claim that we can isolate bankruptcy issues (such as whether the

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trustee should be able to void preferences) from the question of how losses should be borne in the event that a firm fails (such as whether secured creditors should be paid before tort victims). Warren insists that we cannot do this. The issue, it must be noted, is not *how* losses from a firm failure should be distributed, but whether this question (however hard it may be to answer) is a question of the law generally (as Jackson and I would argue) or one peculiar to bankruptcy law (as Warren would argue).

Even though Warren and I usually end up in the same place, our debate is important. The way in which Jackson and I think about bankruptcy law is so different from the approach of traditional scholars like Warren that we may reach different conclusions about new issues that confront both Congress and the courts. In the first part of my response to Warren, I briefly review the major features of her view of bankruptcy policy and explain why I find it wanting. In the subsequent parts, I try to show what drives my own view of bankruptcy policy.

I. THE TRADITIONAL VIEW OF BANKRUPTCY POLICY

Warren admits that her own view of bankruptcy policy is "dirty, complex, elastic, [and] interconnected" (p. 811).¹ But like most traditional views of bankruptcy policy, it rests on a number of fairly simple propositions: (1) bankruptcy law has a special role to play in determining how losses from a business failure should be borne; (2) creditors as well as others may sometimes be required to give up some of their ultimate rights to the assets of the firm so that the firm will have a better chance of surviving; (3) entrusting a bankruptcy judge with equitable discretion is a useful and unobjectionable way to balance the conflicting and competing interests of the parties; and (4) creditors in bankruptcy have no cause to complain when they lose some rights they had outside of bankruptcy, because bankruptcy is an entirely new game that deals with different kinds of problems. These propositions sound innocuous enough, but none of them can withstand close scrutiny, and adhering to them invites analysis that is unfocused and misguided.

Warren asserts that the law must distribute losses that flow from a business failure and that distributing such losses should be the central concern of bankruptcy law. The second observation, however, does not follow from the first. As long as many firms close

¹ All parenthetical page references are to Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775 (1987) (this issue).

or fail outside of bankruptcy, treating the question of how to distribute the losses that flow from a business failure as a bankruptcy question ignores much of the problem and creates perverse incentives. Warren argues, for example, that bankruptcy law should favor those who are least able to bear the costs of a business failure. For this reason, she argues, employees rightly enjoy their limited priority under existing bankruptcy law. Warren, however, needs to explain why those who are least able to bear these costs should nevertheless bear them when the firm closes or fails outside of bankruptcy. (Warren cannot be arguing that the costs should be distributed the same way regardless of whether a bankruptcy petition is filed, because when losses are distributed the same way inside of bankruptcy as outside, distribution of losses is not a *bankruptcy* problem.)

Warren's argument for protecting workers only when the firm is in bankruptcy (and not when a firm closes without defaulting to its creditors or when the creditors work out their differences with the firm without filing a bankruptcy petition) is hard to understand:

Bankruptcy does not, of course, offer complete protection to all those who might be affected by the outcome of a bankruptcy dispute. . . . [T]he *debtor* is always free to redeploy the firm's assets. . . . Chapter 11 offers only limited protection against the *creditors'* making the decision to dissolve the business.

(pp. 788-89, emphasis in original).

Warren seems to derive what bankruptcy law ought to be from what it is, but one cannot derive the normative from the positive. Moreover, it seems odd to argue, as a matter of policy, that existing management should be able to close a plant and throw workers out, but that those who lent money to the management and who come into control of the firm only because the firm failed to meet its obligations to them should not.² From the perspective of the workers who are tossed out, the loss is the same in both cases.

Even if one argues that creditors should bear greater legal obligations to workers than should shareholders, it will not do to ad-

² In a footnote, Warren asserts that the debtor (presumably existing management) has an informational advantage over creditors and hence is better positioned to make decisions (p. 789, n.27). But because the question is the extent to which the rights of third parties need to be taken into account, one would not expect either managers or creditors to internalize the cost, regardless of how well-informed they were.

vocate giving workers a special priority in bankruptcy but not elsewhere. In a world in which workers enjoy a special priority only in bankruptcy, creditors will strive to resolve their differences outside of bankruptcy. To argue that there should be differences between the obligations of the debtor and those of the creditors is not the same as arguing that there should be differences between obligations in and out of bankruptcy.

Warren thinks that the benefits of bankruptcy justify additional burdens on creditors. But the issue is not whether the burdens on creditors in bankruptcy are just, but whether the burdens should exist only in bankruptcy. Creditors enjoy the benefits of the nonbankruptcy debt collection system as well. Why should they not have to take the rights of workers into account when they use that system? More to the point, taxing creditors differently depending on which enforcement mechanism they use invites troublesome forum shopping. But Warren does not take the problem of forum shopping seriously.³ In Warren's world, workers are protected from the costs of a business failure only when their employer and its creditors choose to enter bankruptcy. Why the rights of workers should turn on the decision of those who have every incentive to ignore them is baffling.

Warren seems to inhabit the middle ground between the position that Jackson and I have developed (that *bankruptcy* policy is limited only to the problems associated with multiple default) and the opposite position (that bankruptcy policy and the problem of

³ Warren implies that this concern about "the pre-bankruptcy maneuverings of creditors about to go into bankruptcy that would result if bankruptcy and nonbankruptcy fora gave creditors different rights" is one that I have newly discovered to save my earlier work (p. 804). This is not the case. The problem of forum shopping has always been a point of focus in my work on bankruptcy. See, e.g., Douglas G. Baird and 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, 101-02 (1984). Far from being a makeshift addition to a theory of bankruptcy that focuses on the collective action problem, a concern about forum shopping is antecedent to it. Only after one recognizes that the forum shopping problem exists does one have to worry about what makes bankruptcy law distinctive.

The importance Jackson and I have always attached to the problem is evident in our choice of *Butner v. United States*, 440 U.S. 48 (1979), at the start of our casebook on bankruptcy. *Butner* arose under the 1898 Bankruptcy Act and dealt with an obscure feature of North Carolina real property law. Notwithstanding its lack of substantive relevance, we have always taught the case first in our bankruptcy course because *Butner* recognizes explicitly that departing from nonbankruptcy rules in bankruptcy introduces the problem of forum shopping and holds that bankruptcy rules should depart from nonbankruptcy rules only if some specific *bankruptcy* policy justifies it. Like the Court, Jackson and I may be wrong about the importance of forum shopping, but, if we are wrong, we have been wrong for a long time. It is not something I stumbled onto only after reading Warren.

distributing losses from firm failures and closings are one and the same). Warren must believe that there is a special set of concerns when a firm fails and at the same time defaults to multiple creditors, for Warren's conception of bankruptcy, like mine, does not extend to cases in which a firm fails or closes without defaulting to multiple creditors. (Indeed, such a conception of bankruptcy would be so foreign that it would be hard to call it bankruptcy.) Warren, however, never explains the link that she and many others see between multiple default and firm failure; she never explains why the presence of a dispute among creditors requires a special set of rules governing the distribution of losses from the closing or failure of a firm.

Warren and others seem to think that a glance at history and situation sense make the link self-evident.⁴ Jackson and I, however, have made two points that should give pause to those who find it hard to put aside the lay intuition that a firm that fails is a firm that "goes bankrupt." First, we raise the problem of forum shopping, which I have already mentioned and to which I shall return. Even if bankruptcy's gatekeeping rules were much better than they are, those who want a special legal regime governing loss distribution when a firm fails or closes at the same time it defaults to creditors must expect to see in bankruptcy many cases that do not belong there, and many cases outside bankruptcy that belong in bankruptcy.

The second point is deeper. To argue that a special set of distributional concerns arises when a debtor defaults to many creditors at the same time it fails or closes is to assume a link exists between who has rights to the assets of a firm and how those assets are used. Such links are hard to show and harder to justify, as a large body of literature has shown.⁵ Traditional bankruptcy schol-

⁴ If Warren were to develop her argument, she might begin with the hypothesis that the various extralegal checks that constrain debtors (as well as new owners and creditors when they act in concert) from neglecting the rights of workers and others do not work effectively when there were multiple defaults and the creditors cannot act in concert. The manager of a firm might refuse to close the plant doors because of the effect on the community; the creditors who foreclose might share no such sensibility. I would respond to this kind of argument by questioning one of its factual assumptions. The effect of a collective bankruptcy proceeding is to allow creditors (and shareholders) to act in concert. Because it allows them to act as one, they should hire the same kind of managers and conduct business in the same way as a single owner would under the same circumstances. The sensibilities of the managers and the extent of the obligation they bear to the community around them should be the same. Warren might disagree. Warren and I might then be able to discuss the ways in which our hypotheses could be tested.

⁵ The seminal article is Franco Modigliani and Merton H. Miller, *The Cost of Capital, Corporate Finance and the Theory of Investment*, 48 *Amer. Econ. Rev.* 261 (1958). The

ars are alone in the academy in their belief that the financing decisions of a firm and its investment decisions are inseparable. Whether a firm continues to manufacture a particular product or even stays in business is an issue utterly distinct from the question of who owns the firm's assets. Thus, in a world in which all assertions of ownership rights 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. To assert, as Warren does, that a creditor may need to sacrifice some of its ownership interest so that the firm might survive takes issue with most of what has been written about corporate finance over the last three decades. Warren argues that the legislative history of the Bankruptcy Code shows that some legislators embraced the idea that limiting the rights of creditors may increase a firm's chances of reorganizing successfully. I could dispute whether that is a fair reading of the legislative history, but this is quite beside the point. Limiting the rights of creditors either affects a firm's chance of surviving or it does not. The truth of the proposition is completely independent of what Congress may or may not have thought; the proposition must stand or fall on its own. If Warren wants to rely on it, she should at least acknowledge the body of authority that goes the other way.⁶

Warren relies throughout on the bankruptcy judge to ensure

point is not that investment and financing decisions can always be completely separated, but rather that it is extremely hard to explain why they should not be, especially in a context such as bankruptcy where assertions of ownership rights are stayed.

⁶ This literature is premised on the idea that owners of a firm (but for agency costs) share the same goals. As I suggested earlier, Warren might be able to take on this literature by questioning this assumption—by arguing, for example, that creditors have a particular set of values and goals when they are fighting among themselves that distinguishes them from any others who might control the business. I suspect that developing this argument rigorously would be difficult. Warren cannot compare how creditors in bankruptcy behave towards workers or the community with how existing managers would treat them. As the Supreme Court recognized in *Commodity Futures Trading Com'n v. Weintraub*, 471 U.S. 343, 352-53 (1985), the filing of a bankruptcy petition effects a change of ownership. The right comparison is between creditors in bankruptcy and some new owner outside of bankruptcy, as might appear, for example, when there is a hostile takeover. New owners have all the powers and rights of old owners, regardless of whether they share their sensibilities. Indeed, existing law imposes *fewer* legal obligations on new owners than on old owners with respect to things such as collective bargaining agreements. Warren seems to believe that new owners should have *greater* legal obligations than old owners, perhaps because the extralegal checks on them are correspondingly smaller. But this argument does not take Warren all the way to where she wants to go. To explain why obligations of creditors present a distinct *bankruptcy* problem, she must explain how creditors are different from other kinds of new owners. On its face, in an era in which corporate raiders close plants and trim workforces, it does not seem that the negative effects of changing ownership that Warren identifies are at all peculiar to bankruptcy.

that everything comes out right in the end. But judicial discretion is no panacea, even in a court of equity. Warren puts too much faith in the ability of bankruptcy judges to control the conflicting incentives of the various parties. Controlling a party who has an incentive to misbehave is inherently difficult, and alternatives such as eliminating the incentive entirely are sometimes available. As between eliminating a bad incentive and asking a bankruptcy judge to police misbehavior, Jackson and I favor the former. Allowing someone to gamble with someone else's money is always a bad idea, even when a conscientious judge is looking over the gambler's shoulder. Jackson and I have no objection to judicial discretion per se. The art of judging inevitably requires an intelligent weighing of competing interests. But we live in an imperfect world. Judges, like the rest of us, are prone to error. The advantages and disadvantages of judicial discretion under any set of conditions must be weighed against the alternatives. Our argument is simply that Warren and other traditional scholars are too willing to accept the steady hand of a fair judge when other ways of keeping the parties in line may be preferable.

The last theme that Warren dwells upon arises from her observation that the rights of secured creditors change for better as well as worse when a bankruptcy petition is filed. Tracking down assets may be easier when a bankruptcy petition is filed and a trustee is appointed. From this, Warren draws the conclusion that the secured creditor has nothing to complain about. A creditor who claims both the benefits of bankruptcy procedures and the benefits of substantive rights under nonbankruptcy law is trying to have it both ways.

This strand to Warren's argument, however, is defective in two respects. First, it assumes that Jackson and I would neglect the procedural difficulties that creditors would have under state law in calculating the value of their rights. But we have consistently taken the opposite view. We would insist, for example, that for purposes of adequate protection, the value of the secured creditor's rights should be measured as of the time it would have been able to repossess and sell the collateral under state law. Second, Warren confuses the question of whether an inquiry is difficult and inexact with whether it should be undertaken at all. Jackson and I have argued that powerful reasons exist for ensuring that rights in and outside of bankruptcy remain constant. To assert that maintaining parity is difficult may be an argument for settling on an approximation and being content with rough justice, but it is not an argument against parity. The difficulty of keeping rights con-

stant inside and outside of bankruptcy should not mean that anything goes.

II. LOSS DISTRIBUTION AND NONBANKRUPTCY PRIORITY RULES

My basic disagreement with Warren is not with the distributional schemes she embraces, but with whether a single set of rules should distribute losses that flow from a business failure. Many laws, from UCC Article 9 to ERISA, concern themselves with distributing such losses. Nonbankruptcy priority rules distribute losses and will continue to do so regardless of whether a special set of bankruptcy priority rules exists. A coherent approach to the question of how losses from failed firms should be distributed cannot ignore the distributional effects many legal rules have on firms that are not in bankruptcy. Legal rights should turn as little as possible on the forum in which one person or another seeks to vindicate them. Whenever we must have a legal rule to distribute losses in bankruptcy, we must also have a legal rule that distributes the same loss outside of bankruptcy.⁷ All Jackson and I advocate is that these two rules be the same.

Liens matter most when the debtor does not have enough money to pay its creditors. Secured creditors enjoy a lower interest rate on comparable loans because they are more likely to be paid. State reporters are filled with disputes between creditors of an insolvent debtor. These disputes arise outside of bankruptcy and exist only because the debtor does not have enough money to go around. The drafters of Article 9 recognized that by allowing one creditor to take a security interest in all of a debtor's property, they might be leaving others with nothing. For better or worse, the drafters of Article 9 knew that their main business was creating priorities among creditors.⁸

⁷ The point is not that I somehow prefer state legislators to those in Congress. Many of the nonbankruptcy rules that set priorities are federal, and none of them is beyond Congress's power under the commerce clause. I have never argued against Congress altering rights creditors have under state law, only that whenever it does change them, it should not limit the changes to bankruptcy.

I should also add that the debate I am waging is normative and is limited to an analysis of what bankruptcy policy ideally should be, not necessarily what is politically possible. A politician might agree with my basic view of bankruptcy but nevertheless think that a distortion of bankruptcy law was a small enough price to pay for achieving at least a partial reform of the law. From the perspective of a politician, a second-best solution that introduces the problem of forum shopping may be better than no solution at all.

⁸ See Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Drafter*, 15 Ga. L. Rev. 605, 625 (1981). The drafters of Article 9 rejected decisions such as *Benedict v. Ratner*, 268 U.S. 353 (1925), and *Zartman v.*

Secured creditors are not the only ones who enjoy liens under nonbankruptcy law. Everyone from sellers of fertilizer to liquor wholesalers to landlords to the tax collector may enjoy a lien of one kind or another. Many of these liens exist without any special collection rights attached to them. All they do is fix a place in line; and having a place in line matters largely because some people may be shut out.

There are other priority problems for which state law is undeveloped and unclear. For example, in jurisdictions where the legislature has passed no special statute, it may be hard to ascertain the state's place in the queue when it is trying to enforce an environmental cleanup order. But to say that state law is unclear is not to say that the best way to clarify the law is to create a priority that is effective only in bankruptcy.

In rejecting these nonbankruptcy priorities in bankruptcy, Warren does not follow through and explain why they are appropriate outside of bankruptcy. As long as these priorities exist and have distributional consequences outside of bankruptcy, Warren must explain why they are either necessary or desirable in that context. The only point Jackson and I make is that the priorities that exist under nonbankruptcy law should run parallel to priorities in bankruptcy. To the extent that these priorities generate bad distributional consequences, they should be changed in both settings.

To say that bankruptcy and nonbankruptcy priorities should be the same does not say anything about what those priorities should be. Despite Warren's assertions to the contrary, Jackson and I in our work on bankruptcy do not say who should bear the loss when a firm fails; we do not conceive this as a bankruptcy question. In our work on bankruptcy, we have talked only about the issues that remain after one decides how losses should be distributed because we regard only these issues as distinct *bankruptcy* issues. To respond to us in a normative debate about bankruptcy policy, Warren has to challenge our assertion that fixing priorities among creditors is not a bankruptcy problem. She cannot assert (as she does repeatedly) that following existing nonbankruptcy priorities in bankruptcy generates bad results. Warren needs to show why she tolerates these bad results outside of bankruptcy and why the results she wants in bankruptcy cannot be had

First National Bank of Waterloo, 189 N.Y. 267, 82 N.E. 127 (1907), that seemed to embrace the idea that a cushion of assets should remain for general creditors. See UCC § 9-205, comment 1.

by changing the nonbankruptcy rules. Even if Warren has some reason for rejecting the idea of parity, she must still explain why the problem of forum shopping is unimportant.

I could talk at length, as I have elsewhere, about how I think the losses that accompany a business failure should be borne. I have participated in the debate about whether secured credit is a good idea and I have concluded tentatively that it is. By contrast, I think many other kinds of liens (such as those enjoyed by liquor wholesalers) are the ill-advised products of special interest lobbying. I would like to see changes in the shabby treatment retirees receive under existing law, especially with respect to health and medical benefits. Notwithstanding Warren's hints to the contrary, I would reject as grotesque any set of rules that used heartless notions of economic efficiency as the sole standard by which to measure the rights of these people. But I do not think that any of this has much to do with a normative discussion of bankruptcy policy. In any event, given all that Jackson and I have said about these and other questions of nonbankruptcy law, we can hardly be accused of harboring secret agendas. Warren can challenge my views about secured credit, but if she wants to do this in a debate about bankruptcy policy, she needs to show that the two are linked.

III. BANKRUPTCY AND THE PROBLEM OF FORUM SHOPPING

As a definitional matter, one can make bankruptcy mean anything at all. But my notion of bankruptcy law is, I think, largely uncontroversial. As far as corporations are concerned, bankruptcy law is a procedure in which the actions of those with rights to the assets of a firm are stayed and the affairs of the firm are sorted out in an orderly way. Two characteristics of this procedure are crucial for present purposes: (1) it is an alternative avenue for vindicating legal rights, in the sense that those with rights to the debtor's assets could, in the absence of the stay, vindicate them elsewhere (albeit perhaps less effectively); and (2) it involves the rights of more than a single player.

The challenge facing anyone who wants to write about bankruptcy policy is to explain why a distinct bankruptcy law exists at all. Introducing multiple avenues of enforcement is costly. To say that existing bankruptcy law does good hardly suffices. Other things being equal, one would want to transplant what good things are done in bankruptcy to ordinary avenues of rights enforcement and do away with bankruptcy law. If Warren thinks nonbankruptcy law's ordering of creditors is inappropriate when a bankruptcy filing has signaled that there is not enough money to pay all

their due, she must explain why she would permit this ordering to operate in nonbankruptcy disputes even when there is likewise not enough money to cover all claims. If these nonbankruptcy priorities bring no benefits of their own and if they bring normatively undesirable distributional consequences when the debtor's assets are insufficient, it would seem better to eliminate these priorities entirely, rather than merely create a separate enforcement mechanism that sometimes can be used to ignore them.

A. The Costs of Forum Shopping

Warren properly observes that the avenue that the law provides for vindicating substantive rights gives shape to those substantive rights. For example, the rights of a beneficiary of a contractual promise are ultimately measured by what the beneficiary will see at the end of the day when its claim has been fully litigated. Any settlements will be made in light of what the beneficiary would receive if it went the full route. A procedure that vindicates the right—a right to have the sheriff seize assets and sell them to satisfy a judgment—fleshes out the substantive right.

We live in a world in which there are multiple avenues of enforcement for every substantive right. One avenue is provided under ordinary rules of debt collection; another, under the aegis of bankruptcy law. To justify this state of affairs, one must explain why more than one avenue of enforcement is called for. An additional avenue of enforcement creates special costs and, accordingly, deserves close scrutiny—quite apart from the interests being served or the people being protected. Someone who wants to expound on bankruptcy policy should begin by asking why the policies that bankruptcy law should promote require these additional costs. One should then ask what differences should exist between the various avenues of enforcement, assuming that some differences are desirable. The differences in the avenues should stem from the reason for having separate avenues and not from anything else.

It is possible to criticize worlds with multiple avenues of enforcement without taking a position on the wisdom of the substantive rights of any of the players. For example, let us assume that in a jurisdiction there are two different cities and that it is costly to go from one to the other. For this reason, one might have a different court in each city so that parties who lived in the same city would not have to travel great distances to settle their disputes. But the existence of the two courthouses does not mean that substantive legal questions should be treated differently in the two

places. The reason for having the two avenues of enforcement (the cost of travel to the courthouse) does not justify any differences in the way the courts do business.

The point of having two different courthouses would be compromised if the substantive rules in the two cities were different. For example, assume that an insolvent corporation owes money to its bank and to its workers. Assume further that the bank and the workers discover that the court in one city is pro-labor and the court in the other is anti-labor. Under the pro-labor avenue, the workers will be paid before the bank; under the anti-labor avenue, the bank will be paid first. The workers have an incentive to bring the litigation in one city, and the bank has an incentive to bring the litigation in the other, even if they both live in the same city. Of course, other factors (such as the cost of litigating in a distant place) might lead each party to pursue its rights in the nearest court. One could also allow the courts to transfer cases back and forth if the facts seemed to warrant it. But there is no need to introduce this problem into the litigation. There is no virtue in giving the parties an incentive to litigate in any place but the most convenient courthouse if reducing litigation costs is the reason for having the two courthouses.

The gains from having two courthouses instead of one will turn on the extent to which the differences in the rules these courts follow are minimized. Empirical research might be necessary to determine *the extent* to which different rules would undercut the goal of having more convenient courthouses, but such research is not necessary to assert that such differences can only undercut the goal. They cannot promote it.

It may be that two avenues of enforcement are required for reasons other than the need to reduce litigation costs. But such alternative avenues are best avoided unless the costs they bring are justified. As a matter of first principles, the decision to grant special rights to workers or banks or anyone else does not require creating a different avenue of enforcement. Of course, if there are multiple avenues of enforcement, one cannot accurately describe the nature of the rights that the workers or banks enjoy without taking account of the various different avenues of enforcement and the length of the shadow each kind of legal proceeding casts on behavior that takes place outside. But to observe such a complicated and seamless web is not to celebrate it.

B. Priority Rules and Forum Shopping

I do not think that I have said anything terribly controversial.

There is no virtue in giving parties an incentive to engage in forum shopping for its own sake. Yet the premise upon which Jackson and I have built our theory of bankruptcy law is not much more complicated than that. Bankruptcy law creates another avenue of enforcement. It represents a parallel system of debt collection. Saying that bankruptcy is an alternative avenue of enforcement is not saying that it is somehow less important than the ordinary means of debt collection. Nor do Jackson and I assume that whatever priorities are created under nonbankruptcy law are right. They frequently are not.

When we talk about bankruptcy policy, Jackson and I do treat nonbankruptcy rules as a baseline; but we do this only because, by and large, existing bankruptcy law does not set substantive rights and its procedural rights can be understood only against the background of nonbankruptcy procedural rights. One can talk about the rights of a lien creditor without talking about the rights of a trustee in bankruptcy. One cannot talk about the rights of the trustee in bankruptcy without talking about the rights of a lien creditor. Bankruptcy debt collection rules simply do not have general applicability, even in cases of default or insolvency. By contrast, nonbankruptcy debt collection rules always apply (although they perhaps are stayed in a given case). If bankruptcy rules formed the baseline for the enforcement of all legal rights, "bankruptcy law" would take on a radically different meaning than it has now.

One must be careful, however, to understand the difference between the vocabulary Jackson and I use to describe the structure of the law and the substance of the law itself. To say that in a well-conceived legal system, bankruptcy law should begin by looking at nonbankruptcy substantive rights that are enforceable under a nonbankruptcy avenue says *nothing* about what those substantive rights are under existing law or what they should be. Warren has done nothing to suggest that our model of bankruptcy law is inconsistent with *any* set of substantive rights. Jackson and I have asked *why* a parallel debt collection system is desirable at all. The answer, we assert, is the collective action problem. But we then suggest that *this* reason for a second avenue of enforcement provides no reason for reassessing relative entitlements. Workers should not have a different place in line simply because someone has been able to start a bankruptcy proceeding.⁹ All that Jackson

* Warren apparently thinks that existing nonbankruptcy law gives workers both too much and too little. She seems to endorse the existing bankruptcy scheme in which workers

and I require is that the differences in the two avenues follow from the reasons for having the two avenues in the first place. We have no objection to differences in multiple avenues of enforcement. We object only to *unnecessary* differences.

Warren agrees that a tension will exist in bankruptcy between senior and junior creditors; but she argues that there are many ways of overcoming these tensions, including, for example, denying recognition to secured creditors in bankruptcy altogether. There are, of course, many ways of ensuring that fights between creditors in bankruptcy do not destroy the value of the firm as a whole, including relying (as Warren would) on the steady hand of a fair bankruptcy judge. But each way is different, and one must have a method for choosing among them. Jackson and I have argued that we should adopt the alternative that minimizes forum shopping. Warren misses that point when she claims that giving all creditors equal status in bankruptcy is the logical extension of our position (p. 804). Allowing priorities outside of bankruptcy but not inside is an open invitation to forum shopping and would exacerbate all the problems Jackson and I want to minimize. Treating secured and unsecured creditors alike in bankruptcy while recognizing priority rights elsewhere makes no more sense than making the rights of workers turn on the city in which the litigation is brought.

IV. "REHABILITATION," NONCOGNIZABLE INJURIES, AND BANKRUPTCY POLICY

Warren suggests that bankruptcy law should be designed to keep businesses from closing even when those with legally cognizable interests in the business want it to close. She does not, however, explain why special rules in bankruptcy are necessary to achieve this goal. One could, for example, have a federal statute that prevented any business from ceasing operations without making a showing in court that the business was unprofitable, destined to fail, or whatever. One cannot say that bankruptcy is necessary to protect those without legally cognizable interests without first answering the question of why these individuals cannot be given such interests.¹⁰ Similarly, one should not assert that bankruptcy

are sometimes better off (p. 790 & n.28, discussing 11 U.S.C. § 507(a)(3)-(4) (1982)), and sometimes worse off (p. 792-93 & n.38, discussing 11 U.S.C. § 1113(c)(3) (1982 & 1985 Supp.)).

¹⁰ There is nothing particularly novel in saying that nonbankruptcy law can concern itself with limitations on plant closings and the like. See, e.g., *Fort Halifax Packing Co. v. Coyne*, 107 S.Ct. 2211 (1987); Note, *An Economic Case for Mandatory Bargaining over Par-*

law is necessary to prevent the owners of firms from taking actions that injure third parties without explaining why some other kind of legal rule cannot prevent these injuries without encouraging forum shopping.

The law by omission or commission affects who bears the losses from a failed business, but one must explain why placing the solution in bankruptcy law is the preferred course of action. Business "failure" is not necessarily connected with default. Moreover, default itself is not necessarily connected with bankruptcy. Any time resources are shifted from one use to another, or from one place to another, there are likely to be spill-over effects—both positive and negative. If I run a business that makes widgets, I might decide tomorrow to get out of that business and invest my money elsewhere. I can make that decision even if the business is not insolvent. I can make that decision even if the business is not in default. Indeed, I can make that decision even if the business has no creditors at all. The rust belt is littered with firms that have closed or moved elsewhere, not because these businesses did not have enough to pay off creditors, but because they had better opportunities elsewhere.¹¹ Such a decision has exactly the same effect on workers and customers and nearby property owners as does the decision to close up shop of an insolvent business after default to numerous creditors and a bankruptcy petition is filed. Warren nowhere explains what it is about default in bankruptcy against those with legally cognizable injuries that suddenly makes the injuries of others relevant. If Warren thinks bankruptcy proceedings are appropriate whenever a firm fails or closes and such dislocations happen, she must contemplate court intervention so dramatically different from current bankruptcy proceedings that using the word "bankruptcy" to describe it is inappropriate.

As I noted earlier, one should not link default and bankruptcy. Default is not necessarily connected with a collective action problem. Indeed, it is because default does not *always* raise a collective problem that there are two avenues of enforcement: the existence of bankruptcy's avenue of enforcement springs from the collective action problem. When Warren focuses on *default*, she does not tell

tial Termination and Plant Relocation Decisions, 95 Yale L. J. 949 (1986); Note, Mandatory Bargaining and the Disposition of Closed Plants, 95 Harv. L. Rev. 1896 (1982).

¹¹ For two such examples and a discussion of the devastating effects such closings can have on workers, see Retiree Health Benefits: The Fair-Weather Promise, Hearing Before the Special Committee on Aging, Sen. Hrg. No. 99-932, 99th Cong., 2d Sess. 8-9, 10-11 (Aug. 7, 1986) (statements of Lillian Grimaldi and Leonard Harris).

us why default policies should exist only in bankruptcy. To discuss bankruptcy policy, one must discuss default in connection with the existence of more than one procedure for vindicating the legal rights that arise from the default. Linking—without explanation—default to only one of several different avenues of enforcement threatens to undermine whatever justifications exist for having multiple avenues of enforcement in the first instance.

In thinking about bankruptcy policy as applied to corporations and other business entities, one must be careful not to confuse them with flesh-and-blood persons. Warren is rhetorically most effective when she alludes to poorhouses, sanctuaries, and escapes to foreign jurisdictions in discussing the problem of insolvent debtors (p. 780 & n.10), but none of this has much to do with the bankruptcy of a corporation. Legal disputes in corporate bankruptcies frequently are between financial institutions and sophisticated investors. The bankruptcy of a corporation does not necessarily mean that anyone will starve. Warren can argue that we should have a special concern for those who are not professionals, but she must show both that this concern is a bankruptcy concern and that it should affect all bankruptcy disputes—even those between professionals. As a positive matter, Warren is wrong to think that existing bankruptcy law cares about the rights of noncreditors. A bankruptcy judge takes these into account only when there is a dispute between those with legally cognizable claims. Contrary to Warren's assertion, creditors are as free to close a firm down as are its managers, inside of bankruptcy and out, as long as the creditors present a united front.

The problem of retiree health benefits provides a good test for Warren's claim that only bankruptcy law is primarily concerned with priorities when there is not enough to go around. A firm promises health benefits to its workers when they retire. If the firm files a Chapter 7 petition, the retirees probably have only unsecured claims against the firm. Section 507 gives them no special priority.¹² Under existing law, the retirees will receive only a few cents on the dollar for their health claims. If a legislator asked Warren about the problem, what would she say? Would Warren advocate bringing retiree health benefits within the scope of section 507? Would she raise the \$2,000 cap? Would she insist on empirical data? Would she want to leave the rights of retirees to a

¹² 11 U.S.C. § 507(4) (1982) applies only to obligations to employee benefit plans arising from services rendered within six months of the petition. Hence the section does not apply to anyone who has been retired for more than half a year.

bankruptcy judge and have the judge balance the worth of these rights against other interests?

Firms that have made such promises to retirees have closed without ever defaulting to creditors or without bankruptcy petitions ever being filed. Would Warren nevertheless tell the legislator that legislation is needed only for firms that are in bankruptcy? We have an elaborate federal nonbankruptcy law, in the form of ERISA, that deals with employee benefit plans.¹³ Retiree health benefits fall within the scope of ERISA, but the ERISA's funding and vesting requirements apply only to pension plans. One can argue that ERISA's funding requirements should extend to retiree health benefits. But what does any of this have to do with bankruptcy law? Why should a legislator tinker with the Bankruptcy Code rather than amend ERISA? If Warren wants to argue that ERISA is in fact a bankruptcy statute by a different name, then so are many other provisions of the United States Code. ERISA's funding provisions matter most when firms fail, but in this respect ERISA is like any other law that matters the most when times are bad. The challenge of entering a normative debate about bankruptcy policy is to isolate what is distinctive about bankruptcy. If one does not, one simply talks about social policy generally.

V. SECURED CREDITORS IN BANKRUPTCY

Few would advocate trimming back the rights of secured creditors outside of bankruptcy merely by asserting that misery loves company. Opponents of secured credit would feel obliged to discuss what the benefits and costs of secured credit were. In principle, arguments against secured credit in bankruptcy should be similarly rigorous, even if one believes that the rights of secured creditors in bankruptcy should be different from their rights outside. But when the virtues and vices of secured credit are mixed with any number of other issues in bankruptcy, vague notions about equity can replace hard thinking. Warren would ask the bankruptcy judge to understand the basis of every legally cognizable right as well as some fairness interests that are not legally cognizable, and then trade them off against one another. Judicial reasoning in such an environment is apt to be especially fuzzy.

Warren wonders why, if I am willing to give bankruptcy judges discretion to handle some issues, I advocate rules that would keep bankruptcy judges from addressing other problems. Rather than

¹³ Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1051, 1081 (1982).

let a forum shopping problem exist and then ask the bankruptcy judge to be sensitive to it, I would eliminate it to the extent possible. My approach, however, does not show a contempt for bankruptcy judges. Guiding the decision making of judges is what legislation is all about. Rules exist in every legal system because unbridled discretion is not a good thing. Judges ordinarily do not play tennis without a net. Warren carries a heavy burden in suggesting that bankruptcy should be different.

Whatever adjustments should be made to the rights of secured creditors should be made outside of bankruptcy law. In bankruptcy, whatever rights the secured creditors have under nonbankruptcy law should be respected. The idea is not to give them a *good* deal, but rather to approximate the *same* deal that they had outside of bankruptcy so that no one has an incentive to begin a bankruptcy proceeding simply because its distributional rule is different.¹⁴ For purposes of this debate, I can stipulate to any set of rights for secured creditors Warren chooses—including the abolition of priority rights for secured creditors altogether. Warren must do more than assert that Jackson and I look too kindly on secured creditors. She must show why giving secured creditors a *different* deal in bankruptcy is a good idea, given the costs of forum shopping. Warren must explain why she thinks that for any level of priority protection accorded secured creditors outside of bankruptcy, the appropriate level in bankruptcy is something less.

Implicit in Warren's attack is the idea that providing adequate protection for the costs of delay undercuts the ability of the debtor

¹⁴ Warren has confused our enthusiasm for protecting rights that exist outside of bankruptcy (whatever they may be) with enthusiasm for those rights for their own sake. It is wrong to suggest that, even *ex post*, I always favor secured creditors. I have argued that the section 1111(b) election gives secured creditors too much, because it deviates (this time in their favor) from the value of their nonbankruptcy rights. I have suggested adequate protection of the secured creditor's interest in its collateral should take into account the costs of the delay attributable to bankruptcy, but I have also argued for limits on adequate protection. The protected value should be liquidation value, not going-concern value, and bankruptcy law should account for the delay that would exist under nonbankruptcy law when a secured creditor attempted to exercise its default rights. Similarly, I have argued that, because giving the secured creditor the time value of its claim eliminates the creditor's risk that the collateral's value may decrease, the secured creditor should not be entitled to any *increase* in the value of the collateral. I also agree with Judge Randall that, if a secured creditor's loan is reinstated under section 1124(2), the proper measure of compensation during bankruptcy is that provided by the contract—because, upon reinstatement, the analogy is one of a continuing contract, rather than one of a default, followed by repossession and resale. See *In re Timbers of Inwood Forest*, 793 F.2d 1380, 1404 (5th Cir. 1986), *aff'd en banc*, 808 F.2d 363, cert. granted as *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assoc.*, 107 S.Ct. 2459 (May 26, 1987). When all is said and done, a secured creditor may well find some other view of bankruptcy more to its liking.

to reorganize. This assertion is hardly self-evident. Indeed, it seems to ignore the well-recognized distinction between financing decisions and investment decisions. The question of how much a secured creditor should be protected may affect who owns the firm, but the ownership of the firm is a question quite distinct from its survival.

A simple but fairly common fact pattern illustrates the point. Debtor owns an apartment complex. There are many general creditors, and all concede that the secured creditor is owed more than the apartment complex is worth. Even if this case belongs in bankruptcy, the payment of adequate protection to the secured creditor will not affect anyone other than the general creditors and the secured creditor. The tenants will live in their apartments and the employees will do their jobs. Warren may argue that the secured creditor should leave something for the general creditors. But what does the relative share of the general creditors and the secured creditor have to do with bankruptcy policy, even as articulated by Warren? What interests are there to be balanced other than the interests of two kinds of creditors? Payment of adequate protection for the costs of delay will not do anything other than change the relative rights of secured and general creditors. Jackson and I can justify our proposed division: it ensures that general creditors do not begin a bankruptcy proceeding simply to enhance their substantive entitlements. How can Warren justify any other distribution as a matter of bankruptcy policy? In the example just posed, jobs and suppliers are not threatened. Indeed, in this case and in nearly all bankruptcy cases, protecting the debtor—that is, the business's collection of assets—and providing it with a last chance is not implicated either. The question of who owns the apartment building has nothing to do with how it is used.

CONCLUSION

The belief that nonbankruptcy law does not take sufficient account of many whose interests deserve the protection of the law in hard times colors the view Warren and many others have of bankruptcy policy. Legal rights, however, are formed (for better or for worse) with bad times in mind. Legal rights matter least when times are good. If a legal rule is wrong or unjust, it must be changed. The incantation of "bankruptcy policy" will not make it disappear. Hard times are themselves not invariably or even typically associated with default, let alone bankruptcy. That our laws seem to leave too many unprotected may be a telling criticism of our lawmakers, our laws, and our society, but not of our Bank-

ruptcy Code.

The world is a messy and complicated place, where justice is often hard to find. But it does not follow that bankruptcy policy should be vague and mysterious and that nothing more can be said other than that bankruptcy judges have a general mandate to do equity, but not too much equity. Bankruptcy law has its own contours and the key to understanding it lies in recognizing its limitations. Warren and I disagree so dramatically in our view of bankruptcy law not because of politics or ideology. Much of what she would like to see as a part of bankruptcy are things I would like to see as part of our substantive law more generally. We differ because we approach the job of understanding and reforming the law in opposing ways. I believe that one can talk intelligently about bankruptcy without at the same time developing an all-encompassing view of social policy.

The theory of bankruptcy law that Jackson and I have developed is an inviting target. It is not so vague that it can never be right or wrong. It generates falsifiable hypotheses. But Warren has not faced our theory squarely. Warren must do more than assert that having a good bankruptcy judge balance everything is preferable to a bankruptcy law built on the theory Jackson and I have developed. Such an assertion does not focus on our theory or even on bankruptcy. It applies equally to any legal theory that suggests that rules are sometimes preferable to vaguely restrained judicial discretion. One cannot begin to understand the existing state of affairs or comprehend the possibility of reform without first searching for the principles that underlie the law. A panegyric on the virtues of equitable jurisprudence is neither a theory nor an adequate substitute for a theory.